

SUGGESTED ANSWERS

FINAL COURSE

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BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

PAPER – 1 : ADVANCED ACCOUNTING

Answer all questions.

Working notes should form part of the answer.

Question 1

The following is the extract from the Balance Sheets of Popular Ltd.:

Liabilities	As at 31.3.2004 Rs. in lakhs	As at 31.3.2005 Rs. in lakhs	Assets	As at 31.3.2004 Rs. in lakhs	As at 31.3.2005 Rs. in lakhs
Share capital	500	500	Fixed assets	550	650
General reserve	400	425	10% investment	250	250
Profit and Loss account	60	90	Stock	260	300
18% term loan	180	165	Debtors	170	110
Sundry creditors	35	45	Cash at bank	46	45
Provision for tax	11	13	Fictitious assets	10	8
Proposed dividend	<u>100</u>	<u>125</u>			
	<u>1,286</u>	<u>1,363</u>		<u>1,286</u>	<u>1,363</u>

Additional information:

- Replacement values of Fixed assets were Rs.1,100 lakhs on 31.3.04 and Rs.1,250 lakhs on 31.3.2005 respectively.
- Rate of depreciation adopted on Fixed assets was 5% p.a.
- 50% of the stock is to be valued at 120% of its book value.
- 50% of investments were trade investments.
- Debtors on 31st March, 2005 included foreign debtors of \$35,000 recorded in the books at Rs.35 per U.S. Dollar. The closing exchange rate was \$ 1= Rs.39.
- Creditors on 31st March, 2005 included foreign creditors of \$60,000 recorded in the books at \$ 1 = Rs.33. The closing exchange rate was \$ 1 = Rs.39.
- Profits for the year 2004-05 included Rs.60 lakhs of government subsidy which was not likely to recur.
- Rs.125 lakhs of Research and Development expenditure was written off to the Profit and Loss Account in the current year. This expenditure was not likely to recur.
- Future maintainable profits (pre-tax) are likely to be higher by 10%.
- Tax rate during 2004-05 was 50%, effective future tax rate will be 40%.

(xi) Normal rate of return expected is 15%.

One of the directors of the company Arvind, fears that the company does not enjoy a goodwill in the prevalent market circumstances.

Critically examine this and establish whether Popular Co. has or has not any goodwill.

If your answers were positive on the existence of goodwill, show the leverage effect it has on the company's result.

Industry average return was 12% on long-term funds and 15% on equity funds. (16 Marks)

Answer

1. Calculation of Capital employed (CE)	Rs. in lakhs	
	As on 31.3.04	As on 31.3.05
Replacement Cost of Fixed Assets	1100.00	1250.00
Trade Investment (50%)	125.00	125.00
Current cost of stock		
$130 + 130 \times \frac{120}{100}$	286.00	
$150 + 150 \times \frac{120}{100}$		330.00
Debtors	170.00	111.40
Cash-at-Bank	<u>46.00</u>	<u>45.00</u>
Total (A)	<u>1727.00</u>	<u>1861.40</u>
Less: Outside Liabilities		
18% term loan	180.00	165.00
Sundry creditors	35.00	48.60
Provision for tax	<u>11.00</u>	<u>13.00</u>
Total (B)	<u>226.00</u>	<u>226.60</u>
Capital employed (A-B)	<u>1501.00</u>	<u>1634.80</u>
Average Capital employed at current value = $\frac{\text{CE as on 31.3.2004} + \text{CE as on 31.3.2005}}{2}$		
	$= \frac{1501 + 1634.80}{2} = 1567.90 \text{ Lakhs}^*$	

* Average capital employed can also be calculated in the following manner:

Closing capital employed as on 31.3.2005	Rs. 1,634.80 lakhs
Less: $\frac{1}{2}$ of actual post tax profit for 2004-2005	<u>Rs. 90.00 lakhs</u>
Average capital employed	<u>Rs. 1,544.80 lakhs</u>

2.	Future Maintainable Profit		Rs. in Lakhs
	Increase in General Reserve	25	
	Increase in Profit and Loss Account	30	
	Proposed Dividends	<u>125</u>	
	Profit After Tax	<u>180</u>	
	Pre-Tax Profit = $\frac{180}{1 - 0.5}$		360
	Less: Fictitious Assets written off (10 – 8)	2.00	
	Non-Trading investment income (10% of Rs.125)	12.50	
	Subsidy	60.00	
	Exchange Loss on creditors [0.6 lakhs × (39-33)]	3.60	
	Additional Depreciation on increase in value of Fixed Assets (current year) $(1250 - 650 = 600 \times \frac{5}{100})$ i.e.,	<u>30.00</u>	<u>108.10</u>
			251.90
	Add: Exchange Gain on Debtors [0.35 lakhs × (39-35)]	1.40	
	Research and development expenses written off	125.00	
	Stock Adjustment (30-26)	<u>4.00</u>	<u>130.40</u>
			382.30
	Add: Expected increase of 10%		<u>38.23</u>
	Future Maintainable Profit before Tax		420.53
	Less: Tax @ 40% (40% of Rs.420.53)		<u>168.21</u>
	Future Maintainable Profit		<u>252.32</u>
3.	Valuation of Goodwill		Rs. in lakhs
(i)	According to Capitalisation of Future Maintainable Profit Method		
	Capitalised value of Future Maintainable Profit		
	= $\frac{256.28}{15} \times 100$		1,682.13
	Less: Average capital employed		<u>1567.90</u>
	Value of Goodwill		<u>114.23</u>
	Or		

(ii) According to Capitalisation of Super Profit Method	Rs. in lakhs
Future Maintainable Profit	252.32
Less: Normal Profit @ 15% on average capital employed (1567.90 × 15%)	<u>235.19</u>
Super Profit	<u>17.13</u>
Capitalised value of super profit $\frac{17.13}{15} \times 100$ i.e. Goodwill	114.2

Goodwill exists, hence director's fear is not valid.

Leverage Effect on Goodwill	Rs. in lakhs
Future Maintainable Profit on equity fund	252.32
Future Maintainable Profit on Long-term Trading Capital employed	
Future Maintainable Profit After Tax	252.32
Add: Interest on Long-term Loan (Term Loan)	
(After considering Tax) $165 \times 18\% = 29.7 \times \frac{50}{100}$	<u>14.85</u>
	267.17
Average capital employed (Equity approach)	1567.90
Add: 18% Term Loan $(180+165)/2$	<u>172.50</u>
Average capital employed (Long-term Fund approach)	<u>1740.40</u>

Value of Goodwill

(A) Equity Approach	
Capitalised value of Future Maintainable Profit = $\frac{252.32}{15} \times 100 =$	1682.13
Less: Average capital employed	<u>1567.90</u>
Value of Goodwill	<u>114.23</u>
(B) Long-Term Fund Approach	
Capitalised value of Future Maintainable Profit = $\frac{267.17}{12} \times 100 =$	2226.42
Less: Average capital employed	<u>1740.40</u>
Value of Goodwill	<u>486.02</u>

Comments on Leverage effect of Goodwill:

Adverse Leverage effect on goodwill is 371.79 lakhs (i.e., Rs.486.02-114.23). In other words, Leverage Ratio of Popular Ltd. is low as compared to industry for which its goodwill value has been reduced when calculated with reference to equity fund as compared to the value arrived at with reference to long term fund.

Working Notes:

	Rs. in lakhs
(1) Stock adjustment	
(i) Excess current cost of closing stock over its Historical cost (330 – 300)	30.00
(ii) Excess current cost of opening stock over its Historical cost (286-260)	<u>26.00</u>
(iii) Difference [(i– ii)]	<u>4.00</u>
(2) Debtors' adjustment	
(i) Value of foreign exchange debtors at the closing exchange rate (\$35,000×39)	13.65
(ii) Value of foreign exchange debtors at the original exchange rate (\$35,000×35)	<u>12.25</u>
(iii) Difference [(i) – (ii)]	<u>1.40</u>
(3) Creditors' adjustment	
(i) Value of foreign exchange creditors at the closing exchange rate (\$60,000×39)	23.40
(ii) Value of foreign exchange creditors at the original exchange rate(\$60,000×33)	<u>19.80</u>
(iii) Difference [(i) – (ii)]	<u>3.60</u>

Question 2

The summarized Balance sheets of X Ltd. and its subsidiary Y Ltd. as at 31.3.2005 were as follows:

Liabilities	X Ltd. Rs.	Y Ltd. Rs.	Assets	X Ltd. Rs.	Y Ltd. Rs.
Share capital (Share of Rs.10 each)	50,00,000	10,00,000	Fixed assets	60,00,000	18,00,000
			Investment in Y Ltd. (60,000 shares)	6,00,000	---
General reserves	50,00,000	20,00,000	Sundry debtors	35,00,000	5,00,000
Profit and Loss account	20,00,000	15,00,000	Inventories	30,00,000	25,00,000
Secured loan	20,00,000	2,50,000	Cash and bank	39,00,000	2,00,000
Current liabilities	<u>30,00,000</u>	<u>2,50,000</u>			
	<u>1,70,00,000</u>	<u>50,00,000</u>		<u>1,70,00,000</u>	<u>50,00,000</u>

X Ltd. holds 60% of the paid-up capital of Y Ltd. and the balance is held by a foreign company.

A memorandum of understanding has been entered into with the foreign company by X Ltd. to the following effect:

- (i) The shares held by the foreign company will be sold to X Ltd. at a price per share to be calculated by capitalizing the yield at 15%. Yield, for this purpose, would mean 50% of the average of pre-tax profits for the last 3 years, which were Rs.12 lakhs, 18 lakhs and 24 lakhs respectively. (Average tax rate was 40%).
- (ii) The actual cost of shares to the foreign company was Rs.4,40,000 only. Gains accruing to the foreign company are taxable at 20%. The tax payable will be deducted from the sale proceeds and paid to government by X. 50% of the consideration (after payment of tax) will be remitted to the foreign company by X Ltd. and also any cash for fractional shares allotted.
- (iii) For the balance of consideration, X Ltd. would issue its shares at their intrinsic value.

It was also decided that X Ltd. would absorb Y Ltd. Simultaneously by writing down the Fixed assets of Y Ltd. by 10%. The Balance Sheet figures included a sum of Rs.1,00,000 due by Y Ltd. to X Ltd. and stock of X Ltd. included stock of Rs.1,50,000 purchased from Y Ltd., who sold them at cost plus 20%.

The entire arrangement was approved and put through by all concern effective from 1.4.2005.

You are required to indicate how the above arrangements will be recorded in the books of X Ltd. and also prepare a Balance Sheet after absorption of Y Ltd. Workings should form part of your answer. (16 Marks)

Answer

		X Ltd.			
		Balance Sheet as at 1 st April, 2005			
Liabilities		Amount (Rs.)	Assets		Amount (Rs.)
Share Capital:					
Shares	5,00,000		Fixed Assets	78,00,000	
Shares issued in lieu of purchase consideration	<u>33,466</u>		Less :Revaluation loss	<u>1,80,000</u>	76,20,000
(Shares of Rs.10 each)	5,33,466	53,34,660	Sundry Debtors (35,00,000+5,00,000)	40,00,000	
General Reserve		50,00,000	Less: Mutual Debts	<u>1,00,000</u>	39,00,000
Capital Reserve		13,20,000	Inventories (30,00,000+25,00,000)	55,00,000	
Profit and Loss Account	20,00,000				
Less: unrealized profit on stock	<u>25,000</u>	19,75,000			
Securities Premium (33,466×20)		6,69,320	Less: Unrealised profit on stock	<u>25,000</u>	54,75,000
Secured Loans (20,00,000 + 2,50,000)		22,50,000	Cash at Bank		27,03,980

Current Liabilities			
(30,00,000 +			
2,50,000)	32,50,000		
Less: Mutual Debts	<u>1,00,000</u>	<u>31,50,000</u>	
		<u>1,96,98,980</u>	<u>1,96,98,980</u>

Working Notes:-

(1) Yield of Y Ltd.

$$\text{Average of Pre Tax Profit} = \frac{12 + 18 + 24}{3} = \text{Rs.18 lakhs}^*$$

$$\text{Yield} = 18 \times \frac{50}{100} = \text{Rs.9 lakhs}$$

(2) Price per share of Y Ltd:-

$$\text{Capitalised value of yield of Y Ltd.} = \frac{9 \text{ lakhs}}{15} \times 100 = 60 \text{ lakhs.}$$

$$\text{No. of shares} = 1,00,000$$

$$\text{Price per share} = \frac{60 \text{ lakhs}}{1 \text{ lakh}} = \text{Rs.60 per share}$$

(3) Purchase consideration for 40% of share capital of Y Ltd.

$$= 1,00,000 \times 60 \times \frac{40}{100} = \text{Rs.24,00,000}$$

(4) Calculation of intrinsic value of shares of X Ltd.

Rs.

Total Assets excluding Investments in Y Ltd. 1,64,00,000

Value of Investment $60,000 \times 60$ 36,00,000

2,00,00,000

Less: Outside Liabilities:

Secured Loan 20,00,000

Current Liabilities 30,00,000 50,00,000

Net Assets 1,50,00,000

$$\text{Intrinsic value per share} = \frac{\text{Net Assets}}{\text{No. of Shares}}$$

$$= \frac{\text{Rs.1,50,00,000}}{5,00,000} = \text{Rs.30 per share}$$

* By setting the trend, weighted average profit can also be calculated.

(5) Discharge of purchase consideration by X Ltd.

	Equity share capital	Cash	Total
	Rs.	Rs.	Rs.
(i) Payment of Tax $(24 - 4.40) \times \frac{20}{100} =$	---	3,92,000	3,92,000
(ii) Issue of shares to foreign company [50% of $(24 - 3.92) = 10.04$ lakhs No. of shares issued by X Ltd. $\frac{10,04,000}{30} = 33,466.6666$ shares Value of shares capital $= 33,466 \times 30 =$	10,03,980	---	10,03,980
(iii) Cash Payment [50% of $(24 - 3.92) =$ 10.04 lakhs	---	10,04,000	10,04,000
(iv) Cash for fractional shares $= 0.6666 \times 30$	---	20	20
Total	<u>10,03,980</u>	<u>13,96,020</u>	<u>24,00,000</u>

(6) Calculation for Goodwill/Capital Reserve to X Ltd.

		Rs.
Total of Assets as per Balance Sheet of Y Ltd.		50,00,000
Less: 10% Reduction in the value of Fixed Assets $(\frac{10}{100} \times 18,00,000)$		<u>1,80,0000</u>
		48,20,000
Less: Secured Loan	2,50,000	
Current Liabilities	<u>2,50,000</u>	<u>5,00,000</u>
Net Assets		43,20,000
Less: Purchase consideration (outside shareholders)		<u>24,00,000</u>
		19,20,000
Less: Investment in Y Ltd. as per Balance Sheet of X Ltd.		<u>6,00,000</u>
Capital Reserve		<u>13,20,000</u>

- (7) Cash and Bank Balance of X Ltd. after acquisition of shares

	Rs.
Opening Balance (X Ltd.)	39,00,000
Cash and Bank Balance of Y Ltd.	<u>2,00,000</u>
	41,00,000
Less: Remittance to the foreign company	<u>10,04,020</u>
	30,95,980
Less: T.D.S. paid to Government	<u>3,92,000</u>
	<u>27,03,980</u>

- (8) Unrealised profit included in stock of X Ltd. =
- $1,50,000 \times \frac{20}{120} = \text{Rs.} 25,000$

Question 3

- (a) A company had imported raw materials worth US Dollars 6,00,000 on 5th January, 2005, when the exchange rate was Rs.43 per US Dollar. The company had recorded the transaction in the books at the above mentioned rate. The payment for the import transaction was made on 5th April, 2005 when the exchange rate was Rs.47 per US Dollar. However, on 31st March, 2005, the rate of exchange was Rs.48 per US Dollar. The company passed an entry on 31st March, 2005 adjusting the cost of raw materials consumed for the difference between Rs.47 and Rs.43 per US Dollar.

In the background of the relevant accounting standard, is the company's accounting treatment correct? Discuss.

- (b) A private limited company manufacturing fancy terry towels had valued its closing stock of inventories of finished goods at the realisable value, inclusive of profit and the export cash incentives. Firm contracts had been received and goods were packed for export, but the ownership in these goods had not been transferred to the foreign buyers.

Comment on the valuation of the stocks by the company.

- (c) A company with a turnover of Rs.250 crores and an annual advertising budget of Rs.2 crore had taken up the marketing of a new product. It was estimated that the company would have a turnover of Rs. 25 crores from the new product. The company had debited to its Profit and Loss account the total expenditure of Rs.2 crore incurred on extensive special initial advertisement campaign for the new product.

Is the procedure adopted by the company correct?

- (d) A company deals in petroleum products. The sale price of petrol is fixed by the government. After the Balance Sheet date, but before the finalisation of the company's accounts, the government unexpectedly increased the price retrospectively. Can the company account for additional revenue at the close of the year? Discuss.

(4x4=16 Marks)

Answer

- (a) As per AS 11 (revised 2003), 'The Effects of Changes in Foreign Exchange Rates', monetary items denominated in a foreign currency should be reported using the closing rate at each balance sheet date. The effect of exchange difference should be taken into profit and loss account. Sundry creditors is a monetary item, hence should be valued at the closing rate i.e, Rs.48 at 31st March, 2005 irrespective of the payment for the same subsequently at lower rate in the next financial year. The difference of Rs.5 (48-43) per US dollar should be shown as an exchange loss in the profit and loss account for the year ended 31st March, 2005 and is not to be adjusted against the cost of raw- materials. In the subsequent year, the company would record an exchange gain of Re.1 per US dollar, i.e., the difference between Rs.48 and Rs.47 per US dollar. Hence, the accounting treatment adopted by the company is incorrect.

- (b) Accounting Standard 2 "Valuation of Inventories" states that inventories should be valued at lower of historical cost and net realisable value. AS 9 on "Revenue Recognition" states, "at certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases, when sale is assured under forward contract or a government guarantee or when market exists and there is a negligible risk of failure to sell, the goods invoiced are often valued at Net-realisable value."

Terry Towels do not fall in the category of agricultural crops or mineral ores. Accordingly, taking into account the facts stated, the closing stock of finished goods (Fancy terry towel) should have been valued at lower of cost and net-realisable value and not at net realisable value. Further, export incentives are recorded only in the year the export sale takes place. Therefore, the policy adopted by the company for valuing its closing stock of inventories of finished goods is not correct.

- (c) According to paras 55 and 56 of AS 26 'Intangible Assets', "expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset".

In the given case, advertisement expenditure of Rs. 2 crores had been taken up for the marketing of a new product which may provide future economic benefits to an enterprise by having a turnover of Rs.25 crores. Here, no intangible asset or other asset is acquired or created that can be recognised. Therefore, the accounting treatment by the company of debiting the entire advertising expenditure of Rs.2 crores to the Profit and Loss account of the year is correct.

- (d) According to para 8 of AS 4 (Revised 1995), the unexpected increase in sale price of petrol by the government after the balance sheet date cannot be regarded as an event occurring after the Balance Sheet date, which requires an adjustment at the Balance Sheet date, since it does not represent a condition present at the balance sheet date. The revenue should be recognized only in the subsequent year with proper disclosures. The retrospective increase in the petrol price should not be considered as a prior period

item, as per AS 5, because there was no error in the preparation of previous period's financial statements.

Question 4

- (a) P Limited is considering the acquisition of R Limited. The financial data at the time of acquisition being:

	P Limited	R Limited
Net profit after tax (Rs. in lakhs)	60	12
Number of shares (lakhs)	12	5
Earning per share (Rs.)	5	2.40
Market price per share (Rs.)	150	48
Price earning ratio	30	20

It is expected that the net profit after tax of the two companies would continue to be Rs.72 lakhs even after the amalgamation.

Explain the effect on EPS of the merged company under each of the following situations:

- P Ltd. offers to pay Rs.60 per share to the shareholders of R Ltd.
- P Ltd. offers to pay Rs.78 per share to the shareholders of R Ltd.

The amount in both cases is to be paid in the form of shares of P Ltd.

- (b) A company has a capital base of Rs.1 crore and has earned profits to the tune of Rs.11 lakhs. The Return on Investment (ROI) of the particular industry to which the company belongs is 12.5%. If the services of a particular executive are acquired by the company, it is expected that the profits will increase by Rs.2.5 lakhs over and above the target profit.

Determine the amount of maximum bid price for that particular executive and the maximum salary that could be offered to him.

- (c) The following information is available of a concern; calculate E.V.A.:

Debt capital 12%	Rs. 2,000 crores
Equity capital	Rs. 500 crores
Reserve and surplus	Rs. 7,500 crores
Capital employed	Rs. 10,000 crores
Risk-free rate	9%
Beta factor	1.05
Market rate of return	19%
Equity (market) risk premium	10%
Operating profit after tax	Rs.2,100 crores
Tax rate	30%

(10+6+4= 20 Marks)

Answer

- (a) (i) In this case, P Ltd. offers to pay Rs.60 per share.

The share exchange ratio would be $\frac{60}{150} = 0.4$

It means, P Ltd. would give 0.4 shares for every one share of R Ltd. In other words, P Ltd. would give 2 shares for 5 shares of R Ltd.

The total number of shares to be issued by P Ltd. to R Ltd.

$$= 5,00,000 \times 0.4 = 2,00,000 \text{ shares}$$

or

$$5,00,000 \times \frac{2}{5} = 2,00,000 \text{ shares}$$

Total number of shares of P Ltd. after acquisition of R Ltd.

$$= 12,00,000 + 2,00,000 = 14,00,000 \text{ shares}$$

Calculation of E.P.S. of the amalgamated company

$$= \frac{\text{Total Net Profit after Interest and Tax}}{\text{Total Number of shares}}$$

$$= \frac{72,00,000}{14,00,000} = \text{Rs.5.14 per share}$$

After amalgamation, The EPS of P Ltd., will improve from Rs.5 to Rs.5.14 whereas EPS of former shareholders of R Ltd would reduce from present 2.40 per share to $5.14 \times 0.4 = \text{Rs.2.056}$ per share after merger.

- (ii) In this case, P Ltd. offers Rs.78 per share to the shareholders of R Ltd.

The Exchange Ratio would be $\frac{78}{150} = 0.52$ shares of P Ltd. for each share of R Ltd.

In other words, P Ltd would give 52 shares for per 100 shares of R Ltd.

P Ltd would issue $5,00,000 \times 0.52 = 2,60,000$ shares to shareholders of R Ltd.

$$\text{E.P.S. of the Merged Company} = \frac{72,00,000}{12,00,000 + 2,60,000} = 4.93$$

After Merger, there is a dilution in the E.P.S., of P Ltd. from 5 to 4.93.

After Merger E.P.S. of former shareholders of R Ltd.

$$= 4.93 \times 0.52 = 2.56$$

There is a gain of Re. 0.16 in E.P.S. of merged company in comparison to E.P.S. of R Ltd. of Rs.2.40 before merger.

Comments:

Initial increase in and decrease in earnings per share are possible in both cases of Merger. Generally, the dilution in E.P.S. will occur wherever the Price Earnings ratio of acquired company calculated on the basis of price paid exceed the P/E ratio of acquired company and vice-versa.

In Situation (i) - The price offered by P Ltd. per share of R Ltd. is Rs.60 and E.P.S. of R Ltd. is 2.4, which would become the earnings of P Ltd. after merger.

Price Earning (P/E) Ratio of P Ltd. after merger = $\frac{60}{2.40} = 25$. It is lower than the P/E Ratio of P Ltd. before merger i.e., 30, the E.P.S. of P Ltd. after merger increases to Rs.5.14.

In Situation (ii) - The price earnings (P/E) ratio offered for Merger is $\frac{78}{2.4} = 32.5$ which is higher than P/E Ratio of P Ltd. before Merger. Hence, the E.P.S. of P Ltd after merger would get diluted.

(b) Capital Base	=	Rs.1,00,00,000
Actual Profit	=	Rs. 11,00,000
Target Profit @ 12.5%	=	Rs. 12,50,000

Expected Profit on employing the particular executive

$$= \text{Rs.}12,50,000 + 2,50,000 = \text{Rs.}15,00,000$$

Additional Profit = Expected Profit – Actual Profit

$$= 15,00,000 - 11,00,000 = \text{Rs.}4,00,000$$

Maximum bid price = $\frac{\text{Additional Profit}}{\text{Rate of Return on Investment}}$

$$= \frac{4,00,000}{12.5} \times 100 = \text{Rs.}32,00,000$$

Maximum salary that can be offered = 12.5% of Rs.32,00,000 i.e., 4,00,000

Maximum salary can be offered to that particular executive upto the amount of additional profit i.e., Rs.4,00,000.

(c) E.V.A. = NOPAT – COCE

NOPAT = Net Operating Profit after Tax

COCE = Cost of Capital Employed

COCE = Weighted Average Cost Of Capital $\times$ Average Capital Employed

$$= \text{WACC} \times \text{Capital Employed}$$

Debt Capital	Rs.2,000 crores
Equity capital 500 + 7,500	= Rs.8,000 crores
Capital employed	= 2,000+8,000 = Rs.10,000 crores
Debt to capital employed	= $\frac{2,000}{10,000} = 0.20$
Equity to Capital employed	= $\frac{8,000}{10,000} = 0.80$
Debt cost before Tax	12%
Less: Tax (30% of 12%)	<u>3.6%</u>
Debt cost after Tax	<u>8.4%</u>

According to Capital Asset Pricing Model (CAPM)

Cost of Equity Capital = Risk Free Rate + Beta × Equity Risk Premium

Or

= Risk Free Rate + Beta (Market Rate – Risk Free Rate)

= 9 + 1.05 × (19-9)

= 9 + 1.05 × 10 = 19.5%

WACC = Equity to CE × Cost of Equity capital + Debt to CE × Cost of debt

= 0.8 × 19.5% + 0.20 × 8.40%

= 15.60% + 1.68% = 17.28%

COCE = WACC × Capital employed

= 17.28% × 10,000 crores = 1728 crores

E.V.A. = NOPAT – COCE

= Rs. 2,100 – Rs. 1,728 = Rs. 372 crores

Question 5

- (a) Mohur Ltd. has equity capital of Rs.40,00,000 consisting of fully paid equity shares of Rs.10 each. The net profit for the year 2004-05 was Rs.60,00,000. It has also issued 36,000, 10% convertible debentures of Rs.50 each. Each debenture is convertible into five equity shares. The tax rate applicable is 30%. Compute the diluted earnings.

- (b) Find out the average capital employed of ND Ltd. from its Balance sheet as at 31st March, 2006:

Liabilities	(Rs. in lakhs)	Assets	(Rs. in lakhs)
Share Capital:		Fixed Assets:	
Equity shares of Rs.10 each	50.00	Land and buildings	25.00
9% Pref. shares fully paid up	10.00	Plant and machinery	80.25
Reserve and Surplus:		Furniture and fixture	5.50
General reserve	12.00	Vehicles	5.00
Profit and Loss	20.00	Investments	10.00
Secured loans:		Current Assets:	
16% debentures	5.00	Stock	6.75
16% Term loan	18.00	Sundry Debtors	4.90
Cash credit	13.30	Cash and bank	10.40
Current Liabilities and Provisions:		Preliminary expenses	0.50
Sundry creditors	2.70		
Provision for taxation	6.40		
Proposed dividend on:			
Equity shares	10.00		
Preference shares	<u>0.90</u>		
	<u>148.30</u>		<u>148.30</u>

Non-trade investments were 20% of the total investments.

Balances as on 1.4.2005 to the following accounts were:

Profit and Loss account Rs.8.70 lakhs, General reserve Rs.6.50 lakhs. (8+8 = 16 Marks)

Answer

- (a) Interest on Debentures @ 10% for the year
- $$36,000 \times 50 \times \frac{10}{100}$$
- = Rs.1,80,000
- Tax on interest @ 30%
- = Rs.54,000
- Diluted Earnings (Adjusted net profit)
- = (60,00,000 + 1,80,000 - 54,000)
- = Rs. 61,26,000

(b) Computation of Average Capital employed

	(Rs. in Lakhs)	
Total Assets as per Balance Sheet		148.30
Less: Preliminary Expenses	0.50	
Non-trade investments (20% of Rs. 10 lakhs)	<u>2.00</u>	<u>2.50</u>
		145.80
Less: Outside Liabilities:		
16% Debentures	5.00	
16% Term Loan	18.00	
Cash Credit	13.30	
Sundry Creditors	2.70	
Provision for Taxation	<u>6.40</u>	<u>45.40</u>
Capital Employed as on 31.03.2006		100.40
Less: $\frac{1}{2}$ of profit earned:		
Increase in reserve balance	5.50	
Increase in Profit & Loss A/c	11.30	
Proposed Dividend	<u>10.90</u>	
	27.70 X 50 %	<u>13.85</u>
Average capital employed		<u>86.55</u>

Question 6

The Balance Sheet of Golden and Silver Limited as on 31.3.2006 are given below:

Liabilities	Golden Ltd. (Rs.)	Silver Ltd. (Rs.)	Assets	Golden Ltd. (Rs.)	Silver Ltd. (Rs.)
Equity share capital	2,40,000	2,40,000	Fixed assets	88,000	1,68,000
General reserve	40,000	32,000	Investment	1,80,000	10,000
Profit and Loss account	24,000	39,000	Sundry debtors	12,000	30,000
Bills payable	4,000	10,000	Bills receivable	8,000	32,000
Sundry creditors	8,000	15,000	Stock in trade	20,000	80,000
			Cash at bank	<u>8,000</u>	<u>16,000</u>
	<u>3,16,000</u>	<u>3,36,000</u>		<u>3,16,000</u>	<u>3,36,000</u>

Note: Contingent liability of Golden Ltd.: Bills discounted not yet matured at Rs.5,000.

Additional information:

- (i) On 1.10.2003, Golden Ltd. acquired 16,000 shares of Rs.10 each at the rate of Rs.11 per share.
- (ii) Balances to General reserve and Profit and Loss account of Silver Ltd. stood on 1.4.2003 at Rs.60,000 and Rs.32,000 respectively.
- (iii) Dividends have been paid @ 10% for each of the years 2003-04 and 2004-05. Dividend for the year 2003-04 was paid out of the pre-acquisition profits. No dividend has been proposed for the year 2005-06 as yet and no provision need to be made in consolidated Balance Sheet. Golden Ltd. has credited all dividends received to profit and Loss account.
- (iv) On 1.3.2006, bonus shares were issued by Silver Ltd. at the rate of one fully paid share for every five held and effect has been given to that in the above accounts. The bonus was declared from general reserves from out of profits earned prior to 1.4.2003.
- (v) On 1.10.2003, Fixed assets was revalued at Rs.2,16,000, but no adjustment had been made in the books.
- (vi) Depreciation had been charged @ 10% p.a. on the book value as on 1.4.2003 (on straight line method), there being no addition or sale since then.
- (vii) Out of Current profits Rs.4,000 have been transferred to General reserve every year.
- (viii) Bills receivable of Golden Ltd. include Rs.4,000 bills accepted by Silver Ltd. Bills discounted by Golden Ltd., but not yet matured include Rs.3,000 accepted by Silver Ltd.
- (ix) Sundry creditors of Golden Ltd. include Rs.4,000 due to Silver Ltd. Sundry debtors of Silver Ltd. include Rs.8,000 due from Golden Ltd.
- (x) It is found that Golden Ltd. has remitted a cheque of Rs.4,000, which has not yet been received by Silver Ltd.

Prepare consolidated Balance Sheet as at 31.3.2006 of Golden Ltd. and its Subsidiary.

(16 Marks)

Answer

Golden Ltd and its Subsidiary Silver Ltd.
Consolidated Balance Sheet
as on 31st March, 2006

Liabilities	Amount Rs.	Assets	Amount Rs.
Share capital (24,000 shares of Rs.10 each)	2,40,000	Fixed Assets (1,68,000- 12,000+3,000)	88,000 <u>1,59,000</u>
Minority Interests	60,400		2,47,000

Capital Reserve	53,200	Investment	14,000
General Reserve	48,000	(4,000*+10,000)	
Consolidated P&L Account	28,400	Debtors	
Bills Payable	14,000	(12,000+30,000-4,000)	38,000
Less: Mutual indebtedness	<u>4,000</u>	Less: Mutual Debts	<u>4,000</u>
Sundry creditors	23,000	Bills Receivable	40,000
Less: Mutual indebtedness	<u>4,000</u>	Less: Mutual Debts	<u>4,000</u>
	19,000	Stock (20,000+80,000)	1,00,000
		Remittance in Transit	4,000
		Cash at Bank	
		(8,000+16,000)	<u>24,000</u>
	<u>4,59,000</u>		<u>4,59,000</u>

Note: Contingent Liability of Bills discounted not yet matured for payment Rs.2,000.

Working Notes:-

(i) Interest of Golden Ltd in Silver Ltd.	Rs.
Share capital of Silver Ltd. on 31.3.2006	2,40,000
Less: Issue of Bonus Shares ($\frac{1}{6}$ of Rs.2,40,000)	<u>40,000</u>
Share capital before Bonus issue	<u>2,00,000</u>
No. of Equity Shares before Bonus issue	$\frac{2,00,000}{10}$
No. of shares held by Golden Ltd.	16,000
Interest of Golden Ltd. in Silver Ltd	$\frac{16,000}{20,000} \times 100$
Minority shareholders' Interest	20%

(ii) Analysis of Profit of Silver Ltd.

	Rs.	Capital Profit Rs.	Revenue Reserve Rs.	Revenue Profit Rs.
General Reserve on 31.3.2006 (After Bonus issue)	32,000			
Add: Bonus issue	<u>40,000</u>			
Balance (before bonus issue)	<u>72,000</u>			

* Rs. 1,80,000 – (16,000 shares x Rs. 11)

General Reserve on 1.4.2003	60,000		
Less: Bonus issue	<u>40,000</u>	20,000	
Increase in General Reserve (Transfer of Rs.4000 p.a. for 3 years)			
(72,000 – 60,000)	<u>12,000</u>	2,000	10,000
Profit and Loss Account			
Increase in Profit after Dividend			
39,000 – 12,000 =	<u>27,000*</u>	4,500	22,500
Additional depreciation written back due to revaluation of fixed assets			3,000
(12,000 × $\frac{10}{100} \times 2.5$)		_____	_____
	<u>26,500</u>	<u>10,000</u>	<u>25,500</u>
Share of Golden Ltd. (80%)	21,200	8,000	20,400
Share of Minority Shareholders (20%)	<u>5,300</u>	<u>2,000</u>	<u>5,100</u>
	<u>26,500</u>	<u>10,000</u>	<u>25,500</u>

(iii) Loss on Revaluation has been calculated as follows:

	Rs.
Value of Assets on 1.4.2003 ($1,68,000 \times \frac{100}{70}$)	2,40,000
Less : Depreciation for 6 months ($2,40,000 \times \frac{10}{100} \times \frac{1}{2}$)	<u>12,000</u>
Valuation of Assets on 1.10.2003	2,28,000
Less: Re-valued value of Assets	<u>2,16,000</u>
Loss on Revaluation	<u>12,000</u>

* It has been assumed that Profit of Rs.27,000 after payment of dividend for the year 2004-2005, has been earned evenly in 3 years, (year 2003-04, 2004-05 and 2005-06) hence profit per year would be $\frac{27,000}{3}$ = Rs.9000. Half of the profit of Rs.9,000 for the year 2003-04 would be pre-acquisition (Capital Profit) and Remaining half i.e. Rs.4500 would be post-acquisition profit (Revenue profit).

(iv) Cost of Control

		Rs.
Cost of Investment in Silver Ltd.		1,76,000
Less: Dividend out of capital profit	16,000	
Less: Paid up value of investment (including Bonus Shares)		
$(1,60,000 + 1,60,000 \times \frac{1}{5})$	1,92,000	
Less: Capital Profit	<u>21,200</u>	<u>2,29,200</u>
Capital Reserve		<u>53,200</u>

(v) Minority Interest

Paid-up share capital (Including Bonus Shares)		
$(40,000 + 40,000 \times \frac{20}{100})$		48,000
Add: Share in Capital Profit	5,300	
Share in Revenue Reserve	2,000	
Share in Revenue Profit	<u>5,100</u>	<u>12,400</u>
		<u>60,400</u>

(vi) General Reserve

Balance in Golden Ltd.	40,000
Add: Share in Silver Ltd.	<u>8,000</u>
	<u>48,000</u>

(vii) Consolidated Profit and Loss Account

Balance in Golden Ltd.	24,000
Less: Dividend credited out of Pre-acquisition Profit (Capital Profit)	<u>16,000</u>
	8,000
Add: Share in Profit of Silver Ltd.	<u>20,400</u>
	<u>28,400</u>

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

Question No. 1 is compulsory. Answer any four from the rest.
Figures in the margin indicate marks allotted to each question.
Working notes should form part of the answer.

Question 1

- (a) Following are the estimates of the net cash flows and probability of a new project of M/s X Ltd.:

	Year	P=0.3	P=0.5	P=0.2
Initial investment	0	4,00,000	4,00,000	4,00,000
Estimated net after tax cash inflows per year	1 to 5	1,00,000	1,10,000	1,20,000
Estimated salvage value (after tax)	5	20,000	50,000	60,000

Required rate of return from the project is 10%. Find:

- (i) the expected NPV of the project.
- (ii) the best case and the worst case NPVs.
- (iii) the probability of occurrence of the worst case if the cash flows are
 - (a) perfectly dependent overtime
 - (b) independent overtime.
- (iv) Standard deviation and coefficient of variation assuming that there are only three streams of cash flow, which are represented by each column of the table with the given probabilities.
- (v) Coefficient of variation of X Ltd. on its average project which is in the range of 0.95 to 1.0. If the coefficient of variation of the project is found to be less riskier than average, 100 basis points are deducted from the Company's cost of Capital

Should the project be accepted by X Ltd ?

- (b) What is a re-financing? Briefly explain indicating at least two institutions which offer such re-financing. (16+4=20 Marks)

Answer

- (a) (i) Expected cash flows:-

Year		Net cash flows	P.V.	PV. @ 10%
0	$(4,00,000 \times 1)$	= (-)4,00,000	1.000	(-)4,00,000
1 to 4	$(1,00,000 \times 0.3 + 1,10,000 \times 0.5 + 1,20,000 \times 0.2)$	= 1,09,000	3.169	3,45,421
5	$[1,09,000 + (20,000 \times 0.3 + 50,000 \times 0.5 + 60,000 \times 0.2)]$	= 1,52,000	0.621	94,392
		NPV=		<u>39,813</u>

(ii) ENPV of the worst case

$1,00,000 \times 3.790 = \text{Rs.}3,79,000$ (Students may have 3.791 also the values will change accordingly)

$20,000 \times 0.621 = \text{Rs.}12,420/-$

$\text{ENPV} = (-)4,00,000 + 3,79,000 + 12,420 = (-)\text{Rs.}8,580/-$

ENPV of the best case

$\text{ENPV} = (-)4,00,000 + 1,20,000 \times 3.79 + 60,000 \times 0.621 = \text{Rs.}92,060/-$

(iii) (a) Required probability = 0.3

(b) Required probability = $(0.3)^5 = 0.00243$

(iv) The base case NPV = $(-)4,00,000 + (1,10,000 \times 3.79) + (50,000 \times 0.621)$
 $= \text{Rs.}47,950/-$

$\text{ENPV} = 0.30 \times (-)8580 + 0.5 \times 47950 + 92060 \times 0.20$
 $= \text{Rs.}39,813/-$ Therefore,

$\sigma \text{ENPV} = \sqrt{0.3(-8580 - 39,813)^2 + 0.5(47950 - 39,813)^2 + 0.2(92,060 - 39,813)^2}$
 $= \text{Rs.}35,800/-$

Therefore, $\text{CV} = 35,800/39,813 = 0.90$

(v) Risk adjusted cost of capital of X Ltd. = $10\% - 1\% = 9\%$.

NPV

Year	Expected net cash flow	PV @ 9%	
0	(-) 4,00,000	1.000	(-)4,00,000
1 to 4	1,09,000	3.239	3,53,051
5	1,52,000	0.650	<u>98,800</u>
		ENPV =	<u>51,851</u>

Therefore, the project should be accepted.

(b) RE-FINANCING

"Re-financing" is a process by which a large financial institution provides funds or reimburses funds to another institution to help development, relief or other similar causes identified as the purpose of the former. It can also, in another way, be described as a wholesale distribution of financial assistance to a retailing institution. Often, governmental support or subsidized funding is reached to the ultimate beneficiaries, through such channel.

National Bank for Agriculture and Rural Development (NABARD) is a governmental organization established with the primary objective of financing the farm sector; it is an arm through which government extends certain concessions/privileges to the farming community. NABARD does not deal with farmers directly but deals with many banks such as scheduled and nationalized banks providing re-financing for quite a few schemes intended for the benefit of the agricultural sector. This is one example.

Small Industries Development Bank of India (SIDBI) is another governmental organization whose objective is to assist the development of small industries. It is another institution which is engaged in refinancing activities; it funds a few schemes intended for SSIs through scheduled/nationalized banks.

Question 2

- (a) ABC Ltd. has 50,000 outstanding shares. The current market price per share is Rs.100 each. It hopes to make a net income of Rs.5,00,000 at the end of current year. The Company's Board is considering a dividend of Rs.5 per share at the end of current financial year. The company needs to raise Rs.10,00,000 for an approved investment expenditure. The company belongs to a risk class for which the capitalization rate is 10%. Show, how does the M-M approach affect the value of firm if the dividends are paid or not paid.
- (b) Mr. X on 1.7.2000, during the initial offer of some Mutual Fund invested in 10,000 units having face value of Rs.10 for each unit. On 31.3.2001 the dividend operated by the M.F. was 10% and Mr. X found that his annualized yield was 153.33%. On 31.12.2002, 20% dividend was given. On 31.3.2003 Mr. X redeemed all his balance of 11,296.11 units when his annualized yield was 73.52%. What are the NAVs as on 31.3.2001, 31.12.2002 and 31.3.2003?
- (c) How tax considerations are relevant in the context of a dividend decision of a company?
- (d) Explain briefly the advantages of holding securities in 'demat' form rather than in physical form. (6+6+4+4= 20 Marks)

Answer

- (a) When dividends are paid

$$100 = (5 + P_1)/(1 + 0.10)$$

Therefore, $P_1 = \text{Rs.}105/-$.

Value of firm

$$= \text{Rs.}([50,000/- + 7,50,000/-/105/-] \times 105/-) - 10,00,000/- + 5,00,000/-/1.10$$

$$= \text{Rs.}(60,00,000/- - 5,00,000/-)/1.10$$

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

When dividend is not paid

$$100 = 1/1.1 \times P_1$$

Therefore, $P_1 = \text{Rs.}110/-$.

Value of firm

$$= \text{Rs.}([50,000/- + (5,00,000/-/110/-) \times 110/-] - 10,00,000/- + 5,00,000/-)/1.10$$

$$= \text{Rs.}(60,00,000/- - 5,00,000/-) / 1.10$$

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

M.M. approach indicates that the value of the firm in both the situations will be the same.

(b) Yield for 9 months = $(153.33 \times 9/12) = 115\%$

$$\text{Amount receivable as on 31.03.2001} = 1,00,000/- + (1,00,000 \times 115\%)$$

$$= \text{Rs.}2,15,000/-$$

$$\text{Therefore, NAV as on 31.03.2001} = (2,15,000 - 10,000)/10,000 = \text{Rs.}20.50$$

$$\text{Therefore, units as on 31.03.2001} = 10487.80 \text{ i.e., } (2,15,000/20.50)$$

$$\text{Dividend as on 31.03.2002} = 10,487.80 \times 10 \times 0.2 = \text{Rs.}20,975.60$$

$$\text{Therefore, NAV as on 31.03.2002} = 20,975.6/(11,296.11 - 10,487.80)$$

$$= \text{Rs.}25.95$$

$$\text{NAV as on 31.03.2003} = 1,00,000 + (1,00,000 \times 73.52\% \times \frac{33}{12})/11296.11$$

$$= \text{Rs.}26.75$$

(c) DIVIDEND DECISION AND TAX CONSIDERATIONS

Traditional theories might have said that distribution of dividend being from after-tax profits, tax considerations do not matter in the hands of the payer-company. However, with the arrival of Corporate Dividend Tax on the scene in India, the position has changed. Since there is a clear levy of such tax with related surcharges, companies have a consequential cash outflow due to their dividend decisions which has to be dealt with as and when the decision is taken.

In the hands of the investors too, the position has changed with total exemption from tax being made available to the receiving-investors. In fact, it can be said that such exemption from tax has made the equity investment and the investment in Mutual Fund Schemes very attractive in the market.

Broadly speaking Tax consideration has the following impacts on the dividend decision of a company:

Before introduction of dividend tax: Earlier, the dividend was taxable in the hands of investor. In this case the shareholders of the company are corporates or individuals who are in higher tax slab, it is preferable to distribute lower dividend or no dividend. Because dividend will be taxable in the hands of the shareholder @ 30% plus surcharges while long term capital gain is taxable @ 10%. On the other hand, if most of the

shareholders are the people who are in no tax zone, then it is preferable to distribute more dividend.

We can advise that before distributing dividend, company should look at the shareholding pattern.

After introduction of dividend tax: Dividend tax is payable @ 12.5% - surcharge + education cess, which is effectively near to 14%. Now if the company were to distribute dividend, shareholder will indirectly bear a tax burden of 14% on their income. On the other hand, if the company were to provide return to shareholder in the form of appreciation in market price – by way of Bonus shares – then shareholder will have a reduced tax burden. For securities on which STT is payable, short term capital gain is taxable @ 10% while long term capital gain is totally exempt from tax.

Therefore, we can advise that if the company pays more and more dividend (while it still have reinvestment opportunities) then to get same after tax return shareholders will expect more before tax return and this will result in lower market price per share.

(d) ADVANTAGES OF HOLDING SECURITIES IN 'DEMAT' FORM

The Depositories Act, 1996 provides the framework for the establishment and working of depositories enabling transactions in securities in scripless (or demat) form. With the arrival of depositories on the scene, many of the problems previously encountered in the market due to physical handling of securities have been to a great extent minimized. In a broad sense, therefore, it can be said that 'dematting' has helped to broaden the market and make it smoother and more efficient.

From an individual investor point of view, the following are important advantages of holding securities in demat form:

- ◆ It is speedier and avoids delay in transfers.
- ◆ It avoids lot of paper work.
- ◆ It saves on stamp duty.

From the issuer-company point of view also, there are significant advantages due to dematting, some of which are:

- ◆ Savings in printing certificates, postage expenses.
- ◆ Stamp duty waiver.
- ◆ Easy monitoring of buying/selling patterns in securities, increasing ability to spot takeover attempts and attempts at price rigging.

Question 3.

- (a) XYZ Ltd. is an export oriented business house based in Mumbai. The Company invoices in customers' currency. Its receipt of US \$ 1,00,000 is due on September 1, 2005.

Market information as at June 1, 2005.

Exchange Rates		Currency Futures	
US \$/Rs.		US \$/Rs.	Contract size
Spot	0.02140	June	0.02126
1 Month Forward	0.02136	September	0.02118
3 Months Forward	0.02127		

	Initial Margin	Interest Rates in India
June	Rs.10,000	7.50%
September	Rs.15,000	8.00%

On September 1, 2005 the spot rate US \$Re. is 0.02133 and currency future rate is 0.02134. Comment which of the following methods would be most advantageous for XYZ Ltd.

- (a) Using forward contract
- (b) Using currency futures
- (c) Not hedging currency risks.

It may be assumed that variation in margin would be settled on the maturity of the futures contract.

- (b) Spot rate 1 US \$ = Rs.48.0123

180 days Forward rate for 1 US \$ = Rs.48.8190

Annualised interest rate for 6 months – Rupee = 12%

Annualised interest rate for 6 months – US \$ = 8%

Is there any arbitrage possibility? If yes how an arbitrageur can take advantage of the situation, if he is willing to borrow Rs.40,00,000 or US \$83,312.

- (c) ABC Ltd. is considering a project in US, which will involve an initial investment of US \$ 1,10,00,000. The project will have 5 years of life. Current spot exchange rate is Rs.48 per US \$. The risk free rate in US is 8% and the same in India is 12%. Cash inflow from the project are as follows:

Year	Cash inflow
1	US \$ 20,00,000
2	US \$ 25,00,000
3	US \$ 30,00,000
4	US \$ 40,00,000
5	US \$ 50,00,000

Calculate the NPV of the project using foreign currency approach. Required rate of return on this project is 14%. (10+5+5 = 20 Marks)

Answer

(a)

Receipts using a forward contract = $1,00,000/0.02127$ = Rs.47,01,457

Receipts using currency futures

The number of contracts needed is $(1,00,000/0.02118)/4,72,000 = 10$

Initial margin payable is $10 \times \text{Rs.}15,000 = \text{Rs.}1,50,000$

On September 1 Close at 0.02133

Receipts = $\text{US\$}1,00,000/0.02133$ = 46,88,233

Variation Margin = $[(0.02134 - 0.02118) \times 10 \times 472000/-]/0.02133$

OR $(0.00016 \times 10 \times 472000)/0.02133 = 755.2/0.02133$ 35,406

47,23,639

Less: Interest Cost – $1,50,000 \times 0.08 \times 3/12$

Rs.3,000

Net Receipts

Rs.47,20,639

Receipts under different methods of hedging

Forward contract

Rs.47,01,457

Futures

Rs.47,20,639

No hedge

US\$ $1,00,000/0.02133$

Rs.46,88,233

The most advantageous option would have been to hedge with futures.

(b) Spot Rate = $\text{Rs.}4000000/- / 83312 = 48.0123$

Forward Premium on US\$ = $[(48.8190 - 48.0123)/48.0123] \times 12/6 \times 100$

= 3.36%

Interest rate differential = 12% - 8%

= 4% (Negative Interest rate differential)

Since the negative Interest rate differential is greater than forward premium there is a possibility of arbitrage inflow into India.

The advantage of this situation can be taken in the following manner:

1. Borrow US\$ 83312 for 6 months

Amount to be repaid after 6 months

= US \$ $83312 (1 + 0.08 \times 6/12) = \text{US\$}86644.48$

2. Convert US\$ 83312 into Rupee and get the principal i.e. Rs.40,00,000

Interest on Investments for 6 months – Rs.4000000/- x 0.06

= Rs.240000/-

Total amount at the end of 6 months = Rs.(4000000 + 240000/-)

= Rs.4240000/-

Converting the same at the forward rate

= Rs.4240000/- / Rs.48.8190=

= US\$ 86851.43

Hence the gain is US \$ (86851.43 – 86644.48) = US\$ 206.95OR

Rs.10103 i.e., (\$206.95 x Rs.48.8190)

- (c) $(1 + 0.12) (1 + \text{Risk Premium}) = (1 + 0.14)$

Or, $1 + \text{Risk Premium} = 1.14/1.12 = 1.0179$

Therefore, Risk adjusted dollar rate is $= 1.0179 \times 1.08 = 1.099 - 1 = 0.099$

Calculation of NPV

Year	Cash flow (Million) US\$	PV Factor at 9.9%	P.V.
1	2.00	0.910	1.820
2	2.50	0.828	2.070
3	3.00	0.753	2.259
4	4.00	0.686	2.744
5	5.00	0.624	<u>3.120</u>
			12.013
		Less: Investment	<u>11.000</u>
		NPV	<u>1.013</u>

Therefore, Rupee NPV of the project is = Rs. (48 x 1.013) Million

= Rs.48.624 Million

Question 4

- (a) From the following data for certain stock, find the value of a call option:

Price of stock now	=	Rs.80
Exercise price	=	Rs.75
Standard deviation of continuously compounded annual return	=	0.40
Maturity period	=	6 months
Annual interest rate	=	12%

Given

Number of S.D. from Mean, (z)	Area of the left or right (one tail)
0.25	0.4013
0.30	0.3821
0.55	0.2912
0.60	0.2578

$$e^{0.12 \times 0.05} = 1.0060$$

$$\ln 1.0667 = 0.0645$$

- (b) Following are the details of cash inflows and outflows in foreign currency denominations of MNP Co. an Indian export firm, which have no foreign subsidiaries:

Currency	Inflow	Outflow	Spot rate	Forward rate
US \$	4,00,00,000	2,00,00,000	48.01	48.82
French Franc (FFr)	2,00,00,000	80,00,000	7.45	8.12
U.K. £	3,00,00,000	2,00,00,000	75.57	75.98
Japanese Yen	1,50,00,000	2,50,00,000	3.20	2.40

- (i) Determine the net exposure of each foreign currency in terms of Rupees.
(ii) Are any of the exposure positions offsetting to some extent?
(c) X Co., Ltd., invested on 1.4.2005 in certain equity shares as below:

Name of Co.	No. of shares	Cost (Rs.)
M Ltd.	1,000 (Rs.100 each)	2,00,000
N Ltd.	500 (Rs.10 each)	1,50,000

In September, 2005, 10% dividend was paid out by M Ltd. and in October, 2005, 30% dividend paid out by N Ltd. On 31.3.2006 market quotations showed a value of Rs.220 and Rs.290 per share for M Ltd. and N Ltd. respectively.

On 1.4.2006, investment advisors indicate (a) that the dividends from M Ltd. and N Ltd. for the year ending 31.3.2007 are likely to be 20% and 35%, respectively and (b) that the probabilities of market quotations on 31.3.2007 are as below:

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

You are required to:

- (i) Calculate the average return from the portfolio for the year ended 31.3.2006;

- (ii) Calculate the expected average return from the portfolio for the year 2006-07; and
 (iii) Advise X Co. Ltd., of the comparative risk in the two investments by calculating the standard deviation in each case. (8+4+8 = 20 Marks)

Answer

- (a) Applying the Black Scholes Formula,

Value of the Call option now:

The Formula $C = SN(d_1) - K_e^{(-rt)} N(d_2)$

$$d_1 = \ln(S/K) + (r + \sigma^2 / 2)t$$

$$d_2 = d_1 - \sigma\sqrt{t}$$

Where,

C = Theoretical call premium

S = Current stock price

t = time until option expiration

K = option striking price

r = risk-free interest rate

N = Cumulative standard normal distribution

e = exponential term

σ = Standard deviation of continuously compounded annual return.

ln = natural logarithm

$$d_1 = \frac{\ln(1.0667) + (12\% + (0.08)^{0.5})}{.40\sqrt{0.5}}$$

$$= \frac{0.0645 + (0.2)^{0.5}}{0.40 \times 0.7071}$$

$$= \frac{0.1645}{0.2828}$$

$$= 0.5817$$

$$d_2 = 0.5817 - 0.2828$$

$$= 0.2989$$

$$Nd_1 = N(0.5817)$$

$$Nd_2 = N(0.2989)$$

$$\text{Price} = S_0 N(d_1) - \frac{E}{e^{rt}} \times N(d_2)$$

$$= (80 \times Nd_1) - 75/[1.0060 \times N[d_2]]$$

Value of option

$$= 80 Nd_1 - \frac{75}{1.0060 \times Nd_2}$$

$$Nd_1 = N(0.5817)$$

$$= 0.7190 + 0.000578$$

$$= 0.7195$$

$$Nd_2 = N(0.2989)$$

$$= 0.6141 + 0.003382$$

$$= 0.6175$$

$$\text{Price} = 80 \times 0.7195 - \frac{75}{1.0060 \times 0.6175}$$

$$= 57.56 - 74.55 \times 0.6175$$

$$= 57.56 - 46.04$$

$$= \text{Rs.}11.52$$

(b) (i) Net exposure of each foreign currency in Rupees

	Inflow	Outflow	Net Inflow	Spread	Net Exposure
	(Millions)	(Millions)	(Millions)		(Millions)
US\$	40	20	20	0.81	16.20
FFr	20	8	12	0.67	8.04
UK£	30	20	10	0.41	4.10
Japan Yen	15	25	-10	-0.80	8.00

(ii) The exposure of Japanese yen position is being offset by a better forward rate

(c)

Calculation of return on portfolio for 2005-06

(Calculation in
Rs./share

	M	N
Dividend received during the year	10	3
Capital gain/loss by 31.03.06		

Market value by 31.03.06	220	290	
Cost of investment	200	300	
Gain/loss	20	(-)10	
Yield	30	(-)7	
Cost	200	300	
% return	15%	(-)2.33%	
Weight in the portfolio	57	43	
Weighted average return			7.55%

Calculation of estimated return for 2006-07

Expected dividend	20	3.5	
Capital gain by 31.03.07			
$(220 \times 0.2) + (250 \times 0.5) + (280 \times 0.3) - 220 = (253 - 220)$	33		
$(290 \times 0.2) + (310 \times 0.5) + (330 \times 0.3) - 290 = (312 - 290)$		22	
Yield	53	25.5	
*Market Value 01.04.06	220	290	
% return	24.09%	8.79%	
*Weight in portfolio $(1,000 \times 220) : (500 \times 290)$	60.3	39.7	
Weighted average (Expected) return			18.02%

(*The market value on 31.03.06 is used as the base for calculating yield for 06-07)

Calculation of Standard deviation.

M Ltd.

Expected market value	Expected gain	Expected dividend	Expected yield	Deviations	Square of deviations	Probability factor	Sq. of d x prob.
220	0	20	20	-33	1089	0.2	217.80
250	30	20	50	-3	9	0.5	4.50
280	60	20	80	27	729	0.3	218.70
							441.00
Standard deviation						21	

N Ltd.

Expected market value	Expected gain	Expected dividend	Expected yield	Deviations	Square of deviations	Probability factor	Sq. of d x prob.
290	0	3.5	3.5	-22	484	0.2	96.80
310	20	3.5	23.5	-2	4	0.5	2.00
330	40	3.5	43.5	18	324	0.3	97.20
							196.00
Standard deviation							14

Share of company M Ltd. is more risky as the S.D. is more than company N Ltd.

Question 5

- (a) AB Ltd., is planning to acquire and absorb the running business of XY Ltd. The valuation is to be based on the recommendation of merchant bankers and the consideration is to be discharged in the form of equity shares to be issued by AB Ltd. As on 31.3.2006, the paid up capital of AB Ltd. consists of 80 lakhs shares of Rs.10 each. The highest and the lowest market quotation during the last 6 months were Rs.570 and Rs.430. For the purpose of the exchange, the price per share is to be reckoned as the average of the highest and lowest market price during the last 6 months ended on 31.3.06.

XY Ltd.'s Balance Sheet as at 31.3.2006 is summarised below:

	Rs. lakhs
Sources	
Share Capital	
20 lakhs equity shares of Rs.10 each fully paid	200
10 lakhs equity shares of Rs.10 each, Rs.5 paid	50
Loans	100
Total	350
Uses	
Fixed Assets (Net)	150
Net Current Assets	200
	350

An independent firm of merchant bankers engaged for the negotiation, have produced the following estimates of cash flows from the business of XY Ltd.:

Year ended	By way of	Rs. lakhs
31.3.07	after tax earnings for equity	105
31.3.08	do	120

31.3.09	do	125
31.3.10	do	120
31.3.11	do	100
	terminal value estimate	200

It is the recommendation of the merchant banker that the business of XY Ltd. may be valued on the basis of the average of (i) Aggregate of discounted cash flows at 8% and (ii) Net assets value. Present value factors at 8% for years

1-5:	0.93	0.86	0.79	0.74	0.68
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You are required to:

- (i) Calculate the total value of the business of XY Ltd.
 - (ii) The number of shares to be issued by AB Ltd.; and
 - (iii) The basis of allocation of the shares among the shareholders of XY Ltd.
- (b) The 6-months forward price of a security is Rs.208.18. The borrowing rate is 8% per annum payable with monthly rests. What should be the spot price?
- (c) An Indian company is desirous of obtaining foreign technology. Write a brief note explaining the important financial considerations it should take into account in this context. (12+4+4= 20 Marks)

Answer

- (a) Price/share of AB Ltd. for determination of number of shares to be issued:

(Rs.570 + Rs.430)/2	Rs.	500
Value of XY Ltd based on future cash flow capitalization (105x0.93)+(120x0.86)+(125x0.79)+(120x0.74)x(300x0.68)	Rs. lakhs	592.40
Value of XY Ltd based on net assets	Rs. lakhs	250.00
Average value (592.4+250)/2		421.20
No. of shares in AB Ltd to be issued 42120000/500	Nos.	84240
Basis of allocation of shares		
Fully paid equivalent shares in XY Ltd. (20+5) lakhs		2500000
Distribution to fully paid shareholders 84240x20/25		67392
Distribution to partly paid shareholders 84240-67392		16848

(b) Calculation of spot price

The formula for calculating forward price is:

$$A = P (1+r/n)^{nt}$$

Where

- A = Forward price
- P = Spot Price
- r = rate of interest
- n = no. of compoundings
- t = time

Using the above formula,

$$208.18 = P (1 + 0.08/12)^6$$

$$\text{Or } 208.18 = P \times 1.0409$$

$$P = 208.18/1.0409 = 200$$

Hence, the spot price should be Rs.200.

(c) FINANCIAL CONSIDERATIONS WHILE BUYING FOREIGN TECHNOLOGY

- ◆ Lump sum vs. royalty: Whether to pay for the technology in a lump sum front-end or as royalty over a period of years, is an important issue. Advantages of lump sum payment are (a) the amount will become certain (b) the amount can be discounted forward and therefore be less; (c) the forex exposure risk is avoided; (d) it provides an opportunity to reduce the per unit cost of technology by maximizing sales. The main advantage of royalty payment is (a) it ensures that the sales benefit is realized before technology payment accrues; (b) it provides easy instalments for funding;

The advantages of lump sum model becomes the disadvantages of the royalty model and vice versa. It is for the organization to choose what is best under its circumstances.

- ◆ Tax issues: Deduction of tax at source is mandatory. This should be important from the receipt's point of view and should be made clear to them. If it is a lump sum upfront payment, tax also could be certain; whereas, in protracted royalty payment, there is a chance of tax uncertainty.

As to allowability in the hands of the payer, there have been various case laws and it would be advisable for the payer to obtain beforehand expert opinion as to how to plan its tax shield in the best manner possible.

- ◆ Government clearance: Automatic permission will be given for foreign technology agreements upto certain limits – currently, USD 2 million or royalty at 5% for domestic sales and 8% for export sales. In other cases approval will have to be obtained.

Question 6

- (a) Discuss the various kinds of Systematic and Unsystematic risk
- (b) A firm has a sales of Rs.6 crores, Variable cost Rs.3.5 crores and Fixed cost of Rs.0.65 crores. The firm has debt and equity resources worth of Rs.7 crores and 10 crores respectively. With the data given show:
 - (i) The firm's ROI.
 - (ii) EBIT if sales decline to Rs.4 crores.
 - (iii) If the industry's assets turnover is 4 times, does the firm has high or low asset turnover? The cost of debt is 10%, ignore taxation.
- (c) What are the characteristic features of Financial and Operating Lease?
- (d) Write short note on Inter Bank Participation Certificate. (6+6+4+4 = 20 Marks)

Answer

- (a) There are two types of Risk - Systematic (or non-diversifiable) and unsystematic (or diversifiable) relevant for investment - also, called as general and specific risk.

Types of Systematic Risk

- (i) Market risk: Even if the earning power of the Corporate sector and the interest rate structure remain more or less unchanged prices of securities, equity shares in particular, tend to fluctuate. Major cause appears to be the changing psychology of the investors. The irrationality in the security markets may cause losses unrelated to the basic risks. These losses are the result of changes in the general tenor of the market and are called market risks.
- (ii) Interest Rate Risk: The change in the interest rate have a bearing on the welfare of the investors. As the interest rate goes up, the market price of existing fixed income securities falls and vice versa. This happens because the buyer of a fixed income security would not buy it at its par value or face value if its fixed interest rate is lower than the prevailing interest rate on a similar security.
- (iii) Social or Regulatory Risk: The social or regulatory risk arises, where an otherwise profitable investment is impaired as a result of adverse legislation, harsh regulatory climate, or in extreme instance nationalization by a socialistic government.
- (iv) Purchasing Power Risk: Inflation or rise in prices lead to rise in costs of production, lower margins, wage rises and profit squeezing etc. The return expected by investors will change due to change in real value of returns.

Classification of Unsystematic Risk

- (i) Business Risk: As a holder of corporate securities (equity shares or debentures) one is exposed to the risk of poor business performance. This may be caused by a variety of factors like heightened competition, emergence of new technologies, development of substitute products, shifts in consumer preferences, inadequate

supply of essential inputs, changes in governmental policies and so on. Often of course the principal factor may be inept and incompetent management.

- (ii) Financial Risk: This relates to the method of financing, adopted by the company, high leverage leading to larger debt servicing problem or short term liquidity problems due to bad debts, delayed receivables and fall in current assets or rise in current liabilities.
- (iii) Default Risk: Default risk refers to the risk accruing from the fact that a borrower may not pay interest and/or principal on time. Except in the case of highly risky debt instrument, investors seem to be more concerned with the perceived risk of default rather than the actual occurrence of default. Even though the actual default may be highly unlikely, they believe that a change in the perceived default risk of a bond would have an immediate impact on its market price.

(b)		(Rs. Crore)
	Sales	6.0
Less	Variable cost	<u>3.5</u>
	Contribution	2.5
Less	Fixed Cost	<u>0.65</u>
	EBIT	1.85
Less:	Interest	<u>.70</u>
	EBT	1.15

Total Investment = Debt + Capital

$$7 + 10 =$$

17 Crores

(i)
$$ROI = \frac{EBIT}{Total Investment} = \frac{1.85}{17} = 10.88\%$$

(ii) If Sales declines to 4 crores

	Sales	4.0
	Variable Cost 33% as Sales decline by 33%	<u>2.33</u>
	Contribution	1.67
Less:	Fixed Cost	<u>.65</u>
	EBIT	1.02
Less:	Interest	<u>.70</u>
	EBT	0.32

(iii)
$$Asset\ turnover = \frac{Sales}{Total Asset} = \frac{6}{17} = .3529$$

The firm has a lower Asset turnover as compared to the industry.

(c) Salient features of Financial Lease

- (i) It is an intermediate term to long-term arrangement.
- (ii) During the primary lease period, the lease cannot be cancelled.
- (iii) The lease is more or less fully amortized during the primary lease period.
- (iv) The cost of maintenance, taxes, insurance etc., are to be incurred by the lessee unless the contract provides otherwise.
- (v) The lessee is required to take the risk of obsolescence.
- (vi) The lessor is only the Financier and is not interested in the asset.

Salient features of Operating Lease

- (i) The lease term is significantly less than the economic life of the equipment.
- (ii) It can be cancelled by the lessee prior to its expiration date.
- (iii) The lease rental is generally not sufficient to fully amortize the cost of the asset.
- (iv) The cost of maintenance, taxes, insurance are the responsibility of the lessor.
- (v) The lessee is protected against the risk of obsolescence.
- (vi) The lessor has the option to recover the cost of the asset from another party on cancellation of the lease by leasing out the asset.

(d) Inter Bank Participation Certificate

The Inter Bank Participation Certificates are short term instruments to even out the short term liquidity within the Banking system particularly when there are imbalances affecting the maturity mix of assets in Banking Book.

The primary objective is to provide some degree of flexibility in the credit portfolio of banks. It can be issued by schedule commercial bank and can be subscribed by any commercial bank.

The IBPC is issued against an underlying advance, classified standard and the aggregate amount of participation in any account time issue. During the currency of the participation, the aggregate amount of participation should be covered by the outstanding balance in account.

There are two types of participation certificates, with risk to the lender and without risk to the lender. Under 'with risk participation', the issuing bank will reduce the amount of participation from the advances outstanding and participating bank will show the participation as part of its advances. Banks are permitted to issue IBPC under 'with risk' nomenclature classified under Health Code-I status and the aggregate amount of such participation in any account should not exceed 40% of outstanding amount at the time of issue. The interest rate on IBPC is freely determined in the market. The certificates are neither transferable nor prematurely redeemable by the issuing bank.

Under without risk participation, the issuing bank will show the participation as borrowing from banks and participating bank will show it as advances to bank.

The scheme is beneficial both to the issuing and participating banks. The issuing bank can secure funds against advances without actually diluting its asset-mix. A bank having the highest loans to total asset ratio and liquidity bind can square the situation by issuing IBPCs. To the lender, it provides an opportunity to deploy the short-term surplus funds in a secured and profitable manner. The IBPC with risk can also be used for capital adequacy management.

This is simple system as compared to consortium tie up.

PAPER – 3 : ADVANCED AUDITING

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

Question 1

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

- (a) Mr. Rajesh is appointed as the auditor of NOIDA Travels Ltd. with audit fees of Rs. 35,000. He purchased air ticket from Delhi to Kolkata and back for Rs. 18,000 from the client for his personal work and the amount remains unpaid at the end of the year as it is a general practice of the client to give credit to all. Mr. Rajesh claims that he does not incur any disqualification as contained in Section 226(3)(d) of the Companies Act. (5 Marks)
- (b) Apex Ltd., a well reputed manufacturing public limited company has made a contribution of Rs. 2.5 lacs during the financial year ended 31.3.06 to a political party for running a school, situated in the village, where most of the workers of the company reside. It is admitted that the benefit of the school is mostly for the children of the workers of the company. The company has not made any profits in the last four years. (4 Marks)
- (c) Dark Ltd. has received a grant of Rs.20 lacs under the Government's Subsidy Scheme for acquiring an imported machinery for setting up an oil exploration plant and the entire grant received is credited to Profit and Loss account. (Marks 4)
- (d) You notice a misstatement resulting from fraud or suspected fraud during the audit and conclude that it is not possible to continue the performance of audit. (5 Marks)

Answer

- (a) Disqualification of auditors: The guidance note on "Independence of Auditors" issued by the ICAI in this context recommends that "a question of indebtedness may also be raised where an auditor of a company purchases goods or services from the company audited by him. In such a case, if the amount outstanding exceeds Rs. 1000, irrespective of the nature of the purchase or period of credit allowed to other customers, the provisions concerning disqualification of auditor as contained in sec 226 (3) (d) will be attracted. This is applicable in the case of purchase of air tickets for personal work by the auditor of a company on normal terms and conditions of the business of the company as the amount outstanding at the end of the year exceeded Rs. 1000. Therefore, the contention of Mr. Rajesh that he does not incur disqualification is not correct as he has purchased a ticket of the value of Rs. 18,000. The provisions concerning disqualifications of auditor as contained in Sec 226 (3) (d) will be attracted.
- (b) Restrictions regarding political contribution: Section 293-A of the Companies Act 1956 deals with prohibitions and restrictions regarding political contribution. A non-Government company which has been in existence for not less than three years may contribute any amount or amounts directly or indirectly to any political party or for any political purpose to any person provided that the aggregate of the amounts which may be so contributed by a company in any financial year shall not exceed 5% of its average net

profits determined in accordance with the provisions of Section 349 and 350 during the three immediately preceding financial years. The company in question has not made any profit in last four years and contributed Rs. 2.5 lacs during the year to a political party for running a school. This is violation of the provisions of Section 293-A of the Companies Act although the children of its workers are benefited. The auditor would have to qualify his report stating the contravention of the provisions of the Companies Act.

- (c) Accounting for Government Grants (AS-12): According to AS 12 where Government grant is received for the acquisition of a specific fixed assets, the same can not be credited to Profits and Loss Account. It fails to match revenue with the cost. As per AS 12, it should be presented in the Balance Sheet showing the grant as a deduction from the gross value of the asset concerned in arriving at its book value. Alternatively, the Government grants related to a depreciable fixed asset may be treated as deferred income which should be recognised in the Profit and Loss Account on a systematic and rational basis over the useful life of the asset. By crediting the entire amount of grant to Profit and Loss Accounts the company has treated it as a revenue income which is not in accordance with the requirements of the accounting standard. Therefore, the statutory auditor would have to qualify the impact that the income has been overstated to appropriately that extent in qualifying the audit report. Qualify appropriate stated that income has been over stated to the extent of the amount of grant net of proportionate credit that would have been worked out.
- (d) Impossibility to continue the performance of audit: If an auditor concludes that it is not possible to continue the performance of auditing because of misstatement resulting from fraud or suspected fraud, he should take action in accordance with the requirement of AAS 4 "The Auditor's Responsibility to consider Fraud and Error".
- (i) He should consider the professional and legal responsibilities applicable in the circumstances including whether there is a requirement for the auditor to report to the person(s) who made the audit appointment.
 - (ii) He should consider whether he has to report to the regulatory authorities.
 - (iii) If the auditor withdraws, he should discuss with the appropriate level of management and those who charged with the governance about the reasons for the withdrawal.

In view of the exceptional nature of circumstances and the need to consider the legal requirement, he may also seek legal advice for determining the appropriate course of action.

Question 2

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

- (a) Mr. Rahul, a locally based Chartered Accountant, accepted an audit assignment at a fee lower than that charged by the previous auditor, who was stationed in another town and had to spend a lot of money on travel for which he did not charge separately. (4 Marks)

- (b) The superannuation-cum-pension fund for the employees of a company was under a separate 'trust'. Both the company and the trust were under the same management. The auditor, who was auditing the accounts of the company as well as the trust noted some irregularities in the operation of the trust and commented upon these irregularities in the confidential report given to the trustees, but did not mention about these irregularities in his report on the Annual accounts of the Trust. (5 Marks)
- (c) M/s XYZ a firm of Chartered Accountants received Rs. 2 lakhs in January, 2006 on behalf of one of their clients, who has gone abroad and deposited the amount in their Bank account, so that they can return the money to the client in July, 2006, when he is due to return to India. (5 Marks)
- (d) Mr. J.J. a practicing Chartered Accountant engages himself as part time finance manager of Quick Return Securities Ltd. He is of the view that as both functions are independent, he need not take permission from the Institute. (4 Marks)

Answer

- (a) Undercutting of fees: The case of Mr. Rahul should be analysed in the light of clause 12 of Part I of First Schedule to the Chartered Accountants Act, 1949. Clause 12 of the said Schedule deems a Chartered Accountant in practice to be guilty of professional misconduct "if he accepts a position as auditor previously held by some other chartered Accountant or a restricted state auditor in such conditions as to constitute undercutting". In considering whether variation in fees charged would constitute undercutting the following factors should be considered:
- the quantum of work;
 - incidental and out of pocket expenses and
 - other terms of appointment.
- Since the previous auditor was stationed in another town and therefore, had to incur higher cost on account of conveyance, and the previously the fee was decided on a composite basis inclusive of traveling expenses of the auditor, it cannot be said that Mr. Rahul has accepted an audit assignment based on under cutting of fees. Accordingly, Clause 12 will not be attracted.
- (b) disclosure of material facts: A chartered Accountant in practice is deemed to be guilty of professional misconduct under clause 5 of Part I of the Second Schedule if he "fails to disclose a material fact known to him which is not disclosed in a financial statement but disclosure of which is necessary to make the financial statement not misleading". In this case, the Chartered Accountant was aware of the contraventions and irregularities committed by the trust as these were referred to in the confidential report given by the Chartered Accountant to the trustees of the company. However, he had issued the annual accounts without any qualification. On similar facts it was held by the Supreme Court in Kishorilal Dutta Vs. P. K. Mukherjee that it was the duty of the Chartered Accountant to have disclosed the irregularities and contravention to the beneficiaries of the fund in the statement of accounts signed by him. Accordingly, in the present case

also it has to be held that the Chartered Accountant is guilty of professional misconduct if the amount of irregularities is proved material.

- (c) Money of clients to be deposited in separate bank account: Clause 10 of Part I of Second Schedule states that a Chartered Accountant shall be deemed to be guilty of professional misconduct if "he fails to keep money of his clients in separate banking account or to use such money for the purpose for which they are intended."

XYZ received the money in January, 2006 which is to be paid only in July 2006, hence it should be deposited in a separate bank account. Since in this case XYZ have failed to keep the sum of Rs. 2 lakhs received on behalf of their client in a separate Bank Account and it amounts to professional misconduct under clause 10 of part I of Second Schedule.

Connected case Law : Mr. R. S. Murugai Vs. (1) S K Gadh & (2) V. K. Bajaj

- (d) Engaging in any business other than the profession of CA: Clause II of Part I of First Schedule of CA Act, 1949 states that a Chartered Accountant is deemed to be guilty of professional misconduct if he engages in any business other than the profession of Chartered Accountant unless permitted by the Council for the same.

In the given case Mr. J. J. a practicing Chartered Accountant is engaging himself as part time Finance Manager without the permission of the Institute which is a misconduct attracted by clause II of Part I of First Schedule.

This is similar to a reported case in Anil Kumar in Re

Question 3

- (a) Draft audit report u/s 227(3)(f) of the Companies Act, 1956 on the following three situations in respect XYZ Ltd. as on 31.3.2006:
- (i) Where all directors have given written representations that they have not defaulted u/s 274(1)(g) of the Companies Act, 1956. (2 Marks)
 - (ii) Where one of the directors, Mr. Flexible has failed to produce written representation that he has not defaulted u/s 274(1)(g) of the Companies Act, 1956. (3 Marks)
 - (iii) Where on the basis of written representations received from the directors it is noticed that one of the directors, Mr. Rigid has defaulted in terms of Section 274(1)(g) of the Companies Act, 1956. (3 Marks)
- (b) State the important characteristics of an effective system of Computer Audit Programme. (8 Marks)

Answer

- (a) Draft audit report u/s 227 (3) (f):

- (i) Where the directors have not defaulted :

"On the basis of the written representations received from the directors and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31 March, 2006 from being appointed as a directors in terms of Section 274(1)(g) of the Companies Act, 1956."

- (ii) Where one of the directors failed to produce written representation.

"Mr. Flexible who is also a director of XYZ Ltd. has not produced any written representation to the company as to whether XYZ Ltd. as at 31.03.06 had not defaulted in terms of Section 274(1)(g) of the companies Act. In the absence of the representation we are unable to comment whether Mr. Flexible is disqualified from being appointed as director in terms of section 274(1)(g). As far as other directors are concerned on the basis of the written representation received from such directors and taken on record by the Board, we report that none of the remaining directors is disqualified as on 31.3.2006 from being appointed as a director in terms of Section 274(1) (g) of the Companies Act, 1956".

- (iii) Where a director is found to be disqualified.

"On the basis of the written representation received from Mr. Rigid who is a director of XYZ Ltd. as on 31.3.2006 and taken on record by the board, we report that Mr. Rigid is disqualified from being appointed as a director in terms of Section 274(1) (g) of the Companies Act, 1956. As far as other directors are concerned, on the basis of written representations received and taken on record by the board we report that none of the remaining directors is disqualified as on 31.3.2006 from being appointed as director in terms of Section 274 (1) (g) of the Companies Act."

- (b) Important characteristics of an effective system of computer audit program:

- (i) The system has to be simple to use and eliminate the need to remember countless details normally required in writing or revising computer programs.
- (ii) It has to be easily understandable even by those with little computer expertise and easy to use.
- (iii) It has to be capable of being used with different configuration of computers.
- (iv) The package has to include adequate support at the time of installation, provide adequate training to the staff and to provide documentation. There should be a provision for future revision of the program.
- (v) The package should have statistical sampling capability.
- (vi) The system has to be acceptable to all users in terms of easy execution and compatible with the existing system.
- (vii) The program has to be capable of processing different types of applications.
- (viii) The program should have strong report writing function including the ability to prepare multiple reports in a single program run and to generate flexible output report formats.

Question 4

- (a) Enumerate the main areas to be covered by the auditor in the case of environment audit of an industrial unit. (8 Marks)
- (b) State the salient features of the directions to the auditors of Government companies

issued by the Comptroller and Auditor General of India u/s 619(3) of the Companies Act, 1956 in relation to :

- (i) Assets and Investments, and
- (ii) Inventory and Contracting (8 Marks)

Answer

- (a) Main areas to be covered in the case of environment audit of an industrial unit:
 - (i) Layout and design of the factory to provide for the installation pollution control devices with provision for upgradation of pollution control measures to meet regulatory authorities' requirements. Areas of deficiency to be included in the report.
 - (ii) The use of all resources such as air, water, land, energy, raw material and human resources with minimum waste and interlinking for best results to be looked into and reported.
 - (iii) It has to be reported whether all pollution control measures in vogue are effective with reference to the type of industry, nature of working and grade of polluting the environment.
 - (iv) Availability of adequate trained staff and safety amenities with provision for constant upgradation to be verified.
 - (v) Availability of adequate health care provisions and medical facilities for the workers to be looked into.
 - (vi) Availability of proper system to eliminate industrial unhygienic state.
 - (vii) Availability of adequate safeguard against occupational health hazards depending upon the nature of industry to be verified.
 - (viii) Existence of adequate information system and reporting of compliance of statutory legal provisions to the board at regular intervals to be verified.
 - (ix) Compliance of regularly mechanism by way of updating the existing environment system with the latest changes in the regulations to be looked into.
 - (x) It has to be verified as to how social aspects are addressed by the industry as they have an obligation to protect the society from pollution hazards of the industry.
- (b) (i) Assets and Investments :
 - (i) Have the dates of installation and commissioning of plant and Machinery been clearly fixed by the authority to whom the powers have been delegated by the board?
 - (ii) Indicate whether the property and assets registers are posted upto date and are reconciled with the financial books?
 - (iii) Examine and indicate whether the company has a system of monitoring the timely recovery of outstanding dues? Highlight the significant instances of failure of the system, if any.

- (iv) Indicate whether the cash and imprest balances were physically verified during the year on a regular basis by an authorized officer? Highlight the inadequacies in this regard, if any.
 - (v) Indicate whether the company has laid down an investment policy? If yes, please indicate the following:
 - (a) Authority which approved the policy. (b) Is it in accordance with the laws, rules and regulations applicable to the company? (c) in our opinion are there any defects in the policy? (d) Has the company followed it in case of all material investments made during the year? (e) Were the investments made by the company in its the best interest. (f) Is the short fall in the market value of the current investments and permanent diminution in the value of long terms investments reflected in the books? If not, describe the failure.
 - (vi) Indicate whether the deposits with Banks/ financial Institutions and others have been in accordance with laws, rules, regulations etc. applicable to the company? Further state whether these were properly authorized by the competent authorities.
- (ii) Inventory and contracting :
- (i) Examine whether the company has prescribed the following in regard to the management to stores:
 - a. Maximum and minimum limits of stores and spares.
 - b. Economic order quantity for procurement of stores.
 - (ii) Indicate whether the company usually makes advance payments to suppliers contractors? If so indicate whether the company has an efficient system for monitoring and adjusting such advances?

Question 5

- (a) Explain the propriety elements in the Companies (Auditors) Report Order, 2003.(8 Marks)
- (b) "The auditors should communicate audit matters of governance interest arising from the audit of financial statements with those charged with the governance of an entity". Briefly state the matters to be included in such Communication. (8 Marks)

Answer

- (a) Propriety elements in CARO 2003:
 - (i) If a company has given or taken loans, secured or unsecured to/ from companies, Firms or other parties listed in the register maintained u/s 301 of the Companies Act, whether the rate of Interest and other terms and conditions of such Loans are prima facie prejudicial to the interest of the company.
 - (ii) If overdue amount of loan given to or taken from companies, firms or other parties listed in the register maintained u/s 301 of the Companies Act is more than one

Lakh, what reasonable steps have been taken by the company for recovery/ payment of the principal and interest.

- (iii) Whether the particulars of contracts or arrangements referred to in sec 301 of the Act have been entered in the register required to be maintained. To ensure the transactions entered in the register maintained u/s 301 have been made at prices which are reasonable at the relevant time.
 - (iv) Whether the company is regular in depositing undisputed statutory dues including PF, income tax, sales tax, customs, excise duties and other statutory dues and if not, the arrears outstanding for more than 6 months from the date they became payable shall be indicated.
 - (v) Whether the company has made any preferential allotment of shares to parties covered in the register maintained u/s 301 and if so, whether the price at which they were issued is prejudicial to the interests of the company.
- (b) Communications of audit matters with those charged with governance (AAS 27): AAS 27 deals with communications of audit matters with those charged with governance. The following are the audit matters of governance interest which are to be communicated.
- (i) The general approach and overall scope of audit including expected limitations.
 - (ii) The selection of or change in significant accounting policies and practices that have a material effect on the entity's financial statements.
 - (iii) The potential effect on the financial statements of any significant risks and exposures.
 - (iv) Adjustment to financial statements arising out of audit which have a significant effect on the financial statement.
 - (v) Material uncertainties that may cast significant doubt on the entity's ability to continue as a going concern.
 - (vi) Disagreement with management on matters which could have significant impact to the financial statements and to audit report.
 - (vii) Expected modifications to the audit report.
 - (viii) Others matters like material weakness in internal control measures, questions on management integrity and fraud involving management.
 - (ix) Other matters agreed in terms of audit engagement.

Question 6

Explain the scope of concurrent audit of a bank with reference to Reserve Bank of India guidelines. (16 Marks)

Answer

Scope of concurrent audit of banks with reference to RBI guidelines:

The following are the areas to be covered:

- (i) Daily cash transactions with reference to abnormal receipts and payments. This will include currency chest transactions, major expenses met by cash, high value receipts and disbursements.
- (ii) Purchase and sale of shares securities etc. Physical verification of investments and rates at which they are entered into.
- (iii) Verification of procedure and documentation to open new current, savings, term deposit accounts, etc. Unusual operations noticed have to be thoroughly examined.
- (iv) Verification of advances, overdrafts, temporary OD, Cash credit accounts, term loans, bills purchase, letters of credit etc. Procedure for sanction and documentation to be verified. Any deviation noticed to be examined in great detail.
- (v) Foreign exchange transactions to be verified with reference to RBI guidelines.
- (vi) Verification of balancing of all ledgers and registers, inter branch reconciliation calculation and verification of interest, discount, commission etc.
- (vii) Revenue leakage to be detected.
- (viii) Special efforts to be made in all fraud prone areas. The attempt should be to ensure that all effective measures are taken to prevent frauds.
- (ix) Verification of high value transactions.
- (x) Procedure for safe custody of security forms with the branch.
- (xi) Whether all procedures for tax deduction at source are followed and the tax so deducted are deposited into Government Account within the time fixed.
- (xii) Verification of returns, statements, calculation of capital adequacy ratio and compliance with requirements of government business.
- (xiii) Study of RBI and Internal Inspection reports statutory auditors report and compliance thereto.
- (xiv) Whether the customers' complaints are dealt with promptly.

Question 7

- (a) (i) What are general matters to be considered by an auditor while taking up a engagement?
(ii) What are the major sources of obtaining information about the client's business?
(4x2=8 Marks)
- (b) State the reporting responsibility of an auditor in the context of non-compliance of Law and Regulation in an audit of Financial Statement.
(8 Marks)

Answer

- (a) (i) General matters to be considered while taking up a new engagement:
- General Economic factors: General level of economic activity (for example, recession, growth)
- (i) The market and competition
 - (ii) Cyclical or seasonal activity
 - (iii) Government policies
- The industry: important conditions affecting the client's business
- (i) The market and competitions
 - (ii) Cyclical or seasonal activity
 - (iii) Changes in product technology
 - (iv) Business risk
- The entity:
- (i) Management and ownership- important characteristics
 - (ii) Operating Management
 - (iii) The entity's business – products markets, suppliers, expenses, operations.
 - (a) Nature of business(es) (for example manufacturing whole seller, financial services, import/ exports)
 - (b) Location of production facilities, warehouses, offices.
 - (c) Employment (for example, by location, supply, wage levels, union contracts, pension commitments, Government regulation)
 - (d) Products or services and markets.
 - (iv) Financial performance– factors concerning the entity's financial condition and profitability.
 - (v) Reporting environment- external influences which affect management in the preparation of the financial statements.
 - (vi) Legislation:
 - (a) Regulatory environment and requirements
 - (b) Taxation both direct and indirect.
- (ii) Information about the client's business: The auditor can obtain information about client's business from the following sources:
- (i) The client's annual Reports to shareholders;
 - (ii) Minutes of meetings of shareholders, board of directors and important committees;

- (iii) Internal financial management report for current and previous periods, including budgets, if any;
 - (iv) The previous year's audit working papers, and other relevant files;
 - (v) Firm personnel responsible for non audit services to the client who may be able to provide information on matters that may affect the audit;
 - (vi) Discussions with the client;
 - (vii) The client's policy and procedures manual;
 - (viii) Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publication, trade Journals, magazines, newspapers or text books;
 - (ix) Consideration of the state of the economy and its effects on the client's business;
 - (x) Visits to the client's premises and plant facilities to the management.
- (b) Reporting responsibility of an auditor in the context of non-compliance of Law and Regulation: The auditor should as soon as practicable, either communicate with the audit committee, the Board of Directors and senior management or obtain evidence that they are appropriately informed regarding non-compliance that comes to the auditors attention.

If in the auditor's Judgment, the non compliance is believed to be intentional and/ or material, the auditor should communicate the findings without delay.

If the auditor suspects that members of senior management, including members of the Board of Directors, are involved in non-compliance, the auditor should communicate the matter to the next higher level of authority at the entity, such as, the audit committee or Board of Directors, to the users of the auditors report or financial statements.

If the auditors concludes that the non-compliance has a material effect on the financial statements and has not been properly reflected in the financial statements the auditor should express a qualified or an adverse opinion.

If the auditor is precluded by the entity from obtaining sufficient and appropriate audit evidence to evaluate whether non-compliance is, or is likely to have occurred that have or may have material impact on the financial statements, the auditor should express a qualified opinion or a disclaimer of opinion on the financial statements on the basis of a limitation on the scope of the audit.

If the auditor is unable to determine whether non compliance has occurred because of limitations imposed by the circumstances rather than by the entity, the auditor should consider the effect on the auditor's report.

The auditor's duty of confidentiality would ordinarily preclude reporting non compliance to a third party. However, in certain circumstances, that duty of confidentiality is overridden by statement, law or by courts of laws.

Question 8

Write short notes on any four of the following:

- (a) Effect of uncertainties on revenue recognition
- (b) Powers and duties of an auditor of a Multi-state Cooperative Society
- (c) Solvency margin in case of an insurer carrying on general insurance business
- (d) Reporting on a compilation engagements
- (e) Types of market under NEAT (National Exchange Automated Trading).
- (f) Broad objectives of operational audit. (4x4=16 Marks)

Answer

- (a) Effect of uncertainties on Revenue recognition: Para 9 of AS 9 "Revenue Recognition" deals with the effect of uncertainties on revenue recognition. The Para states:
 - (i) Recognition of revenue requires that revenue is measurable and at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.
 - (ii) Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g. for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases it may be appropriate to recognize revenue only when it is reasonably certain that the ultimate collection will be made. When there is no uncertainty as to ultimate collection, revenue is recognized at the time of sale or rendering of service even though payments are made by instalments.
 - (iii) When the uncertainty relating to collectability arises subsequent to the time of sale or rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.
 - (iv) When recognition of revenue is postponed due to effect of uncertainties, it is considered as revenue of the period in which it is properly recognised.
- (b) Powers and duties of an auditor of a Multi-state Cooperative Society: Under Section 73 of the Multi-State Cooperative Societies Act, 2002 every auditor of a multi – State Co-operative Society shall have a right of access at all times to the books, accounts and vouchers of the Multi-State Co-operative Society whether kept at the head office of the Multi-State Co-operative Society or elsewhere and shall be entitled to require from the officers or other employees of the Multi-State Co-operative Society such information and explanation as the auditor may think necessary for the performance of the duties as an auditor.

As per section 73 (2) the auditor shall make the following inquiries:

- (a) Whether loans and advances made by the Multi-State Co-operative Society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi-State Co-operative or its members;
 - (b) Whether transactions of the Multi-State Co-operative Society which are represented merely by book entries are not prejudicial to the interest of the Multi-State Co-operative Society;
 - (c) Whether personal expenses have been charged to revenue account; and
 - (d) Where it is stated in the books and papers of the Multi-State Co-operative Society that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.
- (c) Solvency margin in case of an insurer carrying on general insurance business: In case of an insurer carrying on general insurance business, the solvency margin should be the highest of the following amounts :
- (i) fifty crore rupees (one hundred crores of rupees in case of reinsurer), or
 - (ii) a sum equivalent to twenty percent of the net premium income; or
 - (iii) a sum equivalent to thirty percent of net incurred claims.

Subject to credit for reinsurance in computing net premiums and net incurred claims being actual but a percentage, determined by the regulation but not exceeding fifty percent. It may be noted that conditions regarding maintenance of the above mentioned solvency margin may be relaxed by the authorities in certain special circumstances.

If, at any time, an insurer does not maintain the required solvency margin, the insurer is required to submit a financial plan to the authority indicating the plan of action to correct the deficiency in the solvency margin. If, on consideration of the plan, the authority finds it inadequate the insurer has to modify the financial plan.

Sub-section (2c) of Sec 64 A states that if an insurer fails to comply with the requirements of the insurance Act, 1938, it shall deemed to be insolvent and may be wound up by the court.

- (d) Reporting on a compilation engagements: The report on compilation engagements should ordinarily, be in the following layout:
- (i) Title – The title of the report should be “Accountants Report on compilation of un-audited financial Statements.”
 - (ii) Addressee : The report should ordinarily be addressed to the appointing authority.
 - (iii) Identification of the financial information also noting that it is based on the information provided by the management.

- (iv) When relevant, a statement that the accountant is not independent of the entity;
 - (v) A statement that the Management is responsible for :
 - * Completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant;
 - * Maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;
 - * Preparation and presentation of financial statements or other financial information in accordance with the applicable laws and regulation, if any;
 - * Establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities.
 - * Establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non-compliance.
 - (vi) A statement that the engagement was performed in accordance with the Auditing and Assurance Standards.
 - (vii) A statement that the neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information.
 - (viii) A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework.
 - (ix) Date of the report.
 - (x) Place of signature.
 - (xi) Accountant's signature.
- (e) Type of markets under NEAT
- (i) Normal Market: All orders of regular lot size or multiples thereof are traded in the normal market. Normal market consists of regular lot orders, special term orders, negotiated trade order and stop loss order depending on their order tributes.
 - (ii) Odd Lot Market: If the order size is less than the regular lot size such orders are traded in the odd lot market. In an odd lot market both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place.
 - (iii) Spot Market: Spot orders are similar to normal market orders except that spot orders have different settlement periods vis-a-vis normal market.
 - (iv) Auction Market: In the auction market, auctions are initiated by the exchange on behalf of trading members, for completing the settlement process.
- (f) Broad objectives of operational audit :
- (i) Appraisal of controls: Operations and the results in which management is interested are largely a matter of control. If controls are effective in design and are faithfully

adhered to, the result that can be attained will be subject to the other limiting constraints in the organization.

- (ii) Evaluation of performance: In the task of performance evaluation, an operational auditor is heavily dependent upon availability of acceptable standards. The operational auditor cannot be expected to possess technical background in so many diverse technical fields obtaining even in one enterprise. Even when examining or appraising performance or reports of performance, the operational auditor's mind is invariably fixed on control aspects.
- (iii) Appraisal of objectives and plans: 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.
- (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. In evaluating organisational structure, the operational auditor should consider whether the structure is in conformity with the management objectives and it is drawn up on the basis of matching of responsibility and authority. He should also analyse whether line of responsibility has been fixed, whether delegation of responsibility or authority is clear and there is no overlapping area.

PAPER – 4 : CORPORATE LAWS AND SECRETARIAL PRACTICE

Question 1

Answer any two of the following:

- (a) M/s Star Health Specialities Ltd. owns a Multi-specialty Hospital in Chennai. Dr. Hamilton, a practising Heart Surgeon, has been appointed by the company as its non-executive ordinary director and it wants to pay him fee, on case to case basis, for surgery performed on the patients at the hospital. A question has arisen whether payment of such fee to him would amount to payment of managerial remuneration to a director subject to any restriction under the Companies Act, 1956.

Advise the company, which seeks to ensure that the same does not contravene any provision of the Companies Act, 1956. (5 Marks)

- (b) The shares of MLM Ltd. were listed in Cochin Stock Exchange. The stock exchange delists the shares of the company. The aggrieved company approaches you to know the remedy available to the company. Give your suggestion to the company keeping in view the provision of the Securities Contracts (Regulation) Act, 1956. (5 Marks)
- (c) Explain the powers, which can be exercised by the Securities and Exchange Board of India under the Securities Contracts (Regulation) Act, 1956, while approving the schemes for corporatisation and demutualization submitted by recognized stock exchanges, so that there is segregation of ownership and management from the trading rights of members of such stock exchanges. (5 Marks)

Answer

- (a) Under the proviso to sub-section (1) or section 309 of the Companies Act, 1956, in case–
- (i) the services rendered are of a professional nature; and
 - (ii) in the opinion of the Central Government, the director possesses the requisite qualifications for the practice of the profession,
- the remuneration paid for these services shall be outside the scope of Section 309 of the Act and shall not be a part of managerial remuneration. It is then not open to the Central Government to put any restriction on the amount of remuneration payable to him for his approach work. The company is, accordingly, advised to approach the Ministry of Company Affairs to seek an affirmative expression of opinion that Dr. Hamilton who is a qualified surgeon, possesses the requisite qualification to practice the profession of surgery.
- (b) Section 21A of Securities Contracts (Regulation) Act, 1956 contains the provision relating to delisting of securities. As per this section
- (1) A recognized Stock Exchange may delist the securities after recording reasons therefor from any recognized stock exchange on any ground or grounds as may be prescribed under this Act.

- (2) The Securities of a company shall not be delisted unless the company concerned has been given a reasonable opportunity of being heard.
- (3) A listed company may file an appeal before the Securities Appellate Tribunal (SAT) against the decision of the recognized stock exchange delisting the securities within fifteen days from the date of the decision of recognized stock exchange delisting the securities.
- (4) Securities Appellate Tribunal may, if it is satisfied that the company was prevented by sufficient cause from filing the appeal within the said period, allow it to be filed within a further period of not exceeding one month.

So here, the company may make an appeal to the Securities Appellate Tribunal against the delisting within fifteen days or such extended period not exceeding one month after showing sufficient cause of not filing within fifteen days.

(c) Corporatisation and Demutualisation – Power of SEBI under SCRA, 1956

SEBI has been empowered under sub-section (2) of Section 4B of Securities Contracts (Regulation) Act, 1956 to approve the scheme of corporatisation and demutualisation with or without modification. SEBI can reject the proposed scheme if it is satisfied that it would not be in the interest of the trade and also in the public interest to approve the scheme. Besides these general powers, SEBI has got certain specific powers under Section 4B(6). SEBI, while approving the scheme, may, by an order in writing restrict

- (a) the voting rights of the shareholders who are also stock-brokers of the recognized stock exchange.
- (b) the right of shareholders in a stockbroker of the recognized stock exchange to appoint the representatives on the governing board of the stock exchange.
- (c) the maximum number of representatives of the stock-broker of the recognized stock exchange to be appointed on the governing board of the stock exchange shall not exceed one-fourth of the total strength of the governing body.

On receipt of approval of scheme, stock exchange will issue shares to public within 12 months so that at least 51% equity shares are with public other than shareholders having trading rights. SEBI can extend the period upto another 12 months [Section 4B(8)].

Question 2

Answer any two of the following:

- (a) Mr. Loma, an Indian National desires to obtain foreign exchange for the following purposes:
 - (a) Payment to be made for securing insurance for health from a company abroad.
 - (b) Payment of commission on exports under Rupee State Credit Route.
 - (c) Gift remittance exceeding US Dollars 10,000.

Advise him whether he can get foreign exchange and if so, under what condition?

(7 Marks)

- (b) Mrs. Kamala, a resident in India is likely to inherit an immovable property in U.S.A. from her father, who is a resident outside India. Advise Mrs. Kamla about the restrictions, if any, in this regard under the Foreign Exchange Management Act, 1999 explaining the relevant provisions of the Act. Will your answer be different, if she is likely to inherit foreign securities? (7 Marks)
- (c) (i) Mr. ZPM was appointed as a Member of the Competition Commission of India by Central Government. He has a professional experience in international business for a period of 12 years, which is not a proper qualification for appointment of a person as member. Pointing out this defect in the Constitution of Commission, Mr. YKJ, against whom the commission gave a decision, wants to invalidate the proceedings of the commission. Examine with reference to the provisions of the Competition Act, 2002 whether Mr. YKJ will succeed.
- (ii) ABC Ltd. made an initial public offer of certain number of equity shares. Examine whether these shares can be considered as 'Goods' under the Competition Act, 2002 before allotment. (7 Marks)

Answer

- (a) Under provision of Section 5 of FEMA 1999, certain Rules have been made for drawl of foreign exchange for current account transactions. As per these rules, foreign exchange for some of the current account transaction is prohibited. As regards some other current account transaction foreign exchange can be drawn with prior permission of the Central Government while in case of some other current account transaction, the prior permission of Reserve Bank of India is required.
1. The payment required to be made for securing insurance for health from a company abroad as referred in item 1 can be made after obtaining permission from Central Government of India, as prescribed in Second Schedule to Foreign Exchange Management (Current Account Transaction) Rules 2000. Hence Mr. LOMA can draw foreign exchange after obtaining such permission.
 2. As regards item no. 2 i.e., the payment of commission on export under Rupee State Credit Route, such payment is prohibited as referred in First Schedule to Foreign Exchange Management (Current Account Transaction) Rules 2000. Hence Mr. LOMA cannot withdraw for the said purpose.
 3. The item referred here is covered by Third Schedule to Foreign Exchange Management (Current Account Transaction) Rules 2000. As per this schedule, gift remittance exceeding USD 5,000 per beneficiary per annum requires permission of RBI. Since the amount involved here is more than USD 5000, Mr. LOMA can draw foreign exchange after permission from RBI.

In all the cases, where remittance of foreign exchange is allowed either by general or specific permission, the remitter has to obtain the foreign exchange from an authorized person as defined in Section 2(c) read with section 10 of FEMA, 1999.

- (b) Acquisition of immovable property situated outside India and foreign securities by a person resident in India are regulated by Sections 4 and 6 of the Foreign Exchange Management Act, 1999.

Section 4 of FEMA 1999 provides that no person resident in India shall acquire, hold, own, possess or transfer any foreign exchange, foreign security of any immovable property situated outside India, except as provided in the Act. Section 6(4) provides that a person resident in India may hold, own, transfer or invest in foreign currency foreign security or any immovable property situated outside India if such currency security or property was inherited from a person who was resident outside India. Further, RBI is empowered to frame regulations relating to capital account transactions in consultation with the Central Government (Section 6(2)) and Section 6(3). Accordingly RBI has issued certain Regulations. Two regulations are relevant in this case.

In terms of Regulations 5(1) (a) of Foreign Exchange Management (Acquisition and Transfer of Immovable Property outside India) Regulations 2000, a person resident in India may acquire immovable property outside India by way of gift or inheritance from a person who was resident outside India without approval of RBI.

Similarly, in terms of Regulations 19(1) (iii) of Foreign Exchange Management (Transfer or issue of any Foreign Securities) Regulation 2000 a person resident in India being an individual may acquire foreign securities by way of inheritance from a person whether resident in or outside India.

In the light of the provisions of FEMA and Regulations explained above there are no restrictions with regard to inheritance of either immovable property situated outside India or foreign security. Such inheritance do not require approval of RBI.

- (c) (i) As per section 15 of Competition Act 2002 any act or proceeding of the Commission shall not be invalidated merely on the ground of:
- (a) any vacancy in, or any defect in the constitution of the Commission; or
 - (b) any defect in the appointment of a person acting as a Chairperson or as a member; or
 - (c) any irregularity in the procedure of the Commission not affecting the merits of the case.

Here in this case Mr. ZPM should have professional qualification of not less than 15 years as per section 8 of the Act but this disqualification will not invalidate the proceeding of the Commission.

- (ii) Section 2(i) of Competition Act, 2002 defines 'goods' as follows:

'Goods' means goods as defined the Sale of Goods Act, 1930 and includes –

- (a) products manufactured, processed or mined;
- (b) debentures, stock and shares after allotment

- (c) in relation to goods supplied, distributed or controlled in India, goods imported into India.

Hence, debentures and shares can be considered as 'goods' within the meaning of section 2(i) of Competition Act, 2002 only after allotment and not before allotment.

Question 3

Answer any two of the following:

- (a) State the circumstances under which Securities and Exchange Board of India may exercise the following powers:
- (i) Prohibit a company from issuing prospectus, any offer document or advertisement soliciting money from public for the issue of securities.
 - (ii) Pass cease and desist order in respect of any listed company.

Explain the remedies available under Securities and Exchange Board of India Act, 1992 to companies aggrieved by the above orders of SEBI. (8 Marks)

- (b) XYZ Automobiles Ltd. intends to make a public issue of 2,00,00,000 equity shares of Rs. 10 each through the 100% book building process indicating a price band.

You are required to answer the following with reference to the SEBI (Disclosure and Investor Protection) Guidelines:

- (i) What is the price band that can be indicated in the red herring prospectus, if the floor price is proposed to be fixed at Rs. 300 per equity share ?
 - (ii) What are the restrictions, if the company wants to revise the price band during the bidding period?
 - (iii) How the shares are to be allocated to different categories of investors like Qualified institutional buyers, Retail individual investors, etc.? (8 Marks)
- (c) There is an apparent difference between section 292 of the Companies Act, 1956, which permits the board to delegate its power to make loans and section 372A of the Companies Act, which requires approval of loan by a resolution passed at a board meeting with the consent of all the directors present at the meeting. How would you interpret these two provisions applying the rule of harmonious construction ? (8 Marks)

Answer

- (a) Power of SEBI and remedies available to aggrieved persons: Section 11 of SEBI Act, 1992 specifies that the basic duty of SEBI is to protect the interests of investors in securities and regulate the securities market. The certain measures which can be taken by SEBI are to fulfill its objectives are listed in Section 11, 11A, 11 AA, 11B, 11C and 11 D. Section 11 A(2)(b)(i) specifically empowers SEBI to prohibit any company from issuing prospectus, any offer document or advertisement soliciting money from the public for the issue of securities by general or special order if such prohibition is necessary to the purpose of protection of investors.

According to proviso to Section 11 D, SEBI can issue cease and desist order in respect of any listed company only if SEBI has reasonable grounds to believe that such company has indulged on insider trading or market manipulation and not otherwise.

Aggrieved companies may appeal against orders of SEBI made under SEBI Act, rules or regulations to Securities Appellate Tribunal (SAT) under Section 15T (1)(a). Such appeal should be filed within 45 days from the date on which a copy of the order of SEBI is received by the company. It shall be in the prescribed form accompanied by prescribed fees. Delay in filing appeal can be condoned by SAT for sufficient reasons (Section 15T(3)). Efforts will be made by SAT to dispose of appeal within 6 months [Section 15T(6)].

If the company is aggrieved by the order of SAT, further appeal against the order of SAT can be made to Supreme Court within 60 days from the date of communication of the order on any question of law arising out of such order. The period can be extended by Supreme Court upto further 60 days if sufficient cause is shown (Section 15Z).

Thus, appeal lies only on question of law. As far as facts are concerned, decision of SAT is final. Further, Section 20 A bars jurisdiction of civil court in respect of orders issued by SEBI.

(b) Book Building:

- (1) Cap Price: In the price band, the lower end is called floor price and the higher end is called cap price. As per SEBI Guidelines, the cap of the price band shall not be more than 20% of the floor price of the band i.e., cap of the price shall be less than or equal to 120% of the floor price of the band. Applying this principle, the cap price shall be equal to or less than Rs. 360/-. Hence the company may indicate a price band with a floor price of Rs. 300/- and maximum cap price of Rs. 360/- [Clause 11.3.1 (viii) (b) (a) of SEBI Guidelines, 2000].

- (2) Revision of Price Band: The price band can be revised during the bidding period in which case the maximum revision on either side shall not exceed 20% i.e., floor of price band can move up or down to the extent of 20% of floor of the price band disclosed in red herring prospectus and cap of the revised price band will be fixed accordingly (i.e., maximum 20% above floor price) [Clause 11.3.1. (viii) (b) (b)].

However, any revision in the price band should be widely publicized by informing the stock exchanges, issuing press release and also on the relevant website and the terminals of syndicate members. [Clause 11.3.1 (viii) (b) (c)]

In case the price band is revised, the bidding period shall be extended for a further period of 3 days subject to the total bidding period not exceeding 10 days [Clause 11.3.4.1 (i) read with clause 11.3.1 (viii) (b) (d)].

There are certain additional requirements in case the revision involves lowering of the floor price. The manner in which the shortfall, if any, in the project financing, arising on account of lowering of price band to the extent of 20%, will be met shall be disclosed in the red herring prospectus. It shall also be disclosed that allotment shall not be made unless the financing is tied up. [Clause 11.3.1 (viii) (b) (e)].

Allocation to different categories of investors: Maximum 50% of the net issue to the public shall be allocated on a proportionate basis to Qualified Institutional Buyers (QIBs) like banks, FIIs, Financial Institutions, Mutual Funds. 5% of the QIB portion shall be available for allocation on a proportionate basis to Mutual Funds only and the remainder of the QIB portion shall be available for allocation on a proportionate basis to all QIBs, including Mutual Funds.

At least 15% of the Net Issue to the public shall be available for allocation on a proportionate basis to non-Institutional Bidders.

At least 35% of the Net Issue to the public shall be available for allocation on a proportionate basis to Retail individual bidders subject to valid bids being received at or above issue price [clause 11.3.5(i) and clause 11.3.5 (i) (a) as amended w.e.f., 19.9.05].

(c) Rule of Harmonious Construction

Where there are in an enactment two or more provisions which cannot be reconciled with each other, they should be so interpreted, wherever possible, as to give effect to all of them. This is what is known as the Rule of Harmonious Construction. Importance should not be attached to a single clause in one section overlooking the provisions of another section. If it is impossible to avoid inconsistency, the provision which was evaluated or amended later in point of time must prevail. The rule of Harmonious Construction is applicable only where there is real and not merely apparent conflict between the provisions of an Act, and one of them has not been made subject to the other.

Every loan falling within the purview of Section 372 A of the Companies Act, 1956 must be sanctioned by a resolution of the Board of Directors passed at its meeting (Section 372 A(2)). Every such resolution must be passed with the consent of all the directors present at the Board meeting, that is no one dissenting or unanimously.

Every loan covered by Section 372 A falls within the purview of Section 292 (i)(e). That section permits delegation by the Board of its power of making loans vide proviso to Section 292 (i), subject to the conditions stipulated in Section 292(3). The condition that the resolution delegating the power must specify the total amount upto which loans may be made by the delegate, the purposes for which the loans may be made and the maximum amount of loans which may be made for each purpose in individual cases.

However, by harmonious interpretation of both the provisions of Section 292 and 372A and in absence of specific prohibition in Section 372A against delegations, the Boards power under Section 372A may be delegated in accordance with the provisions of Section 292 by passing unanimous resolution of the Board. Any other interpretation will make provisions of Section 292 redundant.

Question 4

- (a) Mr. Adam, a 15% shareholder of a company and other shareholders have lost confidence in the Managing Director (MD) of the company. He is a director not liable to retire by

rotation and was re-appointed as Managing Director for 5 years w.e.f. 1.4.2005 in the last Annual General Meeting of the company.

Mr. Adam seeks your advise to remove the MD after following the procedure laid down under the Companies Act, 1956.

- (i) Specify the steps to be taken by Mr. Adam and the Company in his behalf;
 - (ii) Draft a suitable resolution to be passed for removal of MD;
 - (iii) Is it necessary to state reasons to support the resolution for his removal ? (8 Marks)
- (b) Registrar of Companies has issued a show cause notice to the company and its directors to show cause as to why prosecution be not filed against them for not appointing a qualified Company Secretary, in contravention of the provision of section 383A of the Companies Act, 1956. According to the company, there is adequate justification for not appointing the Secretary as it is a closely held company with only 7 shareholders and there is no adequate work for him. Further, the company cannot afford to pay him the salary, which will not be less than Rs. 15,000 to 20,000 p.m.

What is the remedy available to the company and its directors –

- (i) before any prosecution is filed by ROC ?
- (ii) after the prosecution is filed by ROC in the Magistrate's Court ? (7 Marks)

Answer

- (a) (i) Under Section 284 of the Companies Act, 1956, a company may, by ordinary resolution, remove a director before the expiry of his tenure. For the purpose, special notice from a shareholder (Mr. Adam in the present case) shall be required to be given to the company for moving a resolution to remove a director. On receipt of notice, the company shall forthwith send a copy thereof to the director concerned (MD in the present case) and he shall be entitled to be heard on the proposed resolution at the meeting. Copy of the representation, if any, made by the director be also sent to all members of the company to whom notice of the general meeting is normally sent. In case, the representation is received too late, the same shall be read at the meeting. The representation need not be sent if the Company Law Board is satisfied that it will cause needless publicity for defamatory matter.

Under Section 190, special notice of the intention to move the resolution shall be given not less than 14 days before the meeting.

In the present case, if the AGM is due to be held, Mr. Adam may send the special notice 14 days before the AGM. Otherwise, he may request the company to convene EGM under section 169 for consideration of the special notice and resolution for removal of MD. He already holds more than 10% shares in the company.

Once the ordinary resolution is passed in the general meeting, MD will cease to be a director of the company and consequently MD of the company.

- (ii) Mr. Adam may give special notice of his intention to move the following resolution, as ordinary resolution: "RESOLVED THAT Mr., Managing Director of the Company be and is hereby removed as a director of the company under Section 284 of the Companies Act, 1956 with immediate effect."
 - (iii) A statement of reasons is not necessary to support the resolution for removal of a director. LIC vs. Escorts Ltd. (1986) 59 Comp. Cases 548(SC)
- (b) Provisions of Section 383A of the Companies Act, 1956 are mandatory in nature requiring appointment of Whole Time Qualified Company Secretary where the paid up capital of the company is Rs. 2 crores or more. If a company fails to appoint the Company Secretary, the company and every officer of the company in default is liable to fine of Rs. 500 for every day during which the default continues. It is also provided that it shall be a defence to prove that all reasonable efforts were made to comply with this provision or that the financial position of the company was such that it was beyond its capacity to engage a Whole Time Secretary.

In the present case, it appears that the financial position of the company does not permit it to appoint a Whole Time Qualified Company Secretary. However, such a defence is available to the accused during the trial by the Magistrate's court. It is advisable for the company to appoint the secretary, even though there is not sufficient work under the company law; however, he may also attend other functions in the company.

Remedy before prosecution is filed

It is open to the company and its directors, in reply to show cause notice, to make an application under section 621A of the Companies Act, 1956 to Registration of Companies for compounding the offence, after appointing the secretary. ROC shall forward the same to the CLB/Regional Director, as the case may be, along with his comments. Once the offence is compounded, no prosecution can be filed by ROC.

Alternatively, directors may approach the High Court for relief under Section 633(2) of the Act, having acted honestly and reasonably and they ought to be excused. However, no relief is available to company.

Lastly, the company and directors may reply to the show cause notice with their explanations and request for not taking any action. However, normally in such a case ROC may leave the matter to be decided by the court, after the prosecution is filed by him.

Remedy after prosecution is filed

Application may be made under Section 621A by the company and its directors for compounding the offence to ROC, even after the prosecution is filed. Once the offence is compounded by CLB/Regional Director, as the case may be, the same shall be brought to the notice of the court by ROC and the company and its directors shall be discharged.

The remedy; under Section 633(2) before the High Court is not available after the prosecution is filed. A similar relief can, however, be sought from the trial court under Section 633(1) of the Act.

The other remedy is to contest the prosecution case in the trial court and plead its case in defence.

It is also open to them to plead guilty on the first date of appearance and pay the fine imposed by the court.

Question 5

- (a) M/s. Raman Limited having a paid up share capital of Rs. 5 crores owns an agency of Cement Corporation of India Ltd. and proposes to supply cement, on credit, to M/s. Raman Enterprises Private Limited. Mr. Raman is a common Director in both the companies.

State the requirements of the Companies Act, 1956, if any, to be complied with by the company on the facts of this case.

Will it make any difference, if -

- (i) M/s. Raman Enterprises Private Limited were a public company;
 - (ii) M/s. Raman Limited were carrying on real estate business and it proposes to sell a flat to M/s. Raman Enterprises Private Ltd. for Rs. 50 lakhs? (8 Marks)
- (b) The official liquidator of ABC Limited (in liquidation) instituted misfeasance proceedings under section 543 of the Companies Act, 1956 against 'A', a director of the company in liquidation. During the pendency of misfeasance proceedings 'A' died.

What is meant by Misfeasance ? Is it possible for the official liquidator to implead the legal representatives of 'A' and continue the proceeding against them ? (7 Marks)

Answer

- (a) Under Section 297 of the Companies Act, 1956 except with the consent of the board of directors of a company, a director of the company or his relative; a firm in which such director or relative is a partner; or a private company of which the director is a member or director, shall not enter into any contract with the company for the sale, purchase or supply of any goods, materials or services. Where the paid up capital of the company is not less than Rs. 1 crore, it will also require previous approval of the Central Government. Exemption from the said provisions are available in the following circumstances -
- (i) the purchase of goods and materials from the company or sale of goods and materials to the company is for cash at prevailing market prices;
 - (ii) any contract for sale, purchase or supply of goods, materials and services in which the company, or director etc. regularly trades the cost of which does not exceed Rs. 5,000 in any year.

In the present case, Mr. Raman is a common director in both the contractee companies. Accordingly, apart from the approval of the Board, previous approval of the Central Government (power delegated to Regional Director) is also required for entering into the proposed contract of supply of cement on credit. The provisions of Section 299 and 300

of the Companies Act, 1956 have also to be complied with and in the Board meeting Mr. Raman shall disclose his interest in the contract and shall not participate in the discussions on this item and shall not vote for the same. The particulars of the contract be also recorded in the Register of Contracts.

- (i) Section 297 does not apply to a contract where both the contractee companies are public companies. If Ram Enterprises happens to be a public company, section 297 will have no applicability.
- (ii) Section 297 does not apply to a contract relating to immovable properties being the sale of flat in case of Raman Ltd. is a real estate company. The expression 'goods' used in the section has been defined in the Sale of Goods Act, 1930 according to which it means every kind of movable property. Hence, sale of flat will not amount to sale of 'goods' for purposes of section 297 of the section.

(b) Misfeasance

The term 'misfeasance' has not been defined in the Companies Act, 1956. It can be considered as an act or omission in the nature of breach of trust in relation to the company which causes losses or injuring to the company. Although loss to the company has not been expressly stated in Section 543 nevertheless such 'loss' has to be implied in case of misapplication or retainer. Only such an act of misfeasance as results in the loss to the company will fall within the ambit of section 543.

As regards the second question (ii) in case of death of the directors, the Supreme Court held that the proceedings commenced against the delinquent director of a company liquidation under section 543 can be continued after his death against his legal representatives and the amount declared to be due in such misfeasance proceeding can be realized from the estate of the deceased on the hands of his legal representatives. The Court further held that the legal representatives would not, however, be liable for any sum beyond the value of the estate of the deceased in their hands (Official Liquidator, Supreme Bank Ltd. V.P.A. Tendolkar (1973) 43 Comp. (Case 382) (Official Liquidator vs. Parthasarthy Sinha (1983) 53. Comp. Case (SC) (3c)). Hence the misfeasance proceeding can be continued against the legal representatives of A.

Question 6

- (a) Bush and Tony Private Limited approached you seeking your opinion on the following appointments relating to Directors and their relatives.
 - (i) Appointment of Mr. Somen (relative of one of the Directors) as the Managing Director of the company on a monthly remuneration of Rs. 35,000 and other perquisites as are currently being allowed to other executives of the company.
 - (ii) Appointment of Mr. Raman (relative of one of the Directors) as the General Manager – Sales of the company on a consolidated monthly remuneration of Rs. 30,000.

Express your opinion explaining the relevant provisions of the Companies Act, 1956.

(8 Marks)

- (b) XYZ Dairy Products Producer Company Limited proposes to shift its Registered Office from Hosur in Tamil Nadu to Bangalore in Karnataka. Explain the requirements under the Companies Act, 1956 to give effect to his proposal. (7 Marks)

Answer

- (a) As per provisions of Section 314(1) of the Companies Act, 1956, except with the consent of the company accorded by way of a special resolution, no director or relative of a director shall hold any office or place of profit, which carries a monthly remuneration of Rs. 10,000 or more, except that of Managing Director or Manager of the company.

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

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

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

The registered office of XYZ Dairy Products Producers Company Ltd. from Hosur in Tamil Nadu to Bangalore in Karnataka requires amendment to the Memorandum of Association.

The producer companies are required to comply with the provisions contained in Part IX A of the Companies Act, 1956. According to Section 581 ZQ, the producer companies are also required to comply with the other provisions of the Companies Act insofar as the same are not varied by, or are inconsistent with the provisions of Part IX A. Hence XYZ Dairy Products Producer Company Ltd. has to comply with the requirements under Section 581 H and also take into account the circumstances under which the registered office of the company may be shifted from one state to another state as stated in Section 17(1).

The requirements under Section 581 H are – (1) special resolution for altering the situation clause of memorandum of Association (2) A copy of the amended memorandum, together with a copy of the special resolution duly certified by two directors shall be filed with the Registrar of Companies, Tamil Nadu and Registrar of Companies, Karnataka within 30 days (proviso to section 581 M(2)). The alteration of the Memorandum of Association is required to be confirmed by the Company Law Board on petition (Section 581 H(4))

Form No. 18 is also required to be filed with the Registrar of Companies, Karnataka as required under Section 146 (i.e. notice of change of situation of registered office)

Question 7

- (a) Messrs Ahimsa Private Limited was incorporated in the year 2001 under the Companies Act, 1956 by 3 brothers, namely, Amit, Anil and Akhlesh. All the three were Promoter-directors named in the Articles of Association and subscribed for 100 shares each in the company through Memorandum of Association. Thereafter, from time to time, further shares were allotted in proportion of one-third to each of them and in due course, the company started earning substantial profits. Due to greed of money, the two brothers, namely, Amit and Anil, joined hands together to assume complete control of the company, leaving their brother, Akhlesh in lurch. Both the brothers got further shares allotted to themselves, thereby their joint shareholding increased from 66 2/3% to 90%, while the shareholding of Akhelesh got reduced from the erstwhile 33 1/3 % to 10%. No notice of any Board Meeting was sent to Akhlesh, who was sidelined and was also removed as a Director.

Aggrieved by the decisions taken by his two brothers at his back, Akhlesh seeks your advice for taking out appropriate proceedings before the court or judicial authority of competent jurisdiction. Also suggest the nature of reliefs he may claim while filing his case. (8 Marks)

- (b) Mr. XYZ is the Managing Director of M/s. ABC Ltd. and also BCD Ltd. PQR Ltd. decides to appoint him as the Managing Director of the company. State the legal requirements under the Companies Act, 1956 to give effect to the proposed appointment. Draft a resolution for the appointment of Mr. XYZ as the Managing Director of PQR Limited. (7 Marks)

Answer

- (a) Under Section 397 of the Companies Act, 1956 on an application by any member of a

company, the Company Law Board (Tribunal as per amended provision which has not come into force) is of the opinion that –

- (i) the company's affairs are being conducted in a manner which is prejudicial to public interest or in a manner oppressive to any member(s); and
- (ii) to wind up the company would unfairly prejudice such member(s), but that otherwise the facts justify winding up of the company on just and equitable ground,

The CLB may, with a view to bringing to and end the matters complained of, make such order as it thinks fit.

As per section 399, a member holding 10% shares is entitled to file such a petition.

In the present case, Mr. Akhlesh was holding 33% shares in the company which is nothing but a quasi partnership and was participating in the management. By further allotment of shares in a clandestine manner and without the consent of Mr. Akhlesh, his shareholding was reduced to 10% while the shareholding of his brothers stood at 90%. This is a serious act of oppression of Akhlesh, a minority shareholder. On similar facts, it was held by Supreme Court in *Dale & Carrington Inv. Private Ltd. Vs. P.K. Prathpan*, (2004) 122 Comp cases 175(SC) that assuming meetings of board of directors did take place, the manner in which the shares were issued in favour of R without informing other shareholders about it and without offering them to any other shareholder, was totally mala fide and the sole object of R in this was to gain control of the company by becoming a majority shareholder. This was clearly an act of oppression on the part of R. The only relief that has to be granted in the present case was to undo the advantage gained by R through his manipulation and fraud. The allotment of all the additional shares in favour of R had to be set aside.

Section 397 protects the rights of shareholders and not as a director. It has, however, been held by CLB in a number of cases that in a family company like the present one, removal of the promoter-director is also an act of oppression.

In the facts and circumstances of this case, Akhlesh is advised to file a petition under Section 397 of the Act. Being a 10% shareholder he is entitled to file the petition, before the Principal Bench of Company Law Board at New Delhi. He may seek the following reliefs:

- (i) the alleged allotment of further shares be declared null and void and set aside;
- (ii) the alleged removal of the petitioner, Mr. Akhlesh be declared as null and void and set aside;
- (iii) The Board of Directors be re-constituted with the petitioner and his two brothers and an independent person, as the Chairman of the board of directors to be appointed by the Company Law Board with casting vote;
- (iv) the petitioner may be appointed as Managing director of the company having substantial powers of management.

(b) As per section 316

- (a) A person can act a Managing Director in two or more than two companies provided none of those companies is a public company
- (b) a public company may appoint a person as its managing director, who is already a Managing Director or Manager in any other company (including a private company) only if such appointment is made by a unanimous resolution passed at a meeting of the board of which specific notice has been given to all directors then in India.
- (c) a person can be a Managing Director in more than two public companies only within the approval of the Central Government. Central Government may permit a person to be appointed as a Managing Director if it is satisfied that it is necessary that the company should have a common Managing Director for their proper working and function as a single unit.

So the PQR Ltd. can appoint Mr. XYZ as Managing Director of the company subject to approval of the Central Government.

Draft Resolution

“Resolved that subject to the approval of the Central Government under sub-section (4) of Section 316, Mr. XYZ who is already the Managing Director of two companies, namely M/s ABC Ltd. and M/s BCD Ltd., be and is hereby appointed as Managing Director of the company for a period of five years commencing from, with the consent of all the directors present at the meeting of which meeting and the resolution to be moved there at specific notice was given to all directors then in India, on the terms and conditions in the draft agreement tabled before the meeting and initialed by the Chairman for the purpose of identification and that SPM, the Secretary of the company be and hereby authorized to apply to the Central Government for seeking their approval.”

“Resolved further that Shir LMD, Director and Shri SPM, the Secretary of the company be and is hereby authorized to execute the said agreement subject to such modifications / alterations made by the Central Government while giving their approval and to affix the company seal of the company thereon”.

Question 8

- (a) The scheme of amalgamation was approved by overwhelming majority of the members of the merging companies, namely, ABC Ltd. and XYZ Ltd. at meetings called as per directors of the court. When the scheme of amalgamation was awaiting sanction of the court, the exchange ration was questioned by a small group of dissenting shareholders of ABC Ltd. The exchange ratio was fixed by a firm of reputed Chartered Accountants. Examine with reference to the court rulings, whether the dissenting shareholders will succeed. (8 Marks)
- (b) Premier Housing Finance Company Ltd. is prepared to give housing loans to the employees of Supreme Chemicals Ltd. subject to the condition that the loans are guaranteed by Supreme Chemicals Ltd. Supreme Chemicals Ltd. is not a listed company and the company will be exceeding the limits prescribed under the Companies Act, 1956

by providing such guarantee. The company desires to give the guarantee early as part of employees' welfare measure without waiting for the next annual general meeting, which is due only after eight months. Advise the company about the legal requirements under the Companies Act, 1956 to give effect to the above proposal. What would be your advice, if the company was required to provide security instead of guarantee? (7 Marks)

Answer

(a) Exchange Ratio

In this case, the exchange ratio was fixed by a reputed firm of Chartered Accountants and the scheme of amalgamation was approved by overwhelming majority of members of both the merging companies i.e., ABC Ltd. and XYZ Ltd.

Courts (now NCLT) leave the aspect of share valuation to the expert valuers and shareholders, unless the person who challenges the valuations satisfies the court that the valuation is grossly unfair, the court will not disturb the scheme (Piramal Spg. & Weaving Mills Ltd. in re (1980) 50 Comp. Cas. 514 (Bom)).

In *Micheer H. Mafatlal Vs. Mafatlal Industries Ltd.* ((1996) 87 Comp. Cas 792 (SC)) it was held that the Company Court exercises supervisory jurisdiction in sanctioning the scheme. It has no appellate jurisdiction over commercial window of majority of members of that class.

Further in *Kiritbhai Hirala & Patel Vs. Arvind Intex Ltd.* (2000) 28 SCL 130 (Guj), it was held that the High Court cannot exercise the jurisdiction of an appellate court and interfere with the wishes of the requisite number of shareholders only because valuation figure could have been different had another method of valuation was followed. However, the court should interfere, if it finds that the scheme approved by majority is unconscionable, unfair or illegal.

In view of the above court rulings, the dissenting shareholders are not likely to succeed unless they are able to satisfy the court that the valuation is grossly unfair especially when the exchange rates is fixed by a reputed firm of Chartered Accountants.

Section 394A of the Companies Act, 1956 requires the court to give notice of every application made to it under section 391 or 394 to the Central Government. The Court should take into consideration the representations, if any, made to it by that government before passing any order. The Court is, however, not bound to accept the views of the Central Government. Thus objection of the Central Government as regards valuation of shares was rejected by the court in the face of views explained by two independent chartered accountants (*M.G. Investments & Industrial Co. Ltd. Vs. New Sherrycle Spinning & Manufacturing Co. Ltd.*). Thus, unless the Central Government establishes that the exchange ratio was unfair or inequitable and not in public interest, the court will refuse to interfere.

(b) Guarantee to a body corporate

Supreme Chemicals Ltd. proposes to give guarantee to a body corporate and as such it attracts section 372 A of the Companies Act, 1956. Where the aggregate of bonus and

investments so far made the amounts for which guarantee or security so far provided along with the proposed investment guarantee etc. exceeds the limits prescribed under Section 372 A(i), such investments, guarantee etc. are required to be authorised by a special resolution passed in a general meeting. Only after the special resolution is so passed, such investments, etc. can be made [First proviso to Section 372 A(1)].

However the second proviso to Section 372 A(1) provides an exception in the case of guarantee. The Board may give guarantee without being previously authorized by a special resolution, subject to the following condition:

- (i) Unanimous resolution is passed in the meeting of the Board authorizing to give guarantee
- (ii) Obtaining shareholders previous approval by special resolution is prevented by exceptional circumstances. In this case there is an urgent necessity.
- (iii) The Board resolution for providing the guarantee is confirmed at a general meeting (annual or extraordinary) within 12 months from the date of the Board Meeting.
- (iv) The special resolution must specify the particulars prescribed in the 3rd proviso to Section 372 A(1) such as the Limit, particulars of the Company to which guarantee is proposed to be given, purpose of the proposed guarantee, and other relevant details.

Subject to this above conditions, Supreme Chemicals Ltd. may give guarantee to Premier Housing finance Co. Ltd. without obtaining previous approval of the shareholders by special resolution.

This exception is available in the case of guarantee only. The board cannot provide security unless it is previously authorized by a special resolution, as the prescribed limits are likely to be exceeded.

Question 9

- (a)
 - (i) Articles of Association of a listed company has fixed payment of sitting fee for each Meeting of Directors subject to maximum of Rs. 10,000. In view of increased responsibilities of independent directors of listed companies, the company proposes to increase the sitting fee to Rs. 25,000 per meeting. Advise the company about the requirement under Companies Act, 1956 to give effect this proposal.
 - (ii) Ram & Company was appointed as auditor of ABC Ltd. at the Annual General Meeting held on 30th September, 2004. Can Ram & Co. continue as auditor of the company in case the next annual general meeting has not been held in time ? What would be the position in case the next annual general meeting was held on 30th September, 2005, but adjourned without considering the business of appointment or re-appointment of auditor ? (8 Marks)
- (b) Explain the legal position in respect of the following with reference to the provisions of the Companies Act, 1956:
 - (i) XYZ Limited, having one Indian subsidiary company and an overseas subsidiary

company, attached to its Balance sheet documents mentioned under section 212 in respect of its Indian subsidiary company only.

- (ii) Statutory auditors of a public company did not verify the correctness of the particulars furnished in the Boards' Report in respect of certain employees under section 217(2A). (7 Marks)

Answer

- (a) (i) Under Section 310 of the Companies Act, 1956 approval of the Central Government shall not be required where sitting fee for each meeting of the Board of a Committee thereof does not exceed the prescribed sum under Rule 10-B of the Central Government's (General Rules & Forms, 1956) as under:

1.	Companies with paid up capital of Rs. 10 crores and above or turnover of Rs. 50 crores and above	Sitting fee not to exceed Rs. 20,000
2.	Other companies	Sitting fee not to exceed Rs. 10,000

Any increase in the sitting fee will require amendment of relevant provision of the Articles of Association. In the given case, the proposed sitting fee of Rs. 25,000 will require approval of the Central Government as the same exceeds the prescribed limits. The company can pay the sitting fee upto Rs. 20,000 depending upon the aforesaid parameters laid down in Rule 10-B.

- (ii) Tenure of auditor

The tenure of an auditor is laid down in section 224(1) of the Companies Act, 1956. It is from the conclusion of the annual general meeting to the conclusion of the next annual general meeting. Therefore, the tenure of office of the auditor does not expire on the last date on which the annual general meeting was due to be held in terms of Section 166. Hence Ram & Co. can continue as auditor even if the AGM for the year 2005 has not been held in time.

In case AGM for 2005 was held on 30.9.05 that adjourned without considering the business of appointment or reappointment of auditor, the tenure of Ram and Co. will extend till the conclusion of the adjourned meeting.

- (b) Section 212 of the Companies Act, 1956 does not make any distinction between an Indian subsidiary and an overseas subsidiary company. Under section 4(4), a company shall be deemed to be the holding company of another, if only that other is its subsidiary. Under Section 4(5), the expression 'Company' includes any body corporate and the definition of body corporate in Section 2(7) includes a company incorporated outside India. In view of this, the Indian holding company is legally bound to comply with the requirements in respect of both the Indian and foreign subsidiary companies. However, if there is any difficulty in complying with this requirement, the Board of Directors of XYZ Ltd. may apply to the Central Government under section 212(8) either to waive the

requirement or to modify the same. Hence, the company has violated the provisions of section 212.

Section 224 (2) stipulates that the auditor shall make a report on the accounts examined by him and on every balance sheet and profit and loss account and on every other document declared by the Companies Act to be part of or annexed to balance sheet or profit and loss account, which are laid before the company on general meeting during his tenure of office which the profit and loss account is annexed to the balance sheet, the Board's report is only attached to the balance sheet. Hence the auditor of the company is not required to verify the correctness of the particulars furnished in the Board's report in respect of certain employees.

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, specially the accounting standards. Questions requiring practical application of Accounting Standards and Guidance Notes in real life situations have not been answered well. It is also observed that the candidates neglect the theoretical aspects of the subject, they are advised to go through the study material carefully. A thorough practice and lots of reading of the subject is required to maintain the level of knowledge expected from the students of Final Level.

Specific Comments

Question 1. Valuation of goodwill: The answer to this question was not given satisfactorily by most of the candidates. The adjustments for additional information given in the question was not correctly carried out, thereby the average capital employed, future maintainable profits and goodwill were incorrectly worked out. Few candidates failed to understand the leverage effect.

Question 2. Corporate restructuring: The candidates have performed badly in this question. A large number of candidates considered the total value of shares of Y Ltd. for calculating purchase consideration instead of taking 40% of the share value. They did not take into account the value of investments in Y Ltd. while calculating the intrinsic value of shares of X Ltd. Consequently, the number of shares to be issued and the cash to be paid by X Ltd., goodwill and cash balance of X Ltd. after absorption of Y Ltd. was also calculated incorrectly. 10% reduction in the value of fixed assets was also not considered by some of them while computing goodwill.

Question 3. Problems based on practical application of Accounting Standards

(a) AS 11(Revised): Many candidates could not appreciate that the exchange difference at the close of the year should not be adjusted against the raw-materials. Otherwise the question was well answered.

(b) AS 2: This part of the question was well answered by majority of the candidates.

(c) AS 26: Candidates showed lack of knowledge of AS 26 'Accounting for Intangible Assets'. A large number of candidates wrongly opined that the advertisement expenses should be treated as deferred expenses.

(d) AS 4: 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 4.

Question 4.(a) EPS : The candidates have performed unsatisfactorily in this part of the question. The answers of the candidates showed lack of knowledge in this topic.

(b) Determination of maximum bid price: The performance of the candidates, in this part of

the question, was below average. The requirement of the question appeared to be not clear to most of the candidates. Barring few, no one could calculate the maximum bid price. Some of them understood maximum bid price as to mean the highest salary that could be offered.

(c) Calculation of EVA: The candidates exhibited poor knowledge on this topic. Except few, no candidate was able to give correct answer for this part of the question. Most of the candidates calculated the cost of equity capital but they failed to arrive at the debt cost after tax. Consequently, the calculation of EVA was wrong.

Question 5. (a) Computation of diluted earnings: This part of the question was satisfactorily answered by most of the candidates. However, some of them added interest on debentures instead of deducting it from net profit while calculating diluted earnings.

(b) Average capital employed: Most of the candidates calculated the capital employed on 31st March, 2006 correctly. But the calculation of average capital employed was wrong due to incorrect calculation of profit earned during the year. Many of them appeared to be ignorant that half of the profit earned during the year should be adjusted in the capital employed.

Question 6. Holding Company Accounts: Average performance of the candidates was reported by the examiners in this question. Candidates failed to calculate correctly the pre and post acquisition reserve, profit earned after acquisition, pre and post acquisition dividend, revaluation loss and excess depreciation charged. As a result, the computation of minority interest and capital reserve was also wrong. Some candidates erred in the treatment of mutual indebtedness. Most of the candidates did not present the consolidated balance sheet in the prescribed format.

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

General Comments

The overall performance of candidates was below average. Students lacked adequate preparation. Particularly they were not conversant with theoretical knowledge.

The performance of the candidates in both theory and practical questions was not up to the desired standard. Candidates seem to lack conceptual clarity, analytical ability and communication skills. Candidates did not follow logical and systematic approach for solving the questions. Question nos. were either not written or not written legibly. Answer to each question has not been commenced on a fresh page. Answer to different parts of one question has been written in different places along with answers to other questions.

Specific Comments

Question 1 (a) Many of the examinees were not able to complete the answer to this part of the question correctly. Most of them experienced difficulty in understanding the technicality in the question. Their answers exhibited lack of knowledge in respect of Analysis of Risk and uncertainty in Capital Budgeting. The overall performance of the examinees has been quite dismal.

(b) This part of the question was attempted by many candidates. Their answers however,

exhibited lack of knowledge of Re-financing in some cases. The overall performance was of average level.

Question 2 (a) The performance of the candidates was not satisfactory. Most of them generally calculated correctly market price per share at the end of period but failed to calculate value of the firm. Their answers exhibited lack of knowledge in respect of M.M. approach.

(b) Many candidates could not answer to this part of the question correctly. It appears that they lacked conceptual clarity in Mutual Fund, NAV and its return etc. The overall performance was very poor.

(c)&(d) These theory parts have been attempted fairly by majority. Most of them performed reasonably well.

Question 3 (a) Many examinees were not able to complete the answer to this part of the question correctly. They lacked knowledge in respect of Hedging - forward Contract Currency future etc. The overall performance of the examinees has been quite dismal.

(b) Most of the candidates could not properly answer to this part of the question. Their answers exhibited lack of knowledge of arbitrage possibility/Gain and Loss of Arbitrager. Some of the candidates have solved the problem correctly. However, the overall performance was not upto the mark.

(c) Only a few candidates answered to this part of the question correctly. Most of the candidates made errors in calculation of Risk adjusted dollar rate/Forward rate of exchange for different years. The overall performance was very poor.

Question 4 (a) Many candidates could not answer to this part of the question correctly. It appears that they lacked conceptual knowledge in respect of valuation of call option by application of Black and Scholes model. The performance of them has been quite dismal.

(b) Except few cases, answers were not appropriately organized. Most of answers exhibited lack of knowledge in respect of net exposure of foreign currency.

(c) Most of the candidates who attempted this part of the question have not been able to understand the question and failed to make out what is required in the question. They lacked conceptual knowledge of Portfolio Management.. Their performance was very poor.

Question 5 (a) Most of the candidates could not properly answer to this part of question. Their answers exhibited lack of knowledge in respect of valuation of business on the basis of average of NPV and Aggregate D.C. flows. Some of the candidates answered to this question correctly. However, overall performance was not up to the mark.

(b) This part of the question was well attempted by majority. Their performance was satisfactory.

(c) This theory part of the question has been attempted fairly by majority. Most of them performed reasonably well.

Question 6 (a) Most of the candidates could not properly answer to this part of question. Various kinds of systematic and unsystematic risk were not highlighted fully by most of the

candidates due to lack of proper conceptual knowledge.

(b) Except (iii) of this part of the question. Most of the candidates answered to the question correctly. Their performance was satisfactory.

(c) By and large answers were upto the mark and the candidates were aware of the concepts

(d) The answers of this part of the question were generally not appropriately organized. Most of answers lacked the qualities of presentation. Some of them were writing unnecessary and irrelevant details. The overall performance was poor.

PAPER – 3 :- ADVANCED AUDITING

General Comment

Performance of the Candidates, in general, was satisfactory. However in Q.3(b), 4, 5(a), 7(a)(i) and 8(b), their answers lacked the understanding of the question, its requirement and knowledge of the topics and relevant statute.

Specific Comments

Question1.(a) Generally well attempted by almost all the candidates.

(b) Poor Performance. Candidates in general attempted this part on imagination as if it relates to benefit of company worker or company can't give donation to a political party. Answer lacked the requirement and knowledge of Sec. 293-A.

(c) By and large satisfactory. However only few candidates have written about alternative treatment as deferred income.

(d) Average Performance. Most of the candidates failed to highlight the recourse available to the auditor in terms of AAS 4.

Question .2(a) Well answered and correct judgement of the case. Candidates in general provided good idea of the factors to be evaluated for analyzing the undercutting of fee.

(b) Average Performance. Most of the candidates just mentioned that misstatement should be disclosed separately but failed to highlight the materiality concept.

(c) Generally well answered by almost all the candidates.

(d) Well attempted by majority of the candidates.

Question 3. (a) Average Performance. Only few candidates correctly drafted the audit report. Most of the candidate just mentioned the reporting requirement. Few also highlighted the factors leading to disqualification of directors instead of drafting the report.

(b) Poor Performance. Most of the candidates presented the answer as benefit of computer audit programme and discussed about audit tools. Their answer lacked the understanding of the question.

Question 4. (a) Answered by few candidates with average performance. Most of the candidate just wrote about pollution by and in industry and ways to prevent it.

(b) Poor Performance. Most of the candidates failed to highlight the salient features of directions u/s 619(3). They gave just general answer on verification and vouching of the items.

Question 5. (a) Good Performance. However, most of the candidates mixed the correct answer with non-proprietary element under CARO, 2003.

(b) Average Performance. Most of the candidates failed to mention the important matter to be included in communication as required in the question and instead just highlighted the auditor's duty to communicate.

Question 6. Not attempted by many candidates. Average performance and those answered failed to cover the important areas to be covered in the scope of concurrent audit.

Question 7.(a) (i) Very poor performance. Almost all the candidate took it as a question on requirement u/s.224 & 225.

(a) (ii) Satisfactory performance. Candidates presented a good idea of both internal and external source of obtaining information.

(b) Average Performance. Most of the candidate answered this as non- compliance with true and fair view of the financial statement and accounting standards.

Question 8.(a) Fairly good answer by most of the candidate.

(b) Poorly answered by most of the candidate and their answer just mentioned the general power of auditor and failed to answer the matter to be enquired u/s. 73(2).

(c) Average performance. Answer lacked knowledge of method of calculating the solvency margin and Sec. 64(2C).

(d) Good performance.

(e) Good performance.

(f) Average performance. Many candidates mixed their answer with concept of internal and management audit.

PAPER – 4 : CORPORATE LAWS AND SECRETARIAL PRACTICE

General Comments

Question 1. The performance in general was 'average'. The following were the observations:

(a) Lack of knowledge of the English language.

(b) Lack of writing / drafting skills

(c) Lack of practical application of the sections and relevant case law wherever necessary

(d) Lack of update of the knowledge in the subject

(e) Adequate time should be devoted by the candidates in preparing for the examination.

Specific Comments

Question 1. In relation to question on Company Law, candidates did not refer to Section 309 of the Companies Act, 1956. Also answers did not reflect that the remuneration paid to Dr. Hamilton was not a managerial remuneration and further the requirement of obtaining opinion of the Central Government in rendering is professional service as a heart surgeon is advisable.

In relation to question on Securities Contracts (Regulations) Act, 1956, candidates did not write the conditions to be fulfilled by the stock exchange before issuing an order for delisting the shares of the company. In relation to the question on demutualisation and corporatisation, the specific powers which can be exercised by SEBI in accordance with Section 4(B)(6) and (8) and restrictions which can be imposed on the shareholders was not properly dealt with.

Question 2. Candidates in general, were not adequately prepared on the questions relating to Foreign Exchange Management Act, 1999.

In relation to questions on Competition Act, 2002 answers were generalised and candidates did not state the relevant provisions of the said Act (i.e., Section 15). Some of the candidates wrongly stated that shares before allotment were covered by the term 'goods'.

Question 3. Most of the candidates were not aware of the provisions in the SEBI Act, 1992 and the relevant SEBI (DIP) Guidelines 2000 dealing with price band in a book-building process. The question on the interpretation between Section 292 and 372A of the Companies Act, 1956 were not clearly and correctly brought out.

Question 4. Students lacked the drafting skills in respect of a resolution to be passed for removal of MD. The obligation on specified companies to appoint a Whole Time Company Secretary in accordance with Section 383A of the Companies Act, 1956 and penal consequences were not properly written.

Question 5. Section 297 read with Section 299 and 300 of the Companies Act were not stated by many candidates. Cases in which the interested director shall disclose his contract, the requirement of obtaining clear permission of the Central Government and exemptions under Section 297 were not stated. The meaning of the term 'Misfeasance' was not written correctly by most of the candidates and the scope of proceedings for such acts for misfeasance under Section 543 of the Companies Act was not known to many.

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Section 391, 394 and 394A) of the Companies Act, 1956.

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PAPER – 3 :- ADVANCED AUDITING

General Comment

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PAPER – 4 : CORPORATE LAWS AND SECRETARIAL PRACTICE

General Comments

Question 1. The performance in general was 'average'. The following were the observations:

(a) Lack of knowledge of the English language.

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PAPER – 5 : COST MANAGEMENT

Question No. 1 is compulsory.

Answer any four questions from the rest.

Working notes should form part of the answer.

Question 1

- (a) X Ltd. manufactures a semiconductor for which the cost and price structure is given below:

	Rs. per unit
Selling price	500
Direct material	150
Direct labour	100
Variable overhead	50
Fixed cost = Rs. 2 lakhs.	

The product is manufactured by a machine, whose spare part costing Rs. 2,000 needs replacement after every 100 pieces of output. This is in addition to the above costs. Assume that no defectives are produced and that the spare part is readily available in the market at all times at Rs. 2,000.

- (i) Prepare the profitability statement for production levels of 2,000 units and 3,000 units, when fixed cost = Rs. 1 lakhs.
 - (ii) What is the break-even point (BEP) for the above data?
 - (iii) Comment on the BEP, if the fixed cost can be reduced to Rs. 1,80,000 from the existing level of 2 lakhs.
- (b) Give two examples for each of the following categories in activity based costing:
- (i) Unit level activities
 - (ii) Batch level activities
 - (iii) Product level activities
 - (iv) Facility level activities.
- (c) Outline the features of penetration pricing strategy. (14 + 4 + 6 = 24 Marks)

Answer

(a) (i) X Ltd. Profitability Statement:

Particulars	Volume Level	
	2000 units	3000 units
		Rs.'000
Sales	1,000	1,500
Variable costs		
Direct Material	300	450
Direct Labour	200	300
Variable overhead	100	150
Part costs*	40	60
Fixed cost	100	100
Total cost	740	1,060
Profit	260	440

*Part cost: $\frac{2,000}{100} \times 2,000 = 40,000$ $\frac{3,000}{100} \times 2,000 = 60,000$

- (ii) For computing the BEP: Parts cost although a step fixed cost can be considered as variable for the limited purpose of computing the range in which BEP occurs. The variable parts cost per unit is Rs. 20 $\left(\frac{2,000}{100} \right)$

Range in which the BEP occur	$\frac{1,00,000}{(200 - 20)} = 555.55$	$\frac{2,00,000}{(200 - 20)} = 1,111.11$
Range	501–600	1,101–1,200
General Fixed Cost	Rs. 1,00,000*	Rs. 2,00,000
Parts cost	$(6 \times 2,000) = \text{Rs. } 12,000$	$(12 \times 2,000) = \text{Rs. } 24,000$
Total Fixed Cost	Rs. 1,12,000	Rs. 2,24,000
Gross Contribution/unit**	Rs. 200	Rs. 200
BEP	560 units	1,120 units

**Gross Contribution per unit

Sales – Direct Material – Direct Labour – Variable Overheads

Rs. 500 – Rs. 150 – Rs. 100 – Rs. 50 = Rs. 200

(iii) When fixed cost is Rs. 1,80,000. Range of BEP will be

$$\frac{1,80,000}{180} = 1,000 \text{ (901–1,000)}$$

Since the BEP of 1,000 falls on the upper most limits in the range 901 – 1,000 there will be one more BEP in the subsequent range in 1,001 – 1,100.

Range	901 – 1,000	1,001 – 1,100
	Rs.	Rs.
Gross fixed cost	1,80,000	1,80,000
Parts cost	20,000	22,000
	(10 × 2,000)	(11 × 2,000)
Total fixed cost	2,00,000	2,02,000
Gross contribution/unit	200	200
BEP	1,000 units	1,010 units

(b) Examples:

- | | |
|-----------------------------|--|
| (i) Unit level activities | <ul style="list-style-type: none"> (i) Use of indirect materials (ii) Inspection or testing of every item produced or say every 100th item produced (iii) Indirect consumables |
| (ii) Batch level activities | <ul style="list-style-type: none"> (i) Material ordering (ii) Machine set up costs (iii) Inspection of products – like first item of every batch |
| (iii) Product level | <ul style="list-style-type: none"> (i) Designing the product (ii) Producing parts to a certain specification (iii) Advertising costs, if advertisement is for individual products |
| (iv) Facility level | <ul style="list-style-type: none"> (i) Maintenance of buildings (ii) Plant security (iii) Production manager's salaries (iv) Advertising campaigns promoting the company |

(c) Penetration Pricing:

- (i) It is a policy of using a low price as the principal instrument for penetrating mass markets early.
- (ii) This method is used for pricing a new product and to popularize it initially.
- (iii) Profits may not be earned in the initial stages. However, prices may be increased as and when the product is established and its demand picks up.
- (iv) The low price policy is introduced for the sake of long term survival and profitability and hence it has to receive careful consideration before implementation. It needs an analysis of the scope for market expansion and hence considerable amount of research and forecasting are necessary before determining the price.
- (v) The circumstances in which penetrating pricing can be adopted are:

Elastic demand: The demand of the product is high when price is low. Hence, lower prices mean large volumes and hence more profits.

Mass Production: When there are substantial savings in large-scale production, increase in demand is sustained by the adoption of low pricing policy.

Frighten off competition: The prices fixed at a low-level acts as an entry barrier to the prospective competitors. The use of this policy by existing concerns will discourage the new concerns to enter the market. This pricing policy is also known as "stay-out-pricing".

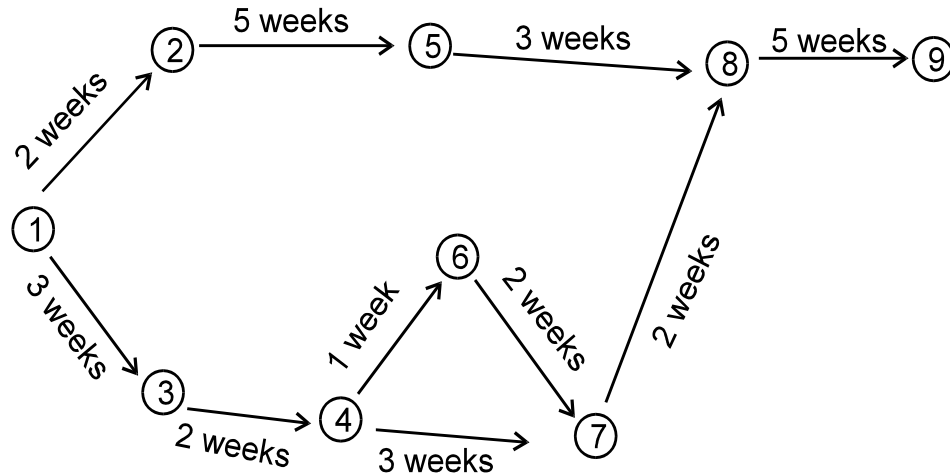
Question 2

- (a) A BPO company is taking bids for 4 routes in the city to ply pick-up and drop cabs. Four companies have made bids as detailed below:

Bids for Routes (Rs.)				
Company/Routes	R ₁	R ₂	R ₃	R ₄
C ₁	4,000	5,000	—	—
C ₂	—	4,000	—	4,000
C ₃	3,000	—	2,000	—
C ₄	—	—	4,000	5,000

Each bidder can be assigned only one route. Determine the minimum cost that the BPO should incur.

- (b) A network is given below:
- (i) Name the paths and give their total duration.
 - (ii) Give three different ways of reducing the project above duration by four days.



- (c) Division Z is a profit center which produces four products A, B, C and D. Each product is sold in the external market also. Data for the period is:

	A	B	C	D
Market price per unit (Rs.)	150	146	140	130
Variable cost of pdn. Per unit (Rs.)	130	100	90	85
Labour hours required per unit	3	4	2	3

Product D can be transferred to division Y, but the maximum quantity that may be required for transfer is 2,500 units of D.

The maximum sales in the external market are:

A	2,800 units
B	2,500 units
C	2,300 units
D	1,600 units

Division Y can purchase the same product at a price of Rs. 125 per unit from outside instead of receiving transfer of product D from Division Z.

What should be the transfer price for each unit for 2,500 units of D, if the total labour hours available in division Z are 20,000 hours? (6 + 6 + 7 = 19 Marks)

Answer

(a) Reducing minimum from each column element (figure in '000s)

Step 1					Step 2				
	R ₁	R ₂	R ₃	R ₄		R ₁	R ₂	R ₃	R ₄
C ₁	1	1	—	—	C ₁	0	0	—	—
C ₂	—	0	—	0	C ₂	—	0	—	0
C ₃	0	—	0	—	C ₃	0	—	0	—
C ₄	—	—	2	1	C ₄	—	—	1	0

Number of lines to connect all zeros nos. is 4 which is optional.

Alternatively you may also reduce the minimum from each row.

Step 1					Step 2				
	R ₁	R ₂	R ₃	R ₄		R ₁	R ₂	R ₃	R ₄
C ₁	0	1		—	C ₁	0	1	—	—
C ₂	—	0		0	C ₂	—	0	—	0
C ₃	1	—		0	C ₃	0	—	0	—
C ₄	—	—		0	C ₄	—	—	0	0

Number of lines to connect all zeros nos. is 4 which is optional.

All diagonal elements are zeros and are chosen. The minimum cost is Rs. 15,000 C₁ – R₁ 4,000; C₂ – R₂ 4,000; C₃ – R₃ 2,000; C₄ – R₄ 5,000; (Total) = 15,000.

(b) (i) Assuming that the duration of activity 3 – 5 is 4 weeks.

The various critical paths are:

1-2-5-8-9	15 weeks
1-3-4-7-8-9	15 weeks
1-3-4-6-7-8-9	15 weeks
1-3-5-8-9	15 weeks

(ii) Note: Since the duration for activity 3-5 is not specified it is open for you to assume the duration. Depending upon the duration assumed, three possibilities emerge.

1. If the duration assumed is more than 4 weeks then that path (13, 35, 58, 89) alone will be critical. In that case you can choose any of the activity in the critical path.
2. If the duration assumed is exactly 4 weeks then it will be one of the 4 critical paths and the various possibilities are given below.

3. If the duration assumed is less than 4 weeks then the solution should be based on 3 of the critical paths namely 12589, 1346789 and 134789. This has 16 combinations.

Reduce in the following ways, the project duration. Since all the paths are critical, reduction is possible by combining activities. The activities can be independent, common to few paths and common to all the paths. The various categories are as follows:

1. Common to all the paths. 8-9
2. Independent :

Combination	1.	1-2,3-5,4-6 and 4-7.
Combination	2.	2-5,3-5,4-6 and 4-7.
Combination	3.	1-2,3-5,4-7, 6-7.
Combination	4.	2-5,3-5,4-7, 6-7.
3. Activities common to two of the paths.

Combination	1.	1-2,1-3.
Combination	2.	1-3,2-5.
Combination	3.	3-4,5-8.
Combination	4.	5-8,7-8.
4. Activities common to two of the paths and two independent activities.

Combination	1.	1-2,3-4,3-5.
Combination	2.	1-2,3-5,7-8.
Combination	3.	2-5,3-4,3-5.
Combination	4.	2-5,3-5,7-8.
Combination	5.	4-6,4-7,5-8.
Combination	6.	4-7,5-8,6-7.

(Any three of the above combination.)

- (c) Ranking of products when availability of time is the key factor

Products	A	B	C	D
	Rs.	Rs.	Rs.	Rs.
Market price	150	146	140	130
Less: Variable cost	130	100	90	85
Contribution p.u. (Rs.)	20	46	50	45
Labour hours p.u.	3	4	2	3
Contribution/labour hour	6.66	11.5	25	15

Ranking	IV	III	I	II
Maximum demand (units)	2,800	2,500	2,300	1,600
Total No of hours	8,400	10,000	4,600	4,800
Allocation of 20,000 hours on the basis of ranking	600*	10,000	4,600	4,800

***Balancing figure**

Note: Time required meeting the demand of 2,500 units of product D for division Y is 7,500 hours. This requirement of time viz, 7,500 hours for providing 2,500 units of product D for division Y can be met by sacrificing 600 hours of Product A (200 units) and 6,900 hours of Product B (1,725 units)

Transfer Price = Variable cost + Opportunity cost

$$\text{Or } \frac{\text{Rs}85 + (\text{Rs}6,900 \times 11.5 + 600 \times 6.66)}{2,500} = \frac{\text{Rs}85 + (79350 + 4000)}{2500}$$

$$= \text{Rs } (85 + 33.34) = \text{Rs } 118.34$$

Question 3

- (a) A Multinational company runs a Public Medical Health Centre. For this purpose, it has hired a building at a rent of Rs. 10,000 per month with 5% of total taking. Health centre has three types of wards for its patients namely. General ward, Cottage ward and Deluxe ward. State the rent to be charged to each bed-day for different type of ward on the basis of the following informations:
- The number of beds of each type are General ward 100, Cottage ward 50, Deluxe ward 30.
 - The rent of Cottage ward bed is to be fixed at 2.5 times of the General ward bed and that of Deluxe ward bed as twice of the Cottage ward bed.
 - The occupancy of each type of ward is as follows:
General ward 100%, Cottage ward 80% and Deluxe ward 60%. But, in general ward there were occasions when beds are full, extra beds were hired at a charges of Rs. 20 per bed. The total hire charges for the extra beds incurred for the whole year amount to Rs. 12,000.
 - The Health Centre engaged a heart specialist from outside and on an average fees paid to him was Rs. 15,000 per trip. He makes three trips in the whole year.

(v) The other expenses for the year were as under:

	Rs.
Salary of Supervisors, Nurses, Ward boys	4,25,000
Repairs and maintenance	90,000
Salary of doctors	13,50,000
Food supplied to patients	40,000
Laundry charges for their bed linens	80,500
Medicines supplied	74,000
Cost of oxygen, X-ray etc. other than directly borne for	
Treatment of patients	49,500
General administration charges	63,000

(vi) Provide profit @ 20% on total taking.

(vii) The Health Centre imposes 8% service tax on rent received.

(viii) 360 days may be taken in a year.

(b) (i) What is simulation?

(ii) What are the steps in simulation?

(c) Briefly explain the learning curve ratio. (12 + 5 + 2 = 19 Marks)

Answer

(a) Statement of Total Cost

Total cost	Amount (Rs)	
Salary of Supervisor, Nurses, Ward boys	4,25,000	
Repairs and Maintenance	90,000	
Salary of doctors	13,50,000	
Food supplied to patients	40,000	
Laundry charges for their bed linens	80,500	
Medicines supplied	74,000	
Cost of oxygen, X ray etc, other than directly borne for treatment of patients	49,500	
General administration charges	63,000	Rs 21,72,000
Building rent	(10 × 12,000) =	Rs 1,20,000
Additional building rent on takings		5% on Total Taking

Hire charges extra beds		Rs 12,000
Fees to heart specialists	(3 × 15,000) =	Rs 45,000
Total cost		Rs 23,49,000 + 5% on Total Taking
Profit		20% on Total Taking
Total takings		Rs 23,49,000 + 25% of Total Taking
Total taking (assuming X to be the rent per day)		1,05,000 × X

Rent to be charged

$$1,05,000 \times X = 23,49,000 + 25\% (1,05,000 \times X) = 78750 X = 23,49,000 \text{ or } X = 29.83 \text{ (Rounded Off)}$$

No of beds with Equivalent Rent

Nature of wards	Occupancy	Weight of rent	Ward Days
General ward	100 × 360 × 100%	36,000 × 1	36,000
Additional general ward	<u>12,000</u> 20	600 × 1	600
Cottage ward	50 × 360 × 80%	14,400 × 2.5	36,000
Deluxe ward	30 × 360 × 60%	6,480 × 5	32,400
Total			1,05,000

Rent to be charged

Particulars	Basic	Service tax	Total
General ward	29.83	2.39	32.22
Cottage ward	74.58	5.97	80.55
Deluxe ward	149.15	11.93	161.08

Note : You may assume Total Taking to include Service Tax also.

$$\begin{aligned} \text{Rent} &= 23,49,000 + 25\% \times (1,05,000 X \times 1.08) + 0.08 \times (1,05,000 X) = 1,05,000 X \times 1.08 \\ &= 23,49,000 + 28350 X + 8400 X = 1,13,400 X \end{aligned}$$

Therefore X = Rs 30.65

Rent to be charged

Particulars	Basic	Service tax	Total
General ward	30.65	2.45	33.10
Cottage ward	76.63	6.13	82.76
Deluxe ward	153.25	12.26	165.51

- (b) (i) Simulation is a quantitative procedure which describes a process by developing a model of that process and then conducting a series of organized trial and error experiments to predict the behaviour of the process over time.
- (ii) Steps in the simulation process:
- Define the problem and system you intend to simulate.
 - Formulate the model you intend to use.
 - Test the model, compare with behaviour of the actual problem environment.
 - Identify and collect data to test the model.
 - Run the simulation.
 - Analyse the results of the simulation and, if desired, change the solution you are evaluating.
 - Rerun the simulation to tests the new solution.
 - Validate the simulation i.e., increase the chances of valid inferences.

(c) Learning curve ratio

In the initial stage of a new product/process, the learning effect pattern is so regular that the rate of decline established at the outset can be used to predict labour cost in advance.

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

For example, if the average labour cost for the 1st 500 units of a pelt is Rs. 25 and the average labour cost of the 1st 1,000 units is Rs. 20, then

$$\text{Learning curve ratio} = \frac{\text{Rs. 20}}{\text{Rs. 25}} \times 100 = 80\%$$

Question 4

- (a) A company following standard marginal costing system has the following interim trading statement for the quarter ending 30th June, 2005, which reveals a loss of Rs. 17,000,

detailed below:

		Rs.
Sales		4,99,200
Closing stock (at prime cost)		<u>18,000</u>
		5,17,200
Costs:		
Direct material	1,68,000	
Direct labour	1,05,000	
Variable overhead	<u>42,000</u>	
	3,15,000	
Fixed overhead	1,20,000	
Fixed Admn. Overhead	40,000	
Variable distribution Overhead	19,200	
Fixed selling Overhead	<u>40,000</u>	
	2,19,200	
Total costs		<u>5,34,000</u>
Loss		<u>17,000</u>

Additional information is as follows:

- (i) Sales for the quarter were 1,200 units. Production was 1,400 units, of which 100 units were scrapped after complete manufacture. The factory capacity is estimated at 2,000 units.
- (ii) Because of low production, labour efficiency during the quarter is estimated to be 20% below normal level.

You are required to analyse the above and report to the management giving the reasons for the loss.

- (b) List the steps involved in target costing process with the help of a block diagram.

(13 + 6 = 19 Marks)

Answer

(a)	Details	Working	Amount (Rs.)
		<u>4,99,200</u>	
(1)	Selling price at cost	1,200	416
		<u>1,48,000</u>	
(2)	Raw materials	1,400	120

	<u>1,05,000</u>	
Labour	<u>1,750</u>	60
[Equivalent units (1,400/80%)]		
Factory overhead	<u>42,000</u>	
	<u>1,400</u>	30
Total manufacturing cost		210
Distribution overheads	<u>19,200</u>	
	<u>1,200</u>	16
Total cost		226
Contribution		190
Total fixed cost: Factory	1,20,000	
Administration	40,000	
Selling	40,000	2,00,000

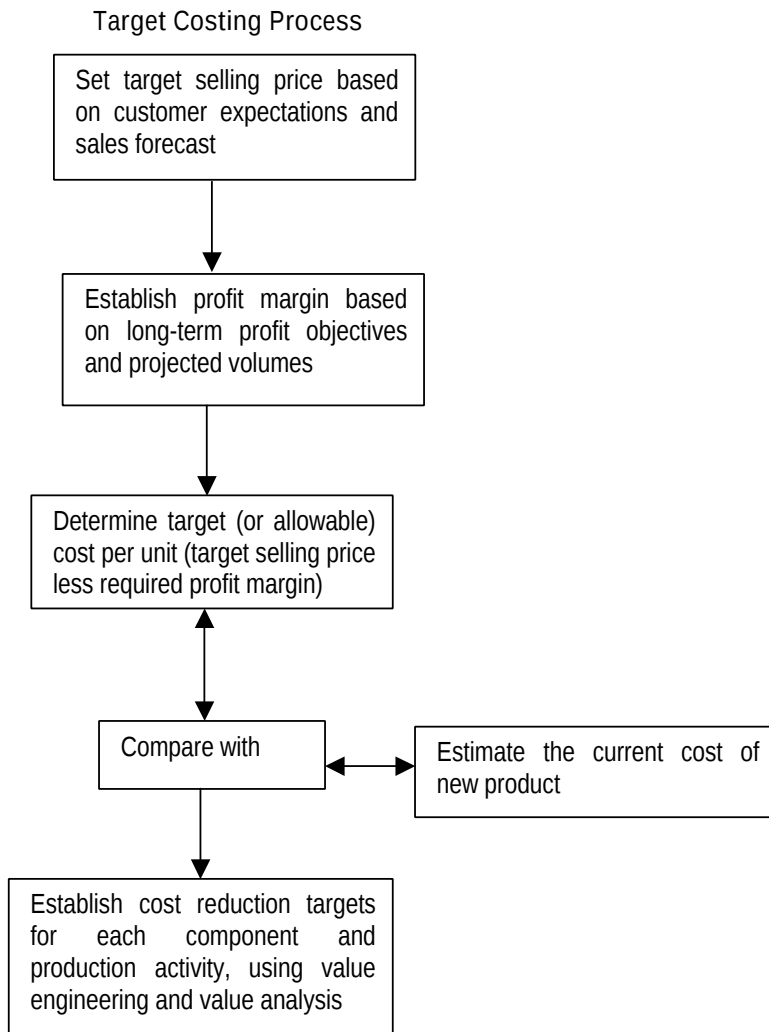
(ii) Standard Profit for 1,200 units sold:

	Rs.	Rs.
Contribution	$1,200 \times 190$	2,28,000
Less: Fixed costs		<u>2,00,000</u>
Profit		<u>28,000</u>

(iii) Reconciliation

	Rs.	Rs.
Budgeted profit	$(2,000 \times 190 - 2,00,000)$	1,80,000
Less: Volume variance	800×190	1,62,000
Standard profit		28,000
Factors causing loss:		
Units scrapped	100×210	21,000
Labour inefficiency	350×60	21,000
Undervaluation of closing stock	$100 \times (210 - 180)$	3,000
Actual profit		<u>-17,000</u>

(b)

**Question 5**

- (a) (i) What do you mean by ERP?
(ii) Name six benefits of ERP in an enterprise.
- (b) A project consists of seven activities for which relevant data are given below:
(i) Draw the network

(ii) Name and highlight the critical path.

Activity	Preceding activity	Activity duration (days)
A	—	4
B	—	7
C	—	6
D	A, B	5
E	A, B	7
F	C, D, E	6
G	C, D, E	5

- (c) A Ltd. makes 2 products, Tables (T) and Chairs (C), which must be processed through Assembly (A) and Finishing (F) departments. Assembly has 60 hours available per week; finishing can handle upto 48 hours a week.

Manufacture of one table requires 4 hours of assembly and 2 hours in finishing. Each chair requires 2 hours in assembly and 4 hours in finishing.

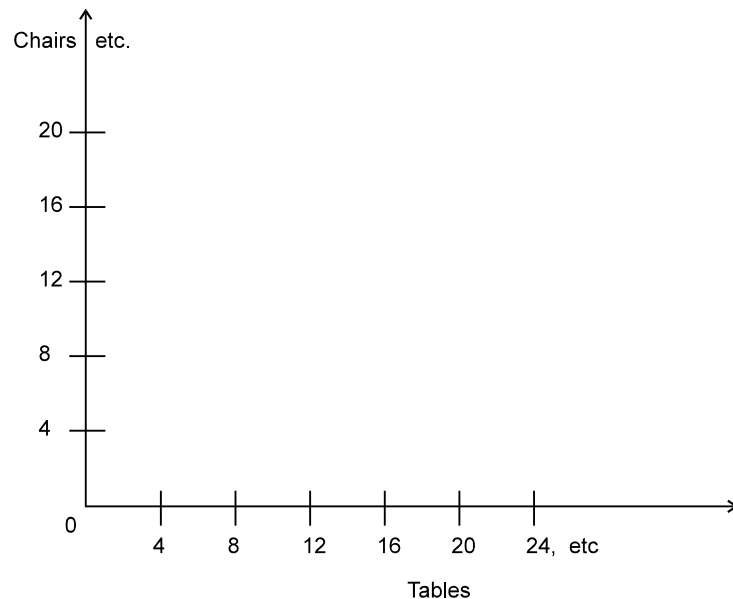
Profit is Rs. 80 per table and Rs. 60 per chair. Choose the best combination of chairs and tables to be produced to maximize profit.

(i) Formulate the Linear Programming model equations.

(ii) Present graphically.

(iii) What is the maximum profit?

Use the graph provided as follows:

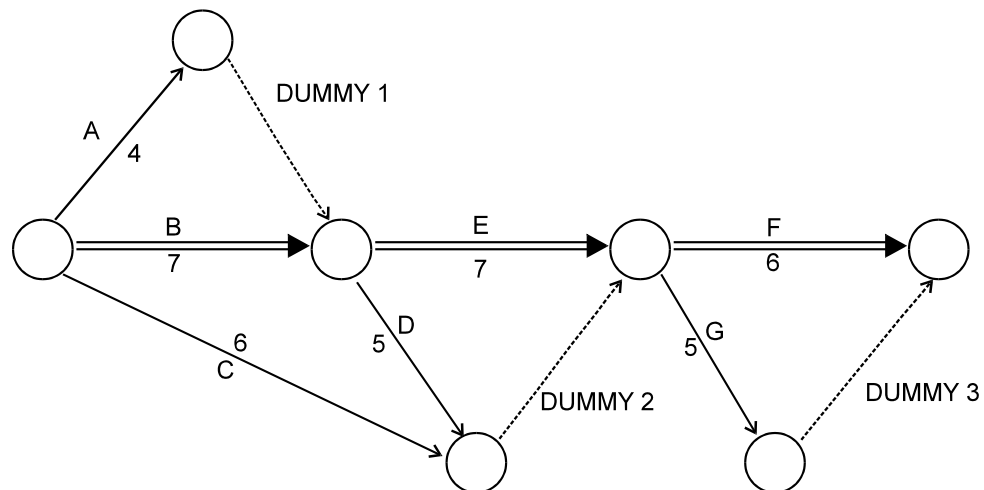


(5 + 6 + 8 = 19 Marks)

Answer

- (a) (i) Enterprise resource planning (ERP) software (i) attempts to integrate all departments and functions across a company into a single computer system that can serve all those different departments' particular needs. In fact ERP combines all computerized departments together with the help of a single integrated software that runs off a single database so that various departments can more easily share information and communicate with each other
- (ii) Benefits of ERP
- (a) Product costing.
 - (b) Inventory management.
 - (c) Distribution and delivery.
 - (d) E-commerce.
 - (e) Automatic control of quality.
 - (f) Sales service.
 - (g) Improved production planning.
 - (h) Quick response to change in market condition.
 - (i) Competitive edge by improving business process.

(b)



Critical path : B,E,F = $7+7+6 = 20$ days

- (c) Let T be the number of tables and C be the number of chairs produced. We have

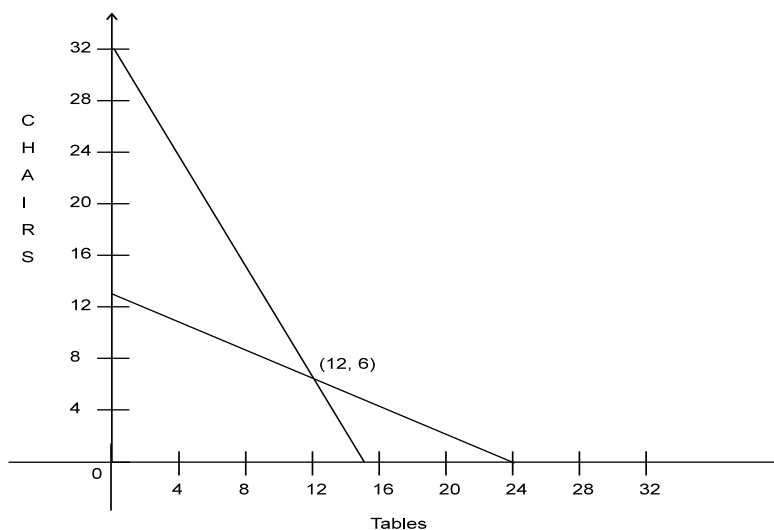
$$\text{Maximum profit} = 80T + 60C$$

Subject to Constraints:

$$4T + 2C \leq 60 \quad (1)$$

$$2T + 4C \leq 48 \quad (2)$$

$$T \geq 0, C \geq 0$$



Corner points within the feasible region:

1. $(0,0) = \text{Rs } 0$
2. $(16,0) = 16 \times 80 = \text{Rs } 1,280$
3. $(12,6) = 12 \times 80 + 6 \times 60 = \text{Rs } 1,320$
4. $(0,12) = 12 \times 60 = \text{Rs } 720$

Maximum profit at 12 Tables and 6 Chairs . Maximum profit = Rs 1,320

Question 6

- (a) The following figures are available. Find out the missing figures, giving appropriate formulae:

	Rs.
Budgeted profit	15,000
Less: Adverse variances:	
Contribution price variance	10,600

Direct materials variance	1,000	
Fixed overhead variance	<u>600</u>	<u>(12,200)</u>
		2,800
Add: Favourable variances		
Contribution quantity variance	1,800	
Direct wages variance	600	
Variable overhead variance	<u>1,800</u>	<u>4,200</u>
Actual profit		<u>7,000</u>

There is no inventory

Production units = Sales units for both actual and budget.

Other Information

Standard selling price	Rs. 18/unit
Standard variable cost	Rs. 15/unit
Standard contribution	Rs. 3/unit
Actual selling price	Rs. 17/unit
Budgeted sales	10,000 units

Standard material cost p.u. = Re. 1 (which is 5 kg. @ Rs. 20 Paise/kg.).

Material usage variance = 400 (Adv.)

Actual labour hours @ actual rate = Rs. 63,000

Actual labour hours @ standard rate = Rs. 61,950

Variable overhead standard rate = Rs. 2

Standard hours of production = 4 per unit

Variable overhead at standard rate = Rs. 84,800.

Variable overhead expenditure variance = 400 (A).

Budgeted fixed overhead = Rs. 15,000.

Find out the following:

- (i) Actual sales units
- (ii) Actual sales rupees
- (iii) Actual quantity of raw materials used
- (iv) Labour efficiency variance
- (v) Actual variable overhead in rupees
- (vi) Variable overhead efficiency variance

- (vii) Actual fixed overheads
 (viii) Operating profit variance.
- (b) Under the single plan, record the journal entries giving appropriate narration, with indication of amounts of debits or credits alongside the entries, for the following transactions using the respective control A/c.
- (i) Material price variance (on purchase of materials)
 (ii) Material usage variance (on consumption)
 (iii) Labour rate variance.
- (c) Explain with a diagram the value chain activities within the firm with suitable classifications under primary and support activities and also the industry value chain indicating what the end use consumer pays for. (8 + 6 + 5 = 19 Marks)

Answer

(a)	Rs.	Rs
(1)	Budgeted contribution = Budgeted Profit + Budgeted Fixed Cost	15,000 + 15,000 = 30,000
	Plus Contribution quantity variance	1,800
	Total Standard contribution	31,800
	Standard Contribution per unit	3
	Actual Sales Volume	10,600 units
(2)	Actual Sales Volume 10,600 × 17	1,80,200
(3)	Actual quantity of Raw Materials used	
	Standard consumption 10,600 × 5	53,000 Kgs.
	Add: Material Usage Variance $\frac{400}{.2}$	2,000 kgs.
	Actual consumption	55,000 Kgs.
(4)	Labour Efficiency variance	
	Standard labour cost for Standard hours (63,000 + 600)	63,600
	Standard labour cost for actual hours	61,950
	Labour efficiency variance	1,650 F
(5)	Actual variable overhead	
	Selling Overhead variance – Variable overhead	Rs. 84,800 – Rs. 1,800 = Rs. 83,000

- (6) Variable Overhead efficiency variance

Actual hours (AH)	<u>61,950</u>	
	1.5	41,300 hours
Standard hours (SH)	$60,600 \times 4$	42,400 hours
Standard rate per hour (SR)	<u>63,600</u>	
	$10,600 \times 4$	Rs. 1.5

Efficiency variance SR (SH – AH) = 2 (42,400 – 41,300) = 2,200F

- (7) Actual fixed overheads: Budgeted Overhead + Fixed Overhead variance
-
- = 15,000 + 600 = Rs. 15,600.

- (8) Operating profit variance

If budgeted profit is considered (15,000 – 7,000) = Rs. 8,000 adverse

If standard profit is considered (16,800 – 7,000) = Rs. 9,800 adverse

(b)

- (i) Dr. Material Control A/c

Dr. or Cr. Material Price Variance A/c

Cr. Creditors A/c

(Being price variance during purchase of materials)

- (ii) Dr. WIP Control A/c

Dr. or Cr. Material Usage Variance A/c

Cr. Material Control A/c

(Being recording of usage variance at Standard cost of excess/under utilized quantity)

- (iii) Dr. Wages Control A/c

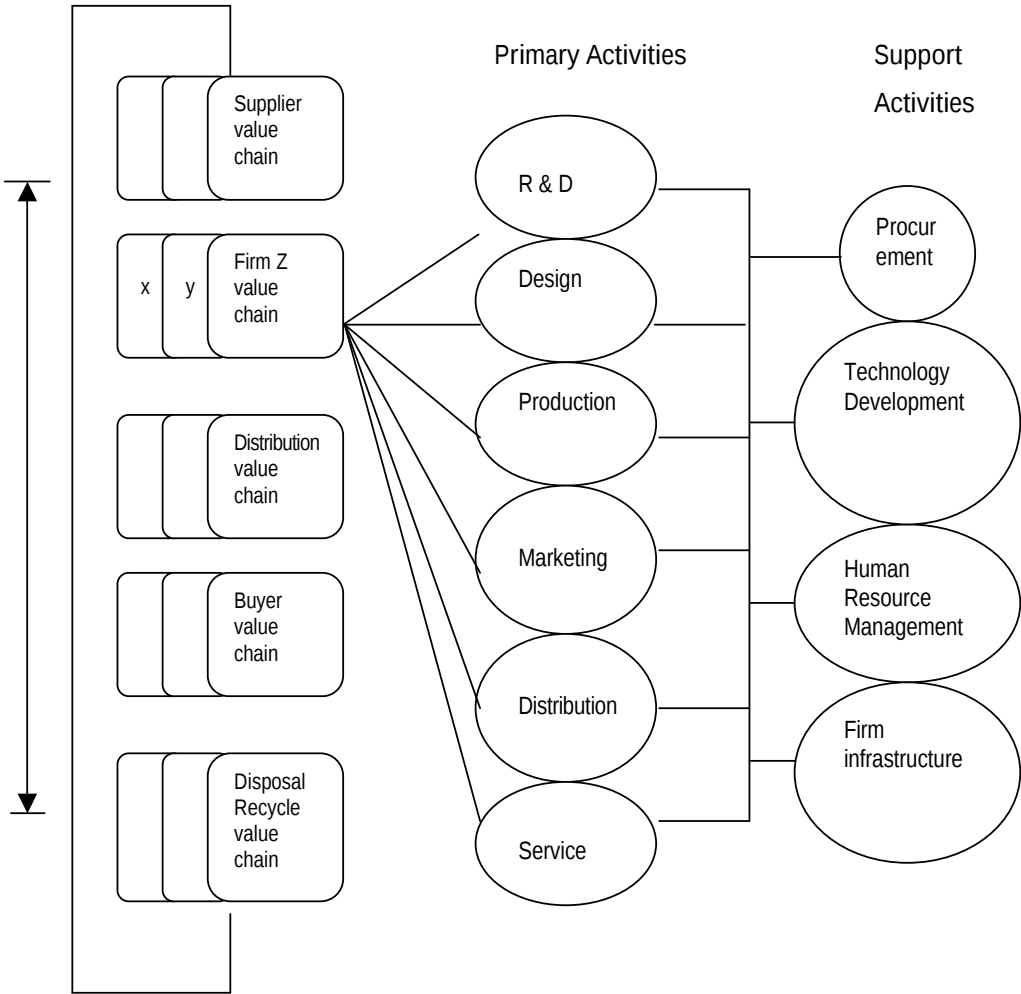
Dr. or Cr. Labour Rate Variance A/c

Cr. Cash

(Being entry to record wages at standard rate)

(c) Industry Value Chain

Value Chain Activities
within the firm



PAPER – 6 : MANAGEMENT INFORMATION AND CONTROL SYSTEMS

Question No. 1 is compulsory.

Answer any four questions from remaining six questions.

Question 1

- (a) Why Computerised Information systems are more vulnerable to many more kinds of threats than manual systems? Name some of the key areas where large amounts of data stored in electronic form are most vulnerable.
- (b) Discuss some common types of field interrogation as a validation control procedure in an EDP set up.
- (c) Differentiate between General and Application controls. Also mention the broad categories into which the first can be subdivided.
- (d) How does MIS auditing enhance the control process? (5 + 5 + 5 + 5 = 20 Marks)

Answer

- (a) When large amounts of data are stored in electronic form they are vulnerable to many more kinds of threats than when they exist in manual form. Since the data is in electronic form and many procedures are invisible through automation, Computerized Information Systems (CIS) are vulnerable to destruction, misuse, error, fraud, hardware and software failures. Online systems and those utilizing the Internet are especially vulnerable because data and files can be immediately and directly accessed through computer terminals at many points in the network. Hackers can penetrate corporate networks and cause serious system disruptions. Computer viruses can spread rampantly from system to system, clogging computer memory or destroying programs and data. Software presents problems because of high costs of correcting errors and because software bugs may be impossible to eliminate. Data quality can also severely impact system quality and performance.

Following are the key areas due to which data stored in electronic form are most vulnerable:

- | | |
|---|---------------------------------|
| (1) Hardware failure, | (2) Software failure, |
| (3) Personnel actions, | (4) Terminal access penetration |
| (5) Theft of data, services, equipment, | (6) Fire |
| (7) Electrical problems, | (8) User errors |
| (9) Program changes, | (10) Telecommunication problems |
- (b) Some common types of field interrogation as a validation control procedure in an EDP set up are discussed below:
 - (1) Limit Checks: The field is checked by the program to ensure that its value lies within certain predefined limits.

- (2) Picture checks: These check against entry of incorrect characters into processing.
 - (3) Valid Code Checks: Checks are made against predetermined transactions codes, tables or other data to ensure that input data are valid. They may either be embedded in the programs or stored in files.
 - (4) Check digit: It is an extra digit that is added to the code when it is originally assigned. It allows the integrity of the code to be established during subsequent processing.
 - (5) Arithmetic Checks: Arithmetic is performed in different ways to validate the result of other computations of the values of selected data fields.
 - (6) Cross Checks: It may be employed to verify fields appearing in different files to check that the results tally.
- (c) General controls apply to a wide range of exposures that systematically threaten the integrity of all applications processed within CBIS environment. Application controls are focused on exposures associated with specific systems such as payroll, accounts receivable etc. These controls help to ensure the completeness and accuracy of transaction processing, authorization, and validity.

General controls can be subdivided under following headings:

- (1) Operating system controls
 - (2) Data managements Controls
 - (3) Organizational structure controls
 - (4) Systems development controls
 - (5) Systems maintenance controls
 - (6) Computer Centre security controls
 - (7) Internet and intranet controls
 - (8) Personal computers control.
- (d) Comprehensive and systematic MIS auditing can help organizations to determine the effectiveness of the controls in their information systems. Regular data quality audits should be conducted to help organizations ensure a high level of completeness and accuracy of the data stored in their systems. Data cleansing should also be performed to create consistent and accurate data for company wide use in e-commerce and e-business.

An MIS audit identifies all of the controls that govern individual information systems and assesses their effectiveness. To accomplish this, the auditors must acquire a thorough understanding of operations, physical facilities, telecommunications, control system, data security objectives, organizational structure, manual procedures and individual applications.

The auditor usually interviews key individuals who use and operate specific information system concerning their activities and procedures. Applications controls, overall integrity controls and control discipline are examined. The auditor should trace the flow of sample transactions through the system and perform tests using, if appropriate, automated audit software.

The auditor lists and ranks all control weaknesses and estimates the probability of their occurrences. He then assesses the financial and organisational impact of each threat. Management is expected to device a plan for countering significant weaknesses in controls.

Question 2

- (a) State the factors to be considered for designing an effective Management Information System.
- (b) Enumerate various information which are required for sales support and sales analysis.

(10 + 10 = 20 Marks)

Answer

- (a) The following factors should be considered for designing an effective MIS:
 1. Management Oriented: The development of Management Information system should start from assessment of management needs and overall business objectives. Such system does not only take care of the information requirements of the top management but it also caters to the information needs of the middle and operating levels of management.
 2. Management Directed: As MIS is oriented towards the information needs of the management; it is essential that management should direct the development efforts of such systems on an on-going basis. Management should devote sufficient time not only at the stage of conceptualization and designing, but also for the regular reviews of its effectiveness. In short, management should play the key role in setting the system specifications as well as subsequent trade-off occurring in system development.
 3. Integrated: All functional and operational information sub-systems should be integrated into one entity. Such Information system has the potential of generating meaningful and comprehensive information to management.
 4. Common Data flows: For such integrated information system, data is captured only once and as close to its original generating source as possible. This eliminates duplication in data collection, documents and procedures. It also simplifies operations and produces an efficient and effective information system. However, the duplication cannot be avoided to some extent in order to ensure such system.
 5. Meticulous Planning: It takes 3 to 5 years, sometimes even longer period, to get the MIS system established firmly in an organization. Therefore, there should be meticulous planning in designing and development of MIS system. It should be

designed considering the future objectives and information needs of the organization. The system obsolescence should be avoided before it becomes operational.

6. Sub Systems approach: Although MIS is considered to be a single entity, it is broken into various sub systems so that it can be implemented one at a time by developing the systems in phases. This ensures meaningful and effective implementation of information systems.
7. Common Database: The common database holds all functional systems together, consolidates and integrates data of all functional systems. The access to this database is allowed to the users of sub systems on need-to-know and need-to-do basis. It eliminates duplication in data storage, updating and protection as well as optimizes the cost of data storage and management.
8. Computerized: MIS can be established using a manual system. Use of computers increases the effectiveness of the system. In fact, it equips the information system to handle variety of applications by catering quickly to their information requirements.

While designing an MIS, it should also be considered that computerization has following effects on management Information Systems:

- (1) High speed of data processing and retrieval.
- (2) Expanded scope of use of Information system.
- (3) Wide scope analysis.
- (4) Increased complexity of system design and operations.
- (5) Integrated functioning of various information sub-systems.
- (6) Enhanced effectiveness of Information Systems.
- (7) Comprehensive Information.

(b) Information requirements for sales support and sales analysis are enumerated below:

- (i) Sales support: A specialized sales support information system must provide the following information to sales personnel:
 - Products descriptions and performance specifications.
 - Product Prices.
 - Quantity discounts and other product discount information.
 - Sales incentives for salespersons.
 - Sales promotions.
 - Financing plans for customers.
 - The strengths and weaknesses of competitors' products.
 - The histories of customers ' relations with the company.

- Sales policies and procedures established by the company.
- Products that have not yet been introduced.
- Products' inventory levels.
- Buying habits of consumers.

These and other information come from a variety of sources. Product performance specifications, for example, may come from the engineering department.

(ii) Sales Analysis:

To keep abreast with the competitors in the market, the sales analysis is a very vital activity. It must provide the following information:

- Sales trends (product-wise)
- Product wise profitability
- Region, branch wise sales performance
- Sales person wise performance

The above information is derived from Sales Transaction Processing System as well as from other systems like Financial Accounting System and HR Management System etc. The majority of information comes from actual sales transactions and is contained on sales invoices. To fully support the sales analysis system, invoices should contain information about product type, product quality, price discount terms, customer identity and type, sales region, and salesperson.

Information from other sources should also be included in the sales reports. Specifically, the sales reports must contain information about the profitability of products, product lines, sales territories, and individual sales persons. Profitability reporting requires information about product administrative and selling costs.

Question 3

- (a) What are the project management items associated with an I.T. project system failures? Give the elements to be included in the adopted framework to avoid such failures.
- (b) Discuss some of the commonly used coding schemes.
- (c) Describe Bench marking problem on vendor's proposal. (10 + 5 + 5 = 20 Marks)

Answer

- (a) Items associated with IT project system failure are as follows:
 - (i) Underestimation of the time to complete the project.
 - (ii) Senior management did not monitor the project closely enough.
 - (iii) Underestimation of necessary resources.
 - (iv) Size and scope of the project underestimated.
 - (v) Inadequate project control mechanism.

(vi) Systems specifications kept changing.

(vii) Inadequate planning.

Elements to be included in the framework to avoid such failures are as stated below:

(i) User participation in defining and authorizing the system.

(ii) Assignment of appropriate staff to the system development and definition of their responsibilities and authorities.

(iii) A clear written statement of system nature and scope.

(iv) A feasibility study that is the basis of senior management approval to proceed with the system.

(v) A system master plan, including realistic time and cost estimates for control of the system.

(vi) A risk management program to identify and manage risks associated with each project.

(vii) Division of the system into manageable processes often called phases.

(viii) Approval of work accomplished in one phase before working on the next phase.

(ix) Integration of the quality assurance plan including the systems development cycle (SDLC) methodology with the system master plan.

Project management, particularly the planning process and establishing the project schedule can ultimately determine the success of the project.

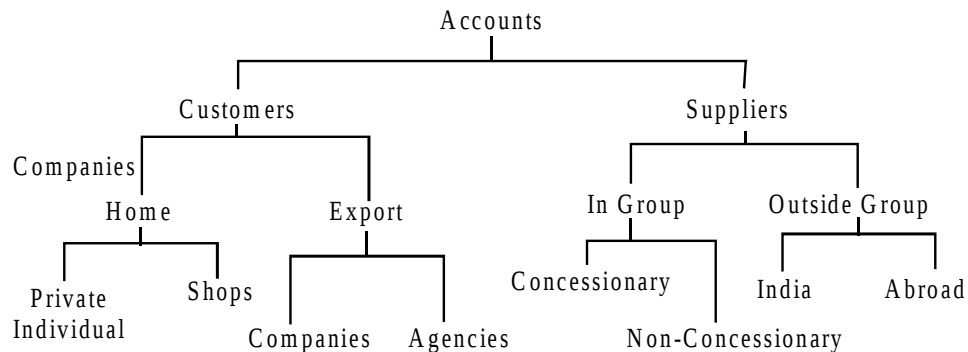
(b) Some of the commonly used coding schemes are discussed below:

(1) Classification codes: They place separate entities such as events, people or objects into distinct groups called classes. A code is used to distinguish one class from another. The code is recorded on the source document by the user. In an online system, it can be keyed directly in the system through a terminal. The user classifies the event into one of the several categories and records the code. Classification codes vastly simplify the input process because only a single digit code is required.

(2) Function Codes: These codes state the activities or work to be performed without spelling out all the details in narrative statements. Analysts use this type of codes frequently.

(3) Significant digit Subset Codes: Suppose item numbers are to be assigned to the different materials and products that a firm stocks or sells. Then numbers are assigned in sequence from the first to the last or a prefix can be added to the identification numbers. Codes can be divided into subsets or sub codes, characters that are part of the identification number and that have special meaning. Using digits in an identification number to convert additional information does not add to the length of the data but provides invaluable information to the management.

- (4) Mnemonic Codes: These are suitable where the codes have to be remembered by the people.
- (5) Hierarchical Classification:



This classification can be developed for use in almost any business and for all kinds of office records.

- (c) Bench Marking Problem: Benchmarking problems for vendors' proposals are sample programs that represent at least a part of the buyer's primary computer work load. They include software considerations and can be current applications programs or new programs that have been designed to represent planned processing needs i.e., benchmarking problems are oriented towards testing whether a computer offered by the vendor meets the requirements of the job on hand of the buyer. They are required to be representative of the job mix of the buyer. Obviously, benchmarking problems can be applied only if job mix has been clearly specified. The benchmarking problems, would then comprise long jobs, short jobs, tape jobs, disk jobs, mathematical problems, input and output loads etc, in proportion typical of the job mix. If the job is truly represented by the selected benchmarking problems, then this approach can provide a realistic and tangible basis for comparing all vendors' proposals. Tests should enable buyer to effectively evaluate cross performance of various systems in terms of hardware performance (CPU and input/output units), compiler language and operating system capabilities, diagnostic messages, ability to deal with certain types of data structures and effectiveness of software utilities.

Bench marking problems, however, suffer from a couple of disadvantages. It takes considerable time and effort to select problems representative of the job mix which itself must be precisely defined. It also requires the existence of operational hardware, software and services of systems. Nevertheless, this approach is very popular because it can test the functioning of vendor's proposal. The manager can extrapolate in the light of

the results of bench marking problems, the performance of the vendors' proposals on the entire job mix.

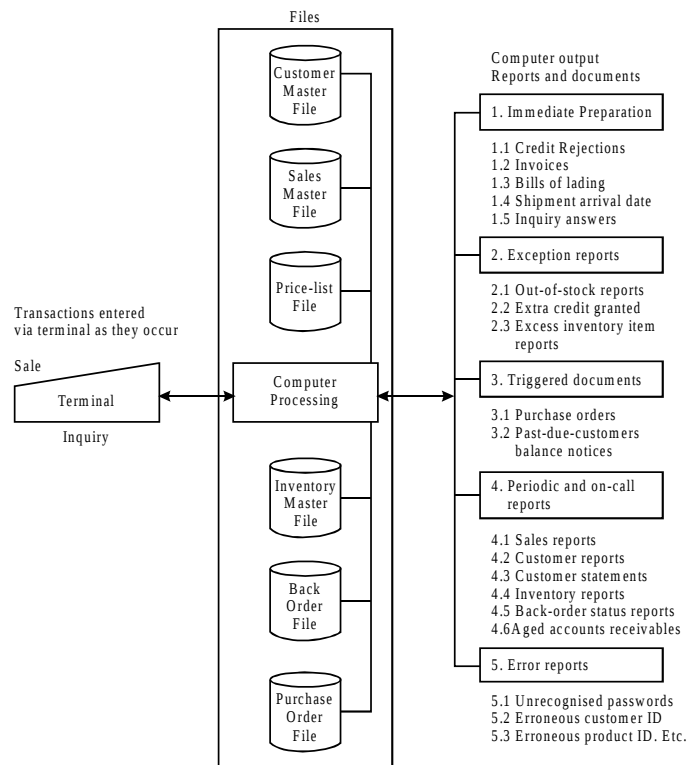
Question 4

- Describe the sequence of events which occur immediately for each transaction when controlled by the sales order entry computer programs in an OLRT system.
- Why is personnel training important? What type of training should be imparted to users?
- How can computer fraud be committed using input in four different ways?

(10 + 5 + 5 = 20 Marks)

Answer

- Sales order processing system: Controlled by the sales order entry computer programs in an OLRT systems, the following events occur immediately for each transaction in the sequence given below :



- The sales person tells the computer the nature of the transaction by entering a transaction code identifying it as a credit sales transaction; this activates the sales

order processing computer program. The customer number, the item number and quantity are then entered.

2. The computer program checks the customer's account in the customer file to "validate" the customer number (to establish that a credit customer exists with that number) and to see how much additional credit the customer can be granted; the up-to-date credit status of the customer is contained in the customer's account. If the customer cannot be extended further credit, the salesperson is notified by the computer and the credit transaction is cancelled.
3. The product number of the product ordered is checked for validity in the inventory file, and the stock level of that item shown by the inventory file is compared with the number of items ordered. If there is an insufficient quantity of a product, the program examines the purchasing file to establish when the next shipment is due. The system conveys this information to the terminal of the salesperson and awaits further instructions. The salesperson consults with the customer and then cancels the order for that item or changes the order to the quantity available and back-orders the additional items desired, according to the customer's wishes.
4. The computer program then seeks product pricing and quantity discount information from the price list file and special "preferred customer" discount information, if any, from the customer file. The total cost of the item to the customer including tax is calculated by the computer.
5. The details of the transaction, including the cost details, may appear on a display device at the salesperson's terminal so that they can be told to the customer. Changes may be made in the order by the customer and entered into the computer. The salesperson signals the computer when the customer approves the transaction.
6. An invoice is printed out for mailing, either at the salesperson's terminal or on a printer at a central location.
7. On a printer at the warehouse location of the merchandise, the computer system prepares a multipart-shipping document, which is the authorisation for shipping personnel to select, pack, and ship the merchandise ordered. One copy of the document, known as the "bill of lading" is enclosed and shipped with the merchandise.
8. Product records in the inventory file are adjusted to reflect the decrease in inventory caused by the sale.
9. The customer's account is updated to reflect the details of the transaction, and a new customer balance is calculated and placed in the account.
10. The record for each item in the sales file is updated with details of the transaction. This updating may include all details necessary for sales analysis based on customer type and territory, as well as other factors. A separate transaction listing that records all details of the entire transaction in one transaction file (not shown) may also be made for control and backup purpose.

- (b) Personnel training: A system can succeed or fail depending on the way it is operated and used. The quality of training received by the personnel involved with the system in various capacities helps or hinders the successful implementation of information system. Thus, training is a major component of systems implementation.

When a new system is acquired which often involves new hardware and software, some type of training is needed. Users must be instructed first how to operate the equipment. The training must also instruct individuals involved in trouble shooting of the system, determining whether the problem is caused by the equipment or software or by something they have done in using the system. Training in data coding emphasizes the methods to be followed in capturing data from transactions or preparing data for decision support activities. Users should be trained on data handling activities such as editing data, formulating inquiries and deleting records of data. They will have to prepare disks, load paper into printers or change ribbons on printers, format and test the disk.

- (c) The simplest and most common way to commit a fraud is to alter computer input. In collusive fraud, one perpetrator, for example, opened an account at a bank and then prepared blank deposit slip. The slips were similar to those available in bank lobby, with his account number encoded. One morning he replaced all the deposit slips in the bank lobby with his forged ones. For three days all bank deposits using the forged slips went directly into his account. Then he withdrew the money and disappeared.

In disbursement frauds, the perpetrator can cause a company to either pay too much for ordered goods or to pay for goods that are never ordered. He may keep the amount low enough so that most companies may not bother for purchase orders or approvals for such small amounts.

To commit payroll frauds, perpetrator can enter data to increase that salary, create a fictitious employee or retain a terminated employee on records and proceeds to intercept and cash the illegal cheques.

In a cash receipt fraud, the perpetrator may hide the theft by falsifying system input e.g. he may sell full-price tickets but enter the sale as half-price tickets and pocket the difference.

Question 5

- (a) Describe some of the powers of the Cyber Appellate Tribunal.
 (b) What are the five different levels of integration of CASE tools?
 (c) What are the subversive threats? How do the intruders manipulate the messages being transmitted? (5 + 5 + 10 = 20 Marks)

Answer

- (a) Powers of the Cyber Appellate Tribunal: Section 58 of the Information Technology Act 2000 provides for the procedures and powers of the Cyber Appellate Tribunal. The Tribunal shall also have the powers of the Civil Court under the Code of Civil Procedure, 1908. Some of the powers specified are in respect of the following matters:

- (i) Summoning and enforcing the attendance of any person and examining him on oath.
 - (ii) Requiring production of documents and other electronic records.
 - (iii) Receiving evidence on affidavits.
 - (iv) Reviewing its decisions.
 - (v) Issuing commissions for examination of witness etc.
- (b) There are five different levels of integration of CASE tools as stated below:
- (1) Platform integration: Here the tools to be implemented run on the same platform where platform means either a single computer/operating system or a network of system.
 - (2) Data integration: It is the process of exchange of data by CASE tools. The result from one tool can be passed on as input to other tools.
 - (3) Presentation integration: It means that the tools in the system use a common metaphor or style and a set of common standards for user interaction.
 - (4) Control Integration: It is the mechanism of one tool in a workbench or environment to control the activation of other tools in the CASE system.
 - (5) Process integration: This means that the CASE system has embedded knowledge about the process activities, their phasing, their constraints and the tools needed to support their activities.
- (c) Subversive threats refer to a situation where an intruder attempts to violate the integrity of some components in the subsystem. By installing an invasive tap on communication line, he can read and modify data or through inductive tap, he can monitor electromagnetic transmissions and allow the data to be read only. Subversive attacks can provide intruders with important information about messages being transmitted.
- The intruders can manipulate messages in following ways:
- (i) Intruders may insert a message in a message stream being transmitted e.g. EFTs add transfer of funds in an additional account.
 - (ii) They may delete a message being transmitted, e.g. remove a/c withdrawal message.
 - (iii) They may modify the contents of message e.g. increase the amount filled in a deposit transaction.
 - (iv) Intruders may alter the order of the message in a message stream.
 - (v) They may duplicate message in a message stream, or copy deposit transactions for their accounts.
 - (vi) They may deny message services between a sender and a receiver by discarding messages or delaying messages.

- (vii) They may use techniques to establish spurious associations so that they are regarded as legitimate users of a system. They may play back a handshaking sequence previously used by a legitimate user of the system.

Question 6

Please read carefully the following three scenarios and answer the questions given below:

(a) Scenario 1 :

Nobody told you that your Internet use in the office was being monitored. Now you have been warned you will be fired if you use the Internet for recreational surfing again. What are your rights?

(b) Scenario 2 :

Your employees are abusing their Internet privileges, but you don't have an Internet usage policy. What do you do?

(c) Scenario 3 :

Employee Mr. X downloads adult material to his PC at work, and employee Miss Y sees it. Miss Y then proceeds to sue the company for sexual harassment. As the employer, are you liable? (5 + 7 + 8 = 20 Marks)

Answer

- (a) Scenario 1: When you are using your office computer, you have virtually no rights. You would have a tough time convincing the court that the boss invaded your privacy by monitoring your use of the company PC during office hours. You should probably be grateful that you only got a warning stating that you will be fired if you use the Internet for recreational surfing again .
- (b) Scenario 2: Although the law is not fully developed in this area, courts are taking a straightforward approach. If it is a company computer, the company can control the way in which it is to be used by its employees. You really don't need an Internet usage policy to prevent inappropriate use of your company's computer. To protect the company in future, it is advisable to distribute an Internet usage policy to your employees as soon as possible to stop your employees from abusing their Internet privileges.
- (c) Scenario 3: Whether it comes from the Internet or from a magazine, adult material simply has no place in the office. So Miss Y could certainly sue the company for making her work in a sexually hostile environment. The best defense for the company is to have an Internet usage policy that prohibits employees to access adult sites. Of course, you have to follow-through and monitor. Today, software is available for monitoring the employees whenever they visit adult sites. It will shut down the computer and alert the person who is monitoring Internet usage. If someone is caught browsing adult material in the office, you must at least send a written communication to the offending employee. If the company lacks a strict Internet usage policy, Miss Y could prevail in the Court.

Question 7

Write short notes on the following:

- (a) Enterprise Controlling
(b) Integrated Test Facility

(c) Restorative Information Protection

(d) Internet Frauds.

(4 × 5 = 20 Marks)

Answer

- (a) Enterprise Controlling: Enterprise can be managed by using an integrated enterprise management. This consists of getting accounting data prepared by subsidiaries for corporate reporting which will be automatically prepared simultaneously within the local books of each subsidiary. This data is transferred to a module called enterprise controlling (EC).

It is easy to transfer the data to the EC module to automatically set up consolidated financial statements including elimination of inter-company transactions currency translations etc. Enterprise controlling consist of 3 modules. EC-CS component is used for financial statutory and management consolidation. EC-PCA allows to work with internal transfer prices and at the same time to have the right values from company, profit centre and enterprise perspectives in parallel. It is also possible to take data directly from EC-PCA to ES-CS consolidation.

EC-EIS (Executive Information System) allows to take financial data from EC-PCA, EC-CS or any other application and combines with any external data such as market data, industry benchmark and / or data from non-SAP applications to build a company specific comprehensive enterprise information system.

EC allows to control the whole enterprise from a corporate and a business unit perspective within one common infrastructure. From EC-EIS top-level2 reports, end users can drill down to more detailed information within EC or any other R/3 application.

- (b) Integrated Test Facility: It is one of the five concurrent audit techniques. It places a small set of fictitious records in the master files. The records might represent a fictitious division, department, or branch office, or a customer or supplier. Processing test transactions to update these dummy records will not affect the actual records. Because fictitious and actual records are processed together, company employees usually remain unaware that this testing is taking place. The system can distinguish ITF records from actual records, collect information on the effect of the test transactions and report the results. The auditor compares processing and expected results in order to verify that the system and its controls are operating correctly.

In a batch processing system, the ITF technique eliminates the need to reverse test transactions and is easily concealed from operating employees. ITF is well suited to testing on-line processing systems because test transactions can be submitted on a frequent basis. All this can be accomplished without disrupting regular processing operations. However, care must be taken not to combine dummy and actual records during the reporting process.

- (c) Restorative Information Protection: Security events that damage information will happen. If an organization cannot recover or recreate critical information in an acceptable time period, the organization will suffer and possibly have to go out of business.

Planning and operating an effective and timely information backup and recovery program is vital to an operation. It does not simply involve backing up just the valuable information

but it frequently also means backing up the system as well, since the information may need services that the system provides to make the information usable.

The key requirement of any restorative information protection plan is that the information can be recovered. There is a common belief that if the backup program has written the information to the backup media, it can be recovered from the backup media. However, there are many variables that can prove that belief wrong.

Some of the questions that any restorative information protection program must address are:

- (i) Has the recovery process been tested recently?
 - (ii) How long did it take?
 - (iii) How much productivity was lost?
 - (iv) Did everything go according to plan?
 - (v) How much extra time was needed to input the data changes since the last back up?
- (d) Internet frauds: With the fast changing and emerging Information Technology, the threat on information security is also increasing. One of the major threats is Internet Frauds. Whereas the Internet should be used for legitimate commerce and for business enhancement, its power is also being harnessed for criminal and fraudulent purposes. It attracts the fraudsters to make easy money because of:
- It is unregulated in so far as who may set up a site. No license fees are payable to any central authority and no form of vetting is, or in practical terms ever could be, carried out on those persons or entities setting up sites.
 - An Internet site can be set up anywhere in the world at very low cost and can reach anywhere else in the world at low cost. This means that fraudsters now have "global reach" and can access a far larger market of potential victims than ever before. As fraudsters are always looking for new victims, this is a very attractive feature.
 - An impressive site with links to established companies or financial institutions might be no more than an empty shell designed to attract and trap the unwary. There is no easy way of separating the genuine from the false.
 - The glamour and novelty of the Internet and the spurious credibility claimed by a site may cause otherwise prudent investors to become involved in fraudulent schemes.
 - A site may, and probably will, operate outside the legal jurisdiction of the country in which the victim of the fraud resides. A company which gives itself a UK Internet address may not have absolutely any legal or commercial connection with the jurisdiction.

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

The Suggested Answers for Paper 7: Direct Taxes are based on the provisions applicable for A.Y. 2006-07, which is the assessment year relevant for November, 2006 examination.

PAPER – 7 : DIRECT TAXES

Answer all questions

Question 1

RST Ltd. is engaged in the manufacture and sale of drugs and pharmaceuticals. Its net profit for the year ending 31-3-2006 after debit/credit of the following items to the Profit and Loss Account was Rs.28,00,000.

- (i) Income-tax paid on non-monetary perquisites provided to the employees Rs.1,00,000.
- (ii) Legal fees incurred in defending title to factory premises Rs.2,00,000.
- (iii) Expenditure on scientific research (not in respect of cost of land or building) on in-house research and development facility approved by the prescribed authority Rs.10,00,000.
- (iv) Interest paid on arrears of sales tax Rs.1,00,000.
- (v) Cash payment of Rs.20,000 made on 10.10.2005 to a supplier towards purchase of raw material.
- (vi) Rent received from letting out vacant land Rs.1,00,000.
- (vii) Arrears of rent received in respect of a house property, which was let out in the earlier years and which was not charged to tax in any earlier year, Rs.2,00,000. The said property was sold during the year ending 31.3.2004.

The company had paid royalty in India to a foreign company amounting to Rs.3,00,000 on 1.5.2004, which was disallowed by the Assessing Officer for the assessment year 2005-06 since tax was not deducted thereon. The company deducted and paid tax at source on the said amount of royalty on 1.1.2006.

The company has brought forward loss from property relating to the assessment year 2004-05 amounting to Rs.40,000.

Compute the total income of RST Ltd. for the assessment year 2006-07.

Furnish explanations for the treatment of the various items given above. (16 Marks)

Answer

Computation of total income of RST Ltd for the assessment year 2006-07

Particulars	Rs.	Rs.
Profits and gains of business or profession		
Net profit as per profit and loss account		28,00,000
Add: Income-tax paid on non-monetary perquisites provided to employees not allowable [See Note (i)]		<u>1,00,000</u>
		29,00,000

Less: Deduction / Additional deduction allowable		
Additional sum allowable towards scientific research expenditure [See Note (iii)]	5,00,000	
Royalty paid during the year ending 31.3.2005, without deduction of tax, disallowed in A.Y. 2005-06, now allowable as tax thereon is deducted and paid [See Note (viii)]	<u>3,00,000</u>	8,00,000
		<u>21,00,000</u>
Less: Income credited in the profit and loss account to be considered under other heads of income		
Rent received from letting out vacant land [See Note (vi)]	1,00,000	
Arrears of rent received in respect of property let out in the earlier years [See Note (vii)]	<u>2,00,000</u>	3,00,000
		<u>18,00,000</u>
Income from house property		
Arrears of rent received in respect of property let out in earlier years	2,00,000	
Less: 30% of Rs.2,00,000	<u>60,000</u>	
	1,40,000	
Less: Brought forward loss from property relating to A.Y.2004-05 set off [See Note (ix)]	<u>40,000</u>	1,00,000
Income from other sources		
Rent received from letting out vacant land [See Note (vi)]		<u>1,00,000</u>
Total Income		<u>20,00,000</u>

Explanations for the treatment of the various items are furnished herein below -

- (i) Income-tax paid by an employer on non-monetary perquisites provided to the employees is not deductible as per section 40(a)(v).
- (ii) Legal fees incurred in defending title to factory premises is an expenditure incurred wholly and exclusively for the purpose of business and is, therefore, allowable under section 37(1). This was held by the Supreme Court in *Dalmia Jain & Co. Ltd. v. CIT* (1971) 81 ITR 754.
- (iii) Expenditure on scientific research incurred by the company is entitled to deduction at 1- $\frac{1}{2}$ times as per section 35(2AB)(1). Since the company has debited Rs.10,00,000 in the profit and loss account, the additional deduction of Rs.5,00,000 is claimed while computing its total income.

- (iv) Interest paid on arrears of sales tax is not penal in nature but is compensatory in character and is an allowable deduction under section 37(1) as held by the Supreme Court in *Lachmandas Mathurdas v. CIT* (2002) 254 ITR 799.
- (v) Disallowance under section 40A(3) is attracted where cash payment in excess of Rs.20,000 is made in respect of any expenditure. In such a case, 20% of the expenditure is disallowed. Since the cash payment made by the company is Rs.20,000, that is, not exceeding Rs.20,000, the expenditure does not attract disallowance under section 40A(3).
- (vi) Rent received from letting out vacant land is assessable under the head "Income from other sources".
- (vii) Arrears of rent received in respect of the house property let out in earlier years is deemed to be income from house property in the year of receipt. Such arrears of rent, after deduction of 30% thereof, is assessable as income from house property even though the assessee is not the owner of the property in the year of its receipt as provided in section 25B.
- (viii) Royalty paid during the year ending 31.3.2005 in respect of which tax was deducted and paid during the previous year ending 31.3.2006 is allowable as deduction for the assessment year 2006-07 as per the proviso to section 40(a)(i).
- (ix) Brought forward loss from house property relating to the assessment year 2004-05 is set off against the deemed income from house property for the assessment year 2006-07 in accordance with the provisions of section 71B.

Question 2

- (a) What is a zero coupon bond? State briefly the treatment of zero coupon bonds in the hands of the issuer and the investor under the Income-tax Act, 1961. (8 Marks)
- (b) A Hindu undivided family is carrying on the business of purchase and sale of food grains. The Karta of the family manages the business. Can the Hindu undivided family pay salary to the Karta and claim the payment made as a deduction from the profits of its business? If so, what are the conditions and limitations for such payment? (4 Marks)

Answer

- (a) Section 2(48) of the Income-tax Act, 1961 defines a zero coupon bond to mean a bond issued by any infrastructure capital company or infrastructure capital fund or a public sector company on or after 1.6.2005 (which the Central Government may notify in this behalf), in respect of which no payment and benefit is received or receivable before maturity or redemption from such issuing entity.

Discount, which is the difference between the amount received or receivable by the issuer on issue of the zero coupon bond and the amount payable by the issuer on maturity or redemption thereof, would be allowed as deduction in the hands of the issuer on a pro rata basis having regard to the period of life of the bond as provided in section

36(1)(iiia). No tax is required to be deducted at source under section 194A in respect of income paid or payable in relation to a zero coupon bond.

Maturity or redemption of a zero coupon bond will be treated as a transfer for purposes of capital gains in the hands of the investor as provided in section 2(47)(iva). Zero coupon bond held for not more than 12 months will be treated as a short-term capital asset. Thus, a zero coupon bond held for more than 12 months will be treated as a long-term capital asset. The proviso to section 112(1) will be applicable to long-term capital gain arising from the transfer of zero coupon bonds. Consequently, where the tax payable in respect of long-term capital gain arising from the transfer of zero coupon bonds exceeds 10% of the amount of capital gains before indexation, then, such excess shall be ignored while computing the tax payable by the investor.

- (b) The Supreme Court has, in *Jugal Kishore Baldeo Sahai v. CIT* (1967) 63 ITR 238, held that if remuneration is paid to the karta of a Hindu undivided family (HUF) under –
- (i) a valid agreement which is bona fide and
 - (ii) is in the interest of, and expedient for, the business of the family and
 - (iii) the payment is genuine and not excessive,

such remuneration would be an expenditure laid out wholly and exclusively for the purpose of business of the family and would be allowable as a deduction while computing the income of the HUF. The test which should be applied for judging what is a valid agreement is whether the agreement for payment of salary to the karta was by or on behalf of all the members of the family and whether it was in the interests of the business of the family so that it could be justified on the grounds of commercial expediency. Thus, the HUF can pay salary to the karta for services rendered by him to the business of the family under a valid agreement, which may be express or implied. Such payment will be eligible for deduction from the business profits of the HUF, if it is not excessive and is not unreasonable.

Question 3

- (a) ABC Club, a members' club, registered as a society under Orissa State Societies Registration Act, derived surplus from the sale of refreshments, beverages, etc. and letting out rooms to its members. The club provided these facilities and amenities to its members as part of advantage attached to the membership. The club claims that the said surplus accruing to it is not income at all for the purpose of the Income-tax Act, 1961. Examine the validity of the claim made by the club. Would your answer be different, if the club was incorporated as a company or if some members alone took advantage of the facilities and amenities it provided? (6 Marks)
- (b) State whether the following persons have to mandatorily furnish their return of income for the assessment year 2006-07.
- (i) Mr. A, an individual, aged 50 years, whose gross total income before deduction under section 80C is Rs.1,90,000 and total income after deduction under section 80C is Rs.95,000.

(ii) M/s. XYZ, a firm, which has incurred a loss.

(4 Marks)

Answer

- (a) ABC Club can claim that the surplus derived by it from the various facilities and amenities provided to its members does not constitute income on the basis of the principle of mutuality. The basic principle of mutuality is that no one can trade with himself and no one can make profit out of himself. The essence of mutuality is complete identity between the contributors and the participators. A mutual concern or association stands on this principle. ABC Club provided various facilities to its members as part of the usual privileges attached to the membership of the club and derived surplus from such activity. Such surplus cannot be called as income for the purpose of the Income-tax Act, 1961. The Supreme Court has, in CIT v. Bankipur Club Ltd. (1997) 226 ITR 97 and Chelmsford Club v. CIT (2000) 243 ITR 89, where the facts were similar, held that such surplus was not taxable as income on the principle of mutuality. The claim of ABC Club is, therefore, valid.

The answer would be the same even if the club was incorporated as a company as the incorporation does not destroy the identity of the contributors and the participators. The answer would also not be different even if some members of the club alone took advantage of the facilities offered by it. In fact, the Supreme Court in the two decisions cited above, has observed that if there is complete identity between the contributors and the participators, it is immaterial what particular form the association takes and where the activity is mutual, the fact that, as regards certain activities, only certain members of the association take advantage of the facilities which it offers, does not affect the mutuality of the enterprise.

- (b) (i) The fourth proviso to section 139(1) requires every person, whose total income without giving effect to the provisions of section 10A, 10B, 10BA and Chapter VIA exceeds the maximum amount not chargeable to tax, to compulsorily furnish the return of income for the relevant assessment year on or before the due date. The total income of Mr.A before deduction under section 80C exceeds the taxable limit of Rs.1,00,000. Therefore, Mr. A has to compulsorily furnish his return of income for the assessment year 2006-07.
- (ii) The Finance Act, 2005 has made it compulsory for firms to furnish their returns of income and loss on or before the due date. Therefore, M/s XYZ has to furnish its return of loss for the assessment year 2006-07 on or before the due date.

Question 4

- (i) S, an individual purchased a site on 21.4.2000 for Rs.2,00,000. He completed construction of a building thereon on 14.2.2003 at a cost of Rs.10,00,000. He sold the property consisting of site and building on 7.12.2005 for Rs.20,00,000. S seeks your opinion on the nature of capital gain arising to him from the sale of the property for the assessment year 2006-07. Computation of capital gain is not necessary. (5 Marks)

- (ii) J, a citizen of India, is employed in the Indian Embassy at Tokyo, Japan. He received salary and allowances at Tokyo from the Government of India during the year ending 31.3.2006 for services rendered by him in Tokyo. Besides, he was allowed perquisites by the Government. He is a non-resident for the assessment year 2006-07. Examine the taxability of salary, allowances and perquisites in the hands of J for the assessment year 2006-07. (3 Marks)
- (iii) Q, a non-resident, made an application to the Authority for Advance Rulings on 2.1.2006 in relation to a transaction proposed to be undertaken by him. On 31.3.2006, he decides to withdraw the said application. Can he withdraw the application on 31.3.2006?(2 Marks)

Answer

- (i) Site and building are separate capital assets for the purpose of capital gains. This distinction is clear from the scheme of the Income-tax Act, 1961. For the purpose of section 32, a building which is entitled to depreciation means only the superstructure and does not include the site on which it is built. This was held by the Apex Court in CIT v. Alps Theatre (1967) 65 ITR 377.

In this case, the site is a long-term capital asset since it is held by S for more than 36 months and the building is a short-term capital asset since it is held by S for less than 36 months. The site is an independent capital asset and continues to be so even after the construction of the building thereon. Even though the property consisting of site and building was sold as a single asset for a consolidated price of Rs.20,00,000, such price can be attributed to the site and building separately. Therefore, in the case of S, the capital gain attributable to the site is assessable as long-term capital gain and the capital gain attributable to the building is assessable as short-term capital gain for the assessment year 2006-07. On identical facts, the Rajasthan High Court in CIT v. Vimal Chand Golecha (1993) 201 ITR 442, the Madras High Court in CIT v. Dr. D. L. Ramachandra Rao (1999) 236 ITR 51 and the Karnataka High Court in CIT v. C.R. Subramanian (2000) 242 ITR 342 have taken this view.

- (ii) Section 9(1)(iii) of the Income-tax Act, 1961 provides that salaries payable by the Government to a citizen of India for service outside India shall be deemed to accrue or arise in India. As such, salary received by J is liable for taxation, even though he was a non-resident for A.Y.2006-07.

Section 10(7) exempts any allowances or perquisites paid or allowed as such outside India by the Government to a citizen of India for rendering service outside India. Therefore, the allowances and perquisites received by J are exempt as per section 10(7).

- (iii) Section 245Q(3) of the Income-tax Act, 1961 provides that an applicant, who has sought for an advance ruling, may withdraw the application within 30 days from the date of the application. Since more than 30 days has elapsed since the date of application by Q to the Authority for Advance Rulings, he cannot withdraw the application on 31.3.2006.

Question 5

- (a) Can an order of assessment, which was in accordance with the law as it stood on the date when it was passed, be rectified by the Assessing Officer under section 154 of the Income-tax Act, 1961, on account of a subsequent amendment of the law with retrospective effect? (4 Marks)
- (b) An appeal was preferred by the assessee to the Commissioner (Appeals) against the order of assessment made by the Assessing Officer. The appeal was allowed by the Commissioner (Appeals). The assessee later found that he was entitled to a certain deduction, which was neither claimed by him nor allowed by the Assessing Officer in the course of assessment. The issue of deduction was not raised by the assessee in the appeal before the Commissioner (Appeals) and was not considered by the Commissioner (Appeals). Examine the power of the Commissioner to revise under section 264 the order of assessment in order to allow such deduction on an application by the assessee. (4 Marks)
- (c) M, an individual, had let out his building on a monthly rent of Rs.12,000. The tenant deducted tax under section 194-I from the rent paid to M, but did not remit such tax to the credit of the Central Government. M filed his return of income for the assessment year 2006-07 including therein the rental income from the said building and paid the balance tax on his total income after taking credit for tax deducted at source by the tenant. The Assessing Officer has called upon M to pay the tax to the extent of tax deducted at source. Is the Assessing Officer justified in doing so? (4 Marks)

Answer

- (a) An order of assessment, which was in accordance with the law as it stood on the date when it was passed, becomes erroneous on account of a retrospective amendment of the law made subsequently. Such an order falls within the scope of section 154. The Supreme Court has, in IAC of Agricultural I.T. v. V.K. Ravi Namboodiripad (1974) 96 ITR 73, held that an assessment based on the law as it stood on the date of assessment could be rectified after an amendment of the law with retrospective effect within the period of limitation. In CIT v. E. Sefton & Co. (P.) Ltd. (1989) 179 ITR 435, the Calcutta High Court observed that if the assessment order is plainly and obviously inconsistent with the specific and clear provision as amended retrospectively, indisputably there is a mistake apparent from record. In the light of the retrospective amendment, the assessment order had to be revised. In view of this, it can be said that the Assessing Officer can, under section 154 of the Income-tax Act, 1961, rectify the order of assessment in the light of the later amendment of the law with retrospective effect, subject to limitation provided under sub-section (7) of section 154.
- (b) Section 264(4)(c) provides that the Commissioner shall not revise an order which has been made the subject of an appeal to the Commissioner (Appeals). This bar remains unaffected by the scope of the appeal to the Commissioner (Appeals). Therefore, the fact that the relief claimed in the application filed by the assessee under section 264(1)

was not the subject matter of appeal to the Commissioner (Appeals) does not alter the position that the order of assessment was the subject of the appeal.

The word 'order' in section 264(4)(c) refers to the order appealed against and not to the relief claimed in appeal. In view of this, the Commissioner cannot exercise his powers under section 264 to revise the order of assessment and allow the deduction claimed by the assessee in his application.

- (c) Section 205 of the Income-tax Act, 1961 provides that where tax is deductible at source under the provisions of Chapter XVII, the assessee shall not be called upon to pay the tax himself to the extent to which tax has been deducted from that income. Section 205, therefore, bars a direct demand being made on an assessee to the extent of tax deducted from the income. The Income-tax Department can recover the tax deducted at source from the tenant and not from M in view of the clear mandate in section 205. The Karnataka High Court has in Smt. Anusuya Alva v. DCIT (2005) 278 ITR 206 ruled that tax deducted at source by the tenant from the rent paid but not remitted to the credit of the Central Government can be recovered only from the tenant and not from the landlord. Therefore, in view of the clear mandate in section 205, the Assessing Officer is not justified in law in calling upon M to pay the said tax.

Question 6

- (a) Write a brief note on filing of memorandum of cross-objections before the Income-tax Appellate Tribunal. (5 Marks)
- (b) C, an individual, resident in India, paid medical insurance premium amounting to Rs.20,000 by cash during the year ending 31.3.2006 out of his income chargeable to tax in respect of the policy taken on the health of his dependent father in accordance with the scheme framed by the General Insurance Corporation of India and approved by the Central Government. Besides, he paid Rs.90,000 during the year ending 31.3.2006 for the medical treatment of his dependent mother, aged 69 years, in respect of a disease specified in Rule 11DD(1) of the Income-tax Rules, 1962. He received Rs.20,000 from the insurance company for the said medical treatment of his mother. C seeks your advice on the deductions, if any, available in respect of these two payments. (6 Marks)
- (c) An Assessing Officer entered a hotel run by a person, in respect of whom he exercises jurisdiction, at 8 p.m. for the purpose of collecting information, which may be useful for the purposes of the Act. The hotel is kept open for business every day between 9 a.m. and 9 p.m. The hotelier claims that the Assessing Officer could not enter the hotel after sunset. The Assessing Officer wants to take away with him the books of account kept at the hotel. Examine the validity of the claim made by the hotelier and the proposed action of the Assessing Officer with reference to the provisions of section 133B of the Income-tax Act, 1961. (4 Marks)

Answer

- (a) Section 253(4) of the Income-tax Act, 1961 gives the respondent, in every appeal filed before the Income-tax Appellate Tribunal, a right to file a memorandum of cross-objections against any part of the order of the Commissioner (Appeals). This right of filing a memorandum of cross-objections is an independent right given to the respondent in an appeal and is in addition to the right of appeal which may or may not be exercised by the assessee or the Assessing Officer under section 253(1) or section 253(2). The memorandum of cross-objections has to be in the prescribed form and verified in the prescribed manner and has to be filed within 30 days of the receipt of notice of the appeal. The Tribunal is empowered to permit filing of memorandum of cross-objections after the expiry of the prescribed period if sufficient cause is shown. Such memorandum of cross-objections will be disposed of by the Appellate Tribunal as if it were an appeal presented within the time specified in section 253(3). There is no fee for filing a memorandum of cross-objections.

- (b) Section 80D of the Income-tax Act, 1961 provides for deduction in respect of medical insurance premium paid by an individual or a Hindu undivided family subject to certain conditions and limitations. One of the conditions for allowance of the deduction is that the premium should be paid by cheque. C has paid the premium by cash and not by cheque. C is, therefore, not eligible for deduction under section 80D.

However, C is eligible for deduction under section 80DDB in respect of the payment made by him during the relevant previous year for the medical treatment of his dependent mother in respect of the specified disease. The ceiling limit of deduction is Rs.60,000 since the payment made is in respect of his dependent mother who is above 65 years of age. Section 80DDB provides that the assessee shall be allowed a deduction of the amount actually paid for medical treatment of the specified disease or Rs.60,000 (since the payment is in respect of a senior citizen), whichever is less, in respect of that previous year in which such amount was actually paid. The second proviso to that section provides that deduction under that section shall be reduced by the amount received under an insurance. From a combined reading of the section and the proviso, it can be inferred that in this case, Rs.20,000, being the amount received from the insurer, should be deducted from Rs.60,000, which is the deduction allowable as per section 80DDB (since it is lower than the amount of Rs.90,000 actually paid). Therefore, Rs.40,000 [i.e. Rs.60,000 minus Rs.20,000] is the deduction available under section 80DDB.

- (c) Section 133B(2) of the Income-tax Act, 1961 empowers an income-tax authority to enter any place of business during the hours at which such place is open for the conduct of business. The hotel is open from 9.00 a.m. to 9.00 p.m. for the conduct of business. The Assessing Officer entered the hotel at 8.00 p.m. which falls within the working hours. The claim made by the hotelier to the effect that the Assessing Officer could not enter the hotel after sunset is not in accordance with law.

Section 133B(3) provides that an income tax authority acting under this section shall, on no account, remove or cause to be removed from the place wherein he has entered, any

books of account. In view of this clear prohibition in section 133B(3), the proposed action of the Assessing Officer to take away with him the books of account kept at the hotel is not valid in law.

Question 7

- (a) What is an adventure in the nature of trade? State the factors which are relevant in deciding whether a transaction is an adventure in the nature of trade. (7 Marks)
- (b) The assessment of B, an individual, for the assessment year 2004-05 was made under section 143(3) of the Income-tax Act, 1961 on 18.3.2005. The assessment has become final and is not the subject-matter of an appeal or revision. The Assessing Officer issued a show cause notice for levy of penalty under section 271(1)(c) to B on 25.3.2005. B furnished a reply to the said notice on 30.3.2005. There was a change in incumbent and the Assessing Officer, who made the assessment and issued the show cause notice, was succeeded by another. The successor-Assessing Officer suo motu issued a notice under section 129 to B on 20.9.2005. B did not respond to the said notice. The successor-Assessing Officer passed an order on 4.10.2005 levying penalty under section 271(1)(c). Examine the validity of the order of penalty passed with reference to the aspect of limitation. (8 Marks)

Answer

- (a) The term “business” has been defined in section 2(13) of the Income-tax Act, 1961 to include any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture. Adventure in the nature of trade implies that the adventure has the characteristics of trade but not all of them. That indeed is the distinguishing mark of an adventure since if it possessed all the characteristics, it would be a full blown trade straightaway.

The Supreme Court has, in *G. Venkataswami Naidu & Co. v. CIT* (1959) 35 ITR 594 and *CIT v. H. Holck Larsen* (1986) 160 ITR 67, identified certain factors which are relevant in deciding whether a transaction is an adventure in the nature of trade.

In deciding whether a transaction is an adventure in the nature of trade, several factors are relevant such as, the motive, intention or purpose with which the article sold was bought earlier, the character of articles purchased and sold, that is, whether the articles are fit for sale as merchandise, ordinary occupation of the assessee, that is, whether he is a trader or not, whether the purchase of the commodity and its resale were allied to his usual trade or incidental to it, quantity of the commodity purchased and sold, acts prior to purchase showing a design or purpose, manner of disposal, similarity of transactions to operations usually associated with trade or business, repetition of transactions, period of holding, circumstances that led to the sale, treatment in books of account etc. In each case, it is the total effect of all relevant factors and circumstances that determine the character of the transaction.

- (b) Section 275(1) provides for the time limit for passing an order of penalty. Clause (c) thereof requires that the order of penalty should be passed before the expiry of the

financial year in which the proceedings, in the course of which action for the imposition of penalty has been initiated, are completed, or six months from the end of the month in which action for imposition of penalty is initiated, whichever period expires later. The time limit in this case, as per section 275(1)(c), is 30.9.2005. Explanation to section 275 states that in computing the period of limitation, the time taken in giving an opportunity to the assessee to be re-heard under the proviso to section 129 shall be excluded. A plain reading of the proviso to section 129 indicates that it is the assessee who may demand to be re-heard before any order is passed against him. In the instant case, notice under section 129 was not issued by the successor- Assessing Officer at the instance of B. B did not request him to provide an opportunity of re-hearing. The Supreme Court has in *Pradip Lamps Works v. CIT* (2001) 249 ITR 797 ruled that where the assessee replied to the show cause notice issued by the predecessor-Assessing Officer, the successor-Assessing Officer can levy penalty without giving a fresh notice of hearing to the assessee in the absence of a demand by the assessee for re-hearing. The Karnataka High Court, in *B. N. Amarnath v. CIT* (2003) 259 ITR 590, held that the Explanation to section 275 could not be invoked by the Department unilaterally to compute the period of limitation on its own, by issue of notice under section 129, without there being any request for re-hearing by B.

Therefore, in this case, the order of penalty should have been passed by the successor-Assessing Officer on or before 30.9.2005 as per the provisions of section 275(1)(c). The order of penalty having been passed on 4.10.2005 is barred by limitation and therefore, invalid.

Question 8

D, an individual, has the following assets and liabilities as on 31.3.2006

Assets	Rs. in lakhs
Plot of land at Bhopal comprising an area of 1,200 square metres on which building has been constructed without the approval of the appropriate authority	25
Building constructed on land at Bhopal without the approval of the appropriate authority and used for his business purposes.	10
Motor cars held as stock-in-trade	60
Gold jewellery brought into India from Singapore, where he was residing, on his return to India on 1.11.2002 for permanently residing in India.	6
Jewellery made of Platinum.	9
Interest in the coparcenary property of the Hindu undivided family of which he is a member	15`
Cash in hand recorded in the books of account	5
Fixed deposits in a co-operative bank	10

Liabilities	
Loan borrowed for marriage of daughter	6
Loan borrowed for construction of building at Bhopal	5

The minor married daughter of D holds a plot of land at Indore valued at Rs.20 lakhs.

The amounts stated against the assets, except cash in hand, are the values determined as per section 7 of the Wealth-tax Act, 1957 read with Schedule III thereto.

Compute the net wealth of D for the assessment year 2006-07.

State the reasons for inclusion or exclusion of the various items. (10 Marks)

Answer

Computation of net wealth of Mr. D for the A.Y.2006-07

Particulars	Note	Rs.
Plot of land of 1,200 sq. mts. at Bhopal	(a)	25,00,000
Building constructed on land at Bhopal – construction without the approval of appropriate authority – not an asset under section 2(ea) since used for business purposes	(b)	Nil
Motor cars held as stock-in-trade – not an asset under section 2(ea)	(c)	Nil
Gold jewellery brought from Singapore on 1.11.2002 on his return to India for permanently residing in India – Exempt under section 5(v)	(d)	Nil
Jewellery made of platinum	(e)	9,00,000
Interest in coparcenary property of the HUF– Exempt under section 5(ii)	(f)	Nil
Cash in hand in excess of Rs.50,000	(g)	4,50,000
Fixed deposits in a co-operative bank–not an asset under section 2(ea)	(h)	Nil
Gross wealth		38,50,000
Less: Liabilities		
Loan borrowed for marriage of daughter – not deductible	(i)	Nil
Loan borrowed for construction of building at Bhopal – not deductible	(j)	Nil
Net wealth		38,50,000

The reasons for the inclusion or exclusion of the various items are furnished below -

- (a) Plot of land at Bhopal on which building has been constructed without the approval of the appropriate authority is an asset under section 2(ea) and is, therefore, includible in the net wealth. Since the plot of land comprises an area of more than 500 square meters, it is not eligible for exemption under section 5(vi).

- (b) Building constructed on land at Bhopal without the approval of the appropriate authority is not a specified asset under section 2(ea) since it is used for business purposes by D. It is, therefore, not includible in the net wealth.
- (c) Motor cars held as stock-in-trade do not fall under the purview of 'asset' under section 2(ea) and are, therefore, outside the net of wealth tax.
- (d) Gold jewellery brought into India on 1.11.2002 from Singapore is exempt for seven successive assessment years beginning with the assessment year 2003-04 under section 5(v).
- (e) Jewellery made of platinum is an asset under section 2(ea) and is, therefore, included in the net wealth.
- (f) Interest in the coparcenary property of the Hindu undivided family of which D is a member is exempt under section 5(ii).
- (g) Cash in hand, in excess of Rs.50,000, is includible in the net wealth of an individual, whether such cash is recorded in the books of account or not.
- (h) Fixed deposits in a co-operative bank do not constitute 'assets' within the meaning of section 2(ea) and, therefore, are excluded from net wealth.
- (i) Only loans borrowed in relation to the 'assets' as per section 2(ea) are deductible. Hence, loan borrowed for marriage of daughter is not deductible.
- (j) Since building at Bhopal is used for business purposes and is, therefore, not an asset and excluded while computing the net wealth, the loan borrowed for its construction is not a deductible debt.
- (k) Assets held by a minor married daughter are not includible in the net wealth of any parent as per section 4(1)(a)(ii). Hence, the value of the plot of land at Indore, held by the minor married daughter, does not form part of the net wealth of D.

The suggested answers for Indirect Taxes (Paper 8) are based on the provisions as amended by the Finance Act, 2005 and Notifications/Circulars issued up to 30.04.2006 which are relevant for November 2006 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) Briefly explain any two of the following with reference to the provisions of the CENVAT Credit Rules, 2004:
- (i) Job work
 - (ii) Principal inputs
 - (iii) Deemed Cenvat Credit. (2 x 2 = 4 Marks)
- (b) Briefly examine the correctness or otherwise of any two of the following statements with reference to the Central Excise Act, 1944 giving reasons to support your answers:
- (i) Parts used for repair or replacement during warranty period are excisable.
 - (ii) In case of samples distributed free, valuation should be adopted on the basis of Rule 8 of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 i.e. cost of production plus 10%.
 - (iii) Exemption from duty does not mean exemption from registration. (3 x 2 = 6 Marks)
- (c) M/s Super Pipes Ltd. is engaged in the manufacture of m.s. galvanized pipes. The excise department has required the assessee to include the cost of galvanization in the assessable value of the m.s. galvanized pipes for the purposes of determination of excise duty. The assessee claims that as the process of galvanization does not amount to manufacture, the cost of galvanization is not includible in the assessable value of the said pipes made from H.R. coils.
- Briefly discuss whether the stand taken by the assessee is correct with reference to the provisions of the Central Excise, Act, 1944. (5 Marks)
- (d) “Everything that is sold is not necessarily a marketable commodity chargeable to excise duty under the provisions of the Central Excise Act, 1944.” Discuss. (5 Marks)

Answer

- (a) (i) As per rule 2(n) of the CENVAT Credit Rules, 2004, “job work” means processing or working upon of raw material or semi-finished goods supplied to the job worker, so as to complete a part or whole of the process resulting in the manufacture or finishing of an article or any operation which is essential for aforesaid process and the expression “job worker” shall be construed accordingly.

Provisions for sending inputs/capital goods for further processing, testing, repair, reconditioning or any other purpose are contained in rule 4(5) of the CENVAT Credit Rules, 2004.

- (ii) As per explanation to rule 9A of the CENVAT Credit Rules, 2004, "principal inputs" means any input which is used in the manufacture of final products where the cost of such input constitutes not less than 10% of the total cost of raw-materials for the manufacture of unit quantity of a given final product.

Assessee other than the notified exempt assessee are required to submit information relating to principal inputs in form ER-5 and ER-6 to the Superintendent of Central Excise.

- (iii) According to rule 13 of the CENVAT Credit Rules, 2004, the Central Government may by a notification in the Official Gazette declare certain inputs/input services, on which "deemed CENVAT credit" at specified rates will be allowed to the manufacturer of final products or provider of output services, even if such declared inputs/input services are not directly used by such a manufacturer or provider of output service but are contained in the said final products/used in providing the output service, irrespective of the actual amount of duty/service tax paid on such declared inputs/input services.

- (b) (i) Correct. The Supreme Court in the case of ECE Industries Ltd. v. CCE, 2004 (164) ELT 236 (SC) has held that parts used for repair, replacement during the warranty period are excisable. If some spare parts are supplied as free replacements for defective parts, excise duty is payable on such spare parts.
- (ii) Incorrect. CBEC vide Circular No.813/10/2005-CX dated 25.4.2005 has clarified that in case of samples distributed free, valuation should be done on basis of rule 4, i.e. valuation should be done on the basis of value of identical goods cleared at or around the same time.
- (iii) Correct. The goods that are exempt from duty of excise by virtue of provisions of section 5A of the Central Excise Act do not become non-excisable goods. Hence, every person who manufactures excisable goods has to obtain registration in accordance with the provisions of section 6 of the Act read with rule 9 of the Central Excise Rules, 2002.

However, persons who manufacture excisable goods which are chargeable to nil rate of excise duty or are fully exempt from duty by a notification are exempt from obtaining registration subject to the declaration to be made in the specified form.

- (c) The facts of the case are similar to the case of Siddhartha Tubes Ltd. v. CCE, Indore – 2006 (193) ELT 6 (SC) wherein the Apex Court has held that galvanization cost is includible in the assessable value of m.s. galvanized pipes even though 'galvanization' does not amount to manufacture. The Apex Court explained that the concepts of 'manufacture' and 'valuation' are two different and distinct concepts and the present case relates to valuation. The Supreme Court stated that m.s. galvanized pipes were manufactured out of H.R. coils after passing through various processes (including

galvanization). Such a process added to the quality of the product and increased the value of pipes. Process of galvanization was incidental to the manufacture of pipes and, therefore, cost of that process was rightly included in the assessable value.

Therefore, the stand taken by M/s. Super Pipes Ltd. is not correct in law.

- (d) Unless the goods are capable of being marketed, they cannot be charged to duty. Marketability is the capability of a product of being put into the market for sale. Supreme Court in *Union of India v. Delhi Cloth and General Mills Case* – 1977 (1) ELT (J199) has held that in order to become goods, it is necessary that an article must be something which can ordinarily come to the market to be bought and sold.

However, the Apex Court in *UOI v Indian Aluminium Co. Ltd.* 1995 (77) ELT 268 has held that dross and skimmings are not marketable commodity even if they can be sold to recover some metal as everything which is sold is not necessarily a marketable commodity as known to the commerce and which, it may be worthwhile to trade in. The dross and skimmings arising during the manufacture of aluminium are nothing but rubbish which is thrown up in the course of manufacture. It may be possible to recover some metal from them and therefore they can be sold. However, they are not metal in the same class as waste or scrap.

This view has been reiterated by the Supreme Court in *CCE v. Tata Iron and Steel Co. Ltd.* 2004 (165) E.L.T. 386 (S.C.) wherein the Apex Court has held that the dross and skimming are merely the refuse, scum or rubbish produced during the process of manufacture. The Supreme Court has held that merely because the dross and skimming are sold to customers, it cannot be inferred that they are marketable commodity as even rubbish can be sold. However, that does not make rubbish a marketable commodity. Mere selling of a commodity does not mean that it is marketable since a commodity can also be sold as rubbish. Marketability means selling of a commodity which is known to the commerce and which may be worthwhile to trade in.

In view of these decisions it can be inferred that in order to be marketable, an item should be capable of being bought and sold. Even waste and scrap can be excisable goods, if they are known in commercial parlance and are marketable – *UOI v. Khandelwal Metal and Engg. Works* (1985) 20 ELT 222 (SC). However, the item should be something which is worthwhile to trade in and not just refuse, scum or rubbish.

Question 2

- (a) Answer in brief the following questions relating to provisions made under rule 6 of the Central Excise (Removal of Goods at Concessional Rate of Duty for Manufacture of Excisable Goods) Rules, 2001:
- (i) What will be the consequences in case the goods received at concessional rate are not used for the intended purpose?
 - (ii) Whether a manufacturer receiving the subject goods can return such goods to the original manufacturer?

- (iii) When will the subject goods be deemed as not having been used for the intended purpose? (2 x 3 = 6 Marks)
- (b) Discuss briefly whether a refund effected by the Central Excise Department, pursuant to orders of court, in respect of a bank guarantee (towards disputed excise duty) encashed by the department, would be subject to the provisions of section 11B of the Central Excise Act, 1944 relating to "unjust enrichment." (4 Marks)
- (c) A manufacturer of cameras sells leather cases/soft cases and instruction manuals along with cameras. The cost of such cases and manuals were being charged separately apart from the cost of the camera. The excise department has claimed that the cost of such cases and manuals should be included in the assessable value of the camera. According to the excise department, as per Rule 5 of the Interpretative Rules for Central Excise Tariff brought into force from 28-2-2005, cases for cameras, musical instruments, drawing instruments, necklaces etc. specially shaped for those articles, suitable for long-term use will be classified along with those articles, if such articles are normally sold along with such cases.
- Examine briefly with the help of decided case law, if any, whether the stand taken by the department is correct in law. (5 Marks)

Answer

- (a) In order to obtain excisable goods at nil or concessional rate of duty, a manufacturer is required to follow the procedure prescribed in the Central Excise (Removal of Goods at Concessional Rate of Duty for Manufacture of Excisable Goods) Rules, 2001. The questions may be answered as under:
- (i) As per rule 6 of the said rules, if the goods received at concessional rate (subject goods) are not used for the intended purpose, the manufacturer shall be liable to pay differential duty (equivalent to the concession availed) along with interest and the provisions of section 11A and section 11AB shall apply mutatis mutandis for effecting such recoveries.
- (ii) Yes, a manufacturer may return the subject goods to the original manufacturer if the subject goods on receipt are found to be defective or damaged or unsuitable or surplus to his needs. Such returned goods shall be added to the non duty paid stock of the manufacturer of the subject goods and dealt with accordingly. (Proviso to rule 6 of the said rules).
- (iii) It has been clarified by the explanation to rule 6 of the said rules that subject goods shall be deemed as not being used for intended purpose, if the same have been lost or destroyed by natural causes or unavoidable accidents during -
- transport from the place of procurement to the manufacturer's premises, or
 - from the manufacturer's premises to the place of procurement, or
 - during handling or storage in the manufacturer's premises.

- (b) The Supreme Court in the case of *Oswal Agro Mills Ltd. v. Assistant Collector of C.Ex., Ludhiana* 1994 (70) ELT 48 (SC) has held that refund of an encashed bank guarantee for all or part of the disputed excise duty pursuant to an order of the Court is not governed by the provisions of section 11B, since furnishing of a bank guarantee is not equivalent to payment of excise duty.

The Supreme Court stated that section 11B applies when an assessee claims refund of excise duty. A claim for refund is a claim for repayment. It presupposes that the amount of the excise duty has been paid over to the excise authorities. It is then that the excise authorities would be required to repay or refund the excise duty.

The Apex Court explained that a bank guarantee is a security for the Revenue for recovering the dues in the event the Revenue succeeds in the dispute concerning the duty. However, if the bank refuses to honour its guarantee the revenue or the principal administrative officer of the Court (where the bank guarantee is in his favour) has to file a suit against the bank for the amount due upon the bank guarantee. Therefore, the amount of the disputed tax or duty that is secured by a bank guarantee cannot be considered as having been paid to the Revenue. Thus, there arises no question of its refund and hence provisions of section 11B would not be attracted.

- (c) The Supreme Court in the case of *CCEx.,Goa v. Phil Corporation Ltd.* (2005) 180 ELT 311 (SC) has observed that the question of includibility of the cost of instruction manual and soft case in the camera would depend on the fact that whether such articles can be considered to be the components of the camera or whether they are merely accessories. It has been held by the Apex Court that such articles are mere accessories and therefore their value should not be included in the assessable value of the camera.

Rule 5 of new Interpretative Rules for Central Excise Tariff inter alia provides that camera cases, musical instrument cases, gun cases, drawing instrument cases, necklace cases and similar containers, specially shaped or fitted to contain a specific article or set of articles, suitable for long-term use and presented with the articles for which they are intended, shall be classified with such articles when of a kind normally sold therewith. However, here it has to be kept in mind that valuation and classification provisions are two independent provisions and thus, should not be interlinked.

Therefore, the Department's claim is not tenable.

Question 3

- (a) Briefly explain the provisions relating to compounding of offences with reference to section 9A of the Central Excise Act, 1944 and Rule 6 of the Central Excise (Compounding of Offences) Rules, 2005 dealing with the power of the Compounding authority. (3 Marks)
- (b) M/s. Solid Cement Ltd. is engaged in the manufacture of cement. Explosives are used for blasting the mines in order to excavate limestone, which is used in the manufacture of cement/clinkers in the factory situated at some distance away from the mines.

Cenvat credit on explosives has been denied by the excise department on the ground that the explosives are not used as inputs "within the factory of production". You are required to advise with reference to the Cenvat Credit Rules, 2004 whether the stand taken by the department is correct. (4 Marks)

- (c) A Small Scale Industrial unit (SSI) is required to pay the following central excise duties by January 15, 2006 for clearances effected from its factory in respect of final products manufactured during the month of December, 2005:

Basic Excise Duty (B.E.D.): Rs.36,000

Special Excise Duty (S.E.D.): Rs.18,000

National Calamity Contingent Duty (N.C.C.D.): Rs.1,000

Education Cess (E.C.): 2% of B.E.D. + S.E.D. + N.C.C.D.

Balances available as credit at the beginning of the month i.e. December, 2005 were as follows:

B.E.D. Rs.24,000, N.C.C.D. Rs.2,000, E.C. Rs.600.

No inputs were received during the month. However, certain inputs were received on January 1, 2006 on which total duty paid by the suppliers of inputs was as follows :

B.E.D. Rs.16000, E.C. Rs.320

Excise duty paid on capital goods received during the month was as follows:

B.E.D. Rs.40,000, E.C. Rs.800

For the month of December, 2005 you are required to determine :

- (i) the credit available for utilisation;
- (ii) the permissible extent to which such available credit may be utilised against payment of B.E.D., S.E.D., N.C.C.D., and E.C.; and
- (iii) the B.E.D., S.E.D., and E.C. payable through account current (P.L.A.).

(4 + 2 + 2 = 8 Marks)

Answer

- (a) Section 9A(2) of the Central Excise Act provides that any offence under the Act can be compounded by the Chief Commissioner of Central Excise. The offence may, either before or after the institution of prosecution, be compounded by the Chief Commissioner of Central Excise on payment, by the person accused of the offence to the Central Government, of such compounding amount as may be prescribed.

Rule 6 of the Central Excise (Compounding of Offences) Rules, 2005 deals with the power of Compounding authority to grant immunity from prosecution. The Chief Commissioner having jurisdiction over the place where the offence under the Act have been or alleged to have been committed is the compounding authority. As per rule 6 of the Central Excise (Compounding of Offences) Rules, 2005, the compounding authority,

if he is satisfied that any person who has made the application for compounding of offence under these rules has co-operated in the proceedings before him and has made full and true disclosure of facts relating to the case, grant to such person, subject to such conditions as he may think fit to impose, immunity from prosecution for any offence under the Central Excise Act, 1944 with respect to the case covered by the compounding of offence.

- (b) The Supreme Court has held in the case of *Vikram Cement v. CCE*, Indore 2006 (194) ELT 3 (SC) that CENVAT credit on inputs being explosives used for blasting mines to produce limestone for use in manufacture of cement/clinkers in factory situated at some distance away from mines could not be denied on the ground that they were not used as inputs within the factory.

The above-mentioned decision overrules the contrary opinion of the Supreme Court in the case of *J.K. Udaipur Udyog Ltd.* 2004 (171) E.L.T. 289 (SC). In this case, the credit on explosives used for blasting mines was disallowed on the ground that the same were not used within the factory but in a mine which could not qualify to be a factory. Therefore, the stand taken by the department is not correct.

Further, it may be noted that in *Vikram Cement v. CCE* 2006 (197) ELT 145 (SC), it has been held that CENVAT credit is available only when mines are captive mines i.e. they constitute one integrated unit with the main cement factory. Credit would not be available if the supplies from the mine are made to various cement factories of different assesseees.

- (c) (i) The CENVAT credit available for December, 2005 is computed below:

Particulars	B.E.D Rs.	N.C.C.D Rs.	E.C Rs.
Opening Balance	24,000	2,000	600
Capital Goods received during December, 2005 (50%)	20,000	-	400
Total	44,000	2,000	1,000

- (ii) Credit of B.E.D Rs.44,000 can be utilized for B.E.D and S.E.D. However, credit of N.C.C.D and E.C can only be utilized for payment of N.C.C.D and E.C respectively.

- (iii) Duty payable through P.L.A for December, 2005 is computed as follows:

B.E.D & S.E.D: Rs.10,000 [(Rs.36,000 + 18,000) – Rs.44,000]

Education cess payable on final products manufactured during the month of December, 2005 is Rs.1,100 [2% of (Rs.36,000 + Rs.18,000 + Rs.1,000)].

E.C: Rs.100 [Rs.1,100 – Rs.1,000]

Balance credit of Rs.1,000 of N.C.C.D (Rs.2,000 – Rs.1,000) will be carried forward, which can be utilized in subsequent month(s) only for payment of N.C.C.D on final products.

Notes:

- (i) CENVAT credit on capital goods is available @ 50% in the year 2005-06 and the balance will be available in the subsequent financial year.
- (ii) CENVAT credit on inputs received upto 31.12.2005 only can be used for paying excise duty on final products manufactured during the month of December, 2005 even if duty is payable by 15.1.2006.

Question 4

- (a) Write a brief note on the powers of review to be exercised by the Committee of Chief Commissioners under section 35B and section 35E of the Central Excise Act, 1944.
(3 Marks)
- (b) With regard to exports under the Central Excise Act, 1944 write a brief note on:
 - (i) Who is authorised to sanction rebate claim?
 - (ii) The time limit for the filing of such rebate claim. (2 x 2 = 4 Marks)
- (c) Write short note on "submission of list of records" under rule 22(2) of the Central Excise Rules, 2002. (4 Marks)
- (d) With reference to Rule 8(3) and Rule 8(3A) of the Central Excise Rules, 2002 explain in brief the consequences, if duty is not paid fully on the due date or within 30 days after the due date. (4 Marks)

Answer

- (a) The Finance Act, 2005 has inserted a new sub-section (1B) in section 35B to empower the Central Board of Excise and Customs constituted under the Central Board of Revenue Act, 1963 to constitute a Committee by notification in the Official Gazette. The Committee shall consist of two Chief Commissioners or two Commissioners of Central Excise for the purpose of giving direction to the proper officer to appeal on its behalf to the Appellate Tribunal. Accordingly sub-section (2) of section 35B has also been amended to provide that the Committee of Commissioners of Excise shall review the orders of the Commissioner of Central Excise (Appeals).

Similarly section 35E has bestowed the powers of review of orders of a Commissioner to the Committee of Chief Commissioners of Central Excise. Accordingly, now the Committee of Chief Commissioners will direct such Commissioner or any other Commissioner to apply to the Appellate Tribunal and shall make such order within a period of six months, but not beyond a period of one year from the date of decision or order of the adjudicating authority.
- (b) (i) The rebate of excise duty paid on exported goods is granted under rule 18 of the Central Excise Rules, 2002. The rebate claim can be filed with any of the following Officers of the Central Excise:
 - (i) Deputy/Assistant Commissioner of Central Excise having jurisdiction over the factory of production of export goods or the warehouse; or

- (ii) Maritime Commissioner
- (ii) As per section 11B of the Central Excise Act, 1944, the claim must be filed within one year from the date of export.
- (c) As per rule 22(2) of the Central Excise Rules, 2002, every assessee and first stage dealer and second stage dealer should submit to the officer empowered to visit and inspect under rule 22(1) a list in duplicate, of:
 - (i) all the records prepared and maintained for accounting of transaction in regard to receipt, purchase, manufacture, storage, sale or delivery of goods including inputs and capital goods;
 - (ii) all the records prepared and maintained for accounting of transaction in regard to payment for input services and their receipt or procurement; and
 - (iii) all the financial records and statements including trial balance or its equivalent.
- (d) Rule 8(3) of the Central Excise Rules, 2002 provides that if the assessee fails to pay the amount of duty by 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 Act on the outstanding amount, for the period starting with the first day after due date till the date of actual payment of the outstanding amount. Currently, the rate of interest is 13%.

Under rule 8(3A), if duty is not paid within 30 days after the due date, the assessee shall lose the facility to pay duty in monthly instalments. This forfeiture will commence from the date of order passed by Assistant/Deputy Commissioner of Central Excise. The forfeiture of facility will continue for a period of two months or till such date on which all dues including interest are paid, whichever is later.

Further, during the said period of two months (or till outstanding amount and interest is paid, whichever is later), the assessee shall be required to pay excise duty for each consignment by debit to the account current (i.e. without utilizing CENVAT credit). In the event of any failure, it shall be deemed that such goods have been cleared without payment of duty and the consequences and penalties as provided in these rules shall follow.

Question 5

- (a) Briefly comment with reasons on any two of the following statements:
 - (i) Section 35C(2A) of the Central Excise Act, 1944 curtails the power of the Appellate Tribunal to grant stay beyond six months.
 - (ii) Two factories located in the same premises are to be considered as one factory for the purpose of arriving at the "aggregate value of clearances" in terms of Small Scale Exemption Notification No.8/2003- C.E., dated 1-3-2003.
 - (iii) The Central Excise Officer incharge of a warehouse may permit export without physical storage of the goods in the warehouse.

(3 x 2 = 6 Marks)

- (b) (i) Briefly explain with reference to section 11A of the Central Excise Act, 1944 as to who is authorised to issue a show cause notice.
- (ii) A show cause notice under section 11A of the Central Excise Act, 1944 was issued by Superintendent of Central Excise and the case was adjudicated by a Deputy Commissioner. This was inspite of there being in existence a circular of the Central Board of Excise and Customs to the effect that the same ought to have been done by a Commissioner. Explain briefly whether the action in the present case is sustainable in law. (2 + 3 = 5 Marks)
- (c) Explain briefly the provisions relating to charging of interest under section 11DD of the Central Excise Act, 1944. (4 Marks)

Answer

- (a) (i) Section 35C(2A) of the Central Excise Act, 1944 provides that if an order of stay is made by the Appellate Tribunal in any proceeding relating to an appeal filed under sub-section (1) of Section 35B, the appeal shall be decided within 180 days. If appeal is not disposed of by the Tribunal within 180 days, the stay shall stand automatically vacated.

The Apex Court in the case of CCE v. Kumar Cotton Mills Pvt. Ltd. (2005) 180 ELT 434 (SC) has held that the amendment did not in any way curtail the powers of the Tribunal to grant stay exceeding six months. The Supreme Court observed that sub-section (2A) could not be construed as punishing the assessee for matters which might be completely beyond their control e.g. many of the Tribunals are not constituted and it is not possible for such Tribunals to dispose of matters. Occasionally by reason of other administrative exigencies for which the assessee cannot be held liable, the stay applications are not disposed within the time specified.

However, it has been made clear by the Apex Court that the Tribunal could extend the period of stay only:

- (i) on good cause; and
 - (ii) if it was satisfied that the matter could not be heard and disposed of by reason of the fault of the Tribunal and not for reasons attributable to the assessee.
- (ii) In the case of Rollantainers Ltd. v. CCEx. (2004) 170 ELT 257 (SC), the Supreme Court has held that two factories located in the same premises with common boundaries could not be treated as one factory for the purpose of small scale exemption as they had separate staff, separate management, separate passage, separate entrance with separate Central Excise Registration and produced different end products. Further, the end product of one factory was not the raw material for the other, they were not subsidiary of each other and there was no commonality of purpose between the two factories. Mere common boundary did not make them as one factory even though at apex level both the factories were maintained by one company.

This case proves that situs of a factory alone should not be considered as the sole criterion for clubbing its clearances with the other factory's clearances. The clubbing of clearances is dependant upon the facts and circumstances of each case.

- (iii) The Officer-in-charge of the warehouse may permit waiver from physical warehousing (i.e. permitting export without physically storing the goods in the warehouse) where exporter so requests in writing provided all the formalities relating to record-keeping shall be completed in usual manner with suitable record in the Warehousing Register: "warehousing waived". This permission will be given in exceptional cases where delay occurred due to delayed supply from the factory or longer transit period or requirement of immediate export or any other genuine reasons, provided the entire consignment is entered for export in the original packing. Such cases of permission granted will be reported to the Superintendent-in-charge of the warehouse at the earliest.
- (b) (i) Section 11A of the Central Excise Act, 1944, specifies that show cause notice should be issued by a 'Central Excise Officer'. As per section 2(b) of the Act a 'Central Excise Officer, means the Chief Commissioner of Central Excise, Commissioner of Central Excise, or any other officer of the Central Excise Department, invested by the CBEC constituted under the Central Boards of Revenue Act, 1963 with any of the powers of a Central Excise Officer under this Act.
- (ii) In *Pahwa Chemicals Pvt. Ltd. v. CCE* (2005) 181 ELT 339 (SC), the Supreme Court has held that a show cause notice can be issued by any 'Central Excise Officer'. These statutory powers cannot be cut down by issuing a Circular. The Circulars issued by the Board (specifying powers of various officers) are nothing more than administrative directions. The Central Excise Officers, as a matter of propriety, should follow the directions and only deal with the work which has been allocated to them by virtue of these Circulars. However, if an officer still issues a notice or adjudicates contrary to the Circulars, it would not be a ground for holding that he has no jurisdiction to issue the show cause notice or to set aside the adjudication especially as no prejudice is caused thereby to the assessee.

Therefore, the action in the present case is sustainable in law.

- (c) Where an amount has been collected in excess of the duty assessed or determined and paid on any excisable goods under this Act or the rules made thereunder from the buyer of such goods, the person who is liable to pay such amount as determined under sub-section (3) of section 11D, shall, in addition to the amount, be liable to pay interest at such rate, not below 10% and not exceeding 36% p.a., as is for the time being fixed by the Central Government, by notification in the Official Gazette, from the first day of the month succeeding the month in which the amount ought to have been paid under this Act, till the date of payment of such amount. Currently the rate is 15% as notified vide Notification No. 68/2003 C.E. dated 12.09.2003.

However, in cases where the amount becomes payable consequent to issue of an order, instruction or direction by the Board under section 37B, and such amount payable is

voluntarily paid in full, without reserving any right to appeal against such payment at any subsequent stage, within 45 days from the date of issue of such order, instruction or direction, as the case may be, no interest shall be payable and in other cases the interest shall be payable on the whole amount, including the amount already paid.

Where the amount determined under section 11D(3) is reduced or increased by the Commissioner (Appeals), the Appellate Tribunal or the court, as the case may be, the interest payable thereon shall be on such reduced or increased amount respectively.

PART - B

Question 6

- (a) Explain briefly with reference to the provisions of the Customs Act, 1962 any two of the following:
- (i) Customs port
 - (ii) Goods
 - (iii) Stores. (2 x 2 = 4 Marks)
- (b) Examine briefly the powers of the department, if it is not satisfied with an order made under section 47 of the Customs Act, 1962 pursuant to which goods have been cleared. (3 Marks)
- (c) An importer imported certain inputs for manufacture of final product. A small portion of the imported inputs were damaged in transit and could not be used in the manufacture of the final product. An exemption notification was in force providing exemption in respect of specified raw materials imported into India for use in manufacture of specified goods, which was applicable to the imports made by the importer in the present case. Briefly examine whether the importer could claim the benefit of the aforesaid notification in respect of the entire lot of the inputs imported including those that were damaged in transit. (3 Marks)
- (d) Write short notes on the following with reference to the provisions of the Customs Act, 1962:
- (i) Relevant dates for submission of refund application
 - (ii) Prohibition and regulation of drawback (3 x 2 = 6 Marks)
- (e) State briefly the provisions of section 17 of the Customs Act, 1962 relating to assessment of goods. (4 Marks)

Answer

- (a) (i) As per section 2(12) of the Customs Act, 1962, 'customs port' means any port appointed under clause (a) of section 7 to be a customs port and includes a place appointed under clause (aa) of that section to be an inland container depot.
- As per clause (a) and (aa) of section 7(1) of the Customs Act, the Board may, by notification in the Official Gazette, appoint the ports and airports and the places which alone shall be customs ports or customs airports and the inland container

depots for the unloading of imported goods and the loading of export goods or any class of such goods.

- (ii) According to section 2(22) of the Customs Act, 1962, 'goods' includes –
 - (a) vessels, aircrafts and vehicles;
 - (b) stores;
 - (c) baggage;
 - (d) currency and negotiable instruments and
 - (e) any other kind of movable property.
- (iii) As per section 2(38) of the Customs Act, 1962, 'stores' means goods for use in a vessel or aircraft and includes fuel and spare parts and other articles of equipment, whether or not for immediate fitting.

Stores are also goods but are covered by special provisions in sections 85 to 90. The definition does not cover goods for use in a vehicle.

- (b) Goods are cleared from customs after proper officer makes an order permitting clearance of the same for home consumption under section 47 of the Customs Act. Once goods are cleared after issue of such order but the department is not satisfied with the order, following action can be taken:
 - (i) Department can file a review application under section 129D(2) of the Customs Act against the order of the proper officer with the Commissioner (Appeals); or
 - (ii) Action can be taken under section 28 of the Customs Act by issuing a show cause notice.

It has been held by the Supreme Court in *UOI v. Jain Shudh Vanaspati Ltd.* (1996) 86 ELT 460 (SC) that action can be taken under section 28 of the Customs Act, even after goods are released from Customs by issuing a show cause notice etc.

- (c) The facts of the case are similar to the case of *BPL Display Devices Ltd. v. CCEx., Ghaziabad* (2004) 174 ELT 5 (SC) wherein the Supreme Court has held that the benefit of the notifications cannot be denied in respect of goods which are intended for use for manufacture of the final product but cannot be so used due to shortage or leakage.

The Apex Court has held that no material distinction can be drawn between loss on account of leakage and loss on account of damage. The benefit of said exemption cannot be denied as inputs were 'intended for use' in the manufacture of final product but could not be so used due to shortage/leakage/damage. It has been clarified by the Supreme Court that words "for use" have to be construed to mean "intended for use".

Therefore, the importer can claim the benefit of the notification in respect of the entire lot of the inputs imported including those that were damaged in transit.

- (d) (i) According to section 27 of the Customs Act, 1962, a refund claim should be lodged before the expiry of six months. However, in case of imports made by individual for personal use or by Government or by any educational, research or charitable

institution or hospital, the refund claim should be filed before the expiry of one year. Following are the relevant dates to calculate the time limit of six months or one year for the purpose of submission of refund application:

- (a) If the refund claim is lodged by the importer, the time limit should be calculated from the date of payment of duty.
- (b) If the refund claim is lodged by the buyer of imported goods, the time limit should be calculated from the date of purchase.
- (c) In case of goods which are exempt from payment of duty by an ad-hoc exemption, the limitation of one year or six months, as the case may be, should be computed from the date of issue of such exemption order.
- (d) Where any duty is paid provisionally, the time limit should be computed from the date of adjustment of duty after the final assessment thereof.

The time limit of six months or one year would not be applicable if duty is paid under protest.

- (ii) Section 76 of the Customs Act, 1962 contains the provisions in respect of prohibition and regulation of drawback. The provisions are:
 - (a) Notwithstanding anything herein before contained, no drawback shall be allowed -
 - (i) in respect of any goods, the market price of which is less than the amount of drawback due thereon,
 - (ii) where the amount of drawback in respect of any goods is less than Rs.50.
 - (b) Without prejudice to the provisions of sub-section (1), if the Central Government is of the opinion that goods of any specified description in respect of which drawback is claimed under this Chapter are likely to be smuggled back into India, it may, by notification in the Official Gazette, direct that drawback shall not be allowed in respect of such goods or may be allowed subject to such restrictions and conditions as may be specified in the notification.
- (e) Sub-section (1) of section 17 lays down that after an importer has entered any imported goods or an exporter has entered any export goods the imported goods or the export goods, without undue delay, be examined and tested by the proper officer.

Sub-section (2) provides that after such examination and testing, the duty, if any, leviable on such goods shall be assessed.

Sub-section (3) lays down that for the purpose of assessing duty under sub-section (2), the proper officer may require the importer, exporter or any other person to produce any contract, broker's note, policy of insurance, catalogue or other document whereby the duty leviable on the imported goods or export goods can be ascertained. The proper officer may also require the importer/exporter to furnish any information required for such ascertainment which is in his power to produce or furnish.

Sub-section (4) provides that imported goods or export goods may, prior to the examination or testing thereof, be permitted by the proper officer to be assessed to duty on the basis of the statements made in the entry relating thereto and the documents produced and the information furnished under sub-section (3). However, if it is found subsequently on examination or testing of the goods or otherwise that any statement in such entry or document or any information so furnished is not true in respect of any matter relevant to the assessment, the goods may, without prejudice to any other action which may be taken under this Act, be re-assessed to duty.

Question 7

- (a) What will be the dates of commencement of the definitive anti-dumping duty in the following cases under section 9A of the Customs Tariff Act, 1975 and the rules made thereunder:
- (i) where no provisional duty is imposed;
 - (ii) where provisional duty is imposed;
 - (iii) where anti-dumping duty is imposed retrospectively from a date prior to the date of imposition of provisional duty. (2 x 3 = 6 Marks)
- (b) M/s. Pure Energy Ltd. is engaged in oil exploration and has imported software containing seismic data. The importer is entitled to exemption from customs duty subject to the condition that an "essentiality certificate" granted by the Director General of Hydrocarbons is produced at the time of importation of the goods. The certificate was not made available to the importer within a reasonable time by the Director General of Hydrocarbons. The customs department rejected the importer's claim for exemption. Examine briefly whether the department's action is sustainable in law. (4 Marks)
- (c) (i) Briefly explain the powers of officers of Customs under section 5 of the Customs Act, 1962. (2 Marks)
- (ii) With reference to section 6 of the Customs Act, 1962, examine briefly whether the Central Government could entrust any functions of the Central Board of Excise and Customs or any officer of Customs to any officer of any other department. (3 Marks)

Answer

- (a) The Central Government has power to levy anti-dumping duty on dumped articles in accordance with the provisions of section 9A of the Customs Tariff Act, 1975 and the rules framed thereunder.
- (i) In a case where no provisional duty is imposed, the date of commencement of anti-dumping duty will be the date of publication of notification, imposing anti-dumping duty under section 9A(1), in the Official Gazette.
 - (ii) In a case where provisional duty is imposed under section 9A(2), the date of commencement of anti-dumping duty will be the date of publication of notification, imposing provisional duty under section 9A(2), in the Official Gazette.

- (iii) In a case where anti-dumping duty is imposed retrospectively under section 9A(3) from a date prior to the date of imposition of provisional duty, the date of commencement of anti-dumping duty will be such prior date as may be notified in the notification imposing anti-dumping duty retrospectively, but not beyond 90 days from the date of such notification of provisional duty.
- (b) This issue has been addressed to by the Supreme Court in the case of Commissioner of Customs v. Tullow India Operations Ltd. (2005) 189 ELT 401 (SC). The Apex Court has observed that if a condition is not within the power and control of the importer and depends upon the acts of public functionaries, non-compliance of such a condition, subject to just exceptions cannot be held to be a condition precedent which would disable it from obtaining the benefit for all times to come.

In the given case also the certificate has not been granted within a reasonable time. Therefore, in view of the above-mentioned judgement, the importer M/s Pure Energy Ltd. cannot be blamed for the lapse by the authorities. The Directorate General of Hydrocarbons is under the Ministry of Petroleum and Natural Gas and such a public functionary is supposed to grant the essentiality certificate within a reasonable time so as to enable the importer to avail of the benefits under the notification.

- (c) (i) An officer of customs may exercise the powers and discharge the duties conferred or imposed on him under this Act subject to such conditions and limitations as the Board may impose. He may also exercise the powers and discharge the duties conferred or imposed under this Act on any other officer of customs who is subordinate to him. However, a Commissioner (Appeals) shall not exercise the powers and discharge the duties conferred or imposed on an officer of customs other than those specified in Chapter XV (Appeals and Revision) and section 108 (power to summon persons for giving evidence).
- (ii) As per section 6 of the Customs Act, 1962, the Central Government may, by notification in the Official Gazette, entrust either conditionally or unconditionally to any officer of the Central or the State Government or a local authority any functions of the Board or any officers of customs under this Act.

Question 8

- (a) Write a brief note on any two of the following with reference to the Customs Act, 1962:
- (i) Fine and Penalty
 - (ii) Rules and Regulations
 - (iii) Power to search persons under section 100 and section 101. (3 x 2 = 6 Marks)
- (b) Explain briefly if the Authority for Advance Rulings could entertain applications from residents with specific reference to section 28E(c) of the Customs Act, 1962. (3 Marks)
- (c) Write a brief note on "remission of duty in case of volatile goods" under section 70 of the Customs Act, 1962. (3 Marks)

- (d) Briefly explain "standard unit of quantity" with reference to the First Schedule to the Customs Tariff Act, 1975. (3 Marks)

Answer

- (a) (i) Section 125 of the Customs Act provides for the power of the customs officer to give an option to the owner of the goods or, where such owner is not known, the person from whose possession or custody the offending goods have been seized to pay 'fine' in lieu of confiscation of such offending goods. The provisions in this regard are as follows:
- (i) The customs officer may give an option to pay a fine in lieu of confiscation (Redemption Fine) in case of prohibited goods.
 - (ii) In case of other goods, the customs officer shall give an option of payment of redemption fine.
 - (iii) The amount of such fine cannot exceed the market price of the confiscated goods less the duty paid thereon.
 - (iv) Where any fine in lieu of confiscation of goods is imposed, the owner of goods or the person from whom the goods were seized, shall in addition be liable to pay duty and charges payable in respect of such goods.

The word 'penalty' means punishment under the law, i.e. such punishment as is provided in penal laws. It also means the sum payable as a punishment for a default. Penalty provisions under the Customs Act are for improper importation/exportation of goods, short-levy or non-levy of duty in certain cases, non accounting for goods and contravention etc. not expressly mentioned.

- (ii) According to section 2(36) of the Act, 'rules' means the rules made by the Central Government under any provision of this Act. Section 156 of the Act gives the Central Government the general power to make rules.

As per section 2(35) of the Customs Act, 1962, 'regulations' means the regulations made by the Central Board of Excise and Customs (CBEC) under any provision of this Act. The Board gets the authority to make regulations under section 157 of the Customs Act, 1962.

While the rules are to be framed in consistence with the provisions of the Act, the regulations are subject to an additional limitation, i.e. they should not be contrary to the rules also.

Rules have to be placed before the Parliament, while regulations framed by CBECE are not required to be placed before the Parliament. However, both are 'subordinate legislations' and are legally valid and enforceable.

- (iii) Search under section 100 is conducted by the proper officer of the customs, whereas search under section 101 is conducted by the officer of customs empowered by the Commissioner of Customs.

A person can be searched under section 100 if the proper officer has reason to believe that any goods liable to confiscation or documents relating thereto are secreted in his person. However, a person can be searched under section 101 only for certain specified goods which are liable to confiscation or documents relating thereto. The specified goods are gold, diamonds, manufactures of gold or diamonds, watches, and any other notified goods.

Section 100 applies to only the persons specified therein e.g. any person in a customs area. However, for search under section 101, there is no restriction regarding place of such person.

- (b) Yes, the Authority for Advance Rulings (AAR) can entertain applications from residents also. Section 28E(c) of the Customs Act, 1962 has been amended by the Finance Act, 2005 so as to include the following within the definition of an applicant:
 - (i) a joint venture in India, and
 - (ii) a resident falling within any such class or category of persons as the Central Government may by notification in the Official Gazette specify in this behalf.
- (c) Section 70 of the Customs Act provides for the remission of duty in case of shortage of the volatile goods, which are warehoused. The Assistant or Deputy Commissioner of Customs is empowered to remit the duty leviable on such deficiency, if following conditions are satisfied:
 - (i) The goods should be found deficient in quantity at the time of removal from the warehouse;
 - (ii) The deficiency should be on account of natural loss, i.e. evaporation etc.

These provisions are applicable only to such warehoused goods as the Central Government, having regard to the volatility of the goods and the manner of their storage, may, by notification in the Official Gazette, specify.
- (d) 'Standard Unit of Quantity' is a unit of measure. It has been prescribed in column 3 of the First Schedule to the Customs Tariff for each tariff item to facilitate the collection, comparison and analysis of trade statistics. The unit of measure is indicated by abbreviations. Some abbreviations are cc-cubic centimeter, cm-centimetre(s), g-gram(s), mt- Metric Tonne.

Board's Circular No.51/2003 dated 18.06.2003 provides that an importer should use single standard unit of quantity. Usage of single standard unit of quantity has been again emphasized vide Directorate General of Valuation, CBEC Letter No. F VAL/217/2001 dated 9.11.2005.

Use of different units of quantity for the same goods has been causing serious problems in data analysis for National Import Data Base. Unacceptable units like sacks, cartons, bundles are often used in respect of certain goods. These practices make it difficult to do value comparison for such kind of goods. Data analysis and Risk Management also will run into difficulties due to such inconsistent use of units of quantity.

PART – C

Question 9

- (a) Export of Services Rules, 2005 were made effective from March 15, 2005. Answer the following questions with reference to the said rules:
- (i) What are the three categories of taxable services dealt with under Rule 3?
 - (ii) What are the three options available to an exporter of taxable services under these rules for claiming exemption or rebate of service tax? (3 x 2 = 6 Marks)
- (b) With reference to the Finance Act, 1994 as amended and the rules made thereunder relating to service tax, state whether registration is required or not in the case of the following persons or class of persons:
- (i) Input service distributor
 - (ii) Small service provider whose aggregate value of taxable service is Rs.3,50,000 per annum.
 - (iii) India based recipient of taxable services provided from abroad by a non-resident not having any place of business in India. (1 x 3 = 3 Marks)
- (c) Answer any three of the following with reference to the Finance Act, 1994 as amended relating to applicability of service tax:
- (i) Entrance fee and life membership fee paid by members of the club providing various services and facilities and organizing get togethers and functions for its members.
 - (ii) Construction of residential complex having ten bungalows.
 - (iii) Selling of SIM (Subscribers Identification Module) card and the process of activation thereof by mobile/cellular telephone companies.
 - (iv) Study material or written text provided by commercial training and coaching centre. (2 x 3 = 6 Marks)

Answer

- (a) (i) Rule 3 of Export of Services Rules, 2005 classifies the taxable services in three categories as under:
- (a) when the immovable property in respect of which the service is rendered is situated abroad [Rule 3(1)(i)];
 - (b) when the service is partly/fully performed outside India [Rule 3(1)(ii)];
 - (c) when service is provided from India, but recipient of service is located outside India [Rule 3(1)(iii)].
- In order to be treated as export of services, different requirements in each of the three categories have to be fulfilled.
- (ii) The three options available to an exporter of taxable services for claiming exemption or rebate of service tax are:

- (a) Export taxable service without payment of service tax under Rule 4 and utilize CENVAT credit of excise duty/service tax paid on inputs/input services used in providing exported taxable services for payment of service tax on other services.
 - (b) Export taxable service without payment of service tax and claim rebate of service tax paid on input services and excise duty paid on inputs used in providing such taxable service under Rule 5.
 - (c) Pay service tax on exported service and claim rebate of service tax paid on such taxable service under Rule 5.
- (b) (i) Yes. As per section 69(2) of the Finance Act, 1994 and Notification No.26/2005-ST dated 07.06.2005, an input service distributor is required to make an application for registration.
- (ii) Yes. Any provider of taxable service whose aggregate value of taxable service in a financial year exceeds Rs.3,00,000 is required to get registration under section 69(2) of the Finance Act, 1994.
- (iii) Yes. As per Circular No.B1/6/2005-TRU dated 27.7.2005 an India based recipient of taxable services provided from abroad by a non-resident not having any place of business in India is deemed to be the service provider and hence has to obtain registration.
- (c) (i) Membership of clubs or associations has been made a taxable service w.e.f. 16.6.2005. Facilities or advantages are provided to members in return for a subscription or other consideration. Entrance fee and life membership fee shall also be treated in the same way as a subscription, hence these would also be taxable.
- (ii) Construction of residential complex has been made a taxable service w.e.f. 16.6.2005. However, construction of residential complex having only 12 or less residential units is not chargeable to service tax. Thus, construction of residential complex having 10 bungalows would not be chargeable to service tax.
- (iii) M.F. (D.R.) Circular No. 23/3/97- S.T., dated 13.10.1997 has clarified that the amount received by the cellular telephone company from subscribers towards SIM card forms part of the value of taxable service for levy of service tax.
- (iv) The gross amount charged for rendering the taxable services is liable to service tax. However, Notification No.12/2003-ST, dated 20.06.2003 exempts so much of the value of all the taxable services, as is equal to the value of goods and materials sold by the service provider to the recipient of service from the service tax leviable thereon subject to condition that there is documentary proof specifically indicating the value of the said goods and materials. Further, the said exemption is available only when CENVAT credit on such goods and materials sold has not been taken by the service provider.

Therefore, the stuzdy material and written text provided by the coaching centre will be charged to service tax if the conditions set out in the above notification are not complied with. However, if the conditions are complied with, exemption will be granted.

SUMMARY OF EXAMINERS' COMMENTS ON THE PERFORMANCE OF CANDIDATES

PAPER – 5 : COST MANAGEMENT

General Comments

The performance of the candidates is short of what is expected of a Final student. There appears to be a lack of knowledge in concepts which build upon the basics like Standard Marginal Costing, Target Costing, Value Chain Analysis etc. Students are requested to do extensive reading of the subject, in order to understand the various traditional and modern concepts. This will help them prepare and perform better in future examinations.

Specific Comments

Question 1. (a) This was a practical question part requiring students to prepare profitability statements at two different levels of output and subsequently compute the break even point from the given data. Certain students lacked the understanding of stepped costs and hence were not able to arrive at the correct answer.

(b) This was a theory part requiring students to give two examples of Unit, Batch, Product and Facility level activities. Examiners have observed that many students did not have a clear concept regarding activity based costing.

(c) This was theory part requiring students to outline the features of penetrative pricing. Most of the students have attempted the answer on the desired lines.

Question 2. (a) This practical part required candidates to determine the minimum cost. Most of the students were able to arrive at the correct answer to this assignment problem.

(b) This practical part required candidates to determine the total duration and give three different ways to reduce the project duration. Many candidates could not write about the ways to crash project time.

(c) This practical part required candidates to identify an appropriate transfer price from the given data relating to a profit centre which produces for captive consumption and also for the external market. Most of the students were able to approach the problem satisfactorily.

Question 3. (a) This was a practical question part requiring candidates to compute the rent to be charged to each bed-day for different types of wards in a Medical Health Centre. Many students were unable to compute equivalent ward days and hence arrived at the wrong rates.

(b) This theory question part required examinees to explain the concept of simulation. The question part was attempted fairly well by a majority of the candidates.

(c) This theory question part required students to explain briefly the 'learning curve ratio'. The question part was done well by most of the candidates.

Question 4. (a) This was a practical question part requiring candidates to have a clear understanding of a standard marginal costing system. Many students could not calculate the cost of labour in efficiency and hence arrived at the wrong answer. Some candidates failed to compute

correct marginal cost, Contribution and the Valuation of Stock. A majority of students also failed to answer correctly the 'Report to the management giving reasons for the losses'.

(b) This was a theory part requiring students to list the steps to be followed in Target Costing. The question part was done well by most of the students; however, a few did not use the block diagram for explanation purposes. Also, a few students gave very superficial answers.

Question 5. (a) This was a theory question part requiring candidates to explain the meaning of ERP and name six benefits arising out of the same. Although the question has been attempted satisfactorily, the examiners have reported that there appears to be a lack of conceptual clarity in this subject area.

(b) This practical question part required candidates draw a network and highlight the critical path. Many candidates failed to draw the network correctly, although they named the critical path correctly.

(c) This practical question part required students to formulate a linear programming model from the given data and identify maximum profit. Most of the students did this problem very well.

Question 6. (a) This practical question part required students to have a clear conceptual understanding of Standard Costing and Variance analysis. Very few students were able to attempt this question.

(b) This was a theory question part requiring candidates to have knowledge of integrated/interlocking systems of accounts in situations where standard costing is adopted. Many students were unable to give the correct Journal Entries.

(c) This theory part required a sound understanding of concepts of Value Chain. Many of the students were not able to answer this question on the desired lines.

PAPER – 6 : MANAGEMENT INFORMATION AND CONTROL SYSTEMS

General Comments

Candidates wrote answers without first analyzing the exact requirement of each question. Candidates exhibited lack of adequate preparation and in-depth knowledge of the subject.

Specific Comments

Question 1. (a) Most of the candidates failed to understand the meaning of 'vulnerable' and the 'key areas' that are most vulnerable when data is stored in electronic form.

(b) Majority of the candidates were clueless about common types of field interrogation as a validation control procedure.

(c) Many candidates failed to highlight distinction between general and application controls. However, second part of the question i.e. broad categories into which general controls can be divided was answered correctly by them.

Question 2. (b) Many candidates could correctly identify the information required for sales support and sales analysis whereas others listed all the information rather than being specific about each part.

Question 3. (a) Candidates lacked understanding of the question. Instead of quoting reasons for project failure, they discussed about software and hardware aspects of computer system failure.

(b) This part was well attempted by majority of the candidates.

(c) Answered by few candidates with an average performance. Various aspects of benchmarking problem were not covered by many candidates.

Question 4. (a) Very few examinees stated correctly the sequence of events which occur immediately for each transaction when controlled by the sales order entry computer program in an OLRT system.

(c) Candidates failed to split the answers into four different ways of committing computer frauds using input.

Question 5. (a) Most of the candidates attempted this question on powers of Cyber Appellate Tribunal. Few stated basic and fundamental powers like summons, receiving evidence and examination of an oath.

(c) Many candidates did not understand the meaning of "subversive threats" and hence confused them with computer frauds.

Question 6. The given question is a case study. Performance was satisfactory.

Question 7. (a) Most of the candidates gave vague answers about Enterprise Controlling.

(b) Candidates exhibited lack of conceptual clarity about integrated test facility.

(c) Some of the candidates could not explain the concept of restorative information protection.

PAPER – 7 : DIRECT TAXES

General Comments

Most candidates do not possess the required expert knowledge in income-tax. Therefore, their answers were vague and based on surmises and conjectures. Lengthy answers dealing with irrelevant points were common. Many candidates have not given proper notes in support of their answers. The presentation of answers was also very poor in many cases. Most candidates do not start the answer to each question on a fresh page. Other deficiencies were very poor handwriting, poor English, lack of expression and spelling and grammatical mistakes.

Specific Comments

Question 1. (i) Most of the candidates have answered this question without furnishing proper/adequate explanations or reasons for the treatment of various items i.e. additions/deletions made to the net profit as per profit & loss account. For example, many students have stated that interest paid on arrears of sales-tax is an allowable expenditure without giving the reason for the same, namely, because the expenditure is not penal in nature but compensatory in character.

(ii) The question only requires computation of total income. Some candidates have calculated tax payable and also book profits as per Section 115JB of the Act, which are not required.

Some of the other common mistakes committed are -

- (1) Income-tax paid on non-monetary perquisites provided to the employees was confused with FBT.
- (2) As regards expenditure on scientific research, deduction was provided at 125% or 100% instead of 150%.
- (3) Treatment of rent received from vacant land as business income or as income from house property.
- (4) Failure to provide deduction of 30% from arrears of rent received and treatment of arrears of rent received as income from other sources.

Question 2. (b) Some candidates have wrongly answered that the salary paid to Karta is not allowable. Few candidates have discussed about the maximum salary payable to partners of a firm as per Section 40(b)(v) of the Act, which is irrelevant.

Question 3. (a) Some candidates have discussed the provisions relating to section 80P applicable to Co-operative Societies. Most candidates have not explained the concept of mutuality, which is relevant in this case. A few candidates have stated that the club has to pay FBT. Some other candidates have considered the club as a trade, professional or similar association and stated that the income derived from the specific services performed for its members is taxable as per section 28(iii) of the Act.

(b) Some candidates were not aware of the recent amendments by the Finance Act, 2005 with regard to mandatory filing of return by an individual if his gross total income exceeds maximum amount not chargeable to tax before deduction under chapter VI-A and also mandatory filing of loss return by firms on or before the due date. Many candidates have answered that the firm has to file loss return for carrying forward the loss to subsequent year, which is not relevant in the context of the question asked.

Question 4. (a) Many candidates have considered site and building as a single asset and computed capital gain. Some candidates have treated the sale of land and building together as a slump sale and applied the provisions of section 50B.

(b) This question is on taxability of salary, allowances and perquisites of an Indian citizen employed in the Indian embassy at Japan. Some candidates have wrongly answered that his salary is exempt and allowances and perquisites are taxable whereas the correct answer is that the salary is taxable and the allowances and perquisites are exempt under section 10(7).

Question 5. (b) Many candidates have wrongly answered that the Commissioner has the power to revise the order under section 264 since the issue of deduction was not the subject matter of appeal before the Commissioner (Appeals).

(c) The question is whether the tax deducted at source but not paid by tenant can be recovered from the landlord. Some candidates have given irrelevant answers like the return filed by landlord is defective since TDS Certificate has not been filed along with such return and that the landlord should be given time to file the TDS Certificate.

Question 6. (a) Many candidates were not aware of what is meant by "Memorandum of cross objections" and hence, were not able to answer correctly.

(b) Most of the candidates were not aware of the ceiling of Rs.60,000 in the case of medical treatment of a senior citizen under section 80DDB.

(c) Many candidates confused the power to collect information under section 133B by the Assessing Officer with the power of survey under section 133A and have wrongly answered that the Assessing Officer could not enter the hotel after sunset.

Question 7. (a) Most of the candidates have not understood as to what is an adventure in the nature of trade and their answers were vague and based on surmises and conjectures. Some candidates have confused the same with speculative trade.

(b) Most of the candidates were not aware of the provisions relating to Explanation to section 275 and the proviso to section 129 and hence were not able to answer this question.

Question 8. Some candidates have not discussed the reasons for exclusion or inclusion of certain items. Few candidates have made mistakes in treatment of interest in the coparcenary property of the HUF and land owned by minor married daughter.

PAPER – 8 : INDIRECT TAXES

General comments

Overall performance of the candidates was very poor. The preparation level of the candidates was not commensurate with the preparation level required to appear in the Final Level of Chartered Accountancy Examinations. The candidates were not aware with the recent developments in the indirect tax laws. It has been felt that the students do not refer to "Supplementary Study Paper" and "Select Cases in Direct and Indirect Taxes - An Essential Reading for the Final Course". It has been observed that candidates resort to selective study thereby either scoring good marks in excise portion and poor marks in customs or vice-versa. Candidates do not attempt all parts of a question at one place. Further, they do not start the new question on a fresh page. It is advised that candidates should work upon their writing skills and improve the presentation of answers.

Specific comments

Question 1. (a) (i) Most of the candidates wrongly discussed about the availability of the CENVAT credit to the job worker, instead of explaining job work.

(ii) Most of the candidates defined 'input' in place of 'principal inputs'.

(iii) Generally, the candidates were unaware of the concept of deemed credit. They wrongly explained that when certain activities are considered as deemed manufacture, deemed CENVAT credit should be available.

(b) Majority of the candidates were ignorant of the recent Circular on valuation of samples.

(c) Though the question was based on valuation, most of the candidates wrongly discussed about manufacture. Even when the question stated that galvanisation doesn't amount to manufacture, the candidates wrote that galvanisation amounts to manufacture. A very few candidates were able to cite the case law on which the question was based.

Question 2. (a) The candidates gave general answer to this part. In most of the cases, the answers were wrong.

(b) Most of the candidates explained the provisions of section 11B of the Central Excise Act, 1944. However, they failed to answer the issue raised in the question.

(c) This question was based on valuation. However, most of the candidates confused it with classification and could not differentiate between the two. Only a few candidates could get the answer right, but most of the right answers were not supported by any reasoning.

Question 3. (a) Majority of the candidates were not aware of the provisions of section 9A of the Central Excise Act, 1944 and Compounding Rules made thereunder. They wrote vague answers.

(b) Very few students were aware of the Supreme Court's decision in the case of Vikram Cement v. CCEx., Indore 2006 (194) ELT 3 (SC). Thus, most of them answered wrongly.

(c) Due to the lack of understanding of concepts relating to availment and utilisation of CENVAT credit, most of the candidates could not give the right answer.

Question 4. (a) The candidates were unaware of the amendments made in section 35B and 35E and wrote vague answers. Some of them narrated the provisions relating to the powers of the Chief Commissioner/Commissioner of Central Excise.

(b) While part (i) was attempted satisfactorily, the candidates could not give correct time limit for sanction of rebate claim under part (ii).

(d) Most of the candidates were unaware of the amendments in provisions relating to interest under Rule 8(3) and forfeiture of facility of monthly payment of duty under Rule 8(3A).

Question 5. (a)(i) Most of the candidates could not explain the situation/conditions when Tribunal could extend the period of stay. They simply explained that the Tribunal cannot grant a stay beyond a period of six months.

(iii) Some candidates wrongly explained that physical export could be made only after physical checking and verification.

(b)(i) The candidates did not know that the Central Excise Officer is authorised to issue show cause notice.

(ii) Only a very few candidates could answer this part correctly.

(c) The candidates were not aware of the provisions of section 11DD relating to interest on

amount collected in excess of duty and instead discussed the provisions relating to interest on short payment of duty or interest on refund of duty.

Question 6. (a) Most of the candidates did not define customs port and stores correctly. A few candidates answered that 'goods' have not been defined in the Customs Act, 1962.

(b) The candidates lacked the basic understanding of the powers of the department when it is dissatisfied with an order made under section 47 and thus, wrote vague answers.

(c) Many candidates concluded that only proportionate amount of exemption would be available.

(d)(i) A large number of candidates failed to narrate the different situations for determining the relevant dates for submission of a refund application. Instead, they only explained that the application for refund might be submitted within a period of 6 months.

(d)(ii) Excepting a few candidates, none was able to explain the provisions of section 76 asked for. Most of the candidates answered on the basis of provisions of section 74 and section 75.

Question 7. (a) Barring a few candidates, none was aware of the provisions relating to dates of commencement of anti-dumping duty.

(b) Most of the candidates wrongly concluded that since the "essentiality certificate" has not been produced at the time of importation, the rejection of the claim of the importer by the Customs Authority is justified.

(c) Majority of the candidates were not aware of the provisions of section 5 and section 6 of the Customs Act, 1962 and thus, wrote vague answers.

Question 8. (a) Most of the candidates did not possess sound knowledge of the provisions of the Customs Act. Accordingly, they failed to distinguish between 'Fine and Penalty' and 'Rules and Regulations' and explained a lot of non-related issues.

(b) Instead of answering on the basis of the provisions of the Customs Act, 1962, majority of the candidates referred to the provisions of the Income-tax Act, 1961.

(c) This question was based on the provisions of section 70 relating to remission of duty on volatile goods. However, many candidates wrongly answered on the basis of section 23 relating to remission of duty on lost or destroyed goods.

Question 9. (a) Most of the candidates were unaware of the provisions relating to export of services and wrote incorrect answers.

(b)(ii) Many candidates wrongly answered that small service provider whose aggregate value of taxable service is Rs.4,00,000 per annum is exempt from obtaining registration.

(c) This part was not attempted satisfactorily. Even correct answers were backed by incorrect reasoning.