

CA FINAL

SUGGESTED

ANSWERS

JUNE 2009



Compiled By
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PAPER – 1 : ADVANCED ACCOUNTING

Answer all questions.

Working notes should form part of the answer.

Question 1

(a) Following is the information of two companies for the year ended 31st March, 2009:

	Aikya Ltd. (Rs.)	Bakya Ltd. (Rs.)
Equity shares of Rs.10 each	8,00,000	10,00,000
10 per cent Preference shares of Rs.10 each	6,00,000	4,00,000
Profit after tax	3,00,000	3,00,000

Assume that the market expectation is 18 percent and 80 percent of the profits are distributed as dividends.

- (i) What is the rate you would pay to the equity shares -
 - (a) If you are buying a small lot?
 - (b) If you are buying a controlling interest in shares?
 - (ii) If you plan to invest only in Preference shares, which company's preference share would you choose?
- (b) From the following particulars of three companies, ascertain the value of goodwill. Terms and conditions are as follows:
- (i) Assets are to be revalued.
 - (ii) Goodwill is to be valued at four years' purchase of average super profits for three years. Such average is to be calculated after adjustment of depreciation at ten per cent on the amount of increase/decrease on revaluation of fixed assets. Income tax is to be ignored.
 - (iii) Normal profit on capital employed is to be taken at 10 per cent, capital employed being considered on the basis of net revalued amounts of tangible assets.

The summarized Balance Sheets and relevant information are given below:

				(Rs. in Lakhs)			
Liabilities	P Ltd.	Q Ltd.	R Ltd.	Assets	P Ltd.	Q Ltd.	R Ltd.
Equity shares of Rs.10 each	12.00	14.00	6.00	Goodwill	-	1.00	-
Reserves	2.00	1.00	2.00	Net tangible block	16.00	12.00	10.00
10 percent debentures	4.00	-	2.00	Current assets	6.00	5.00	2.00

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Trade and
expenses
creditors

4.00	3.00	2.00
22.00	18.00	12.00

22.00	18.00	12.00
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	P Ltd. Rs.	Q Ltd. Rs.	R Ltd. Rs.
Revaluation of tangible block	20,00,000	10,00,000	12,00,000
Revaluation of current assets	7,00,000	2,80,000	1,60,000
Average annual profit for three years before charging debenture interest	3,60,000	2,88,000	1,56,000

(10+6 = 16 Marks)

Answer

- (a) (i) (a) Buying a small lot of equity shares: If the purpose of valuation is to provide database to aid a decision of buying a small (non-controlling) portion of the equity of the companies, dividend capitalization method is most appropriate. Under this method, value of equity share is given by:

$$\frac{\text{Dividend Per Share}}{\text{Market Capitalisation Rate}} \times 100$$

$$\text{Aikya Ltd: } \frac{\text{Rs.2.40}}{18} \times 100 = \text{Rs.13.33 (approx.)}$$

$$\text{Bakya Ltd: } \frac{\text{Rs.2.08}}{18} \times 100 = \text{Rs.11.56 (approx.)}$$

[Refer Working Note for computation of dividend per share]

- (b) Buying controlling interest in equity shares: If the purpose of valuation is to provide database to aid a decision of buying controlling interest in the company, Earnings per share (EPS) capitalization method is the most appropriate. Under this method, value of equity share is given by:

$$\frac{\text{Earning Per Share (EPS)}}{\text{Market Capitalisation Rate}} \times 100$$

$$\text{Aikya Ltd: } \frac{\text{Rs.3}}{18} \times 100 = \text{Rs.16.67 (approx.)}$$

$$\text{Bakya Ltd: } \frac{\text{Rs.2.60}}{\text{Rs.18}} \times 100 = \text{Rs.14.44 (approx.)}$$

[Refer Working Note for computation of earnings per share]

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- (ii) Preference Dividend coverage ratios of both companies are to be compared to make such decision. Dividend coverage ratio is given by:

$$\frac{\text{Profit after Tax}}{\text{Preference Dividend}}$$

$$\text{Aikya Ltd: } \frac{\text{Rs. 3,00,000}}{\text{Rs. 60,000}} = 5 \text{ times}$$

$$\text{Bakya Ltd: } \frac{\text{Rs. 3,00,000}}{\text{Rs. 40,000}} = 7.5 \text{ times}$$

If we are planning to invest only in Preference Shares, we would prefer shares of Bakya Ltd., as there is more coverage for preference dividend.

Working Note:

Computation of earnings per share and dividend per share

	Aikya Ltd. Rs.	Bakya Ltd. Rs.
Profit after tax	3,00,000	3,00,000
Less: Preference Dividend	<u>60,000</u>	<u>40,000</u>
Earnings available to equity shareholders (A)	<u>2,40,000</u>	<u>2,60,000</u>
Number of equity shares (B)	80,000	1,00,000
Earning per share (A/B)	3.00	2.60
Retained earnings (20%)	48,000	52,000
Dividend declared (80%) (C)	1,92,000	2,08,000
Dividend per share (C/B)	2.40	2.08

- (b) Valuation of Goodwill

	P Ltd. Rs.	Q Ltd. Rs.	R Ltd. Rs.
Average annual profit after charging debenture interest	3,20,000	2,88,000	1,36,000
Less/Add : Depreciation on increased/decreased portion of revaluation	(-)40,000	+20,000	(-) 20,000
	<u>2,80,000</u>	<u>3,08,000</u>	<u>1,16,000</u>
Less: Normal profit at 10% on capital employed as calculated in working note	1,90,000	98,000	96,000
Super Profit	<u>90,000</u>	<u>2,10,000</u>	<u>20,000</u>
Goodwill valued at four years' purchase of super profits	<u>3,60,000</u>	<u>8,40,000</u>	<u>80,000</u>

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Working Note:

Calculation of Capital Employed

	P Ltd. Rs.	Q Ltd. Rs.	R Ltd. Rs.
Tangible fixed assets	20,00,000	10,00,000	12,00,000
Current assets	7,00,000	2,80,000	1,60,000
	27,00,000	12,80,000	13,60,000
Less: Debentures and Creditors	8,00,000	3,00,000	4,00,000
	19,00,000	9,80,000	9,60,000

Question 2

Agni Ltd. and Bayu Ltd. both engaged in similar merchandising activities since 2006, decide to amalgamate their businesses. A holding company, Chandrama Ltd. would be formed on 1st January, 2008 to acquire the entire shares in both the companies.

From the information given below you are required to prepare:

- (a) A statement of purchase consideration, supported by requisite working notes.
- (b) Balance Sheet of Chandrama Ltd. after the transactions have been completed.
 - (i) The terms of the offer were:
 - Rs.100, 15 per cent debentures for every Rs.100 of net assets owned by each company on 31st December, 2007.
 - Rs.100 equity shares based on two years purchase of profit before taxation. The profit is to be determined by taking weighted average profits of 2006 and 2007, weights being 1 and 2 respectively.
 - (ii) It was agreed that the accounts of Bayu Ltd. for the two years ended 31st December, 2007 be adjusted, where necessary, to conform to the accounting policies followed by Agni Ltd.
 - (iii) The Pre-tax profits, including investment income, of the two companies were as follows:

	2006 Rs.	2007 Rs.
Agni Ltd.	16,38,000	18,36,000
Bayu Ltd.	17,88,300	25,74,000

- (iv) Agni Ltd. values its stock on FIFO basis while Bayu Ltd. used a different basis. To bring Bayu Ltd.'s values in line with those of Agni Ltd, value of its stock will require to be reduced by Rs.36,000 at the end of 2006 and Rs.1,02,000 at the end of 2007.
- (v) Both the companies use straight line method of depreciation.

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- (vi) Bayu Ltd. deducts 1 per cent from trade debtors as a general provision against doubtful debts.
- (vii) Prepaid expenses in Bayu Ltd. include advertisement expenditure carried forward of Rs.1,80,000 in 2006 and Rs.90,000 in 2007, being part of initial advertising in 2006, which is being written off over three years. Similar expenditure in Agni Ltd. has been fully written off in 2006.
- (viii) To bring Director's remuneration on to a comparative basis, the profits of Bayu Ltd. are to be reduced by Rs.1,20,000 in 2006 and Rs.1,80,000 in 2007 and the net assets are also to be adjusted accordingly.

Balance Sheets as at 31st December, 2006 and 2007 were as follows:

Agni Ltd.					
Liabilities	2006	2007	Assets	2006	2007
	Rs.	Rs.		Rs.	Rs.
Share capital issued and subscribed: 12,000 shares of Rs.100 each, fully paid	12,00,000	12,00,000	Fixed assets: Furniture and Fixtures: at cost	6,90,000	6,90,000
Reserves and Surplus:			Less: depreciation	(69,000)	(1,38,000)
Capital reserve	-	2,10,000	Investments:		
Revenue reserve	7,98,300	16,74,000	Quoted investments at market value	-	7,80,000
Current Liabilities and provisions:			Current assets:		
Sundry creditors	15,02,700	18,21,000	Stock at cost	18,30,000	21,75,000
Provision for taxation	8,40,000	9,60,000	Sundry debtors	18,00,000	22,20,000
			Prepaid expenses	30,000	42,000
			Cash at bank	60,000	96,000
	<u>43,41,000</u>	<u>58,65,000</u>		<u>43,41,000</u>	<u>58,65,000</u>
Bayu Ltd.					
Liabilities	2006	2007	Assets	2006	2007
	Rs.	Rs.		Rs.	Rs.
Share capital: Issued and subscribed 15,000 Equity shares of Rs.100 each, fully paid	15,00,000	15,00,000	Fixed assets: Furniture and fixture at cost	9,60,000	9,60,000
Reserves and surplus:			Less: Depreciation	(1,44,000)	(2,88,000)

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Revenue reserve	8,58,000	21,42,000	Investments:		
Current liabilities and provisions:			Quoted investments		
Sundry creditors	14,70,000	14,82,000	(Market value Rs.14,70,000)	-	12,00,000
Bank overdraft	-	5,10,000	Current assets:		
Provision for taxation	9,30,000	12,90,000	Stock at cost	17,91,000	22,26,000
			Sundry debtors		
			Less: provision	17,82,000	26,73,000
			Prepaid expenses	2,16,000	1,44,000
			Cash at bank	1,53,000	9,000
	<u>47,58,000</u>	<u>69,24,000</u>		<u>47,58,000</u>	<u>69,24,000</u>

(16 Marks)

Answer

(a) Statement of Purchase Consideration

		Agni Ltd.		Bayu Ltd.		
Year	PBT (Rs.)	Weight	Rs.	PBT (Rs.)	Weight	Rs.
2006	16,38,000	1	16,38,000	15,18,300*	1	15,18,300
2007	18,36,000	2	36,72,000	27,63,000*	2	55,26,000
Total Profit			53,10,000	70,44,300		
Weighted average profit (Divided by 3)			17,70,000	23,48,100		
(i)	Two years' purchase of average profits		35,40,000	46,96,200		
(ii)	Net assets (Refer working notes 2 and 3)		30,84,000	35,43,000		
			66,24,000	82,39,200		

(iii) Discharge of purchase consideration

82,362 Shares will be issued for goodwill amounting Rs. 82,36,200
(Rs.35,40,000 + Rs. 46,96,200)

66,270 15% Debentures will be issued for net assets amounting Rs. 66,27,000
(30,84,000 + 35,43,000)

Total purchase consideration will amount to Rs.1,48,63,200.

* (Refer W.N. 1)

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(b) Balance Sheet of Chandrama Ltd. as on 1st January, 2008

Liabilities	Rs.	Assets	Rs.
Share Capital- issued and subscribed		Investments	
82,362 Equity shares of Rs.100 each, fully paid up	82,36,200	Shares in Agni Ltd.	66,24,000
(Issued for consideration other than cash)		Shares in Bayu Ltd.	82,39,200
Secured Loans			
66,270 15% Debentures of Rs.100 each, fully paid	66,27,000		
	1,48,63,200		1,48,63,200

Working Notes:

1. Statement of adjusted Net Profits of Bayu Ltd.

	Year 2006		Year 2007	
	Rs.	Rs.	Rs.	Rs.
Net Profit as given		17,88,300	-	25,74,000
Add: Provision for Bad Debts - Note (a)	18,000		27,000	
Advertising	-		90,000	
Depreciation- Note (b)	48,000		48,000	
Appreciation in Investment	-		2,70,000	
Value of Opening Stock	-	66,000	36,000	4,71,000
		18,54,300		30,45,000
Less: Value of Closing Stock	36,000		1,02,000	
Advertising	1,80,000		-	
Directors' Remuneration	1,20,000	3,36,000	1,80,000	2,82,000
		15,18,300		27,63,000

Note:

	Rs.	Rs.
	Year 2006	Year 2007
(a) Sundry Debtors as per Balance sheet	17,82,000	26,73,000
Provision created		
1% of (Rs. 17,82,000 / .99)	18,000	
1% of (Rs. 26,73,000 / .99)		27,000

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- (b) Rate of depreciation under straight line method for Agni Ltd. and Bayu Ltd. can be computed as follows:
 Agni Ltd. = Rs.(69,000 / 6,90,000) × 100= 10%.
 Bayu Ltd. = Rs.(1,44,000 / 9,60,000) × 100= 15%
 Difference of 5% in depreciation amount i.e. (5% of Rs.9,60,000 = Rs. 48,000) has been added back to ensure uniform accounting policies.

2. Statement of Net Assets of Agni Ltd.

	Rs.	Rs.
Total Assets		58,65,000
Less: Sundry Creditors	18,21,000	
Provision for Taxation	<u>9,60,000</u>	27,81,000
		<u>30,84,000</u>

3. Statement of Adjusted Net Assets of Bayu Ltd.

	Rs.	Rs.
Furniture and Fixtures	9,60,000	
Less: Depreciation at 10% p.a. for two years	<u>1,92,000</u>	7,68,000
Quoted investments at market value		14,70,000
Stock (Rs.22,26,000 – Rs.1,02,000)		21,24,000
Sundry Debtors after Reversal of Provision (Rs.26,73,000 + Rs.27,000)		27,00,000
Prepaid Expenses (Rs.1,44,000 – 90,000)		54,000
Cash at Bank		<u>9,000</u>
		71,25,000
Less: Sundry Creditors	14,82,000	
Bank Overdraft	5,10,000	
Liability for Directors' Remuneration (1,20,000 + 1,80,000)	3,00,000	
Provision for Taxation	<u>12,90,000</u>	35,82,000
		<u>35,43,000</u>

Question 3

- (a) Parikshit Ltd. holds Rs.1,00,000 of loans yielding 18 per cent interest per annum for their estimated lives of 9 years. The fair value of these loans, after considering the interest yield, is estimated at Rs.1,10,000.

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The company securitises the principal component of the loan plus the right to receive interest at 14% to Susovana Corporation, a special purpose vehicle, for Rs.1,00,000.

Out of the balance interest of 4 percent, it is stipulated that half of such balance interest, namely 2 per cent, will be due to Parikshit Ltd. as fees for continuing to service the loans. The fair value of the servicing asset so created is estimated at Rs.3,500. The remaining half of the interest is due to Parikshit Ltd. as an interest strip receivable, the fair value of which is estimated at Rs.6,500.

Give the accounting treatment of the above transactions in the form of journal entries in the books of originator.

- (b) The Annuity fund of Patiala University accepts an annuity – based gift from an alumnus who specifies that he receives a monthly payment of Rs.25,000 for the remainder of his life. The gift consists of cash of Rs.20 lakh and securities having a market value of Rs.15 lakh at the time of the gift. The investment income of annuity fund for a particular month comes to Rs.38,500.

Draft journal entries in the University's books.

- (c) From the following information taken from the books of Sunagarik Ltd. relating to staff and community benefits, you are required to prepare a statement classifying the various items under the appropriate heads, required under corporate social reporting:

Particulars	Rs. in lakhs
Environmental improvements	36.18
Medical facilities	9.00
Training programmes	18.45
Generation of job opportunities	109.35
Municipal taxes	19.26
Increase in cost of living in the vicinity due to company's operations	29.79
Concessional transport, water-supply etc.	20.25
Generation of business	45.00
Leave encashment and leave travel benefits	93.60
Education facilities for children of staff members	38.88
Subsidised canteen facilities	25.92
Extra work put in by staff and officers for drought relief	33.30

(6+5+5= 16 Marks)

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Answer

(a)

Journal Entries in the Books of Originator

S.No.	Particulars		Debit Rs.	Credit Rs.
1.	Bank A/c	Dr.	1,00,000	
	To Loans (Cost of Securitised Component)			90,910
	To Profit on Securitisation			9,090
	(Being securitization of principal amount and right to receive interest at 14% interest rate)			
2.	Servicing Asset A/c	Dr.	3,180	
	Interest Strip A/c	Dr.	5,910	
	To Loans			9,090
	(Being creation of servicing asset and interest strip receivable)			

Working Notes:

1.	Fair value of securitized component of loan		Rs.
	Fair value of Loan		1,10,000
	Less: Fair value of servicing asset	3,500	
	Fair value of interest strip	<u>6,500</u>	<u>10,000</u>
			<u>1,00,000</u>

2. Apportionment of carrying amount based on relative Fair Values

Particulars	Fair Value Rs.	% based on Total Fair Value Rs.	Carrying Amount/Cost Rs.
Securitised component of the loan	1,00,000	90.91%	90,910
Servicing Asset	3,500	3.18%	3,180
Interest Strip Receivable	6,500	5.91%	5,910
	<u>1,10,000</u>	<u>100.00%</u>	<u>1,00,000</u>

3.	Profit on Securitisation		Rs.
	Net proceeds from securitisation		1,00,000
	Less: Cost (apportioned carrying amount) of securitized component of loan		<u>90,910</u>
			<u>9,090</u>

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(b)

Books of Patiala University
Journal Entries

S.No.	Particulars		Debit Rs.	Credit Rs.
1.	Bank A/c	Dr.	20,00,000	
	Investments A/c	Dr.	15,00,000	
	To Annuity Fund A/c			35,00,000
	(Being receipt of annuity based gift in the form of cash and marketable securities)			
2.	Bank A/c	Dr.	38,500	
	To Annuities Payable A/c			25,000
	To Annuity Fund A/c			13,500
	(Being monthly investment income received from the fund and surplus accruing after meeting the annuity payable, transferred to the fund)			
3.	Annuities Payable A/c	Dr.	25,000	
	To Bank A/c			25,000
	(Being monthly annuity payment made)			

(c)

Sunagarik Ltd.

Statement relating to Staff and Community Benefits

I.	Social Benefits and Cost to Staff	Rs. in lakhs
A.	Social Benefits to Staff	
1.	Medical Facilities	9.00
2.	Training Programmes	18.45
3.	Concessional Transport and Water Supply	20.25
4.	Leave Encashment and Leave Travel Benefits	93.60
5.	Educational Facilities for children of staff members	38.88
6.	Subsidized canteen facilities	25.92
	Total	206.10
B.	Social Costs to Staff	
	Extra work put in by staff and officers for drought relief	33.30
	Net Social Benefits to Staff (A-B)	172.80

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II. Social Benefits and Cost to Community

A. Social Benefits to Community

1. Environmental Improvements	36.18
2. Generation of Job Opportunities	109.35
3. Municipal Taxes	19.26
4. Generation of Business	45.00
Total	209.79

B. Social Costs to Community

Increase in cost of living in the vicinity due to company's operations	29.79
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Net Social Benefits to Community (A – B)	180.00
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Social Benefits to staff and community (I +II)	352.80
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Question 4

- (a) The borrowings profile of Santra Pharmaceuticals Ltd. set up for the manufacture of antibiotics at Navi Mumbai is as under:

Date	Nature of borrowings	Amount borrowed	Purpose of borrowings	Incidental expenses
		Rs.		
1 st January, 2008	15% demand loan	60 lakhs	Acquisition of Fixed assets	8.33%
1 st July, 2008	14.5% Term loan	40 lakhs	Acquisition of plant and machinery	5%
1 st October, 2008	14% bonds	50 lakhs	Acquisition of fixed assets	8%

The incidental expenses consist of commission and service charges for arranging the loans and are paid after rounding off to the nearest lakh.

Fixed assets considered as qualifying assets are as under: Rs.

Sterile Manufacturing shed	10,00,000
Plant and machinery (total)	90,00,000
Other fixed assets	10,00,000

The Project is completed on 1st January, 2009 and is ready for commercial production. Show the capitalization of the borrowing costs.

- (b) A company is engaged in the business of ship building and ship repair. On completion of the repair work, a work completion certificate is prepared and countersigned by ship owner (customer). Subsequently, invoice is prepared based on the work completion certificate describing the nature of work done together with the rate and the amount.

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Customer scrutinizes the invoice and any variation is informed to the company. Negotiations take place between the company and the customer. Negotiations may result in a deduction being allowed from the invoiced amount either as a lumpsum or as a percentage of the invoiced amount. The accounting treatment followed by the company is as follows:

- (i) When the invoice is raised, the customer's account is debited and ship repair income account is credited with the invoiced amount.
- (ii) Deduction, if any, arrived after negotiation is treated as trade discount by debiting the ship repair income account.
- (iii) At the close of the year, negotiation in respect of certain invoices had not been completed. In such cases, based on past experience, a provision for anticipated loss is created by debiting the Profit and Loss account. The provision is disclosed in Balance Sheet.

Following two aspects are settled in the negotiations:

- (i) Errors in billing arising on account of variation between the quantities as per work completion certificate and invoice and other clerical errors in preparing the invoice.
- (ii) Disagreement between the company and customer about the rate/cost on which prior agreement has not been reached between them.

Comment:

- (i) Whether the accounting treatment of deduction as trade discount is correct? If not, state the correct accounting treatment.
- (ii) Whether the disclosure of the provision for anticipated loss in Balance Sheet is correct; if not, state the correct accounting treatment. (10+6 = 16 Marks)

Answer

(a) Specific Borrowings

14.5% Term Loan for acquisition of Plant & Machinery	Rs.
Interest from 1 st July, 2008 to 31 st December, 2008 = Rs. 40,00,000 $\times$ 14.5% $\times$ $\frac{6}{12}$	2,90,000
Incidental Expenses	<u>2,00,000</u>
Total	<u>4,90,000</u>
General Borrowings	
15% Demand Loan	
Interest from 1 st January, 2008 to 31 st December, 2008 = Rs. 60,00,000 $\times$ 15%	9,00,000
Incidental Expenses	<u>5,00,000</u>
Sub Total (A)	<u>14,00,000</u>

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14% Bonds

Interest from 1st October, 08 to 31st December, 08 = Rs.50,00,000 x 14% x $\frac{3}{12}$ 1,75,000

Incidental Expenses 4,00,000

Sub Total (B) 5,75,000

Total General Borrowing Cost (A+B) 19,75,000

Total Average Outstanding Borrowings will be as under:

$$\frac{(60,00,000 \times 12 + 50,00,000 \times 3)}{12}$$
 72,50,000

Weighted Average Borrowing Cost =
$$\frac{\text{Total Borrowing Cost} \times 100}{\text{Total Average Outstanding}}$$

$$\frac{19,75,000 \times 100}{72,50,000}$$
 27.24%

Allocation of General Borrowing Fund

Item	Cost	Specific Borrowing	Net of specific borrowing
Sterile Manufacturing Shed	10,00,000	Nil	10,00,000
Plant & Machinery	90,00,000	40,00,000	50,00,000
Other Fixed Assets	10,00,000	Nil	10,00,000

Item	Expenditure on qualifying asset out of general borrowing fund	Capitalization Rate	Cost eligible for capitalization
Sterile Manufacturing Shed	10,00,000	27.24	2,72,400
Plant & Machinery	50,00,000	27.24	13,62,000
Other Fixed Assets	10,00,000	27.24	2,72,400

Borrowing Costs to be Capitalized

Assets	Specific Borrowing Cost	General Borrowing Cost	Total
Sterile Manufacturing shed	Nil	2,72,400	2,72,400
Plant & Machinery	4,90,000	13,62,000	18,52,000
Other Fixed Assets	Nil	2,72,400	2,72,400
Total	4,90,000	19,06,800*	23,96,800

* Borrowing cost capitalized on general borrowings is Rs.19,06,800 which is less than the actual borrowing cost.

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- (b) (i) As per AS 9 “Revenue Recognition”, revenue is recognized at the time when the invoice is raised to the customers; however the treatment of deduction as trade discount is not in accordance with AS 9. Considering the treatment prescribed by AS 4 “Contingencies and Events occurring after the Balance Sheet Date”, adjustment of the difference between the invoice amount and the amount finally settled against ‘Ship Repair Income’ account is in order. Events occurring up to the date of approval of the accounts by the Board of Directors should be taken into consideration in determining the amount of adjustment to be made in this regard. The description of the difference as ‘trade discount’ is not appropriate.
- (ii) In respect of ship repair jobs for which negotiations between the ship owners and the company are not over, the accounting treatment is not appropriate. Instead, the amount of difference between the invoiced amount and the amount likely to be finally settled (as estimated on the basis of past experience) should be adjusted in the “Ship Repair Income” by a corresponding credit to the accounts of the respective ship owners. Consequently, the figure of sundry debtors included in the balance sheet would be net of adjustment for such difference. In other words, the amount of the difference would be neither shown under the head provisions nor shown as a deduction from the sundry debtors in the balance sheet.

Question 5

- (a) Santhosh Ltd. granted 500 options to each of its 2,500 employees in 2003 at an exercise price of Rs.50 when the market price was the same. The contractual life (vesting and exercise period) of the options granted is 6 years with the vesting period and exercise period being 3 years each. The expected life is 5 years and the expected annual forfeitures are estimated at 3 per cent. The fair value per option is arrived at Rs.15. Actual forfeitures in 2003 were 5 per cent. However at the end of 2003 the management of Santhosh Ltd. still expects that the actual forfeitures would average only 3 per cent over the entire vesting period. During 2004 the management revises its estimated forfeiture rate to 10 per cent per annum. Of the 2,500 employees, 1,900 employees have completed the 3 year vesting period. 1,000 employees exercise their right to obtain shares vested in them in pursuance of ESOP at the end of 2007 and 500 employees exercise their right at the end of 2008. The rights of the remaining employees expire unexercised at the end of 2008. The face value per share is Rs.10. Show the necessary journal entries with suitable narrations. Workings should form part of the answer.
- (b) On 1st February, 2008, an Indian Company sold goods to an American Company at an invoice price of US \$20,000 when the spot market rate was Rs.48.10 to a U.S. dollar. Payment was to be made in three months time, namely, by 1st May, 2008.
- To avoid the risk of foreign exchange fluctuations the Indian exporter acquired a forward contract to sell U.S. \$20,000 at Rs.47.90 per U.S. dollar on 1st May, 2008.
- The Indian company’s accounting year ended on 31st March, 2008 and the spot rate on this date was Rs.47.20 per U.S. dollar. The spot rate on 1st May, 2008, the date by which the money was due from the American buyer, was Rs.50 per dollar.
- Show what accounting entries will have to be made in the books of the Indian exporter at the relevant period of time.
- (10+10 = 20 Marks)

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Answer

(a) Journal Entries			
Year 2003		Rs.	Rs.
Employee Compensation Expense A/c	Dr.	57,04,205	
To Employee Stock Options Outstanding A/c			57,04,205
(Being the compensation expenses recognized in respect of the ESOP)			
Profit and Loss A/c	Dr.	57,04,205	
To Employee Compensation Expense A/c			57,04,205
(Being expenses of the year transferred to P & L A/c)			
Year 2004			
Employee Compensation Expense A/c	Dr.	34,08,295	
To Employee Stock Options Outstanding A/c			34,08,295
(Being the compensation expenses recognized in respect of the ESOP)			
Profit and Loss A/c	Dr.	34,08,295	
To Employee Compensation Expense A/c			34,08,295
(Being expenses of the year transferred to P & L A/c)			
Year 2005			
Employee Compensation Expense A/c	Dr.	51,37,500	
To Employee Stock Options Outstanding A/c			51,37,500
(Being the compensation expenses recognized in respect of the ESOP)			
Profit and Loss A/c	Dr.	51,37,500	
To Employee Compensation Expense A/c			51,37,500
(Being expenses of the year transferred to P & L A/c)			
Year 2007			
Bank A/c	Dr.	2,50,00,000	
Employee Stock Options Outstanding A/c	Dr.	75,00,000	
To Share Capital A/c			50,00,000
To Securities Premium			2,75,00,000

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(Being shares issued to employees against options vested in them in pursuance of the ESOP)

Year 2008

Bank A/c	Dr.	1,25,00,000	
Employee Stock Options Outstanding A/c	Dr.	37,50,000	
To Share Capital A/c			25,00,000
To Securities Premium A/c			1,37,50,000

(Being shares issued to employees against options vested in them in pursuance of the ESOP)

Employee Stock Options Outstanding A/c	Dr.	30,00,000	
To General Reserve A/c			30,00,000

(Being the balance standing to the credit of stock options outstanding account, in respect of vested options expired unexercised, transferred to general reserve account)

Working Notes:

1. Fair value of options recognized as expense

Year 2003

Number of options expected to vest = $500 \times 2,500 \times .97 \times .97 \times .97 = 11,40,841$ options

Fair value of options expected to vest = $11,40,841 \times \text{Rs.}15 = \text{Rs.}1,71,12,615$

One third of fair value recognized as expense = $\text{Rs.}1,71,12,615 / 3 = \text{Rs.}57,04,205$

Year 2004

Fair Value of options revised in the year = $500 \times 2500 \times 0.90 \times 0.90 \times 0.90 \times \text{Rs.}15 = \text{Rs.}1,36,68,750$

Revised cumulative expenses in year 2004 = $1,36,68,750 \times \frac{2}{3}$ 91,12,500

Less: Already recognized in year 2003 57,04,205

Expenses to be recognized in year 2004 34,08,295

Year 2005

Number of options actually vested = $1900 \times 500 = 9,50,000$

Fair Value of options actually vested = $9,50,000 \times 15$ 1,42,50,000

Less: Expense recognized till year 2005 91,12,500

Balance amount to be recognized 51,37,500

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2. Amount recorded in share capital account and securities premium account upon issue of shares

Particulars	Year 2007	Year 2008
Number of employees exercising option	1,000	500
Number of shares issued upon exercise of option @ 500 per employee	<u>5,00,000</u>	<u>2,50,000</u>
Exercise price received @ Rs.50 per share	2,50,00,000	1,25,00,000
Corresponding amount recognized in the 'Employee stock options outstanding A/c' @ Rs.15 per option	<u>75,00,000</u>	<u>37,50,000</u>
Total consideration	<u>3,25,00,000</u>	<u>1,62,50,000</u>
Amount to be recorded in 'Share capital A/c' @ Rs.10 per share	50,00,000	25,00,000
Amount to be recorded in 'Securities premium A/c' @ Rs.55 (i.e.65 –10) per share	<u>2,75,00,000</u>	<u>1,37,50,000</u>
	<u>3,25,00,000</u>	<u>1,62,50,000</u>

- (b) Journal Entries in the books of Indian Exporter

	Dr.	Cr.
	Rs.	Rs.
1 st February, 2008		
Sundry Debtors (American Company)A/c	Dr. 9,62,000	
To Sales A/c		9,62,000
(Being sales recorded at Rs. 9,62,000 [US\$ 20,000 x Rs.48.10])		
Forward (Rs.) Contract Receivables A/c (20,000 US \$ x Rs.47.9)	Dr. 9,58,000	
Deferred Discount A/c (20,000 US \$ x Rs. .20)	Dr. 4,000	
To Forward (\$) Contract Payable A/c (20,000 US \$ x Rs.48.10)		9,62,000
(Being forward exchange cover purchased and deferred discount amounting Rs.4,000 recorded)		
31 st March, 2008		
Profit and Loss A/c	Dr. 18,000	
To Sundry Debtors (American Company) A/c		18,000
(Being transaction loss recorded {20,000 US \$ x [Rs.48.10 less Rs. 47.2]} that occurred between the date of transaction and the date of closing of accounts)		

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Forward (\$) Contract Payable A/c	Dr.	18,000	
To Profit and Loss A/c			18,000
(Being exchange gain recorded {20,000 US \$ x [Rs.48.10 less Rs. 47.2]} as less rupees becoming payable to the exchange dealer on the basis of the spot rate at the end of the year)			
Discount A/c	Dr.	2,666	
To Deferred Discount A/c			2,666
(Being proportionate discount [two-third of Rs.4,000] charged as discount expenses)			
1 st May, 2008			
Bank A/c (20,000 US\$ x Rs. 50)	Dr.	10,00,000	
To Sundry Debtors A/c (20,000 US \$ x Rs. 47.2)			9,44,000
To Profit and Loss A/c (20,000 US \$ x Rs. 2.8)			56,000
(Being actual receipt of money from the buyer recorded)			
Forward (\$) Contract Payable (20,000 US \$ x Rs. 47.2)	Dr.	9,44,000	
Profit and Loss A/c (20,000 US \$ x Rs. 2.8)	Dr.	56,000	
To Bank A/c (20,000 US \$ x Rs. 50)			10,00,000
(Being delivery of 20,000 Dollars against forward contract at spot rate on 1 st May)			
Bank A/c	Dr.	9,58,000	
To Forward (Rs.) Contract Receivable A/c			9,58,000
(Being forward contract settled)			
Discount A/c (4,000- 2,666)	Dr.	1,334	
To Deferred Discount A/c			1,334
(Being balance amount of discount recognized)			

Question 6

- (a) Pilot Ltd. supplies the following information using which you are required to calculate the economic value added.
- Financial Leverage 1.4 times
 - Capital (equity and debt)

Equity shares of Rs.1,000 each	34,000 (number)
Accumulated profit	Rs. 260 lakhs
10 percent Debentures of Rs.10 each	80 lakhs (number)

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- Dividend expectations of equity shareholders 17.50%
 - Prevailing Corporate Tax rate 30%
- (b) Amigo Mutual Fund Ltd. is a SEBI Registered mutual fund. The Company follows the practice of valuing its investments on “mark to market basis”. For the financial year ended March, 2009 the investments which were acquired at a cost of Rs.109 crores were reflected in the Balance Sheet at Rs.89 crore. The company insists that the depreciation in value of the investments need not be disclosed separately in its financial statements since its investment valuation policy is disclosed as part of its accounting policies. Discuss the validity of this argument.
- (c) Good Drugs and Pharmaceuticals Ltd. acquired a sachet filling machine on 1st April, 2007 for Rs.60 lakhs. The machine was expected to have a productive life of 6 years. At the end of financial year 2007-08 the carrying amount was Rs.41 lakhs. A short circuit occurred in this financial year but luckily the machine did not get badly damaged and was still in working order at the close of the financial year. The machine was expected to fetch Rs.36 lakhs, if sold in the market. The machine by itself is not capable of generating cash flows. However, the smallest group of assets comprising of this machine also, is capable of generating cash flows of Rs.54 crore per annum and has a carrying amount of Rs.3.46 crore. All such machines put together could fetch a sum of Rs.4.44 crore if disposed. Discuss the applicability of Impairment loss.
- (d) EXOX Ltd. is in the process of finalizing its accounts for the year ended 31st March, 2008. The company seeks your advice on the following:
- (i) The Company's sales tax assessment for assessment year 2005-06 has been completed on 14th February, 2008 with a demand of Rs.2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.
 - (ii) The Company has entered into a wage agreement in May, 2008 whereby the labour union has accepted a revision in wage from June, 2007. The agreement provided that the hike till May, 2008 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 2008. (6+4+3+3= 16 Marks)

Answer

(a) Computation of EVA	Rs. in lakhs
Net Profit after Tax (Refer Working Note 1)	140
Add: Interest [adjusted for tax effect ($800 \times 10\% \times 0.70$)]	<u>56</u>
	196
Less: Cost of Capital (Refer Working Note 2)	<u>161</u>
Economic Value Added (EVA)	<u>35</u>

PAPER – 1 : ADVANCED ACCOUNTING

Working Notes:

1. Interest and Net Profit

$$\text{Financial Leverage} = \frac{\text{Profit before Interest \& Taxes (PBIT)}}{\text{Profit before Tax (PBT)}}$$

Interest on Borrowings = Rs. 800 lakhs × 10% = Rs.80 lakhs

Therefore,	1.40	=	PBIT
			PBIT – Interest
	1.40	=	PBIT
			PBIT – 80
	1.40 (PBIT- 80)	=	PBIT
	1.40 PBIT- 112	=	PBIT
	1.40 (PBIT- PBIT)	=	112
	0.40 PBIT	=	112
	PBIT	=	112/0.40
	PBIT	=	Rs. 280 lakhs
	PBT = PBIT- I =280-80	=	Rs. 200 lakhs
	Tax (30%)	=	Rs. 60 lakhs
	Net profit after tax	=	Rs. 140 lakhs

2. Cost of Capital

	Rs.(in lakhs)
Equity Shareholders' funds	600
10% Debenture holders' funds	<u>800</u>
Total	<u>1400</u>

$$\text{Weights assigned to Equity shareholders fund} = \frac{600}{1400} = 0.4286$$

$$\text{Weights assigned to Debenture holders fund} = \frac{800}{1400} = 0.5714$$

Source of Funds	Amount (Rs.in lakhs)	Weight	Cost %	WACC %
(1)	(2)	(3)	(4)	(5)=(3 × 4)%
Equity share holders' funds	600	0.4286	17.50	7.50
Debenture holders' funds	<u>800</u>	<u>0.5714</u>	<u>7.00*</u>	<u>4.00</u>
Total	<u>1400</u>	<u>1.0000</u>	<u>----</u>	<u>11.50</u>

* Rate of interest net of corporate tax of 30%.

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Cost of Capital = Average Capital Employed × Weighted Average cost of Capital (WACC)
= Rs.1400 lakhs × 11.50% = Rs.161 lakhs

- (b) The Guidance note on “Accounting for Investments in Financial Statements of Mutual Funds” provides that Investments should be marked to market on balance sheet date with provision for depreciation, if any, in the value of investments debited to revenue account. The provision so created should be shown as a deduction from the value of investments in the Balance Sheet. The Guidance notes further states that the depreciation or appreciation should be worked out on individual basis or by category of investment basis but not on an overall basis. Keeping in view ‘prudence’ as a factor for preparation of financial statements and correct disclosure of the amount of depreciation on investments, the Guidance Note states that the gross value of depreciation on investments should be reflected in the revenue account rather than the same being netted off with the appreciation in the value of other investments. Thus the claim of Amigo Mutual Fund Ltd. is not correct.
- (c) As per provisions of Para 91(b) of AS 28 “Impairment of Assets”, impairment loss is not to be recognized for a given asset if the related cash generating unit (CGU) is not impaired. In the given question, the related cash generating unit, which is group of asset to which the damaged machine belongs, is not impaired; as the recoverable amount is more than the carrying amount of group of assets. Hence there is no need to provide for impairment loss on the damaged sachet filling machine.
- (d) (i) Since the company is not appealing against the addition of Rs. 0.66 crore, the same should be provided for, in its accounts for the year ended on 31st March, 2008. The amount paid under protest can be kept under the heading ‘Loans & Advances’ and disclosed along with the contingent liability of Rs.2.10 crore.
- (ii) The arrears for the period from June, 2007 to March, 2008 are required to be provided for in the accounts of the company for the year ended on 31st March, 2008.

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

Question No. 1 is compulsory. Answer any four questions from the rest. Working notes should form part of the answer.

Question 1

- (a) Shivam Ltd. is considering two mutually exclusive projects A and B. Project A costs Rs.36,000 and project B Rs.30,000. You have been given below the net present value probability distribution for each project.

Project A		Project B	
NPV estimates (Rs.)	Probability	NPV estimates (Rs.)	Probability
15,000	0.2	15,000	0.1
12,000	0.3	12,000	0.4
6,000	0.3	6,000	0.4
3,000	0.2	3,000	0.1

- (i) Compute the expected net present values of projects A and B.
- (ii) Compute the risk attached to each project i.e. standard deviation of each probability distribution.
- (iii) Compute the profitability index of each project.
- (iv) Which project do you recommend? State with reasons. (14 Marks)
- (b) Presently a company is working with an earning before interest and taxes (EBIT) of Rs.90 lakhs. Its present borrowings are as follows:

	Rs. in lakhs
12% term loan	300
Working capital borrowings:	
Borrowing from bank at 15%	200
Fixed deposits at 11%	90

The sales of the company are growing and to support this, the company proposes to obtain additional borrowing of Rs.100 lakhs at a cost of 16%. The increase in EBIT is expected to be 18%. Calculate the present and the revised interest coverage ratio and comment. (6 Marks)

FINAL EXAMINATION : JUNE, 2009

Answer

- (a) (i) Statement showing computation of expected net present value of Projects A and B :

Project A			Project B		
NPV Estimate (Rs.)	Probability	Expected Value	NPV Estimate	Probability	Expected Value
15,000	0.2	3,000	15,000	0.1	1,500
12,000	0.3	3,600	12,000	0.4	4,800
6,000	0.3	1,800	6,000	0.4	2,400
3,000	0.2	600	3,000	0.1	300
	1.0	EV = 9,000		1.0	EV = 9,000

- (ii) Computation of Standard deviation of each project

Project A

P	X	(X – EV)	P (X-EV) ²
0.2	15,000	6,000	72,00,000
0.3	12,000	3,000	27,00,000
0.3	6,000	- 3,000	27,00,000
0.2	3,000	- 6,000	72,00,000
			Variance = 1,98,00,000

Standard Deviation of Project A = $\sqrt{1,98,00,000}$ = Rs.4,450

Project B

P	X	(X – EV)	P (X-EV) ²
0.1	15,000	6,000	36,00,000
0.4	12,000	3,000	36,00,000
0.4	6,000	- 3,000	36,00,000
0.1	3,000	- 6,000	36,00,000
			Variance = 1,44,00,000

Standard Deviation of Project A = $\sqrt{1,44,00,000}$ = Rs.3,795

- (iii) Computation of profitability of each project

Profitability index = Discount cash inflow / Initial outlay

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

$$\text{In case of Project A : PI} = \frac{9,000 + 36,000}{36,000} = \frac{45,000}{36,000} = 1.25$$

$$\text{In case of Project B : PI} = \frac{9,000 + 30,000}{30,000} = \frac{39,000}{30,000} = 1.30$$

- (iv) Measurement of risk is made by the possible variation of outcomes around the expected value and the decision will be taken in view of the variation in the expected value where two projects have the same expected value, the decision will be the project which has smaller variation in expected value. In the selection of one of the two projects A and B, Project B is preferable because the possible profit which may occur is subject to less variation (or dispersion). Much higher risk is lying with project A.

(b) Present EBIT = Rs.90 lakhs

Interest Charges (Present)	(Rs. in lakhs)
Term Loan @ 12%	36.00
Bank Borrowings @ 15%	30.00
Public Deposit @ 11%	<u>9.90</u>
	<u>75.90</u>

$$\text{Present Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{Interest Charges}}$$

$$\text{or } \frac{\text{Rs.90 Lakhs}}{\text{Rs.75.90 Lakhs}} = 1.19$$

$$\text{Revised EBIT} = \text{Rs.90 lakhs} \times \frac{118}{100} = \text{Rs. 106.2 lakhs}$$

Proposed interest charges	(Rs. in lakhs)
Existing charges	75.90
Add: Additional Charges (16% on 100 lakhs)	<u>16.00</u>
Total	<u>91.90</u>

$$\therefore \text{ Revised Interest Coverage Ratio} = \frac{\text{Rs.106.2 lakhs}}{\text{Rs.91.90 lakhs}} = 1.16$$

Analysis: With the proposed increase in the sales the burden of interest on additional borrowing of Rs.100 lakhs will adversely affect the interest coverage ratio which has been reduced by 3% (from 1.19 to 1.16).

FINAL EXAMINATION : JUNE, 2009

Question 2

- (a) Following information is provided relating to the acquiring company Mani Ltd. and the target company Ratnam Ltd:

	Mani Ltd.	Ratnam Ltd.
Earnings after tax (Rs. lakhs)	2,000	4,000
No. of shares outstanding (lakhs)	200	1,000
P/E ratio (No. of times)	10	5

Required:

- (i) What is the swap ratio based on current market prices?
 - (ii) What is the EPS of Mani Ltd. after the acquisition?
 - (iii) What is the expected market price per share of Mani Ltd. after the acquisition, assuming its P/E ratio is adversely affected by 10%?
 - (iv) Determine the market value of the merged Co.
 - (v) Calculate gain/loss for the shareholders of the two independent entities, due to the merger. (10 Marks)
- (b) X Ltd. reported a profit of Rs.65 lakhs after 35% tax for the financial year 2007-08. An analysis of the accounts revealed that the income included extraordinary items Rs.10 lakhs and an extraordinary loss Rs.3 lakhs. The existing operations, except for the extraordinary items, are expected to continue in the future; in addition, the results of the launch of a new product are expected to be as follows:

	Rs. lakhs
Sales	60
Material costs	15
Labour Costs	10
Fixed costs	8

You are required to :

- (a) Compute the value of the business, given that the capitalization rate is 15%.
- (b) Determine the market price per equity share, with X Ltd.'s share capital being comprised of 1,00,000 11% preference shares of Rs. 100 each and 40,00,000 equity shares of Rs. 10 each and the P/E ratio being 8 times. (10 Marks)

Answer

- (a) (i) SWAP ratio based on current market prices:

EPS before acquisition:

Mani Ltd. : Rs.2,000 lakhs / 200 lakhs: Rs.10

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

Ratnam Ltd.: Rs.4,000 lakhs / 1,000 lakhs: Rs. 4

Market price before acquisition:

Mani Ltd.: Rs.10 × 10 Rs.100

Ratnam Ltd.: Rs.4 × 5 Rs. 20

SWAP ratio: 20/100 or 1/5 i.e. 0.20

(ii) EPS after acquisition:

$$\frac{\text{Rs. (2,000 + 4,000) Lakhs}}{(200 + 200) \text{ Lakhs}} = \text{Rs.15.00}$$

(iii) Market Price after acquisition:

EPS after acquisition : Rs.15.00

P/E ratio after acquisition 10 × 0.9 9

Market price / share (Rs. 15 X 9) Rs.135.00

(iv) Market value of the merged Co.:

Rs.135 × 400 lakhs shares Rs. 540.00 Crores
or Rs. 54,000 Lakhs

(v) Gain/loss per share:

	Rs. Crore	
	Mani Ltd.	Ratnam Ltd.
Total value before Acquisition	200	200
Value after acquisition	<u>270</u>	<u>270</u>
Gain (Total)	<u>70</u>	<u>70</u>
No. of shares (pre-merger) (lakhs)	200	1,000
Gain per share (Rs.)	35	7
(b)		(Rs. Lakhs)

(a) Profit before tax $\frac{65}{1-0.35}$	100
Less: Extraordinary income	(10)
Add: Extraordinary losses	<u>3</u>
	93

Profit from new product

Sales 60

Less: Material costs 15

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Labour costs	10		
Fixed costs	<u>8</u>	<u>(33)</u>	<u>27</u>
Expected profits before taxes			120
Taxes @ 35%			<u>(42)</u>
Profit after taxes			<u>78</u>
Capitalization rate	15%		
Value of business	$\frac{\text{Rs.78Lakhs}}{0.15} =$		520
(b) Future maintainable profits (After Tax)			78
Less: Preference share dividends			
100,000 shares of Rs.100 @ 11%			<u>(11)</u>
			<u>67</u>
Earning per share	$= \frac{\text{Rs.67,00,000}}{40,00,000} =$		Rs.1.675
PE ratio			8
Market price per share			Rs.13.40

Question 3

- (a) Sundaram Ltd. discounts its cash flows at 16% and is in the tax bracket of 35%. For the acquisition of a machinery worth Rs.10,00,000, it has two options – either to acquire the asset by taking a bank loan @ 15% p.a. repayable in 5 yearly installments of Rs.2,00,000 each plus interest or to lease the asset at yearly rentals of Rs.3,34,000 for five (5) years. In both the cases, the instalment is payable at the end of the year. Depreciation is to be applied at the rate of 15% using 'written down value' (WDV) method. You are required to advise which of the financing options is to be exercised and why.

Year	1	2	3	4	5
P.V factor @16%	0.862	0.743	0.641	0.552	0.476

(14 Marks)

- (b) Briefly explain the terms "capital rationing". (6 Marks)

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

Answer

(a) Alternative I: Acquiring the asset by taking bank loan:

Years	1	2	3	4	5
(a) Interest (@15% p.a. on opening balance)	150,000	120,000	90,000	60,000	30,000
Depreciation (@15%WDV)	<u>150,000</u>	<u>127,500</u>	<u>108,375</u>	<u>92,119</u>	<u>78,301</u>
	300,000	247,500	198,375	152,119	108,301
(b) Tax shield (@35%)	<u>105,000</u>	<u>86,625</u>	<u>69,431</u>	<u>53,242</u>	<u>37,905</u>
Interest less Tax shield (a)-(b)	45,000	33,375	20,569	6,758	(-)7,905
Principal Repayment	<u>2,00,000</u>	<u>2,00,000</u>	<u>2,00,000</u>	<u>2,00,000</u>	<u>2,00,000</u>
Total cash outflow	2,45,000	2,33,375	2,20,569	2,06,758	1,92,095
Discounting Factor @ 16%	<u>0.862</u>	<u>0.743</u>	<u>0.641</u>	<u>0.552</u>	<u>0.476</u>
Present Value	2,11,190	1,73,397	1,41,385	1,14,131	91,437

Total P.V of cash outflow = Rs.731,540

Alternative II: Acquire the asset on lease basis

Year	Lease Rentals Rs.	Tax Shield @35%	Net Cash Outflow	Discount Factor	Present Value
1.	3,34,000	1,16,900	2,17,100	0.862	1,87,140
2.	3,34,000	1,16,900	2,17,100	0.743	1,61,305
3.	3,34,000	1,16,900	2,17,100	0.641	1,39,161
4.	3,34,000	1,16,900	2,17,100	0.552	1,19,839
5.	3,34,000	1,16,900	2,17,100	0.476	1,03,340
Present value of Total Cash out flow					7,10,785

Advice -By making Analysis of both the alternatives, it is observed that the present value of the cash outflow is lower in alternative II by Rs.20,755 (i.e.Rs.731,540 – Rs.7,10,785) Hence, it is suggested to acquire the asset on lease basis.

- (b) Capital rationing refers to a situation where a company cannot undertake all positive NPV projects it has identified because of shortage of capital under such situation. A decision maker is compelled to reject some of the viable projects, this is known as a situation involving capital rationing .

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Following questions are very much relevant, in terms of financing investment projects.

- (i) What would be the requirement of funds for capital investments in the forthcoming planning period?
- (ii) How much fund is available for capital investment?
- (iii) How to allocate available fund to viable investment proposals?

Profitability index may be used to rank the viable investment proposals to facilitate ultimate selection.

In Capital rationing, it may also be more desirable to accept several small investment proposals than a few large investment proposals so that there may be full utilization of budgeted amount. This may result in accepting relatively less profitable investment proposals in full utilization of budget is a primary consideration capital rationing may lead to a situation where a firm foregoes the next most profitable investment considering the budget ceiling even though it is estimated to yield a rate of return much higher than the required rate of return.

Thus capital rationing may not always lead to optimum results.

Question 4

- (a) The equity share of VCC Ltd. is quoted at Rs. 210. A 3-month call option is available at a premium of Rs.6 per share and a 3-month put option is available at a premium of Rs. 5 per share. Ascertain the net payoffs to the optionholder of a call option and a put option.
 - (i) the strike price in both cases in Rs. 220; and
 - (ii) the share price on the exercise day is Rs. 200,210,220,230,240.

Also indicate the price range at which the call and the put options may be gainfully exercised. (10 Marks)

- (b) A mutual fund that had a net asset value of Rs.16 at the beginning of a month, made income and capital gain distribution of Rs.0.04 and Rs.0.03 respectively per unit during the month, and then ended the month with a net asset value of Rs.16.08. Calculate monthly and annual rate of return. (4 Marks)
- (c) Explain the term "debt securitisation". (6 Marks)

Answer

- (a) Net payoff for the holder of the call option (Rs.)

Strike price on exercise day	200	210	220	230	240
Option exercise	No	No	No	Yes	Yes
Outflow (Strike price)	Nil	Nil	Nil	220	220
Out flow (premium)	6	6	6	6	6
Total Outflow	6	6	6	226	226

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Less inflow (Sales proceeds)	-	-	-	230	240
Net payoff	-6	-6	-6	4	14

Net payoff for the holder of the put option (Rs.)

Strike price on exercise day	200	210	220	230	240
Option exercise	Yes	Yes	No	No	No
Inflow (strike price)	220	220	Nil	Nil	Nil
Less outflow (purchase price)	200	210	-	-	-
Less outflow (premium)	5	5	5	5	5
Net Payoff	15	5	-5	-5	-5

The loss of the option holder is restricted to the amount of premium paid. The profit (positive payoff) depends on the difference between the strike price and the share price on the exercise day.

- (b) Calculation of monthly return on the mutual funds:

$$r = \frac{(\text{NAV}_t - \text{NAV}_{t-1}) + I_t + G_t}{\text{NAV}_{t-1}}$$

$$\text{Or, } r = \frac{(\text{Rs.16.08} - \text{Rs.16.00}) + (\text{Rs.0.04} + \text{Rs.0.03})}{16}$$

$$= \frac{0.08 + 0.07}{16} = 0.009375$$

or, $r = 0.9375\%$ or 11.25% p.a

- (c) Debt securitization: - It is a financial market process by which individual/Retail debts are pooled and restructured into a security instrument. Such restructured instrument assumes appropriate personality to be recognized in a larger market, bought and sold freely.

Essentially, there are three phases in a securitization process:

- (i) The Origination phase: In this phase, a borrower seeks a loan from a financial institution. The latter assesses the credit worthiness of the borrower, determines the terms and conditions and extends the loans.
- (ii) The pooling phase: Many small loans are pooled together to create an underlying pool of receivables/assets.
- (iii) The securitization phase: The pooled assets are often transferred to a special purpose vehicle (SPV) which structures the market security based on the underlying

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pool. The SPV issues pass through securities or some other types of securities to beneficiaries (Retail Investors), usually, SPV takes the form of a trust.

Securitisation helps to reduce the cost of capital and improves recycling of funds.

Question 5

- (a) The following 2-way quotes appear in the foreign exchange market:

	Spot	2-months forward
RS/US \$	Rs.46.00/Rs.46.25	Rs.47.00/Rs.47.50

Required:

- (i) How many US dollars should a firm sell to get Rs.25 lakhs after 2 months?
 - (ii) How many Rupees is the firm required to pay to obtain US \$ 2,00,000 in the spot market?
 - (iii) Assume the firm has US \$ 69,000 in current account earning no interest. ROI on Rupee investment is 10% p.a. Should the firm encash the US \$ now or 2 months later? (6 Marks)
- (b) X & Co. is contemplating whether to replace an existing machine or to spend money in overhauling it. X & Co. currently pays no taxes. The replacement machine costs Rs. 95,000 and requires maintenance of Rs.10,000 every year at the year end for eight years. At the end of eight years, it would have a salvage value of Rs.25,000 and would be sold. The existing machine requires increasing amounts of maintenance each year and its salvage value falls each year as follows:

Year	Maintenance (Rs.)	Salvage (Rs.)
Present	0	40,000
1	10,000	25,000
2	20,000	15,000
3	30,000	10,000
4	40,000	0

The opportunity cost of capital for X & Co. is 15%. You are required to state, when should the firm replace the machine:

(Given : Present value of an annuity of Re. 1 per period for 8 years at interest rate of 15% - 4.4873; present value of Re.1.00 to be received after 8 years at interest rate of 15% - 0.3269) (10 Marks)

- (c) According to the position taken by Miller and Modigliani, dividend decision does not influence value. Please state briefly any two reasons, why companies should declare dividend and not ignore it. (4 Marks)

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Answer

- (a) (i) US \$ required to get Rs. 25 lakhs after 2 months at the Rate of Rs. 47/\$

$$\therefore \frac{\text{RS.}25,00,000}{\text{Rs.}47} = \text{US \$ } 53191.489$$

- (ii) Rs. required to get US\$ 2,00,000 now at the rate of Rs. 46.25/\$

$$\therefore \text{US \$ } 200,000 \times \text{Rs.}46.25 = \text{Rs.}92,50,000$$

- (iii) Encashing US \$ 69000 : now Vs 2 month later

Proceed if we can encash in open mkt \$ 69000 × Rs.46 = Rs. 31,74,000

Opportunity gain

$$= 31,74,000 \times \frac{10}{100} \times \frac{2}{12} \quad \text{Rs. } 52,900$$

Likely sum at end of 2 months 32,26,900

Proceeds if we can encash by forward rate :

$$\text{\$ } 69000 \times \text{Rs.}47.00 \quad \text{Rs. } 32,43,000$$

It is better to encash the proceeds after 2 months and get opportunity gain.

- (b) X & Co. -Equivalent cost of new machine

	Rs.
Cost of New Machine at present	95,000
Add: PV of annual repairs @ Rs.10,000 per	
Annum for 8 years (Rs.10,000 × 4.4873)	<u>44,873</u>
	1,39,873
Less: PV of salvage value at the end	
of 8 th year (Rs.25,000 × 0.3269)	<u>8,173</u>
	<u>1,31,700</u>

Equivalent annual cost (EAC) – Rs.1,31,700/4.4873 = Rs 29,350

Equivalent Annual Cost (EAC) of keeping the machine				
	I year (Rs.)	II Years (Rs.)	III Year (Rs.)	IV Year (Rs.)
Salvage value	40,000	25,000	15,000	10,000
Add: PV of Annual Maintenance (AM/1.15)	8,696	17,391	26,087	34,783

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Total	48,696	42,391	41,087	44,783
Less: PV of salvage				
Values at end of the year (S.V/1.15)	21,739	13,043	8,696	Nil
	26,957	29,348	32,391	44,783
×	1.15	1.15	1.15	1.15
Equivalent Annual cost	31,000	33,750	37,250	51,500

Recommendation:-

The firm should replace the old machine immediately because the equivalent annual cost (EAC) of the new machine at Rs.29,350 is lower than the cost of using the existing machine in all the years, i.e. first year, second year, third and fourth year .

- (c) The position taken by M & M regarding dividend does not take into account certain practical realities is the market place. Companies are compelled to declare annual cash dividends for reasons cited below:-
- Shareholders expect annual reward for their investment as they require cash for meeting needs of personal consumption.
 - Tax considerations sometimes may be relevant. For example, dividend might be tax free receipt, whereas some part of capital gains may be taxable.
 - Other forms of investment such as bank deposits, bonds etc, fetch cash returns periodically, investors will shun companies which do not pay appropriate dividend.
 - In certain situations, there could be penalties for non-declaration of dividend, e.g. tax on undistributed profits of certain companies.

Question 6

- (a) What is sensitivity analysis in Capital budgeting? (6 Marks)

- (b) Z Co. Ltd. issued commercial paper worth Rs.10 crores as per following details:

Date of issue : 16th January, 2009

Date of maturity: 17th April, 2009

No. of days : 91

Interest rate 12.04% p.a

What was the net amount received by the company on issue of CP? (Charges of intermediary may be ignored) (4 Marks)

- (c) Explain briefly the advantages of investing in mutual funds. (5 Marks)
- (d) Write a brief note on the Small Industries Development Bank of India. (5 Marks)

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

Answer

- (a) Sensitivity analysis in capital budgeting: Sensitivity analysis is used in capital budgeting for measuring the risk more precisely future being always uncertain and estimations are always subject to error, sensitivity analysis takes care of estimation errors by using a number of possible outcomes in evaluating a project. The methodology adopted here is to evaluate a project by using a number of estimated cash flows so as to provide to the decision maker an insight into the variability of outcome. Thus, it is a technique of risk analysis which studies the responsive of NPV or IRR to variation in underlying factors like selling price, quantity sold, return from an investment etc.

However, it should not be viewed as the method to remove the risk or uncertainty, it is only a tool to analyse and measure the risk and uncertainty. In terms of capital budgeting the possible cash flows are based on three assumptions (namely):-

- (a) Cash flows may be worst (Pessimistic).
- (b) Cash flows may be most likely,
- (c) Cash flows may be most optimistic.

Sensitivity analysis involves following three steps:-

- (i) Identification of all the variables.
- (ii) Definition of the underlying quantitative relationship among the variables, and
- (iii) Analysis of the impact of the changes in each of the variables on the NPV of the project.

- (b) The company had issued commercial paper worth Rs.10 crores

No. of days Involves = 91 days

Interest rate applicable = 12.04 % p.a.

Interest for 91 days = $12.04\% \times \frac{91\text{days}}{365\text{days}} = 3.001\%$

= or Rs. 10 crores $\times \frac{3.001}{100 + 3.001} = \text{Rs.} 29,13,563$
or Rs. 29.1356 Lakhs

∴ Net amount received at the time of issue:-

Rs.10.00 Crores – 0.2913 Crore = Rs.9.7087 Crore

- (c) The advantages of investing in mutual funds are as under:

1. Professional Management

Investors can avail of the services of experienced and skilled professionals, backed by a dedicated investment research team that analyses performance and prospects of companies to select suitable investments.

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2. Diversification

Mutual funds invest in a number of companies across a broad cross section of industries and sectors. Investors achieve this diversification with far less money and risk they could do on their own.

3. Return potential

Over a medium to long term, mutual funds have the potential to provide a higher return as the investments are diversified.

4. Low costs

Mutual funds are a less expensive way to invest as compared with direct investment in the capital market.

5. Liquidity

In open-ended schemes, investors get money promptly at NAV from the mutual fund itself.

In close-ended schemes, investors can sell units on a stock exchange at the prevailing market price or avail of direct repurchase at NAV-related prices which some such schemes offer periodically.

6. Transparency

Investors get regular information on the value of their investments.

(d) Small Industries Development Bank of India (SIDBI)

The small industries Bank of India (SIDBI) was set up in the 1980 by industrial development bank of India (IDBI) to give special funding focus to small scale units. Besides normal fixed capital and working capital funding schemes, SIDBI makes available financial assistance under technology development and modernization, ISO9000 series certification schemes etc. Like NABARD in the area of agricultural finance, SIDBI functions as a re-financing institution operating special funds sanctioned by Government.

SIDBI participates in venture capital funds set up by public sector institutions dedicated to financing of small scale units.

SIDBI schemes for working capital financing of SSI through the re-financing route are very popular.

PAPER – 3 : ADVANCED AUDITING

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

Question 1

As an auditor, how would you deal with the following?

- (a) In the audit of an organization whose objects are charitable or religious, the organization holds that the Accounting Standards are not applicable to it since only a very small proportion of its activities are business in nature. (5 Marks)
- (b) During the audit for the year ended on 31st March, 2009 of XYZ Ltd. you come across certain personal expenses of employees having been debited to Profit and Loss account. (4 Marks)
- (c) While conducting the audit of ABC Ltd. for the year ended on 31st March, 2009, you find that the company has disposed off substantial part of the fixed assets, but the management of the company represents to you that they will continue in business. (4 Marks)
- (d) A Ltd. has not made provisions for proposed dividends in its accounts but proposes to charge the dividends to Profit and Loss account as and when paid. (5 Marks)

Answer

- (a) Applicability of Accounting Standards

Explanation

The Accounting Standards (AS) are issued for the use in the presentation of general purpose financial statements which are issued to the public by such 'commercial, industrial or business enterprises' as may be specified by the Institute from time to time. They become mandatory on the dates specified in the respective AS or notified by the council in this behalf.

The reference to 'commercial, industrial or business enterprises' is in the context of the nature of activities carried on by an enterprise rather than with reference to its objects. AS apply in respect of commercial, industrial or business activities of any enterprise irrespective of whether it is profit oriented or is established for charitable or religious purposes. AS will not, however, apply to those activities which are not of commercial, industrial or business in nature (e.g. an activity of collecting donations and giving them to flood affected people).

The exclusion of an entity from the applicability of the AS is permissible only if no part of the activity of entity is commercial, industrial or business in nature. In other words, even if a very small proportion of the activities of an entity is considered to be commercial, industrial or business in nature, then it can not claim exemption from the application of

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AS. In such a case, the AS will apply to all its activities including those which are not commercial, industrial or business nature.

Conclusion

In view of the above discussion, the contention of the organisation that only a very small proportion of its activities consist of business in nature, is wrong and AS would apply to all its activities including charitable or religious.

(b) Personal expenses of employees (debited to profit and loss account)

Explanation

The practice of meeting certain types of personal expenses of employees by the company is considered normal and is being recognised by the statutory authorities also. The charging of such personal expenses of the employees by the company to its profit and loss account is justifiable or not depends upon the terms and conditions of appointment of the employees. If the terms and conditions of employment include payment of expenses of personal nature, then such expenses can be incurred by the company. Where, however the contract of employment does not contain any provision for payment of expenses of a personal nature, then there is no warrant for incurring or reimbursement of such expenses by the company. Illustration of such expenses are medical re-imbursement, conveyance for personal use, expenses on leave travel, maternity benefits, provisions of rent free quarters, canteen facilities etc.

Conclusion

Thus, charging of such personal expenses to profit and loss account either on the basis of company's contractual obligations or in accordance with the accepted business practice is perfectly normal and legitimate and does not call for any comments by the auditor. However, where personal expenses not covered by contractual obligations or by accepted business practice, is charged to profit and loss account, it would be the duty of the auditor to report thereon in terms of Section 227 (IA) of the Companies Act, 1956.

(c) Going Concern

Explanation

Paragraph 4 (1) (c) of CARO 2003, requires the auditor to comment, in case where a substantial part of the fixed assets has been disposed off during the year, whether such disposal has affected the going concern status of the company. For this purpose, the auditor should carry out audit procedure and gather sufficient and appropriate audit evidences to satisfy himself/herself that the company shall be able to continue as a going concern for the foreseeable future, despite the sale of substantial part of fixed assets. The auditor should use his professional judgement to determine whether an asset or group of assets sold by the company is a substantial part of fixed assets.

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Audit procedure

The audit procedure includes -

- (a) Discussion with the management and analysis as to the significance of the fixed assets to the company as a whole
 - (b) Scrutiny of the minutes of the meetings of the board of directors and important committees for understanding the entity's business plans for the future.
 - (c) Review of subsequent events after the balance sheet date for analyzing the effect of such disposal of substantial part of the fixed assets on the going concern.
 - (d) Feasibility of the plans – the auditor should obtain sufficient appropriate audit evidence that the plans of the management are feasible, are likely to be implemented and that the outcome of these plans would improve the situation.
 - (e) The auditor should also seek written representation from the management in this regard.
- (d) Non-Provisions for proposed dividends

Explanation

It is observed, while studying the financial statements of various companies that they do not provide for the proposed dividend and charge the dividend to the profit and loss account as and when its payment is made.

The Council of the ICAI has considered this issue and is of the view that proposed dividend does not represent a liability nor does it amount to a provision, pending the approval of the shareholders in general meeting. The Council is further of the opinion that merely because the prescribed form as given in the schedule VI of the Companies Act, 1956, requires proposed dividend to be shown under 'Current Liabilities and Provisions' it does not mean that in fact the proposal for the dividend becomes a liability or is necessarily a provision. Since, however, the form of balance sheet prescribed under schedule VI part I-A requires, "proposed dividends" to be shown/disclosed, the council is of the opinion that though on correct accounting principles, the proposed dividends does not become a liability, the attention of the shareholders would have to be drawn to the fact that no appropriation has been made for the proposed dividends, the amount in respect of which should be specified.

Recommendation of Council

The council therefore recommends that non-provision for proposed dividends should be disclosed by means of a note in the accounts and that the auditor should refer to the note in his report and make his report subject thereto.

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Question 2.

Comment on the following with reference to the Chartered Accountants Act, 1949 as amended by the Chartered Accountants (Amendment) Act, 2006 and schedules thereto:

- (a) Mr. B, a practicing Chartered Accountant, expressed his opinion on the financial statements of M/s ABC Ltd. for the year ended on 31st March, 2009. It was later found that the closing stock was valued arbitrarily by Management which was accepted by him without verification and large amount of revenue expenditure was capitalised. (5 Marks)
- (b) Mr. A was appointed by H Ltd. to audit the PF trust maintained by the company. While conducting the audit he noticed that large amount of loans have been given out of the trust to the employer company in contravention of the rules of the PF trust. He disclosed the irregularities to the trustees and to the company but not to the individual subscribers of the PF. When queried on his omission to disclose, he explained that he owed no duty to the individual members. (5 Marks)
- (c) Mr. B was appointed as auditor of XYZ Ltd. in place of Mr. A. Mr. B had sent a letter of communication to Mr. A under certificate of posting and proceeds to conduct the audit. Mr. A makes a complaint to the institute on the basis of non-receipt of communication. (4 Marks)
- (d) A Chartered Accountants firm pays share in the profits to a widow of its deceased partner. (4 Marks)

Answer

(a) Explanation

According to the clause (7) of Part - I of the Second schedule to the Chartered Accountants Act, 1949, a member shall be deemed to be guilty of professional misconduct if " he is grossly negligent in the conduct of his professional duties". It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use.

Mr. B. adopted arbitrary valuation of closing stock and accepted the valuation as done by the management without verification. He also failed to point out large amount of revenue expenditure, capitalized, thereby affecting the profitability of the company.

Conclusion

In view of the above, Mr. B. is to be held guilty of gross negligence in the conduct of his professional duties.

(b) Explanation

According to clause (5) of Part-I of the Second schedule of the Chartered Accountants Act, 1949, a member shall be deemed to be guilty of professional misconduct if he "fails to disclose a material fact known to him which is not disclosed in the financial statement,

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but disclosure of which is necessary in making such financial statement not misleading". Further it is no defense for a chartered accountant to say that he had disclosed the irregularities to the company. It is his duty to have made the disclosures thereof to the beneficiaries of the Provident Fund trust also in the statement of accounts signed by him.

Conclusion

In view of the above, his statement that he owed no duty to the individual members is wrong and hence he is guilty of professional misconduct under clause 5.

(c) Explanation

As per clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice is deemed to be guilty of professional misconduct if he "accepts a position as auditor, previously held by another chartered accountant, without first communicating with him in writing".

The Council has taken the view that a mere posting of a letter under "Certificate of posting" is not sufficient to establish communication with the retiring auditor unless there is some evidence to show that the letter has, in fact, reached the person communicated with. A chartered accountant who relies upon a letter posted "under certificate of posting". Therefore, does so at his own risk. Merely obtaining a "Certificate of posting" does not fulfill the requirements of clause (8). There should be a positive evidence of the fact that the communication addressed to outgoing auditor by the incoming auditor reached his hands. Certificate of posting of a letter cannot, in the circumstances, be taken as positive of its delivery to the addressee.

Members should therefore, communicate with a retiring auditor in such a manner as to retain in their hands positive evidence of the delivery of the communication to the addressee. In the opinion of the Council, communications by letter sent by Registered post with A.D. or by hand against written acknowledgment would in the normal course provide such evidence.

Conclusion

In view of the above, Mr. A, a retiring auditor, complains about the non-receipt of communication and as Mr. B the incoming auditor, has no positive evidence to prove the delivery of communication to the retiring auditor, he will be held guilty of professional misconduct under clause(8) of Part-I, First schedule.

(d) Explanation

Clause 2, Part I of the first schedule to the Chartered Accountants Act, 1949, is applicable. This clause says that a legal representative or widow of a deceased partner would be entitled to share the profits only where the partnership agreement contains a

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provision that on the death of the partner, his widow or legal representative would be entitled to such payment by way of sharing of fees or otherwise, for some specified period. The widow of a partner, when the partnership agreement does not contain such provision, entitling her to share in profits, would not be entitled to such profits.

Conclusion

In the given case, if such a clause is present in the partnership deed, the sharing is permissible, otherwise not. If no such clause exists, and if the firm still pays share in the profits to a widow of the deceased partner, the firm shall be considered as guilty of professional misconduct.

Question 3.

- (a) State the points in an investigation of frauds through suppliers ledger. (6 Marks)
- (b) State the circumstances that may warrant the introduction of Cost audit. (6 Marks)
- (c) State your views on reference to an expert in the Auditor's report. (4 Marks)

Answer

- (a) Investigation of frauds through suppliers' ledger

The following methods of fraud should be borne in mind:

- (i) Adjusting fictitious or duplicate invoices as purchases in the accounts of suppliers and subsequently misappropriating the amounts when payments are made to the suppliers in respect of these invoices.
- (ii) Suppressing the credit notes issued by suppliers and withdrawing the corresponding amounts not claimed by them.
- (iii) Withdrawing amounts unclaimed by suppliers, for one reason or another by showing that the same have been paid to them.
- (iv) Accepting purchase invoice at prices considerably higher than their market price and collecting the excess amount paid in cash, from the suppliers.

- (b) Circumstances that may warrant the introduction of cost audit

- (i) Price fixation: The need for fixation of retention price in case of materials of national importance, like steel, cement etc. may be useful in knowing the true cost of production.
- (ii) Cost variation within the industry: Where the cost of production varies significantly from unit to unit in the same industry, cost audit may necessary to find the reasons for such differences.
- (iii) Inefficient management: Where a factory is run inefficiently and uneconomically managed, cost audit may be necessary. It may be particularly useful for the government before it takes over any unit.

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- (iv) Tax-assessment: Where a duty or tax is levied on products based on cost of production, the levying authorities may ask for cost audit to determine the correct cost of production.
 - (v) Trade disputes: Cost audit may be useful in settling trade disputes about claims for higher wages, bonus, etc.
- (c) Reference to an expert in the auditor's report

When expressing an unqualified opinion, the auditor should not refer to the work of an expert in his report.

If, as a result of the work of an expert, the auditor decides to express other than an unqualified opinion, it may in some circumstances benefit the reader of his report if the auditor, in explaining the nature of his reservation, refers to or describes the work of the expert, where-in doing so the auditor considers it appropriate to disclose the identity of the expert, he should obtain prior consent of the expert for such disclosure, if such consent has not been obtained.

Question 4.

- (a) State the internal controls in the area of Loans and Advances of Banks. (12 Marks)
- (b) What shall comprise the auditor's report of Mutual Funds? (4 Marks)

Answer

- (a) Internal controls in the area of loans and advances of banks
- (i) The bank should make advances only after satisfying itself as to the creditworthiness of the borrowers and after obtaining sanction from the proper authorities of the bank.
 - (ii) All the necessary documents (e.g. agreements, demand promissory notes, letters of hypothecation etc) should be executed by the parties before advances are made.
 - (iii) Sufficient margin should be kept against securities taken so as to cover any decline in the value thereof and also to comply with Reserve Bank directives. Such margins should be determined by the proper authorities to the bank as a general policy or for particular accounts.
 - (iv) All the securities should be received and returned by responsible officer. They should be kept in the joint custody of two such officers.
 - (v) All the securities requiring registration should be registered in the name of the bank or otherwise accompanied by the documents sufficient to give title to the bank.
 - (vi) In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipts. The godowns should be regularly and frequently inspected by a responsible officer of the branch concerned, in addition by the inspectors of the bank.
 - (vii) Surprise checks should be made in respect of hypothecated goods not in possession of

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the bank.

- (viii) Market value of goods should be checked by officers of the bank by personal enquiry in addition to the invoice value given by the borrowers.
- (ix) As soon as any increase/decrease takes place in the value of securities proper entries should be made in the Drawing Power Book. These entries should be checked by an officer.
- (x) All the accounts should be kept within both the drawing power and the sanctioned limit at all times.
- (xi) All the accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the H.O. regularly.
- (xii) The operation in each advance should be reviewed at least once every year.

(b) Auditor's report of Mutual Funds

The auditor's report of mutual funds shall comprise the following:

- (i) He has obtained all information and explanation which, to the best of his knowledge and belief were necessary for the purpose of audit.
- (ii) The balance sheet and the revenue account give a fair and true view of the scheme, state of affairs and surplus/ deficit in the fund for the accounting period to which the balance sheet or, as the case may be, the revenue account relates.
- (iii) The statement of account has been prepared in accordance with accounting policies and standards as specified in the ninth schedule prescribed by SEBI (MF) regulations, 1996.

Question 5.

- (a) State briefly the Communication/Reporting requirements as per AAS 21 on Non-Compliance in an audit of financial statement: (8 Marks)
 - (i) To the management
 - (ii) To the users of the auditor's report on the financial statements.
 - (iii) To the regulatory and enforcement authorities.
- (b) State the reporting requirement regarding books of account (prescribed, maintained and examined) in Form No. 3CD of Tax Audit under Section 44AB of the Income Tax Act, 1961. (8 Marks)

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Answer

(a) AAS 21 (SA 250): Communication/reporting of non-compliance in an audit of financial statement:

(i) To management

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 auditor's attention.

If in the auditor's judgment, the non-compliance is believed to be intentional and/or material, the auditor should communicate the finding 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 such as an audit committee or board of directors. Where no higher authority exists or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor may consider seeking legal advice.

(ii) To the users of the auditor's report

If the auditor concludes that the non-compliance has a material effect on the financial statement, the auditor should express a qualified or an adverse opinion.

If the auditor is precluded by the entity from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statement, has or is likely to have occurred, 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 in the auditor's report.

(iii) To regulatory and enforcement authorities

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 statute, law or by courts of law (for example, the auditor is required to report certain matters of non-compliance to the Reserve Bank of India (RBI) as per the requirements of Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1988, issued by RBI.

(b) Tax-Audit under section 44 AB of I.T. Act, 1961, Reporting requirements regarding books of account under clause 9 of form - 3CD

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- (i) Whether books of account are prescribed U/S 44 AA, if yes, list of books so prescribed: Books of account may have been prescribed but all these might not have been maintained or produced. Tax auditor should exercise professional judgment and skill as to whether it warrants disclosure or qualification in form no. 3CB or 3CA.
- (ii) Books of account maintained: (In case books of account are maintained in a computer system, mention the books of account generated by such computer system). The tax auditor should obtain a complete list of books of account and other documents maintained (both financial and non-financial) and mark appropriate marks of identification. The list of books of accounts maintained should be given under this clause. As to the requirements regarding mentioning of the books of account generated by the computer system, only such books of account and other records which come within the scope of "proper books of account" should be mentioned and insist on proper print-outs of books of accounts.
- (iii) List of books of account examined: This would constitute the books of original entry and other books of account. While the assessee is to maintain proper evidence in the form of bills, vouchers, documents, etc., it may be noted that these are essential to support the entries in the books of account and no reference to such supporting evidence need to be made under this clause.

Question 6.

- (a) State the audit procedures for verification of outstanding premium and agents' balances of General Insurance companies. (6 Marks)
- (b) When should an auditor make a disclaimer opinion in his Audit report? (5 Marks)
- (c) What are the general principles that propriety audit need to conform? (5 Marks)

Answer

- (a) Audit procedures for verification of outstanding premium and agents' balances of General Insurance Companies

Following are the audit procedures to be followed for verification of outstanding premium and agents' balances.

- (i) Scrutinize and review control account debit balances and their nature should be enquired into.
- (ii) Examine in-operative balances and treatment given for old balances with reference to company rules.
- (iii) Enquire into the reasons for retaining the old balances.
- (iv) Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.

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- (v) Check age-wise, sector-wise analysis of outstanding premium.
- (vi) Verify whether outstanding premiums have since been collected.
- (vii) Check the availability of adequate bank guarantee or premium deposit for outstanding premium.

(b) Disclaimer opinion in audit report

A disclaimer of opinion is expressed when:

- (i) The possible effect of a limitation on the scope is so material and pervasive that the auditor has not been able to obtain sufficient audit evidences and is accordingly unable to express an opinion on the financial statements.
- (ii) A limitation on the scope of the auditor's work may sometimes be imposed by the entity, for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes, is necessary.
- (iii) A scope limitation may be imposed by circumstances, e.g. when the timing of the auditor's appointment is such that he is unable to observe the counting of physical inventories.
- (iv) It may also arise when in the opinion of the auditor, the client's accounting records are inadequate or when he is unable to carry out an audit procedure that he believes, is desirable.
- (v) The resolution on certain matters dependent upon future events, may also cause the auditor to make a disclaimer of opinion.
- (vi) However when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists; the auditor should ordinarily not accept such a limited engagement as an audit engagement unless required by statute. Also a statutory auditor should not accept such an audit engagement when the limitation infringes on the auditor's duties.

When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary, had the limitation not existed.

(c) General principles of propriety audit

In government accounting, it is observed that instead of too much dependence on documents, vouchers and evidence, more emphasis should be given to the substance of transactions and looks into the appropriateness thereof on a consideration of financial prudence, public interest and prevention of wasteful expenditure.

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Propriety requires the transactions, and more particularly expenditure to confirm to certain general principles. These principles are:

- (i) that the expenditure is not the prima facie more than the occasion demands and that every official exercises the same degree of vigilance in respect of expenditure as a person of ordinary prudence would exercise in respect of his own money,
- (ii) that the authority exercises its power of sanctioning expenditure to pass an order which will not directly or indirectly accrue to its own advantage,
- (iii) that the funds are not utilized for the benefit of a particular person or group of persons and
- (iv) that, apart from the agreed remuneration or reward, no other avenue is kept open to indirectly benefit the management personnel, employees and others.

Question 7.

- (a) "When the computer information systems are significant, the auditor should obtain an understanding of the CIS environment and whether it may influence the assessment of inherent and control risk". What factors an auditor has to consider in such risk assessment? (12 Marks)
- (b) In an operational audit performance evaluation, what factors can cause unsatisfactory production performance? (4 Marks)

Answer

- (a) Factors, an auditor has to consider in his understanding of the computer information systems (CIS) environment as well as risk assessment (erstwhile AAS 29)

The nature of the risks and internal control characteristics in CIS environment include the following:

- (i) Lack of transaction trails

Some computer information systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form. Where a complex application system performs a large number of processing steps, this may not be a complete trail. Accordingly, errors embedded in an application's program logic may be difficult to detect on a timely basis by manual (user) procedures.

- (ii) Uniform processing of transactions

Processing of transactions are done by the same processing instructions. Thus, the clerical errors ordinarily associated with manual processing are virtually eliminated. Conversely programming errors or other systematic errors in hardware or software will ordinarily result in all transactions being processed incorrectly.

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(iii) Lack of segregation of function

Many control procedures that would ordinarily be performed by separate individuals in manual systems may become concentrated in a CIS environment. Thus, an individual who has access to computer programs, processing or data may be in a position to perform incomplete functions.

(iv) Potential for errors and irregularities

Potential for human error in the development, maintenance and execution of CIS may be greater than in manual system.

(v) Initiation or execution of transactions

Computer information systems may include the capability to initiate or cause the execution of certain types of transactions automatically. Management's authorization of these transactions may be implicit in its acceptance of the design of the CIS and subsequent modification.

(vi) Dependence of other controls over computer processing

Computer processing may produce reports and other output, that are used in performing manual control procedures. The effectiveness of these manual control procedures can be dependent on the effectiveness of controls over the completeness and accuracy of computer processing.

(vii) Potential for increased management supervision

CIS can offer management a variety of analytical tool that may be used to review, supervise and enhance entire internal control structure.

(viii) Potential for the use of computer-assisted audit techniques (CAAT)

In case of processing and analysis of large quantitative of data using computers, may require the use of specialized computer audit techniques and tools in the execution of audit tests.

Both the risks and the control introduced as a result of these characteristics of computer information systems have a potential impact on the auditor's assessment of risk, and the nature, timing and extent of audit procedures.

(b) Factors which can cause unsatisfactory production performance in an operational audit performance evaluation

(i) Non-availability of raw materials

(ii) Inadequate or unskilled personnel

(iii) Lack of proper supervision

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- (iv) Lack of proper machine maintenance
- (v) Strikes and/or lock out
- (vi) Problems of power supply
- (vii) Non-availability of essential machine spares
- (viii) Lack of proper quality control
- (ix) Poor quality of raw materials
- (x) Other causes like fire, earthquake etc.

Question 8.

Write short notes on any four of the following:

- (a) Usefulness of careful and adequate audit planning.
- (b) Verification of Margin Deposit Book in the audit of Members of Stock Exchanges.
- (c) Professional Negligence.
- (d) Purposes for which analytical procedures are used by auditors.
- (e) Unqualified opinion in the context of the Auditor's report.
- (f) Assessing the reliability of Audit evidence. (4 x 4 = 16 Marks)

Answer

- (a) Usefulness of careful and adequate audit planning

The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Careful and adequate audit planning helps him to:

- (i) Ensure that appropriate attention is devoted to important areas of the audit
- (ii) Ensure that potential problems are promptly identified
- (iii) Ensure that the work is completed expeditiously
- (iv) Utilize the assistants properly and
- (v) Co-ordinate the work done by other auditors and experts

- (b) Verification of margin deposit book

A member is required to maintain a margin deposit book wherein details of all the margins deposited with the Clearing House are to be recorded. The book should be verified to ascertain whether the member has complied with all the directives regarding margins etc. issued by SEBI from time to time. The margin payments made by the members may be cross checked with the daily margin statements downloaded from the Stock Exchange.

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The auditor should apply appropriate audit procedures to satisfy himself that margins have been properly calculated, collected and paid. The auditor should examine that margin deposit lying with the Clearing House are supported by confirmation. The auditor should verify whether adjustment entries relating to settlement margin and daily margin which is adjusted at the time of settlement are correctly passed or not. The auditor should also ensure that exemptions from payment of margins of Institutional Traders have been claimed correctly.

(c) Professional negligence

Negligence, which is culpable, generally consists of under mentioned three elements:

- (i) Existence of duty or responsibility owed by one party to another to perform some act with certain degree of care and competence.
- (ii) Occurrence of a breach of such duty and
- (iii) Loss or detriment, being suffered by the party to whom the duty was owed as a result of negligence.

In this context, professional negligence would constitute failure to perform duties according to "accepted professional standards", resulting in some damage to a party to whom duty is owed.

(d) Purposes for which analytical procedures are used

The main objects are:

- (i) To assist the auditor in planning the nature, timing and extent of audit procedures
- (ii) As a substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and
- (iii) As an overall review of the financial statements in the final review, stage of the audit."

(e) Unqualified opinion in the context of the auditor's report

All unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements.

An unqualified opinion indicates implicitly, that any changes in the accounting principles or in the methods of their application and the effects thereof, have been properly determined and disclosed in the financial statements.

An unqualified opinion also indicates that:

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- (i) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied
 - (ii) the financial statements comply with relevant statutory requirements and regulations, and
 - (iii) there is an adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.
- (f) Assessing the reliability of audit evidence - AAS 5 (SA 500)
- The reliability of audit evidence depends on its source - internal or external and also on its nature, visual, documentary or oral. The reliability of audit evidence is dependent on the circumstances under which it is obtained. The following generalisations may be useful in assessing the reliability of audit evidence.
- (i) External evidence: It is usually more reliable than the internal evidence e.g. confirmation received from a third party.
 - (ii) Internal evidence: It is more reliable when related internal control is satisfactory.
 - (iii) Evidence in the form of documents and written representations is usually more reliable than the oral representations.
 - (iv) Evidence obtained by the auditor himself is more reliable than that obtained through the entity.

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

Question 1

Answer any two of the following:

- (a) The Board of Directors of XYZ Ltd. filled up a casual vacancy caused by the death of Mr. P by appointing Mr. C as a director on 3rd April, 2009. Unfortunately Mr. C expired on 15th May, 2009 after working about 40 days as a director. The Board now wishes to fill up the casual vacancy by appointing Mrs. C in the forthcoming meeting of the Board. Advise the Board in this regard. X(5 Marks)
- (b) M/s Goyanka & Company, which is a member of a recognised stock exchange desire to buy and sell shares of Crossroads Company Limited on their own count as well as on behalf of investors. Advise M/s Goyanka & Company whether there are any restrictions for dealing in securities on their own count under the provisions of the Securities Contracts (Regulation) Act, 1956. (5 Marks)
- (c) The Mewar Rural Financial Corporation, Udaipur, established under a special statute issued 5 years bonds to public directly and not through any Stock Exchange. Decide whether the said act of the Mewar Rural Financial Corporation is in violation of the provisions of the Securities Contracts (Regulation) Act, 1956. (5 Marks)

Answer

- (a) Section 262 of the Companies Act, 1956 authorises the Board of Directors to fill up casual vacancies if the office of any director appointed by the company in general meeting is vacated before his term of office and hence the appointment of C was in order. In normal course, C could have held his office as director up to the date to which Mr. P would have held but Mr. C expired on 15th May 2009 and again a vacancy has arisen in the office of director owing to death of Mr. C who was appointed by the board to fill up the casual vacancy.

Hence the present vacancy cannot be considered as casual vacancy as stated in section 262 and therefore the board cannot fill up the same.

The board may however appoint Mrs. C as an additional director under section 260 of the Act provided the articles of association authorises the board to do so, in which case Mrs. C will hold the office until the conclusion of the next annual general meeting.

- (b) SHARE TRANSACTIONS BY MEMBERS OF STOCK EXCHANGE AS PRINCIPALS:

Members of stock exchange normally carry out transactions on behalf of investors and hence principal and agent relationship exists between them. A member can enter into transaction as principal with another member of the exchange only. If a member of stock exchange desires to enter into contract as principal with a non member then he has to get written consent from such person to act as principal. The contract note should

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indicate that he is acting as principal. (Section 15 of the Securities Contracts (Regulation) Act, 1956).

Where the member has obtained the consent of such person otherwise than in writing he shall secure written confirmation by such person or such consent within three days from the date of such contract.

However, such written consent of such person is not necessary for closing outstanding contract entered into by such person in accordance with the bye-laws, if the member discloses in the note, memorandum or agreement of sale or purchase in respect of such closing out that he is acting as principal.

Spot delivery contracts are not within the purview of section 15 of the said Act. (Section 18).

Thus M/s Goyanka & Company working as stock broker must bear in mind the above restrictions while entering into any transaction as principal with a non – member.

(c) DIRECT ISSUE OF BONDS BY CORPORATION:

In order to prevent undesirable transactions in securities and to promote healthy stock market, the Securities Contracts (Regulation) Act, 1956 was enacted. Stock Exchanges are recognised under the Act. Section 73 of the Companies Act, 1956 lays down that offer of shares and debentures to public for subscription shall only be made after obtaining the permission of the stock exchange.

Section 28 of the Securities Contracts (Regulation) Act, 1956 lays down that the provisions of the Act shall not apply to the Government, Reserve Bank of India, any local authority or any corporation set up by a special law or any person who has effected any transaction with or through the agency of any such authority as stated above.

As given in the question, the Mewar Rural Financial Corporation is a corporation established under a special statute enacted by competent legislature. Therefore, the said corporation need not require to seek permission of any stock Exchange for the said purpose because it is exempted from the requirement given in the legislation.

There is no violation of the provisions of the Securities Contracts (Regulation) Act, 1956 because the provisions of Section 28 of the said act are not applicable to the said corporation.

Question 2

Answer any two of the following:

- (a) State the kind of approval required for the following transaction under the Foreign Exchange Management Act, 1999:
 - (i) L, a famous playback singer of India wants to perform a musical night in Paris for Indians residing there. Foreign exchange to the extent of US D 20,000 is required for this purpose.
 - (ii) M requires US D 5,000 to make payment related to ' call back services' of telephone.

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- (iii) N wants to pursue a course in business management in New York.. He wants to draw US D 50,000 towards expenses for studying abroad.
- (iv) R wants to draw US D 20,000 to make donation to a charitable trust situated in South Korea. (7 Marks)
- (b) Mr. Raman is a software engineer of Armtex Ltd. The company sent him to Japan to develop a software programme there on deputation for 2 years. He earned a sum of US \$ 3,000 as a honorarium there. On his return to India he wants to hold this foreign currency with him. Whether Mr. Raman will be allowed to keep the foreign currency with him. (7 Marks)
- (c) The Central Government on the recommendation of selection committee appoints Mr. RKP aged 56 years as Member of the Competition Commission of India to be effective from 1st January, 2009. State with reference to the provisions of Competition Act, 2002 the term for which he will be appointed and whether he can be reappointed as such and also if he resigns after two years whether the vacancy can be filled up by the Chairman of the commission.

You are further required to mention the composition of the selection committee on whose recommendation the central Government appoints chairman and other members of the Competition Commission of India. (7 Marks)

Answer

- (a) (i) Foreign exchange drawals for cultural tours require prior permission/approval of the Government of India irrespective of amount of foreign exchange required. Therefore, in the given case L, the singer is required to seek permission of the Government of India.
- (ii) Drawal of foreign exchange for payment related to 'call back services' of telephones is prohibited. Therefore 'M' can not draw foreign exchange.
- (iii) Release of foreign exchange for education abroad is permitted up to USD 100,000 on self declaration basis. Therefore 'N' can draw foreign exchange on self declaration basis for pursuing a course in business management in New York.
- (iv) Making donation exceeding USD 10000 per annum per beneficiary require Reserve Bank of India's prior approval. Therefore 'R' can draw USD 20000 to make donation after taking prior approval from Reserve Bank of India.
- (b) As per Section 8 of Foreign Exchange Management Act, 1999 where any amount of foreign exchange is due or has accrued to any person resident in India, such person shall take all reasonable steps to realize and repatriate to India such foreign exchange within such period and in such manner as may be specified by Reserve Bank of India.

But as per section 9(e) of the said Act, this provision shall not apply to foreign exchange acquired from employment, business trade, vocation, service honorarium, gifts, inheritance or any other legitimate means up to such limit as the Reserve Bank of India may specify.

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The Reserve Bank of India has specified the following persons with the limits for possession and retention of foreign currency by a person resident in India:

Any person may possess foreign coins without any restriction to the amount.

Any person resident in India is permitted to retain in aggregate foreign currency not exceeding USD 2,000 or its equivalent in the form of currency notes/bank notes or travelers cheques acquired by him;

Any person resident in India but not permanently resident therein is permitted to hold the foreign currency without limit, if the foreign currency was acquired when he was resident outside India and was brought into India and declared to the custom authorities.

In the given case as Mr. Raman earned a sum of USD 3000 as a honorarium when he was in employment in Japan. But in view of the restrictions under FEMA and the aforesaid regulation he can retain foreign exchange up to USD 2000 only and not more than that.

- (c) Term of office of chairperson and other members are contained in Section 10 of the Competition Act, 2002.

As per this section the chairperson and every other member shall hold office as such for a term of five years from the date on which he enters upon his office and shall be eligible for re-appointment. They shall not hold office as such after attaining the age of sixty-five years. [Section 10(1)]

A vacancy caused by the resignation or removal of the chairperson or any other member by death or otherwise shall be filled by fresh appointment in accordance with the provisions of Sections 8 and 9 of the Act. [Section 10(2)]

Keeping the above provision in mind Mr. RKP can be appointed as member of the commission for a term of 5 years as he is aged 56 years on 1-1-09. He can also be reappointed but his reappointment will be only up to the age of 65 years. If Mr. RKP resigns as member after working for two years the resulting vacancy can be filled up by fresh appointment approved by the Selection Committee and the Chairman has no power to fill up the vacancy on his own.

Selection committee for chairperson and members of commission

The chairperson and other members of the commission shall be appointed by the Central Government from a panel of names recommended by a selection committee.

Selection committee shall consisting of –

- (a) The chief justice of India or his nominee ----- as chairperson;
- (b) The secretary in the ministry of corporate affairs ----- as member;
- (c) The secretary in the ministry of law and justice ----- as member;
- (d) Two experts of repute who have special knowledge of, and professional experience in international trade, economics, business, commerce, law, finance, accountancy,

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management, industry, public affairs or competition matters including competition law and policy as members. (Section 9)

Question 3

Answer any two of the following:

(a) Point out the circumstances whereunder the following powers may be exercised by the Securities and Exchange Board of India:

- (i) Prohibiting a company from issuing or publishing any document or advertisement soliciting money from public for the issue of securities.
- (ii) Pass cease and desist order in relation to any listed company.

What remedies are available to the companies against such orders under the Securities and Exchange Board of India Act, 1992? (8 Marks)

(b) The Balance Sheet of Get Well soon Ltd as at 31.3.2009 disclosed the following details:

- | | |
|------------------------------|---------------|
| (i) Authorised share capital | Rs.400 crores |
| (ii) Paid up share capital | Rs.150 crores |
| (iii) Reserves and surplus | Rs.750 crores |

The company has issued in the year 2004, Fully Convertible Debentures of Rs.100 crores which are due for conversion in the year 2009. The company proposes, after conversion of Debentures to issue Bonus shares in the ratio of 1:1. Explain briefly the requirements of the Companies Act, 1956 and the Securities and Exchange Board of India (SEBI) guidelines to be followed by the company in this regard. (8 Marks)

(c) The word “May” doesn’t mean “Shall”. Yet the word ‘May’ under certain circumstances means “Shall”. Discuss the statement in the context of interpretation of statutes and the importance of distinction between mandatory and directory provisions. (8 Marks)

Answer

(a) Power of Securities Exchange Board of India (SEBI) to issue prohibition order and directions:

Under Section 11 of the SEBI Act, 1992 the basic duty of the SEBI is to protect the interests of investors in securities and regulate the securities market. Section 11A(b) specifically empowers SEBI to prohibit any company from issuing or publishing 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 for the purpose of protection of investors interest.

According to Section 11D, SEBI can issue cease and desist order in respect of any listed company only if SEBI has reasonable grounds to believe that such a company has indulged in insider trading or market manipulation.

Aggrieved companies may appeal against orders of SEBI made under SEBI Act, 1992 rules or regulations to the Securities Appellate Tribunal (SAT) under section 15 T of the

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said Act. 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.

If the company is aggrieved by the order of SAT, further appeal against the order of SAT can be made to the Supreme Court within 60 days from the date of communication of the order on any question of law arising out of such order.

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

- (b) Chapter xv of Securities and Exchange Board of India (SEBI) (disclosure & investor protection) guidelines, 2000, contains the guidelines for issue of bonus shares, following which M/s Get well soon Ltd. can make a bonus issue in the ratio of 1:1 as follows:

1. The articles of M/s Get well Soon Ltd. must authorize it to issue the bonus shares. If there is no provision in the articles authorizing the company to issue bonus shares, firstly, the articles shall be amended by passing a special resolution.
2. Steps for determining whether any increase in authorised share capital is required.
 - (a) Paid up share capital as on 31st March, 2009 Rs.150 crores.
 - (b) Paid up capital (after conversion of Rs.100 crores fully convertible debentures, assuming that these debentures shall be converted into share capital Rs.100 crores) Rs.250 crores.
 - (c) Proposed bonus issue – 1 share for every held .
 - (d) Post bonus issue capital. Rs.500 crores.

Since the authorised share capital of the company is only Rs.400 crores, it has to take steps to increase the amount to Rs.500 crores or beyond by complying with the provisions laid down in section 94 and 97 of the companies Act,1956.

3. Sources of bonus shares.

Reserves and surplus (since free reserves built out of the genuine profits can be used for issue of bonus issue). Rs. 750 Crores

Since the source of issue of bonus shares (Rs.750 crores) is sufficient to issue bonus shares (Rs.250 crores), the proposed issue can be made.

4. Other legal requirements for issue of bonus shares are as under.

- (a) A resolution shall be passed by the board in a duly convened board meeting.
- (b) The bonus issue shall be made within 6 months of passing the board resolution.
- (c) After the issue of bonus shares, the company shall file with Securities and Exchanges Board of India (SEBI) a compliance certificate duly signed by the statutory auditor of the company or a secretary in whole time practice.

The bonus issue can be made if there is no default in –

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Payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption there of; and Payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus, etc.

- (c) The use of the word 'may' in a statutory provision will not by itself show that the provision is directory in nature. In some cases the legislature may use the word 'may' as a matter of pure conventional courtesy and yet intend a mandatory force. Therefore, in order to interpret the legal import of the word 'may' we have to consider various factors, e.g. the object and the scheme of the Act, the context or background against which the words have been used, the purpose and advantages of the Act sought to be achieved by use of this word and the like.

Coming to the word 'shall' the use of the word 'shall' would not of itself make a provision of the Act mandatory. It has to be construed with reference to the context in which it is used. Thus, as against the government the word 'shall' when used in a statute is to be construed as 'may' unless a contrary intention is manifest. Hence, a provision in a criminal statute that the offender shall be punished as prescribed in the statute is not necessary to be taken as against the government to direct prosecution under that provision rather under some other applicable statute.

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

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

- (i) The nature and design of the statute.
- (ii) The consequence which would flow from construing from one way or the other.
- (iii) The impact of other provisions by resorting to which the necessity of complying with the provisions in question can be avoided.
- (iv) Whether or not the statute provides any penalty if the provision in question is not complied with.
- (v) If the provision in question is not complied with, whether the consequences would be trivial or serious.
- (vi) Most important of all, whether the object of the legislation will be defeated or furthered.

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

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Question 4

(a) The following information is available from the audited Balance sheet of Makewell Ltd:

	Rs. In lakhs
Equity Share Capital	60
Calls outstanding	01
Preference Share Capital	21
Share application money	10
Securities Premium Account	15
Capital Redemption Reserve	18
Fixed Assets Revaluation Reserve	09
General Reserve	30
Profit and Loss Account (credit balance)	17
Dividend Equalisation Reserve	05

The company proposes to acquire 3 lakh equity shares of Rs.10 each of PQR Ltd. It also intends to execute a corporate guarantee for Rs.25 lakhs in favour of Goodwill Ltd a wholly owned subsidiary company and a corporate loan of Rs.50 lakhs to ABC Ltd. State the legal requirements to be complied with to give effect to the above proposals.

(8 Marks)

- (b) Sunrise Limited is a subsidiary company of Hotline Limited. The financial year of Sunrise Limited is 1st July to 30th June, whereas the financial year of Hotline Limited is from 1st April to 31st June, whereas the financial year of Hotline Limited is from 1st April to 31st march every year. To maintain uniformity and consolidation of annual accounts the Board of Directors of Hotline Limited decided that the accounting year of Sunrise Limited for the year 1st July,2007 to 30th June, 2008 be extended from present 12 months to 21 months i.e. 1st July,2007 to 31st March,2009.

Mention, in the light of the provisions of the Companies Act, 1956, the steps to be taken by the Hotline Limited in this regard.

(7 Marks)

Answer

- (a) As per Section 372A of the Companies Act, 1956, a company cannot directly or indirectly:
1. Make any loan to any other body corporate.
 2. Give any guarantee, or provide security in connection with a loan made by any other person to , or to any other person by, any body corporate; and
 3. Acquire by way of subscription, purchase or otherwise the securities of any other body corporate,

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exceeding 60% of its paid up share capital and free reserve or 100% of its free reserves whichever is more.

In case the aggregate of loan and advances so far made, the amounts for which guarantee or security so far provided to or in all other bodies corporate, along with the investment, loan, guarantee or security proposed to be made or given by the board, exceeds the aforesaid limits, no investment or loans shall be made or guarantee shall be given or security shall be provided unless previously authorized by special resolution passed in the general meeting.

Here the term loan includes debentures, or any deposit of money made by one company with another company, not being a banking company, and free reserves means those reserves which, as per latest audited balance sheet of the company, are free for distribution as dividend and shall include balance to the credit of the Securities Premium Account but shall not include share application money.

Again as per section 372A (8) any guarantee made by a holding Company to its wholly owned Subsidiary is not within the purview of section 372 A.

Now in the given case the total amount of investment proposed is as under.

	Rs.
Investment proposed in shares of PQR Limited	30,00,000
Corporate loan to ABC Ltd.	<u>50,00,000</u>
Total	<u>80,00,000</u>

Corporate guarantee of Rs.25,00,000 in favour of wholly owned subsidiary is exempted. (u/s 372 A (8))

Paid up share capital

Equity share capital	60,00,000
Less call outstanding	<u>1,00,000</u>
Balance	59,00,000
Add: Preference share capital	<u>21,00,000</u>
Paid up share capital	<u>80,00,000</u>

Free reserve

Security Premium A/c	15,00,000
General Reserve	30,00,000
Profit and Loss A/c	17,00,000
Dividend equalization reserve	<u>5,00,000</u>
	<u>67,00,000</u>

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Share application is not included as per explanation given in the Act Capital redemption reserve and fixed assets revaluation reserve are not free for distribution as dividend and hence are not included in free reserve.

Therefore the limit for inter corporate loan and investment will be higher of the following two

60% of (80,00,000 + 67,00,000) = 88,20,000

100% of 67,00,000 = 67,00,000

Rs.88,20,000, being the higher of these two amounts, will be the limit for loan and investment.

As the investment proposed is below the limit the company can go ahead with the investment. For this purpose, the company has to convene a Board meeting whereat the above social loans and investments including corporate guarantee can be approved by means of a resolutions. As per section 372A (2) the resolutions should be passed at the meeting of the board with the consent of all the directors present at the meeting.

(b) EXTENSION OF FINANCIAL YEAR:

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

Thus the management can extend the financial year of Sunrise Limited from 12 months to 21 months.

Following steps are required to be taken for this purpose.

1. To convene a meeting of the Board of Directors of Sunrise Limited whereat the resolution for extending the financial year is to be passed so that the year ending matches with the year ending of Hotline Ltd.
2. To make an application under Section 213 of the Companies Act, 1956 to the Central Government giving full details and specific reasons for seeking the extension in year ending.
3. To attach the following to the application:-
 - (a) A certified copy of the Last Balance Sheet and Profit & Loss Account of Hot Line Limited and Sunrise Limited.

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- (b) A certified copy of the Memorandum of Association and Articles of association of both the companies.
- (c) A certified copy of the resolution of the Board of Directors proposing the extension of the financial year.
- (d) Requisite fee payable to the Central Government under Rules.

Question 5

- (a) The issued, subscribed and paid-up share capital of ABC Company Limited is Rs.10 lakhs consisting of 90,000 equity shares of Rs.10 each fully paid up and 10,000 preference shares of Rs.10 each fully paid up. Out of the members of company, 400 members holding one preference share each and 50 members holding 500 equity shares applied for relief under Sections 397 and 398 of the Companies Act, 1956. As on the date of petition, the company had 600 equity shareholders and 5,000 preference shareholders.

State with details whether the above petition under Section 397 and 398 is maintainable. Will your answer be different, if preference shareholders have subsequently withdrawn their consent? (8 Marks)

- (b) Mr. Shrikant is working as Chief accountant in Black marbles Limited. The Board of Directors of the said company propose to charge him with the duty of ensuring compliance with the provisions of the Companies Act, 1956 so that books of account can be properly maintained and Balance sheet and Profit and loss Account can be prepared as per the provisions of law.

Draft a "Board Resolution" for the said purpose.

Also point out the consequences in case of default, when such a resolution is passed.

(7 Marks)

Answer

- (a) As per section 399 of the Companies Act, 1956, in the case of a company having a share capital, members eligible to apply for oppression and mismanagement shall be lowest of the following:

100 members; or

1/10th of the total number of members; or

Members (including equity shareholder as well as preference shareholder) holding not less than 1/10th of the issued share capital of the company.

The consent to be given by shareholder is reckoned at the beginning of the proceedings. The withdrawal of consent by shareholder during the course of proceedings does not affect the maintainability of the application.

In the question above, the shareholding pattern of the company is as follows:

Rs. 9,00,000 equity share capital held by 600 members.

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Rs. 1,00,000 preference share capital held by 5,000 members.

Rs. 10,00,000 total share capital held by 5,600 members.

The application alleging oppression and mismanagement has been made by the members as follows:

(a) Number of members making the application:

- Preference shareholders	400
- Equity shareholders	50
- Total members	450

(b) Amount of share capital held by members making the application:

- Preference share capital	Rs. 4,000 (400 preference shares of Rs.10 each)
- Equity share capital	Rs. 5,000 (500 equity shares of Rs.10 each)
- Total capital	Rs. 9,000

The application shall be valid if it has been made by the lowest of the following:

100 members

560 members (being 1/10th of 5,600)

Members holding Rs.1,00,000 share capital (being 1/10th of Rs.10,00,000)

As it is evident, the application made by 450 members meets the eligibility criteria specified u/s 399; therefore, the application is maintainable.

Such application shall remain valid despite the fact that some of the applicants have withdrawn their consent.

(b) DRAFT BOARD RESOLUTION:

“Resolved that pursuant to Sections 209 (7) and 211 (8) of the Companies Act, 1956 Mr. Shrikant, Chief Accountant of the company be and is hereby charged with the duty of seeing that the requirements of Sections 209 and 211 of the Companies Act, 1956 are duly and fully complied with.

Resolved further that Mr. Shrikant is hereby entrusted with the authority to do such acts, things and deeds as may be necessary or expedient for the purpose of compliance with the requirements of the said sections 209 and 211 of the said Act.”

Consequences in case of default

According to Section 209 (6) of the companies Act, 1956 the following persons are responsible to ensure that the company duly complies with the provisions of section 209:

1. The managing Director or manager of the company, if any;
2. All officers and other employees of the company or.

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3. If the company has no managing director, every director of the company.

Penalty for default is imprisonment up to six months or fine up to Rs.10,000/- if the persons mentioned above fail to take all reasonable steps to ensure that the provisions of Section 209 are duly complied with by the company or default has been committed by their own willful act. The punishment by way of imprisonment shall not be imposed unless the default was committed willfully [Section 209(5)].

In any penal proceedings, it shall be a defence to prove that a competent and reliable person was charged with the duty of seeing that these requirements are complied with and that he was in a position to discharge that duty. Thus, the above Board resolution makes the chief accountant responsible for compliance with the provisions of sections 209 and 211 of the Companies Act, 1956.

Question 6

- (a) As per their Articles of association the maximum number of Directors of each of the following companies is 9:
- (i) Goodheart Company Limited.
 - (ii) Frontline Trading Private Limited.
 - (iii) Hindustan Zink limited (a Government company under section 617 of the Companies Act, 1956).

The Board of Directors of the aforesaid companies propose to increase the number of Directors to 15. Advise, whether under the provisions of the companies Act,1956, the Board of Directors can do so?
(8 Marks)

- (b) Mr. Ramanathan is a Director of Fraudulent Ltd, Honest Ltd. and Regular Ltd. For the financial year ended on 31st March,2008 two irregularities were discovered against fraudulent Ltd. for the financial year ended on 31st March,2008 two irregularities were discovered against Fraudulent Ltd. Fraudulent Ltd. did not file its annual accounts for the year ended 31.3.2008 and failed to pay interest on loans taken from a financial institution for the last three years.

On 1st June, 2009 Mr. Ramnathan is proposed to be appointed as additional director of Goodwill Ltd, which company has sought a declaration from Mr. Ramnathan and he also submitted the declaration stating that the disqualification specified in Section 274 of the Companies Act,1956 is not attracted in his case. Decide under the provisions of the Companies Act:

- (i) Whether the declaration submitted by Mr. Ramanathan to Goodwill Ltd. is in order?
- (ii) Whether Mr. Ramnathan can continue as a Director in Honest Ltd. and Regular Ltd.?
(7 Marks)

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Answer

(a) INCREASE IN THE NUMBER OF DIRECTORS:

As per Section 259 of the Companies Act, 1956, in the case of a company incorporated after 21st July, 1951, any increase in the number of its directors beyond the maximum fixed by its Articles of Association as originally adopted and registered and in the case of a company existing prior to that date, any increase in the number of directors shall not have any effect unless approved by the Central Government, and it is to become void to the extent to which it is disapproved by the Central Government. However, such approval from the Central Government is not required if the number of directors is increased to 12 or less than that.

The above mentioned provision of the Companies Act, 1956 are applicable only to public companies or private companies which are subsidiaries of public companies. Based on the above mentioned provisions, following conclusion can be drawn in respect of companies as mentioned in the question.

In the case of Good heart company Limited the Directors have to obtain the approval of the Central Government for increasing the number of Directors from 9 to 15.

In the case of Front Line Trading Private Limited (Which is a Private company) and Hindustan Zink Limited (a Government company) the provisions of section 259 of the companies Act, 1956 are not applicable and hence the directors of these companies can increase the number of directors from 9 to 15 without the approval of the Central Government, subject to fulfillment of other procedural requirements.

(b) DISQUALIFICATION OF DIRECTOR:-

According to section 274 (1) (g) of the Companies Act, 1956, a person who is already a Director of a public company becomes disqualified for being appointed as Director, if the concerned company has committed default on either of the two counts mentioned below:-

- (a) The concerned public company has not filed the annual accounts and annual return for any continuous three years (financial) commencing on and after 1st April, 1999 or.
- (b) The concerned public company has failed to repay its deposits or interests on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more.

Such a person is disqualified to act as a Director of any other public company for a period of five years from the date on which the public Company make default as specified above.

Here Mr. Ramanathan is a Director of Fraudulent Limited. Fraudulent Limited was regular in filing Annual returns but did not file annual accounts for only one year i.e. financial year ended 31st March, 2008. The disqualification will not apply unless the company has

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committed defaults in respect of both the matters for three consecutive financial years. Hence the provision of section 274 is not attracted.

The disqualification specified in sub-clause (b) is not applicable in matter of loans from public financial institutions. In view of this Mr. Ramnathan is eligible to be appointed as additional Director in Goodwills Limited and declaration submitted by him is in order

The disqualification if any would come in to operation only at the time of appointment or reappointment Hence Mr. Ramnathan can continue as director of Honest Ltd and Regular Ltd.

Question 7

- (a) The promoters of Balaji Producer Company Ltd; proposed to be registered under Section 581C of the Companies Act, 1956 desire to have the following information.
- (i) Can the company be registered with seven individuals?
 - (ii) What is the minimum number of directors required to be appointed?
 - (iii) The time limit within which the first annual general meeting of the company should be held after incorporation.
 - (iv) Whether the funds of the company can be given as loans to any of the directors of the company? (8 Marks)

Advise the promoters on the above said issues with relevant details.

- (b) AB Ltd. fails to raise its paid up capital up to Rs.5 Lakhs so as to comply with the provisions of the Companies (Amendment) Act, 2002. The Registrar of companies New Delhi struck off the name of the company from the Register in 2003. Mr. Mercy a creditor of the company having information that there are assets available with the company, seeks your advice on the following issues:
- (i) Can the name of the company be restored?
 - (ii) If the answer of the above question is in the affirmative, who can apply for restoration and who is the competent authority for considering the restoration of name?
 - (iii) Is there any time 'Limit for making' application for restoration and if so how many years? (7 Marks)

Answer

- (a) According to the provisions of Section 581C of the Companies Act 1956, a producer company can be formed any ten or more individuals, each of them being a producer, or any two or more producer institutions, or a combination of ten or more individuals and producer institutions, desirous of forming a producer company having its objects specified in section 581B and otherwise complying with the requirements and provisions of the Act

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Thus seven individuals cannot form a producer company.

Every producer company shall have at least 5 directors and not more than 15 directors (section 581 Q).

A producer company shall hold its first annual general meeting within a period of 90 days from the date of its incorporation.

According to section 581ZK; a producer company can grant loans and advances to any of its directors or their relatives only after obtaining the approval of the members in general meeting and also subject to the conditions if any imposed by the articles of association of the producer company.

- (b) Section 560(6) of the Companies Act, 1956 provides for restoration of a company's name previously struck off the register.

As per section 560 (6), if a company, or any member or creditor thereof, feels aggrieved by the company having been struck off the register, the court (tribunal) on an application made by the company, member or creditor before the expiry of twenty years from the publication in the official gazette of the notice aforesaid, may, if satisfied that the company was, at the time of the striking off, carrying on business or in operation or otherwise that it is just that the company be restored to the register, and the court (tribunal) may, by the order, give such directions and make such provisions as seem just for placing the company and all other persons in the same position as nearly as may be as if the name of the company had not been struck off.

Upon a certified copy of the order under sub-section (6) being delivered to the registrar for registration, the company shall be deemed to have continued in existence as if its name had not been struck off.

In view of the above the following advice may be given to Mr. Mercy.

- (i) Yes. The name of the company (AB Ltd) can be restored after following the procedure stated above.
- (ii) The application has to be made to the concerned High Court where the registered office of AB Ltd. is situated. Mr. Mercy as creditor can make the application. Such an application can be made by the company, or any member of the company also.
- (iii) Yes. There is a time limit of 20 years beyond which the power to restore the company is not possible.

Question 8

- (a) A Mortgage was created over the property of a public company. The loan was advanced by the son of the director. All the directors already knew this fact. Thus the director was interested in the transaction. But he has neither disclosed his interest nor abstained from voting while approving the said transaction. Later on a suit was filed for setting aside the

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mortgage on the ground that since the interested director voted on the matter, the contract was void. Advise with reasons.

- (i) Whether the contract became void due to non-disclosure of interest by the concerned director?
- (ii) Is there any ban on such a contract under the Companies Act, 1956? (8 Marks)
- (b) Decide in the light of the provisions of the companies Act, 1956 the validity and extent of powers of Board of Directors and the procedure to be complied with in the following matters:
 - (i) Delegation of power of the Managing Director of the company to invest surplus funds of the company in the shares of some companies.
 - (ii) Donation of Rs.5 lakhs to a hospital established exclusively for the benefit of employees and a donation of Rs.5 lakhs to a charitable trust registered under Section 12A and exempted under Section 80G of the Income-tax Act, 1961.
 - (iii) Donation of Rs.5 Lakhs to a political party registered with the appropriate authority. (7 Marks)

Answer

- (a) Section 299 of the Companies Act, 1956 requires the disclosure of interest by a director while section 300 prohibits an interested director to participate or vote in respect of that particular transaction at the Board meeting. Further his presence will not be counted for quorum also. But where a whole body of directors is aware of the facts relating to an interest of a director, a formal disclosure is not necessary. (Ramakrishna Rao Vs. Bangalore Race Club).

The mere voting by an interested director will not render the contract void or voidable unless with the absence of that vote, there would have been no quorum. The mere fact that voting under such situation is an offence punishable with fine under section 299(4) and 300(4) of the Act does not ipso facto render the contract void or voidable. In this case, there is no allegation of earning secret profits. Thus the action against the company will fail as the contract of mortgage is fair and in the interest of the company.

Under section 299 and 300 of the Act, there is no ban on contract in which a director is interested. The only requirement is that the interest should be disclosed, bonafide and fair. (P. Leslie & co. Vs. Vo wapshare)

Even where the interest is not disclosed the transaction is only voidable against the interested director, and not void. (Narayan Das Shreeram Somani vs Sangli Bank).

- (b) **POWERS OF BOARD OF DIRECTORS:**
 - (i) Section 292 of the Companies Act, 1956 empowers the Board of Directors to delegate to the Managing Director the power to invest in general terms. But section

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372A (2) of the said act provides that no investment shall be made, unless it is sanctioned by a resolution passed at a meeting of the Board with the consent of all the directors present. Section 372A does not provide for delegation. Hence the proposed delegation of power to the Managing Director to invest is not in order.

- (ii) Donation to a hospital run exclusively for the benefit of employees of the company is in order. The limit of 5% of average net profits during the last three financial years is applicable only to contributions to charitable and other funds not directly relating to the business of the company or the welfare of its employees. Thus, under section 293 (1) (e) of the Companies Act, 1956, the Board is empowered to make the proposed donation to the hospital.

However the donation of Rs.5 Lakhs to a charitable trust is subject to the limit laid down in section 293(1) i.e. Rs.50,000 or 5% of the average net profits of the company during the last three financial years whichever is higher.

Thus to contribute Rs.5 lakhs the average net profits for last three financial years should be Rs.100 lakhs.

- (iii) Donation of Rs.5 Lakhs to a political party can be made if the company is in existence for more than 3 years and the donation amount cannot exceed 5% of the average net profit for the preceeding three years. Further the procedure laid down in Section 293 A should also be complied with.

Question 9

- (a) The shareholders and creditors of Wagonbound Company Limited, in meeting convened for approval of a scheme of reconstruction of the company, passed resolutions. The scheme of reconstruction provided for the following:

- (i) Sale of vacant land and appropriation of proceeds for payment of outstanding wages, tax dues and repayment of loan.
- (ii) Unsecured creditors to forego 40% of their claims against the company and receive debentures for the balance amount.

A few share holders and creditors raised objections against the said arrangements. Advise the directors about the steps to be taken to give effect to the proposed scheme under the Companies Act, 1956. (8 Marks)

- (b) High Value Builder Ltd. is financially insolvent and is unable to pay its debts. Mr. X an unsecured creditor has to recover a sum of Rs.5 lakhs from the company. Advise Mr. X about the steps and the procedure to be followed to put the company into compulsory winding up, as an alternative for the recovery of his dues. (7 Marks)

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Answer

(a) RECONSTRUCTION SCHEME OF COMPANY:

The provisions contained in sections 391 to 394 of the Companies Act, 1956 are applicable to Wagonbound Company Limited as it can be considered as a company liable to be wound up within the meaning of Section 390 of the Companies Act, 1956. The proposed scheme involves a compromise or arrangement with members and creditors and it attracts section 391 of the said Act.

While the company or any creditor or member can make application to the Court/Tribunal under Section 391, it is usual for the company to make an application. On such application the Court/Tribunal may order that a meeting of creditors and/or members be called and held as per the directions of the Court/Tribunal.

The company must send notice of meeting to every creditor/member containing a statement setting forth the terms of compromise or arrangement explaining its effect. Material interest of directors, Managing Director or manager of the company in the scheme and the effect of scheme on their interest should be fully disclosed (Section 393). At the meetings convened as per directions of the Court/Tribunal majority in number representing at least $\frac{3}{4}$ in value of creditors/members present and voting must agree to compromise or arrangement. Thereafter the company must present a petition to the Court/Tribunal for confirmation of the compromise or arrangement.

The notice of application made by the company will be served on the Central Government and the Tribunal will take into consideration representation, if any, made by the Central Government (Section 394A). The Court/Tribunal will sanction the scheme, if satisfied, after considering all relevant matters.

Copy of order issued by the Court/Tribunal must be filed with the Registrar of Companies and then only the order will come into effect. Copy of the said order must be annexed to every Memorandum of Association issued thereafter. The scheme sanctioned by the Court/Tribunal shall be binding on all members and creditors even those who were dissenting.

Note: The power under the scheme of reconstruction etc. are still with the high courts pending constitution of the National Company Law Tribunal.

(b) Mr. X has to take the following steps to put High Value Builders Ltd. into compulsory winding up:

- (i) A petition for winding up of the company is to be filed in the High Court where the registered office of the company is located under Section 439(1) (b) read with Section 433(e) and (f) of the Companies Act, 1956. A copy of the petition should also be served on the company.

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- (ii) The petition should be filed along with an affidavit showing sufficient ground for the appointment of a provisional liquidator till an order is passed by the High Court appointing an official liquidator..
- (iii) After obtaining the winding up order from the High Court the same should be advertised within 14 days in a newspaper in English language and in the regional language of the state where the company is registered.
- (iv) A Certified copy of the winding up order passed by the court should be filed with the concerned Registrar of Companies alongwith the prescribed fees within 30 days from the date of the winding up order.
- (v) If the shares of the company are listed in a stock exchange, copy of the petition alongwith the order may be filed with the stock exchange concerned.
- (vi) The winding up proceedings will be carried out by the official liquidator till dissolution of the company.

PAPER – 5 : COST MANAGEMENT

Question Nos. 1 is compulsory.

Answer any four questions from the rest.

Working notes should form part of the answer.

Question 1

- (a) TQM Limited makes engines for motor cars for its parent company and for two other motor car manufacturers. (11 Marks)

On 31st December, the company has sufficient work order for January and one further order for 21,000 engines. Due to recession in the economy, no further order are expected until May when it is hoped economic prospect for the motor car industry will have improved. Recently factory has been working at only 75% of full capacity and the order for 21,000 engines represents about one month production at this level of activity.

The board of directors are currently considering following two options:

- (i) Complete the order in February and close the factory in March and April.

OR

- (ii) Operate at 25 per cent of full capacity for each of three months of February, March and April.

The costs per month at different levels of activities are as follows:

	At 75% (Rs.)	At 25% (Rs.)	Idle (Rs.)
Direct Material	5,25,000	1,75,000	--
Direct Labour	5,23,600	1,73,250	--
Factory overhead:			
Indirect material	8,400	4,900	4,900
Indirect labour	1,01,500	59,500	--
Indirect expenses:			
Repairs and maintenance	28,000	28,000	--
Others expenses	52,500	34,300	26,600
Office overheads:			
Staff salaries	1,48,400	98,000	67,550
Other overheads	28,000	19,950	11,200

Other information is as follows:

- Material cost and labour cost will not be incurred where there is no production.

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- On the reopening of the factory, one time cost of training and engagement of new personnel would be Rs.65,800 and overhauling cost of plant would be Rs.14,000.
- Parent company can purchase engines from open market at reasonable price.

Required:

- (i) To express your opinion, along with calculations, as to whether the plant should be shut down during the month of March and April or operate 25% of full capacity for three months.
- (ii) To list and comment on cost and non-costs factors which might be relevant to the discussion.

(b) The following are Product Nova Shaft's data for next year budget: (9 Marks)

Activity	Cost Driver	Cost Driver volume/year	Cost Pool
Purchasing	Purchase orders	1,500	Rs.75,000
Setting	Batches produced	2,800	Rs.1,12,000
Materials handling	Materials movements	8,000	Rs.96,000
Inspection	Batches produced	2,800	Rs.70,000
Machining costs	Machine hours	"50,000"	Rs.1,50,000

Purchase orders	25
Output	15,000 units
Production batch size	100 units
Materials movements per batch	6
Machine hours per unit	0.1

Required:

- (i) Calculate the budgeted overhead costs using activity based costing principles.
 - (ii) Calculate the budgeted overhead costs using absorption costing (absorb overhead using machine hours).
 - (iii) How can the company reduce the ABC for Product Nova Shaft?
- (c) Explain goals and performance measure for each perspective of Balance Score Card.

(4 Marks)

PAPER – 5 : COST MANAGEMENT

Answer

(a) (i)

	Option I At 75% in Feb and close in March and April (Rs.)	Option II At 25% each from Feb – April (Rs.)
Direct Material	5,25,000	5,25,000
Direct Labour	5,23,600	5,19,750
	10,48,600	10,44,750
Factory Overhead :		
Indirect Material	8,400	14,700
Two months idle	9,800	
Indirect Labour	1,01,500	1,78,500
Training cost	65,800	
Indirect Exp. :		
Repairs & Maintenance	28,000	84,000
Over hauling cost	14,000	
Others Expenses	52,500	1,02,900
Idle × 2	53,200	
Office overhead:		
Staff Salaries	1,48,400	2,94,000
Idle 67,550 × 2	1,35,100	
Other overheads	28,000	59,850
Idle	22,400	
Total overhead cost	6,67,100	7,33,950
Total cost	17,15,700	17,78,700

The more economic course of action is to operate at 75% capacity for a month only, and close the plant for March and April. This option will save (Rs.17,78,700 – Rs.17,15,700) = Rs.63,000.

1

(ii) Cost Factors and Non Cost Factors

In regard to the decision on close down of operations or continuing with operations, the factors to be considered are:

(a) Cost factors:

1. The proposal which involves the lower total costs will be selected.

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- (2) If the company has contracted the purchases from high quality and high price suppliers, a change in the procurement policy to 'shop around' may be considered to obtain economics in purchases.
- (3) The services of unskilled labour, if any, who do not require re-training may be dispensed with. They may be recruited and put on work without incurring training cost on re-opening of the factory. This will save training and idle time cost.
- (4) The possibility of wage freeze may reluctantly be considered as an extreme measure.

(b) Non-cost factors:

- (1) If the skilled workers are discharged, it may be difficult to get them back on rolls when the factory is re-opened. Skilled workers may be scarce and training and orientation costs may be heavy on re-opening of the factory. Thus it is advisable to continue operations in the interests of these types of workers.
- (2) Even though the closure is temporary in nature, the competitors may usurp the market and the company may lose a sizable market share on re-opening. To avoid this situation, continuance of production is better.
- (3) It is advisable to continue operations to avoid heavy depreciation of plant and machinery and obsolescence risk.
- (4) Regular customers may switch over to competitor's products and may not return after re-opening of the factory. This may result in reduction in sales.

(b) (i) Computation of the activity based overheads

Step 1: Compute cost per unit of cost driver = Cost pool / cost driver volume

Activity	Cost Driver	Cost Pool (a)	Cost driver volume/yr (b)	Cost/Unit of cost driver (a)/(b)
Purchasing	Purchase orders	Rs.75,000	1,500	Rs.50/purchase order
Setting	Batches produced	Rs.112,000	2,800	Rs.40/batch
Materials handling	Material movements	Rs. 96,000	8,000	Rs.12/movement
Inspection	Batches produced	Rs.70,000	2,800	Rs.25/batch
Machining	Machine hours	Rs.150,000	50,000	Rs.3/machine hour

Step 2: Compute the volume of cost drivers consumed by Product Nova Shaft

Purchase orders (given) = 25

Batches = 15,000/100 = 150

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Materials movement = 150 batches × 6 = 900

Machine hours = 15,000 units × 0.1 = 1,500

Step 3: Compute the Activity Based Overheads Cost for Product Nova Shaft

Activity	Cost Driver	Costing Rate / Cost Driver Unit Rs.		
Purchasing	Purchase orders	50	25 order × Rs.50	Rs.1,250
Setting	Batches produced	40	150 batches × Rs.40	Rs.6,000
Material handling	Material movements	12	900 movement × Rs.12	Rs.10,800
Inspection	Batches produced	25	150 batches × Rs.25	Rs.3,750
Machining	Machine hours	3	1,500 hours × Rs.3	<u>Rs.4,500</u>
				Rs.26,300

- (ii) Computation of budgeted overheads costs for Product Nova Shaft using absorption costing

Budgeted overheads = (Rs.75,000 + Rs.96,000 + Rs.112,000 + Rs.70,000 + Rs.150,000) = Rs.503,000

Budgeted absorption cost/machine hour = Rs.503,000 / 50,000 = Rs.10.06

Budgeted machining hours for Product Nova Shaft = 1,500

Budgeted absorbed overhead = 1,500 × Rs.10.06 = Rs.15,090

- (iii) Ways in which the company can reduce the ABC for product Nova Shaft:

- Reduce the number of batches by increasing the batch size which will then reduce the setting up overhead, materials handling and inspection costs.
- Reduce the number of purchase orders
- Innovate ways of speeding up production so that the machining hours are reduced.

- (c) Goals and performance measures for each perspective of balance scorecard.

Customer Perspective

Goals	Performance Measures
Price	Competitive price
Delivery	Number of on time delivery, lead time from receipt of order to delivery to customer.

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Quality	Own quality relative to industry standards, number of defects or defect level.
Support	Response time, customer satisfaction survey.
Internal Business Perspective	
Goals	Performance Measures
Efficiency of manufacturing process	Manufacturing cycle time
Sales penetration	Sales plan, Increase in number of customer in a unit of time.
New Product introduction	Rate of new product introduction.
Innovation and Learning Perspective	
Goals	Performance Measures
Technology leadership	Performance of product, use of technology
Cost leadership	Manufacture overhead per quarter
Market leadership	Market share in all major markets
Research and development	Number of new products, Patents
Financial Perspective	
Goals	Performance Measures
Sales	Revenue and profit growth
Cost of Sales	Extent in remain fixed or decreased each year
Profitability	Return on capital employed
Prosperity	Cash flows

Question 2

- (a) A company is organized on decentralized lines, .with each manufacturing division operating as a separate profit centre. Each division manager has full authority to decide on sale of division's output to outsiders or to other divisions. Division AB manufactures a single standardized product. Some output is sold externally and remaining is transferred to division XY where it is a subassembly in the manufacture of the division product. The unit cost of division AB product and division XY is as follows: (12 Marks)

	Division AB (Rs.)	Division XY (Rs.)
Transfer from division AB to XY	--	42.00
Direct Material	6.00	35.00
Direct Labour	3.00	4.50
Direct expenses	3.00	--

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Variable manufacturing overheads	3.00	18.00
Fixed manufacturing overheads	6.00	18.00
Variable selling and packing expenses	3.00	2.50
	24.00	120.00

Division AB sold 40,000 units annually at the standard price of Rs.45 in external market. In additions to the external sales, 10,000 units are transferred annually to division XY at internal price of Rupees 42 per unit. Variable selling and packing expenses are not incurred by supplying division- for the internal transfer of the product. Division XY incorporates the transferred goods into more advance product. The manager of division XY disagrees with the basis used to set the transfer price. He argues that transfer price should be made at variable cost since he claims that his division is taking output that division AB should be unable to sell at price Rs.45.

He also submitted a report of the relationship between selling price and demand to support of his disagreement. The report of customer demand at various selling prices for division AB and for division XY is as follows:

Division AB

Selling price per unit (Rs.)	30	45	60
Demand (Units)	60,000	40,000	20,000

Division XY

Selling price per unit (Rs.)	120	135	150
Demand (Units)	15,000	10,000	5,000

The company has sufficient capacity to meet demand at various selling prices. Internal transfer demanded units will be decided by XY division.

Required:

- (i) To calculate divisional profitability and overall profitability of company if division AB transfers demanded units to XY at price of Rs. 42.
 - (ii) To calculate divisional profitability and overall profitability of company if division AB transfers demanded units to XY at variable cost.
 - (iii) In place of internal transfers, AB division can sell 10,000 units of their product in new external market without effecting existing market, at price Rs. 32 per unit and XY division can 'purchase these units at the rate of Rs. 31 in open market. Calculate company's profit by following above strategies.
- (b) Define the term 'value-chain'. Mention three 'useful strategic frameworks of the value-chain analysis. (4 Marks)
- (c) Meena is a news reporter and feature writer for an economic daily. Her assignment is to develop a feature article on 'Product Life-cycle Costing', including interviews with the Chief Financial Officers (CFO) and operating managers. Meena has been given a liberal

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budget for travel so as to research into company's history, operations, and market analysis for the firm she selects for the article. (3 Marks)

Required:

- (i) Meena has asked you to recommend industries and firms that would be good candidates for the article. What would you advice? Explain your recommendations.

Answer

- (a) (i) AB sells product at external market

Selling price (Rs.)	30	45	60
Less Variable cost	18	18	18
Contribution (per unit)	12	27	42
Demands (units)	60,000	40,000	20,000
Total contribution	7,20,000	10,80,000	8,40,000

Optimal output is 40,000 units at a selling price of Rs.45

AB transfer at Rs.42 to XY division then contribution of XY

Selling price (Rs.)	120	135	150
Less Variable cost V+TP (42+60)	102	102	102
Contribution (per unit)	18	33	48
Demands (units)	15,000	10,000	5,000
Total contribution	2,70,000	3,30,000	2,40,000

Manager will choose out put level 10,000 units at a selling price of Rs.135.

Overall profit when transfer made at Rs.42

Division AB contribution on 10,000 units $[42 - (18 - 3)]$ = 2,70,000

Division XY contribution 10,000 $(135 - 102)$ = 3,30,000

Total contribution = 6,00,000

Division AB contribution from external market sale 10,80,000

Total profit 16,80,000

- (ii) AB transfer at variable cost

Selling price (Rs.)	120	135	150
Less Variable cost (15+60)	75	75	75
Contribution (per unit)	45	60	75
Demands (units)	15,000	10,000	5,000
Total contribution	6,75,000	6,00,000	3,75,000

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Optimal is 15,000 units at the rate of 120 per unit.

If AB transfer at Variable cost (Rs.15) then no contribution will be generated by AB division

XY division choose 15,000 units level gives contribution $15,000 \times 45 = 6,75,000$

Division AB contribution from external market sale = 10,80,000

Total contribution = 17,55,000

- (iii) Contribution AB division by selling 10,000 units to new external market at Rs.32 and XY division purchasing at Rs.31.

Contribution $(32 - 18) \times 10,000 = 1,40,000$

XY contribution $[135 - (31 + 60)] = 4,40,000$

Division AB contribution from external market sale = 10,80,000

Total contribution = 16,60,000

- (b) Value chain is the linked set of value-creating activities all the way from basic raw material sources for component suppliers through to the ultimate end-use product or service delivered to the customer. Porter's described the value chain as the internal processes or activities a company performs "to design, produce, market, deliver and support its product". He further stated that "a firm's value chain and the way it performs individual activities are a reflection of its history, its strategy, its approach of implementing its strategy, and the underlying economics of the activities themselves". The business activities are classified in to primary activities and support activities.

Primary activities are those activities which are involved in transforming the inputs in to outputs, delivery and after sales service. Support activities are intended to support the primary activities like for example procurement, human resources management, etc.

Three useful strategic frameworks for value chain analysis are:

- Industry structure analysis;
- Core competencies; and
- Segmentation analysis.

- (c) The product life cycle span the time from the initial R & D on a product to when customer service and support is no longer offered for that product.

Life Cycle Costing technique is particularly important when:

- (a) High percentage of total life-cycle costs are incurred before production begins and revenue are earned over several years and
- (b) High fraction of the life cycle costs are locked in at the R & D and design stages.

Meena should identify those industries and then companies belonging to those industries where above mentioned feature are prevalent. For example, Automobile

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and Pharmaceutical Industries companies like Tata Automobile, M&M, Ranbexy and Dabur will be good candidates for study on product life cycle costing.

Question 3

- (a) JBC Limited, a manufacturing company having a capacity of 60,000 units has prepared a following cost sheet: (9 Marks)

Direct material (per unit)	Rs.12.50
Direct wages (per unit)	Rs.5.00
Semi-variable cost	Rs.30,000 fixed plus 0.50 per unit
Factory overhead (per unit)	Rs.10.00 (50% fixed)
Selling and administration overhead (per unit)	Rs.8.00 (25% variable)
Selling price (per unit)	Rs.40

During the year 2008, the sales volume achieved by the company was 50,000 units.

The company has launched an expansion program as under

- (a) The capacity will be increased to 1,00,000 units.
- (b) The cost of investment on expansion is Rs.5 lakhs which is proposed to be financed through financial institution at 12 per cent per annum.
- (c) The depreciation rate on new investment is 10 per cent based on straight line.
- (d) The additional fixed overheads will amount to Rs.2.00 lakhs up to 80,000 units and will increase by Rs.80,000 more beyond 80,000 units.

After the expansion, the company has two alternatives for operating the expanded plant as under:

- (i) Sales can be increased up to 80,000 units by spending Rs. 50,000 on special advertisement campaign to explore new market.
- (ii) Sales can be increased up to 1,00,000 units subject to the following:
 - (a) Reduction of selling price by Rs.4 per unit on all the units sold.
 - (b) The direct material cost would go down by 4 per cent due to discount on bulk buying.
 - (c) By increasing the variable selling and administration expenses by 4 per cent.

Required.

- (i) Construct a flexible budget at the level 50,000 units, 80,000 units and 1,00,000 units of production and select best profitable level of operation.
 - (ii) Calculate break even point both before and after expansion.
- (b) State major reasons for using simulation technique to solve a problem and also describe basic steps in a general simulation process. (5 Marks)

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- (c) What is penetrating pricing? What are the circumstances in which this policy can be adopted? (5 Marks)

Answer

(a) Flexible Budget

Output level (units)	50,000 (Rs. in lakhs)	80,000 (Rs. in lakhs)	1,00,000 (Rs. in lakhs)
Sales	20.00	32.00	36.00
Direct Material 12.5 per unit (reduction for 1,00,000 units by Rs.0.50)	6.25	10.00	12.00
Direct wages (5.00 per unit)	2.50	4.00	5.00
Semi variable cost (variable)	0.25	0.40	0.50
Factory overhead (V) Rs.5 per unit)	2.50	4.00	5.00
Selling and Adm. (25% variable)	<u>1.00</u>	<u>1.60</u>	<u>2.08</u>
Total variable cost	<u>12.50</u>	<u>20.00</u>	<u>24.58</u>
Contribution	<u>7.50</u>	<u>12.00</u>	<u>11.42</u>
Fixed factory overheads (5×60,000)	3.00	3.00	3.00
Selling and adm. (6 × 60,000)	3.60	3.60	3.60
Semi variable fixed part	.30	.30	.30
Increase due to expansion		2.00	2.80
Interest		.60	.60
Depreciation		.50	.50
Special Advertisement exp.	<u>—</u>	<u>.50</u>	<u>—</u>
Total fixed costs	<u>6.90</u>	<u>10.50</u>	<u>10.80</u>
	<u>0.60</u>	<u>1.50</u>	<u>0.62</u>

Therefore activity level 80,000 units is most profitable level.

Calculation of Break even point

P/V ratio

$7.5/20.00 \times 100 = 37.5\%$, $12.00/32.00 \times 100 = 37.5\%$, $11.42/36.00 \times 100 = 31.72\%$ BEP (value)

$= 6.90/37.5\% = \text{Rs.}18,40,000$, $10.50/37.5\% = \text{Rs.}28,00,000$, $10.80/31.72\% = 34,04,792$

BEP (Units)

$\frac{6.90 \text{ lakhs}}{\text{Rs.}15}$	$\frac{10.50 \text{ lakhs}}{\text{Rs.}15}$	$\frac{10.80 \text{ lakhs}}{\text{Rs.}15}$
= 46,000 units	= 70,000 units	= 94,571 units

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Alternative Solution (BEP in Sales)

Break Even Point in value of sales: $(F \times S) / (S - V)$

At 50000 units' level : $(6,90,000 \times 20,00,000) / 7,50,000 = \text{Rs. } 18,40,000$

At 80000 units' level : $(10,50,000 \times 32,00,000) / 12,00,000 = \text{Rs. } 28,00,000$

At 100000 units' level : $(10,80,000 \times 36,00,000) / 11,42,000 = \text{Rs. } 34,04,553$

(b) Reasons:

- (i) It is not possible to develop a mathematical model and solutions with out some basic assumptions.
- (ii) It may be too costly to actually observe a system.
- (iii) Sufficient time may not be available to allow the system to operate for a very long time.
- (iv) Actual operation and observation of a real system may be too disruptive.

Steps:

- (i) Define the problem or system which we want to simulate.
- (ii) Formulate an appropriate model of the given problem.
- (iii) Ensure that model represents the real situation/ test the model, compare its behaviour with the behaviour of actual problem environment.
- (iv) Identify and collect the data needed to list the model.
- (v) Run the simulation
- (vi) Analysis the results of the simulation and if desired, change the solution.
- (vii) Return and validate the simulation.

(c) The penetration pricing policy implies charging a low price to deter entry of competitors and to expand market share. Circumstances of penetration policy:

- The short run price elasticity of demand is high. By charging a low price, the first entrant is able to establish a market.
- Economies of scale are significant. By entering at a large scale the first firm can both enjoy low average cost and impose a cost penalty on any small scale subsequent entrant.
- Exploitation of established reputation / sales, marketing, distribution strengths. Create platform form for continued sale of related products.
- When there is a threat of competition. It depicted at maturity stage of a product in its life-cycle.

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Question 4

- (a) A project with normal duration and cost along with crash duration and cost for each activity is given below: (12 Marks)

Activity	Normal Time (Hrs.)	Normal Cost (Rs.)	Crash Time (Hrs.)	Crash Cost (Rs.)
1-2	5	200	4	300
2-3	5	30	5	30
2-4	9	320	7	480
2-5	12	620	10	710
3-5	6	150	5	200
4-5	0	0	0	0
5-6	8	220	6	310
6-7	6	300	5	370

Required:

- (i) Draw network diagram and identify the critical path.
 - (ii) Find out the total float associated with each activity.
 - (iii) Crash the relevant activities systematically and determine the optimum project completion time and corresponding cost.
- (b) A factory is going to modify of a plant layout to install four new machines M1, M2, M3 and M4. There are 5 vacant places J, K, L, M and N available. Because of limited space machine M2 cannot be placed at L and M3 cannot be placed at J. The cost of locating machine to place in Rupees is shown below: (7 Marks)

	(Rs.)				
	J	K	L	M	N
M1	18	22	30	20	22
M2	24	18	--	20	18
M3	--	22	28	22	14
M4	28	16	24	14	16

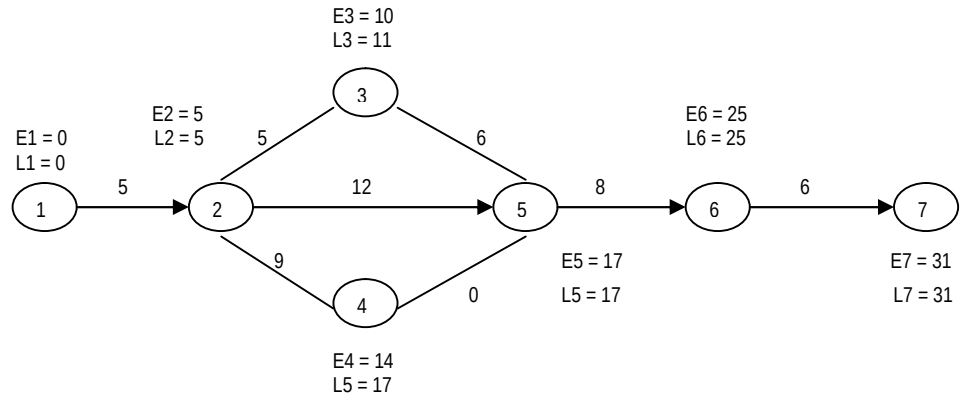
Required:

Determine the optimal assignment schedule in such a manner that the total costs are kept at a minimum.

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Answer

(a) (i) Net work diagram



Path are

- 1-2-5-6-7 = 31 hours, this is critical path
- 1-2-3-5-6-7 = 30 hours
- 1-2-4-5-6-7 = 28 hours

(ii) Total floats

Activity	Duration hours	Early start	Latest start	Early finish	Latest finish	Total float
1-2	5	0	0	5	5	0
2-3	5	5	6	10	11	1
2-4	9	5	8	14	17	3
2-5	12	5	5	17	17	0
3-5	6	10	11	16	17	1
4-5	0	14	17	14	17	3
5-6	8	17	17	25	25	0
6-7	6	25	25	31	31	0

(iii) Calculation of crashing

Activity	Nt	Nc	Ct	Cc	Slop = (Cc-Nc) / (Nt-Ct)
1-2	5	200	4	300	100
2-3	5	30	5	30	0
2-4	9	320	7	480	80
2-5	12	620	10	710	45
3-5	6	150	5	200	50
4-5	0	0	0	0	0

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5-6	8	220	6	310	45
6-7	6	300	5	370	70

The critical path activities are 1-2 2-5 5-6 6-7

Slope 100 45 45 70

Two activities cost slope cost is minimum (2-5 and 5-6) but activity 5-6 is common and critical, it also continuing so reduce by 2 hours, then reduce activity 2-5 by one hour.

	Activity	From-to	Project durations	Cost
I	5-6	8-6 hours	31-2 = 29	$1840 + (2 \times 45) + (29 \times 50) = 3380$
II	2-5	12-11	29-1 = 28	$1840 + 90 + (1 \times 45) + 28 \times 50 = 3375$

After this reduction now two paths are critical 1-2-3-5-6-7 = 28 and 1-2-5-6-7 = 28

So 1-2 3-5 6-7
2-5

Slope cost 100 50+45=95 70

As cost per hour for every alternative is greater than Rs.50 (overhead cost per hour). Therefore, any reduction in the duration of project will increase the cost of project completion. Therefore, time for projects is 28 weeks, minimum cost is Rs.3375.

- (b) Dummy machine (M5) is inserted to make it a balanced cost matrix and assume its installation cost to be zero. Cost of install at cell M3 (J) and M2 (L) is very high marked as é.

	J	K	L	M	N
M1	18	22	30	20	22
M2	24	18	é	20	18
M3	é	22	28	22	14
M4	28	16	24	14	16
M5 (Dummy)	0	0	0	0	0

Step 1

Subtract the minimum element of each row from each element of that row

	J	K	L	M	N
M1	0	4	12	2	4
M2	6	0	é	2	0
M3	é	8	14	8	0

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M4	14	2	10	0	2
M5 (Dummy)	0	0	0	0	0

Step 2

Subtract the minimum element of each column from each element of that column

	J	K	L	M	N
M1	0	4	12	2	4
M2	6	0	e	2	0
M3	e	8	14	8	0
M4	14	2	10	0	2
M5 (Dummy)	0	0	0	0	0

Step 3

Draw lines to connect the zeros as under:

	J	K	L	M	N
M1	0	4	12	2	4
M2	6	0	e	2	0
M3	e	8	14	8	0
M4	14	2	10	0	2
M5 (Dummy)	0	0	0	0	0

There are five lines which are equal to the order of the matrix. Hence the solution is optimal. We may proceed to make the assignment as under:

	J	K	L	M	N
M1	0	4	12	2	4
M2	6	0	e	2	0
M3	e	8	14	8	0
M4	14	2	10	0	2
M5 (Dummy)	0	0	0	0	0

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The following is the assignment which keeps the total cost at minimum:

Machines	Location	Costs Rs.
M1	J	18
M2	K	18
M3	N	14
M4	M	14
M5 (Dummy)	L	<u>0</u>
Total		<u>64</u>

Question 5

- (a) Global Limited uses standard and marginal costing system. It provides the following details for the year 2007-08 relating to its production, cost and sales: (9 Marks)

Particulars	Budget	Actual
Sales units	24,000	25,600
Sales value	6,000	6,784
Materials	960	1,080
Labour	1,440	1,664
Variable overheads	2,400	2,592
Total variable cost	4,800	5,336

The sales budget is based on the expectation of the company's estimate of market share of 12%. The entire industry's sales of the same product for the year 2007-08 is 2,40,000 units. Further details are as follows:

(In Rs.)		
Particulars	Standard	Actual
Material price per kg.	8.00	7.50
Labour rate per hour	6.00	6.40

You are required to :

- Prepare a statement reconciling the budgeted contribution with actual contribution on the basis of important material variances, labour variances, variable overhead variances and sales variances.
- Compute market size variance and market share variance.

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- (b) Fairbilt Furniture Ltd. manufactures three products: Tables, Chairs and Cabinets. The company is in the process of finalizing the plans for the coming year; hence the executives thought it would be prudent to have a look at the product-wise performance during the current year. The following information is furnished: (10 Marks)

	Tables	Chairs	Cabinets
Unit selling price	80	60	36
Direct material	28	24	16
Direct labour	20	12	12
Factory overheads:			
Variable	8	6	4
Fixed	8	6	1.28
Cost of production	64	48	33.28
Selling, distribution and general administration expenses :			
Variable	4	2	2
Fixed	4	6	1.52
Unit cost (I)	72	56	36.80
Unit profit (loss) (II)	8	4	(0.80)
Sales volume (units)	10,000	15,000	15,000
Profit (loss)	80,000	60,000	(12,000)

For the coming period, the selling prices and the cost of three products are expected to remain unchanged. There will be an increase in the sales of tables by 1,000 units and the increase in sales of cabinets is expected to be 8,000 units. The sales of chairs will remain to be unchanged. Sufficient additional capacity exists to enable the increased demands to be met without incurring additional fixed costs. Some among the executives contend that it will be unwise to go for additional production and sale of cabinets, since it is already making losses at Rs.0.80 per unit. The suggestion is that cabinets should be eliminated altogether.

Do you agree? Substantiate with necessary analysis and determine the product wise and overall profits for the coming year.

Answer

- (a) Sales variances

Budgeted Sales	Rs.6000
Budgeted sales quantity	24000
Budgeted selling price	$6000/24000 = \text{Rs.}0.25$
Actual industry sales in units	240000
Budgeted market share	12%
Hence market share required:	$240000 \times 12\% = 28800 \text{ units}$

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SQ	RSQ	AQ	SP	SQ × SP	RSQ × SP	AQ × SP	AQ×AP
24000	28800	25600	0.25	6000	7200	6400	6784

Sales Market Size variance 6000-7200 = Rs.1200 F

Sales Market Share Variance: 7200-6400 = Rs. 800 A

Sales Volume Variance: 6000-6400 = Rs. 400 F

Sales Price variance 6400-6784 = Rs. 384 F

Budgeted contribution:

Sales Rs.6000

Variable costs Rs.4800

Contribution Rs.1200

Units 24000

Contribution/unit : Rs.0.05

(1200/24000)

SQ	RSQ	AQ	SP	SQ × SP	RSQ × SP	AQ × SP
24000	28800	25600	0.05	1200	1440	1280

Sales Market Size variance: 1200 – 1440 = Rs.240 F

Sales Market Share Variance: 1440 – 1280 = Rs.160 A

Sales Volume Variance 1200 – 1280 = Rs. 80 F

As per the requirement of the question (b)

Sales Market Size variance is Rs.1200 F

Sales Market Share variance is Rs.800 A

Sales Variances:

Sales Gross Margin Market Size variance Rs.240 F

Sales Gross Margin Market Share variance Rs.160 A

Sales Gross Margin Volume Variance: Rs. 80 F

Sales Price Variance Rs.384 F

Direct materials :

Budgeted Material costs Rs.960

Budgeted units 24000

Budgeted material cost per 100 units: = Rs.4.00

(960/24000) × 100

Standard price of Material/ kg = Rs.8

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Standard requirement of materials per 100 units of output : 4/8 = 0.50 kg
 Actual output: = 25600
 Standard requirement for actual output =128kg
 $(25600 \times 0.50)/100$
 Actual material cost: = Rs.1080
 Actual price/kg = Rs.7.50
 Actual quantity of materials consumed: = 144 kg
 $(1080/7.50)$

SQ	AQ	SP	SQ × SP	AQ × SP	AP	AQ × AP
128	144	8	1024	1152	7.50	1080

Usage Variance 1024-1152 = Rs.128 A

Price Variance 1152-1080 = Rs. 72 F

Direct Labour:

Budgeted Labour costs Rs.1440
 Budgeted units 24000
 Budgeted Labour cost per 100 units : = Rs.6.00
 $(1440/24000) \times 100$

Standard Labour hour rate/hour = Rs.6
 Standard requirement of labour hours per 100 units of output:6/6 = 1.00 hour
 Actual output = 25600
 Standard hours required for actual output: $(25600 \times 1)/100$ = 256 hours
 Actual labour cost: = Rs.1664
 Actual direct labour hour rate = Rs.6.40
 Actual hours worked $(1664/6.40)$ = 260 hours
 Budgeted direct labour $(1440/6)$ = 240 hours

SH	AH	SR	SH×SR	AH×SR	AR	AH×AR
256	260	6	1536	1560	6.40	1664

Efficiency Variance 1536 – 1560 = Rs. 24 A

Labour Rate Variance 1560 – 1664 = Rs.104 A

Variable Overheads:

Budgeted variable overheads Rs. 2400
 Budgeted direct labour hours 240

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Budgeted variable overhead rate per direct labour hour: $2400/240 = \text{Rs.}10$

A.	Charged to production : 256 hours × 10	Rs.2560
B.	Standard cost of actual hours : 260 × 10	Rs.2600
C.	Actual overheads	Rs.2592
	Efficiency Variance 2560 – 2600	Rs. 40 A
	Expense variance 2600 – 2592	Rs. 8 F

Contribution analysis:

	Budget	Actual
	Rs.	Rs
Sales	6000	6784
Variable costs	4800	5336
Contribution	1200	1448

Statement of Reconciliation between Budgeted and Actual Contribution

		Rs	
Budgeted Contribution		1200	
Gross Margin Sales Volume Variance		80	F
Standard Contribution		1280	
Sales Price Variance		384	F
Total contribution		1664	
Cost Variances:			
	F	A	
Material Usage Variance		128	
Material Price Variance	72		
Labour Efficiency Variance		24	
Labour Rate Variance		104	
Variable OH Efficiency Variance		40	
Variable OH Expense Variance	8	—	<u>216</u> A
Actual Contribution		<u>1448</u>	

- (b) Note : Reconciliation of the figures given for 'cabinets' reveals the fact that the selling price is 36(36.80 – .80)

Fairbilt Furniture Ltd.

Statement showing Product-wise Contribution and Total Profit

	Tables		Chairs		Cabinets		Total
	Per Unit	Total	Per unit	Total	Per unit	Total	
Sales volume (units)		10,000		15,000		15,000	
Selling price (Rs.)	<u>80</u>	<u>800,000</u>	<u>60</u>	<u>900,000</u>	<u>36</u>	<u>540,000</u>	<u>22,40,000</u>
Direct Material	28	280,000	24	360,000	16	240,000	880,000

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Direct Labour	20	200,000	12	180,000	12	180,000	560,000
Variable factory overheads	8	80,000	6	90,000	4	60,000	230,000
Variable selling, distribution and administration overhead	4	40,000	2	30,000	2	30,000	100,000
Total variable cost	60	600,000	44	660,000	34	510,000	1,770,000
Contribution	20	200,000	16	240,000	2	30,000	470,000
Fixed factory overheads		80,000		90,000		19,200	189,200
Fixed selling, distribution and administration overheads		40,000		90,000		22,800	152,800
Total fixed overheads							342,000
Total Profit							128,000

The above analysis shows the cabinets make a contribution of Rs.2 per unit. The loss sustained in the previous year is because of the falling sales volume below breakeven level.

Fairbilt Furniture Ltd.

Budgeted Performance for the Coming Year

	Tables	Chairs	Cabinets
Unit Contribution (Rs.)	20	16	2
Sales Volume (Units)	11,000	15,000	23,000
Total Contribution (Rs.)	220,000	240,000	40,000
Less: Fixed Cost (Rs.)	120,000	180,000	42,000
Profit (Rs.)	100,000	60,000	4,000

The company makes a total profit of Rs.164,000 if all the products are continued. However, if the production of cabinets is discontinued, there will be an adverse effect on the overall profit of the company. This is because cabinets also contribute toward meeting the fixed costs of the company.

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Question 6

- (a) What do you mean by back-flushing in JIT system? What are the problems that must be corrected before it will work properly? (5 Marks)
- (b) Explain the main characteristics of Service sector costing. (5 Marks)
- (c) X is a multiple product manufacturer. One product line consists of motors and the company produces three different models. X is currently considering a proposal from a supplier who wants to sell the company blades for the motors line. (9 Marks)

The company currently produces all the blades it requires. In order to meet customer's needs, X currently produces three different blades for each motor model (nine different blades).

The supplier would charge Rs.25 per blade, regardless of blade type. For the next year X has projected the costs of its own blade production as follows (based on projected volume of 10,000 units):

Direct materials	Rs.75,000
Direct labour	Rs.65,000
Variable overhead	Rs.55,000
Fixed overhead:	
Factory supervision	Rs.35,000
Other fixed cost	<u>Rs.65,000</u>
Total production costs	<u>Rs.2,95,000</u>

Assume (1) the equipment utilized to produce the blades has no alternative use and no market value, (2) the space occupied by blade production will remain idle if the company purchases rather than makes the blades, and (3) factory supervision costs reflect the salary of a production supervisor who would be dismissed from the firm if blade production ceased.

- (i) Determine the net profit or loss of purchasing (rather than manufacturing), the blades required for motor production in the next year.
- (ii) Determine the level of motor production where X would be indifferent between buying and producing the blades. If the future volume level were predicted to decrease, would that influence the decision?
- (iii) For this part only, assume that the space presently occupied by blade production could be leased to another firm for Rs.45,000 per year. How would this affect the make or buy decision?

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Answer

- (a) Backflushing requires no data entry of any kind until a finished product is completed. At that time the total amount finished is entered into the computer system, which multiplies it by all the components listed in the bill of materials for each item produced. This yields a lengthy list of components that should have been used in the production process and which is subtracted from the beginning inventory balance to arrive at the amount of inventory that should now be left of hand. Back the entire production process. Given the large transaction volumes associated with JIT, this is an ideal solution to the problem.

The following problems must be corrected before it will work properly:

- (i) Production reporting
 - (ii) Scrap reporting
 - (iii) Lot tracing
 - (iv) Inventory accuracy.
- (b) Main characteristics of service sector are as below:
- (a) Activities are labour intensive: The activities of service sector generally are labour intensive. The direct material cost is either small or non-existent.
 - (b) Cost-unit is usually difficult to define: The selection of cost units usually, for service sector is difficult to ascertain as compared to the selection of cost unit for manufacturing sector. The following table provides some examples of the cost units for service sector.
 - Hospital – Patient per day, Room per day
 - Accounting firm – Charged out client hours
 - Transport – passenger km., quintal km.
 - Machine maintenance – Maintenance hours provided to user department
 - Computer department – Computer time provided to user department.
 - (c) Product costs in service sector: Costs are classified as product or period costs in manufacturing sector for various reasons.
- (c) (a) This is a make or buy decision so compare the incremental cost to make with the incremental cost buy.

Incremental Costs Per Unit	Make the Blades
Direct materials (Rs.75,000 ÷ 10,000 units)	Rs.7.50
Direct labour (Rs.65,000 ÷ 10,000 units)	Rs.6.50
Variable overhead (Rs.55,000 ÷ 10,000)	Rs.5.50

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Supervision

(Rs.35,000 ÷ 10,000)

Rs.3.50

Total cost

Rs.23.00

Compare the cost to make the blades for 10,000 motors. Rs.23.00, with the cost to buy, Rs.25.00 There is a net loss of Rs.2.00 if 'X' chooses to buy the blades.

- (b) 'X' will be indifferent between buying and making the blades when the total costs for making and buying will be equal at the volume level where the variable costs per unit times the volume plus the fixed avoidable costs are equal to the supplier's offered cost of Rs.25.00 per unit times the volume.

(Direct materials + Direct labour + Variable overhead) × Volume + Supervision =,
Cost to buy × Volume. Let volume in units = x

$$(7.50 + 6.50 + 5.50) \times x + 35,000 = 25.00x$$

$$19.50x + 35,000 = 25.00x$$

$$35,000 = 25.00 \times x - 19.50 \times x$$

$$35,000 = 5.50 \times x$$

$$x = 6,364 \text{ units of blades}$$

As volume of production decreases, the average per unit cost of in house production increases. If the volume falls below 6,364 motors, then 'X' would prefer to buy the blades from the supplier.

- (c) If the space presently occupied by blade production could be leased to another firm for Rs.45,000 per year, 'X' would face an opportunity cost associated with in house blade production for the 10,000 units of Rs.4.50 per unit.

$$\text{New cost to make} = 23.00 + 4.50 = 27.50$$

Now 'X' should buy because the cost to make, 27.50, is higher than the cost to buy, 25.00.

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Question No. 1 is compulsory.

Answer any four questions from remaining six questions.

Question 1

- (a) Explain the three tests that can be used to detect unauthorized or erroneous program changes.
- (b) State the objectives on which an Information system auditor should focus.
- (c) What is a computer fraud and what types of activities does it include?
- (d) Briefly explain the four common cycles of business activity along with listing some of the application systems for each cycle. (5 x 4 = 20 Marks)

Answer

- (a) To test for unauthorized or erroneous program changes, auditors can use a source code comparison program. After auditors thoroughly test a newly developed program, they keep a copy of its source code. At any subsequent time, the auditor may use the comparison program to compare the current version of the program with the original source code. If no changes have been authorized, these two versions should be identical. Therefore any unauthorized differences should result in an investigation. If the difference represents an authorized change, the auditor can refer to the program change specifications to ensure that the changes were authorized and correctly incorporated.

The reprocessing technique also uses a verified copy of the source code. On a surprise basis, the auditor uses the program to reprocess data and compare that output with the company's data. Discrepancies in the two sets of output are investigated to ascertain their cause.

Parallel simulation is similar to reprocessing except that the auditor writes a program instead of saving a verified copy of the source code. The auditor's result is compared with the company's and any differences are investigated. Parallel simulation can be used to test a program during the implementation process.

- (b) An information system auditor should focus on the following objectives:
 - (i) Security provisions to protect computer equipments, programs and data from unauthorized access, modification or destruction.
 - (ii) Program development and acquisition is done in accordance with managements' general and specific authorization.
 - (iii) Program modifications have the authorization and approval of the management.
 - (iv) Processing of transaction files, reports, and other computer records is accurate and complete.

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- (v) Source data that is inaccurate or improperly authorized is identified and handled according to prescribed managerial policies.
- (vi) Computer data files are accurate, complete and confidential.
- (c) Computer frauds have been defined as any illegal act for which knowledge of computer technology is essential for its perpetration, investigation or prosecution. It might be generally thought that computer fraud means no more than “using a computer to commit fraud”. This is far too narrow a definition in view of the many ways that businesses can face the risk of loss as a result of the use or misuse of a computer. A more extensive definition of computer fraud could be given below:

“Using a computer to cause prejudice, in the sense of financial and/or reputational damage, to a business” may be called a computer fraud.

Most specifically, computer frauds include the following:

- Unauthorised theft, use, access, modification, copying and destruction of software or data
- Theft of money by altering computer records or the theft of computer time
- Theft or destruction of computer hardware
- Use or the conspiracy to use computer resources to commit an offence
- Intend to illegally obtain information or tangible property through the use of computer

Using the computer, fraud perpetrators are able to steal more, in much less time and with much less efforts. For example, they can steal millions of rupees in less than a second. Perpetrators can commit a fraud and leave little or no evidence. Therefore, computer fraud is often much more difficult to detect than other types of frauds.

Most frauds have as their object the financial benefit of the fraudster and consequent financial loss to the victim. An equally serious threat to business also arises from activity which is not fraudulent in the traditional sense but which, nonetheless, has the potential to cause damage to the reputation of a business.

- (d) The four common cycles along with application systems are discussed below :
 - (i) Revenue Cycle: It comprises of events related to the distribution of goods and services to other entities and the collection of related payments. Application systems may be – customer order entry, billing, accounts receivable etc.
 - (ii) Expenditure Cycle: It comprises of events related to the acquisition of goods and services from other entities and the settlement of related obligations. Application systems may be – purchasing, accounts payable and payroll etc.

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- (iii) Production Cycle: It comprises of events related to the transformation of goods, and services. Application systems may be – production control and reporting product costing etc.
- (iv) Finance Cycle: It comprises of events related to the acquisition and management of Capital Funds, including cash. Application system can be – Cash management, debt management etc.

Question 2

- (a) State and briefly explain the major categories and the items included therein to estimate the information system costs.
- (b) Why organisations fail to achieve their system development objectives?
- (c) What is an Audit risk? Distinguish between errors and irregularities. Which do you think concern auditors the most? (8+8+4 = 20 Marks)

Answer

- (a) Information system cost can be sub-divided into (i) Development, (ii) Operational and (iii) Intangible cost.

Development costs for a computer based information system include costs of the system development process. It may include following items:

- Salaries of system analysts and computer programmers who design and develop the system.
- Costs of converting and preparing data files and preparing system manual and other supporting documents.
- Costs of preparing new or expanding computer facilities.
- Costs of testing and documenting the system, training employees and other startup costs.

Items included in operating costs are as stated below:

- Hardware/Software rental or depreciation charges.
- Salaries of computer operators and other computer personnel.
- Salaries of system analysts and computer programmer who perform the system maintenance function.
- Cost of input data preparation and control.
- Cost of data processing supplies.
- Cost of maintaining physical facilities.
- Overhead charges of the business firm.

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Intangible costs are those costs which cannot be easily measured. For example.

- Development of a new system may disrupt the activities of an organization and cause a loss of employee productivity or morale.
- Customer sales and goodwill may be lost by errors made during the installation of new system.

Such costs are difficult to measure in rupees, but are directly related to introduction and operation of the information system.

(b) There are many reasons why organizations fail to achieve their systems development objectives. Some of them are briefly discussed below:

1. Lack of senior management support for and involvement in information system development: Developers and users of information systems will watch senior management to determine which systems development projects are important and will act accordingly by shifting their effort away from any project not receiving management attention. In addition management can see that adequate resources, as well as budgetary control over the use of those resources, are dedicated to the project.
2. Shifting user needs: User requirements for information technology are constantly changing, as these changes accelerate, there will be more requests for systems development and more development projects. When these changes occur during a development process, the development team may be faced with the challenge of developing systems whose very purposes have changed since the development process began.
3. Development of strategic system: Because strategic decision making is unstructured, the requirements, specifications and objectives for such development projects are difficult to define; and determining “successful” development will be elusive.
4. New technologies: When an organization tries to create a competitive advantage by applying advanced information technology, it generally finds that attaining systems development objectives is more difficult because personnel are not as familiar with the technology.
5. Lack of standard project management and systems development methodologies: Some organizations do not formalize their project management and systems development methodologies, thereby making it very difficult to consistently complete projects on time or within budget.
6. Over-worked or under-trained development staff: Estimates of the systems development work facing development staffs range up to 4 years. In addition to being overworked, system developers often lack sufficient education background. Furthermore, many companies do little to help their development personnel stay technically updated; in these organizations, a training plan and training budget do not exist.

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7. Resistance to change: People have a natural tendency to resist change, and information systems development projects signal changes – often radical – in the workplace. Business process reengineering is often the catalyst for the systems development project. When personnel perceive that the project will result in personnel cutbacks, threatened personnel may block the progress of the project and the project may fail. Personnel cutbacks often result when reengineering projects are really attempts at “downsizing”.
 8. Lack of user participation: Users must participate in the development effort to define their requirements, feel ownership for project success, and work to resolve development problems. User participation also helps reduce user resistance to change.
 9. Inadequate testing and user training: New systems must be tested before installation to determine that they will operate correctly. Users must be trained to effectively utilize the new system.
- (c) An audit risk is the probability that the auditor will render an unqualified (clean) opinion on financial statements that are, in fact, materially misstated.

An error represents an unintentional misstatement of the financial statement. Errors are unintentional mistakes. It may be material or immaterial. Irregularities are intentional misrepresentation to perpetrate a fraud or to mislead the users of financial statements which can be material. Material misstatements may be caused by errors or irregularities or both.

While any auditor's objective is to minimize the audit risk by performing tests of control and substantive tests, the main concern of an auditor is to detect irregularities.

Question 3

- (a) List and describe the contents of a system manual
- (b) The Software industry continues to undergo constant changes; users need to be aware of recent trends and issues to be effective in their business and personal life. Explain.
- (c) Draw schematic chart of general form of business applications. (8+8+4 = 20 Marks)

Answer

- (a) The contents of a system manual include the following:
 - (i) General description of the existing system.
 - (ii) Flow of the existing system.
 - (iii) Outputs of the existing system – The documents produced by the existing system are listed and briefly described, including distribution of copies.
 - (iv) General description of the new system – its purposes and functions and major differences from the existing system are stated together with a brief justification for the change.

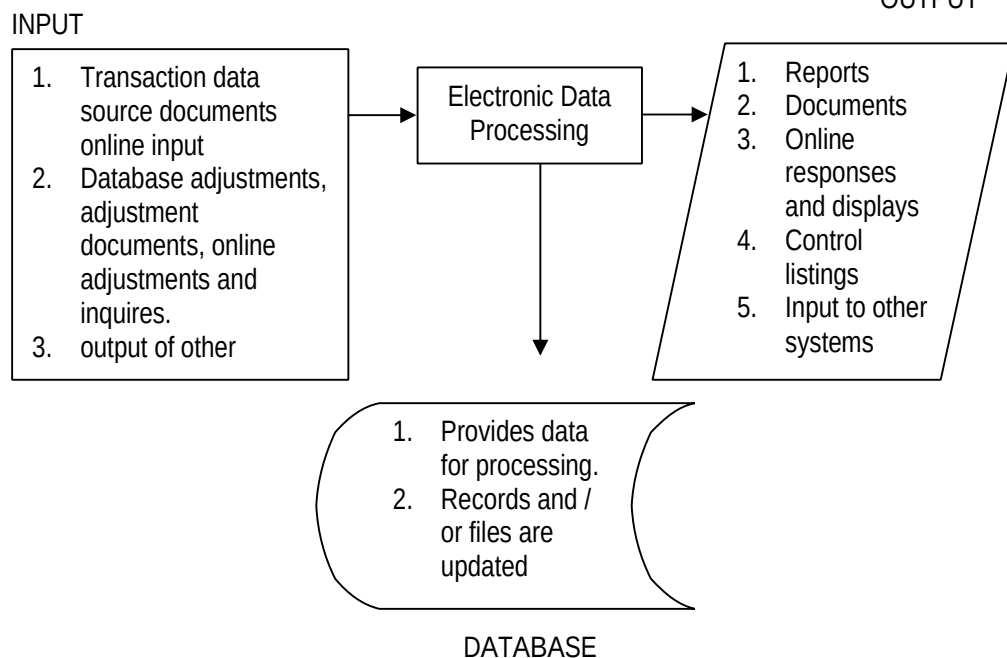
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- (v) Flow of the new system – this shows the flow of the system from and to the computer operation and the flow within the computer department.
 - (vi) Output layouts
 - (vii) Output distribution – the distribution of the new output document is indicated and the number of copies, routing and purpose in each department shown. The output distribution is summarized to show what each department will receive as a part of the proposed system.
 - (viii) Input layouts – the inputs to the new system are described and complete layouts of the input documents and input disks or tapes provided.
 - (ix) Input responsibilities – the source of each input document is indicated as also the user department responsible for each item on the input documents.
 - (x) Macro-logic – the overall logic of the internal flows to be briefly described.
 - (xi) Files to be maintained – the specifications will contain a listing of the tapes, disks, or other permanent records, and the items of information to be included in each file.
 - (xii) List of programs – a list of the programs to be written shall be a part of the systems specifications.
 - (xiii) Timing estimates – a summary of approximate computer timing is provided by the system analyst.
 - (xiv) Controls – this shall include type of controls and the methods in which it will be operated.
 - (xv) Audit trail – audit trail for all financial information and the methods by which errors and defects will be prevented or eliminated.
 - (xvi) Glossary of terms used.
- (b) It is true that software industry is undergoing constant changes; hence the users need to be aware of recent trends and issues. Software bugs, software licensing and copyrighting, open-source software, shareware and freeware, multi-organisational software development, software upgrades and global software support are all important software issues and trends which are briefly explained below:
- A software bug is a defect in a computer program that keeps it from performing in the manner intended. Software bugs are common, even in key pieces of business software.
 - Open-source software is software that is freely available to anyone in a form that can be easily modified. Open-source software development and maintenance is a collaborative process with developers around the world using the internet to keep in close contact via e-mail and to download and submit new software. Shareware and freeware can reduce the cost of software, but sometimes they might not be as powerful as commercial software. Also, their source code formally cannot be modified.

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- Multi-organisation software development is the process of extending software development beyond a single organisation by finding others who share the same business problem and involving them in a common development effort.
- Software upgrades are an important source of increased revenue for software manufactures and can provide useful new functionality and improved quality for software users.
- Global software support is an important consideration for large, global companies putting together standardised, company-wide system. A common solution is outsourcing global support to one or more third-party software distributors.

(c) The schematic chart of general form of business application is given below:



Question 4

- (a) State the inputs, processing and the outputs of a “Share Accounting System”.
- (b) State the steps to be taken to reduce the threat from destructive programs.
- (c) List the main threats from hacking (8+8+4 = 20 Marks)

Answer

(a) Main inputs in a share accounting system are:

- Shareholding data from a fresh issue this is usually supplied by the issue agency on electronic media.
- Share transfer request

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- Split request
- Consolidation request
- Request for bank mandate
- Request for tax exemption forms
- Request for duplicate certificates
- Request for duplicate dividend warranties
- Change in shareholder's address

Processing of a share accounting system involves the following:

- Updating shareholders' master file
- Recording the transfer of shares
- Handling splitting, consolidation, and duplicate requests and printing new certificates.
- Calculation of dividend and income tax to be deducted

Main outputs of the share accounting system are:

- Transferred share certificates
- New share certificates in case of consolidation, splitting and duplicates.
- Dividend warrants and counterfoils.
- Statements of tax-deductions.

- (b) Destructive computer program refers to a computer program that performs a destructive function or produces a destructive result. A program performs a destructive function if it degrades performance of the affected computer, associated peripherals or a computer program; disables the computer, associated peripherals or a computer program; or destroys or alters computer programs or data. Threats from destructive programs can be substantially reduced through a combination of technology controls and administrative procedures. The following steps can be taken to reduce the threat from destructive programs:
- (i) Purchase software only from reputed vendors in original, and only product that are in their original factory - sealed covers should be accepted.
 - (ii) All software should be scanned for viruses and subsequently loaded and/or distributed only after the product is shown to be free of viruses. This includes all initial loads as well as any upgrades or changes applied to the software.
 - (iii) Conduct user training program to raise user awareness about preventive strategy to deal with destructive program.

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- (iv) Install all new applications on a stand – alone computer and implement on main server or LAN only after testing them thoroughly with anti-virus software.
 - (v) Keep servers, workstations and other network devices up to date with security patches and service packs. If possible enable automatic updates on all systems.
 - (vi) Routinely make back copies of key files. There is always a chance that the programs may catch something damaging or, the hard drive may crash. In such situation, backup can be used to restore the program.
 - (vii) Use anti-virus software with current virus signatures. Configure the anti-virus software to monitor files in real-time if possible, and configure automatic daily update of virus signatures if possible.
 - (viii) Keep track of software upgrades, patch and service packs. Update the software on regular basis.
- (c) Hacking is a process of breaking into computers, usually by gaining access without legal authorization to a computer or computer network. The main threats from hacking are:
- (i) Removal or loss of information
 - (ii) Destruction of system integrity
 - (iii) Interference with Web pages
 - (iv) Transmission of virus by email
 - (v) Interception of email, electronic payments and data packets over Internet.
 - (vi) Subverting computer security without authorization or using technology (usually a computer or the Internet) for vandalism (malicious destruction), credit card fraud, identity theft, intellectual property theft, or other types of crime.
 - (vii) Interception of data packets, which can be used to capture passwords and other data in transit over the network.
 - (viii) The hackers can carry out spoofing attack, which involves one program, system, or website successfully masquerading as another by falsifying data and thereby being treated as a trusted system by a user or another program. The purpose of this is usually to fool programs, systems, or users into revealing confidential information, such as user names and passwords, to the attacker (also known as Phishing).
 - (ix) The hackers can also take control of your computer remotely and access confidential information, launch denial of service attacks and scan ports among other destructive things.

Question 5

- (a) Consider the problem of long delays between receipts of orders and delivery in a company. Give the six steps in the system approach to find the solution for the above problem.

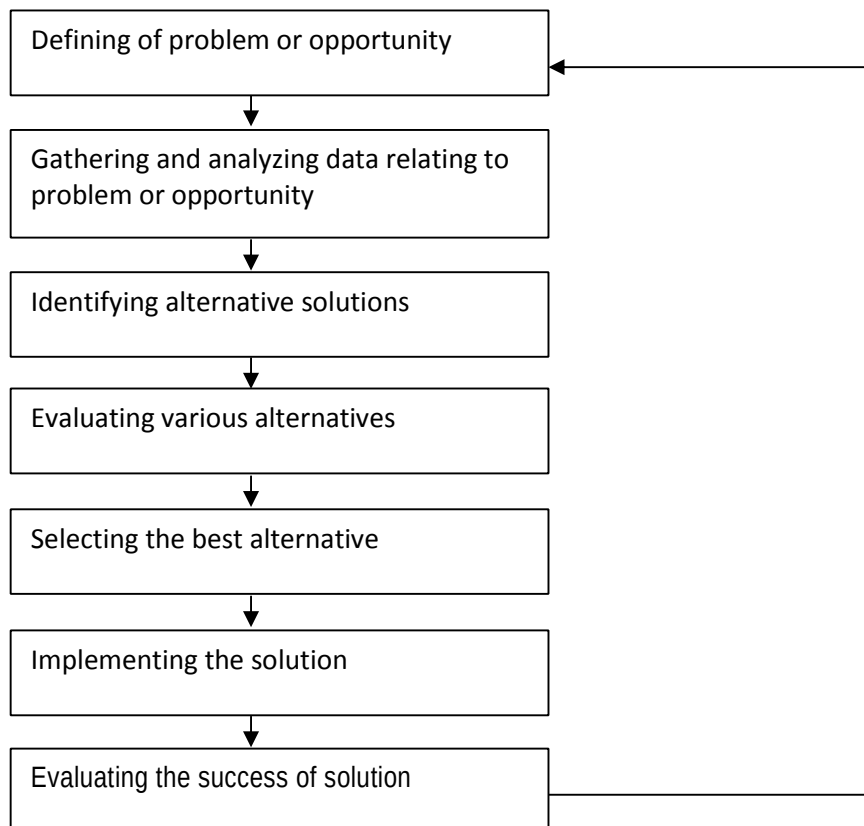
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- (b) Define top level management. What is the main responsibility of top management? Give the information requirement at top level for making decision.
- (c) What is a programmed and a non-programmed decision? Distinguish the difference between the two through an example. (8+8+4 = 20 Marks)

Answer

- (a) To seek solution for the problem of long delays between receipts of orders and delivery in a company by applying systems approach, we would make use of the six steps as shown in the diagram given below. Each of these steps with reference to the given problem is discussed below:

- (i) Defining the problem: The problem involved here is of inordinate delay between the receipts of orders and their delivery. This problem affects the vendor in many ways, e.g., a bad reputation, loss of customers, reduction in profitability and even stoppage of due payments.
- (ii) Gathering and analyzing data concerning the problem: The problem of delay in meeting orders, in this case, say arises due to the following reasons:
- Excessive orders in the hand of vendors
 - Shortage of power (fall in production due to shortage of power)



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- (iii) Identification of alternative solutions: To overcome the stated problem by system approach, the following two solutions may be considered:
- Refusal of orders, in case the total size of orders exceeds the plant capacity of one shift.
 - To run the plant in double shift, to meet the commitment in time. Any shortfall in power supply may be met by installing a generator.
- (iv) Evaluation of alternative solution: Out of the two identified solutions mentioned under the preceding step, the second solution say accounts for an overall increase in profitability of the concern after offsetting additional cost for the generator produced power. It also helps in retaining customers and growth of the concern.
- (v) Selection of the best alternative: Under this step, management examines the alternatives more closely and puts its stamp on the best possible alternative. In this case say the second alternative is finally chosen.
- (vi) Implementation of the solution: The implementation of the solution requires the necessary policy changes. Besides this, the resources required to run the plant in double shift and installation of generators are also to be arranged. Finally, appropriate procedures are developed to exercise smooth production and timely supply to customers and the concerned officers are accordingly instructed.
- (b) Top level management: It is defined as a set of management positions which are concerned with the overall task designing, directing and managing the organisation in an integrated manner.

The main responsibilities of the top management are in the direction of determining the overall goals and objectives of the business. It deals mainly with long term plans, policy matters and broad objectives of the company. Also, it establishes a budget frame work under which the various departments will operate.

The information requirements at top level for decision making are:

- Top management needs information on the trends in the external environment and on the functioning of the internal organizational sub-system.
- Apart from historical information, top management requires ongoing or current information also which is generated through forecasts of the future.

Thus, mostly the information utilized by top management is futuristic and external in nature. Much of the information so generated for strategic planning purpose tends to be incomplete and not fully reliable. It may not be available on time. For control purposes, top management receives summary and 'exception reports' from the middle management.

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The information requirement at top level for making decisions can be categorised into two parts:

- (a) External
 - Competitive activities
 - Customer preferences, style, changes
 - Economic trends
 - Technological changes, legal rulings.
- (b) Internal
 - Historical sales, costs
 - Profit, cash flow, divisional income, sales, expenses.
 - Financial ratios, interests, credit outstanding, long term debt, delinquent accounts.
 - Projects' progress reports and cost updates
- (c) Programmed decisions refer to decisions made on problems and situations by reference to a pre-determined set of precedents, procedures, techniques and rules. These are well structured in advance and pre-decided rule or procedure is applied to arrive at the decision. Non-programmed decisions are those that deal with unusual, non repetitive or exceptional situations. Decisions are taken by application of managerial intelligence, experience, judgment and vision.

The example of programmed decision is: ordering more inventories when the level drops to 100 units or fewer in a retail shop. The example of non-programmed decision is determining the best training for a new employee joining the organization.

Question 6

- (a) List the items of information provided by cash management of Treasury module of SAP.
- (b) Discuss the factors to be considered for valuation of a vendor's proposal.
- (c) List the fears that are expected to arise among employees of an organization during implementation of ERP (8+8+4 = 20 Marks)

Answer

- (a) The list of items of information provided by cash management of Treasury module is as follows:
 - (i) Information on sources and uses of funds to secure liquidity to meet payment obligations when they become due.
 - (ii) Monitors and controls incoming and outgoing payments flows.
 - (iii) Supplies data for short-term money market investment and borrowings.

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- (iv) Enables to know current cash position, short-term cash management, medium and long term financial budgeting.
 - (v) Enable analysis of liquidity.
 - (vi) Helps in cash management decisions
 - (vii) In bank accounting, it helps in electronic banking and control functions for managing and monitoring of bank accounts.
 - (viii) The liquidity forecast function integrates anticipated payment flows from financial accounting, purchasing and sales to create liquidity outlook from medium to long term.
 - (ix) Covers foreign currency holdings and foreign currency items.
- (b) The following factors need to be considered for valuation of a vendor's proposal:
- (i) Performance capability of each proposed system in relation to its cost: There are different ways to measure the performance. Indicator should be chosen according to the requirements of the organisation. There are many measures of performance such as speed of processing, response time, number of users supported, system configuration etc. One way to examine the operating efficiency of a particular system is to use a benchmark test.
 - (ii) Costs and benefits of each system: A cost-benefit analysis of each proposed system should be carried out. Lease-buy decision should also be considered, and also the depreciation schedule.
 - (iii) Maintainability of each proposed system: The ease with which a proposed computer system can be modified. Costs of maintaining are high therefore this factor should be seriously considered. The maintenance cost of large systems like ERP packages is very high, sometimes manifolds of the initial purchase cost. Considerable emphasis should be given on this dimension and must be incorporated in validation process.
 - (iv) Compatibility of each proposed system with the existing system: It is the ability to implement and interface the new system with existing computer resources and software. Compatibility can also involve the operating system, existing application software, or procedural aspects.
 - (v) Vendor support: It includes (i) training the employees, (ii) help in implementing and testing, the new system, (iii) assistance in maintaining the new system, (iv) back-up system.
- (c) Some of the fears which are expected to arise among employees of an organisation during ERP implementation are:
- Job redundancy – loss of job
 - Loss of importance – as information is no longer an individual's prerogative.
 - Change in job profile.

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- An organisational fear of loss of proper control and authorization.
- Increased stress caused by greater transparency.
- Individual fear of loss of authority.

Question 7

- (a) List and explain the Software packages that are helpful in analysis of program logic.
- (b) State the entities to which the Information Technology Act, 2000 does not apply.
- (c) State the methods through which awareness of employees towards security policy can be increased.
- (d) Discuss the advantages of pre-written application Software Packages. (5 x 4 = 20 Marks)

Answer

- (a) The following software packages help in program logic analysis:
 - (i) Automatic Flow Charting Program: It interprets program source code and generates a corresponding program flow chart.
 - (ii) Automated Decision Table Program: It generates a decision table representing the program logic.
 - (iii) Scanning Routines: It searches a program for occurrence of specified variable names or other character combinations.
 - (iv) Mapping Programs: It identifies unexecuted program code. This software can also uncover some unscrupulous programs.
 - (v) Program Tracing: It sequentially prints all application program steps, executed during a program run. Program tracing helps auditors in detecting unauthorized instructions incorrect, logic paths, and unexecuted program code.
- (b) The Information Technology Act, 2000 does not apply to the followings:
 - (i) A negotiable instrument as defined in section 13 of Negotiable Instruments Act, 1981;
 - (ii) A Power of Attorney as defined in section 1A Powers of Attorney Act, 1882;
 - (iii) A trust as defined in section 3 of Indian Trust Act, 1882;
 - (iv) A will as defined in section (h) of section (2) of Indian Succession Act, 1925 including any other testamentary disposition by whatever name called.
 - (v) Any contract for sale or conveyance – immovable property or any interest in such property.
 - (vi) Any such class of documents or transactions as may be notified in the Official Gazette by Central Government.

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- (c) Following are some of the ways through which employees' awareness towards security policy can be increased:
- Pasting the security policies on the notice board or in areas which are more frequently visited by employees.
 - Training to all the staff.
 - Non-disclosure statements signed by the employees.
 - Company newsletter.
 - Visible enforcement of security rules.
 - Periodic audits.
 - Conduct fake security incidents to improve security procedures.
- (d) The advantages of using pre-written application packages are as follows:
- (i) Rapid implementation: Readily available for implementation after purchase, whereas in-house developed software may take months.
 - (ii) Low risk: Since such packages are available in finished form, so the purchaser knows what is expected for what price, whereas in-house development entails uncertainty regarding time & cost.
 - (iii) Quality: The firms engaged in application packages development, have the expertise and the experience in the area, hence can provide better software.
 - (iv) Cost: An application package generally cost less as compared against developing in-house. The developing firms have the advantage of realizing the cost by selling at lower cost to large number of users.

The Suggested Answers for Paper 7: - Direct Taxes are based on the provisions applicable for A.Y. 2009-10, which is the assessment year relevant for June, 2009 examination.

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Answer all questions

Question 1

X, Y and HUF of Z (represented by Z) are partners with equal shares in profits and losses of a firm, M/s Popular Cine Vision, which is engaged in the production of TV serials and telefilms. In the previous year 2007-08, one partner 'A' retired, but his dues have been settled in the previous year 2008-09.

The earlier partnership deed did not authorise payment of remuneration or interest to partners. The partnership deed was revised by the partners on 1st June, 2008 to authorise payment of remuneration of Rs.1 lac per month to each working partner and simple interest at 15% per annum to X and Y on their capital. X, Y and Z are actively associated with the affairs of the firm.

The Profit & Loss Account of the firm for the year ended 31st March, 2009 shows a net profit of Rs.10 lacs after debiting/crediting the following:

- (a) Interest amounting to Rs.15 lacs paid to X and Y on the balances standing to their capital accounts from 1st April, 2008 to 31st March, 2009.
- (b) Remuneration to the partners including partner in representative capacity Rs.30 lacs.
- (c) Interest amounting to Rs.2 lacs paid to Z on loan provided by him in his individual capacity at 16% interest.
- (d) Royalty of Rs.5 lacs paid to partner X, who is litterateur and a professional script writer, for use of his scripts as per an agreement between the firm and X.
- (e) Two separate payments of Rs.18,000 and Rs.15,000 made in cash on 1st February, 2009 to Altaf, a hairdresser, against his bill for services rendered in January, 2009 and two payments of Rs.19,000 and Rs.10,000 made in cash on 1st February and 2nd February, 2009, respectively, to Priyam, an assistant cameraman, against her bill for services provided in January, 2009.
- (f) Amount of Rs.5 lacs provided in the books on 31st March 2009 as liability for remuneration to Shreyashi, a film artist and a non-resident. Tax deducted at source under section 195 from the amount so credited was paid on 3rd June, 2009.
- (g) Amount of Rs.6 lacs provided as gratuity for the year on the basis of actuarial valuation. Gratuity paid to retired employees is Rs.1.50 lacs.
- (h) Interest of Rs.1.20 lacs received on income-tax refund under section 244(1A) in respect of assessment year 2007-08.

The firm has also provided the following additional information:

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The amount due to A, the former partner, was Rs.15 lacs. The dues were settled on 30th September, 2008 by transferring a plot of land purchased two years back having a book value of Rs.10 lacs. The difference of Rs.5 lacs was credited to partners' capital accounts in their profit sharing ratio. The fair market value of the plot on the date of transfer was Rs.16 lacs.

Compute the total income of the firm for the assessment year 2009-10 stating the reasons for treatment of each item. (16 Marks)

Answer

Computation of Total Income of M/s. Popular Cine Vision for the A.Y.2009-10

	Rs.	Rs.
Profits and Gains from Business or Profession		
Net Profit as per Profit & Loss A/c		10,00,000
Add: Expenses disallowed or considered separately		
Interest to partners in excess of 12% (Note 1)	5,00,000	
Disallowance under section 40A(3) for aggregate cash payment exceeding Rs.20,000 in a single day (Note 5)	33,000	
Remuneration to non-resident film artist disallowed under section 40(a)(i) (Note 6)	5,00,000	
Provision for gratuity (Note 7)	4,50,000	
Partners' Remuneration	30,00,000	
Royalty paid to Partner X (Note 4)	5,00,000	49,83,000
		<hr/> 59,83,000
Less: Interest on income-tax refund (Note 8)		<hr/> 1,20,000
Book Profit		58,63,000
Less: Partners' remuneration allowable under section 40(b)(v)		
On first Rs.75,000 90%	67,500	
On next Rs.75,000 60%	45,000	
On balance Rs.57,13,000 40%	22,85,200	
		<hr/> 23,97,700
		<hr/> 34,65,300
Capital Gain		
Short-term capital gain on transfer of land (Note 9)		6,00,000
Income from other sources		
Interest on income-tax refund		<hr/> 1,20,000
Gross Total Income		<hr/> 41,85,300

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Deductions under Chapter VI-A	Nil
Total Income	<u>41,85,300</u>

Notes:

1. As per section 40(b) simple interest at 12% p.a. to partners relating to the period after the date of partnership deed is allowable. Therefore, interest to partners from 1st April to 31st May, 2008 should be disallowed. Further, the excess interest @ 3% paid from 1st June, 2008 to 31st March, 2009 should also be disallowed.

		Rs.
Interest for April and May, 2008	15,00,000 x 2/12	2,50,000
Excess interest from June'08 to March'09	(15,00,000 x 3/15) x 10/12	2,50,000
		<u>5,00,000</u>

Note – It is assumed that Rs.15 lacs is the cumulative interest paid to X and Y during the year, since the question does not mention Rs.15 lacs “each” paid to X and Y.

2. Even though Z is a partner in a representative capacity, he is still a partner. Therefore, remuneration to Z should also be subject to the limits prescribed in section 40(b). This view finds support from the decision of the Supreme Court in the case of Rashik Lal & Co. vs CIT (1998) 229 ITR 458 (SC).
3. As per Explanation 1 to section 40(b) where an individual is a partner in a firm in a representative capacity, the provisions of section 40(b) shall not apply to any interest payable by the firm to such individual in his personal capacity. Z represents his HUF in the firm. However, Z gave the loan in his individual capacity. Hence, assuming that the provisions of section 40A(2) do not get attracted in this case, such interest shall be allowed as deduction in full even though the interest rate is more than 12% p.a.
4. It may be noted that the limits specified under section 40(b)(v) are applicable in case of payment of salary, bonus, commission, or remuneration, by whatever name called, to a working partner. From a plain reading of the section, it is clear that any remuneration, by whatever name called, paid to a working partner, is subject to the limits laid down in section 40(b)(v). Therefore, the royalty of Rs.5 lakh paid to partner X would also be subject to the limits laid down in section 40(b)(v). Hence, the same has to be added back for computing book profits.
5. Section 40A(3), as amended by the Finance Act, 2008, provides for disallowance of any expenditure in respect of which aggregate of payments made otherwise than by an account payee cheque or account payee bank draft in a single day to a person exceeds a sum of Rs.20,000. Hence, the payments of Rs.18,000 and Rs.15,000 in cash on 1.2.2009 to Altaf, a hairdresser, shall be disallowed, since the aggregate payment of Rs.33,000 exceeds the limit of Rs.20,000.

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In case of payment of bill of the assistant cameraman, since the aggregate payment in cash on a single day does not exceed Rs.20,000, disallowance under section 40A(3) is not attracted.

Note – It is possible to take a view that 1st February, 2009 is a bank holiday since it falls on a Sunday and therefore, the exception contained in Rule 6DD(j) would apply in such a case and hence, disallowance under section 40A(3) would not be attracted. However, this view would hold good only if as per the agreement with the hairdresser, the payment is required to be made on a particular date and such date (1st February, 2009, in this case) happens to be bank holiday. Since the question does not mention of any such agreement, the problem has been solved assuming there was no specific requirement to make the payment only on 1st February, 2009 and therefore, the provisions of section 40A(3) would be attracted.

6. As per section 40(a)(i), any sum payable to a non-resident shall not be allowed as deduction, if tax has not been deducted at source or after deduction, has not been paid within the time limit prescribed in section 200(1). Tax deducted from the amount of remuneration credited to payee's account on 31st March 2009 has to be deposited latest by 31st May, 2009. However, the firm has paid the tax only on 3rd June, 2009. Hence, the remuneration shall be disallowed. However, the firm can claim deduction in respect of such remuneration in the assessment year 2010-11.
7. As per section 40A(7), any provision made for payment of gratuity to employees on their retirement or on termination of employment for any reason is disallowed. However, any provision made for the purpose of payment of a sum by way of any contribution to an approved gratuity fund or for the purpose of payment of gratuity which has become payable during the previous year shall be allowed as deduction. The question does not mention any approved gratuity fund. However, gratuity of Rs.1.50 lacs paid to retired employees is allowable as deduction. Hence, the balance provision of Rs.4.50 lacs (i.e., Rs.6 lacs – Rs.1.50 lacs) is to be disallowed.
8. Interest on income-tax refund is assessable under the head "Income from other sources".
9. Distribution of a capital asset by a firm to its partner on dissolution or otherwise attracts capital gains tax liability as per the provisions of section 45(4) and the fair market value of the asset on the date of transfer is deemed to be the full value of consideration received or accruing as a result of the transfer. The words "or otherwise" includes within its scope, cases of distribution of capital assets on retirement of a partner also. [CIT vs. A. N .Naik Associates 265 ITR 346 (Bom.)]. Therefore, distribution of a plot of land on retirement of a partner would attract section 45(4).

Rs.16 lacs, being the fair market value of the plot on the date of transfer, is deemed to be the full value of consideration. Therefore, the capital gain would be Rs.6 lacs (i.e., Rs.16 lacs – Rs.10 lacs).

Question 2

- (a) Mr. Bhargava, a leading advocate on corporate law, decided to reduce his practice and to accept briefs only for paying his taxes and making charities with the fees received on

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- such briefs. In a particular case, he agreed to appear to defend one company in the Supreme Court on the condition that he would be provided with Rs.5 lacs for a public charitable trust that he would create. He defended the company and was paid the sum by the company. He created a trust of that sum by executing a trust deed. Decide whether the amount received by Mr. Bhargava is assessable in his hands as income from profession. (3 Marks)
- (b) The Finance Act, 2008 brought in a new provision effective from 1st April, 2009 for granting deduction of 100% of profit derived by an undertaking from the business of operating and maintaining a hospital located anywhere in India, other than excluded area, subject to certain conditions. State briefly those conditions. (2 Marks)
- (c) Mr. Bansal, a resident Indian and aged 67 years, has derived the following income during the previous year 2008-09:

	Rs.
(i) Income from business in India	2,50,000
(ii) Commission (Gross) from a company in Hong Kong (Tax paid in Hong Kong Rs.60,000)	3,00,000
(iii) Dividend (Gross) from a company in Hong Kong (Tax paid in Hong Kong Rs.18,000)	90,000
(iv) Interest on fixed deposit and savings account with banks in India	2,00,000

India has no double tax avoidance agreement with Hong Kong. Compute the income and tax payable by Mr. Bansal for assessment year 2009-10. (5 Marks)

Answer

- (a) In the instant case, the trust was created by Mr. Bhargava himself out of his professional income. The client did not create the trust. The client did not impose any obligation in the nature of a trust binding on Mr. Bhargava. Thus, there is no diversion of the money to the trust before it became professional income in the hands of Mr. Bhargava. This case is one of application of professional income and not of diversion of income by overriding title. Therefore, the amount received by Mr. Bhargava is chargeable to tax under the head "Profits and gains of business or profession".
- (b) Sub-section (11C) has been inserted in section 80-IB by the Finance Act 2008 with effect from A.Y.2009-10 for granting deduction of 100% of profit derived by an undertaking from the business of operating and maintaining a hospital located anywhere in India, other than the excluded area, subject to the following conditions:
- (i) The hospital should be constructed and should start functioning between 1st April, 2008 to 31st March, 2013.
 - (ii) The hospital should have at least 100 beds for patients.
 - (iii) The construction of the hospital should be in accordance with the regulations or bye-laws of the local authority.

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- (iv) Audit report in the prescribed form signed and verified by a chartered accountant certifying that the deduction has been correctly claimed should be filed along with the return of income.
- (c) Mr. Bansal is entitled to relief under section 91, since :-
- (i) He is a resident in India during the relevant previous year.
 - (ii) Income, by way of commission and dividend, accrues or arises to him outside India (in Hong Kong) during the previous year.
 - (iii) Such income is not deemed to accrue or arise in India during the previous year.
 - (iv) The income in question, namely, commission and dividend, has been subjected to income-tax in Hong Kong in the hands of Mr. Bansal and he has paid tax on such income in Hong Kong.
 - (v) There is no agreement under section 90 for the relief or avoidance of double taxation between India and Hong Kong.

Therefore, he is entitled to the deduction under section 91, from the Indian income-tax payable by him, of a sum, calculated on such doubly taxed income at the Indian rate of tax or at the Hong Kong rate of tax, whichever is lower.

Computation of total income and tax liability of Mr. Bansal for A.Y.2009-10

Particulars	Rs.
Income from business in India	2,50,000
Commission received from a company in Hong Kong	3,00,000
Dividend received from a company in Hong Kong	90,000
Interest on fixed deposits and savings account with banks in India	2,00,000
Total Income	<u>8,40,000</u>
Tax on the above:	
Upto Rs.2,25,000	Nil
Over Rs.2,25,000 & upto Rs.3,00,000	7,500
Over Rs.3,00,000 & upto Rs. 5,00,000	40,000
Over Rs.5,00,000	<u>1,02,000</u>
	1,49,500
Education cess @ 2% and secondary and higher education cess @ 1%	4,485
Total tax liability	<u>1,53,985</u>
Average rate of income-tax in India: (1,53,985/8,40,000 x 100)	18.33%

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Average rate of income-tax in Hong Kong (78,000/3,90,000 x 100)	20%
Double tax relief under section 91 shall be @18.33% or 20% of foreign income, whichever is less [i.e., 3,90,000 x 18.33%]	71,487
Net tax liability (Rs.1,53,985 – Rs.71,487)	<hr/> 82,498 <hr/>

Question 3

- (a) Ayush, an employee of a management consultancy firm, was sent to UK in connection with a project of the firm's client for two months in a previous year. In addition to his salary, the firm paid per diem allowance for the period when he worked in UK to meet expenses on boarding and lodging. Tax was not deducted at source from such allowance by the employer. Ayush did not include such allowance in computation of his taxable salary for the relevant assessment year. In course of assessment of Ayush under section 143(3), the Assessing Officer sent a notice to him asking him to explain why the per diem allowance received by him should not be charged to tax? Ayush sought your advice. (4 Marks)
- (b) Sri Sajjan converted the capital asset, acquired by him in the year 1988, into stock-in-trade at the fair market value on 1st March, 2008. Sri Sajjan sold the entire stock-in-trade so converted, on 25th November, 2008. Sri Sajjan seeks your advice as to the tax implications of the transaction with reference to the provisions of Indian Income-tax Act for the assessment year 2009-10. (5 Marks)
- (c) Intelysis Limited charged depreciation on its fixed assets at the rates prescribed in the Income-tax rules in its accounts consistently. The Assessing Officer disallowed the same and considered depreciation computed at the rates prescribed in the Companies Act, 1956, for the purpose of computation of 'book profit' under section 115JB of the Income-tax Act for the assessment year 2008-09. Examine the correctness of the action of the Assessing Officer. (3 Marks)
- (d) East Bengal Club, a renowned football club, has engaged Raghu, a resident in India, as its coach at a remuneration of Rs.6 lacs annually. The club wants to know from you whether it is liable to deduct tax at source from such remuneration. (3 Marks)

Answer

- (a) Per-diem allowance is exempt from tax under section 10(14), as it is an allowance granted and spent to meet the ordinary daily charges incurred by an employee on account of absence from his normal place of duty. As per the clarification issued in Circular No.8/2005 dated 29.8.2005, such per-diem allowance would be liable to fringe benefit tax in the hands of the employer and employee will not be liable to pay income-tax on any surplus accruing to him from such allowance.
- (b) Conversion of a capital asset into stock-in-trade falls within the definition of transfer under section 2(47). Therefore, in this case, transfer has taken place during the previous year 2007-08. However, as per section 45(2), the capital gains liability arises only in the

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year in which the stock-in-trade is sold i.e. previous year 2008-09 in this case. It is a long-term capital gain since the asset was acquired in 1988. The fair market value (FMV) on the date of conversion i.e. on 1.3.2008 is deemed to be the full value of consideration accruing as a result of transfer of the capital asset.

Therefore, in the year of sale of stock-in-trade (i.e. P.Y. 2008-09), both business income and capital gains would arise.

Business income = Sale consideration – FMV on the date of conversion
of stock-in-trade

Capital gains = FMV on the date of conversion – Indexed cost of acquisition / improvement

- (c) This issue was settled by the Supreme Court in *Malayala Manorama Co. Ltd. v. CIT* (2008) 300 ITR 251. The Apex Court observed that for the purpose of computation of book profit under section 115JB, the Assessing Officer's power is restricted to examining whether the books of account are certified by the authorities under the Companies Act as having been properly maintained in accordance with the Companies Act. Thereafter, he only has the limited power of making additions and deductions as provided for in Explanation 1 to section 115JB. The Assessing Officer does not have the jurisdiction to go behind the net profit shown in the profit and loss account except to the extent provided in Explanation 1 to section 115JB. Where an assessee is consistently charging depreciation in its books of account at the rates prescribed in Income-tax Rules and the accounts of the assessee have been prepared and certified as per the provisions of the Companies Act, the Assessing Officer does not have any jurisdiction under section 115JB to rework the net profit of the assessee by substituting the rates of depreciation prescribed under the Companies Act.

Applying the ratio of the Supreme Court decision to this case, it may be concluded that the action of the Assessing Officer is not correct.

Note - The rates of depreciation prescribed in Schedule XIV to the Companies Act are the minimum rates at which depreciation is to be charged in the profit & loss account. The rates prescribed in the Income-tax Rules are higher than those prescribed in the Companies Act. A company is, therefore, not precluded from adopting higher rates of depreciation, if the circumstances justify. Thus, even if a company adopts the higher rates of depreciation prescribed in the Income-tax Rules, it can be said that the company has prepared the accounts in the manner provided under the Companies Act.

- (d) Section 194J requires deduction of tax at source @10% from the amount credited or paid by way of fees for professional services, where such amount or aggregate of such amounts credited or paid to a person exceeds Rs.20,000 in a financial year. As per Explanation (a) to section 194J, professional services includes, inter alia, services rendered by a person in the course of carrying on such other profession as is notified by the CBDT for the purpose of section 194J. Accordingly, the CBDT has, vide Notification

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No.88 dated 21.8.2008, in exercise of the powers conferred by clause (a) of the Explanation to section 194J notified the services rendered by, inter alia, coaches and trainers in relation to the sports activities as professional services for the purpose of section 194J. Therefore, the club is liable to deduct tax at source under section 194J from the remuneration payable to the Coach, Raghu.

Question 4

- (a) A shareholder of a demerged Indian company received shares from the resulting company in the scheme of demerger. The shareholder wants to transfer the said shares received subsequent to the demerger for consideration. Your advice is sought on the tax consequences as to the shares received on demerger and sought to be transferred. (4 Marks)
- (b) The assessment was made under section 143(1) for assessment year 2005-06. The assessee has received a notice under section 148 on 6th April, 2008 for reopening of assessment. Can the assessee challenge the legality of the notice on the ground of change of opinion? (3 Marks)
- (c) Is it possible for the Assessing Officer to initiate proceeding under section 147 in respect of income involving matters which are the subject matter of an appeal? (2 Marks)
- (d) The Assessing Officer has no power to make any adjustment to the income returned by the assessee while processing the return of income under section 143(1). Examine the correctness of the statement. (5 Marks)

Answer

- (a) As per the provisions of section 47(vid), any transfer or issue of shares by the resulting company to the shareholders of the demerged company in a scheme of demerger is not regarded as a transfer for the purposes of capital gains under section 45, if the transfer or issue is made in consideration of the demerger of the undertaking.

As a consequence of the demerger, the existing shareholders of the demerged company will receive shares in a resulting company. When the shareholder subsequently intends to transfer the said shares, the cost of such shares will have to be arrived at as per the provisions of section 49(2C). According to the said provision, the cost of acquisition of shares in the resulting company will be the amount which bears to the cost of acquisition of shares held by the assessee in the demerged company, the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company immediately before such demerger.

As per the provisions of section 2(42A)(g), for determining the period of holding of such shares, the period for which the shares of the demerged company were held by the assessee would also be considered.

If the shares are held for more than one year, and transferred through a recognized stock exchange and securities transaction tax has been paid on such sale, the long-term capital gain arising therefrom would be exempt under section 10(38). If the total holding period does not exceed one year, then the short-term capital gains arising on sale of such shares would be taxable @15% under section 111A.

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- (b) Under the scheme of section 143(1), only the adjustments relating to any arithmetical error in the return and incorrect claim which is apparent from any information in the return are permitted. In short, what is permissible is only correction of errors apparent on the basis of the return filed. Thus, while making the adjustments under section 143(1), the Assessing Officer has no power to go beyond the information given in the return and make any allowance or disallowance. Therefore, the intimation given under section 143(1) cannot be treated as an order of assessment. Hence, there being no assessment under section 143(1), the question of change of opinion does not arise.

Therefore, the assessee cannot challenge the legality of the notice issued under section 148 reopening the assessment on the grounds of change of opinion in a case where no assessment is made under section 143(3), but only an intimation is issued under section 143(1). This inference is supported by the Supreme Court ruling in ACIT vs. Rajesh Jhaveri Stock Brokers P. Ltd. (2007) 291 ITR 500.

- (c) The Finance Act, 2008 has inserted a second proviso in section 147 with effect from 1st April, 2008 to provide that the Assessing Officer may assess or reassess an income which is chargeable to tax and has escaped assessment, other than the income involving matters which are the subject matter of any appeal, reference or revision. Therefore, in respect of income involving the matters which are the subject matter of an appeal, it is not possible for the Assessing Officer to initiate proceeding under section 147.
- (d) The Finance Act, 2008 has substituted section 143(1) to provide for computation of total income of an assessee after making the following adjustments to the returned income:
- (i) any arithmetical error in the return; or
 - (ii) an incorrect claim, if such incorrect claim is apparent from any information in the return.

Thus, section 143(1) now seeks to allow the Assessing Officer to make adjustments for correcting arithmetical mistakes and incorrect claims apparent from the return filed.

For the purpose of section 143(1), "an incorrect claim apparent from any information in the return" shall mean such claim on the basis of an entry, in the return of income,-

- (i) of an item, which is inconsistent with another entry of the same or some other item in such return;
- (ii) in respect of which, information required to be furnished to substantiate such entry, has not been furnished;
- (iii) in respect of a deduction, where such deduction exceeds specified statutory limit which may have been expressed as monetary amount or percentage or ratio or fraction.

Therefore, the statement is not correct.

Question 5

- (a) Tai Ltd. filed its return of income for assessment year 2008-09 on 6th June, 2008. The return is selected for regular assessment under section 143(3) for which notice under

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- section 143(2) is served on the company on 3rd October, 2009. The company responded to the notice under section 143(2). State whether the service of the notice is within time and if not, whether the assessment order can be challenged by the assessee. (4 Marks)
- (b) Ms. J, a Sikkimese woman, married Mr. K, a non-Sikkimese, on 1st January, 2008. During the previous year 2008-09, she received rent of Rs.12 lacs from letting out of house properties situated in the State of Sikkim. Is she liable to income-tax for assessment year 2009-10? Will your answer be different, if she married Mr. K on 16th April, 2008? (3 Marks)
- (c) Betki Limited is a company in which 70% shares are held by Ruhu Limited. Betki Limited, in its annual general meeting held on 18th May, 2008, declared a dividend amounting to Rs.40 lacs to its shareholders for the year ended 31st March, 2008 and it paid dividend distribution tax on 28th May, 2008. Ruhu Limited did not declare any dividend for the year ended 31st March, 2008. It, however, declared an interim dividend amounting to Rs.60 lacs on 1st December, 2008 for the year ended 31st March, 2009. What is the amount of tax on dividend payable by Ruhu Limited? What would be your answer, if 60% of shares in Ruhu Limited are held by Hilsha Limited, a domestic company? Does the position further change, if Hilsha Limited is a foreign company? (6 Marks)

Answer

- (a) The time limit for service of notice under section 143(2) is six months from the end of the financial year in which the return of income was furnished by the assessee. The return of income for assessment year 2008-09 was filed by the assessee on 6th June, 2008. Therefore, the notice under section 143(2) has to be served by 30th September, 2009. However, the notice was served on the assessee only on 3rd October, 2009. Hence the notice issued under section 143(2) is time-barred.

As per section 292BB, inserted by the Finance Act, 2008, where an assessee had appeared in any proceedings or co-operated in any enquiry relating to an assessment or reassessment, it shall be deemed that any notice required to be served upon him, has been duly served upon him in time in accordance with the provisions of the Act and such assessee shall be precluded from raising any objection in any proceeding or enquiry that the notice was (a) not served upon him or (b) not served upon him in time or (c) served upon him in an improper manner. However, the above provision shall not be applicable where the assessee has raised such objection before the completion of such assessment or reassessment. Therefore, in the instant case if the assessee, Tai Limited, had raised an objection to the proceeding, on the ground of non-service of the notice under section 143(2) upon him on time, then the validity of the assessment order can be challenged. In absence of such objection, the assessment order cannot be challenged.

- (b) Section 10(26AAA), inserted by the Finance Act, 2008, provides that the following income, which accrues or arises to a Sikkimese individual, shall be exempt from income-tax:
- (1) Income from any source in the State of Sikkim; and
 - (2) Income by way of dividend or interest on securities.

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However, the aforesaid exemption will not be available to a Sikkimese woman who marries a non-Sikkimese individual on or after 1st April, 2008.

Since Ms. J, the assessee, married Mr.K on 1st January, 2008, income derived by her by way of rent from properties situated in the State of Sikkim shall be exempt under section 10(26AAA).

However, if she had married Mr. K on 16th April, 2008, the exemption would not be available.

- (c) As per section 115-O, dividend distribution tax at the rate of 15% (plus surcharge @ 10%, education cess @ 2% and secondary and higher education cess @ 1%) is levied on dividend, declared, distributed or paid by a domestic company. As per sub-section (1A), inserted to section 115-O by the Finance Act, 2008, a holding company receiving dividend from its subsidiary company can reduce the same from dividends declared, distributed or paid by it. For this purpose, the matching principle does not apply. This means that even if the dividend received and dividend distributed relate to different periods, the same can be adjusted for the purpose of computing dividend distribution tax of the holding company. However, the dividend shall not be considered for reduction more than once.

The conditions to be fulfilled for this purpose are as follows:

- (1) The subsidiary company should have actually paid the dividend distribution tax;
- (2) The holding company should be a domestic company;
- (3) The holding company should not be a subsidiary company of any other company.

For this purpose, a holding company is a company which holds more than 50% of the nominal value of equity shares of another company.

On the basis of the aforesaid provision, dividend distribution tax payable by Ruhu Limited shall be 16.995% of [(Rs.60,00,000 - (Rs.40,00,000 x 70%)] i.e. Rs.5,43,840.

If 60% of shares of Ruhu Limited are held by Hilsha Limited, then Ruhu Limited is a subsidiary company of Hilsha Limited. In that case, the condition (See condition no.3 above) laid down in section 115-O(1A) is not satisfied and Ruhu Limited cannot reduce the amount of dividend received from Betki Limited for computation of dividend distribution tax. Hence, dividend distribution tax payable by Ruhu Limited shall be 16.995% of Rs.60,00,000 i.e. Rs.10,19,700.

The above situation remains same even if Hilsha Limited is a foreign company.

Question 6

- (a) Antaryami settled 1/4th share of his property under a trust for the education and maintenance of his minor daughter, Poulomi. Under the terms of the trust deed, the income accruing to the trust, after meeting the expenses of maintenance and education of Poulomi, was to be accumulated and paid over to her on her attaining majority. The Assessing Officer assessed the income arising from 1/4th share of the property, settled

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for the benefit of Poulomi, in the hands of Antaryami. Examine the correctness of the assessment. (4 Marks)

- (b) Happy Home is a public charitable trust created under a trust deed for providing relief to physically challenged persons and registered under section 12A of the Income-tax Act. The following are the particulars of receipts of the trust during the year ended 31st March, 2009 :

	Rs. in lacs
(i) Income from properties held by trust (net)	15
(ii) Income (net) from business (incidental to main objects)	14
(iii) Voluntary contributions from public (including the corpus donation of Rs.7 lacs)	18

The trust applied Rs.18 lacs towards various activities and programmes undertaken for the benefit of physically challenged persons during the year. The trust has also paid Rs.8 lacs towards repayment of a loan taken two years back for the purpose of construction of its centre for training the handicapped persons in various handicraft works and sports.

Determine the tax liability, if any, of the trust for the assessment year 2009-10 and also state how the trust can mitigate such liability. (6 Marks)

Answer

- (a) As per section 64(1A), the income of a minor child should be included in the total income of that parent, whose total income before such inclusion is higher.

The Supreme Court, in CIT v. M.R. Doshi (1995) 211 ITR 1, held that where the income from the trust was to be accumulated until the child attained majority, the clubbing provisions would not get attracted, since no benefit accrues to the minor child during the period when such child is a minor.

However, in this case, the minor daughter Paulomi is eligible for the benefits during the period when she is a minor, since income from the trust is being used for meeting her education and maintenance expenses. Only the remaining income is to be accumulated and paid over to her on her attaining majority. Therefore, since benefit under the terms of the trust deed is accruing, even though to a limited extent, to the minor daughter Paulomi during the period when she is a minor, the ratio applicable in the Supreme Court decision cited above cannot be applied in this case. Accordingly, the clubbing provisions under section 64(1A) will get attracted.

Therefore, the stand taken by the Assessing Officer to tax the income in the hands of Antaryami is correct. However, only so much of income as is used for meeting the education and maintenance expenses of Paulomi during the current year should be clubbed in the hands of Antaryami after providing for an exemption of Rs.1,500 under section 10(32).

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(b) Computation of taxable income of Happy Home for the A.Y. 2009-10

Particulars	Rs.	Rs.
Income from properties held by trust	15,00,000	
Income from business incidental to the main objects of the trust	14,00,000	
Voluntary Contribution other than corpus donation (Note 1)	11,00,000	40,00,000
Less: 15% of income accumulated or set apart under section 11(1)(a)		6,00,000
		<u>34,00,000</u>
Less: Amount applied for charitable purposes		
Activities and programmes for the benefit of physically challenged persons	18,00,000	
Repayment of loan taken for construction of training centre (Note 2)	8,00,000	26,00,000
Taxable Income		<u>8,00,000</u>

Tax Payable:

Upto Rs.1,50,000	Nil	
Rs.1,50,000 - Rs.3,00,000	15,000	
Rs.3,00,000 - Rs.5,00,000	40,000	
Balance Rs.3,00,000	90,000	1,45,000
Add: Education cess @ 2%		2,900
Add: Secondary and higher education cess @ 1%		1,450
		<u>1,49,350</u>

In order to mitigate the tax liability, the trust, by notice in writing to the Assessing Officer can opt to accumulate or set apart the income for the purpose of investment in the next 5 succeeding years. The Trust must apply in Form No.10 indicating the purpose of accumulation. The notice of accumulation must be given before the expiry of the time allowed under section 139(1). The amount set apart must be kept in investments/deposits specified in section 11(5). If the above trust has opted for such accumulation, then the tax burden would be reduced to the extent of such accumulation.

Notes:

- (1) Section 11(1)(d) excludes from the total income of the person, any income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution.

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- (2) In CIT vs. Janmabhumi Press Trust (2000) 242 ITR 457, the Karnataka High Court held that where a debt is incurred for the purpose of the trust, the repayment of the debt would amount to an application of the income for the purpose of the trust. Therefore, repayment of loan taken for construction of training centre for physically challenged persons can also be considered as application for charitable purpose.

Question 7

- (a) EF Limited, an Indian company, is engaged in manufacturing electronic components. 74% of shares of the company are held by EF Inc., incorporated in USA. EF Limited has borrowed funds from EF Inc. at LIBOR plus 150 points. The LIBOR prevalent at the time of borrowing is 4% for US \$. The borrowings allowed under the External Commercial Borrowings guidelines issued under Foreign Exchange Management Act are LIBOR plus 200 basis points. Discuss whether the borrowing made by EF Limited is at arm's length ('LIBOR' means London Inter-Bank Offer Rate). (5 Marks)
- (b) Sridhar purchased a residential flat from Devraj in 2005. However, the deed of conveyance has not been registered in the name of Sridhar till date. Sridhar has let out the flat at a monthly rent of Rs.15,000 to Mohan. Sridhar claims that rent received is not chargeable under the head "Income from house property", but the same is chargeable under the head "Income from other sources" and he can claim deduction for expenses on repair and insurance premium on actual basis and also depreciation. Examine the correctness of Sridhar's claim. (3 Marks)
- (c) IT Limited, under its Employment Stock Option Plan, allotted 500 equity shares to its finance manager, Ms. Cynthia on 15th May, 2008, when she exercised her option. The option was granted on 15th January, 2007 and the shares vested with Cynthia on 15th January, 2008. The company's shares are quoted in Bombay Stock Exchange, where the opening price and closing price on the date of vesting were Rs.250 and 256, respectively. The company recovered Rs.50 per share from Cynthia. Compute the value of fringe benefit for the assessment year 2009-10. If fringe benefit tax thereon is recovered by the company from Cynthia, can she claim such tax as a part of cost when she sells the shares? (4 Marks)

Answer

- (a) One of the methods for determination of arm's length price in an international transaction is Comparable Uncontrolled Price method (CUP). Under the CUP method, the price charged or paid for property transferred or services rendered in a comparable uncontrolled transaction, or a number of such transactions, is identified. Such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions, which could materially affect the price in the open market. The adjusted price so arrived at is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction.
- EF Inc., USA and EF Limited, the Indian company shall be deemed to be associated enterprises since the former holds more than 26% voting power in the latter.

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The arm's length rate of interest can be determined by using CUP method having regard to the rate of interest on external commercial borrowing permissible as per guidelines issued under Foreign Exchange Management Act. The interest rate permissible is LIBOR plus 200 basis points i.e., $4\% + 2\% = 6\%$, which can be taken as the arm's length rate. The interest rate applicable on the borrowing by EF Limited, India from EF Inc., USA, is LIBOR plus 150 basis points i.e., $4\% + 1.5\% = 5.5\%$. Since the rate of interest, i.e. 5.5% is less than the arm's length rate of 6%, the borrowing made by the EF Ltd. is not at arm's length. However, in this case, the taxable income of EF Ltd., India, would be lower if the arm's length rate is applied. Hence, no adjustment is required since the law of transfer pricing will not apply if there is a negative impact on the existing profits.

- (b) In order to assess income under the head "Income from house property" the assessee must be the owner of the house property. The need for registration of document in favour of a person to enable him to be treated as the owner of the house property for the purpose of section 22, was considered by the Supreme Court in the case of CIT vs. Poddar Cement Pvt. Ltd. (1997) 226 ITR 625. It was held that so long as a person is entitled to receive income from the house property in his own right and not on behalf of some one else, it is not necessary that the sale deed must be registered in favour of the person to treat him as the owner of the property for the purpose of section 22. In such a case, the income derived from the property is chargeable to tax under the head "Income from house property". The fact that registration is not yet complete does not affect the chargeability of such income under the head "Income from house property". Therefore, the claim of Sridhar that rent should be assessed under the head "Income from other sources" and deduction of various expenses and depreciation should be allowed therefrom is not tenable.

- (c) As per section 115WC(1)(ba), the value of fringe benefit in the case of issue of shares allotted under the Employees' Stock Option Plan is the fair market value of shares on the date on which the option vests with the employee as reduced by the amount actually paid by, or recovered from, the employee in respect of such shares.

As per Rule 40C, in case of shares listed in one recognized stock exchange, fair market value means the average of opening price and closing price of the share on the said stock exchange as on the date of vesting.

Therefore, in this case, the fair market value would be $\frac{250 + 256}{2} = \text{Rs.}253$

Thus, the value of fringe benefit would be $= (253 \times 500) - (50 \times 500) = \text{Rs.}1,01,500$.

Under section 49(2AB), for the purpose of computing capital gain from the transfer of shares received under ESOP, cost of acquisition of such shares shall be the fair market value which has been taken into account while computing the value of fringe benefits under section 115WC(1)(ba). This being a deeming provision, only such fair market value (in this case, Rs.253) shall be considered as cost.

Therefore, even if fringe benefit tax on such shares is recovered by the company from Cynthia, she cannot claim such FBT as part of cost of acquisition of shares, when she sells the shares. This has also been clarified by CBDT Circular no.9/2007 dated 20th December 2007 (Q. No.24).

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Question 8

- (a) Mr. Manocha has a house property in Delhi, which was lying vacant for last 3 years. He constructed the property in 1990 at a cost of Rs.40 lacs. He has let out the same at a monthly rent of Rs.30,000 for a period of three years with effect from 1st January, 2009. The quarterly corporation tax is Rs.30,000. He took a premium of Rs.1,20,000 from the tenant and also security deposit of Rs.1,00,000. The house was constructed on a land measuring 4,000 sq.ft. It has three floors each measuring 960 sq.ft. Compute the value of the house property for wealth tax purpose as at valuation date 31.3.2009. (7 Marks)
- (b) An association of persons (AOP), comprising of two members Akash and Vikash, owns an urban land valued at Rs.60 lakh on the valuation date 31.3.2009. Examine the tax implications under the Wealth Tax Act. (3 Marks)

Answer

- (a) Computation of value of the house property for wealth tax purpose

Particulars	Rs.	Rs.
Computation of Actual Rent & Annual Rent		
Actual Rent (Rs.30,000 x 3)		90,000
Add: Adjustment for premium received from tenant (Rs.1,20,000/3) x 3/12		10,000
15% p.a. of Security Deposit i.e. 15% x Rs.1,00,000 x 3/12		3,750
Actual Rent for 3 months		1,03,750
Annual Rent (Rs.1,03,750 x 12/3)		4,15,000
Computation of Net Maintainable Rent (NMR)		
Gross Maintainable Rent, being the annual rent		4,15,000
Less: Corporation Tax (Rs.30,000 x 4)	1,20,000	
15% of Gross Maintainable Rent	62,250	1,82,250
Net Maintainable Rent (NMR)		2,32,750
Capitalised value of NMR		
Capitalised value (Rs.2,32,750 x 12.5)	29,09,375	
Cost of acquisition	40,00,000	
Capitalised value is the higher of the above		40,00,000
Add: Premium		
(i) Aggregate Area	4000 Sq.Ft.	
(ii) Specified Area (60%)	2400 Sq.Ft.	

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(iii) Built up area	960 Sq.Ft.	
(iv) Unbuilt Area	3040 Sq.Ft.	
(v) Excess of unbuilt area over specified area	640 Sq.Ft.	
% of excess area on aggregate area		
$(640/4000) \times 100$	16%	
(vi) Premium to be added when (v) is 16%		16,00,000
(40% of capitalized value i.e., 40% of Rs.40 lakh)		

Value of house property for wealth-tax purpose	56,00,000
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- (b) The tax implications of an asset owned by an association of persons under the Wealth-tax Act are as follows:
- (i) As per section 3, only individuals, Hindu Undivided Families and Companies are liable to wealth tax. Therefore, an association of persons (AOP) is not chargeable to wealth-tax.
 - (ii) However, as per section 4(1)(b), the value of interest of a member of an AOP in the assets of the AOP is to be included in his net wealth. Schedule III lays down the manner of determination of the value of such interest.
 - (iii) Section 21AA deals with a situation where the shares of the members of an AOP are indeterminate or unknown. Where assets chargeable to wealth-tax are held by an AOP and the individual shares of the members are indeterminate or unknown on the date of formation or at any time thereafter, wealth tax is to be levied in the like manner and to the same extent as applicable to an individual.

The suggested answers for Indirect Taxes (Paper 8) are based on the provisions as amended by the Finance Act, 2008 and Notifications/Circulars issued up to 31.10.2008 which are relevant for June 2009 examinations.

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Answer to question nos. 1, 6 and 9 are compulsory. In addition thereto, answer any two questions from Part “A” and one question from Part “B”.

PART – A

Question 1

- (a) Briefly explain the following with reference to the provisions of the Central Excise Act, 1944 as amended by the Finance Act, 2008:
- (i) Deposit of excise duty collected from the buyer.
 - (ii) Payment of interest on pre-deposit made by an appellant under section 35FF.
- (2×2=4 Marks)
- (b) Explain the provisions of section 3A of the Central Excise Act, 1944 regarding duty payable on the basis of capacity of production in respect of notified goods. (5 Marks)
- (c) X Ltd. of Kanpur was receiving goods in semi-finished condition from its sister concern based at Mumbai. After carrying out some operations, it cleared the goods at lower value than the landing cost of semi-finished goods received from the supplier. After verification of company's records, Revenue Department alleged that the value of the intermediate goods had been inflated by the supplier to pass on excess CENVAT credit and hence, Department wanted to disallow the excess credit so availed as per the provisions of rule 14 of the CENVAT Credit Rules, 2004. Explain, whether the contention of the Department is correct, giving reference to decided case law, if any. (5 Marks)
- (d) Discuss the validity or otherwise of the following statements giving reasons to support your answer:
- (i) Erroneous claim made by the assessee earlier precludes him from subsequently making a claim for correct classification.
 - (ii) Omission to give correct information can be construed as 'suppression of facts' for the purpose of the proviso to section 11A of the Central Excise Act, 1944.
- (2×3=6 Marks)

Answer

- (a) (i) The scope of section 11D was expanded by inserting sub-section (1A) which provides as follows:-

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Every person, who:-

- has collected any amount in excess of the duty assessed or determined and paid on any excisable goods or
- has collected any amount as representing duty of excise on any excisable goods which are wholly exempt or are chargeable to nil rate of duty;

from any person in any manner, shall forthwith pay the amount so collected to the credit of the Central Government.

- (ii) New section 35FF provides that where an amount deposited by the appellant in pursuance of an order passed by the Commissioner (Appeals) or the Appellate Tribunal (hereinafter referred to as the appellate authority), under the first proviso to section 35F, is required to be refunded consequent upon the order of the appellate authority and such amount is not refunded within three months from the date of communication of such order to the adjudicating authority, unless the operation of the order of the appellate authority is stayed by a superior court or tribunal, there shall be paid to the appellant interest at the rate specified in section 11BB after the expiry of three months from the date of communication of the order of the appellate authority, till the date of refund of such amount.
- (b) Central Government, having regard to the nature of the process of manufacture/production of excisable goods of any specified description, the extent of evasion of duty in regard to such goods or such other factors as may be relevant, can issue notification specifying that duty on such notified products will be levied and collected on the basis of production capacity of the factory. In this connection, new section 3A has been introduced under the Central Excise Act, 1944 by Finance Act, 2008 giving the provisions for ascertaining the production capacity, with effect from 10-5-2008. It provides as follows:-
- (i) Capacity will be determined by an officer not below the rank of Assistant Commissioner. Factors relevant to determine production capacity will be specified by rules framed by Central Government.
- (ii) The annual capacity fixed will be deemed to be annual production of such goods by the factory. If factory is not working for part of the year, annual production will be calculated on proportionate basis of the annual capacity of production. If factors determining production capacity are changed during the year, annual capacity will be re-determined on a proportionate basis having regard to such alteration or modification.
- (iii) The rate of duty payable based on production capacity will be notified by Central Government in rules. If factory does not work for a continuous period of 15 days or more in a month, duty calculated will be proportionately reduced, subject to prescribed conditions.

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- (iv) Provision of payment of duty on the basis of production capacity does not apply to goods produced or manufactured, by a 100% Export Oriented Undertaking (EOU) and brought to any other place in India.
 - (v) Even if duty on goods notified u/s 3A is payable as per rates notified if similar goods are imported, CVD will be payable at the rate specified in Central Excise Tariff read with any exemption notification.
- (c) In CCE v. MDS Switchgear Ltd. 2008 (229) ELT 485, the Hon'ble Supreme Court held that CENVAT credit availed by the assessee was justified in this case.

CESTAT's view which was up-held by the Apex Court was that if the Department was of the opinion that the value of the final product was depressed, then they should have charged Kanpur unit with under- invoicing of their product, which had not been done in this case. Valuation as given by the Mumbai unit was duly approved by the Department and the payment of duty was also accepted. The CENVAT Credit Rules, 2004 entitled the recipient unit to avail the benefit of the duty paid by the supplier unit. A quantum of duty already determined by the jurisdictional officers of supplier unit could not be contested by the officers in charge of recipient unit.

- (d) (i) The statement is not valid. The question as to whether erroneous claim made by the assessee earlier precludes him from subsequently making a claim for correct classification was negatively answered by Rajasthan High Court in the case of Guljag Industries Ltd. v. Union of India 2008 (224) ELT 38. In this case, the appellant-the manufacturer wrongly classified the storage tank, motor rails and platforms manufactured by him under chapter heading 73.09 by taking it to be the storage of general use. Later on, he claimed the classification under chapter heading 84.19 on the ground that storage tank concerned, was actively used for manufacturing activity of the plant and was an integral part of the manufacturing process, therefore ought to be classified under chapter heading 84.19. Adjudicating Authority contended that classification once opted by the manufacturer could not be allowed to be altered subsequently. The High Court approved the contention of appellant that earlier claim to a particular classification by the manufacturer did not stop the assessee from claiming the correct classification under a different head by pointing out that the classification earlier claimed was erroneous.
- (ii) The statement is not valid. The question as to whether omission to give correct information can be construed as 'suppression of facts' for the purpose of the proviso to section 11A of the Central Excise Act, 1944 was negatively answered by Supreme Court while deciding the case of Continental Foundation Joint Venture v. CCEx. 2007 (216) ELT 177. The Supreme Court observed that the expression "suppression" used in proviso to section 11A of the Central Excise Act, 1944 should be construed strictly. Suppression means failure to disclose full information with intent to evade payment of duty. When the facts are known to both the parties, omission by one party to do what he might have done would not render it suppression. The Apex Court held that mere omission to give correct information is

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not suppression of facts unless it was deliberate to stop the payment of duty. The Apex Court further explained that an incorrect statement cannot be equated with a wilful misstatement. There cannot be a non wilful suppression or misstatement of a fact. Misstatement of fact must be wilful.

Question 2

- (a) Assessee purchased duty paid M.S. tubes from its manufacturers and cut into requisite length and were put into the swaging machine for undertaking swaging process whereby dies fitted in the machine imparted 'folds' to flat surface of M.S. tube/pipe. Department's view is that 'swaging process' amounts to manufacture whereas assessee denies. Discuss whether the Department's contention is correct by referring to section 2(f) of the Central Excise Act, 1944. You can take the help of decided case law, if any. (5 Marks)
- (b) Briefly explain the provisions relating to re-entry of the goods cleared for export under bond but not actually exported, in the factory of manufacturer as per notification issued under rule 19 of the Central Excise Rules, 2002. (4 Marks)
- (c) Raj & Co. furnishes the following expenditure incurred by them and wants you to find the assessable value for the purpose of paying excise duty on captive consumption. Determine the cost of production in terms of rule 8 of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 and as per CAS-4 (Cost Accounting Standard):
- | | | |
|--------|---|--------|
| (i) | Direct material cost per unit inclusive of excise duty at 10% | Rs.880 |
| (ii) | Direct wages | Rs.250 |
| (iii) | Other direct expenses | Rs.100 |
| (iv) | Indirect materials | Rs.75 |
| (v) | Factory overheads | Rs.200 |
| (vi) | Administrative overhead (25% relating to production capacity) | Rs.100 |
| (vii) | Selling and distribution expenses | Rs.150 |
| (viii) | Quality control | Rs.25 |
| (ix) | Sale of scrap realized | Rs.20 |
| (x) | Actual profit margin | 15% |

(6 Marks)

Answer

- (a) This problem is based on the case law Prachi Industries v. CCEx., Chandigarh 2008 (225) ELT 16 (SC).

In this case, Department took the plea that swaging process amounted to manufacture and duty was payable on the goods manufactured by the appellant. However, the demand by the Department was not accepted. Consequently, the appeal was filed before the Supreme Court.

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The Apex Court held that by reading section 2(f) of the Central Excise Act, 1944, it was clear that manufacture includes "any process incidental or ancillary to the completion of a manufactured product". In other words, incidental process must be an integral part of manufacture resulting into a new finished product which must be of a different physical shape, size and use. Moreover, the said process must impart a change of a lasting character to the original product or raw material. Supreme Court observed that swaging was the process which imparted a change of a lasting character to the plane MS pipe or tube by use of dies which existed in the machine. After the process of swaging, the identity of the plane MS pipe or the tube underwent a change in terms of form, shape or use. Hence, Supreme Court held that swaging amounted to manufacture and thus, excise duty was payable by the assessee.

- (b) The excisable goods cleared for export under bond or undertaking but not actually exported for any genuine reasons may be returned to the same factory provided:
- (i) such goods are returned to the factory within 6 months with original documents like invoice and ARE-1.
 - (ii) the assessee shall give intimation of re-entry of each consignment in Form D-3 within twenty four hours of such re-entry;
 - (iii) such goods are to be stored separately at least for forty eight hours from the time intimation is furnished to the Range Office or shorter period if verification is done by the Superintendent of Central Excise or through Inspector in charge of factory, about the identity of such goods with reference to the invoice, ARE-1 and daily stock account in respect of 5% of intimations, within another 24 hours of receipt of intimation.
 - (iv) the assessee shall record details of such goods in daily stock account and taken in the stock in the factory.
- (c) Computation of assessable value as per rule 8 of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 and CAS-4:-

S. No.	Particulars	Total cost Rs.
1	Material cost consumed–net of excise duty (Note-1)	800
2	Direct wages	250
3	Direct expenses	100
4	Works overheads (75 +200) (Note-2)	275
5	Quality control cost	25
6	Administration overheads (relating to production capacity)	<u>25</u>
7	Total (1 to 6)	1,475

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8	Less: Credit for recoveries/scrap/by products/ miscellaneous income	<u>20</u>
9	Cost of production (8-9)	1,455
10	Add: 10% as per rule 8 (Note-3)	<u>145</u>
11	Assessable value	<u>1,600</u>

Note:

1. Material Consumed: Rs. 880-Rs. 80 (excise duty) =Rs. 800
2. Indirect materials and factory overheads have been included in works overheads.
3. Actual profit margin earned is not relevant for excise valuation as per rule 8 of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000.

Question 3

- (a) Is there any discretion under section 11AC of the Central Excise Act, 1944 to impose penalty less than the amount equal to duty evaded? Briefly explain based on case law, if any. (3 Marks)
- (b) Explain eligibility of CENVAT credit in each of the following occurrences during the month of January, 2008 for an assessee:
- (i) Assessee received a consignment of inputs on which excise duty paid was Rs.12,000. The invoice is dated 10th January, 2008. The transporters delivered the goods on 1st February, 2008.
 - (ii) Inputs on which CENVAT credit availed earlier Rs.5,000, were sent to production centre and on its way, the inputs were completely damaged due to careless handling. Inputs have become unfit for use.
 - (iii) CENVAT credit of Rs.20,000 was taken on certain inputs. Due to long storage they have become unfit and were sold as scrap for Rs.5,000 and excise duty is 14.42%. (3×2=6 Marks)
- (c) S & Co., a small scale unit, had cleared goods of the value of Rs.750 lakhs during the financial year 2007-08. Records show that the following clearances were included in the total turnover of Rs.750 lakhs :

	Rs. in lakhs
(i) Total exports during the year	200
(ii) Job work in terms of Notification No. 214/86	50
(iii) Job works in terms of Notification No. 83/94-CE	50
(iv) Clearance of excisable goods without payment of duty to a 100% E.O.U.	20
(v) Goods manufactured in rural area with others' brand	100

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Find out whether the unit is eligible to avail concession for the year 2008-09, under Notification No. 8/2003 dated 1st March, 2003, giving reasons for your answer. 30% of total exports were to Nepal. (5 Marks)

Answer

- (a) The Supreme Court in case of Union of India v. Dharmendra Textile Processors 2008 (231) ELT 3 (SC) has held that there is no discretion to impose lower penalty under section 11AC of the Central Excise Act, 1944. In notes to clause, while introducing section 11AC, it has been mentioned that levy of penalty under the said section is a mandatory penalty.

Earlier, similar view was taken by Bombay High Court, in case of C.C.E. & C., Aurangabad v. Godavari Manar Sahakari Sakhar Karkhana Ltd. 2008 (228) ELT 172, wherein it pronounced that under section 11AC, there was no discretion vested with the authority to impose any penalty different than the one prescribed by the said provision. It was evident that legislature had not fixed any upper or lower limit, but prescribed only one quantum for penalty which was equal to the duty intentionally evaded.

Hence, there is no discretion under section 11AC of the Central Excise Act, 1944 to impose penalty less than the amount equal to duty evaded. The Court observed that the reason for such stiff and stringent provision was that since the penalty under section 11AC was a sort of penal provision, the said provision ought to be harsh and stringent.

- (b) (i) The assessee is eligible for CENVAT credit in the month of February, 2008 and not in the month of January, 2008 because the inputs have been received only in the month of February. Rule 4(1) of CENVAT Credit Rules, 2004 provides that the CENVAT credit in respect of inputs may be taken immediately on receipt of the inputs in the factory of the manufacturer or in the premises of the provider of output service. As the inputs in the problem have been received in February, 2008, CENVAT credit can be taken only in the month of February, 2008.
- (ii) In this case, the inputs were issued from the stores to the production department but got damaged due to careless handling on its way to production centre. It is a clear indication that the inputs are removed from the stores which is to be construed as if they were removed for use 'in or in relation to manufacture'. Hence, there is no need to reverse the CENVAT credit already availed.
- (iii) In this case, since the inputs were subsequently sold as scrap, the assessee will have to reverse CENVAT credit of Rs. 20,000 already taken on inputs. Since, credit on inputs is available only for inputs used in or in relation to manufacture of final products, if the inputs are lost or destroyed in the store room, credit of duty paid on such inputs will not be available, as it cannot be said that they are used 'in or in relation to manufacture'.
- (c) In order to claim the benefit of exemption under Notification No. 8/2003 – C.E. in the financial year 2008-09, the total turnover of the unit should not exceed Rs.400 lakh in the

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preceding financial year 2007-08. For the purpose of computing the turnover of Rs. 400 lakh:-

- (i) Export turnover has to be excluded. However, export to Nepal and Bhutan cannot be excluded as these are treated as "clearance for home consumption". Therefore, clearances worth Rs.140 lakh will be excluded while clearances worth Rs.60 lakh exported to Nepal shall remain included.
- (ii) Job work under Notification No. 214/86-CE and under Notification No. 85/94-CE shall not to be included. Consequently, clearances worth Rs. 100 lakh are to be excluded.
- (iii) Clearance of excisable goods without payment of duty to EOU has to be excluded as it is considered as "deemed export". Therefore, clearances worth Rs. 20 lakh have to be deducted.
- (iv) Goods manufactured in rural area with other's brand name, the turnover which is cleared without payment of duty shall be included. Therefore, the clearances worth Rs. 100 lakh shall not be excluded.

Therefore, for the year 2008-09, the turnover of S & Co. for claiming the SSI exemption will be:-

= Rs. 750 lakh – (140 + 20 + 100) lakh = Rs. 490 lakh. Hence, S & Co. will not be entitled to exemption under Notification No. 8/2003 dated 01.03.2003 in 2008-09.

Question 4

- (a) Discuss with reference to the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000, the following:
 - (i) Goods sold only through inter-connected undertaking
 - (ii) Valuation in case of job worker. (2×3=6 Marks)
- (b) As per section 11B(2) of the Central Excise Act, 1944, refund shall be granted to the applicant only in specified cases otherwise shall be credited to Consumer Welfare Fund. You are required to explain briefly such cases. (5 Marks)
- (c) Rule 9(2) of the Central Excise Rules, 2002 provides for exemption from registration to specified categories of persons. Explain briefly those categories. (4 Marks)

Answer

- (a) (i) Goods sold through inter-connected undertaking
If goods are sold only through inter-connected undertaking, the value shall be determined as per rule 10 of Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 as follows:-
 - (i) When the assessee so arranges that the excisable goods are not sold by him except to or through an inter-connected undertaking, the value of goods shall

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be the “transaction value” if:-

- (a) the buyer is not a holding or subsidiary of assessee, or
- (b) buyer and seller are relatives, or
- (c) buyer is a relative and a distributor of the assessee or a sub-distributor of such distributor, or
- (d) buyer and seller are so associated that they have interest, directly or indirectly, in the business of each other.

(ii) In any other case, price will be “normal transaction value” of buyer to unrelated person (as per rule 9 of the said rules).

(ii) Valuation in case of job work

Where the goods are manufactured by a job worker on behalf of a person, provisions of rule 10A (a new rule inserted from 1-4-2007) of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 shall apply. Rule 10A provides that the value for payment of excise duty would be based on the sale value at which the principal manufacturer sells the goods to an unrelated buyer.

(b) Refund shall be granted by the Assistant Commissioner, on being satisfied that excise duty and interest, if any, paid on such duty is refundable, to the applicant only in the following cases:

- (i) rebate of duty of excise on excisable goods exported out of India or on excisable materials used in the manufacture of goods which are exported out of India;
- (ii) unspent advance deposits lying in the applicant's account current maintained with the Commissioner of Central Excise;
- (iii) refund of credit of duty paid on excisable goods used as inputs in accordance with rules made, or any notification issued, under the Act;
- (iv) the duty of excise and interest, if any, paid on such duty paid by the manufacturer, if he had not passed on the incidence of such duty to any other person;
- (v) duty of excise and interest, if any, paid on such duty borne by the buyer if he has not passed on the incidence of such duty to any other person;
- (vi) the duty of excise and interest, if any, paid on such duty borne by any other such class of applicants as the Central Government may, by Notification in the Official Gazette, specify.

In other cases, the Assistant Commissioner shall make an order for credit of amount refundable to the "Consumer Welfare Fund".

(c) Central Board of Excise and Customs, as per the power given under section 9(2) of the Central Excise Act, 1944, vide Notification No.36/2001-CE. (NT) dated 26.06.2001, has exempted the following specified categories of persons from obtaining registration:

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- (i) Persons who manufacture the excisable goods, which are chargeable to nil rate of duty or are fully exempt from duty by a notification subject to the declaration to be made in a specified form.
- (ii) Small scale units having the slab exemption based on value of clearances under a notification. However, they have to give the declaration when their clearances touch Rs. 90 lakh.
- (iii) In respect of final products falling under chapter 61 or 62, the job-worker need not get registered if the principal manufacturer undertakes to discharge the duty liability.
- (iv) Persons manufacturing excisable goods by following the warehousing procedure under the Customs Act, 1962 subject to certain prescribed conditions.
- (v) The person who carries on whole sale trade or deals in excisable goods except first and second stage dealer, as defined in the CENVAT Credit Rules, 2004.
- (vi) A hundred percent Export Oriented Undertaking or a unit in EPZ or a unit in SEZ licensed or appointed; as the case may be under the Customs Act, 1962.
- (vii) Persons who use excisable goods for any purpose other than the processing or manufacture of goods availing benefit of concessional duty exemption notification.
- (viii) Person who gets his goods manufactured on his account from any other person subject to the conditions that the said person authorizes the person actually manufacturing or fabricating the said goods, to comply with all procedural formalities under the Central Excise Act, 1944 and the rules made there under and to furnish information in order to enable the determination of value of the said goods.

Note: Any four points may be mentioned.

Question 5

- (a) State the categories of cases that cannot be settled as per section 32E of the Central Excise Act, 1944. (5 Marks)
- (b) Write a brief note on the following with reference to the Central Excise Act, 1944:
 - (i) Tampering or altering MRP after removal
 - (ii) Remission of duty on lost/or destroyed goods. (2×3=6 Marks)
- (c) Under what circumstances, the appellant shall be entitled to produce before the Commissioner of Central Excise (Appeals) additional evidence as per rule 5 of the Central Excise Appeal Rules, 2002? (4 Marks)

Answer

- (a) As per section 32E(1) of the Central Excise Act, 1944, an application for settlement is not entertained by the Settlement Commission under the Central Excise Act, in the following circumstances:

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- (i) The applicant has not filed a return showing production, clearance and central excise duty paid in the prescribed manner.
- (ii) The applicant has not received a show cause notice for recovery of duty issued by the Central Excise Officer.
- (iii) The additional amount of duty accepted by the applicant does not exceed Rs. 3 lakh.
- (iv) An application/case is pending with the Tribunal or Court.
- (v) Any excisable goods or books of account/documents are seized and 180 days have not yet expired.
- (vi) Application pertains to interpretation of classification of excisable goods.
- (vii) The applicant, while filing the application, has not deposited the additional amount of excise duty accepted by him along with interest due under section 11AB.

Note: Any four points may be mentioned.

- (b) (i) Tampering or altering MRP after removal ;
Rule 5 of the Central Excise (Determination of Retail Sale Price of Excisable Goods) Rules, 2008 provides that where a manufacturer alters or tampers the retail sale price declared on the package of goods after their removal from the place of manufacture, resulting into increase in the retail sale price, then such increased retail sale price shall be taken as the retail sale price of all goods removed during a period of one month before and after the date of removal of such goods. However, where the manufacturer alters or tampers the declared retail sale price resulting into more than one retail sale price available on such goods, then, the highest of such retail sale price shall be taken as the retail sale price of all such goods.
- (ii) Remission of duty on lost/destroyed goods.
“Remission” means waiver or cancellation of excise duty legally payable. Rule 21 of the Central Excise Rules, 2002 provides that where it is shown to the satisfaction of the Commissioner that goods have been lost or destroyed by natural causes or by unavoidable accident or are claimed by the manufacturer as unfit for consumption or for marketing, at any time before removal, he may remit the duty payable on such goods, subject to such conditions as may be imposed by him by order in writing.
- (c) As per Rule 5 of the Central Excise (Appeal) Rules, 2001, only under following circumstances the appellant shall be entitled to produce before the Commissioner (Appeals) any evidence, whether oral or documentary, other than the evidence produced by him during the course of proceeding before adjudicating authority:
 - (i) where the adjudicating authority has refused to admit evidence which ought to have been admitted; or
 - (ii) where the appellant was prevented by sufficient cause from producing the evidence which was called upon to produce by the adjudicating authority; or

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- (iii) where the applicant was prevented by sufficient cause from producing before the adjudicating authority any evidence which is relevant to any ground of appeal; or
- (iv) where the adjudicating authority has made the order appealed against without giving sufficient opportunity to the appellant to adduce evidence relevant to any ground of appeal.

PART B

Question 6

- (a) As per section 15 of the Customs Act, 1962, briefly discuss the date for determining the rate of duty and tariff valuation of imported goods. (3 Marks)
- (b) Referring to section 25 of the Customs Act, 1962, discuss the following:
 - (i) General exemption
 - (ii) Special exemption (2×2=4 Marks)
- (c) The assessee imported capital goods and deposited them in the warehouse. The said goods were not removed from the warehouse within the period permitted under section 61(1)(a) i.e. five years. Subsequently, the assessee filed an application for relinquishment of title of such warehoused goods. The Department contended that since the assessee did not file an application for extension of warehousing period before the expiration of five years' period fixed under section 61(1)(a), after expiration of the said period, the goods could no longer be termed as 'warehoused goods'. Therefore, the assessee lost its title to the same and consequently, it lost its right to relinquish its title thereto. It was further claimed that the relinquishment of title to the said goods ought to have been made by the assessee before the expiration of the warehousing period and not thereafter and therefore the goods were 'deemed to have been improperly removed from the warehouse'. Consequently, the assessee became liable to pay duty, penalty and interest with respect to the said goods as provided under section 72(1)(b) of the Customs Act, 1962. (5 Marks)

Discuss, whether the contention of the Department is correct, by referring to case law, if any.

- (d) K imported some old machinery from London claiming that the machinery was fully exempted from customs duty under a notification. Assistant Commissioner of Customs, the authority in original, differed and held that the machinery so imported was covered under a different heading and attracted customs duty. Therefore, K had to furnish bank guarantee for duty payable for release of machine.

Subsequently, the Assistant Commissioner of Customs ordered to encash the bank guarantee to realize the duty. This order was issued to K and immediately thereafter, the Customs Department invoked bank guarantee by sending request to bank for making payment to them. K contended that order of the Assistant Commissioner was appealable and the period of filing appeal was yet to expire. Hence the action of the Department

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was not correct. You are required to comment whether the action of customs Department is correct in law based on decided case law, if any. (5 Marks)

- (e) Whether the right of warehouse-keeper to recover the warehousing charges from the sale proceeds of the goods kept therein is superior to the right of the Revenue to recover custom duty? Answer briefly, by referring to section 150(2)(b) of the Customs Act, 1962.

(3 Marks)

Answer

- (a) Section 15 of the Customs Act 1962 provides that the rate of duty and tariff valuation, if any, applicable to any imported goods, shall be the rate and valuation in force-

- (a) in the case of goods entered for home consumption under section 46, on the date on which a bill of entry in respect of such goods is presented under that section.;
- (b) in the case of goods cleared from a warehouse under section 68, on the date on which a bill of entry for home consumption in respect of such goods is presented under that section;
- (c) in the case of any other goods, on the date of payment of duty

- (b) (i) Special Exemption : As per section 25 of the Customs Act, 1962:

If the Central Government is satisfied that it is necessary in the public interest so to do, it may, by special order in each case, exempt from payment of duty, any goods on which duty is leviable only under circumstances of an exceptional nature to be stated in such order. Further, no duty shall be collected if the amount of duty leviable is equal to, or less than, one hundred rupees.

- (ii) General Exemption: As per section 25 of the Customs Act, 1962:

If the Central Government is satisfied that it is necessary in the public interest so to do, it may, by notification in the Official Gazette, exempt generally either absolutely or subject to such conditions (to be fulfilled before or after clearance) as may be specified in the notification, goods of any specified description from the whole or any part of duty of customs leviable thereon.

- (c) The facts of the given case are similar to the facts of the case of CCus v i2 Technologies Software (P) Ltd. 2007 (217) ELT 176 (Kar.)

The High Court, while dismissing the Department's appeal observed that the owner of the goods (importer) though loses control over the goods when he deposits them in the warehouse, but he does not lose his title or ownership to such goods so long as they remain in the warehouse either during the continuance of the warehousing period or even after its expiration. Therefore, the High Court rejected the Department's contention that on the expiration of the warehousing period or on the expiration of extended warehousing period, the owner of the goods loses his title in respect of such goods and consequently, also loses his right to relinquish his title to such warehoused goods.

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The High Court elaborated that on a plain reading of the provisions of section 23(2), 47, 68 and the proviso to section 68 of the Customs Act, 1962, it is clear that the owner of warehoused goods has the right to relinquish his title to goods 'at any time before an order for clearance of goods for home consumption has been made in respect thereto'. There is no prohibition on relinquishing the title to such goods after the expiration of the warehousing period or after the expiration of the extended period. The High Court pointed out that the provisions of section 23(2) and proviso to section 68 make it clear that upon relinquishment of his title to any imported goods, including the warehoused goods, the owner of such goods shall not be liable to pay duty thereon and when the owner is not liable to pay duty, the question of paying any interest on the duty and penalty would not arise.

Therefore, in the instant case, the Department's contention is not correct.

- (d) Bombay High Court, in the case of *Ocean Driving Centre Ltd. v. Union of India* 2005 (180) E.L.T 313, had an opportunity to address the similar situation. In that case, the petitioner contended that he had a statutory right of appeal before the Appellate Authority and also he had a right to move an application to get the pre-deposit waived in terms of section 129E of the Customs Act, 1962. He further submitted that he had an arguable case on classification. The debatable question had resulted in release of goods subject to furnishing bank guarantee at the stage of provisional assessment. Had it not been a debatable issue, he would not have been allowed to claim release of goods on furnishing the bank guarantee, which was furnished to secure the dues of Department. The same was valid and should have been kept alive till the dispute was finally resolved. According to them, the order of assessment was not final and conclusive.

The High Court observed that it was not in dispute that the appeal period was yet to expire and that the order was an appealable order as per the Departmental circular no. 396/29/98-C.E dated 2nd June, 1998, the Department was expected not to resort to coercive action so long as the appeal period was not over. Hence, the Departmental action was contrary to their own policy. According to the High Court, it was not proper on the part of Department to encash the bank guarantee before the expiry of statutory period provided for filing appeal.

Thus, the stand taken by the Department was not tenable in law.

- (e) In the case of *Associated Container Terminals Ltd. v. Union of India* 2008 (226) E.L.T 169, Delhi High Court held that as per the words used in section 150(2)(b), the right of warehouse keeper to recover the warehousing charges from the sale proceeds appeared to be superior to the right of the Revenue to recover customs duty. The Court noted the following words used in section 150(2)(b):

“-----and other charges ,if any, payable in respect of goods sold ,to the carrier, if notice of such charges has been given to the person having custody of the goods”.

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High Court observed that these words make it clear that it does not pertain to custom duty and refers to the payment of warehousing charges. So, it takes precedence over recovery of custom duty which is relatable to section 150(2)(e) of the Customs Act, 1962.

Question 7

(a) Compute the assessable value and customs duty payable from the following information:

- (i) F.O.B. value of machine 8,000 UK Pounds
- (ii) Freight paid (air) 2,500 UK Pounds
- (iii) Design and development charges paid in UK 500 UK Pounds
- (iv) Commission payable to local agent @ 2% of F.O.B., in Indian Rupees
- (v) Date of bill of entry 24.10.2007 (Rate BCD 20%; Exchange rate as notified by CBEC Rs.68 per UK Pound)
- (vi) Date of entry inward 20.10.2007 (Rate of BCD 18%; Exchange rate as notified by CBEC Rs.70 per cent UK Pound)
- (vii) C.V.D. is payable @ 16% plus education cess as applicable
- (viii) Special C.V.D. – as applicable
- (ix) Insurance charges have been actually paid but details are not available.

(6 Marks)

(b) What is 'redemption fine' in lieu of confiscation? What is the limit for imposing redemption fine under section 125(1) of the Customs Act, 1962? (4 Marks)

(c) Briefly explain the provisions of section 28BA of the Customs Act, 1962 regarding provisional attachment of property pending adjudication. (5 Marks)

Answer

7 (a) Computation of assessable value and duty thereon:

FOB value	8,000 UK pounds
Add: Design and development charges	500 UK pounds
Add: Freight (air) (Note-3)	1,600 UK pounds
Add: Insurance 1.125% of FOB (Note-4)	<u>90 UK pounds</u>
Total	<u>10,190</u>
Total in Rupees @ Rs. 68 per pound (Note-1)	Rs. 6,92,920
Add: Local agency commission	

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(2% of 8000 UK pounds)= 160 UK pounds × Rs. 68	Rs. <u>10,880</u>
C.I.F value	Rs. 7,03,800
Add: Landing charges @1%of CIF value	Rs. <u>7,038</u>
Assessable value	Rs. 7,10,838
Add: Basic custom duty @ 20% (Note-2)	Rs. <u>1,42,167.60</u>
Total	Rs. 8,53,005.60
Add: CVD @16.48%	Rs. 1,40,575.32
Add: Education cess (3% of custom duty) = 3% of (Rs. 1,42,167.60+ Rs. 1,40,575.32)=Rs. 2,82,742.92	Rs. <u>8,482.28</u>
Total for Special CVD	Rs. 10,02,063.20
Special CVD @4%	Rs. 40,082.53

Total duty payable: Rs. 1,42,167.60

Rs. 1,40,575.32

Rs. 8,482.28

Rs. 40,082.53

Rs. 3,31,307.73

or Rs. 3,31,308

Notes:

1. Exchange rate =Rs. 68 per UK pound (date of presentation of bill of entry)
2. Section 15 of the Customs Act, 1962 provides that rate of duty shall be :-
the rate in force on the date of presentation of bill of entry
or
the rate in force on the date of entry inward
whichever is later.
3. The air freight should not exceed 20% of FOB value.
4. Where the insurance charges are not ascertainable, such cost shall be 1.125% of FOB value of the goods.

(b) Redemption fine in lieu of confiscation:

Section 125 (1) of the Custom Act, 1962 provides that whenever confiscation of goods is ordered, the adjudicating officer may give option to the owner of the goods to pay fine in lieu of confiscation, if the importation or exportation of goods are prohibited under the Act or any other law for the time being in force.

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However, if importation or exportation of goods was not prohibited, the option to pay redemption fine shall be given to owner of the goods. This is called 'redemption fine'. After payment of redemption fine, the goods are returned to the owner of goods. Section 125(2) of the Customs Act makes it clear that where any fine in lieu of confiscation of goods is imposed, the owner of goods or the person from whom the goods were seized, is liable to pay duty and charges in respect of such goods, in addition to the fine.

Limit for imposing the redemption fine

As per proviso to section 125(1) of the Customs Act, 1962, redemption fine up to market price of goods less duty chargeable thereon can be imposed. In addition, duty and other charges in respect of such goods are also payable.

- (c) Section 28BA of the Customs Act, 1962 provides for provisional attachment of property pending adjudication as under:
- (1) During the pendency of any proceeding under section 28 or 28B, the proper officer may provisionally attach any property belonging to the person to whom notice is served under section 28(1) or 28(B)(2), as the case may be, in accordance with the rules made under section 142 in this respect.
 - (2) When proper officer is of the opinion that the attachment is necessary for the purpose of protecting revenue interest, only then he can do so but before that the permission in writing from the Commissioner of Customs must be obtained.
 - (3) Such an attachment can be done for a period of six months from the date of order of Commissioner of Customs permitting for such an attachment.
 - (4) The period may be extended by Chief Commissioner of Customs for a further period or periods as he may deem fit. The reasons of such an extension shall be recorded in writing. The total period of extension in any case shall not exceed two years.
 - (5) If an application for settlement of a case is made to the Settlement Commission, period from the date of making the application to the date of an order passed by the Commission under section 127C(1) shall be excluded from the extended period mentioned in point (4) above.

Question 8

- (a) If any duty demanded or drawback paid is recoverable from a person, what is the procedure envisaged under section 142 of the Customs Act, 1962? (5 Marks)
- (b) Briefly discuss the provisions in relation to interest on drawback as per section 75A of the Customs Act, 1962. (3 Marks)
- (c) What is the time-limit provided for issuance of show-cause notice in section 28 of the Customs Act, 1962? (4 Marks)
- (d) What are the orders of Commissioner (Appeals) not appealable to Appellate Tribunal as per section 129A of the Customs Act, 1962? (3 Marks)

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Answer

- (a) Section 142 of the Customs Act provides following procedure for recovery of duty demanded or drawback paid:
- a. Deducting from any amount payable by any Customs Officer to such person.
 - b. Detaining and selling goods belonging to such person, which are under control of customs authorities;
 - c. Issuing a certificate to District Collector in whose district any property of the person is situated or where he carries on business.
 - d. Distraining and detaining any property belonging to the person and selling the same.
 - e. Recovering from successor by attaching goods, materials, machinery, plant etc. transferred to successor in trade or business.
 - f. Enforcing a bond executed under the Act.

- (b) Payment of interest on delayed payment of drawback

As per section 75A, where any drawback payable to a claimant under section 74 or 75 is not paid within a period of one month from the date of filing a claim for payment of such drawback, there shall be paid to the claimant, in addition to the amount of drawback, interest at the rate fixed under section 27A from the date after the expiry of the said period of one month till the date of payment of such drawback.

Further, if any drawback has been paid erroneously to claimant or it becomes otherwise recoverable, the claimant shall within a period of 2 months from the date of demand, pay in addition to the said amount of drawback, interest at the rate fixed under section 28AB of the Customs Act, 1962.

- (c) As per section 28, the time limit for issuance of show cause notice is as under:

- (i) In the case of import made by an individual for his personal use or by the Government or by any educational, research or charitable institution or hospital- within one year from the relevant date;
- (ii) In any other case -within six months from the relevant date.

Where any duty has not been levied or has been short levied or interest has not been charged or has been partly paid or the duty or interest has been erroneously refunded by reason of collusion or any wilful mis-statement or suppression of facts by the importer or the exporter or the agent or employee of the importer or exporter, the time period shall be extended to five years.

Where the service of the notice is stayed by an order of Court, the period of such stay shall be excluded in computing the aforesaid period of six months or one year or five years as the case may be.

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- (d) No appeal shall lie to the Appellate Tribunal and the Appellate Tribunal shall have no jurisdiction to decide any appeal in respect of any order passed by the Commissioner of Appeals under section 129A, if such order relates to:
- (i) any goods imported or exported as baggage;
 - (ii) any goods loaded in conveyance for importation into India, but which are not unloaded at their place of destination in India, or so much of the quantity of such goods as has not been unloaded at any such destination, if goods unloaded at such destination are short of the quantity required to be unloaded at that destination.
 - (iii) payment of drawback as provided in Chapter X and the rules made there under.

PART C

Question 9

- (a) State with reason whether service tax liability arises in the following cases:
- (i) Services provided by 'angadia' in undertaking delivery of documents or goods received from a customer to another person for a consideration.
 - (ii) Commission received by distributors for distribution of mutual fund units.
 - (iii) Consultancy services in the field of computer software engineering by consulting engineer. (3×2=6 Marks)
- (b) (i) What is the exemption provided to practicing Chartered Accountants under Notification No.25/2006 ST dated 13.7.2006 ? (2 Marks)
- (ii) Define the term 'gross amount charged' as per explanation (c) to section 67 of Finance Act, 1994, as amended, with reference to associated enterprises. (3 Marks)
- (iii) M, an assessee fails to pay service tax of Rs.15 lakhs payable by 5th January. He pays the amount on 16th January. What is the penalty payable by M? (4 Marks)

Answer

- (a) (i) Yes, the services provided by 'Angadia' will be covered under courier agency services. The Circular No. 96/7/2007 ST dated 23.08.2007 clarifies that angadias are covered within the definition of 'courier agency' [section 65(33) of the Finance Act, 1994 as amended]. Therefore, such services provided by angadia is liable to service tax under courier agency service.
- (ii) Yes, the services provided by distributors for distribution of mutual funds units are liable to service tax under business auxiliary service. The Circular No. 96/7/2007 ST dated 23.08.2007 clarifies that distributors receive commission from mutual fund for providing services relating to purchase and sale of mutual fund units. Services provided by such distributors are in the nature of commission agent and are, thus, liable to service tax under business auxiliary service [section 65(105)(zzb)].
- (iii) Yes, as per the Finance Act, 1994 as amended by Finance Act, 2008, "consulting services in the field of computer software engineering" have been included within

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the scope of taxable services provided by a 'consulting engineer'. Hence, the consultancy services provided in the field of computer software engineering by consulting engineer shall be liable to service tax.

- (b) (i) As per Notification No.25/2006 ST dated 13.07.2006, the taxable service provided or to be provided by a practising Chartered Accountant in his professional capacity to a client, relating to representing the client before any statutory authority in the course of proceedings initiated under any law for the time being in force, by way of issue of notice, is exempt from the whole of service tax leviable thereon.

- (ii) With effective from 10.05.2008, the definition of gross amount charged has been amended; now it reads as under:

Gross amount charged includes payment by cheque, credit card, deduction from account and any form of payment by issue of credit notes or debit notes and book adjustment, and any amount credited or debited, as the case may be, to any account, whether called "suspense account" or by any other name, in the books of account of a person liable to pay service tax, where the transaction of taxable service is with any associated enterprise.

Here, associated enterprise has the meaning assigned to it in section 92A of the Income tax Act, 1961.

- (iii) Penalty payable is:

- (a) 2% of the amount of default per month

In this case, delay is of 11 days. Therefore,

$$\text{Amount} = 2\% \text{ of } (15,00,000 \times 11/31) = \text{Rs} 10,645$$

or

- (b) Penalty @Rs. 200 per day of default

$$= \text{Rs.} 200 \text{ per day} \times 11 = \text{Rs } 2,200$$

whichever is higher

Thus, penalty payable is Rs 10,645.