

No. of Questions: 6

AG

Total Marks: 100

No. of Pages Printed: 7

Time Allowed: 3 Hours

Answer all Questions

All Working notes should form part of your Answer

1. X Ltd. and Z Ltd. are subsidiaries of H Ltd.

H Ltd's accounts for the year ended 31st March 2006 have been prepared. In respect of the income from the subsidiaries H Ltd. accounts only for dividend, if any, received from them.

Particulars in respect of the subsidiaries are given.

Particulars	X Ltd Rs.	Y Ltd Rs.	Z Ltd. Rs.
Equity share capital of Rs.100 each on the date of respective balance sheets	50,00,000	80,00,000	1,20,00,000
12% Cumulative preference share capital of Rs.100 each Financial year ends on	5,00,000	-	10,00,000
Financial year ends on	31 st march	31stDec	31 st Oct
Equity dividend received in 2005-06 by H Ltd. in respect of earlier years from	-	-	14,00,000
Equity dividend received in 2005-06 by H Ltd. in respect of earlier years from	7,50,000	-	-
Total divisible profit for the last year	15,00,000	18,00,000	25,00,000
Total undistributed profits for earlier years since they became subsidiaries of H Ltd.	32,00,000	40,00,000	60,00,000

Y Ltd purchased fixed assets for Rs.6,00,000 and lent an amount of Rs.4,00,000 upto 31st March 2006 since the last closing. Z Ltd purchased investments for Rs.7,20,000 and borrowed Rs.3,50,000 upto 31st March 2006 since the last closing.

H Ltds schedule of investments as on 31st March 2006 includes inter alia, the following;

Rs.

40,000 Equity shares of X Ltd@Rs.120 per share	48,00,000
72,000 Equity shares of Y Ltd@Rs.110 per share	79,20,000
84,000 Equity shares of Z Ltd @ Rs.150 per share	1,26,00,000
3,000 12% Cumulative Preferences shares of X Ltd.@Rs.100 each	3,00,000
7,000 12% Cumulative Preferences shares of Z Ltd@Rs.100 each	7,00,000
	<u>2,63,20,000</u>

Prepare the statement pursuant to section 212 of the Companies Act, 1956 to be furnished along with the accounts of H Ltd for the year ended 31st March 2006.

(16 Marks)

2. The Balance Sheet of S Limited as on 31st March, 2007 was as follows:

Liabilities	Amount (Rs)	Assets	Amount (Rs)
5,00,000 Equity Shares of Rs.10 each fully paid	50,00,000	Goodwill	10,00,000
9% 20,000 Preference shares of Rs.100 each fully paid	20,00,000	Patent	5,00,000
10% First debentures	6,00,000	Land and Building	30,00,000
10% Second debentures	10,00,000	Plant and Machinery	10,00,000
Debentures interest outstanding	1,60,000	Furniture and Fixtures	2,00,000
Trade creditors	5,00,000	Computers	3,00,000
Director's loan	1,00,000	Trade Investment	5,00,000
Bank O/D	1,00,000	Debtors	5,00,000
Outstanding liabilities	40,000	Stock	10,00,000

Provision for Tax	1,00,000	Discount on issue of debentures	1,00,000
		Profit and Loss Accounts (Loss)	15,00,000
	96,00,000		96,00,000

Note: Preference dividend is in arrears for last three years.

A holds 10% first debentures for Rs. 4,00,000 and 10% second debentures for Rs. 6,00,000. He is also creditors for Rs. 1,00,000. B holds 10% first debentures for Rs. 2,00,000 and 10% second debentures for Rs. 4,00,000 and is also creditors for Rs. 50,000.

The following scheme of reconstruction has been agreed upon and duly approved by the court.

- (i) All the equity shares be converted into fully paid equity shares of Rs. 5 each.
- (ii) The preference shares be reduced to Rs. 50 each and the preference shareholders agree to forego their arrears of preference dividends in consideration of which 9% preference shares are to be converted into 10% preference shares.
- (iii) Mr. 'A' is to cancel Rs. 6,00,000 of his total debt including interest on debentures and to pay Rs. 1 lakh to the company and to receive new 12% debentures for the Balance amount.
- (iv) Mr. 'B' is to cancel Rs. 3,00,000 of his total debt including interest on debentures and to accept new 12% debentures for the balance amount.
- (v) Trade creditors (other than A and B) agreed to forego 50% of their claim.
- (vi) Directors to accept settlement of their loans as to 60% thereof by allotment of equity shares and balance being waived.
- (vii) There were capital commitments totalling Rs. 3,00,000. These contracts are to be cancelled on payment of 5% of the contract price as a penalty.
- (viii) The Directors refund Rs. 1,10,000 of the fees previously received by them.
- (ix) Reconstruction expenses paid Rs. 10,000.
- (x) The taxation liability of the company is settled at Rs. 80,000 and the same is paid Immediately.
- (xi) The assets are revalued as under:

	(Rs)
Land and Building	28,00,000
Plant and Machinery	4,00,000
Stock	7,00,000
Debtors	3,00,000
Computers	1,80,000
Furniture and Fixtures	1,00,000
Trade Investment	4,00,000

Pass Journal entries for all the above mentioned transactions including amounts to be written off of Goodwill, Patents, Loss in Profit & Loss Account and Discount on issue of debentures. Prepare Bank Account and working of allocation of Interest on Debentures between A and B.

(16 Marks)

3. It was agreed by all parties that L Ltd. would acquire R Ltd. a small manufacturing company on 1st July 2006. R Ltd. was to be wound up and its books closed subsequent to the payment by L Ltd. of the net sum due in respect of its collection of the debtors and its payment of the creditors of R Ltd. on behalf of that company. The summary balance sheet of R Ltd. as on 30th June 2006.

R Ltd Balance sheet as on 30th June 2006

	Rs	Rs
Authorised and Issued share capital:		
20,000 10%Preference shares of Rs.10 each fully paid		2,00,000
1,00,000 equity shares of Rs.10 each fully paid		10,00,000
Capital Reserves		3,50,000
Profit and Loss A/c		1,70,000
12% Debentures		5,00,000
		<u>22,20,000</u>
Goodwill		1,40,000
Other fixed assets		10,00,000
Current assets:		
Stocks and work in progress	4,50,000	
Sundry debtors	8,00,000	
Cash at bank	1,50,000	
	<u>14,00,000</u>	
Less: Current Liabilities		
Sundry creditors	3,20,000	10,80,000
		<u>22,20,000</u>

The take over terms required that on 1st July 2006, the agreed purchase consideration would be Rs.10 each in L Ltd. fully paid, for every 2 shares held;

- A) the issue at par to the preference shareholders of R Ltd. of 312% preference shares of Rs.10 each in L Ltd. fully paid for every 2 shares held;
- B) the issue to the equity shares of Rs.10 each in L Ltd. credited as Rs.7.50 paid up, for every 5 shares held;
- C) the issue to the debenture holders of R Ltd. of such number of 10% debentures of Rs.100 each in L Ltd. so as to maintain the same amount of interest.

The purchase contract agreed that L Ltd. would take over only the fixed assets and the stock and work in progress of R Ltd, the balance of the purchase price being a payment for goodwill, it was agreed that L Ltd. would collect the debts and settle the creditors of R Ltd., paying over the net balance in cash to that company after the retention of a service charge of 1% on the sums collected and $\frac{1}{2}\%$ on the sums paid.

In completing these transaction, bad debts of Rs.45,000 arose. Discounts received by L Ltd. for early payment of some creditors amounted to Rs.12,000. R Ltd. debenture holders interest had been paid upto 30th June 2006, but the preference dividend for 2005-06 which had not been provided for, was paid in the winding up process. R Ltd. incurred and paid wind up cost of Rs.8,620.

For the determination of the purchase price settled by L Ltd., property included in R Ltd. fixed assets was valued at Rs.1,20,000 more than shown in the books. The remaining fixed assets over subjected to additional depreciation of Rs.45,000. the stock and work in progress was valued at Rs.4,15,000. these values were to be reflected in the opening entries on the books of L Ltd. but no adjusting entries were made in the books of R Ltd.

You are required to:

- A) Show the necessary ledger accounts to close the books of R Ltd.
- B) show your calculation of and state the cost of goodwill acquired by L Ltd. how such goodwill can be treated in the books of L Ltd. ignore taxation.

(16Marks)

- 4a.** M & P Ltd acquired 100% of the ordinary share capital of MC Ltd on 1 April 2006. The following balance sheets of the two companies existed at 31 March 2006:

	M & P Ltd Rs.000	MC Ltd Rs.000
Tangible fixed assets	7,000	8,000
Working capital	20,000	3,000
	27,000	11,000

M&P Ltd share capital (Rs.1 shares)	3,000	-
MC Ltd share capital (Rs.2 shares)	-	2,000
Share premium	1,000	4,000
P&L account	23,000	5,000
	27,000	11,000

Additional information:

1. Fair values of tangible fixed assets for MC Ltd were Rs.1,000,000 greater than shown in the balance sheet at acquisition.
2. The Market price of M&P Ltd shares was Rs.4 at the time of the acquisition. The acquisition was achieved through a cash offer of Rs.16,000,000.
3. The above balance sheets for the two companies are stated immediately prior to the acquisition.

i) Prepare the consolidated balance sheet of the group after the acquisition and provide a brief explanation of any adjustments that you have made.

(8 Marks)

ii) Explain how the consolidated balance sheet would differ if the acquisition was achieved through a share swap of four M&P Ltd shares for one MC Ltd share (calculations are not required).

(4 Marks)

4b. Enumerate the stages involved in a yield based valuation of equity shares.

(4 Marks)

5a. The following information is available of a concern; calculate E.V.A.:

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

(8 Marks)

- 5b.** On 24th January, 2006 A of Chennai sold goods to B of Washington, U.S.A. for an invoice price of \$40,000 when the spot market rate was Rs.44.20 per US \$. Payment was to be received after three months on 24th April, 2006. To mitigate the risk of loss from decline in the exchange-rate on the date of receipt of payment, A immediately acquired a forward contract to sell on 24th April, 2006 US \$ 40,000 @ Rs.43.70. A closed his books of account on 31st March, 2006 when the spot rate was Rs.43.20 per US \$. On 24th April, 2006, the date of receipt of money by A1, the spot rate was Rs.42.70 per US \$.
- (8 Marks)**
- 6a.** Discuss with reference to the Accounting Standards, the nature of classification and disclosure requirements in the statement of profit and loss of an entity in the following cases
- (i) Losses sustained as a result of enemy action.
- (ii) Disposal of long-term investments of a trading entity.
- (4 Marks)**
- 6b.** C Ltd. launched a project for producing product S in October, 2004. The Company incurred Rs.20 lakhs towards Research and Development expenses upto 31st March, 2006. Due to prevailing Market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to Defer the expenditure write off to future years.
- Advise the Company as per the applicable Accounting Standard.
- (4 Marks)**
- 6c.** In April, 2006 a Limited Company issued 1,20,000 equity shares of Rs. 100 each. Rs. 50 per share was called up on that date which was paid by all shareholders. The remaining Rs. 50 was called up on 1.9.2006. All shareholders paid the sum in September, 2006, except one shareholder having 24,000 shares. The net profit for the year ended 31.3.2007 is Rs. 2,64,000 after dividend on preference shares and dividend distribution tax of Rs. 64,000. Calculate basic earnings per share.
- (4 Marks)**
- 6d.** Explain the treatment of intra-segment transactions while preparing segment reports.
- (4 Marks)**
- 6e.** A private limited company manufacturing fancy terry towels had valued its closing stock of inventories of finished goods at the realizable value, inclusive of profit and the export cash incentives. Firm contracts had been received and goods were packed for export, but the ownership in these goods had not been transferred to the foreign buyers. Comment on the valuation of the stocks by the company.
- (4 Marks)**

PRIME ACADAMY

26TH SESSION MODEL EXAM

FINAL - ADVANCED ACCOUNTING (ANSWERS)

1. Annexure to the Accounts of H Ltd.

Statement pursuant to sec 212 of the companies act, 1956 relating to subsidiary cos.

1.Financial year of the subsidiary ended on	X Ltd 31 st March 94	Y Ltd. 31 st Dec 93	Z Ltd 31 st Oct 93
2(A) No. of equity shares of subsidiary company held at the end of the financial year extent of holding.	40,000 80%	72,000 90%	84,000 70%
2(B) No. of preference shares of subsidiary company held a the end of the financial year extent of holding	3000 60%	-	7000 70%
3.Net aggregate amounts of profits less losses of the subsidiary for the year as above so as far it concerns members of H Ltd a) Dealt with in the accounts of H Ltd b)Not dealt with in the accounts of H Ltd			

	36,000	-	14,84,000
	11,52,000	16,20,000	2,66,000
4.Net aggregate amounts of profits less losses of the subsidiary for the year as above so as far it concerns members of H Ltd			
a) Dealt with in the accounts of H Ltd			
b) Not dealt with in the accounts of H Ltd	7,50,000	-	-
	18,10,000	36,00,000	42,00,000
5.Change of interest of H Ltd. in the subsidiary between the end of the financial year of the subsidiary and that of H Ltd.	-	-	-
6.Material changes between the end of the financial year of the subsidiary and that of H Ltd.			
A)Fixed assets			
B)investments	-	+ 6,00,000	-
C)moneys lent by subsidiary	-	-	+ 7,20,000
D)moneys borrowed by subsidiary for any purpose other than that of meeting current liabilities	-	+ 4,00,000	-
	-	-	+ 3,50,000

2. Journal Entries in the Books of Y Ltd.

Dr. Cr.

Rs. Rs.

(i) Equity Share Capital (Rs. 10 each) A/c Dr. 50,00,000

To Equity Share Capital (Rs. 5 each) A/c 25,00,000

To Reconstruction A/c	25,00,000
-----------------------	-----------

(Being conversion of 5,00,000 equity shares of Rs. 10 each fully paid into same number of fully paid equity shares of Rs. 5 each as per scheme of reconstruction.)

(ii) 9% Preference Share Capital (Rs.100 each) A/c Dr. 20,00,000

To 10% Preference Share Capital (Rs.50 each) A/c	10,00,000
--	-----------

To Reconstruction A/c	10,00,000
-----------------------	-----------

(Being conversion of 9% preference share of Rs. 100 each into same number of 10% preference share of Rs. 50 each and claims of preference dividends settled as per scheme of reconstruction.)

(iii) 10% First Debentures A/c Dr.	4,00,000
------------------------------------	----------

10% Second Debentures A/c Dr.	6,00,000
-------------------------------	----------

Trade Creditors A/c Dr.	1,00,000
-------------------------	----------

Interest on Debentures Outstanding A/c Dr.	1,00,000
--	----------

Bank A/c Dr.	1,00,000
--------------	----------

To 12% New Debentures A/c	7,00,000
---------------------------	----------

To Reconstruction A/c	6,00,000
-----------------------	----------

(Being Rs. 6,00,000 due to A (including creditors) cancelled and 12% new debentures allotted for balance amount as per scheme of reconstruction)

(iv) 10% First Debentures A/c Dr.	2,00,000
-----------------------------------	----------

10% Second Debentures A/c Dr.	4,00,000
-------------------------------	----------

Trade Creditors A/c Dr.	50,000
-------------------------	--------

Interest on Debentures Outstanding A/c Dr.	60,000
--	--------

To 12% New Debentures A/c 4,	10,000
------------------------------	--------

To Reconstruction A/c	3,00,000
-----------------------	----------

(Being Rs. 3,00,000 due to B (including creditors) cancelled and 12% new debentures allotted for balance amount as per scheme of reconstruction.)

(v) Trade Creditors A/c Dr.	1,75,000
-----------------------------	----------

To Reconstruction A/c		1,75,000
(Being remaining creditors sacrificed 50% of their claim.)		
(vi) Directors' Loan A/c Dr.	1,00,000	
To Equity Share Capital (Rs. 5) A/c		60,000
To Reconstruction A/c		40,000
(Being Directors' loan claim settled by issuing 12,000 equity shares of Rs. 5 each as per scheme of reconstruction.)		
(vii) Reconstruction A/c Dr.	15,000	
To Bank A/c		15,000
(Being payment made for cancellation of capital commitments.)		
(viii) Bank A/c Dr.	1,10,000	
To Reconstruction A/c		1,10,000
(Being refund of fees by directors credited to reconstruction A/c.)		
(ix) Reconstruction A/c Dr.	10,000	
To Bank A/c		10,000
(Being payment of reconstruction expenses.)		
(x) Provision for Tax A/c Dr.	1,00,000	
To Bank A/c		80,000
To Reconstruction A/c		20,000
(Being payment of tax for 80% of liability in full settlement.)		
(xi) Reconstruction A/c Dr.	47,20,000	

To Goodwill A/c	10,00,000
To Patent A/c	5,00,000
To Profit and Loss A/c	15,00,000
To Discount on issue of Debentures A/c	1,00,000
To Land and Building A/c	2,00,000
To Plant and Machinery A/c	6,00,000
To Furniture & Fixture A/c	1,00,000
To Computers A/c	1,20,000
To Trade Investment A/c	1,00,000
To Stock A/c	3,00,000
To Debtors A/c	2,00,000

(Being writing off of losses and reduction in the value of assets as per scheme of reconstruction.)

Working Notes:

(1) Outstanding interest on debentures have been allocated between A and B as follows:

A's Share	Rs.
10% First Debentures 4,00,000	
10% Second Debentures 6,00,000	10,00,000
10% on Rs. 10,00,000 i.e. (A)	1,00,000
B's Share	
10% First Debentures 2,00,000	
10% Second Debentures 4,00,000	6,00,000
10% on Rs. 6,00,000 i.e. (B)	60,000
Total (A) + (B)	1,60,000

(2) Bank Account

Rs.

Rs.

To A (reconstruction)	1,00,000	By Balance b/d	1,00,000
To Reconstruction A/c		By Reconstruction A/c	15,000
(paid by directors)	1,10,000		
(capital commitment penalty paid)		By Reconstruction A/c	
		(reconstruction expenses paid)	10,000
		By Provision for tax A/c(tax paid)	80,000
	-----	By Balance c/d	<u>5,000</u>
	2,10,000		2,10,000

3A. R Ltd Realisation Account

	Rs.		Rs.
To Goodwill	1,40,000	By creditors discount received	12,000
To Other fixed assets	10,00,000	By L Ltd. purchase Consideration	21,00,000
To stock and work in progress	4,50,000		
To Debtors bad debts	45,000		
To L Ltd. Service charges	9,090		
To Debenture holders a/c	1,00,000		
To Preference shareholders a/c	1,00,000		
Bank A/c preference div. winding up costs	20,000 8,620		
To Equity shareholders a/c profit in realization	2,39,290		<u>21,12,000</u>

	<u>21,12,000</u>		
--	------------------	--	--

Bank Account	Rs.		Rs.
To Balance b/d	1,50,000	By Realisation A/c	
		-preference div.	20,000
		-winding up costs	8,620
To L Ltd (Net remittance)	4,37,910	By Equity shareholders A/c	5,59,290
	<u>5,87,910</u>	-balance paid	
			<u>5,87,910</u>

L Ltd. Account	Rs.		Rs.
To Realisation A/c	21,00,000	By Creditors amount paid	3,08,000
		By Realisation A/c service charges	9,090
		By Bank A/c balance received	4,37,910
		By preference shares in L	3,00,000
To Debtors amount collected	7,55,000	By 10% Debentures in L Ltd.	6,00,000
		By Equity shares in L Ltd	12,00,000
	<u>28,55,000</u>		<u>28,55,000</u>

Debenture holders Account

To 10% Debentures in L Ltd.	Rs. 6,00,000	By 12% Debenture A/c	Rs. 5,00,000
		By Realization A/c premium on conversion	1,00,000
	<u>6,00,000</u>		<u>6,00,000</u>

Sundry shareholders Account

	Pref Rs.	Equity Rs.		Pref Rs.	Equity Rs.
To Preference shares in L Ltd	3,00,000	-	By share capital	2,00,000	10,00,000
To Equity share in L Ltd.	-	12,00,000	By Realisation A/c	1,00,000	-
To Bank A/c final settlement	-	5,59,290	By Realization A/c profit	-	2,39,290
			By profit & Loss A/c	-	1,70,000
			By Capital reserve	-	3,50,000
	<u>3,00,000</u>	<u>17,59,290</u>		<u>3,00,000</u>	<u>17,59,290</u>

Working notes;

Computation of purchase consideration

Particulars	Amount Rs.	Form
Debenture holders of R Ltd $6000 \times \text{Rs.}100$	6,00,000	6000 10% Debentures in L Ltd.
Preference shareholders of R Ltd; $20000 \times \frac{3}{2} \times \text{Rs.}10$	3,00,000	12% preference shares in L Ltd.
Equity shareholders of R Ltd; $1,00,000 \times \frac{8}{5} \times \text{Rs.}7.50$	12,00,000	1,60,000 equity shares in L Ltd.

3A. Calculation of goodwill acquired by L Ltd;

Assets acquired	Rs.
Fixed assets	10,75,000
Stock and work in progress	<u>4,15,000</u>
	14,90,000
Less; Purchase consideration	<u>21,00,000</u>
Purchased goodwill	<u>6,10,000</u>

4. a.

	Rs.000	Rs.000	
Cost of investment		19,200	
Equity @ 28 February 2003	25,000		
Less: transactions during year			
• Revaluation	(500)		$\frac{1}{2}$
• Retained profit for year (W1)	(900)		$\frac{1}{2}$
• Rights issue (W2)	(5,500)		$\frac{1}{2}$
Net assets on BS @ 1 March 2002	18,100		
Add: Fair Value adjustments (500+100-50-20)	530		1
FV of assets	18,630		
	x 80%		$\frac{1}{2}$
FV of assets acquired		(14,904)	
Goodwill		4,296	$\frac{1}{2}$
(W1)			
Earnings for the year since acquisition		Rs.1.5 million	
Less: Dividends paid		(Rs.0.6 million)	$\frac{1}{2}$
Retained profits for year		Rs.0.9 million	$\frac{1}{2}$
(W2)			
Rights issue shares (2.5 million x 1/5)		(0.5 million)	1

Share capital raised since acquisition

**Rs.5.5
million**

Goodwill should be written off against consolidated profit and loss over an appropriate period; presumed to be no more than 20 years but can be rebutted; if taken as more than 20 years an impairment review must be done every year.

(N.B Full credit should be given for alternative methodologies to calculate goodwill)

(i) Balance sheet:

	M&P Group Rs.000	
Goodwill	4,000	W1
Tangible fixed assets	16,000	W2
Working capital	7,000	W3
	27,000	

M &P plc Share capital (Rs.1 shares)	3,000	W4
Share premium	1,000	W5
P&L account	23,000	W7
	27,000	

Presentation

 $\frac{1}{2}$

	Workings	
W1	Cost of investment to M&P @ FV = = Rs.16m Less: Equity acquired @ FV = (11m+1m) = Rs.12 m Goodwill = Rs.4m	1 $\frac{1}{2}$

	Note: (Rs.2m /Rs.2 = 1 million shares) – acquired 100% of MC shares Goodwill is the additional amount paid for the business above the fair value of the individual net assets acquired	
W2	M&P Rs.7m + MC Rs.8m + Rs.1m at FV = Rs.16 m	1
W3	M&P Rs.20m + MC Rs.3m - Rs.16m consideration = Rs.7 m All assets controlled by the group should be combined at their fair value	$\frac{1}{2}$ 1
W4	M&P only = Rs.3 m Share capital	1
W5	M only = Rs.1 m Share premium The ownership of the assets controlled are shown under capital and reserves; post acquisition the assets are owned by the holding company and any minority interests (nil here with the 100% acquisition)	$\frac{1}{2}$ 1
W6	M&P only = Rs.23m MC P&L is pre-acquisition	$\frac{1}{2}$ $\frac{1}{2}$

		(8)
--	--	------------

(ii) Goodwill – calculation of goodwill would be exactly the same except the consideration would be made up as the market value of the M&P shares swapped (4 shares x Rs.4 market value x 1 million MC shares = Rs.16 million). $\frac{1}{2}$

Tangible Fixed Assets – would be combined in exactly the same way (ie at fair value). $\frac{1}{2}$

Working Capital – would be combined in full (no cash paid). $\frac{1}{2}$

Share capital – would need to include the new shares in issue (3 million original + 4 million new = Rs.7 million). 1

Share Premium – needs to show the difference between the nominal value of shares issued and the market value of the consideration (ie Rs.16 million - Rs.4 million). 1

Profit and loss – will be exactly the same. $\frac{1}{2}$

(note : calculations are for illustration only – they are **not** required to get the marks)

4b) The stages involved in computing the value of shares based on yield are the followings;

i) Determining the future maintainable profit

ii) Establishing the total capital employed and its structure.

iii) Determining the yield. the yield depends on a number of factors like pure rate of interest, extent of normal risk, any special commercial risk, financial risk etc.

iv) Dividend estimation for non growth company. Estimate the dividend expected to be paid and capitalise it at the yield.

v) Growth estimation. if the company is a growth oriented company, estimate the rate of growth in profits per annum.

5a) E.V.A. = NOPAT – COCE

NOPAT = Net Operating Profit after Tax

COCE = Cost of Capital Employed

COCE = Weighted Average Cost Of Capital Average Capital Employed
= WACC Capital Employed

Debt Capital Rs.2,000 crores

Equity capital 500 + 7,500 = Rs.8,000 crores

Capital employed = 2,000+8,000 = Rs.10,000 crores

Debt to capital employed = 0.20

Debt cost before Tax 12%

Less: Tax (30% of 12%) 3.6%

Debt cost after Tax 8.4%

According to Capital Asset Pricing Model (CAPM)

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

Or

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

= 9 + 1.05 * (19-9)

= 9 + 1.05 * 10 = 19.5%

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

= 0.8x 19.5% + 0.20x 8.40%

= 15.60% + 1.68% = 17.28%

COCE = WACC x Capital employed

= 17.28% x 10,000 crores = 1728 crores

E.V.A. = NOPAT – COCE

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

5b. Journal Entries in the books of A

2006	Rs.	Rs.
Jan. 24 B Dr.	17,68,000	
To Sales Account		17,68,000
(Credit sales made to B of Washington, USA for \$40,000 recorded at spot market rate of Rs.44.20 per US \$)		
” ” Forward (Rs.) Contract Receivable Account Dr.	17,48,000	
Deferred Discount Account Dr.	20,000	
To Forward (\$) Contract Payable		17,68,000
(Forward contract acquired to sell on 24th April, 2006 US \$40,000 @ Rs.43.70)		
March 31 Exchange Loss Account Dr.	40,000	
To B		40,000
(Record of exchange loss @ Re.1 per \$ due to market rate becoming Rs.43.20 per US \$ rather than Rs.44.20 per US \$)		
” ” Forward (\$) Contract Payable Dr.	40,000	
To Exchange Gain Account		
(Decrease in liability on forward contract due to fall in exchange rate)		
		40,000
” ” Discount Account Dr.	14,667	
To Deferred Discount Account		
(Record of proportionate discount expense for 66 days out of 90 days)		
		14,667
Prime / March 08 Model Exam.	22	

April 24 Bank Account Dr.	17,08,000	
Exchange Loss Account Dr.	20,000	
To B		17,28,000

(Receipt of \$40,000 from B, USA customer @
Rs.42.70 per US \$; exchange loss being Rs.20,000)

" " Forward (\$) Contract Payable Account Dr. 17,28,000

To Exchange Gain Account	20,000
To Bank Account	17,08,000

(Settlement of forward contract by payment of
\$40,000)

" " BankAccount Dr. 17,48,000

" " To Forward (Rs.) Contract Receivable	17,48,000
--	-----------

(Receipt of cash in settlement of forward contract
receivable)

" " Discount Account Dr. 5,333

To Deferred Discount Account	5,333
------------------------------	-------

(Recording of discount expense for 24 days:
Rs..20,000 Rs.5,333 90 days 24 days)

6a. (i) Losses sustained as a result of enemy action constitute an extraordinary item since it is an event which is clearly distinct from the ordinary activities of the enterprise and is not expected to recur frequently or regularly. As per AS 5, the nature and amount of each 26 extraordinary item should be separately disclosed in a manner that its impact on current profit or loss can be perceived.

6b. As per Para 41 of AS 26 "Intangible Assets", expenditure on research should be recognized as an expense when it is incurred. An intangible asset arising from development (or from Prime / March 08 Model Exam. 23

the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the conditions specified in para 44 of the standard. An intangible asset (arising from development) should be derecognised when no future economic benefits are expected from its use according to para 87 of the standard. Therefore, the manager cannot defer the expenditure write off to future years. Hence, the expenses amounting Rs. 20 lakhs incurred on the research and development project has to be written off in the current year ending 31st March, 2006.

6c. Basic earnings per share (EPS) =

Weighted average number of equity shares outstanding during the year

Net profit attributable to equity shareholders= Rs.3

88,000 shares (as calculated in working note) Rs.2,64,000

Working Note:

Calculation of weighted average number of equity shares

	Number of shares	Nominal value of shares	Amount paid
1st April, 2006	1,20,000	100	50
1st September, 2006	96,000	100	100
	24,000	100	50

As per para 19 of AS 20 on Earnings per share, Partly paid equity shares are treated as a fraction of equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period. Assuming that the partly paid shares are entitled to participate in the dividends to the extent of amount paid, weighted average number of shares will be calculated as:

Shares

$$120000 \times \frac{1}{2} \times \frac{5}{12} = 25,000$$

$$96,000 \times \frac{7}{12} = 56,000$$

$$24,000 \times \frac{2}{7} \times \frac{7}{12} = 7,000$$

88,000 shares

6d. Treatment of intra-segment transactions while preparing segment reports can be explained as follows:

- (i) Prior Determination of item: Segment Revenue, Segment Expense, Segment Assets and Segment Liabilities are determined before intra-enterprise balances.

- (ii) Elimination: Intra-enterprise transactions are eliminated as part of the process of preparation of enterprise Financial Statements.
- (iii) No-elimination: When intra-enterprise balances and transactions are within a single segment, they are NOT eliminated.

6e. AS – 2 On valuation of inventories suggests that inventories shall be valued at lower of cost and net realizable value. Based on this fact the closing stock of the finished goods should have been valued at cost, as the same is lower than the realizable value. Also export cash incentive should not be included for the purpose of valuation of closing stock. Hence the policy adopted by the company for valuing its closing stock of inventory of finished goods on selling price + export incentives is not correct.

MS

No of Questions: 6

Total Marks: 100

No of Pages Printed: 3

Time Allowed: 3 Hours

Answer any Five Questions

All Working notes should form part of your Answer

1. ABC Ltd. sells computer services to its clients. The company has recently completed a feasibility study and decided to acquire an additional computer, the details of which are as follows:
 1. The purchase price of the computer is Rs.2,30,000: maintenance, property taxes and insurance will be Rs.20,000 per year. The additional expenses to operate the computer are estimated at Rs.80,000. If the computer is rented from the owner, the annual rent will be Rs.85,000, plus 5% of annual billings. The rent is due on the last day of each year.
 2. Due to competitive conditions, the company feels that it will be necessary to replace the computer at the end of three years with a more advanced model. Its resale value is estimated at Rs.1,10,000.
 3. The corporate income tax rate is 50% and the straight line method of depreciation is followed.
 4. The estimated annual billing for the services of the new computer will be Rs.2,20,000 during the first year, and Rs.2,60,000 during the subsequent two years.

5. If the computer is purchased, the company will borrow to finance the purchase from a bank with interest at 16% per annum. The interest will be paid regularly, and the principal will be returned in one lump sum at the end of the year 3.

Should the company purchase the computer or lease it? Assume (i) cost of capital as 12% (ii) straight line method of depreciation, (iii) salvage value of Rs.1,10,000 and evaluate the proposal from the point of view of lessor also.

(20 Marks)

- 2(a)** From the following particulars, calculate the effective interest p.a as well as the total cost of funds to ABC Ltd., which is planning a CP issue:

Issue Expenses			
Issue price of CP	————→ Rs.97.350	Brokerage	: 0.12% for 3 months
Face Value	————→ Rs.1,00,000	Rating Charges	: 0.5% p.a
Maturity period	————→ 3 months.	Stamp duty	: 0.125% for 3 months.

(6 Marks)

- 2(b)** Distinguish between:

(i) Forward and Futures contracts

(ii) Intrinsic value and Time value of an option.

(8 Marks)

2(c) A Mutual Fund having 300 units has shown is NAV of Rs.8.75 and Rs.9.45 at the beginning and at the end of the year respectively. The Mutual Fund has given two options:

- (i) Pay Rs.0.75 per unit as dividend and Rs.0.60 per unit as a capital gain, or
- (ii) These distributions are to be reinvested at an average NAV of Rs.8.65 per unit.

What difference it would make in terms of return available and which option is preferable? **(6 Marks)**

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

	Exchange Rates	Currency Futures
Us \$/Rs.	US \$ / Rs	Contract size Rs. 4,72,000
Spot	0.02140	June 0.02126
1 month		
Forward	0.02136	September 0.02118
3 Months	Forward	0.02127

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

On September 1,2005 the spot rate US \$/Re.is 0.02133 and currency future rate is 0.2134. Comment which of the following methods would be most advantageous for XYZ Ltd.

- a. Using forward contract
- b. Using currency futures

c. Not hedging currency risks

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

(10 Marks)

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

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

Annualised interest rate for 6 months – Rupee = 12%

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

Is there any arbitrage possibility? If yes how an arbitrageur can take advantage of the situation.

If he is willing to borrow Rs.40,00,000 or US \$ 83.312.

(5 Marks)

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

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

Calculate the NPV of the project using foreign currency approach. Required rate of return on this project is 14%. (5

Marks)

- 4(a)** The historical rates of return of two securities over the past ten years are given. Calculate the Covariance and the Correlation coefficient of the two securities:

Years	1	2	3	4	5	6	7	8	9	10
Security 1 (return percent)		12	8	7	14	16	15	18	20	16
22 Security 2 (return percent)			20	22	24	18	15	20	24	25
22 20										

(10 Marks)

- 4(b)** Write brief note on Leveraged Buyouts (LBOs)

(4 Marks)

- 4(c)** Find the Current market price of a bond having face value of Rs.1,00,000 redeemable after 6 year maturity with YTM at 16% payable annually and duration 4.3202 years. Given $1.16^6 = 2.4364$.

(6 Marks)

- 5(a)** From the following data for Government securities, calculate the forward rates:

Face value (Rs)	Interest rate	Maturity (Year)	Current Price (Rs)
1,00,000	0%	1	91,500
1,00,000	10%	2	98,500
1,00,000	10.5%	3	99,000

(6 Marks)

- 5(b)** On the basis of the following information:

Current dividend (Do) = Rs.2.50

Discount rate (k) = 10.5%

Growth rate (g) = 2%

(i) Calculate the present value of stock of ABC Ltd.

(ii) Is its stock overvalued if stock price is Rs.35, ROE = 9% and EPS = Rs.2.25? show detailed calculations.

(6 Marks)

- 5(c)** (i) What are derivatives?

(ii) Who are the users and what are the purposes of use?

(iii) Enumerate the basic differences between cash and derivatives market.

(8 Marks)

6(a) Briefly explain the objectives of “Portfolio Management”.

(6 Marks)

6(b) What is the procedure for the book building process? Explain the recent changes made in the allotment process.

(6 Marks)

6(c) Write short notes on:

(i) Assumptions of CAPM.

(ii) Determinants of Dividend Policy.

(2 x 3 = 6 Marks)

6(d) What is Credit rating?

(2 Marks)

PRIME ACADAMY

26TH SESSION MODEL EXAM

FINAL – MANAGEMENT ACCOUNTING AND FINANCIAL MANAGEMENT

1 Step 1: Compute Present Value of Purchase Option

Purchase Price	2,30,000
Less: Present Value of Tax saved on depreciation	(51,542)
Less: Present Value of Net Salvage Value	(87,340)
Add: Present Value Of Differential Operating Cost	25,771
PVPO	1,16,889

Working Note1: Present Value of Tax saved on depreciation

Purchase Price	2,30,000
Sale Value	1,10,000
Depreciable Value	1,20,000
Number of Years	3
Annual Depreciation	40,000
Tax Rate	50.00%
Tax Saved on depreciation	20,000

Appropriate Discount rate	8.0%
PVAF	2.577
Present Value	51,542

Working Note2: PV of Net Salvage Value

Sale Value	1,10,000
WDV	1,10,000
Profit	0
Tax	0
Net Sale Value	1,10,000
PVF	0.794
Present Value	87,340

Working Note3: PV of Differential Operating Cost

Cost of Maintainance,property etc	20,000
Tax Saved	10,000
Post Tax Cost	10,000
No of Years	3
PVAF	2.577
Present Value of Annuity	25771

Step 2: Present Value of Lease Option

Year	Rental	Discount factor	Present Value
1	48,000	0.926	44,448
2	49,000	0.857	41,993
3	49,000	0.794	38,906
Total			1,25,347

Working note 4: Lease Rental

Details	Year 1	Year 2	Year 3
Annual Billing	2,20,000	2,60,000	2,60,000
Rental – Fixed	85,000	85,000	85,000
- Variable at 5%	11,000	13,000	13,000
Total	96,000	98,000	98,000
Tax Saved 50%	48,000	49,000	49,000
After Tax	48,000	49,000	49,000

Conclusion: Purchase Option is cheaper and is preferred.

Assumptions:

1. The appropriate discount rate is the after tax cost of debt since leasing is an alternative to borrowing
2. Maintenance, property tax and insurance is payable by owner, not lessee
3. At the end of the useful life asset is sold by ABC as owner. Hence as lessee they will not buy the asset
4. Expenses to operate computer Rs.80,000 are common to the two alternatives and are hence ignored

Evaluation from lessor's view point

Step 1: Initial Flow

2, 30,000

Step 2: In between Flows

Details	Year 1	Year 2	Year 3
Lease Rental Income	96,000	98,000	98,000
Less: Property tax etc	(20,000)	(20,000)	(20,000)
Less: Depreciation	(40,000)	(40,000)	(40,000)
PBT	36,000	38,000	38,000
Tax 50%	18,000	19,000	19,000
PAT	18,000	19,000	19,000
CFAT	58,000	59,000	59,000

Step 3: Terminal Flow

1, 10,000

Step 4: NPV analysis

Year	Cash Flow	Discfactor	Disc. Cash Flow
0	(2,30,000)	1	(2,30,000)
1	58,000	0.893	51,794
2	59,000	0.797	47,023
3	1,69,000	0.712	1,20,328
Total			(10,855)

Not Viable from Lessor's Point of View

Assumption: Appropriate Discount rate, cost of capital, is assumed to be at 12%.

2(a) Basic Interest Cost 0.1089

$[(\text{Face Value} - \text{Issue Price}) / \text{Issue Price}] * [12 / \text{Months}]$

Add: Brokerage 0.125% per quarter x 4 quarters 0.005

Add: Rating Charges Per annum 0.005

Add: Stamp Duty 0.125% per annum x 4 quarters 0.005

Final Cost 0.1239

12.39 %

Note: This assumes that the brokerage, rating charges and stamp duty are all on Issue Price

2(b) (i) Forward and Future Contracts:

Forward contracts are private bilateral contracts which have well established commercial usage. On the other hand future contracts are standardized tradeable contract fixed in terms of size, contract and other features and traded on an exchange.

In forward contracts, price is not publicly disclosed, whereas in future contracts, price is transparent.

Forward contract is exposed to the problem of liquidity whereas to futures there is no liquidity problem.

Forward contracts are settled on one specified delivery date. In the case of futures, there is range of delivery dates.

Forward contracts are settled at the end of contract, but futures are settled daily.

In forward, delivery or final cash settlement usually take place whereas in futures, contract is closed out prior to maturity.

(ii) Intrinsic value and the time value of An Option:

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

Intrinsic value is the value that any given option would have if it were exercised today. This is defined as the difference between the option's strike price (x) and the stock's actual current price (c.p). In the case of a call option, one can calculate the intrinsic value by taking $CP - X$. If the result is greater than Zero (In other words, if the stock's current price is greater than the option's strike price), then the amount left over after subtracting $CP - X$ is the option's intrinsic value. If the strike price is greater than the current stock price. Then the intrinsic value of the option is zero – it would not be worth anything if it were to be exercised today. An option's intrinsic value can never be below zero. To determine the intrinsic value of a put option, simply reverse the calculation to $X - CP$

Example: Let us assume Wipro stock is priced at Rs.105/-. In this case, a Wipro 100 call option would have an intrinsic value of $(Rs.105 - Rs.100 = Rs.5)$. However, a Wipro 100 put option would have an

intrinsic value of zero ($\text{Rs.}100 - \text{Rs.}105 = \text{Rs.}5$). Since this figure is less than zero, the intrinsic value is zero. Also, intrinsic value can never be negative. On the other hand, if we are to look at a Wipro put option with a strike price of Rs.120. Then this particular option would have an intrinsic value of Rs .15 ($\text{Rs.}120 - \text{Rs.}105 = \text{Rs.}15$).

Time Value: This is the second component of an option's price. It is defined as any value of an option there than the intrinsic value. From the above example, if Wipro is trading at Rs.105 and the Wipro 100 call option is trading at Rs.7, then we would conclude that this option has Rs.2 of time value ($\text{Rs.}7 \text{ option price} - \text{Rs.}5 \text{ intrinsic value} = \text{Rs.}2 \text{ time value}$). Options that have zero intrinsic value are comprised entirely of time value.

Time value is basically the risk premium that the seller requires to provide the option buyer with the right to buy/sell the stock upto the expiration date. This component may be regarded as the insurance premium of the option. This is also known as "Extrinsic value." Time value decays over time. In other words, the time value of an option is directly related to how much time an option has until expiration. The more time an option has until expiration. The greater the chances of option ending up in the money.

2(c) Evaluation of Option 1:

a. Dividend	Rs. per unit	0.75
b. Realised capital gain	Rs. per unit	0.60
c. Unrealized capital gain	(closing NAV less Opening NAV)	0.70
A. Total Reward	(a+b+c)	2.05
B. Opening NAV	Rs. per unit	8.75
C. Holding period return	A/B * 100	23.43%

Note: Assumed that the closing NAV is after adjustments for fall in NAV consequent upon declaration of dividend and capital gain distribution.

Evaluation of Option 2:

A. Opening Number of units	given	300
B. Dividend	Rs. per unit	0.75
C Realized Capital Gain	Rs. Per unit	0.60
D Reward per unit	B + C	1.35
E Total Reward	A x D	405
F Reinvestment	Given	8.65
G Number of units allotted	E/ F	46.82
H Total Units	A + G	346.82
I Closing NAV	Given	9.45
J Value of Holdings	H x I	3277
Value of year beginning holding		
K Opening NAV		8.75
L Value	A x K	2625
M Return	(J-L) / L	24.84 %

—Conclusion:

Option 2, viz Reinvestment option is preferred.

3(a) Evaluation of staying exposed

Exposure USD	1, 00,000
Spot rate an 1 September	0.02133 \$ per Re
Rs. Collection	4688233

Evaluation of Forward Contract

Exposure USD	1, 00,000
Sell 3 M Forward Rate	0.02127 \$ per Re
Rs. Collection	4701457

Conclusion 1: Since the forward contract assures higher Rs. Cash flow than staying exposed, forward is preferred

Evaluation of Futures Contract

Exposure USD	1, 00,000
Sell Futures September Futures rate	0.02118
Value	4721435

Cost of Initial Margin

[15,000 x 2% per quarter] 300

Net Cash Flow 4721135

Since Cash contract is Rs. 4, 72,000 he has to take 10 futures contract

Conclusion 1: Since the futures assures a higher Rs. Cash flow than forward contract, futures is preferred

3(b) The exchange rate is Rs.per dollar

Hence Rs. Is home currency and dollar is foreign currency

Step 1: Computation of Theoretical Home rate

a. Spot rate	48.0123
b. Foreign Interest Rate	4
c. Forward Rate	48.819
d. Home Rate [c/ d] x b	1.057474
That is	0.057474 per half year

Step 2: Decide

Since theoretical home rate [5.75%] is less than actual home rate (6 %) money will flow into India.

Proof for Arbitrage:

Step	Action	Computation	Result
1	Borrow USD	At 4% per half year	83312 USD
2	Convert	At spot rate Rs. 48.0123 Step 1 x spot rate	4000001 INR
3	Invest	At 6% per half year	4000001 INR
4	Take Cover	At 48.819 Rs.per dollar	
5	En-cash	Step 3 x 1.06	4240001 INR
6	Realize	Step 5 / forward rate	86851 USD

7	Repay	With Interest at 4% half year	86644
8	Net		207 USD

3(c) Working note 1:

An Indian company is investing in USA

All cash flows are already given in dollars. No adjustment required

Working Note 2: Computation of forward rate

a. Risk free rate India	12.00%
b. Risk Free rate USA	8.00%
c. Spot Rate	48
d. Forward rate $[(1+a)/(1+b) * c]$	49.78

Working note 3: Computation of risky rate

a. Risky rate India	14.00%
b. Spot rate	48
c. Forward rate	49.78
d. Risky dollar Rate $[(b/c) * (1+a)]$	1.099237

Round off as 9.92%

Working note 4: NPV Calculation

Year	CF	DR = 9.92%	Disc.CF
0	(110)	1	(110)
1	20	0.91	18.20
2	25	0.83	20.70
3	30	0.75	22.59
4	40	0.69	27.40
5	50	0.62	31.15
Total			10.04

4(a)

Calculation of Covariance

Year	R1	Deviation ($R_1 - \bar{R}_1$)	R_2 ($R_2 - \bar{R}_2$)	Deviation	Product of deviations
1	12	-2.8	20	-1	2.8
2	8	-6.8	22	1	-6.8
3	7	-7.8	24	3	-23.4
4	14	-0.8	18	-3	2.4
5	16	1.2	15	-6	-7.2
6	15	0.2	20	-1	-0.2
7	18	3.2	24	3	9.6
8	20	5.2	25	4	20.8
9	16	1.2	22	1	1.2
10	22	7.2	20	-1	-7.2

$$\overline{R_1} = 148/10 = 14.8$$

$$R_2 = 210/10 = 21$$

$$-8.00$$

$$\text{Covariance} = \frac{\sum_{i=1}^N [R_1 - \overline{R_1}] [R_2 - \overline{R_2}]}{N}$$

$$= -8/10 = -0.8$$

For calculation of correlation, the standard deviations of the two securities are also required.

Calculation of Standard Deviation

Year	R ₁	R ₁ ²	R ₂	R ₂ ²
1	12	144	20	400
2	8	64	22	484
3	7	49	24	576
4	14	196	18	324
5	16	256	15	225
6	15	225	20	400
7	18	324	24	576
8	20	400	25	625
9	16	256	22	484
10	22	484	20	400
	148	2398	210	4494

Standard deviation of security 1:

$$\begin{aligned} \sigma_1 &= \sqrt{N \sum R_1^2 - (\sum R_1)^2 / N^2} \\ &= \sqrt{(10 \times 2398) - (148)^2 / 10 \times 10} = \sqrt{23980 - 21904 / 100} \\ &= \sqrt{20.76} = 4.56 \end{aligned}$$

Standard deviation of security 2:

$$\begin{aligned} \sigma_2 &= \sqrt{N \sum R_2^2 - (\sum R_2)^2 / N^2} \\ &= \sqrt{(10 \times 4494) - (210)^2 / 10 \times 10} = \sqrt{44940 - 44100 / 100} \\ &= \sqrt{840 / 100} = \sqrt{8.4} = 2.90 \end{aligned}$$

Correlation Coefficient

$$\begin{aligned} r_{12} &= \text{Cov} / \sigma_1 \sigma_2 \\ &= -0.8 / 4.56 \times 2.90 = -0.8 / 13.22 \\ &= -0.0605 \end{aligned}$$

4(b) Leveraged Buyouts (LBOs):

1. A popular technique that was widely used during the 1980s to make acquisition is the leveraged buyouts, which involves the use of a large amount of debt to purchase a firm.
 2. While some leveraged buyouts involve a company in its entirety, most involve a business unit of a company. After the buyout, the company invariably becomes a Private Company.
 3. A large part of the borrowing is secured by the firm's assets, and the lenders, because of a high risk, take a portion of the firm's equity. Junk bonds have been routinely used to raise amounts of debt needed to finance the LBO transaction.
 4. The success of the entire operation depends on their ability to improve the performance of the unit, contain its business risk, exercise cost controls and liquidate disposable assets. If they fail to do so, the high fixed financial costs can jeopardize the venture.
 5. An attractive candidate for acquisition in its industry with a solid profit history and reasonable expectations of growth.
- (a) It must have a good position in its industry with a solid profit history and reasonable expectations of growth.
- (b) The firm should have a relatively low level of debt and a high level bankable asset that can be used as loan collateral.
- (c) It must have a stable and predictable cash flow that are adequate to meet interest and principal payment on the debt and provide adequate working capital.

Of course, a willingness on the part of existing ownership and management to sell the company on a leveraged basis is also needed.

4(c) Duration $4.3202 = (1.16/0.16) - [1.16 + 6(c - 0.16)] / (c[(1.16)^6 - 1] + 0.16)$

$$4.3202 = 1.16/0.16 - 1.16 + 6(c - 0.16) / (c[(1.16)^6 - 1] + 0.16)$$

$$1.16 + 6c - 0.96 / 1.4364c + 0.16 = 2.9298$$

5(a)

Spot rate	Rate	Time	Rate x time	e^{Rt}	Value
91,500	0	1	0	1	91500
98,500	0.1	2	0.2	1.2214	120308
99,000	0.105	3	0.315	1.37028	135658

In the absence of the e^{Rt} table we may use the future value table

5(b)

(i) Using Gordon

CMP = Dividend Next Year / Cost of equity – growth rate

Dividend this year	2.5
Cost of equity	10.5 percent
Growth	2 per cent
Dividend Next year	2.55
CMP	30

(ii) Alternative 1:

If the data of ROE and EPS 2.25 is ignored and we base on price arrived at in (i) above the stock is overvalued

(ii) Alternative 2:

If we consider the ROE and EPS data given the position will be as under

Using the formula $g = b \times r$, we can arrive at the pay out ratio:

Growth rate	g	2.00 %	Given
ROE	r	9.00 %	Given
Cost of equity		10.50 %	Given
EPS		2.25	Given
Retention ratio	b	0.222222	
Payout Ratio	1-b	0.777778	
EPS next year		2.295	
DPS	EPS x Pay out	1.785	

- 5(c)** A derivative contract is a financial instrument whose payoff structure is derived from the value of the underlying asset

The following example will help us to understand the meaning of the three key terms namely derivative, underlying asset and value.

Going for a concert: You and two of your friends want to watch a concert scheduled to be held for next month. Each ticket costs Rs.1, 000. You call up and find that the tickets are fully sold out. An acquaintance, who is a part of the concert team, gives you a reference letter, under which if you show the letter you can buy 3 tickets by paying the price of those three tickets namely Rs. 1,000 each. The letter gives you the right to buy a ticket; it does not represent a ticket. The letter by itself has no market value. Suppose as the concert day draws to a closer, tickets are being sold in the gray market at Rs. 1250. At this point your letter attains value. This is because, thanks to the letter, you can buy the ticket now available in the market at Rs.1250 for Rs. 1000. The letter is now worth Rs. 250 x 3 viz Rs. 750/-. If a week before the concert, the price in the gray market shoots up to Rs.1400, the value of your letter too shoots up. It is now worth Rs. 400 x 3 = Rs. 1200! If the price falls below Rs. 1000, your letter becomes worthless

Five simple tenets flow from this example

- The letter is a derivative instrument. It gives you the right to buy the ticket
- The underlying asset is the ticket
- The letter does not constitute ownership
- It is instead a promise to convey the ownership
- The value of the letter changes with changes in price of the ticket. It derives its value from the value of the ticket.

While in our example the underlying asset was the concert ticket, in the derivative market, the underlying asset could be commodities, precious metals, foreign exchange rate, interest rate relating to financial assets and shares and market indexes.

- 6(a)** The following are the objectives of Portfolio management

- Professional competence
- Capital appreciation

- c. Liquidity
- d. Safety of investment
- e. Tax benefits
- f. Diversification
- g. Risk reduction

6(b) Book Building

Book Building is a relatively new, non-mandatory, means of raising equity or debt through public issues. This method of raising funds was accepted by SEBI based on the recommendations of Malegam Committee.

Also known as offer for sale by tender, this is a process by which an issuer builds up and ascertains the demand as also the likely price for securities and ultimately determines the quantum of securities to be issued.

Book building, as defined in SEBI guidelines is: “a process undertaken by which a demand for the securities proposed to be issued by a body corporate is elicited and build up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document, or information memorandum or offer document.”

In this process, the issuer is assisted by a lead-manager, who is entrusted with the task of collecting bids from prospective investors, based on an indicative price range. The lead manager also maintains full and complete details of bids for facilitating an assessment of likely demand for the proposed issue. Because of this regard keeping function the lead manager is known as a Book-runner. The price as also the size of the issue is determined on the basis of an in-house valuation of the bids received.

6(c) (i) CAPM: Assumptions

Assumptions

Market is perfect: This means that all assets are marketable and that there are no transaction costs or taxes.

Risk free rate: There is a single risk free rate of return (i.e., the R_f is the same for all investors).

Investors can freely borrow or invest at such risk free rate.

Homogenous expectations: Investors have homogeneous expectations about return. Return in turn is dependent on dividends and capital gains. Inflation and its effect on dividends and capital gains are ignored.

(ii) Determinants of dividend policy:

Funds Requirements: A company which has a large upcoming capital expenditure program will prefer a low pay out ratio while a company with negligible capital expenditure plan will prefer a high pay out ratio

Liquidity: Dividends involve cash payment. Cash is to be set apart within 5 days of their declaration. Company high on profit but low on liquidity will opt for a low payout ratio where as a company which is low on profits but high on liquidity will prefer for a high payout ratio.

Access to external financing: Good access to external financing automatically improves liquidity. In this case the company need not use internal resources extensively for financing capital expenditure. Such companies are liberal with their payout

What they want: A company's decision to pay dividend cannot be divorced from what shareholders expect. A company should pay the dividend which the shareholders have come to expect. As we said earlier, a company draws a clientele which likes the company's pay out ratio

The cost of money: External equity is costlier than retained earnings on account of the issue costs involved. Further, fresh issues are made at a discount to market price, leading to under pricing and therefore to higher costs.

Loss of control: External financing, except in the case of rights issue, leads to dilution of control. Financing through retained earnings does not lead to dilution of control.

Taxes: Tax rates for dividend income are different from those of capital gains. The former is at 12.5% and the latter is at 10% in the case of long term capital gains without indexation and the normal rates in the case of short term capital gain.

Inflation: During periods of rising prices the company may find that its depreciation provisions are inadequate and may hence lower its dividend payout. This could indirectly affect the investors who are dependent on dividend income since not only does the purchasing power come down, but the quantum of dividend too drops. A double whammy indeed.

- 6 (d) Credit rating means an assessment carried out from the limited stand point credit – risk evaluation, translated into a current opinion as on a specific date on the quality of a specific debt-security issued, or on obligation undertaken by an enterprise in terms of the ability and willingness of the obligant to meet the principal and the interest payments on the rated debt instrument in a timely manner.

Stripped of jargon, a credit rating is

- a. An expression of opinion of a rating agency
- b. The opinion relates to a debt instrument
- c. the opinion is of a given date
- d. the opinion is base don risk evaluation
- e. the opinion is indicative of the likelihood or probability of interest and principal obligations being met in a timely fashion

These opinions have become important in recent times to investors on account of the increase in the number of issues, and the advent of new and complex financial products, such as asset backed securities and credit derivatives.

No. of Questions: 7

AT

Total Marks: 100

No. of Pages Printed: 6
Hours

Time Allowed: 3

Question No 1 & 2 are Compulsory. Answer any Four from the rest

1. Comment on the following with reference to the Chartered Accountants Act, 1949 and Schedules thereto:
 - (a) L, a chartered accountant did not maintain books of account for his professional earnings on the ground that his income is less than the limits prescribed u/s 44AA of the Income Tax Act, 1961.
 - (b) Mr. P, a Chartered Accountant in practice entered into a partnership with Mr. L, an advocate for sharing of fees for work sent by one to the other. However, due to some disputes, the partnership was dissolved after 1 month without any fees having been received.
 - (c) Z, a Chartered Accountant, certifies a financial forecast of his client which was forwarded to the client's bank based on which the bank sanctioned a loan to the client.
 - (d) A firm of Chartered Accountants was appointed by a company to evaluate the costs of the various products manufactured by it for its information system. One of the partners of the firm was a Non-Executive Director of the company.

Marks)

2. Plaza Ltd is a major food retailer. Further to the success of its national supermarkets in the late 1990s it has extended its operations throughout Europe and most recently to Asia, where it is expanding rapidly. You are a manager in Andando, a firm of Chartered Certified Accountants. You have been approached by Duncan Seymour, the chief finance officer of Plaza, to advise on a bid that Plaza is proposing to make for the purchase of MCM. You have ascertained the following from a briefing note received from Duncan. MCM provides training in management, communications and marketing to a wide range of corporate clients, including multi-nationals. The 'MCM' name is well regarded in its areas of expertise. MCM is currently wholly-owned by Frontiers, an international publisher of textbooks, whose shares are quoted on a recognized stock exchange. MCM has a National and an International business. The National business comprises 11 training centers. The audited financial statements show turnover of Rs12.5 million and profit before taxation of Rs 1.3 million for this geographic segment for the year to 31 December 2005. Most of the National business's premises are owned or held on long leases. Trainers in the National business are mainly full-time employees. The International business have five training centers in Europe and Asia. For these segments, turnover amounted to £6.3 million and profit before tax Rs. 2.4 million for the year to 31 December 2005. Most of the International business's premises are held on operating leases. International trade debtors at 31 December 2005 amounted to Rs. 3.7 million. Although the International centers employ some full-time trainers, the majority of trainers provide their services as freelance consultants.

Required:

(a) Define 'due diligence' & describe the nature & purpose of a due diligence review.

(4 Marks)

(b) Explain the matters you should consider before accepting an engagement to conduct a due

Diligence review of MCM.

(10

marks)

(c) Illustrate how:

(i) Enquiry; and

(4

marks)

(ii) Analytical procedures, might appropriately be used in the due diligence review of MCM.

(6 marks)

- 3.** Geno Vesa Farm Ltd (GVF) is a cheese manufacturer. Its principal activity is the production of a traditional 'Farmhouse' cheese that is retailed around the world to exclusive shops, through mail order and web sales. Other activities include the sale of locally produced foods through a farm shop and cheese-making demonstrations and tours.

The farm's herd of 700 goats is used primarily for the production of milk. Kids (i.e. goat offspring), which are a secondary product, are selected for herd replacement or otherwise sold. Animals held for sale are not usually retained beyond the time they reach optimal size or weight because their value usually does not increase thereafter. There are two main variations of the traditional farmhouse cheese; 'Rabida Red' and 'Bachas Blue'. The red cheese is coloured

using Innittu, which is extracted from berries found only in South American rain forests. The cost of Innittu has risen sharply over the last year as the collection of berries by local village workers has come under the scrutiny of an international action group. The group is lobbying the South American government to ban the export of Innittu, claiming that the workers are being exploited and that sustaining the forest is seriously under threat. Demand for Bachas Blue, which is made from unpasteurised milk, fell considerably in 2003 following the publication of a research report that suggested a link between unpasteurised milk products and a skin disorder. The financial statements for the year ended 30 September 2004 recognised a material impairment loss attributable to the machinery used exclusively for the manufacture of Bachas Blue. However, as the adverse publicity is gradually being forgotten, sales of Bachas Blue are now showing a steady increase and are currently expected to return to their former level by the end of September 2005. Cheese is matured to three strengths – mild, medium and strong – depending on the period of time it is left to ripen which is six, 12 and 18 months respectively. When produced the cheese is sold to a financial institution, Abingdon Bank, at cost. Under the terms of sale, GVF has the option to buy the cheese on its maturity at cost plus 7% for every six months which has elapsed. All cheese is stored to maturity on wooden boards in GVF's cool and airy sheds. However, recently enacted health and safety legislation requires that the wooden boards be replaced with stainless steel shelves with effect from 1 July 2005. The management of GVF has petitioned the government health department that to comply with the legislation would interfere with the maturing process and the production of medium and strong cheeses would have to cease. In 2003, GVF applied for and received a substantial regional development grant for the promotion of tourism in the area. GVF's management has deferred its plan to convert a disused barn into holiday accommodation from 2004 until at least 2006.

Required:

(a) Identify and explain the principal audit risks to be considered when planning the final audit of

GVF Ltd for the year ending 30 September 2005.

(6 Marks)

(b) Describe the audit work to be performed in respect of the carrying amount of the following

items in the balance sheet of GVF Ltd as at 30 September 2005:

(i) Goat herd;

(3 Marks)

(ii) Machinery used in the manufacture of Bachas Blue; and

(3 Marks)

(iii) Cheese.

(3 Marks)

4. Your firm was appointed as auditor to Indigo Co, an iron and steel corporation, in September 2005. You are the manager in charge of the audit of the financial statements of Indigo, for the year ending 31December 2005. Indigo owns office buildings, a workshop and a substantial stockyard on land that was leased in 1995 for 25 years. Day-to-day operations are managed by the chief accountant, purchasing manager and workshop supervisor who report to the managing director. All iron, steel and other metals are purchased for cash at 'scrap' prices determined by the purchasing manager. Scrap metal is mostly high volume. A weighbridge at the entrance to the stockyard weighs trucks and vans before and after the scrap metals that they carry are unloaded into the stockyard. Two furnaces in the workshop melt down the salvageable scrap metal into blocks the size of small bricks that are then stored in the workshop. These are sold on both credit and cash terms. The furnaces are now 10 years old and have an estimated useful life of a further 15 years. However, the furnace linings are replaced every four years. An annual provision is made for 25% of the

estimated cost of the next relining. A by-product of the operation of the furnaces is the production of 'clinker'. Most of this is sold, for cash, for road surfacing but some is illegally dumped. Indigo's operations are subsidised by the local authority as their existence encourages recycling and means that there is less dumping of metal items. Indigo receives a subsidy calculated at 15% of the market value of metals purchased, as declared in a quarterly return. The return for the quarter to 31 December 2005 is due to be submitted on 21 January 2006. Indigo maintains manual stock records by metal and estimated quality. Indigo counted stock at 30 November 2005 with the intention of 'rolling-forward' the purchasing manager's valuation as at that date to the year-end quantities per the manual records. However, you were not aware of this until you visited Indigo yesterday to plan your year-end procedures. During yesterday's tour of Indigo's premises you saw that:

(i) Sheets of aluminium were strewn across fields adjacent to the stockyard after a storm blew

them away;

(ii) Much of the vast quantity of iron piled up in the stockyard is rusty;

(iii) Piles of copper and brass, which can be distinguished with a simple acid test, have been mixed up.

The count sheets show that metal quantities have increased, on average, by a third since last year; the quantity of aluminium, however, is shown to be three times more. There is no suitably qualified metallurgical expert to value stock in the region in which Indigo operates.

The chief accountant disappeared on 1 December, taking the cash book and cash from three days' sales with him. The cash book was last posted to the general ledger as at 31 October 2005. The managing director has made an allegation of fraud against the chief accountant to the police.

The auditors' report on the financial statements for the year ended 31 December 2004 was unqualified.

Required:

(a) Describe the principal audit procedures to be carried out on the opening balances of the

financial statements of Indigo Co for the year ending 31 December 2005.

(4

marks)

(b) Using the information provided, state the financial statement risks arising and justify an

appropriate audit approach for Indigo Co for the year ending 31 December 2005.

(7

marks)

(c) Comment on the matters to be considered in seeking to determine the extent of Indigo Co's

financial loss resulting from the alleged fraud.

(4

marks)

5a. Explain the auditor's responsibilities in respect of subsequent events.

(3 marks)

5b. You are the audit manager of Jinack Ltd. You are currently reviewing two matters that have been left for your attention on the audit working paper file for the year ended 30 September 2005:

(i) Jinack holds an extensive range of stock and keeps perpetual stock records.

There was no full physical stock count at 30 September 2005 as a system of

continuous stock checking is operated by warehouse personnel under the supervision of an internal audit department. A major systems failure in October 2005 caused the perpetual stock records to be corrupted before the yearend stock position was determined. As data recovery procedures were found to be inadequate, Jinack is reconstructing the year-end quantities through a physical count and 'rollback'. The reconstruction exercise is expected to be completed in January 2006.

**(4
marks)**

- (ii) Audit work on after-date bank transactions identified a transfer of cash from Batik Ltd. The audit senior has documented that the finance director explained that Batik commenced trading on 7 October 2005, after being set up as a wholly-owned foreign subsidiary of Jinack. No other evidence has been obtained.

**(3
marks)**

Required:

Identify and comment on the implications of the above matters for the auditors' report on the

financial statements of Jinack Ltd for the year ended 30 September 2005 and, where

appropriate, the year ending 30 September 2006.

5c. Enumerate the 'Basic Elements of Audit Report' as enshrined in AAS-28.

(5 Marks)

6a. With respect to the Stock Exchange, explain the following terms:

(i) Circuit breakers

(4

Marks)

(ii) Clearing and Settlement mechanism

(4

Marks)

6b. You have been appointed as auditor of general insurance company.
Explain how you would verify reinsurance.

(7

Marks)

7. Write short notes on any five of the following:

(5 x3 = 15

Marks)

(a) Certificate for Special Purpose vs. Audit Report

(b) Audit vs. Investigation

(c) Advantages of Cost Audit to Government

(d) Principal Enactments Governing Bank Audit

(e) Corporate Governance

(f) Walkthrough tests

PRIME ACADEMY

26TH SESSION MODEL EXAM

FINAL – ADVANCED AUDITING

1(a) Maintenance of Books of Account:

Under Clause (ii) of Part II of Second Schedule to the Chartered Accountants Act, 1949, the Institute has specified that if a chartered accountant in practice or the firm of Chartered Accountants of which he is a partner fails to maintain and keep in respect of his/its professional practice, proper books of account including the Cash Book and Ledger, he is deemed to be guilty of professional misconduct. Accordingly, it does not matter whether section 44AA of the Income Tax Act, 1961 applies or not. Hence, Mr. L is guilty of professional misconduct.

1(b) Partnership with non-chartered accountants:

As per clause 4 of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant will be guilty of professional misconduct if he enters into partnership with any person other than a chartered accountant in practice or a person resident without India who but for his residence abroad would be entitled to be registered as a member under Clause (v) of subsection (1) of section 4 or whose qualification are recognized by the Central Government or the Council for the purpose of permitting such partnership. This clause puts a restriction on entering into partnership with a non-chartered accountant for the practice of the profession of chartered accountancy. In the instant case since Mr. P, a chartered accountant, has entered into partnership with Mr. L, an advocate, he would be guilty of professional misconduct irrespective of the fact that no work or fee was shared and the partnership was dissolved after one month since the clause does not permit entering into partnership.

1(c) Certification of Financial Forecast:

Under Clause (3) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice is deemed to be guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast. Accuracy does not refer to arithmetical accuracy. All forecasts are estimates based on certain assumptions duly evaluated on a consideration of various relevant factors and cannot be ascertained with accuracy. The Guidance Note on Accountants Report on Profit Forecasts and/or Financial forecasts considered the implications of this clause and made it clear that the chartered accountant can participate in the preparation of profit or financial forecasts and review them. But, first of all, he should clearly indicate in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and, secondly, he should not vouch for the accuracy of the forecasts. In the instant

case, Mr. Z, is deemed to be guilty as it appears that he has certified the financial forecast without taking adequate safeguards

1(d) Evaluation of Cost of Products:

Clause 4 of Part I of the Second Schedule to Chartered Accountants Act, 1949 states that expressing an opinion on financial statements of any business or any enterprise in which the auditor, his firm or a partner in his firm has a substantial interest would constitute misconduct, unless he discloses the interest also in his report. Also, the Council of the Institute of Chartered Accountants of India has stated that in cases where a member of the Institute is a director of a company, or the firm in which the said member is a partner, should not express any opinion on its financial statements. As per facts of the case, the firm has been retained to evaluate the cost of products manufactured by it for its information system.

It is a part of management consultancy service of the firm and moreover its partner was on the Board. Hence, the firm can perform this assignment and it will not constitute misconduct. However, the firm while accepting the position as auditor in future would have to consider whether it would be possible to act in independent manner and express opinion on financial statements.

2. MCM:

(a) Nature and purpose of a 'due diligence' review

- 'Due diligence' may be defined as the process of systematically obtaining and assessing information in order to identify and contain the risks associated with a transaction (e.g. buying a business) to an acceptable level.
- The nature of such a review is therefore that it involves:
 - an investigation (e.g. into a company whose equity may be sold); and
 - disclosure (e.g. to a potential investor) of findings.
- A due diligence assignment consists primarily of enquiry and analytical procedures.
- Its purpose is to find all the facts that would be of material interest to an investor or acquirer of a business. It may not uncover all such factors but should be designed with a reasonable expectation of so doing.
- Professional accountants will not be held liable for non-disclosure of information that failed to be uncovered if their review was conducted with 'due diligence'.

(b) Matters to be considered (before accepting the engagement)

- Information about Duncan Seymour – What is the relationship of the chief finance officer to Plaza (e.g. is he on the management board)? By what authority is he approaching Andando to undertake this assignment?
- The purpose of the assignment must be clarified. Duncan's approach to Andando is 'to advise on a bid'. However, Andando cannot make executive decisions for a client but only provide the facts of material interest. Plaza's management must decide whether or not to bid and, if so, how much to bid.
- The scope of the due diligence review. It seems likely that Plaza will be interested in acquiring all of MCM's business as its areas of operation coincide with Plaza's. However it must be confirmed that Plaza is not merely interested in acquiring only the National or International business of MCM.
- Andando's competence and experience – Andando should not accept the engagement unless the firm has experience in undertaking due diligence assignments. Even then, the firm must have sufficient knowledge of the territories in which the businesses operate to evaluate whether all facts of material interest to Plaza have been identified.
- Whether Andando has sufficient resources (e.g. representative/associated offices), if any, in Europe and Asia to investigate MCM's International business.
- Any factors which might impair Andando's objectivity in reporting to Plaza the facts uncovered by the due diligence review. For example, if Duncan is closely connected with a partner in Andando or if Andando is the auditor of Frontiers.
- Plaza's rationale for wishing to acquire MCM. Presumably it is significant that MCM operates in the same territories as Plaza. Plaza may want to provide extensive training programs in management, communications and marketing to its workforce.
- The relationship, if any, between Plaza and MCM in any of the territories. Plaza may be a major client of MCM. That is, Plaza is currently out-sourcing training to MCM. Acquiring MCM would bring training in-house.
- Time available – Andando must have sufficient time to find all facts that would be of material interest to Plaza before disclosing their findings.
- The acceptability of any limitations – whether there will be restrictions on Andando's access to information held by MCM
(e.g. if there will not be access to board minutes) and personnel.
- The degree of secrecy required – this may go beyond the normal duties of confidentiality not to disclose information to outsiders (e.g. if unannounced staff redundancies could arise).
- Why Plaza's current auditors have not been asked to conduct the due diligence review – especially as they are responsible for (and therefore capable of undertaking) the group audit covering the relevant countries.
- Andando should be allowed to communicate with Plaza's current auditor:

- to inform them of the nature of the work they have been asked to undertake; and
- to enquire if there is any reason why they should not accept this assignment.
- In taking on Plaza as a new client Andando may have a later opportunity to offer external audit and other services to Plaza (e.g. internal audit).

(c) Due diligence review

(i) Enquiries

- Do any members of MCM's senior/executive management have contractual terms that will result in significant payouts to them (e.g. on change of ownership of the company or their being made redundant)?
- What contracts with clients, if any, will lapse or be made void in the event that MCM is purchased from Frontiers?
- What synergy or inter-company trading, if any, currently exists between MCM and Frontiers? For example, Frontiers may publish MCM's training materials.
- Are there any major clients who are likely to be lost if MCM is purchased by Plaza (e.g. any competitor food retailers)?
- What are the principal terms of the operating leases relating to the International business's premises?
- What penalties should be expected to be incurred if operating leases and/or contracts with training consultants are terminated?
- Has MCM entered into any purchase commitments since 31 December 2004 (e.g. to buy or lease further premises)?
- Who are the best trainers that Plaza should seek to retain after the purchase of MCM?
- What events since the audited financial statements to 31 December 2004 were published have made a significant impact on MCM's assets, liabilities, operating capability and/or cash flows? (For example, storm damage to premises, major clients defaulting on payments, significant interest/foreign-exchange rate fluctuations, etc.)

- Are there any unresolved tax issues which have not been provided for in full?
- What effect will the purchase have on loan covenants? For example, term loans may be rendered repayable on a change of ownership.

(ii) Analytical procedures

- Review the trend of MCM's profit (gross and net) for the last five years (say). Similarly earnings per share and gearing.

For both the National and International businesses compare:

- gross profit, net profit, and return on assets for the last five years (say);
- actual monthly turnover against budget for the last 18 months (say). Similarly, for major items of expenditure

such as:

- full-time salaries;
- freelance consultancy fees;
- premises costs (e.g. depreciation, lease rentals, maintenance, etc);
- monthly turnover (also costs and profit) by centre.

- Review projections of future profitability of MCM against net profit percentage at 31 December 2004 for:

- the National business (10·4%);
- the International business (38·1%); and
- overall (19·9%).

- Review of disposal value of owned premises against book values.
- Compare actual cash balances with budget on a monthly basis and compare borrowings against loan and overdraft facilities.
- Compare the average collection period for International's trade debtors month on month since 31 December 2004

Compare financial ratios for each of the national centres against the National business overall (and similarly for the

International Business). For example:

- gross and net profit margins;
- return on centre assets;
- average collection period;
- average payment period;
- liquidity ratio.

■ Compare key performance indicators across the centres for the year to 31 December 2004 and 2005 to date. For example:

- number of corporate clients;
- number of delegates;
- number of training days;
- average revenue per delegate per day;
- average cost per consultancy day.

3. GENO VESA FARM LTD

(a) Principal audit risks

'Industry Farming' is an inherently risky business activity – being subject to conditions (e.g. disease, weather) outside management's control. In some jurisdictions, where the industry is highly regulated, compliance risk may be high. In India, for example, outbreaks of Bird Flu, have brought areas of the farming industry to a standstill for months at a time.

The risks of mail order retailing 'exclusive' products are higher (than for 'essential' products, say) as demand fluctuations are more dramatic (e.g. in times of recession). However, the Internet has provided GVF with a global customer base. The planned audit approach should be risk-based combined with a systems approach to (say) controls in the revenue cycle.

Goat herd

The goat herd will consist of:

- mature goats held for use in the production of milk (i.e. accounted for as depreciable fixed tangible assets;
- kids which are held for replacement purposes; and

- kids which are to be sold (held as stock under SSAP 9 'Stocks and long-term contracts').

Therefore, the number of animals in each category must be accurately ascertained to determine:

- the balance sheet carrying amounts analyzed between current and fixed assets;
- the amount of revenue recognized under the 'accretion approach'; and
- the charge to the profit and loss account (e.g. for depreciation).

There is a risk that the carrying amount of the production animals will be misstated if, for example:

- useful lives/depreciation rates are unreasonable;
- estimates of residual values are not kept under review.

Under the accretion approach revenue is recognized throughout the 'production' process by comparing market prices at stages of growth against comparative stock valuations.

The net realizable value of animals held for sale may fall below cost if they are not sold soon after reaching optimal size and weight.

Unrecorded sales

Raised (bred) animals are not purchased and, in the absence of documentation supporting their origination, could be sold for cash (and the sale unrecorded).

Although the controls over retailing around the world are likely to be strong, there are other sources of income – the shop and other activities at the farm. Although sales from these sundry sources may not be material, there is a risk that it could go unrecorded due to lack of effective controls. 'Rabida Red' The cost of an ingredient which is essential to the manufacturing process has increased significantly. If the cost is passed on to the customers, demand may fall (increasing going concern risk). Supplies of the ingredient, Innittu, may be restricted – further increasing going concern risk. Any disclosure of GVF's socio-environmental policies (e.g. in other information presented with the audited financial statements), if any, should be scrutinized to ensure that it does not mislead the reader and/or undermine the credibility of the

financial statements. 'Bachas Blue' If 'Bachas Blue' has been specifically cited as a cause of a skin disorder then GVF could face contingent liabilities for pending litigation. However, it is more likely that the fall in demand has threatened GVF's going concern. As the fall in demand has

not been permanent, this threat has been removed for the time being. The impairment loss previously recognized in respect of the machinery used exclusively in the manufacture of Bachas Blue should be reversed if there has been a change in the estimates used to determine their recoverable amount. The recoverable amount would have been based on value in use (since net selling price would not have been applicable). GVF's management

will have to provide evidence to support their best estimates of future cash flows for the recalculation of value in use at 30 September 2005.

Maturing cheese

The substance of the sale and repurchase of cheese is that of a loan secured on the stock. Therefore revenue should not be recognized on 'sale' to Abingdon Bank. The principal terms of the secured borrowings should be disclosed, including the carrying amount of the stock to which it applies. Financing costs should all be recognized as an expense in the period unless the Companies Act criteria for capitalization are met. Since the cost of stock should include all costs incurred in bringing them to their present location and condition (of maturity), the cost of maturing cheese should include interest at 7% per six months (as clearly the borrowings are specific). There is a risk that, if the age of maturing cheeses is not accurately determined, the cost of cheese will be misstated. Health and safety legislation At 30 September 2005 the legislation will have been in effect for three months. If GVF's management has not replaced the shelves, a provision should be made for the penalties/fines accruing from non-compliance.

If the legislation is complied with:

- plant and machinery may be overstated e.g:
 - if the replaced shelves are not written off;
 - if the value of machinery, etc is impaired because the maturing cheese business is to be downsized;
- stock may be overstated (e.g. if insufficient allowance is made for the deterioration in maturing cheese resulting from handling it to replace the shelves);
- GVF may no longer be a going concern if it does not have the produce to sell to its exclusive customers.

Grant

There is a risk that the grant received has become repayable. For example, if the terms of the grant specified a timeframe for the development which is now to be exceeded. In this case the grant should be presented as a payable in the balance sheet. If the reason for deferring the implementation is related to cash flow problems, this could have implications for the going concern of GVF.

(b) Audit work on carrying amounts

(i) Goat herd

- Physical inspection of the number and condition of animals in the herd and confirming, on a test basis, that they are tagged (or otherwise 'branded' as being owned by GVF).
- Tests of controls on management's system of identifying and distinguishing held-for-sale animals (stock) from the production herd (depreciable fixed assets).
- Comparison of GVF's depreciation policies (including useful lives, depreciation methods and residual values) with those used by other farming entities.
- 'Proof in total', or other reasonableness check, of the depreciation charge for the herd for the year.
- Observing test counts or total counts of animals held for sale.
- Market values of kids, according to their weight and age, as at 30 September 2005 – for both held-for-sale and held-for-replacement animals.
- For held-for-sale animals only, vouching (on a sample basis) management's schedule of point-of-sale costs (e.g. market dealers' commissions).

(ii) Machinery used in the manufacture of Bachas Blue

- Agree cost less accumulated depreciation and impairment losses at the beginning of the year to prior year working papers (and/or last year's published financial statements).
- Recalculate the current year depreciation charge based on the carrying amount (as reduced by the impairment loss).
- Calculate the carrying amount of the machinery as at 30 September 2005 without deduction of the impairment loss.
- Agree management's schedule of future cash flows estimated to be attributable to the machinery for a period of up to five years (unless a longer period can be justified) to approved budgets and forecasts.
- Recalculate:
 - on a sample basis, the make up of the cash flows included in the forecast;
 - GVF's weighted average cost of capital.
- Review production records and sales orders for the year, as compared with the prior period, to confirm a 'steady increase'.
- Compare sales volume at 30 September 2005 with the pre-'scare' level to assess how much of the previously recognized impairment loss it would be prudent to write back (if any).

- Scrutinize sales orders in the post balance sheet event period. Sales of such produce can be very volatile and another 'incident' could have sales plummeting again – in which case the impairment loss should not be reversed.

(iii) Cheese

- Examine the terms of sales to Abingdon Bank – confirm the bank's legal title (e.g. if GVF were to cease to trade and so could not exercise buy-back option).
- Obtain a direct confirmation from the bank of the cost of goods sold by GVF to Abingdon Bank and the amount re-purchased as at 30 September 2005 (the net amount being the outstanding loan).
- Inspect the cheese as at 30 September 2005 (e.g. during the physical stock count) paying particular attention to the factors which indicate the age (and strength) of the cheese (e.g. its location or physical appearance).
- Observe how the cheese is stored – if on steel shelves discuss with GVF's management whether it's net realizable value has been reduced below cost.
- Test check, on a sample basis, the costing records supporting the cost of batches of cheese.
- Confirm that the cost of goods sold to the bank is included in stock as at 30 September 2005 and the nature of the bank security adequately disclosed.
- Agree the repurchase of cheese which has reached maturity at cost plus 7% per six months to purchase invoices (or equivalent contracts) and cash book payments.
- Test check GVF's stock-ageing records to production records. Confirm the carrying amount of stock as at 30 September 2005 that will not be sold until after 30 September 2006, and agree to the amount disclosed in the notes to stock as a 'non-current' portion.

4. INDIGO CO

(a) Opening balances – principal audit procedures

- Review of the application of appropriate accounting policies in the financial statements for the year ended 31st December 2004 to ensure consistent with those applied in 2005.

- Where permitted (e.g. if there is a reciprocal arrangement with the predecessor auditor to share audit working papers on a change of appointment), a review of the prior period audit working papers.
- Current period audit procedures that provide evidence concerning the existence, measurement and completeness of rights and obligations. For example:
 - after-date receipts (in January 2005 and later) confirming the recoverable amount of trade debtors at 31 December 2004;
 - similarly, after-date payments confirming the completeness of trade and other creditors (for services);
 - after-date sales of stock held at 31 December 2004;
 - review of January 2005 bank reconciliation (confirming clearance of reconciling items at 31 December 2004).
- Analytical procedures on ratios calculated month-on-month from 31 December 2004, to date and further investigation of any distortions identified at the beginning of the current reporting period. For example:
 - stock turnover (by category of metal);
 - average collection payment (debtor days);
 - average payment period (creditor days);
 - gross profit percentage (by metal).
- Examination of historic accounting records for fixed assets and liabilities (if necessary). For example:
 - agreeing balances on asset registers to the client's trial balance as at 31 December 2004;
 - agreeing statements of balances on loan accounts to the financial statements as at 31 December 2004.
- If the above procedures do not provide sufficient evidence, additional substantive procedures should be performed. For example, if additional evidence is required concerning stock at 31 December 2004, cut-off tests may be re performed.

(b) Financial statement risks Assets

- There is a very high risk that stock could be materially overstated in the balance sheet (thereby overstating profit) because:
 - There is a high volume of metals (hence material);

- ☐valuable metals are made more portable;
- ☐subsidy gives an incentive to overstate purchases (and hence stock);
- ☐stock may not exist due to lack of physical controls (e.g. aluminium can blow away);
- ☐scrap metal in the stockyard may have zero net realizable value (e.g. iron is rusty and slow-moving);
- ☐quantities per counts not attended by an auditor have increased by a third.

■Stock could be otherwise misstated (over or under) due to:

- ☐the weighbridge being inaccurate;
- ☐metal qualities being estimated;
- ☐different metals being mixed up; and the lack of an independent expert to identify/measure/value metals.

■Tangible fixed assets are understated as the parts of the furnaces that require replacement (the linings) are not capitalized (and depreciated) as separate items but treated as repairs/maintenance/renewals and expensed.

■Cash may be understated due to incomplete recording of sales.

■Recorded cash will be overstated if it does not exist (e.g. if it has been stolen).

■Trade debtors may be understated if cash receipts from credit customers have been misappropriated.

Liabilities

■The provision for the replacement of the furnace linings is overstated by the amount provided in the current and previous year (i.e. in its entirety). Income statement

■ Turnover will be understated in respect of unrecorded cash sales of salvaged metals and 'clinker'.

■ Scrap metal purchases (for cash) are at risk of overstatement:

- ☐ to inflate the 15% subsidy;
- ☐ to conceal misappropriated cash.

■ The income subsidy will be overstated if quantities purchased are overstated and/or overvalued (on the quarterly returns) to obtain the amount of the subsidy.

■ Cash receipts/payments that were recorded only in the cash book in November are at risk of being unrecorded (in the absence of cash book postings for November), especially if they are of a 'one-off' nature.

- Expenditure is overstated in respect of the 25% provision for replacing the furnace linings. However, as depreciation will be similarly understated (as the furnace linings have not been capitalized) there is no risk of material misstatement to the income statement overall.

Disclosure risk

- A going concern ('failure') risk may arise through the loss of:
 - turnover (e.g. through misappropriation of salvaged metals and/or cash);
 - the subsidy (e.g. if returns are prepared fraudulently);
 - cash (e.g. if material amounts stolen).

Any significant doubts about going concern must be suitably disclosed in the notes to the accounts.

Disclosure risk

arises if the requirements of FRS 18 'Accounting policies' are not met.

- Disclosure risk arises if contingent liabilities in connection with the dumping of 'clinker' (e.g. for fines and penalties) are not adequately disclosed in accordance with FRS 12 'Provisions, contingent liabilities and contingent assets'.

Appropriate audit approach

- A risk-based approach is suitable because:
 - Inherent risk is high at the entity and financial assertion levels;
 - Material errors are likely to arise in stock where a high degree of subjectivity will be involved (regarding quality of metals, quantities, net realizable value, etc);
 - it directs the audit effort to stock, purchases, income (sales and subsidy) and other risk areas (e.g. contingent liabilities).
- A systems-based/compliance approach is not suited to the risk areas identified because controls are lacking/ineffective (e.g. over stock and cash). Also, as the audit appointment was not more than three months ago and no interim audit has been conducted (and the balance sheet date is only three weeks away) testing controls is likely to be less efficient than a substantive approach.
- A detailed substantive/balance sheet approach would be suitable to direct audit effort to the appropriate valuation of assets (and liabilities) existing at balance sheet date. Principal audit work would include:
 - attendance at a full physical stock count at 31 December 2005;
 - verifying cash at bank (through bank confirmation and reconciliation) and in hand (through physical count);
 - confirming the accuracy of the quarterly returns to the local authority.

- A cyclical approach/directional testing is unlikely to be suitable as cycles are incomplete. For example the purchases cycle for metals is 'purchase/cash' rather than 'purchase/creditor/cash' and there is no independent third party evidence to compensate for that which would be available if there were trade creditors (i.e. suppliers' statements). Also the cycles are inextricably inter-related to cash and stock – amounts of which are subject to high inherent risk.
- Analytical procedures may be of limited use for substantive purposes. Factors restricting the use of substantive analytical procedures include:
 - fluctuating margins (e.g. as many factors will influence the price at which scrap is purchased and subsequently sold, when salvaged, sometime later);
 - a lack of reliable/historic information on which to make comparisons.

(c) Extent of alleged fraud – Matters to be considered

- Details reported to police: The managing director may have made some estimate of the possible extent of the fraud in reporting the chief accountant's disappearance to the police.
- The minimum loss (assuming no insurance) would be sales for the three days before he left. If not known (e.g. because the only record of them was in the cash book) a simple estimate might be 3/20 □ total recorded turnover for a typical month.
- The pattern of cash banking extracted from bank statements: A falling trend starting during the year might mark the time from which the chief accountant began to misappropriate cash.
- Whether other managers have voiced their suspicions, if any, on the chief accountant's behaviour. For example, if there was any marked change in his lifestyle (what he appeared to spend his money on, the hours he worked, etc).
- The prior year auditors' report was unqualified. If this was appropriate the chief accountant's alleged fraudulent activities may have only started in the current year.
- The amount of fidelity insurance cover (i.e. against employees handling cash) that Indigo has taken out to meet any claim for fraud.
- The likelihood, if any, of recovering misappropriated amounts. For example, if the chief accountant has assets (e.g. a house) that can be used to settle Indigo's claims against him in the event that he is caught/successfully prosecuted.

5(a) Auditor's responsibilities for subsequent events:

- Auditors must consider the effect of subsequent events on:

- the financial statements;
- the auditors' report.
- Subsequent events are all events occurring after a period end (i.e. reporting date) i.e.:
 - events after the balance sheet date ; and
 - events after the financial statements have been issued.

Events occurring up to date of auditors' report

- The auditor is responsible for carrying out procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditors' report that may require adjustment of, or disclosure in, the financial statements have been identified.
- These procedures are in addition to those applied to specific transactions occurring after the period end that provide audit evidence of period-end account balances (e.g. stock cut-off and receipts from trade debtors). Such procedures should ordinarily include:
 - reviewing minutes of board/audit committee meetings;
 - scrutinizing latest interim financial statements/budgets/cash flows, etc;
 - making/extending inquiries to legal advisors on litigation matters;
 - inquiring of management whether any subsequent events have occurred that might affect the financial statements (e.g. commitments entered into).
- When the auditor becomes aware of events that materially affect the financial statements, the auditor must consider whether they have been properly accounted for and adequately disclosed in the financial statements. Subsequent events discovered after the date of the auditors' report but before financial statements are issued
- If the auditor becomes aware of such facts which may materially affect the financial statements, the auditor:
 - considers whether the financial statements need amendment;
 - discusses the matter with management; and
 - takes appropriate action (e.g. audit any amendments to the financial statements and issue a new auditors' report).
- If management does not amend the financial statements (where the auditor believes they need to be amended) and the auditors' report has not been released to the entity, the auditor should express a qualified opinion or an adverse opinion (as appropriate).

- If the auditors' report has been released to the entity, the auditor must notify those charged with governance not to issue

the financial statements (and the auditors' report thereon) to third parties.

- The auditor has no obligation to make any inquiry regarding financial statements that have been issued.

- However, if the auditor becomes aware of a fact which existed at the date of the auditors' report and which, if known at that date, may have caused the auditors' report to be qualified, the auditor should:

- consider whether the financial statements need revision;
- discuss the matter with management; and
- take appropriate action (e.g. issuing a new report on revised financial statements).

5(b) Implications for the auditors' report

(i) Corruption of perpetual stock records

- The loss of data (of physical stock quantities at the balance sheet date) gives rise to a limitation of scope.

- The systems failure in October 2005 is clearly a non-adjusting post balance sheet event. If it is material (such that non-disclosure could influence the economic decisions of users) Jinack should disclose:

- the nature of the event (i.e. systems failure); and
- an estimate of its financial effect (i.e. the cost of disruption and reconstruction of data to the extent that it is

not covered by insurance).

- If material this disclosure could be made in the context of explaining how stock has been estimated at 30 September 2005 (see later). If such disclosure, that the auditor considers to be necessary, is not made, the audit opinion should be qualified 'except for' disagreement (over lack of disclosure).

- The limitation of scope of the auditor's work has been imposed by circumstances. Jinack's accounting records (for stock) are inadequate (non-existent) for the auditor to perform tests on them.

- An alternative procedure to obtain sufficient appropriate audit evidence of stock quantities at a year end is subsequent count and 'rollback'. However, the extent of 'roll back' testing is limited as records are still under reconstruction.

■ The auditor may be able to obtain sufficient evidence that there is no material misstatement through a combination

of procedures:

– testing management’s controls over counting stock after the balance sheet date and recording stock

movements (e.g. sales and goods received);

– reperforming the reconstruction for significant items on a sample basis;

– analytical procedures such as a review of profit margins by stock category.

■ ‘An extensive range of stock’ is clearly material. The matter (i.e. systems failure) is not however pervasive, as only stock is affected.

■ Unless the reconstruction is substantially completed (i.e. stock items not accounted for are insignificant) the auditor cannot determine what adjustment, if any, might be determined to be necessary. The auditors’ report should then be qualified, ‘except for’, limitation of scope.

■ However, if sufficient evidence is obtained the auditors’ report should be unqualified.

■ An ‘explanatory paragraph’ would not be appropriate because this matter is not one of significant uncertainty.

■ If the 2005 auditors’ report is qualified ‘except for’ on grounds of limitation of scope there are two possibilities for

the stock figure as at 30 September 2005 determined on completion of the reconstruction exercise:

(1) it is not materially different from the stock figure reported; or

(2) it is materially different.

■ In (1), with the limitation now removed, the need for qualification is removed and the 2006 auditors’ report would

be unqualified (in respect of this matter).

■ In (2) the opening position should be restated and the comparatives adjusted in accordingly. Financial performance. The 2006 auditors’ report would again be unqualified.

■ The cash transfer is a non-adjusting post balance sheet event. It indicates that Batik was trading after the balance

Sheet date. However, that does not preclude Batik having commenced trading before the year end.

- The finance director's oral representation is wholly insufficient evidence with regard to the existence (or otherwise) of Batik at 30 September 2005. If it existed at the balance sheet date its financial statements should have been consolidated (unless immaterial).
- The lack of evidence that might reasonably be expected to be available (e.g. legal papers, registration payments, etc) suggests a limitation of the scope of the audit.
- If such evidence has been sought but not obtained then the limitation is imposed by the entity (rather than by circumstances).
- Whilst the transaction itself may not be material, the information concerning the existence of Batik may be material to users and should therefore be disclosed (as a non-adjusting event). The absence of such disclosure, if the auditor considered necessary, would result in a qualified ('except for') opinion.
- If Batik existed at the balance sheet date and had material assets and liabilities then its non-consolidation would have a pervasive effect. This would warrant an adverse opinion.
- Also, the nature of the limitation (being imposed by the entity) could have a pervasive effect if the auditor is suspicious that other audit evidence has been withheld. In this case the auditor should disclaim an opinion.

5(c) Basic Elements of Auditor's Report:

As per AAS 28, "The Auditor's Report on Financial Statements", the auditor's report includes the following basic elements:

1. Title: It is appropriate to use the term "Auditor's Report" in the title so as to distinguish the same from other reports, e.g., Board of Directors' Report, etc.
2. Addressee: Ordinarily, the auditor's report is addressed to the authority appointing the auditor.
3. Opening or Introductory Paragraph: The auditor's report should identify the financial statements of the enterprise that has been audited including the date of and period covered by the financial statements. This introductory paragraph must state that the preparation of financial statements is the responsibility of the management and that the auditor's responsibility is to express an opinion based on audit.
4. Scope Paragraph: The auditor's report should describe the scope of the audit stating that the audit was conducted in accordance with auditing standards generally accepted in India. It must also lay down briefly the work performed by the auditor and the constraints involved in discharge of his attest function.

5. **Opinion Paragraph:** This paragraph is mainly devoted for expression of opinion as to whether the financial statements give a true and fair view and whether they comply with the statutory requirements.
6. **Date of Report:** The date of an auditor's report on the financial statements is the date on which the auditor signs the report expressing an opinion on the financial statements. The date of report informs the reader that the auditor has considered the effect on the financial statements and on the report of the events and transactions of which the auditor became aware and that occurred up to that date. Since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.
7. **Place of Signature:** The report should name specific location, which is ordinarily the city where the audit report is signed.
8. **Auditor's Signature:** The report should be signed by the auditor in his personal name. Where the firm is appointed as the auditor, the firm name should also be mentioned. The proprietor or partner signing the report should also mention his membership number.

6(a) (i) Circuit Breakers

1. Individual Security-wise 2. Market-wide

1. In Securities:

- (a) It is levied to curb excessive volatility.
- (b) May be 2%, 10%, 20% or 40% based upon categories of shares.
- (c) It is calculated w.r.t. closing price of previous trading day.
- (d) For example, if on 13:06:2005 the closing rate of AFTEC INFOSYS is Rs.100 the price band in case of 20% circuit breaker is 80 (Lower freeze) and 120 (upper freeze).

2. Market wide C.B.

- a. w.e.f. 02:07:2001
- b. It has 3 stages of index movement 10%, 15% and 20%.
- c. It brings about trading halt in market nationwide (all markets)
- d. The percentages are calculated into absolute points of index variations on quarterly basis, based upon closing index of last day of trading in a quarter.
- e. So far only twice in Indian history.
- f. Depending upon time of index movement and its percentage trading may be halted for specified time period

II. Clearing and Settlement Mechanism

1. The securities pay-in obligations of members are down-loaded by the clearing agency.
2. The members make available the required securities in their pool accounts with Depository Participants (DPs) by the prescribed pay-in time for securities.
3. The depository runs an electronic file to transfer the securities from the pool accounts of members with DPs to the DP account of the clearing agency.
4. The securities are transferred on the pay-out day by the depository from the DP account of

- the clearing agency to the DP accounts of members.
5. Select banks have been empanelled by clearing agency for electronic transfer of funds.
 6. The members are informed electronically of their pay-in obligations of funds.
 7. The members make available required funds in their accounts with clearing banks by prescribed pay-in day.
 8. Same way, funds are transferred on the pay-out day by the clearing banks from the account of the clearing agency to the accounts of members.

6(b) Verification of Reinsurance Inwards

- The Reinsurance inward underwriting should be as per the norms and guidelines prescribed in the Insurance Act, 1938 IRDA Regulations as well as the company's approved programme.
- The auditor should verify the reinsurance inward transactions are as per the arrangements with re-insurers.
- The auditor should examine the **accounting policy** of the company in regard to reinsurance business received, premium received and payment of commission and claim costs.
- The auditor should satisfy himself about the system of control over the reinsurance inward programme.
- The auditor should examine the **foreign currency** transactions and ensure that they comply with Accounting Standards (AS) 11, Accounting for Effects of Changes in Foreign Exchange Rates.
- The auditor should examine whether the **outstanding claim figures** have been properly obtained well in time, under proper arrangements and adequate provision has been made for outstanding claims.
- The auditor should check whether **provision** has also been made for claims incurred but not reported.
- Closing balance of the re-insurer's accounts should be **reconciled** and confirmation should be obtained from them.

Verification of Reinsurance Outward

The auditor should apply the following verification measures for reinsurance outward transactions

- The auditor should verify that reinsurance outward transactions are as per the **norms** and guidelines prescribed in the Insurance Act, 1938, IRDA Regulations and company's approved reinsurance programme.
- The auditor should verify that insurances have been ceded as per **agreements** entered into with various companies.
- The auditor should verify the **confirmations** received from re-insurers regarding claims for losses submitted to them.
- The auditor should examine the aspects of **reinsurance premium**, commission receivable, paid claims- recovered, outstanding losses- recoverable from reinsurers.
- The auditor should examine the **foreign currency transactions** and ensure that they comply with Accounting Standard (AS) - 11.
- The auditor should set whether the sub-ledger balance tallies with general ledger control account. He should also **scrutinize** selected accounts of re-insurers.
- He should verify **any old outstanding** claims paid or outstanding at the end of the year.
The auditor should look into **events after balance sheet date** which might have significant impact on recovery of claims - paid or outstanding.

7(a) Certificate for Special Purpose vs. Audit Report:

A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. Government authorities may, under various statutes or notifications, require reports or certificates from auditors in support of statements or other information prepared by an enterprise. Reports or certificates on specific matters may also be required from auditors by an enterprise, for its own special purposes. These reports or certificates to specific requirements of the individual users are unlike a 'general purposes report' e.g. an auditor's report on financial statements which is intended for general use. A report, on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein, e.g., certification of export turnover, etc. On the other hand, when the reporting auditor gives the report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.

7(b) Audit vs. Investigation:

Etymologically, auditing and investigation are largely overlapping concepts because auditing is nothing but an investigation used in a broad sense. Both auditing and investigation are fact finding techniques but their basic nature and objectives differ as regards scope, frequency, basis, thrust, depth and conclusiveness. Audit and investigation differ in objectives and in their nature. Auditing is general while investigation is specific. The object of auditing is to ensure that the financial statements are free and fair and not misleading or unreliable. The merit of auditing lies in its ability to pronounce in general terms whether the accounts are basically reliable or not and in accordance with the legal requirements and regulations applicable to the particular audit. Audit is not based on suspicion unless circumstances exist to arouse suspicion of the auditor. Investigation implies systematic, critical and special examination of the records of a business for a specific purpose. The examination conducted under investigation is intensive as well as exhaustive so far as the activities or areas of accounting is concerned. Investigation requires a concentrated focus on the subject matter of inquiry and related matters. Often, investigations may spread over a period longer than one year and its scope may extend to inquiry beyond the books of accounts if the circumstances so require.

7(c) Advantages of Cost Audit to Government:

Cost auditor's approach is to ensure that the cost accounting plan is in consonance with the objectives set by the organization and the system of accounting is geared towards the attainment of the objectives. A cost accounting system designed to exercise control over cost may be different from the one if the objective is to fix price. Accordingly, over a period of time

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

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

7(d) Principal Enactments Governing Bank Audit:

There is an elaborate framework governing the functioning of banks in India. The whole of banking sector can be categorizing into several sectors such as commercial banks, cooperative banks, foreign banks, etc. The principal enactments which govern the functioning of various types of bank are as under:

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

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

7(e) Corporate Governance:

Corporate governance is the system by which companies are directed and controlled by the management in the best interest of the shareholders and others ensuring greater transparency and better and timely financial reporting. The Board of Directors is responsible for governance of their companies. A number of reports and codes of corporate governance have been published internationally. The Securities and Exchange Board of India (SEBI) had set up a Committee under the Chairmanship of Shri Kumar Manglam Birla to formulate the code of corporate governance. Based on this report, SEBI has by circular in February 2000 directed stock exchanges to amend the Listing Agreement between them and the entities whose securities are listed on such stock exchanges and include a new Clause 49 in such Listing Agreement. Various clauses deal with composition of board, setting-up of audit committee including scope thereof, remuneration of directors, meetings of Board, contents of management discussions and analysis report, etc. Clause 49 also prescribes that there shall be a separate section on Corporate Governance in the annual reports of company, with a detailed compliance report on Corporate Governance. Non compliance of any mandatory requirement i.e. which is part of the listing agreement with reasons there of and the extent to which the non-mandatory requirements have been adopted, should be specifically highlighted. Further, the entity is required to obtain a certificate from the statutory auditor of the entity as regards compliance of conditions of corporate governance as stipulated in that clause.

7(f) Walkthrough Tests:

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

confirm that the controls have been placed in operation.

When performing a walk-through, the auditor should:

- (i) Be sure that the walk-through encompasses the complete process (initiation, authorisation, recording, processing, and reporting) for each significant process identified, including controls intended to address fraud risk.
- (ii) Ask the entity's personnel, at each of key stage in the process, about their understanding of what the company's prescribed procedures require.
- (iii) Determine whether processing procedures are performed as expected on a timely basis, and look for any exceptions to prescribed procedures and controls.

- (iv) Evaluate the quality of evidence provided and perform procedures that produce a level of evidence consistent with the auditor's objectives. The auditor should follow the whole process, using the same documents and technology that company staff use, asking questions of different personnel at each significant stage, and asking follow-up questions to identify any abuse of controls or fraud indicators.

Once a walk-through is performed, the auditor may carry forward the documentation, noting updates, unless significant changes make preparation of new documentation more efficient. If such significant changes occur in the process flow of transactions or supporting computer applications, the auditor should evaluate the nature of the changes and the effect on related accounts. The auditor should determine whether it is necessary to walk through transactions that were processed both before and after the change.

No. of Questions: 9

CE

Total Marks: 100

No. of Pages Printed: 3

Time Allowed: 3 Hours

Questions 1, 2&3 are compulsory. Answer any four questions from the rest.

Answer any two of the following:

- 1(a)** Mr Ramesh has been appointed as a director of Good luck Limited on 22nd May 2006. The Articles of association of the company provides that the qualification of a director shall be holding 100 shares in the company. Mr Ramesh applied for 100 equity shares of the company on 30th June 2006. But the shares were allotted only at Board meeting held on 19th September 2006. Examine with reference to the relevant provisions of the Companies Act whether Mr Ramesh has complied with the requirements relating to qualification shares. If not, what are the consequences?

(6 Marks)

- 1(b)** Explain the significance of the definition clause in a statute. The definition of a word may be restrictive or extensive. Elaborate this with particular reference to the following definition of "Book and paper" as contained in the Companies Act, 1956.

'Book and paper include accounts, deeds, vouchers, writings and documents.

(6 Marks)

- 1(c)** Healthcare Limited a listed company decides to make a public issue of equity shares . Explain briefly the eligibility norms prescribed by SEBI guidelines to be complied with by the company.

(6 Marks)

- 2.** Answer any two of the following:

(a) Mr Saha an Indian national desires to obtain foreign Exchange for the following purposes:

- (i) Remittance of US dollar 50000 out of winnings on a lottery ticket
- (ii) US Dollar 1, 00,000 for sending a cultural troupe on a tour of USA
- (iii) US Dollar 50000 for meeting the expenses of his business tour to Europe.

Advise him whether he can get foreign Exchange and if so under what conditions? **(8 Marks)**

(b) Miss Jasmine is an air-hostess with British Airways. She flies for 12 days in a month and thereafter a break for 18 days . During the break, she is accompanied of 'base' which is normally the city where the airways headquartered. However, for security considerations, she was based on Mumbai. During the financial year she was accommodated at mumbai for more than 182 days. What would be her residential status under FEMA?

(8 Marks)

(c) (i) Explain the effects of a proviso to a section in a statute

(ii)Examine whether the following contracts require previous approval of the central government keeping in view the effect of the proviso to section 297 (1) of the Companies Act, 1956.

(8 Marks)

3(a) Contracts for purchase of goods from a Public Company having a paid up share capital of more than Rupees one crore by a firm in which a director of the Public company is a partner.

3(b) Contracts attracting section 297(1) to be entered into by a Public company having a paid up share capital of rupees one crore in circumstances of urgent necessity.

(3+5=8 Marks)

4(a) State with reference to the relevant provisions of the Companies Act, 1956 whether the following persons can be appointed as a Director of a Public company:

- (i) Mr. A, who has huge personal liabilities far in excess of his assets and Properties, has applied to the court for adjudicating him as an insolvent and such application is pending.

- (ii) Mr. B who was caught red-handed in a shop lifting case two years ago, was convicted by a court and sentenced to imprisonment for a period of one year.
- (iii) Mr. S a former Bank executive was convicted by a court eight years ago, for embezzlement of funds and sentenced to imprisonment for a period of eight weeks.
- (iv) Mr. R is a Director of SGT Limited which has not filed its Annual return pertaining to the Annual General Meetings held in the calendar years 2003, 2004, and 2005.

4(b) Draft a resolution proposed to be passed at a General Meeting of a Public Company giving consent the Board of Directors for borrowing upto a specified amount in excess of the limits laid down under section 293 (10 (d) of the Companies act, 1956 and also state the borrowings which are to be excluded from the said limits,

(8+8 Marks)

5(a) X was appointed as Managing Director for life by the articles of association of a private company incorporated on 1st June 2006. The articles also empowered X to appoint a successor. X appointed by will "G" to succeed him after his death. Answer the following:

- (i) Can "G" succeed "X" as managing director after the death of "X"?
- (ii) Is it possible for the company in general meeting to remove "X" from his office of directorship during his lifetime?

5(b) Answer the following with reference to a scheme of amalgamation of companies explaining the relevant provisions of the Companies act, 1956.

- (i) Whether companies being amalgamated must be companies registered in India.
- (ii) What is the majority required for approving the scheme of amalgamation in a meeting of members of a company called as per directions of the court? Is the scheme to be approved by preference shareholders?
- (iii) What will the court order dissolution of the transferor company.

(8+8 marks)

6(a) A public limited company has 10 directors as under:

Non-retiring directors	2
Directors liable to retire by rotation	4
Additional directors	4

State the number of directors retiring by rotation at the next annual general meeting and the number of directors vacating office.

6(b) Mr V chartered accountant is a Director in PQR Limited. The company proposes to appoint / engage the firm of V & Co in which Mr V is a partner in one or more of the following capacities.

(i) Consultants on monthly retainer basis

(ii) Authorised representative to appear before Tribunals.

Discuss whether the provisions of section 314 of the Companies Act are attracted in the above situation.

**(8+8
marks)**

7(a) M/s XYZ Limited was wound up with effect from 15-3-2007 by an order of the Court. Mr B, who ceased to be a member of the company from 1-6-2006 (was holding 200 shares of Rs. 10 each on which Rs. 5 per share paid up) has received a notice from the liquidator that he should deposit a sum of Rs. 5000 as his contribution towards the liability on the shares held by him previously.

In this context explain whether Mr.B can be called a contributory and whether he can be made liable and whether there is any limitation on his liability.

7(b) S Ltd is a subsidiary of H Ltd. the financial year of H Ltd is from 1st April to 31st March, whereas the financial year of S Ltd is 1st July to 30th June every year. This now causing difficulties, particularly in view of the requirement of reporting and circulating the Prime / March 08 Model Exam.

consolidated annual accounts as required by Accounting standard (AS – 21) . The Board of Directors of H Ltd decides that the accounting year of S Ltd for the year 1st July 2005 to 30th June 2006 be extended from present 12 months to 21 months i.e 1st July 2005 to 31st March 2007, so that the financial year of the holding company and the subsidiary company end on the same date. State the provisions of the Companies Act, in this respect and mention the steps to be taken in this regard.

(8+8Marks)

8(a) Advise M/s Simple Specialties Ltd in respect of the following proposals under consideration of Board of Directors;

(i) Appointment of wholetime director who is more than 70 years of age.

(ii) Payment of commission of 4% of the net profits per annum to the ordinary directors of the company.

(iii) Payment of remuneration to an ordinary director for rendering professional services:

And

(iv) Payment of remuneration of Rs. 40000 per month to the wholetime director of the company running in loss and having effective capital of Rs. 95 lakhs.

8(b) ASD Engineering Limited proposes to invest Rs. 20 lakhs in Equity Shares of RMS Limited. The proposed investment together with the investments in securities of companies and loans to body corporate already made exceed 60 per cent of the paid up capital and also 100 per cent of the free reserves of the company. The company has taken term loans from LIC.

(8+8Marks)

9(a) What do you understand by Corporate governance? Explain how the provisions of the Companies Act, 1956 relating to audit committee will help in achieving some of the objectives of corporate governance.

9(b) (i) Board of Directors of KT Ltd held a board meeting on 2nd May 2007 at its registered office. You are required to state the salient points to be taken into account while drafting the minutes of the said board meeting.

(ii) Draft a board resolution for the reappointment of Mr John as the Managing Director of YES Limited passed in the above stated board meeting.

(8+8 Marks)

- 1(a)** The relevant provisions for the qualification of shares of a director are Section 270 of the Companies Act. The qualification shares as provided in the Articles of Association of the company should be obtained within 2 months from the date of appointment and the value of qualification of shares should not exceed Rs. 5000.

In the above problem Mr Ramesh should obtain qualification shares on or before 21st July 2006, whereas he has been allotted shares on 19th September 2006 which is non compliance under section 270 and therefore he has to vacate office of director under section 283 of the companies act, 1956.

- 1(b)** The purpose of definition clause is two fold (i) to provide a key to the proper interpretation of enactment and (ii) to shorten the language of enacting part by avoiding repetition of same words contained in the definition part every time the legislature want to refer to the expressions contained in the definitions.

The definition of a word or expression in the definition section may either be restricting of its ordinary meaning or may be extensive of the same. When a word is defined to “mean” such and such, the definition is ‘prima facie’ restrictive and exhaustive we must restrict the meaning of the word to that given in the definition section. But where the word defined to “include” such and such, the definition is ‘prima facie’ extensive: here the word defined is not restricted to the meaning assigned to it but has extensive meaning which also includes the meaning assigned to it in the definition section.

As per Section 2 (8) of the Companies Act, 1956, book and paper include accounts, deeds, (vouchers) writings and documents. This definition is extensive definition and it includes what is assigned to it in the definition section.

1(c) The companies issuing securities offered through an offer document shall satisfy the following at the time of filing draft offer document with SEBI and also at the time of filing the final offer document with Registrar of companies / designated stock exchange.

1. Filing of offer document – An offer document has to be filed with SEBI then only a company can make public issue of securities.

A company can make an IPO if it meets the following requirements-

- It has net tangible assets of at least Rs. 3 crores in each of the preceding 3 full years, of which not more than 50% should be in monetary assets;
- It has distributable profits in at least three years as per the terms of the Companies Act;
- It has a net worth of at least Rs.1 crores in three years. The net worth is the aggregate value of paid-up equity capital and free reserves excluding the aggregate value of accumulated losses and deferred expenditure not written off;
- In case of change of its name within the last one year, at least 50% of the revenue for preceding 1 year is earned by the company from the activity suggested by the new name;
- The issue size does not exceed 5 times the pre-issue net worth.

However, to provide sufficient flexibility and to ensure that genuine companies do not suffer on account of rigidity of the parameters, SEBI has provided another alternative route to the company which does not comply with any of the above five conditions for accessing the primary market. Such an alternative route prescribes the following conditions:-

- Issue shall be through book building process, with at least 50% of the issue size to be mandatory allotted to the Qualified Institutional Buyers (QIB), failing to which mean that the full subscription would be refunded. A QIB means a public financial institution (PFI); banks; mutual funds ; foreign institutional investors (FIIs) registered with SEBI; venture capital funds, etc.; or
- The “project” is appraised and participated to the extent of 15% by Financial Institutions /Scheduled Commercial Banks of which at least 10% comes from the appraiser(s); and
- The minimum post-issue face value of capital of the company shall be Rs. 10 crore or there shall be a compulsory market-making for at least 2 years from the date of listing of the shares.

In addition to satisfying the aforesaid eligibility norms, the company shall also satisfy the criteria of having at least 1000 prospective allottees in its issue. However, above eligibility norms for IPO's are not applicable for the following:-

- Public or private sector banks;

- Infrastructure companies wholly engaged in the business of developing, maintaining and operating infrastructure facility within the meaning of Section 10 (23-G) of the Income Tax Act;
- Rights issue by a listed company. Rights Issue (RI) is when a listed company proposes to issue fresh securities to its existing shareholders as on a record date. This route is best suited for companies who would like to raise capital without diluting stake of its existing shareholders.

Any company making a public issue of value of more than Rs. 50 lakhs is required to file a draft offer document with SEBI for its observations. It should be filed by registered merchant banker at least 21 days prior to the filing it with the Registrar of Companies (ROCs). The Merchant Banker are the specialized intermediaries in the primary market who are required to operate instructions and guidelines of SEBI and to ensure that all the requirements of DIP are complied with while submitting the draft offer document to SEBI. The final offer document must be filed with ROC or the designated stock exchange for listing the securities of the company. The validity period of SEBI's observation letter is three months only. That is, the company has to open its issue within three months period.

Taking a company public through an Initial Public Offer (IPO) is a major task for any entrepreneur. The benefits of going public through IPO are:-

- It allows companies to have greater access to the most substantial source of corporate funding. The companies can also return to the market for additional equity through secondary equity offerings.
- It helps the company to institute stock options for its employees and to attract more talent to their organisation.
- It attracts media attention and helps in marketing the products of the company.
- It helps to expand business relationships of the companies with their partners, suppliers, debtors as well as customers.
- It facilitates the mergers and acquisitions activities of the companies and provide them with the greater flexibility in raising finances.

For many entrepreneurs and top managers of companies, the process and event of going public mark the culmination of years of hard work, public recognition of success and long-delayed financial rewards. Going public gives an opportunity for their business growth, brand equity as well as brings some legal responsibilities for them. It involves sharing of ownership of the company, business opportunities as well as the control over the company's future.

2(a) (i) No, the remittance is not possible as the drawal of Foreign Exchange is prohibited for the funds out of Lottery winnings

(ii) Dance troops who visit to undertake cultural tours abroad are required to obtain prior approval from the Ministry of Human resources development, government of

India , New Delhi . Authorised Dealers may release foreign exchange, on the strength of the sanction from the concerned Ministry, to the extent and subject to conditions indicated therein.

- (iii) Authorised Dealer can release foreign exchange upto USD 25000 for a business trip to any country other than Nepal and Bhutan. Release of foreign exchange in excess of USD 25000 for travel abroad for business purposes requires prior permission from RBI.

2(b) Miss Jasmine stayed in India at Mumbai base for more than 182 days in the preceding financial year. The issue here is whether staying can be considered to residing. While the FERA emphasized 'stay' FEMA emphasizes 'residing'. 'stay' is a physical attribute. While 'residing' denotes permanency. Thus, while Miss Jasmine may be a stayed in India for more than 182 days, it is doubtful whether he can be said to her 'resided' in India for more than 182 days.

Further under section2 (v)(A), she would become resident only if she has come to or stayed in India for employment. It would be doubtful and debatable, whether by staying at Mumbai base during the break, Miss Jasmine can be said to have come to a stayed in India for or on taking up employment. Hence Miss Jasmine would continue to be non-resident.

2(C) (i)The normal function of a proviso is to except something out of the enactment or to qualify something stated in the enactment which would be within its purview if the proviso were not there.

(ii)The effect of the proviso is to qualify the preceding enactment which is expressed in terms which are too general. As a general rule, a proviso is added to qualify or create an exception to what is in the enactment: ordinarily a proviso is not interpreted while stating a general rule and it is cardinal rule of interpretation that a proviso to a particular provision of a statue only embraces the field which is covered by the main provision.

3(a). When a contract for purchase of goods from a public company having a paid up share capital of more than Rupees one crore by a firm in which a director of the public company is a partner. The transaction attracts Section 297 of the Companies Act, 1956 According to Section 297, when the paid up capital of the company is more than Rs. One crore and it enters into contract with a firm in which a director of the public company is a partner, previous approval of the central government is required.

3 (b). In case of urgent necessity, contract can be entered without consent of the Board for the sale and supply of goods and services and in such a case the consent of the Board should be obtained within 3 months of the date of entering into the contract. Where the paid up capital of the public company is more than Rs. 1 crore approval of the Central Government is also required.

4(a) (i) Mr A is not eligible for appointment of Director Under section 274 (1) (c) of the Companies act, 1956

(ii) Mr. B is not eligible for appointment as Director under section 274 (1) (d) of the Companies Act, 1956 according to which if a person has been convicted by Court for any offence involving moral turpitude and sentenced to imprisonment for a period of not less than 6 months and period of 5 years has not elapsed from the date of the sentence.

(iii) As per Section 274 (1) (d) of the Companies Act, 1956 if a person has been convicted by Court for any offence involving moral turpitude and sentenced to imprisonment for a period of not less than 6 months and period of 5 years has not elapsed from the date of the sentence, he cannot be appointed as Director. In the problem given more than 5 years has elapsed, hence Mr S can be appointed as Director .

(iv) Mr R is not eligible to be appointed as Director under section 274(1) (g) of the Companies Act, 1956 since consecutively for 3 years annual returns have not been filed.

4(b) Resolved that consent of the Company be and is hereby, accorded under the provision of Section 293(1)(d) of the Companies Act, 1956, to the Board of directors of the Company for borrowing by issue of Debentures or otherwise from time to time all such sums of money as they may deem necessary for the purposes of business of the Company, apart from temporary loans obtained from the Company's bankers in the ordinary course of business, exceeding the aggregate of the paid-up capital of the Company and its free reserves that is to say reserves, not set apart for any specific

purpose, provided that the total amount up to which the monies may be borrowed by the Board of directors shall not exceed the sum of Rs.3 crores any time'.

Borrowings which are to be excluded from the limits :

Temporary loans obtained from the company's bankers in the ordinary course of business like short term loans, cash credit arrangement and discounting of bills.

5(a) (i) No article can constitute a contract between a company and a third person and that no right merely purporting to be given by an article to a person, whether a member or not, in a capacity other than that of a member, as far instance, director can be enforced against the company (Hickman Vs. Kent on Romney Marsh sheep Breeders' Association (1914-15). If the company doesn't want to appoint "G" in the place of Mr "X" , G cannot succeed.

(ii) Yes, it is possible for the company in general meeting to remove "X" from his office of directorship during his lifetime since no article can constitute a contract between a company and a third person.

5(b) (i) Companies being amalgamated must be companies registered in India.

(ii) The amalgamation scheme should be approved by the members by a majority in number of members present in person or on proxy and voting on the resolution and this majority must represent at least $\frac{3}{4}$ th is in value of shares held by the members who vote in poll.

Yes. Scheme to be approved by preference shareholders. If the consent of the preference shareholders is given in writing the Court may dispense with the requirement of convening the meeting of preference shareholders.

(iii)Section 394(1) (iv) vests powers in the High Court either by order sanctioning the scheme or by a subsequent order of dissolution, without winding up, of any transferor company provided the official liquidator has on scrutiny of the books and papers of the company made a report to the Court that the affairs of the company have not been conducted in a manner prejudicial to the interests of its members or to public interest.

6(a) The 3 additional directors will have to vacate the office at the Annual General meeting and they will not be considered for the calculation of directors retiring by rotation.

The remaining directors i.e 6 are to be taken for the purpose of calculation of retiring directors. As per section 255 two third of the directors are liable to retire by rotation and as per section 256 one third of such directors should retire by rotation. Hence in the problem given one director from the directors liable to retire by rotation should retire at the Annual general meeting.

6(b) (i) Under Section 314 of the Companies Act, 1956, if the company proposes to appoint/engage the firm of V & Co in which Director V is partner on a monthly retainer basis, approval of the shareholder by way of special resolution is required. If the monthly retainership payment is more than Rs. 50000, then approval of the Central government is required.

(ii) As per section 314 of the Companies Act, 1956, if the authorization is one time only then there is no approval from the shareholder is required . Otherwise approval from the shareholders by special resolution and Central government approval is required under Section 314 of the Companies act, 1956.

7(a) In the problem given Mr B ceased to be a member of the company from 1-6-2006 and the company was wound up 15-3-2007 and one year is completed.

As per the provisions of the Companies Act, 1956, a shareholder is liable as a contributory for the amount which he is liable to pay on his share if he ceased as a member within a from the date of winding up of the company.

The liability of the member is Rs. 5000 the amount remaining to be paid on the share .

7(b) As per section 212 the balance sheet of holding company and balance sheet of subsidiary company shall be made –

- i) as at the end of the subsidiary company where such financial year coincides with the financial year of the holding company.
- ii) where financial year of the subsidiary company does not coincide with that of the holding company , the balance sheet of the subsidiary company should end on a day which is 6 months from the end of the date of the balance sheet of the holding company.

In the above problem extension of the date of the annual general meeting is required for which purpose an application has to be made to central government under section 213 of the Companies Act, 1956.

8(a) (i) Appointment of wholetime director who is more than 70 years requires approval of the central government since the appointment is not in conformity with Schedule XIII.

(ii) Under Section 309 of the Companies Act, 1956, the ordinary director can pay remuneration of 1% of the net profits of the company if the company is having Managing Director/ Wholetime Director or 3% of the net profits of the company if the company is not having managing Director / wholetime director. In the circumstances the payment of commission of 4% to the ordinary director the approval of the Central government is required.

(iii) Payment of remuneration can be made to the ordinary director for rendering professional services

- i) for services rendered which are professional in nature; and
- ii) for which Central Government is satisfied that he is qualified to practice the profession.

The following steps are required:–

- a) Convene a Board Meeting after giving notice to all the directors of the company as per section 286 and pass a resolution authorizing such payment for professional services;
- b) Make an application to the Central Government on a plain paper giving full details and asking of its opinion whether the concerned director possesses the requisite qualifications for the practice of the profession;
- c) The expression of opinion by the Central Government under the proviso to section 309(1) of the Act is required for rendering services by any Director, which are of a professional nature. The said proviso is also applicable for practice of the profession as an advocate, as per express provisions made there under.
- d) While making an application, the company should, inter alia, state the name(s) of the company(ies) in which the Advocate/director is a director. The expression of opinion will be required separately for each such director by each such company, if so desired.
- e) Section 309 deals with remuneration of directors individually and not with the firms in which such a director is a partner. The proviso to subsection (1) refers to services rendered by any director in any professional capacity
- f) Attach to the application the following documents:–
 - i) A certified copy of the certificate evidencing the professional qualification of the director;
 - ii) A certified copy of the latest audited balance sheet and profit and loss account.
 - iii) A receipted treasury challan or demand draft evidencing the payment of the requisite fee prescribed under the Companies (Fees on Applications) Rules, 1968.

And forward simultaneously to the Registrar of Companies

- iv) As per schedule XIII approval of the shareholders is required for payment of Rs.40000 per month to the wholetime director of the company running in loss and having effective capital of Rs. 95 lakhs.

8(b) ASD Engineering Company should take the approval from LIC for proposed further investment of Rs. 20 lakhs in RMS Limited. As per section 372 A of the Companies Act, 1956, when the company invests in other companies 60% more than paid up capital and 100% more than its free reserves it should obtain the approval of the shareholders by way of special resolution. Further in the Boarding where the proposal is considered all the directors present at the meeting should approve the resolution unanimously.

9(a) Corporate Governance is indispensable to resilient and vibrant capital markets and is an important instrument of investor protection. It is the blood that fills the veins of transparent corporate disclosure and high quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure.

Audit committee under the Companies Act, 1956.

Audit Committee has a critical role to play in ensuring the integrity of financial management of the company. This Committee add assurance to the shareholders that the auditors, who act on their behalf, are in a position to safeguard their interests. Besides the requirements of Clause 49, section 292A of the Act requires every public having paid up capital of Rs 5 crores or more shall constitute a committee of the board to be known as Audit Committee. As per the Act, the committee shall consist of at least three directors; two-third of the total strength shall be directors other than managing or whole time directors. The Annual Report of the company shall disclose the composition of the Audit Committee. The recommendations of the committee on any matter relating to financial management including Audit Report, shall be binding on the board. In case board does not accept the recommendations so made, the committee shall record the reasons thereof, which should be communicated to the shareholders, probably through the Corporate Governance Report. The committee shall act in accordance with the terms of reference to be specified in writing by the board. The committee should have periodic discussions with the auditors about the Internal Control Systems and the scope of audit including the observations of the auditors. If the default is made in complying with the said provision of the Act, then the company and every officer in default shall be punishable with imprisonment for a term extending to a year or with fine up to Rs 50000 or both.

9(b) (i) The salient points which are required to be taken into account while drafting the minutes of the board meeting.

1. To give names of the directors present at the meeting
2. To give names of the directors absent and asking for the grant of leave of absence by the Board.
3. to give names of directors voting for or against the various resolutions under respective items of business.
4. To read notice given by directors, if any, with regard to their directorships in other companies and their shareholding as per section 299(3) of the companies act, 1956.
5. To mention the fact of unanimity of decisions of directors as contemplated in sections 316, 372A, and 386.
6. To incorporate appointment of officers made at the Board meeting.
7. while delegating the powers care should be taken to draft the resolutions so as to provide automatic cancellation of powers delegated when the delegate ceases to be in the employment of the company.

(ii) RESOLVED that as required vide section 269(1) of the Companies Act, 1956, Mr John who fulfills the conditions laid down in part I and part II of Schedule XIII to the Companies Act, 1956, be and is hereby reappointed as Managing Director of the company for a period of 5 years with effect from 1-2-2008 AND that, he be paid remuneration of Rs. 1,00,000 per month by way of salary, commission and perquisites entitled to him as per part II of schedule XIII to the Act.

RESOLVED FURTHER that the Company Secretary shall file a return in Form No. 25C of General rules & forms, with the Company Law Board and the Registrar of Companies within 90 days of actual assumption of office by My John.

