REVISION TEST PAPER

FINAL (OLD) COURSE

GROUP – I

MAY – 2010

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PAPER – 1 : ADVANCED ACCOUNTING

QUESTIONS

Holding Company Accounts

1. The Balance Sheets of Bat Ltd. and Ball Ltd. as on 31.3.2009 are as follows:

	Bat Ltd.	*Ball Ltd.*		*Bat Ltd.*	*Ball Ltd.*
	Rs.	*Rs.*		*Rs.*	*Rs.*
Share Capital			Investments		
(Shares of Rs. 10 each)	1,60,000	2,00,000	Shares in Ball Ltd.	1,96,000	–
Profit and Loss account	50,000	60,000	Debtors	–	1,20,000
Creditors	–	16,000	Stock	–	80,000
			Cash at Bank	–	70,000
			Cash in hand	14,000	6,000
	2,10,000	2,76,000		2,10,000	2,76,000

Particulars of Bat Ltd.:

(1) This company was formed on 1.4.2008.

(2) It acquired the shares of Ball Ltd. as under:

Date of Acquisition	*No. of Shares*	*Cost*
		Rs.
1.4.2008	8,000	1,10,000
31.7.2008	6,000	86,000

(3) The shares purchased on 31.7.2008 are ex-dividend and ex-bonus from existing holders.

(4) On 31.7.2008 dividend at 10% was received from Ball Ltd. and was credited to Profit and Loss Account.

(5) On 31.7.2008 it received bonus shares from Ball Ltd. in the ratio of one share on every four shares held.

(6) Bat Ltd. incurred an expenditure of Rs. 500 per month on behalf of Ball Ltd. and this was debited to the Profit and Loss Account of Bat Ltd., but nothing has been done in the books of Ball Ltd.

(7) The balance in the Profit and Loss Account as on 31.3.2009 included Rs. 36,000 being the net profit made during the year.

(8) Dividend proposed for 2008-2009 at 10% was not provided for as yet.

Particulars of Ball Ltd.:

(1) The balance in the Profit and Loss Account as on 31.3.2009 is after the issue of bonus shares made on 31.7.2008.

(2) The net profit made during the year is Rs. 24,000 including Rs. 6,000 received from insurance company in settlement of the claim towards loss of stock by fire on 30.06.2008 (Cost Rs. 10,800 included in opening stock).

(3) Dividend proposed for 2008-2009 at 10% was not provided for in the accounts.

Prepare the Consolidated Balance Sheet of Bat Ltd. as on 31.3.2009.

Statutory Financial Statements of a Company

2. On 1st November, 2008 Yash Ltd. was incorporated with an authorized capital of Rs. 1,000 crores. It issued to its promoters equity capital of Rs. 50 crores which was paid for in full. On that day it purchased the running business of Vijay Ltd. for Rs. 200 crores and allotted at par equity capital of Rs. 200 crores in discharge of the consideration. The net assets taken over from Vijay Ltd. were valued as follows: Fixed Assets Rs. 150 crores, Inventory Rs. 10 crores, Customers' dues Rs. 70 crores and Creditors Rs. 30 crores.

Yash Ltd. carried on business and the following information is furnished to you:

(a) Summary of cash/bank transactions (for year ended 31st October, 2009).

		(Rs. in crores)
Equity capital raised:		
Promoters (as shown above)	50	
Others	250	300
Collections from customers		4,000
Sale proceeds of fixed assets (cost Rs.18 crores)		20
		4,320
Payments to suppliers	2,000	
Payments to employees	700	
Payment for expenses	500	3,200
Investments in Upkar Ltd.		100
Payments to suppliers of fixed assets:		
Instalment due	600	
Interest	50	650
Tax payment		270
Dividend		50
Closing cash/bank balance		50
		4,320

(b) On 31st October, 2009 Yash Ltd.'s assets and liabilities were:

	(Rs. in crores)
Inventory at cost	15
Customers' dues	400
Prepaid expenses	10
Advances to suppliers	40
Amounts due to suppliers of goods	260
Amounts due to suppliers of fixed assets	750
Outstanding expenses	30

(c) Depreciation for the year under:

(i) Companies Act, 1956 — Rs. 180 crores

(ii) Income tax Act, 1961 — Rs. 200 crores

(d) Provide for tax at 38.5% of "total income". There are no disallowables for the purpose of income taxation. Provision for tax is to be rounded off.

Yash Ltd. asks you to prepare:

(i) Revenue statement for the year ended 31st October, 2009 and

(ii) Balance Sheet as on 31st October, 2009 from the above information.

Corporate Restructuring

Amalgamation of Companies

3. System Ltd. and HRD Ltd. decided to amalgamate as on 01.04.2008. Their Balance Sheets as on 31.03.2008 were as follows:

(Rs. in '000)

Particulars	*System Ltd.*	*HRD Ltd.*
Source of Funds :		
Equity share capital (Rs. 10 each)	150	140
9% preference share Capital (Rs. 100 each)	30	20
Investment allowance Reserve	5	2
Profit and Loss Account	10	6
10 % Debentures	50	30
Sundry Creditors	25	15
Tax provision	7	4
Equity Dividend Proposed	30	28
Total	307	245

Application of Funds :		
Building	60	50
Plant and Machinery	80	70
Investments	40	25
Sundry Debtors	45	35
Stock	36	40
Cash and Bank	40	25
Preliminary Expenses	6	—
Total	307	245

From the following information, you are required to prepare the draft Balance Sheet as on 01.04.2008 of a new company, Intranet Ltd., which was formed to take over the business of both the companies and took over all the assets and liabilities:

(i) 50 % Debenture are to be converted into Equity Shares of the New Company.

(ii) Out of the investments, 20% are non-trade investments.

(iii) Fixed Assets of Systems Ltd. were valued at 10% above cost and that of HRD Ltd. at 5% above cost.

(iv) 10 % of sundry Debtors were doubtful for both the companies. Stocks to be carried at cost.

(v) Preference shareholders were discharged by issuing equal number of 9% preference shares at par.

(vi) Equity shareholders of both the transferor companies are to be discharged by issuing Equity shares of Rs. 10 each of the new company at a premium of Rs. 5 per share.

Amalgamation is in the nature of purchase.

Internal Reconstruction of a Company

4. The Balance Sheet of Neptune Ltd. as on 31.3.2009 is given below:

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*
Equity shares of Rs.10 each fully paid (80,000 shares)		8,00,000	Freehold property	5,00,000
6% Cumulative pref. shares of 100 each fully paid (5,000 shares)		5,00,000	Plant & machinery	1,80,000
6% Debentures (secured by freehold property)	3,75,000		Trade investment (at cost)	1,70,000
Arrear interest	22,500	3,97,500	Sundry debtors	4,50,000

Sundry creditors	17,500	Stock in trade	2,00,000
Director's loan	3,00,000	Deferred advertisement expenditure	1,50,000
		Profit and Loss A/c	3,65,000
	20,15,000		20,15,000

The Court approved a scheme of re-organisation to take effect on 1.4.2009 and the terms are given below:

(i) Preference shares are to be written down to Rs.75 each and equity shares to Rs.2 each.

(ii) Preference dividend in arrear for 4 years to be waived by 75% and for the balance equity shares of Rs.2 each to be allotted.

(iii) Arrear of debenture interest to be paid in cash.

(iv) Debentureholders agreed to take one freehold property (Book value Rs.3,00,000) at a valuation of Rs.3,00,000 in part payment of their holding. Balance debentures to remain as liability of the company.

(v) Deferred Advertisement Expenditure to be written off.

(vi) Stock value to be written off fully in the books.

(vii) 50% of the Sundry Debtors to be written off as bad debt.

(viii) Remaining freehold property (after take over by Debentureholders) to be valued at Rs.3,50,000.

(ix) Investments sold out for Rs.2,00,000.

(x) 80% of the Director's loan to be waived and for the balance equity shares of Rs.2 each to be issued.

(xi) Company's contractual commitments amounting to Rs.5,00,000 to be cancelled by paying penalty at 3% of contract value.

(xii) Cost of Re-construction Scheme is Rs.20,000.

Show the Journal entries (with narration) to be passed for giving effect to the above transactions and draw Balance Sheet of the company after effecting the Scheme.

Buy-Back of Shares

5. Dee Limited furnishes the following Balance Sheet as at 31st March, 2009:

Liabilities	*Rs.'000*	*Rs.'000*
Share Capital:		
Authorised Capital		30,00
Issued and subscribed capital:		

2,50,000 equity shares of Rs.10 each fully paid up	25,00	
2,000, 10% Preference shares of Rs.100 each (Issued two months back for the purpose of buy back)	2,00	
		27,00
Reserves and Surplus:		
Capital Reserve	10,00	
Revenue Reserve	30,00	
Securities Premium	22,00	
Profit and Loss A/c	35,00	
		97,00
Current liabilities and provisions:		14,00
		1,38,00

Assets	*Rs.'000*
Fixed assets	93,00
Investments	30,00
Current assets, loans and advances (Including cash and bank balance)	15,00
	1,38,000

The company passed a resolution to buy back 20% of its equity capital @ Rs.50 per share. For this purpose, it sold all of its investments for Rs.22,00,000.

You are required to pass necessary journal entries and prepare the Balance Sheet.

Valuation of Shares

6. The following abridged Balance Sheet as at 31st March, 2009 pertains to Omega Ltd.

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

Current Liabilities	1,242	
Provisions	960	
	15,600	15,600

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

(i) Intrinsic value on the basis of book values of Assets and Liabilities including goodwill;

(ii) Value per share on the basis of dividend yield.

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

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

For the year ended 31st March, 2009 the company has earned Rs. 1,371 lakh as profit after tax, which can be considered to be normal for the company. Average EPS for a fully paid share of Rs. 10 of a Company in the same industry is Rs. 2.

Valuation of Goodwill

7. From the following information supplied to you, ascertain the value of goodwill of A Ltd., which is carrying on business as retail trader, under Super Profit Method (at 5 years' purchase of Super Profits):-

Balance Sheet as on 31st March, 2009

	Rs.		Rs.
Paid up capital:		Goodwill at cost	50,000
5,000 shares of Rs.100 each fully paid	5,00,000	Land and Building at cost	2,20,000
Bank Overdraft	1,16,700	Plant and Machinery at cost	2,00,000
Sundry Creditors	1,81,000	Stock in trade	3,00,000
Provision for taxation	39,000	Book debts less provision for bad debts	1,80,000
Profit & Loss Appropriation A/c	1,13,300		
	9,50,000		9,50,000

The company commenced operations in 1990 with a paid up capital of Rs.5,00,000. Profits for recent years (after taxation) have been as follows:-

Year ended 31st March	Rs.	
2005	40,000	(Loss)
2006	88,000	

2007	1,03,000
2008	1,16,000
2009	1,30,000

The loss in 2005 occurred due to a prolonged strike.

The income-tax paid so far has been at the average rate of 40%, but it is likely to be 50% from 2010 onwards. Dividends were distributed at the rate of 10% on the paid up capital in 2006 and 2007 and the rate of 15% in 2008 and 2009. The market price of shares is ruling at Rs.125 at the end of the year ended 31st March, 2009. Profits till 2009 have been ascertained after debiting Rs.40,000 as remuneration to the managing director. The government has approved a remuneration of Rs.60,000 with effect from 1st April, 2009. The company has been able to secure a contract for supply of materials at advantageous prices. The advantage has been valued at Rs.40,000 per annum for the next five years.

Valuation of Business

8. Shree Ltd. gives the following information:

Current profit	Rs.210 lakhs
Compound growth rate of profit	7.5% p.a.
Current cash flows from operations	Rs.270 lakhs
Compound growth rate of cash flows	6.5% p.a.
Current price earning ratio	12
Discount factor	20%

Find out the value of Shree Ltd. taking 10 years' projected profit or cash flows based on (i) Discounted earnings method, and (ii) Discounted cash flows method.

Value Added Statement

9. The following is the Profit and Loss Account of Ganpati Ltd. for the year ended 31.03.2009. Prepare a Gross Value Added Statement of Ganpati Ltd. and show also the reconciliation between Gross Value Added and Profit before taxation.

Profit and Loss Account for the year ended 31.03.2009

	Notes		*Amount* *(Rs. in lakhs)*
Income:			
Sales		–	890
Other Income		–	55
			945
Expenditure:			
Production and operational expenses	(a)	641	–

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

Notes:

(a)	Production and Operational expenses	*Rs. in lakhs*
	Consumption of raw materials	293
	Consumption of stores	59
	Salaries, Wages, Gratuities etc. (Admn.)	82
	Cess and Local taxes	98
	Other manufacturing expenses	109
		641

(b) Administration expenses include salaries, commission to Directors Rs.9.00 lakhs Provision for doubtful debts Rs. 6.30 lakhs.

		Rs. in lakhs
(c)	Interest on loan from ICICI Bank for working capital	9
	Interest on loan from ICICI Bank for fixed loan	10
	Interest on loan from IFCI for fixed loan	8
	Interest on Debentures	2
		29

(d) The charges for taxation include a transfer of Rs. 3.00 lakhs to the credit of Deferred Tax Account.

(e) Cess and Local taxes include Excise Duty, which is equal to 10% of cost of bought-in material.

Economic Value Added

10. (a) What is economic value added and how is it calculated? Discuss.

    (b) Calculate economic value added (EVA) with the help of the following information Sun Limited.

    Financial leverage: 1.4 times;

    Equity Capital Rs.170 lakh;

    Reserve and surplus Rs.130 lakh;

    10% Debentures Rs.400 lakh;

    Cost of Equity: 17.5%

    Income Tax Rate: 30%.

Human Resource Accounting

11. From the following details, compute value of human resources according to Lev and Schwartz (1971) model .

(i)	Annual average earning of an employee till the retirement age	Rs.50,000
(ii)	Age of retirement	65 years
(iii)	Discount rate	15%
(iv)	No. of employees	20
(v)	Average age	62 years

Corporate Social Reporting

12. (a) "The content of corporate social report is essentially based on social objectives." Discuss.

    (b) From the following information of Steel India Ltd. for the year ended 31st March, 2009, prepare their Social Balance Sheet as on that date:

    - A specialist has valued their human assets at Rs.828 lakhs.
    - Their investments were classified as:

(Rs. in lakhs)

	Residential	*Hospital*	*School*	*Welfare*
Buildings	17.00	1.00	1.40	0.80
Equipments	2.80	1.00	1.00	-

- Water, electricity and gas supply systems totalled Rs.1 lakh.
- Their Net owned funds were Rs.26 lakhs.

Financial Reporting of Financial Institutions

13. Write short notes on:

    (i) Minimum net owned fund in the context of NBFC

    (ii) Valuation of portfolio for a mutual fund

    (iii) Obligations of stock broker on inspection by the Board

    (iv) Books of account required to be maintained by a Stock Broker

    (v) Asset management company in the context of a mutual fund

14. A Mutual Fund raised 100 lakh on April 1, 2009 by issue of 10 lakh units of Rs. 10 per unit. The fund invested in several capital market instruments to build a portfolio of Rs. 90 lakhs. The initial expenses amounted to Rs. 7 lakh. During April, 2009, the fund sold certain securities of cost Rs. 38 lakhs for Rs. 40 lakhs and purchased certain other securities for Rs. 28.20 lakhs. The fund management expenses for the month amounted to Rs. 4.50 lakhs of which Rs. 0.25 lakh was in arrears. The dividend earned was Rs. 1.20 lakhs. 75% of the realized earnings were distributed. The market value of the portfolio on 30.04.2009 was Rs. 101.90 lakh. Determine NAV per unit.

15. Krishna Finance Ltd. is a non-banking finance company. It makes available to you the costs and market price of various investments held by it.

		(Rs. in lakhs)
	Cost	*Market price*
Equity Shares:		
Scrip A	40.00	40.80
Scrip B	21.00	16.00
Scrip C	40.00	24.00
	101.00	80.80
Mutual Funds		
MF_1	26.00	16.00
MF_2	20.00	24.00
	46.00	40.00
Government Securities		
GV_1	50.00	44.00
GV_2	50.00	58.00
	100.00	102.00

    (i) Can the company adjust depreciation of a particular item of investment within a category?

    (ii) What should be the value of investments?

Accounting for Not-for-profit Organizations

16. A University receives two grants – one from the Ministry of Human Resources to be used for Aids Research. This grant is for Rs. 45,00,000, which includes Rs. 3,00,000 to cover indirect expenses incurred in administering the grant. The second grant of Rs. 35,00,000 received from a reputed Trust is to be used to set up a centre to conduct seminars on Aids related matters from time to time. During the year, it also received Rs. 5,00,000 worth of equipment donated by a well wisher to be used for Aids research. During the year 2008-2009, the University spent Rs. 32,25,000 of the government grant and incurred Rs. 3,00,000 overhead expenses. Rs. 28,00,000 were spent from the grant received from the Trust. Show the necessary Journal Entries.

Indian AS, IFRS and US GAAPs

17. State the treatment of the following items with reference to Indian Accounting Standards and IFRS:

    (i) Impairment of assets

    (ii) Business combinations.

Accounting Standards and Guidance Notes

18. Write short notes on:

    (i) Disclosure of carrying amounts of financial assets and financial liabilities in Balance Sheet

    (ii) Financial guarantee contract

    (iii) De-recognition of financial liability

    (iv) Impairment of asset and its application to inventory

19. Write short notes on:

    (i) Graded vesting under an employee stock option plan

    (ii) Presentation of MAT credit in the financial statements

    (iii) Accounting for investment by a holding company in subsidiaries.

    (iv) Provisions of AS 26 relating to retirement and disposal of intangible assets.

    (v) Change in accounting estimates.

20. (i) Mr. 'X' as a contractor has just entered into a contract with a local municipal body for building a flyover. As per the contract terms, 'X' will receive an additional Rs.2 crore if the construction of the flyover were to be finished within a period of two years of the commencement of the contract. Mr. X wants to recognize this revenue since in the past he has been able to meet similar targets very easily.

    Is X correct in his proposal? Discuss.

(ii) The accounting year of X Ltd. ends on 30th September, 2009 and it makes its reports quarterly. However for the purpose of tax, year ends on 31st March every year. For the Accounting year beginning on 1-10-2008 and ends on 30-9-2009, the quarterly income is as under:-

1st quarter ending on 31-12-2008	Rs. 200 crores
2nd quarter ending on 31-3-2009	Rs. 200 crores
3rd quarter ending on 30-6-2009	Rs. 200 crores
4th quarter ending on 30-9-2009	Rs. 200 crores
Total	Rs. 800 crores

Average actual tax rate for the financial year ending on 31-3-2009 is 20% and for financial year ending 31-3-2010 is 30%. Calculate tax expense for each quarter.

(iii) P Ltd. has 60% voting right in Q Ltd. Q Ltd. has 20% voting right in R Ltd. Also, P Ltd. directly enjoys voting right of 14% in R Ltd. R Ltd. is a listed company and regularly supplies goods to P Ltd. The management of R Ltd. has not disclosed its relationship with P Ltd.

How would you assess the situation from the viewpoint of AS -18 on Related Party Disclosures?

(iv) On March 01, 2009, X Ltd. purchased Rs. 5 lakhs worth of land for a factory site. Company demolished an old building on the property and sold the material for Rs. 10,000. Company incurred additional cost and realized salvaged proceeds during the March 2009 as follows:

Legal fees for purchase contract and recording ownership	Rs. 25,000
Title guarantee insurance	Rs. 10,000
Cost for demolition of building	Rs. 50,000

Compute the balance to be shown in the land account on March 31, 2009 balance sheet.

(v) The closing inventory at cost of a company amounted to Rs. 2,84,700. The following items were included at cost in the total:

(a) 400 coats, which had cost Rs. 80 each and normally sold for Rs. 150 each. Owing to a defect in manufacture, they were all sold after the balance sheet date at 50% of their normal price. Selling expenses amounted to 5% of the proceeds.

(b) 800 skirts, which had cost Rs. 20 each. These too were found to be defective. Remedial work in April cost Rs. 5 per skirt, and selling expenses for the batch totaled Rs. 800. They were sold for Rs. 28 each.

What should the inventory value be according to AS 2 after considering the above items?

21. (i) A Ltd. acquired 45% of B Ltd. shares on April 01, 2008, the price paid was Rs. 15,00,000. Following are the extract of balance sheet of B Ltd.:

Paid up Equity Share Capital	Rs. 10,00,000
Securities Premium	Rs. 1,00,000
Reserve & Surplus	Rs. 5,00,000

B Ltd. has reported net profits of Rs. 3,00,000 and paid dividends of Rs. 1,00,000. Calculate the amount at which the investment in B Ltd. should be shown in the consolidated balance sheet of A Ltd. as on March 31, 2009.

(ii) Mr. X set up a new factory in the backward area and purchased plant for Rs. 500 lakhs for the purpose. Purchases were entitled for the CENVAT credit of Rs. 10 lakhs and also Government agreed to extend the 25% subsidy for backward area development. Determine the depreciable value for the asset.

(iii) The following date apply to 'X' Ltd. defined benefit pension plan for the year ended 31.03.09, calculate the actual return on plan assets:

- Benefits paid	2,00,000
- Employer contribution	2,80,000
- Fair market value of plan assets on 31.03.09	11,40,000
- Fair market value of plan asset as on 31.03.08	8,00,000

22. The following are the summarized Balance Sheet of Star Ltd. as on 31st March, 2008 and 2009:

		(Rs.'000)
	2008	*2009*
Equity share capital of Rs.10 each	3,400	3,800
Profit and Loss A/c	400	540
Securities Premium	40	80
Debentures	800	900
Long term borrowings	180	240
Sundry Creditors	360	440
Provision for Taxation	20	40
Proposed Dividend	300	480
	5,500	6,520
Sundry Fixed Assets:		
Gross Block	3,200	4,000
Less: Depreciation	640	1,440
Net Block	2,560	2,560

Investment	1,200	1,400
Inventories	1,000	1,400
Sundry Debtors	640	900
Cash and Bank Balance	100	260
	5,500	6,520

The Profit and Loss account for the year ended 31st March, 2009 disclosed:

	(Rs.'000)
Profit before Tax	780
Less: Taxation	160
Profit after tax	620
Less: Proposed dividends	480
Retained Profit	140

The following information is also available:

(1) 40,000 equity share issued at a premium of Re.1 per share.

(2) The Company paid taxes of Rs.1,40,000 for the year 2008-09.

(3) During the period it discarded fixed assets costing Rs.4 lacs, (accumulated depreciation Rs.80,000) at Rs.40,000 only.

You are required to prepare a cash flow statement as per AS-3 (Revised), using indirect method. Ignore debenture interest.

23. (i) S Ltd. grants 1,000 stock options to its employees on 1.4.2005 at Rs.60. The vesting period is two and a half years. The maximum period is one year. Market price on that date is Rs.90. All the options were exercised on 31.7.2008. Journalize, if the face value of equity share is Rs.10 per share.

(ii) Moon Ltd. entered into agreement with Sun Ltd. for sale of goods of Rs.8 lakhs at a profit of 20 % on cost. The sale transaction took place on 1st February, 2009. On the same day Sun Ltd. entered into another agreement with Moon Ltd. to resell the same goods at Rs. 10.80 lakhs on 1st August, 2009. The pre-determined re-selling price covers the holding cost of Sun Ltd. State the treatment of this transaction in the financial statements of Moon Ltd. as on 31.03.09.

(iii) XY Ltd. was making provisions for non-moving stocks based on no issues for the last 12 months upto 31.03.08. Based on technical evaluation the company wants to make provisions during the year 31.03.09.

Total value of stock --- Rs. 150 lakhs.

Provisions required based on 12 months issue Rs. 4.0 lakhs.

Provisions required based on technical evaluation Rs. 3.20 lakhs.

Does this amount to change in accounting policy ? Can the company change the method of provision?

(iv) From the following information relating to X Ltd., calculate Diluted Earnings Per Share as per AS 20:

Net Profit for the current year	Rs.2,00,00,000
Number of equity shares outstanding	40,00,000
Basic earnings per share	Rs.5.00
Number of 11% convertible debentures of Rs.100 each	50,000
Each debenture is convertible into 8 equity shares.	
Interest expense for the current year	Rs.5,50,000
Tax saving relating to interest expense (30%)	Rs.1,65,000

24. (i) A company is engaged in the business of ship building and ship repair. On completion of the repair work, a work completion certificate is prepared and countersigned by ship owner (customer). Subsequently, invoice is prepared based on the work completion certificate describing the nature of work done together with the rate and the amount. Customer scrutinizes the invoice and any variation is informed to the company. Negotiations take place between the company and the customer. Negotiations may result in a deduction being allowed from the invoiced amount either as a lumpsum or as a percentage of the invoiced amount. The accounting treatment followed by the company is as follows:

(i) When the invoice is raised, the customer's account is debited and ship repair income account is credited with the invoiced amount.

(ii) Deduction, if any, arrived after negotiation is treated as trade discount by debiting the ship repair income account.

(iii) At the close of the year, negotiation in respect of certain invoices had not been completed. In such cases, based on past experience, a provision for anticipated loss is created by debiting the Profit and Loss account. The provision is disclosed in Balance Sheet.

Following two aspects are settled in the negotiations:

(i) Errors in billing arising on account of variation between the quantities as per work completion certificate and invoice and other clerical errors in preparing the invoice.

(ii) Disagreement between the company and customer about the rate/cost on which prior agreement has not been reached between them.

Comment whether the accounting treatment of deduction as trade discount is correct? If not, state the correct accounting treatment.

(ii) A major fire has damaged the assets in a factory of a Limited Company on 5th April – five days after the year end and closure of accounts. The loss is estimated at

Rs.10 crores out of which Rs.7 crores will be recoverable from the insurers. Explain briefly how the loss should be treated in the final accounts for the previous year.

(iii) X Ltd. is a subsidiary of Y Ltd. It holds 9% Rs.100 5-year debentures of Y Ltd. and designated them as held to maturity as per AS 30 "Financial Instruments: Recognition and Measurement". Can X Ltd. designate this financial asset as hedging instrument for managing foreign currency risk?

(iv) Rose Ltd. had made an investment of Rs.500 lakhs in the equity shares of Nose Ltd. on 10.01.2009. The realizable value of such investment on 31.03.2009 became Rs.200 lakhs as Nose Ltd. lost a case of patent rights. Rose Ltd. follows financial year as accounting year. How will you recognize this reduction in Financial statements for the year 2008-09?

25. (i) Axe Limited began construction of a new plant on 1st April, 08 and obtained a special loan of Rs.4, 00,000 to finance the construction of the plant. The rate of interest on loan was 10%.

The expenditure that was made on the project of plant is as follows:

	Rs.
1st April, 08	5,00,000
1st August, 08	12,00,000
1st January, 09	2,00,000

The company's other outstanding non-specific loan was Rs.23,00,000 at an interest rate of 12%. The construction of the plant completed on 31st March, 09. You are required to calculate the amount of interest to be capitalized as per the provisions of AS-16 "Borrowing cost".

(ii) X Ltd. has entered into a contract by which it has the option to sell its identified Property, Plant and Equipment (PPE) to Y Ltd. for Rs.100 million after 3 years whereas its current market price is Rs.180 million. Is the put option of X Ltd. a financial instrument? Is the written put option of Y Ltd. a financial instrument? Explain.

(iii) X Ltd. received a revenue grant of Rs.10 cores during 2006-07 from Government for welfare activities to be carried on by the company for its employees. The grant prescribed the conditions for utilizations. However during the year 2008-09, it was found that the prescribed conditions were not fulfilled and the grant should be refunded to the Government.

State how this matter will have to be dealt with in the financial statements of X Ltd. for the year ended 2008-09.

(iv) Goods of Rs.5,00,000 were destroyed due to flood in September, 2006. A Claim was lodged with insurance company. But no entry was passed in the books for insurance claim. In March, 2009, the claim was passed and the company received a payment of Rs.3,50,000 against the claim. Explain the treatment of such receipt in final accounts for the year ended 31st March, 2009.

SUGGESTED ANSWERS/HINTS

1. Consolidated Balance Sheet of Bat Ltd. and its subsidiary Ball Ltd. as at 31st March, 2009

Liabilities	*Amount*	*Assets*	*Amount*
	Rs.		*Rs.*
Share Capital		Stock	80,000
(Shares of Rs. 10 each)	1,60,000	Debtors	1,20,000
Minority Interest	50,800	Cash at Bank	70,000
Capital Reserve	3,040	Cash in hand	20,000
Profit and Loss Account	44,160		
Creditors	16,000		
Proposed Dividend	16,000		
	2,90,000		2,90,000

Working Notes:

(1) *Analysis of profits of Ball Ltd.*

		Capital Profits	*Revenue Profits*
		Rs.	*Rs.*
Profit and Loss Account on 1.4.2008 (60,000 – 24,000)		36,000	
Profit for the year	24,000		
Add back: Loss by fire	4,800		
	28,800		
Less: Expenses not considered	6,000		
	22,800		
Pre-acquisition profits = $\frac{4}{12} \times 22{,}800 =$	7,600		
Less: Loss in pre-acquisition period =	4,800	2,800	
Post-acquisition profits $\left(\frac{8}{12} \times 22{,}800\right)$			15,200
		38,800	15,200
Bat Ltd.'s share (80%*)		31,040	12,160
Minority's share (20%)		7,760	3,040

$$*\frac{8{,}000+6{,}000+\text{Bonus shares }\frac{8{,}000}{4}\text{ i.e. }2{,}000}{20{,}000}\times 100$$

$$=\frac{16{,}000}{20{,}000}\times 100=80\%$$

(2) *Minority interest*

	Rs.
Share capital	40,000
Capital profits	7,760
Revenue profits	3,040
	50,800

(3) *Cost of control*

		Rs.
Face value of investments	1,60,000	
Capital profits	31,040	1,91,040
Investment in Ball Ltd.	1,96,000	
Less: Pre-acquisition dividend	8,000	(1,88,000)
Capital Reserve		3,040

(4) *Profit and Loss Account – Bat Ltd.*

	Rs.
Balance	50,000
Less: Pre-acquisition dividend wrongly credited	8,000
	42,000
Less: Proposed dividend	16,000
	26,000
Add: Expenses of Ball Ltd. written back	6,000
Add: Share in Ball Ltd.	12,160
	44,160

2. **Yash Ltd.**

Balance Sheet as at 31st October, 2009

		Schedule		(Rs. in crores)
I	SOURCES OF FUNDS			
	(1) Shareholders' funds:			
	(a) Capital	A	500	
	(b) Reserves and surplus		387	
				887

	(2)	Loan funds				750
		TOTAL				1,637
II	APPLICATION OF FUNDS					
	(1)	Fixed assets:				
		(a)	Gross block		1,482	
		(b)	*Less*: Depreciation		180	
		(c)	Net block			1,302
	(2)	Investments in Upkar Ltd.				100
	(3)	Current assets, loans and advances:				
		(a)	Inventories	15		
		(b)	Sundry debtors	400		
		(c)	Cash and bank balances	50		
		(d)	Loans and advances:			
			Advances to suppliers	40		
			Prepaid expenses	10		
			Tax payment	270	785	
		Less: Current liabilities and provisions:				
		(a)	Creditors for			
			Goods	260		
			Expenses	30		
				290		
		(b)	Provision for taxation	260	550	
		Net current assets				235
		TOTAL				1,637

Schedule to Balance Sheet *(Rs. in crores)*

A.	Share Capital:	
	Authorised:	1,000
	Issued and paid-up:	
	50 crores equity shares of Rs. 10 each fully paid up	500
	Of the above shares, 20 crores equity shares have been issued for consideration other than cash, on take over of business of Vijay Ltd.	

Profit and Loss Account
for the year ended 31st October, 2009

		(Rs. in crores)
Sales		4,330
Expenditure:		
Stock taken over from Vijay Ltd.	10	
Purchases	2,190	
	2,200	
Closing stock	15	
Inventory consumed/sold	2,185	
Employee cost	700	
Expenses	520	(3,405)
Profit before interest, depreciation and tax		925
Interest		(50)
Profit after interest but before depreciation		875
Depreciation		(180)
Profit after depreciation		695
Profit on sale of fixed assets		2
Profit before tax		697
Provision for tax		(260)
Net profit		437
Dividend		(50)
Balance carried forward		387

Working Notes:

(Rs. in crores)

(1) Net assets of Vijay Ltd. taken over:

Fixed Assets	150
Inventory	10
Customers' dues	70
	230
Less: Creditors	30
	200

Purchase consideration: 20 crores equity shares of Rs. 10 each.

(2) **Customers' Account**

		Rs.			Rs.
To	Business Purchase A/c	70	By	Bank A/c	4,000
To	Sales A/c (Balancing figure)	4,330	By	Balance c/d	400
		4,400			4,400

Suppliers' (Goods) Account

		Rs.			Rs.
To	Bank A/c (2,000 – 40)	1,960	By	Business Purchase A/c	30
To	Balance c/d	260	By	Purchases A/c (Balancing figure)	2,190
		2,220			2,220

Suppliers' (Fixed Assets) Account

		Rs.			Rs.
To	Bank A/c	650	By	Fixed Assets A/c (Balancing figure)	1,350
To	Balance c/d (Loan funds)	750	By	Interest A/c	50
		1,400			1,400

Fixed Assets Account

		Rs.			Rs.
To	Business Purchase A/c	150	By	Bank A/c	20
To	Profit and Loss A/c	2	By	Balance c/d	1,482
To	Suppliers' A/c	1,350			
		1,502			1,502

Expenses Account

		Rs.			Rs.
To	Bank A/c	500	By	Profit and Loss A/c (Balancing figure)	520
To	Balance c/d (Outstanding expenses)	30	By	Balance c/d (Prepaid expenses)	10
		530			530

(3) Calculation of tax provision:

	Rs.
Profit before depreciation	875
Less: Depreciation under Income Tax Act	200
Total income under Income Tax Act	675
Tax due thereon @ 38.5% (rounded off)	260

As sale proceeds of fixed assets are reduced from the appropriate "block of assets" for income tax purpose, and depreciation under Income Tax Act is given in the question, no adjustment for profit on sale of fixed assets Rs. 2 crores needs to be made for tax purposes.

Notes:

(1) Students may provide for dividend distribution tax @ 15%.

(2) The par value of an equity share has been taken as Rs. 10.

3. **M/s Intranet Ltd.**

Draft Balance Sheet as at 1.4.2008

Liabilities	*(Rs.)*	*Assets*	*(Rs.)*
Equity share capital 27,799 Equity shares of Rs.10 each, fully paid up (W.N.2)	2,77,990	Building (Rs. 66,000+Rs. 52,500)) Plant and machinery (Rs. 88,000+Rs. 73,500)	1,18,500 1,61,500
9% Preference share capital (Share of Rs.100 each) (W.N.2)	50,000	Investments (Rs. 40,000+ Rs. 25,000)	65,000
Securities premium (W.N.2)	1,38,995	Stock (Rs. 36,000+ Rs. 40,000)	76,000
Investment allowance reserve (Rs. 5,000+ Rs. 2,000)	7,000	Sundry Debtors 90% of (Rs.45,000+ Rs. 35,000)	72,000
10% Debentures (50% of Rs. 80,000)	40,000	Cash and Bank (Rs.40,000+ Rs.25,000 – Rs.15)	64,985
Sundry creditors (Rs. 25,000+ Rs. 15,000)	40,000	Amalgamation Adjustment Account	7,000
Tax provision (Rs. 7,000+ Rs. 4,000)	11,000		
	5,64,985		5,64,985

Working Notes:

1. Calculation of value of equity shares issued to transferor companies

		System Ltd. (Rs.)		HRD Ltd. (Rs.)
Assets taken over:				
Building		66,000		52,500
Plant and machinery		88,000		73,500
Investments (trade and non-trade)		40,000		25,000
Stock		36,000		40,000
Sundry Debtors		40,500		31,500
Cash & Bank		40,000		25,000
		3,10,500		2,47,500
Less: Liabilities:				
10% Debentures	50,000		30,000	
Sundry Creditors	25,000		15,000	
Tax Provision	7,000	82,000	4,000	49,000
		2,28,500		1,98,500
Less: Preference Share Capital		30,000		20,000
		1,98,500		1,78,500

2. Number of shares issued to equity shareholders, debenture holders and preference shareholders

	System Ltd.	HRD Ltd.	Total
Equity shares issued @ Rs.15 per share (including Rs.5 premium)			
$\frac{\text{Rs.}1,98,500}{15}$	13,233 shares[1]		
$\frac{\text{Rs.}1,78,500}{15}$		11,900 shares	25,133 shares
Equity share capital @ Rs.10	Rs. 1,32,330	Rs.1,19,000	Rs. 2,51,330
Securities premium @ Rs.5	Rs. 66,165	Rs. 59,500	Rs. 1,25,665
	Rs.1,98,495	Rs. 1,78,500	Rs. 3,76,995

[1] Cash paid for fraction of shares = Rs. 1,98,500 less Rs. 1,98,495 = Rs. 5

50% of Debentures are converted into equity shares @ Rs.15 per share			
50,000/2 = 25,000/15	1,666 shares[2]		
30,000/2 = 15,000/15		1,000 shares	2,666 shares
Equity share capital @ Rs.10	Rs. 16,660	Rs.10,000	Rs. 26,660
Security premium@ Rs.5	Rs. 8,330	Rs. 5,000	Rs. 13,330
	Rs. 24,990	Rs. 15,000	Rs. 39,990
9% Preference share capital issued	Rs. 30,000	Rs. 20,000	Rs. 50,000

4. In the Books of Neptune Ltd.

Journal Entries

	Particulars		*Rs.*	*Rs.*
(i)	6% Preference Share Capital A/c (Rs. 100)	Dr.	5,00,000	
	To 6% Preference Share Capital A/c (Rs. 75)			3,75,000
	To Capital Reduction A/c			1,25,000
	(Being the Preference Shares of Rs.100/- each reduced to Rs.75/- as per scheme)			
(ii)	Equity Share Capital A/c (Rs.10)	Dr.	8,00,000	
	To Equity Share Capital A/c (Rs.2)			1,60,000
	To Capital Reduction A/c			6,40,000
	(Being the equity shares of Rs.10/- each reduced to Rs.2/- as per scheme)			
(iii)	Capital Reduction A/c	Dr.	30,000	
	To Equity Share Capital A/c			30,000
	(Arrears of preference share dividend of one year to be satisfied by issue of 1,500 equity shares of Rs.2/- each i.e. to the extent of 25% of arrear dividend)			
(iv)	Accrued Debenture Interest A/c	Dr.	22,500	
	To Bank A/c			22,500
	(Accrued Debenture Interest paid)			
(v)	6% Debenture A/c	Dr.	3,00,000	
	To Freehold Property			3,00,000
	(Claim settled in part by transfer of freehold property as per scheme)			

[2] Cash paid for fraction of shares = Rs. 25,000 less Rs. 24,990 = Rs. 10

(vi)	Capital Reduction A/c	Dr.	9,40,000	
	To Profit and Loss A/c			3,65,000
	To Deferred Advertising Expenses A/c			1,50,000
	To Stock A/c			2,00,000
	To Sundry Debtors A/c			2,25,000
	(Being the various assets written off as per scheme)			
(vii)	Freehold Property A/c	Dr.	1,50,000	
	To Capital Reduction			1,50,000
	(Appreciation in the value of property i.e. (Rs.3,50,000-2,00,000)			
(viii)	Bank A/c	Dr.	2,00,000	
	To Trade Investment			1,70,000
	To Capital Reduction			30,000
	(Trade Investment sold and profit made)			
(ix)	Director's Loan A/c	Dr.	3,00,000	
	To Equity Share Capital A/c			60,000
	To Capital Reduction A/c			2,40,000
	(Directors loan reduced by 80% and remaining balance discharged by issue of equity shares of Rs. 2 each)			
(x)	Capital Reduction A/c	Dr.	15,000	
	To Bank A/c			15,000
	(Payment of 3% penalty for cancellation of Capital Commitments)			
(xi)	Capital Reduction A/c	Dr.	20,000	
	To Bank A/c			20,000
	(Reconstruction expenses paid)			
(xii)	Capital Reduction Account	Dr.	1,80,000	
	To Capital Reserve Account			1,80,000
	(Being balance of capital reduction account transferred)			

Balance Sheet of Neptune Ltd.
as at 1st April, 2009 (As Reduced)

Liabilities	*Rs.*	*Assets*	*Rs.*
<u>Share Capital</u>		Freehold Property	3,50,000
1,25,000, Equity Shares of	2,50,000	Plant	1,80,000

Rs.2/- each (out of above 45,000 shares have been issued for consideration other than cash)			
5,000, 6% Cumulative Preference Shares of Rs.75/- each fully paid	3,75,000	Debtors	2,25,000
Capital Reserve	1,80,000	Cash at Bank	1,42,500
6% Debentures	75,000		
Creditors	17,500		
	8,97,500		8,97,500

5. **Books of Dee Limited**

Journal Entries

Date	*Particulars*		*Dr.'000*	*Cr.'000*
	Bank A/c	Dr.	22,00	
	Profit and Loss A/c	Dr.	8,00	
	To Investment A/c			30,00
	(Being the Sale of all investments)			
	Equity Share Capital A/c	Dr.	5,00	
	Premium payable on buy back A/c	Dr.	20,00	
	To Equity shares buy back A/c			25,00
	(Being the amount due on buy back)			
	Securities Premium A/c	Dr.	20,00	
	To Premium payable on buy back A/c			20,00
	(Being the premium payable on buy back provided for)			
	Securities Premium A/c	Dr.	2,00	
	Revenue Reserve A/c	Dr.	1,00	
	To Capital Redemption Reserve A/c			3,00
	(Being the amount equal to nominal value of equity shares bought back out of securities premium and free reserves transferred to capital redemption reserve a/c)			
	Equity shares buy-back A/c	Dr.	25,00	
	To Bank A/c			25,00
	(Being the payment made on buy back)			

Balance Sheet of Dee Limited as on 1st April, 2009
(After buy back of shares)

Liabilities	*Rs.'000*	*Rs.'000*
Share Capital		
Authorised Capital:		30,00
Issued and Subscribed Capital:		
2,00,000 equity shares of Rs.10 each fully paid up	20,00	
2,000 10% Preference shares of Rs.100 each fully paid up	2,00	22,00
Reserve and Surplus:		
Capital Reserve	10,00	
Capital Redemption Reserve	3,00	
Revenue Reserve	29,00	
Profit and Loss A/c (35,00 – 8,00)	27,00	69,00
Current Liabilities and Provisions		14,00
		10,500
Fixed Assets		93,00
Current assets loans and advances (including cash and bank balance) (15,00+22,00- 25,00)		12,00
		10,500

6.

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

Equivalent number of equity shares of Rs. 10 each.

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

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

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

Value of fully paid share of Rs. 10 = Rs. 25.82 per equity share.

Value of share of Rs. 10, Rs. 8 paid-up = Rs. 25.82 – Rs. 2 = Rs. 23.82 per equity share.

Value of fully paid share of Rs. 5 = $\frac{\text{Rs. } 25.82}{2} = \text{Rs. } 12.91$ per equity share.

(ii) Valuation on dividend yield basis:

Value of fully paid share of Rs. 10 = $\frac{20}{15} \times \text{Rs. } 10 = \text{Rs. } 13.33$

Value of share of Rs. 10, Rs. 8 paid-up = $\frac{20}{15} \times \text{Rs. } 8 = \text{Rs. } 10.67$

Value of fully paid share of Rs. 5 = $\frac{20}{15} \times 5 = \text{Rs. } 6.67$

(iii) Valuation on the basis of EPS:

Profit after tax = Rs. 1,371 lakhs

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

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

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

Earning per share of Rs. 10 each, Rs. 8 paid-up = Re. 0.419 $\times$ 8 = Rs. 3.35

Earning per share of Rs. 5, fully paid-up = Re. 0.419 $\times$ 5 = Rs. 2.10

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

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

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

7. Valuation of Goodwill of A Ltd.

(i) Capital employed:

		Rs.	*Rs.*
Land and Building at Cost			2,20,000
Plant and Machinery at Cost			2,00,000
Stock in trade			3,00,000
Sundry Debtors			1,80,000
			9,00,000
Less:	Sundry Liabilities:		
	Bank overdraft	1,16,700	
	Sundry Creditors	1,81,000	
	Provision for taxation	39,000	3,36,700
Capital employed at the end of the year			5,63,300
Add Back: Dividend paid for the year		75,000	
	Less: Half of the profits	65,000	10,000
Average Capital employed			5,73,300

(ii) Normal Rate of Return

Average Dividends for the last 4 years 12 ½ %

Market price of shares on 31st March Rs.125.

Normal Rate of Return: $\frac{12.5 \times 100}{125} = 10\%$

(iii) Normal Profit on average capital employed

@ 10% on Rs.5,73,300	57,330

(iv) Future maintainable profit-weighted average

Year	Profit Rs.	Weight	Product Rs.
2006	88,000	1	88,000
2007	1,03,000	2	2,06,000
2008	1,16,000	3	3,48,000
2009	1,30,000	4	5,20,000
		10	11,62,000
Average annual profit (after tax)			1,16,200
Average annual profit (before tax)			
$1,16,200 \times \frac{100}{60}$			1,93,667

Adjustments		
Increase in remuneration	-20,000	
Saving in cost of materials	+40,000	20,000
		2,13,667
Less: Taxation @ 50%		1,06,833
Super Profits		1,06,834

8. **Valuation of Business**

Discounted earnings method

(Rs. in lakhs)

Year	*Earnings*	*Discount Factor @ 20%*	*Present value*
1	225.75	0.8333	188.117
2	242.68	0.6944	168.517
3	260.88	0.5787	150.971
4	280.45	0.4823	135.261
5	301.48	0.4019	121.165
6	324.09	0.3349	108.538
7	348.40	0.2791	97.238
8	374.53	0.2326	87.116
9	402.62	0.1938	78.028
10	432.82	0.1615	69.900
			1204.851

Value of the business = Rs.1204.851 Lakhs

Discounted cash flow method

(Rs. In lakhs)

Year	*Earnings*	*Discount Factor @ 20%*	*Present value*
1	287.55	0.8333	239.615
2	306.24	0.6944	212.653
3	326.15	0.5787	188.743
4	347.35	0.4823	167.527
5	369.92	0.4019	148.671
6	393.97	0.3349	131.941
7	419.58	0.2791	117.105

8	446.85	0.2326	103.937
9	475.89	0.1938	92.227
10	506.83	0.1615	81.853
			1484.272

Value of the business = Rs.1484.272 Lakhs

9. **Ganpati Ltd.**

Gross Value Added Statement for the year ended 31st March, 2009

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

Application of Value Added

				%
To Employees				
Salaries, wages, gratuities etc.			82	20.71%
To Directors				
Salaries and commission			9	2.27%
To Government				
Cess and local taxes (98 – 55)	43			
Income tax	27		70	17.68%
To Providers of capital				
Interest on debentures	2			
Interest on fixed loan	18			
Dividends	95		115	29.04%
To Provide for maintenance and expansion of the company				
Depreciation	17			

General reserve	45		
Deferred tax	3		
Retained profits (65 – 10)	55	120	30.30%
		396	100%

Statement showing reconciliation of Gross Value Added with Profits before taxation

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

Working Note:

Calculation of Excise Duty

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

Excise Duty is 10% of x = x/10

x = 461 + 24 + 9 + x/10

x = 494 + x/10 = 549 (approx.)*

Excise Duty = 549 – 494 = Rs. 55

10. (a) Economic Value Added (EVA) is primarily a benchmark to measure earnings efficiency. EVA as a residual income measure of financial performance is simply the operating profit after tax less a charge for the capital employed, equity as well as debt, used in the business.

Mathematically EVA= OPBT – Tax – (TCE × COC)

Where:

OPBT = Opening Profit Before Tax

TCE = Total Capital Employed

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

COC = Cost of Control

Because EVA includes both profit and loss as well as balance sheet efficiency as well as the opportunity cost of investor capital - it is better linked to changes in shareholders wealth and is superior to traditional financial measures such as PAT or percentage of return measures such as ROCE or ROE.

EVA, additionally, is a tool for management to focus on the impact of their decisions in increasing shareholders wealth. These include both strategic decisions such as what investments to make, which business to exit, what financing structure is optimal; as well as operational decisions involving trade-offs between profit and asset efficiency such as whether to make inhouse or outsource, repair or replace an equipment, whether to make short or long production runs etc.

Most importantly the real key to increasing shareholders wealth is to integrate EVA framework in four key areas, viz., to measure business performance, to guide managerial decision making, to align managerial incentives with the shareholders' interests and to improve the financial and business literacy throughout the organisation.

(b) Financial Leverage = $\frac{\text{EBIT}}{\text{EBIT} - \text{Interest}} = \frac{\text{EBIT}}{\text{EBIT} - 10\% \text{ of } 400} = 1.40$

EBIT = {(10% of 400) × 1.40] /0.40 = 140

EBIT (I – t) = 140 (1 – 0.30) = 98

Equity capital = 170 + 130 = 300

Debt Capital = 400

Post-tax cost of debt = 10% (1 – 0.30) = 7%

Overall cost of capital [Post-tax] = 17.5% of 300 + 7% of 400 = 80.5

Economic Value Added (EVA)

= EBIT (I – t) – Overall cost of capital (Post-tax) = 98 – 80.5 = 17.5 (Rs. Lakh)

11. Value of employees as per Lev and Schwartz method:

$$= \frac{50{,}000}{(1+0.15)^{(65\text{-}62)}} + \frac{50{,}000}{(1+0.15)^{(65\text{-}63)}} + \frac{50{,}000}{(1+0.15)^{(65\text{-}64)}}$$

= 32,875.81 + 37,807.18 + 43,478.26 = 1, 14,161.25

Total value of employees is Rs.1, 14,161.25 × 20 = Rs.22,83,225.

12. (a) The content of Corporate Social Report is essentially based on the social objectives. Brummet identified five areas wherein social objectives can be traced out, namely, Net Income Contribution, Human Resource Contribution, Public Contribution, Environmental Contribution and Product or Service Contribution.

In view of the social objectives, the importance of earning objective is not understated; rather attainment of social objectives is dependent on earning objective. A sick business entity becomes liability to the society and sustains social costs instead of generating social benefits.

Human Resource Contribution is the indicator of the impact of organizational activities (viz. pay and allowances, perks and incentives, recruitment, training and development, placement, promotion and transfer, welfare measure, etc.) on people of the organization. Public Contribution is the indicator of general philanthropy in the cultural and social welfare programmes and contribution to national exchequer by way of tax and duties. . .

Industrial activity is supposed to consume irreplaceable resources and produces solid wastes. By this process it pollutes air and water, causes noise and spoils the environment. These are termed as negative social effects. The corporate social objective is the abatement of such negative effect. It is covered by environmental contribution.

Although Brummet covered wide range of objectives, still these are not essentially exhaustive. Social objectives are determined by socio-economic conditions of a country. It is difficult to set universal list of social objectives to be pursued by the corporate sector. For example, in India, regional imbalance, unemployment, reservation for weaker sections of the population, scarcity of foreign exchange, energy deficit, population pressure and illiteracy are some of the widely accepted socio-economic problems. And obviously the general expectation is that the corporate sector will positively contribute to such socio-economic problems. Since the socio-economic problems of a country change over time or the priority attached to a problem shifts.

(b) Social Balance Sheet of Steel India Ltd.

as at 31.03.2009

		(Rs. in lakhs)
Liabilities:		
Organization Equity		26.00
Social Equity (Contribution by staff)		828.00
Total		854.00
Assets:		
Social Capital Investment:		
(a) Buildings		
(i) Residential	17.00	
(ii) Hospital	1.00	
(iii) School	1.40	
(iv) Welfare	0.80	20.20

(b) Equipments		
(i) Residential	2.80	
(ii) Hospital	1.00	
(iii) School	1.00	4.80
(c) Water, Electricity and Gas supply systems		1.00
Human assets (as valued by the specialist)		828.00
Total		854.00

13. (i) The term net owned fund (NOF) is given in the explanation to Section 45-IA of the Reserve Bank of India Act, 1934. As per the definition:

Owned Fund = Aggregate of the paid-up equity capital + Free reserves as disclosed in the latest balance sheet of the company – Accumulated balance of loss – Deferred revenue expenditure – Other intangible assets.

Net Owned Fund = Owned Fund – Investments in shares of subsidiaries/ companies in same group/Other NBFC. – Book value of debentures, bonds, outstanding loans and advances made to and deposits with subsidiaries and companies in the same group (to the extent such sum exceeds 10% of owned fund)

(ii) Market value of portfolio has a direct bearing on the NAV and consequently on portfolio performance. The market value of portfolio is the aggregate market value of different investments. Marker value of a traded security is the last closing price quoted in a stock exchange immediately before the valuation day. In case, a security is traded in more than one stock exchange, the price quoted in an exchange where the security is mostly traded is taken as market value of the security.

Non-traded securities, i.e. securities not traded in a period of 30 days prior to the valuation day, should be valued in the spirit of good faith subject to SEBI regulations. For example, a non-traded debt instrument can be valued by discounting cash flows by YTM of a comparable debt instrument as increased for lack of liquidity. The discounting rate for non-traded government securities should the prevailing market rate.

(iii) It shall be the duty of broker on inspection by the Board every director, proprietor, partner, officer and employee of the stock-broker, who is being inspected, to produce to the inspecting authority such books, accounts and other documents in his custody or control and furnish him with the statements and information relating to the transactions in securities market within such time as the said officer may require.

The stock-broker shall allow the inspecting authority to have reasonable access to the premises occupied by such stock- broker or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the stock- broker or any other person and also provide copies of documents or other materials which, in the opinion of the inspecting authority are relevant.

The inspecting authority, in the course of inspection, shall be entitled to examine or record statements of any member, director, partner, proprietor and employee of the stock- broker. It shall be the duty of every director proprietor, partner, officer and employee of the stock broker to give to the inspecting authority all assistance in connection with the inspection, which the stock broker may be reasonably expected to give.

(iv) Every stock broker is required to maintain the following books of account and records as per Rule 15 of the Securities Contracts (Regulation) Rules, 1957 and Regulation 17 of the SEBI (Stock Brokers and Sub-Brokers) Rules, 1992:

(a) Register of transactions (Sauda book)/Daily transaction list;

(b) Clients ledger;

(c) General ledger;

(d) Journals;

(e) Cash book;

(f) Bank Pass Book;

(g) Documents register/Inward-outward register showing full particulars of shares and securities received and delivered;

(h) Members' contract book showing details of all contracts entered into by him with other members of the stock exchange or counterfoils or duplicates of memos of confirmation issued to such other members;

(i) Counterfoils or duplicates of contract notes issued to clients;

(j) Written consent of clients in respect of contracts entered into as principals;

(k) Margin deposit book;

(l) Register of accounts of sub-brokers;

(m) An agreement with a sub-broker specifying the scope of authority and responsibilities of the stock broker and such sub-brokers.

In addition to the above statutory requirements, stock brokers are also required to maintain scrip wise client wise list in respect of scripts of specified group, client upla statement, duplicate copies of self-certificates submitted on monthly basis, copies of margin statements downloaded by the stock exchange, copies of valan balance sheet (Form 31), details of spot delivery transactions, client data base and broker client agreement, copy of registration certificate of each sub-broker issued by SEBI, copies of the power of attorney/board resolution authorizing directors and employees and copies of pool account statements.

(v) "Asset Management Company" means a company formed and registered under the Companies Act, 1956 and approved as such by the Securities and Exchange Board of India to manage the funds of a mutual fund.

14.

		Rs. in lakhs	Rs. in lakhs	Rs. in lakhs
Opening Bank (100- 90-7)		3.00		
Add:	Proceeds from Sale of Securities	40.00		
Add:	Dividend Received	1.20	44.20	
Deduct:				
Cost of Securities purchased		28.20		
Fund Management Expenses paid (4.50 – 0.25)		4.25		
Capital Gains distributed 75% of (40.00 – 38.00)		1.50		
Dividend Distributed (75% of 1.20)		0.90	(34.85)	
Closing Bank				9.35
Closing Market Value of Port Folio				101.90
				111.25
Less:	Arrears of Expenses			0.25
Closing Net Assets				111.00
Number of Units (Lakhs)				10.00
Closing NAV (Rs.)				11.10

15. **(i)** Yes, Costs and Market price of current investments should be aggregated under each group.

		Rs.
(ii)	Equity Shares	80.80
	Mutual Funds	40.00
	Government Securities	100.00

16. Journal Entries

			Dr. Rs.	Cr Rs.
(i)	Bank A/c	Dr.	80,00,000	
	To Revenue Fund (Restricted) A/c			80,00,000
	(To record grants received from the Government Department and Private organisation)			
(ii)	Expenses A/c	Dr.	60,25,000	
	To Bank A/c			60,25,000
	(To account for Rs.32,25,000 spent from out of Government grant and Rs.28,00,000 from out of Private grant)			
(iii)	Equipment A/c	Dr.	5,00,000	
	To Restricted Revenue Fund A/c			5,00,000
	(To record the receipt of donation of assets from a well wisher)			
(iv)	Revenue Fund (Restricted) A/c	Dr.	60,25,000	
	To Income (Govt. grant) A/c			32,25,000
	To Income (Private grant) A/c			28,00,000
	(To recognise revenue)			
(v)	Revenue Fund (Restricted) A/c	Dr.	3,00,000	
	To Bank A/c			3,00,000
	(To account for overhead expenses incurred)			

17. Treatment under Indian Accounting Standards (AS)and International Financial Reporting Standards (IFRS)

		AS	IFRS
(i)	**Impairment of Assets**	Assets are impaired at higher of fair value less costs to sell and value in use based on discounted cash flows. Impairment test is to be conducted every year and if there is upward increase in the value of asset than reversal of impairment losses is required in certain	Similar to Indian Accounting Standard. However, assets are classified and disclosed separately on the face of the balance sheet as held for sale or disposal.

		circumstances. Assets are not separately classified or disclosed as held for sale on the face of the balance sheet.	
(ii)	**Business Combinations**	No particular Standard has been issued by ICAI till date. However all business acquisitions are business combinations except pooling of interest method for certain amalgamations	All business acquisitions are Combinations as per IFRS 3

18. (i) As per AS 32, carrying amounts of each of the following categories, as defined in AS 30, should be disclosed either on the face of the balance sheet or in the notes:

(a) financial assets at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with AS 30;

(b) held-to-maturity investments;

(c) loans and receivables;

(d) available-for-sale financial assets;

(e) financial liabilities at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with AS 30; and

(f) financial liabilities measured at amortised cost.

(ii) According to para 8.6 of AS 30, A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

(iii) In accordance with paragraphs 43 to 45 of AS 30, An entity should remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished i.e., when the obligation specified in the contract is discharged or cancelled or expires.

An exchange between an existing borrower and lender of debt instruments with substantially different terms should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, should be recognized in the statement of profit and loss.

(iv) The objective of AS 28 'Impairment of Assets' is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Statement requires the enterprise to recognize an impairment loss. This standard should be applied in accounting for the impairment of all assets, other than (i) inventories (AS 2, Valuation of Inventories); (ii) assets arising from construction contracts (AS 7, Accounting for Construction Contracts); (iii) financial assets, including investments that are included in the scope of AS 13, Accounting for Investments; and (iv) deferred tax assets (AS 22, Accounting for Taxes on Income). AS 28 does not apply to inventories, assets arising from construction contracts, deferred tax assets or investments because other accounting standards applicable to these assets already contain specific requirements for recognizing and measuring the impairment related to these assets.

19. (i) **Graded vesting under an employee stock option plan**

In case the options/shares granted under an employee stock option plan do not vest on one date but have graded vesting schedule, total plan should be segregated into different groups, depending upon the vesting dates. Each of such groups would be having different vesting period and expected life and, therefore, each vesting date should be considered as a separate option grant and evaluated and accounted for accordingly. For example, suppose an employee is granted 100 options which will vest @ 25 options per year at the end of the third, fourth, fifth and sixth years. In such a case, each tranche of 25 options would be evaluated and accounted for separately.

(ii) **Presentation of MAT credit in the financial statements**

Balance Sheet

Where a company recognizes MAT credit as an asset on the basis of the considerations specified in the Guidance Note on Accounting for Credit Available in respect of Minimum Alternate Tax under the Income Tax Act, 1961 , the same should be presented under the head 'Loans and Advances' since, there being a convincing evidence of realization of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'.

In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph 11 of the Guidance Note.

Profit and Loss Account

According to paragraph 6 of Accounting Standards Interpretation (ASI) 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit and loss account in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognized as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein.

(iii) Investments by a holding company in the shares of its subsidiary company are normally considered as long term investments. Indian holding companies show investment in subsidiary just like any other investment and generally classify it as trade investment. As per AS 13 'Accounting for Investments', investments are classified as long term and current investments. A current investment is an investment that by its nature is readily realizable and is intended to be held for more than one year from the date of acquisition. A long term investment is one that is not a current one.

Costs of investment include besides acquisition charges, expenses such as brokerage, fees and duties. If an investment is acquired wholly or partly by an issue of shares or other securities, the acquisition cost is determined by taking the fair value of the shares/securities issued. If an investment were to be acquired in exchange – part or whole – for another asset, the acquisition cost of the investment is determined with reference to the value of the other asset exchanged. Dividends received out of incomes earned by a subsidiary before the acquisition of the shares by the holding company and not treated as income but treated as recovery of cost of the assets (investment made in the subsidiary). The carrying cost for current investment is the lower of cost or fair/market value whereas investment in the shares of the subsidiary (treated as long term) are carried normally at cost.

(iv) Para 87, 88 and 89 of AS 26 states that an intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

An intangible asset that is retired from active use and held for disposal is carried at its carrying amount at the date when the asset is retired from active use. At least at each financial year end, an enterprise tests the asset for impairment under

Accounting Standard on Impairment of Assets, and recognises any impairment loss accordingly.

(v) The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

(a) the period of the change, if the change affects the period only; or

(b) the period of the change and future periods, if the change affects both.

The effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.

The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

20. (i) According to para 14 of AS 7 (Revised) 'Construction Contracts', incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when: (i) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and (ii)the amount of the incentive payment can be measured reliably. In the given problem, the contract has not even begun and hence the contractor (Mr. X) should not recognize any revenue of this contract.

(ii) Calculation of tax expense

1^{st} quarter ending on 31-12-2008	$200 \times 20\%$	Rs. 40 lakhs
2^{nd} quarter ending on 31-3-2009	$200 \times 20\%$	Rs. 40 lakhs
3^{rd} quarter ending on 30-6-2009	$200 \times 30\%$	Rs. 60 lakhs
4^{th} quarter ending on 30-9-2009	$200 \times 30\%$	Rs. 60 lakhs

(iii) P Ltd. has direct economic interest in R Ltd to the extent of 14%, and through Q Ltd. in which it is the majority shareholders; it has further control of 12% in R Ltd. (60% of Q Ltd's 20%). These two taken together (14% + 12%) make the total control of 26%.

AS 18 defines related party as one that has at any time during the reporting period, the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Here, Control is defined as ownership directly or indirectly of more than one-half of the voting power of an enterprise; and Significant Influence is defined as participation in the financial and/or operating policy decisions of an enterprise but not control of those policies.

In the present case, control of P Ltd. in R Ltd. directly and through Q Ltd., does not go beyond 26%. However, significant influence may be exercised as an investing party (P Ltd.) holds, directly or indirectly through intermediaries 20% or more of the voting power of the R Ltd.

As R Ltd. is a listed company and regularly supplies goods to P Ltd. Hence, related party disclosure, as per AS 18, is required.

(iv)

Calculation of the cost for Purchase of Land

Particulars		*Rs.*
Cost of Land		500,000
Legal Fees		25,000
Title Insurance		10,000
Cost of Demolition	50,000	
Less: Salvage value of Material	10,000	40,000
Cost of the Asset		575,000

(v) Valuation of Closing Stock

Particulars	*Rs.*	*Rs.*
Closing Stock at cost		2,84,700
Less :Cost of 400 coats (400 x 80)	32,000	
Less: Net Realisable Value (400 x 75) – 5%	28,500	3,500
		2,81,200
Provision for repairing cost to be incurred in future (800 x 5)		4,000
Value of Closing Stock		2,77,200

21. (i) Calculation of the carrying amount of Investment as per equity method

Particulars	*Rs.*	*Rs.*
Equity Shares	1,000,000	
Security Premium	100,000	
Reserves & Surplus	500,000	
Net Assets	1,600,000	
45% of Net Asset	720,000	
Add: 45% of Profits for the year	135,000	
	855,000	
Less: Dividend Received	45,000	810,000

Less: Cost of Investment		1,500,000
Goodwill		690,000

Consolidated Balance Sheet (Extract)

Assets	Rs.	Rs.
Investment in B Ltd.	810,000	
Add: Goodwill	690,000	1,500,000

(ii)

	Rs.(in lakhs)
Cost of the plant	500
Less: CENVAT	10
	490
Less: Subsidy	98
Depreciable Value	392

(iii)

		Rs.
Fair Value of Plan Assets on 31.3.08		8,00,000
Add: Employer Contribution		2,80,000
Less: Benefits Paid		2,00,000
	(A)	8,80,000
Fair Market Value of Plan Asset at 31.3.09	(B)	11,40,000
Actual Return on Plan Asset	(B-A)	2,60,000

22.

(A) Cash flow statement for the year ended 31st March, 2009 *Rs.('000)*

Net Profit before taxation	780	
Add: Adjustment for Depreciation	880	
Loss on sale of fixed assets	280	
Operating profit before changes in working capital	1,940	
Less: Increase in Sundry Debtors	(260)	
Less: Increase in Inventories	(400)	
Add: Increase in Sundry Creditors	80	
Cash generated from operations	1,360	
Less: Income tax paid	(140)	
Net Cash Generated from operating activities		1,220

(B) Cash flow from investing activities

Purchase of fixed assets	(1,200)	

	Sale of fixed assets	40	
	Purchase of investments	(200)	
	Cash used for investing activities		(1,360)
(C)	Cash flow from financing activities		
	Proceeds from issue of shares including premium (400 + 40)	440	
	Proceeds from issue of 14% debentures	100	
	Proceeds from long term borrowings	60	
	Payment of Dividend	(300)	
	Cash generated from financing activities		300
	Net increase in Cash and Cash equivalent (A+B+C)		160
	Cash and Cash equivalent at the opening		100
	Cash and Cash equivalent at the closing		260

Working Notes:

1.	Income tax paid		*Rs.('000)*
	Income tax expenses for the year		160
	Add:	Tax liability at the beginning of the year	20
			180
	Less:	Tax liability at the end of the year	40
			140
2.	Fixed assets purchased		
	Closing gross block		4,000
	Add:	Cost of assets discarded during the year	400
			4,400
	Less:	Opening gross block	(3,200)
	Fixed assets purchased during the year		1,200
3.	Depreciation charged during the year		
	Closing accumulated depreciation		1,440
	Add:	Depreciation charged on assets discarded during the year	80
			1,520
	Less:	Closing accumulated depreciation	(640)
	Depreciation charged during year		880

23. (i)

Books of S Ltd.

Journal Entries

Date	*Particulars*		*Debit Rs.*	*Credit Rs.*
31.3.06	Employees Compensation Expense Account	Dr.	12,000	
	To Employees Stock Option Outstanding Account			12,000
	(Being compensation expense recognized in respect of 1,000 options granted to employees at discount of Rs.30 each, amortized on straight line basis over 2½ years)			
	Profit and Loss Account	Dr.	12,000	
	To Employees Compensation Expense Account			12,000
	(Being employees compensation expense of the year transferred to P&L A/c)			
31.3.07	Employees Compensation Expense Account	Dr.	12,000	
	To Employees Stock Option Outstanding Account			12,000
	(Being compensation expense recognized in respect of 1,000 options granted to employees at discount of Rs.30 each, amortized on straight line basis over 2½ years)			
	Profit and Loss Account	Dr.	12,000	
	To Employees Compensation Expense Account			12,000
	(Being employees compensation expense of the year transferred to P&L A/c)			
31.3.08	Employees Compensation Expense	Dr.	6,000	
	To Employees Stock Option Outstanding Account			6,000
	(Being balance of compensation expense amortized Rs.30,000 less Rs. 24,000)			
	Profit and Loss Account	Dr.	6,000	
	To Employees Compensation Expense Account			6,000
	(Being employees compensation expense of the year transferred to P&L A/c)			
31.7.08	Bank Account (Rs. 60 × 1,000)	Dr.	60,000	
	Employees Stock Option Outstanding Account (Rs.30×1,000)	Dr.	30,000	
	To Equity Share Capital Account			10,000
	To Securities Premium Account			80,000
	(Being exercise of 1,000 options at an exercise price of Rs.60 each)			

Working Notes:

1. Total employees compensation expense

   = 1,000 x (Rs.90 – Rs.60) = Rs.30,000

2. Employees compensation expense has been written off during 2½ years on straight line basis as under:

   I year = Rs.12,000 (for full year), II year = Rs.12,000 (for full year),

   III year = Rs.6,000 (for half year)

(ii) As the substance of transaction is financing rather than sale and the resulting cash flow of Rs.9.60 lakhs received by Moon Ltd., cannot be considered as revenue as per AS 9 Revenue Recognition. Moon Ltd. will account the transaction as financing rather than sale.

Disclosure in the balance sheet will be as follows:

Assets	*Rs. in lakhs*
Current Assets, Loan and Advances	
Goods lying with Sun Ltd.	
(Under sale and repurchase agreement)	8.00
Liabilities	
Secured Loan	
Advance from Sun Ltd.	9.60
Add: Accrued Finance Charges	0.40
	10.00

(iii) The decision of making provision for non-moving stocks on the basis of technical evaluation does not amount to change in accounting policy. Accounting policy of company may require that provision for non-moving stocks should be made. The method of estimating the amount of provision may be changed, in case, a more prudent estimate can be made.

In the instant case, as per AS 1, considering the total value of stocks, the change in the amount of required provision of non-moving stocks from Rs.4.0 lakhs to Rs.3.20 lakhs is not material in nature Such change can be disclosed by way of notes to the accounts in the financial statements of XY Ltd., for the year ending on 31.03.09, in the following manner:

"The company has provided for non-moving stocks on the basis of technical evaluation unlike preceding years. Had the same method been followed as in the previous year, the profit for the year and the corresponding effect on the year end, the net assets would have been higher by Rs.0.80 lakhs".

(iv) Adjusted Net profit for the current year

2, 00,00,000+5,50,000 – 1,65,000= Rs. 2,03,85,000

Number of equity shares resulting from conversion of debentures

= 50,000 × 8 = 4,00,000 (in number)

Total number of equity shares resulting from conversion of debentures

= 40,00,000 + 4,00,000= 44,00,000 Shares

$\therefore$ Diluted Earnings per share = $\frac{\text{Rs.2,03,85,000}}{\text{44,00,000}}$

= Rs.4.63 (Approximately)

24. (i) As per AS 9 "Revenue Recognition", revenue is recognized at the time when the invoice is raised to the customers; however the treatment of deduction as trade discount is not as per AS 9. Considering the treatment prescribed by AS 4 "Contingencies and Events occurring after the Balance Sheet Date", the correct treatment of the difference between the invoice amount and finally settled amount should be under:

The adjustment of the difference between the invoiced amount and the amount finally settled against "Ship Repair Income" account is in order. Events occurring up to the date of approval of the accounts by the Board of Directors should be taken into consideration in determining the amount of adjustment to be made in this regard. The description of the difference as "trade discount" is not appropriate.

(ii) The loss due to break out of fire is an example of event occurring after the balance sheet date. The event does not relate to conditions existing at the balance sheet date. It has not affected the financial position as on the date of balance sheet and therefore requires no specific adjustments in the financial statements. However, paragraph 8.6 of AS 4 states that disclosure is generally made of events in subsequent periods that represent unusual changes affecting the existence or substratum of the enterprise at the balance sheet date. In the given case, the loss of assets in a factory is considered to be an event affecting the substratum of the enterprise. Hence, as recommended in paragraph 15 of AS 4, disclosure of the event should be made in the report of the approving authority.

(iii) Para 82 of AS 30 states that for hedge accounting purposes only instruments that involve a party external to the reporting entity can be designated as hedging instrument. Therefore, debenture issued by the parent company cannot be designated as hedging instrument for the purpose of consolidated financial statements of the group. However, it can be designated as hedging instrument for separate financial statements of X Ltd.

(iv) Recognition of reduction in value of investment would depend upon the nature of investment and nature of decline as per AS13. If the investments were acquired for long term and decline is temporary in nature, reduction in value will not be recognized and investments would be carried at cost. If the decline is of permanent nature, it will be charged to profit and loss account. If the investments are current investments, the reduction should be recognized and charged to Profit and Loss Account as the current investments are carried at cost or fair value which ever is less.

25. (i) Computation of average accumulated expenses

	Rs.
1st April, 2008 Rs.5,00,000 $\times \frac{12}{12}$	5,00,000
1st August, 2008 Rs.12,00,000 $\times \frac{8}{12}$	8,00,000
1st January, 2009 Rs.2,00,000 $\times \frac{3}{12}$	50,000
	13,50,000
Interest on average accumulated expenses	
On specific borrowing (4,00,000 $\times$10***%)***	40,000
On Non-specific borrowings (13,50,000 – 4,00,000) × 12%	1,14,000
Amount of interest to be capitalized	1,54,000
Total expenses to be capitalized for borrowings:	
Cost of Plant (5,00,000 + 12,00,000 + 2,00,000)	19,00,000
Add: Amount of interest to be capitalized	1,54,000
	20,54,000

(ii) It is necessary to evaluate the past practice of X Ltd. If X Ltd. Has the past practice of settling net, then it becomes a financial instrument. If X Ltd. Intends to sell the identified PPE and settle by delivery and there is no past practice of settling net, then the contract should not be accounted for as derivative under AS-30 and AS-31.

(iii) As per para 20 of AS 12, "Government Grants" that became refundable should be accounted for as an extra-ordinary item as per Accounting Standard 5.

Therefore, refund of grant should be shown in the profit and loss account of the company as an extra ordinary item during the year 2008-09.

(iv) As per provisions of AS 5 "Net Profit or Loss for the period, prior period items and changes in accounting policies", prior period items are income or expenses, which arise, in the current period as a result of error or omissions in the preparation of financial statements of one or more prior periods. Further, the nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on current profit or loss can be perceived.

In the given example, it is clearly a case of error in preparation of financial statement for financial year 2006-07. Hence, claim received in financial year 2008-09 is a prior period items and should be separately disclosed in the statement of Profit and Loss.

***Note:* AS 1 to AS 32 (including limited revisions) and ASI 1 to ASI 30 are applicable for May, 2010 examination. However, it may be noted that ASI 2 and ASI 11 have been withdrawn.**

APPENDIX – I

LIST OF INSTITUTE'S PUBLICATIONS RELEVANT FOR MAY, 2010 EXAMINATIONS

The following List of Institute's Publications is relevant for the forthcoming examination i.e. May, 2010. Students may kindly take it into consideration while preparing for the examinations.

Final Examination

Paper 1: Advanced Accounting

I. Statements and Standards

1. Framework for the Preparation and Presentation of Financial Statements
2. Accounting Standards (including limited revisions) – AS 1 to AS 32.

II. Guidance Notes on Accounting Aspects

1. Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets.
2. Guidance Note on Accrual Basis of Accounting.
3. Guidance Note on Accounting Treatment for Excise Duty.
4. Guidance Note on Accounting for Depreciation in Companies.
5. Guidance Note on Availability of Revaluation Reserve for Issue of Bonus shares.
6. Guidance Note on Accounting Treatment for MODVAT/CENVAT.
7. Guidance Note on Accounting for Corporate Dividend Tax.
8. Guidance Note on Accounting for Employee Share-based Payments.
9. Guidance Note on Accounting for Fringe Benefits Tax.
10. Guidance Note on Accounting for Credit Available in respect of Minimum Alternate Tax under the Income Tax Act, 1961.
11. Guidance Note on Measurement of Income Tax for Interim Financial Reporting in the context of AS 25

Note: Official Announcements and Notifications (in relation to syllabus) issued till 31st October, 2009 will be applicable for May, 2010 examination.

APPENDIX – II

Companies (Accounting Standards) Amendment Rules, 2009 – Amendments in Annexure

NOTIFICATION NO. G.S.R.225 (E)

DATED 31-3-2009

In exercise of the powers conferred by clause (a) of sub-section (1) of section 642 read with sub-section (1) of section 21A and sub-section (3C) of section 211 of the Companies Act, 1956 (1 of 1956), the Central Government in consultation with the National Advisory Committee on Accounting Standards, hereby makes the following rules to amended the Companies (Accounting Standards) Rules, 2006, namely:-

1. (1) These rules may be called the Companies (Accounting Standards) Amendment Rules, 2009.

   (2) They shall come into force on the date of their publication in the Official Gazette.

2. In the Companies (Accounting Standard) Rules, 2006, in the Annexure, under the heading "B. ACCOUNTING STANDARDS", in the sub-heading "Accounting Standard (AS) 11" relating to "The Effects of Changes in Foreign Exchange Rates", after paragraph 45, the following shall be inserted, namely:-

"46. In respect of accounting periods commencing on or after 7th December, 2006 and ending on or before 31st March, 2011, at the option of the enterprise (such option to be irrevocable and to be exercised retrospectively for such accounting period, from the date this transitional provision comes into force or the first date on which the concerned foreign currency monetary item is acquired, whichever is later and applied to all such foreign currency monetary items), exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, insofar as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long-term asset/liability but not beyond 31st March, 2011, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with paragraph 15. For the purposes of exercise of this option, an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability. Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously recognized in the profit and loss account before the exercise of the option shall be reversed insofar as it relates to the acquisition of a depreciable capital asset by addition or deduction from the cost of the asset and in other cases by transfer to "Foreign Currency Monetary Item Translation Difference Account" in both cases, by debit or credit, as the case may be, to the general reserve. If the option stated in this paragraph is exercised, disclosure shall be made of the fact of such exercise of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

APPENDIX – III

GN(A) 24 (Issued 2006)

GUIDANCE NOTE ON MEASUREMENT OF INCOME TAX EXPENSE FOR INTERIM FINANCIAL REPORTING IN THE CONTEXT OF AS 25

(The following is the text of the Guidance Note on Measurement of Income-tax Expense for Interim Financial Reporting in the context of AS 25, issued by the Council of the Institute of Chartered Accountants of India.)

1. Accounting Standard (AS) 25, 'Interim Financial Reporting', issued by the Council of the Institute of Chartered Accountants of India (ICAI), prescribes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period. AS 25 became mandatory in respect of accounting periods commencing on or after 1st April, 2002. In accordance with the Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results', the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in the interim financial results presented under Clause 41 of the Listing Agreement entered into between stock exchanges and the listed enterprises. This Guidance Note deals with the measurement of income tax expense for the purpose of inclusion in the interim financial reports.

2. The general principles for recognition and measurement have been laid down in AS 25 as below:

   "27. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

   28. Requiring that an enterprise apply the same accounting policies in its interim financial statements as in its annual financial statements may seem to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period. However, by providing that the frequency of an enterprise's reporting should not affect the measurement of its annual results, paragraph 27 acknowledges that an interim period is a part of a financial year. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements."

3. Paragraph 29(c) of AS 25 illustrates the application of the general principles for recognition and measurement of tax expense in interim periods, as below:

   "29…..

(c) income tax expense is recognized in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes."

4. Appendix 3 to AS 25 illustrates the general recognition and measurement principles for the preparation of interim financial reports. Paragraphs 8 to 16 of the Appendix provide guidance on the computation of income-tax expense for the interim period, which are reproduced in Appendix A to this Guidance Note for ready reference. Paragraph 8 of the Appendix states as below:

"8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period."

5. The various steps involved in the measurement of income tax expense for the purpose of interim financial reports are as below:

(i) An enterprise will first have to estimate its annual accounting income. For this purpose, an enterprise would have to take into account all probable events and transactions that are expected to occur during the financial year. Such an estimate would involve, e.g., estimating on prudent basis, the depreciation on expected expenditure on acquisition of fixed assets, profits from sale of fixed assets/investments, etc. Such future events and transactions should be taken into account only if there is a reasonable certainty that the same would take place during the financial year.

(ii) The enterprise should next estimate its tax liability for the financial year. For this purpose, the enterprise will have to estimate taxable income for the year. By applying the enacted or the substantively enacted tax rate on the taxable income, an estimate of the current tax for the year is arrived at. The estimates of tax liability would have to be based on the estimated deductions, allowances, etc., that would be available to the enterprise, provided there is a reasonable certainty for the same. The enterprise would also have to estimate the deferred tax assets/liabilities by applying the principles of Accounting Standard (AS) 22, 'Accounting for Taxes on Income', issued by the Institute of Chartered Accountants of India. Special considerations may have to be applied in certain cases as below:

(a) Where brought forward losses exist from the previous financial year (when deferred tax asset was not recognised on considerations of prudence as per AS 22): In such a situation, for estimating the current tax liability, the brought forward losses would have to be deducted from the estimated annual accounting income as explained in paragraph 16 of Appendix 3 to AS 25 (reproduced in Appendix A to this Guidance Note). Since such carried forward losses will get set-off during the year, these would not have any tax consequence in future periods.

(b) Where brought forward losses exist (when deferred tax asset was recognised on the considerations of prudence as per AS 22): In such a situation, current tax would be computed in the same manner as explained in (a) above. However, in the determination of deferred tax, the tax expense arising from the reversal of the deferred tax asset recognised previously, to the extent of reversal of deferred tax asset in the current year, would also be considered.

(iii) The enterprise would now have to calculate the weighted average annual effective tax rate. This tax rate would be determined by dividing the estimated tax expense as arrived at step (ii) above by the estimated annual accounting income as arrived at step (i) above. Where different tax rates are applicable to different portions of the estimated annual accounting income, e.g., normal tax rate and a different tax rate for capital gains, the weighted average annual effective tax rate would have to be calculated separately for such portions of estimated annual accounting income.

(iv) The weighted average annual effective tax rate arrived at step (iii) would be applied to the accounting income for the interim period for determining the income tax expense to be recognised in the interim financial reports.

6. Accounting for interim period income-tax expense as suggested above is based on the approach prescribed in AS 25 that the interim period is part of the whole accounting year (often referred to as the 'integral approach') and, therefore, the said expense should be worked out on the basis of the estimated weighted average annual effective income-tax rate. According to this approach, the said rate is determined on the basis of the taxable income for the whole year, and applied to the accounting income for the interim period in order to determine the amount of tax expense for that interim period. This is in contrast to accounting for certain other expenses such as depreciation which is based on the approach prescribed in AS 25 that the interim period should be considered on stand-alone basis (often referred to as the 'discrete approach') because expenses such as depreciation are worked out on the basis of the period for which a fixed asset was available for use. The aforesaid treatments are, however, consistent with the requirement contained in paragraph 27 of AS 25 that an enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements.

7. Appendix B contains examples of computing weighted average annual effective tax rate.

Appendix A

EXTRACTS FROM APPENDIX 3 TO ACCOUNTING STANDARD (AS) 25, INTERIM FINANCIAL REPORTING

Measuring Income Tax Expense for Interim Period

8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

9. This is consistent with the basic concept set out in paragraph 27 that the same accounting recognition and measurement principles should be applied in an interim financial report as are

applied in annual financial statements. Income taxes are assessed on an annual basis. Therefore, interim period income tax expense is calculated by applying, to an interim period's pre-tax income, the tax rate that would be applicable to expected total annual earnings, that is, the estimated average effective annual income tax rate. That estimated average annual income tax rate would reflect the tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 27 of this Statement. Paragraph 16(d) requires disclosure of a significant change in estimate.

10. To the extent practicable, a separate estimated average annual effective income tax rate is determined for each governing taxation law and applied individually to the interim period pre-tax income under such laws. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable a separate rate is applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases, and a weighted average of rates across such governing taxation laws or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.

11. As illustration, an enterprise reports quarterly, earns Rs. 150 lakhs pre-tax profit in the first quarter but expects to incur losses of Rs 50 lakhs in each of the three remaining quarters (thus having zero income for the year), and is governed by taxation laws according to which its estimated average annual income tax rate is expected to be 35 per cent. The following table shows the amount of income tax expense that is reported in each quarter:

(Amount in Rs. lakhs)

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Annual
Tax Expense	52.5	(17.5)	(17.5)	(17.5)	0

Difference in Financial Reporting Year and Tax Year

12. If the financial reporting year and the income tax year differ, income tax expense for the interim periods of that financial reporting year is measured using separate weighted average estimated effective tax rates for each of the income tax years applied to the portion of pre-tax income earned in each of those income tax years.

13. To illustrate, an enterprise's financial reporting year ends 30 September and it reports quarterly. Its year as per taxation laws ends 31 March. For the financial year that begins 1 October, Year 1 ends 30 September of Year 2, the enterprise earns Rs 100 lakhs pre-tax each quarter. The estimated weighted average annual income tax rate is 30 per cent in Year 1 and 40 per cent in Year 2.

(Amount in Rs. lakhs)

	Quarter Ending 31 Dec. Year 1	Quarter Ending 31 Mar. Year 1	Quarter Ending 30 June Year 2	Quarter Ending 30 Sep. Year 2	Year Ending 30 Sep. Year 2
Tax Expense	30	30	40	40	140

Tax Deductions/Exemptions

14. Tax statutes may provide deductions/exemptions in computation of income for determining tax payable. Anticipated tax benefits of this type for the full year are generally reflected in computing the estimated annual effective income tax rate, because these deductions/exemptions are calculated on an annual basis under the usual provisions of tax statutes. On the other hand, tax benefits that relate to a one-time event are recognised in computing income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate.

Tax Loss Carry forwards

15. A deferred tax asset should be recognised in respect of carry forward tax losses to the extent that it is virtually certain, supported by convincing evidence, that future taxable income will be available against which the deferred tax assets can be realised. The criteria are to be applied at the end of each interim period and, if they are met, the effect of the tax loss carry forward is reflected in the computation of the estimated average annual effective income tax rate.

16. To illustrate, an enterprise that reports quarterly has an operating loss carryforward of Rs 100 lakhs for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised. The enterprise earns Rs 100 lakhs in the first quarter of the current year and expects to earn Rs 100 lakhs in each of the three remaining quarters. Excluding the loss carryforward, the estimated average annual income tax rate is expected to be 40 per cent. The estimated payment of the annual tax on Rs. 400 lakhs of earnings for the current year would be Rs. 120 lakhs {(Rs. 400 lakhs - Rs. 100 lakhs) x 40%}. Considering the loss carryforward, the estimated average annual effective income tax rate would be 30% {(Rs. 120 lakhs/Rs. 400 lakhs) x 100}. This average annual effective income tax rate would be applied to earnings of each quarter. Accordingly, tax expense would be as follows:

(Amount in Rs. lakhs)

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Annual
Tax Expense	30.00	30.00	30.00	30.00	120.00

Appendix B

Examples of Computation of Weighted Average Annual Effective Tax Rate

Example 1: *When deferred tax asset was not recognised for carried forward losses from earlier accounting periods.*

	Quarter *I*	Quarter II	Quarter III	Quarter IV	**Total**
	Rs.	Rs.	Rs.	Rs.	Rs.
Estimated Pre-tax Income (after considering estimated depreciation on the probable acquisition of fixed assets during the year)	(25)	175	(25)	50	175
Carried forward losses from earlier accounting periods, the deferred tax asset in respect of which was not recognised as it did not meet the requirements of prudence laid down in AS 22. During this year, in view of the expected taxable income, this loss is expected to be set off thereagainst. Therefore, it will not have any tax effect on future periods.					(25)
Additional estimated depreciation as per tax laws as compared to the accounting depreciation after considering depreciation on probable capital expenditure on acquisition of fixed assets during the year.					(50)
Estimated taxable income on which tax payable.					100
Applicable tax rate (say)					30%
Estimated current tax expense for the year.					30
Estimated deferred tax expense for the year (50x30/100)					15

Weighted Average Annual Effective Tax Rate (current tax)					$\frac{30}{175}$ x100=17.14%
Weighted Average Annual Effective Tax Rate (deferred tax)_					$\frac{15}{175}$ x 100 =8.57%
Tax expense for the interim period Current tax Deferred tax Total	 (4.29) (2.14) (6.43)	 30 15 45	 (4.29) (2.14) (6.43)	 8.57 4.29 12.86	 29.99 15.01 45.00

(a) The above calculation needs to be done for every interim period for which recognition and measurement of tax expense is required.

(b) It is presumed that there are no other differences between accounting income and taxable income.

Example 2: *When deferred tax asset was recognised for carried forward losses from earlier accounting periods.*

	Quarter *I*	Quarter II	Quarter III	Quarter IV	**Total**
	Rs.	Rs.	Rs.	Rs.	Rs.
Estimated Pre-tax Income (after considering estimated depreciation on the probable acquisition of fixed assets during the year)	(25)	175	(25**)**	50	175
Carried forward losses from earlier accounting periods, the deferred tax asset in respect of which was recognised on the basis of considerations of AS 22. During this year, in view of the expected taxable income, this loss is expected to be set off thereagainst. This will result in reversal of the deferred tax asset in the current year.					(25)
Additional estimated depreciation as per tax laws as compared to the accounting depreciation after considering depreciation on probable capital expenditure on					(50)

acquisition of fixed assets during the year.					
Estimated taxable income on which tax payable.					100
Applicable tax rate (say)					30%
Estimated current tax expense for the year.					30
Estimated deferred tax expense for the year: (i) Defered tax liability on account of timing difference in depreciation (50x30/100) 15 (ii) Reversal of deferred tax asset (25x30/100) 7.5					22.5
Weighted Average Annual Effective Tax Rate (Current tax)					$\frac{30}{175}$ x100=17.14%
Weighted Average Annual Effective Tax Rate (Deferred tax)					$\frac{22.5}{175}$ x100=12.86%
Tax expense for the interim period Current tax Deferred tax Total	 (4.29) (3.21) (7.50)	 30.0 22.5 52.5	 (4.29) (3.21) (7.50)	 8.57 6.43 15.00	 29.99 22.51 52.50

(a) The above calculation needs to be done for every interim period for which recognition and measurement of tax expense is required.

(b) It is presumed that there are no other differences between accounting income and taxable income.

Example 3: *When progressive rates of tax are applicable*

Under the Indian tax system, the tax rates for corporates and firms are not progressive (i.e., based on levels of income), but are flat rates. Therefore, the tax rate to be applied in the interim period would be the normal rate applicable to the entity. However, the calculation of weighted average annual effective tax rate can be illustrated as below where the tax rates are progressive:

Estimated annual income Rs.1 lakh

Assumed Tax Rates:

On first Rs. 40,000 30%

On the balance income 40%

Tax expense: 30% of Rs. 40,000 + 40% of Rs. 60,000 = Rs. 36,000

Weighted average annual effective tax rate = $\frac{36,000}{1,00,000}$ x 100 = 36%

Supposing the estimated income of each quarter is Rs. 25,000, the tax expense of Rs. 9,000 (36% of Rs. 25,000) would be recognised in each of the quarterly financial reports.

Example 4: *When different rates of tax are applicable to different portions of the estimated annual accounting income (refer para5(iii))*

Estimated annual income	Rs. 1 lakh
(inclusive of Estimated Capital Gains (earned in Quarter II)	Rs. 20,000

Assumed Tax Rates:

On Capital Gains	10%
On other income:	
First Rs. 40,000	30%
Balance income	40%

Assuming there is no difference between the estimated taxable income and the estimated accounting income,

Tax Expense:

On Capital Gains portion of annual income:

10% of Rs. 20,000	Rs. 2,000
On other income: 30% of Rs. 40,000 + 40% of Rs.40,000	Rs.28,000
Total:	Rs.30,000

Weighted Average Annual Effective Tax Rate:

On Capital Gains portion of annual income: $\frac{2,000}{20,000}$ x 100 = 10%

On other income: $\frac{28,000}{80,000}$ x 100 = 35%

Supposing the estimated income of each quarter is Rs.25,000, when income of Rs.25,000 for 2nd Quarter includes capital gains of Rs.20,000, the tax expense for each quarter will be calculated as below:

		Income	Tax Expense		
Quarter I:		Rs. 25,000	35% of Rs. 25,000 =	Rs. 8,750	
Quarter II:	Capital Gains:	Rs. 20,000	10% of Rs. 20,000 =	Rs. 2,000	
	Other:	Rs. 5,000	35% of Rs. 5,000 =	Rs. 1,750	Rs.12,500
Quarter III:		Rs. 25,000	35% of Rs. 25,000 =		Rs. 8,750
Quarter IV:		Rs. 25,000	35% of Rs. 25,000 =		Rs. 8,750
Total tax expense for the year					Rs. 30,000

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PAPER –2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

QUESTIONS

Foreign Exchange Risk Management

1. (i) The rate of inflation in USA is likely to be 3% per annum and in India it is likely to be 6.5%. The current spot rate of US $ in India is Rs.43.40. Find the expected rate of US $ in India after one year and 3 years from now using purchasing power parity theory.

   (ii) On April 1, 3 months interest rate in the UK £ and US $ are 7.5% and 3.5% per annum respectively. The UK £/US $ spot rate is 0.7570. What would be the forward rate for US $ for delivery on 30th June?

2. Wenden Co is a Dutch-based company which has the following expected transactions.

One month: Expected receipt of	£2,40,000
One month: Expected payment of	£1,40,000
Three months: Expected receipts of	£3,00,000

The finance manager has collected the following information:

Spot rate (£ per €):	1.7820 ± 0.0002
One month forward rate (£ per €):	1.7829 ± 0.0003
Three months forward rate (£ per €):	1.7846 ± 0.0004

Money market rates for Wenden Co:

	Borrowing	Deposit
One year Euro interest rate:	4.9%	4.6
One year Sterling interest rate:	5.4%	5.1

Assume that it is now 1 April.

Required:

(a) Calculate the expected Euro receipts in one month and in three months using the forward market.

(d) Calculate the expected Euro receipts in three months using a money-market hedge and recommend whether a forward market hedge or a money market hedge should be used.

3. CQS plc is a UK company that sells goods solely within UK. CQS plc has recently tried a foreign supplier in Netherland for the first time and need to pay €250,000 to the supplier in six months' time. You as financial manager are concerned that the cost of these supplies may rise in Pound Sterling terms and has decided to hedge the currency risk of this account payable. The following information has been provided by the company's bank:

Spot rate (€ per £):	1·998 ± 0·002
Six months forward rate (€ per £):	1·979 ± 0·004

Money market rates available to CQS plc:

	Borrowing	Deposit
One year Pound Sterling interest rates:	6·1%	5·4%
One year Euro interest rates:	4·0%	3·5%

Assuming CQS plc has no surplus cash at the present time you are required to evaluate whether a money market hedge, a forward market hedge or a lead payment should be used to hedge the foreign account payable.

4. Best of Luck Ltd, London will have to make a payment of $3,64,897 in six month's time. It is currently 1st October. The company is considering the various choices it has in order to hedge its transaction exposure.

Exchange rates:

Spot rate	$1.5617 – 1.5773
Six-month forward rate	$1.5455 – 1.5609

Money market rates:

	Borrow(%)	Deposit(%)
US	6	4.5
UK	7	5.5

Foreign currency option prices (1 unit is £12,500):

Exercise price	Call option (March)	Put option (March)
$1.70	$0.037	$0.096

By making the appropriate calculations and ignoring time value of money (in case of Premia) decide which of the following hedging alternatives is the most attractive to Best of Luck Ltd:

(a) Forward market

(b) Cash (Money) market;

(c) Currency options.

Capital Budgeting with Risk

5. Soft True P Ltd. is a company specializing in the development of business software. The company's managers believe that its future growth potential in the software sector is limited hence are considering diversifying into other activities. One suggestion from operation department is Internet auctions, and financial management team in consultation with the operation department has produced the following draft financial proposal.

(a) The initial cost of the project (capital outlay) of the project will be Rs. 27,00,000.

(b) The year-wise working capital requirement will be as follows:

Year	0	1	2	3	4
Working capital	4,00,000	24,000	24,000	25,000	26,000

(c) Details of inflows and other outflows is as follows:

Internet auctions project

Rs. '000

Year	0	1	2	3	4
Auction fees	–	43,00	66,20	81,00	82,00
Outflows:					
Maintenance costs	–	12,10	18,50	19,20	21,25
Telephone Expenses	–	12,15	19,10	22,30	24,20
Wages	–	14,60	15,20	16,80	17,30
Salaries	–	400	550	600	650
Allocated head office overhead	–	85	90	95	1,00
Marketing	5,00	4,20	2,00	2,00	–
Royalty payments for use of technology	6,80	5,00	3,00	2,00	2,00
Research & Development	1,10		–	–	–
Rent of office	–	2,80	2,90	3,00	3,10
Total outflows	12,90	55,70	67,10	72,25	75,35
Profit before tax	(12,90)	(12,70)	(90)	8,75	6,65

Additional information:

(i) All data include the estimated effects of inflation on costs and prices wherever relevant. Inflation in India is forecast to be 2% per year for the foreseeable future.

(ii) The investment in IT infrastructure and the initial working capital will be financed by a 6 year 5·5% fixed rate term loan. Other years outlays will be financed from existing cash flows.

(iii) It is expected that Government of India shall give a 1% per year subsidy to the cost of the loan to support the creation of jobs associated with this project.

(iv) It is expected that highly skilled IT staff would need to be taken from other activities resulting in a loss of Rs.80,000 per year pre-tax contribution for three years.

(v) Head office cash flows for overheads will increase by Rs. 50,000 as a result of the project in year one, rising by Rs.5,000 per year after year one.

(vi) Corporate tax is at a rate of 24·5% per year, payable in the year that the tax liability arises. The company has other profitable projects.

(vii) Tax allowable depreciation on IT infrastructure is 20% for the first year, and straight line thereafter. The IT infrastructure has an expected working life of six years after which major new investment would be required.

(viii) The company's current weighted average cost of capital is 7·8%.

(ix) The company's equity beta is 1·05.

(x) The average equity beta of companies in the Internet auctions sector is 1·42.

(xi) The market return is 9·5% per year and the risk free rate 4% per year.

(xii) Soft True's capital gearing is:

Book value 55% equity, 45% debt

Market value 70% equity, 30% debt

(xiii) The average gearing of companies in the Internet auction sector is 67% equity, 33% debt by market values.

(xiv) The market research survey was undertaken three weeks ago.

(xv) After tax operating net cash flows after year 4 are expected to stay approximately constant in real terms. The royalty payment will remain at Rs.200,000 in money terms.

(xvi) Issue costs on debt are 1·5%. These costs are not tax allowable.

Required:

Suppose you are an external consultant and you have been approached by the Soft True to prepare a report on the proposed diversification of the company into Internet auctions.

(a) The report must include a revised financial analysis. Make relevant assumptions as required.

(b) Also include in your report discussion of other financial and nonfinancial factors, including real options that Soft True might consider prior to making the investment decision.

Business Valuation

6. Suppose you are verifying a valuation done on an established company by a well-known analyst has estimated a value of Rs. 750 lakhs, based upon the expected free cash flow next year, of Rs. 30 lakhs, and with an expected growth rate of 5%.

You found that, he has made the mistake of using the book values of debt and equity in his calculation. While you do not know the book value weights he used, you have been provided following information:

(a) Company has a cost of equity of 12%.

(b) After-tax cost of debt of 6%.

(c) The market value of equity is three times the book value of equity, while the market value of debt is equal to the book value of debt.

You are required to estimate the correct value of company.

7. ABC (India) Ltd., a market leader in printing industry, is planning to diversify into defense equipment businesses that have recently been partially opened up by the GOI for private sector. In the meanwhile, the CEO of the company wants to get his company valued by a leading consultants, as he is not satisfied with the current market price of his scrip.

He approached consultant with a request to take up valuation of his company with the following data for the year ended 2009:

Share Price	Rs. 66 per share
Outstanding debt	1934 lakh
Number of outstanding shares	75 lakh
Net income	17.2 lakh
EBIT	245 lakh
Interest expenses	218.125 lakh
Capital expenditure	234.4 lakh
Depreciation	234.4 lakh
Working capital	44 lakh
Growth rate 8% (from 2010 to 2014)	
Growth rate 6% (beyond 2014)	
Free cash flow	240.336 lakh (year 2014 onwards)

The capital expenditure is expected to be equally offset by depreciation in future and the debt is expected to decline by 30% by 2014.

Required:

Estimate the value of the company and ascertain whether the ruling market price is undervalued as felt by the CEO based on the foregoing data. Assume that the cost of equity is 16%, and 30% of debt repayment is made in the year 2014.

Interest Rate Risk Management

8. 9 year Government of India security is being quoting at 10.5%. The 364 T Bill (Treasury Bill) is being quoted at 11.25. Last year Indian National Bank had issued a fixed rate bond under statutory requirement at 15% coupon for a period of 10 year. Now when remaining 9 years are yet to expire the Bank wants to convert their fixed rate obligation to floating rate due to anticipation of decline in interest rates. Market quotation for fixed to floating rate swap is T-Bill rate is 75/85 bp over 9 year Government of India security. If T-Bill decline 20 bp over the current year and rises by 5 bp every year thereafter what is the effective cost of funds to Indian National Bank. To hedge interest rate Indian National Bank undertakes swap transaction every year.

Leasing Decision

9. Ageit Charter has been asked to operate a very light aircraft plane for a mining company exploring north and west of Maastricht. Ageit will have a firm one-year contract with the mining company and expects that the contract will be renewed for the five-year duration of the exploration program. If the mining company renews at year 1, it will commit to use the plane for four more years.

   Ageit Charter has the following choices.

   - Buy the plane for €500,000.
   - Take a one-year operating lease for the plane. The lease rate is €118,000, paid in advance.
   - Arrange a five-year, noncancelable financial lease at a rate of €75,000 per year, paid in advance.

   These are net leases: all operating costs are absorbed by Ageit Charter.

   How would you advise Bart Ageit, the charter company's CEO? Assume five-year, straight-line depreciation for tax purposes. The company's tax rate is 35 percent. The weighted-average cost of capital for the very light aircraft plane business is 14 percent, but Ageit can borrow at 9 percent. The expected inflation rate is 4 percent.

   Ms. Ageit thinks the plane will be worth €300,000 after five years. But if the contract with the mining company is not renewed (there is a 20 percent probability of this outcome at year 1), the plane will have to be sold on short notice for €400,000.

   If Ageit Charter takes the five-year financial lease and the mining company cancels at year 1, Ageit can sublet the plane that is, rent it out to another user.

   Make additional assumptions as necessary.

International Capital Budgeting

10. OJ Ltd. Is a supplier of leather goods to retailers in the UK and other Western European countries. The company is considering entering into a joint venture with a manufacturer in South America. The two companies will each own 50 per cent of the limited liability company JV(SA) and will share profits equally . £ 450,000 of the initial capital is being provided by OJ Ltd. and the equivalent in South American dollars (SA$) is being provided by the foreign partner. The managers of the joint venture expect the following net operating cash flows, which are in nominal terms:

	SA$ 000	Forward Rates of exchange to the £ Sterling
Year 1	4,250	10
Year 2	6,500	15
Year 3	8,350	21

   For tax reasons JV(SV) the company to be formed specifically for the joint venture, will be registered in South America.

   Ignore taxation in your calculations.

Assuming you are financial adviser retained by OJ Limited to advise on the proposed joint venture.

(i) Calculate the NPV of the project under the two assumptions explained below. Use a discount rate of 18 per cent for both assumptions.

Assumption 1: The South American country has exchange controls which prohibit the payment of dividends above 50 per cent of the annual cash flows for the first three years of the project. The accumulated balance can be repatriated at the end of the third year.

Assumption 2 : The government of the South American country is considering removing exchange controls and restriction on repatriation of profits. If this happens all cash flows will be distributed as dividends to the partner companies at the end of each year.

(ii) Comment briefly on whether or not the joint venture should proceed based solely on these calculations.

Options and Derivatives

11. You are given three call options on a stock at exercise price of Rs. 30, Rs. 35 and Rs. 40 with expiration date in three months and the premium of Rs. 4, Rs. 2 and Re. 1 respectively. Show how the option can be used to create a butterfly spread. Construct a table with different market prices and show how profit changes with stock prices ranging from Rs. 20 to 50 for the butterfly spread.

12. From the following data for certain stock, find the value of a call option:

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

Given

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

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

In 1.0667 = 0.0645

Dividend Policy

13. The target payout ratio for Cryzal Ltd. is 0.4. The dividend per share for the current year is \$12.9. The weightage given to the current year earnings is 0.55. The dividend per share in previous year was \$11.1. The number of common stock outstanding in the company is 10,00,000. If P/E multiple is 8, applying Lintner Model of dividend policy to the company what is the market capitalization of the company.

14. CMC plc has an all-common-equity capital structure. If has 200,000 share of £2 par value equity shares outstanding. When CMC's founder, who was also its research director and most successful inventor, retired unexpectedly to settle down in the South Pacific in late 2005, CMC was left suddenly and permanently with materially lower growth expectations and relatively few attractive new investment opportunities. Unfortunately, there was no way to replace the founder's contributions to the firm. Previously, CMC found it necessary to plough back most of its earnings to finance growth, which averaged 12% per year. Future growth at a 5% rate is considered realistic; but that level would call for an increase in the dividend payout. Further, it now appears that new investment projects with at least the 14 % rate of return required by CMC's shareholders (k_e = 14%) would amount to only £800,000 for 2006 in comparison to a projected £2,000,000 of net income. If the existing 20 % dividend payout were continued, retained earnings would be £16,00,000 in 2006, but, as noted, investments that yield the 14 % cost of capital would amount to only £800,000.

    The one encouraging thing is that the high earnings from existing assets are expected to continue, and net income of £20,00,000 is still expected for 2006. Given the dramatically changed circumstances. CMC's board is reviewing the firm's dividend policy.

    (a) Assuming that the acceptable 2006 investment projects would be financed entirely by earnings retained during the year, calculate DPS in 2006, assuming that CMC uses the residual payment policy.

    (b) What payout ratio does your answer to part a imply for 2006?

    (c) If a 60 % payout ratio is adopted and maintained for the foreseeable future, what is your estimate of the present market price of the equity share? How does this compare with the market price that should have prevailed under the assumptions existing just before the news about the founder's retirement? If the two values of P_0 are different. Comment on why?

    (d) What would happen to the price of the share if the old 20% payout were continued? Assume that if this payout is maintained, the average rate of return on the retained earnings will fall to 7.5% and the new growth rate will be

    G = (1.0- Payout ratio) × (ROE)

    = (1.0 – 0.2) (7.5%) = (0.8) (7.5%) = 6.0%

Merger and Acquisition

15. AB Ltd. is a firm of recruitment and selection consultants. It has been trading for 10 years and obtained a stock market listing 4 years ago. It has pursued a policy of aggressive growth and specializes in providing services to companies in high-technology and high growth sectors. It is all-equity financed by ordinary share capital of Rs. 500 lakh in shares of Rs. 20 nominal (or par) value.

    The company's results to the end of March 2009 have just been announced. Profits before tax were Rs.1,266 lakh. The Chairman's statement included a forecast that earnings might be expected to rise by 4%, which is a lower annual rate than in recent years. This is blamed on economic factors that have had a particularly adverse effect on high-technology companies.

    YZ Ltd. is in the same business but has been established much longer. It serves more traditional business sectors and its earnings record has been erratic. Press comment has frequently blamed this on poor management and the company's shares have been out of favour with the stock market for some time. Its current earnings growth forecast is also 4% for the foreseeable future. YZ Ltd. has an issued ordinary share capital of Rs.1800 lakh in Rs.100 shares. Pre-tax profits for the year to 31 March 2009 were Rs.1,125 lakh.

    AB Ltd. has recently approached the shareholders of YZ Ltd. with a bid of 5 new shares in AB Ltd. for every 6 YZ Ltd. shares. There is a cash alternative of Rs. 345 per share. Following the announcement of the bid, the market price of AB Ltd. shares fell 10% while the price of YZ Ltd. shares rose 14%. The P/E ratio and dividend yield for AB Ltd., YZ Ltd. and two other listed companies in the same industry immediately prior to the bid announcement are shown below.

			2009	
High	**Low**	**Company**	**P/E**	**Dividend yield %**
425	325	AB Ltd.	11	2.4
350	285	YZ Ltd.	7	3.1

    Both AB Ltd. and YZ Ltd. pay tax at 30%.

    AB Ltd.'s post-tax cost of equity capital is estimated at 13% per annum and YZ Ltd.'s at 11% per annum.

    Assuming that you are a shareholder in YZ Ltd. You have a large, but not controlling interest.

    You bought the shares some years ago and have been very disappointed with their performance. Based on the information and merger terms available, plus appropriate assumptions, to forecast post-merger values, evaluate whether the proposed share-for-share offer is likely to be beneficial to shareholders in both AB Ltd. and YZ Ltd. Also identify why the price of share of AB Ltd. fell following the announcement of bid.

    Note: As a benchmark, you should then value the two companies AB Ltd. and YZ Ltd. using the constant growth form of the dividend valuation model.

Portfolio Management

16. Mr. Sunil Mukharjee has estimated probable under different macroeconomic conditions for the following three stocks:

Stock	Current price (Rs.)	Rates of return(%) during different macroeconomic scenarios		
		Recession	Moderate growth	Boom
Him Ice Ltd	12	-12	15	35
Kalahari Biotech	18	20	12	-5
Puma Softech	60	18	20	15

Mr. Sunil Mukharjee is exploring if it is possible to make any arbitrage profits from the above information.

Required

Using the above information construct an arbitrage portfolio and show the payoffs under different economic scenarios.

17. Consider the following information relating to Stock A and the market for the last five years:

Year	Stock A (%)	Return on Market (%)
2005	29	-10
2006	31	24
2007	10	11
2008	6	-8
2009	-7	3

(a) Determine the regression equation for the return from the stock and the market and calculate the alpha (α), beta (ß) and Unsystematic Risk.

(b) The total variance of the return from the stock A and the components of variance that are explained by the market index and not explained by the market index.

Mutual Funds

18. Ms. Sunidhi is working with an MNC at Mumbai. She is well versant with the portfolio management techniques and wants to test one of the techniques on an equity fund she has constructed and compare the gains and losses from the technique with those from a passive buy and hold strategy. The fund consists of equities only and the ending NAVs of the fund he constructed for the last 10 months are given below:

Month	**Ending NAV (Rs./unit)**	**Month**	**Ending NAV (Rs./unit)**
December 2008	40.00	May 2009	37.00

January 2009	25.00	June 2009	42.00
February 2009	36.00	July 2009	43.00
March 2009	32.00	August 2009	50.00
April 2009	38.00	September 2009	52.00

Assume Sunidhi had invested a notional amount of Rs.2 lakhs equally in the equity fund and a conservative portfolio (of bonds) in the beginning of December 2008 and the total portfolio was being rebalanced each time the NAV of the fund increased or decreased by 15%.

You are **required** to determine the value of the portfolio for each level of NAV following the Constant Ratio Plan.

19. A has invested in three Mutual Fund Schemes as per detailed below:

	MF A	MF B	MF C
Date of investment	01.12.2008	01.01.2009	01.03.2009
Amount of investment	Rs. 50,000	Rs. 1,00,000	Rs. 50,000
Net Asset Value (NAV) at entry date	Rs. 10.50	Rs. 10	Rs. 10
Dividend received upto 31.03.2009	Rs. 950	Rs. 1,500	Nil
NAV as at 31.03.2009	Rs. 10.40	Rs. 10.10	Rs. 9.80

Required:

What is the effective yield on per annum basis in respect of each of the three schemes to Mr. X upto 31.03.2009?

Buy back of Securities

20. Following information is available in respect of dividend, market price and market condition after one year.

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

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

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

And also advise-Whether to accept buy back after?

Economic Value Added

21. Herbal Gyan is a small but profitable producer of beauty cosmetics using the plant Aloe Vera. This is not a high-tech business, but Herbal's earnings have averaged around Rs. 12 lakh after tax, largely on the strength of its patented beauty cream for removing the pimples.

    The patent has eight years to run, and Herbal has been offered Rs. 40 lakhs for the patent rights. Herbal's assets include Rs. 20 lakhs of working capital and Rs. 80 lakhs of property, plant, and equipment. The patent is not shown on Herbal's books. Suppose Herbal's cost of capital is 15 percent. What is its Economic Value Added (EVA)?

Adjusted Present Value

22. TLC is considering a perpetual project with initial investment is Rs.10,00,00,000, and the expected cash inflow is Rs. 85,00,000 a year in perpetuity. The opportunity cost of capital with all-equity financing is 10 percent, and cost of debt is 8%. Since the project is based on the solar technology Government is subsiding the cost of debt by 1%.

    Corporate tax rate is 35%.Use APV to calculate this project's value assuming that.

    (a) First that the project will be partly financed with Rs. 4,00,00,000 of debt and that the debt amount is to be fixed and perpetual.

    (b) The initial borrowing will be increased or reduced in proportion to changes in the future market value of this project.

    Also explain the reasons difference between above two answers

Swap

23. Suppose a dealer quotes 'All-in-cost' for a generic swap at 8% against six month LIBOR flat. If the notional principal amount of swap is Rs.5,00,000.

    (i) Calculate semi-annual fixed payment.

    (ii) Find the first floating rate payment for (i) above if the six month period from the effective date of swap to the settlement date comprises 181 days and that the corresponding LIBOR was 6% on the effective date of swap.

    (iii) In (ii) above, if the settlement is on 'Net' basis, how much the fixed rate payer would pay to the floating rate payer?

    Generic swap is based on 30/360 days basis.

24. Explain the Lintner' s Dividend Model.

25. Write Short Notes on

    (i) Drawbacks of investments in Mutual Funds

    (ii) ESOS and ESPS

    (iii) Factoring and Bill discounting

SUGGESTED ANSWERS/HINTS

1. (i) According to Purchasing Power Parity forward rate is

Spot rate $\left[\frac{1+r_H}{1+r_F}\right]^t$

So spot rate after one year

$$43.40\left[\frac{1+0.065}{1+\ 0.03}\right]^1$$

$= 43.40\ (1.03399)$

$= 44.8751$

After 3 years

$$43.40\left[\frac{1+0.065}{1+0.03}\right]^3 = 43.40\ (1.03398)^3$$

$= 43.40\ (1.10544)$

$=$ Rs.47.9762

(ii) As per interest rate parity

$$S_1 = S_0\left[\frac{1+\text{in A}}{1+\text{in B}}\right]$$

$$S_1 \quad = 0.7570\left[\frac{1+(0.075)\times 3/12}{1+(0.035)\times 3/12}\right]$$

$$= 0.7570\left[\frac{1.01875}{1.00875}\right] = 0.7570 \times 1.0099 = 0.7645$$

S_1 = UK £0.7645 / US$

2. **(a)** **Forward market evaluation**

Net receipt in 1 month = £2,40,000 – £1,40,000	= £1,00,000
WendenCo needs to sell Sterlings at an exchange rate of (1.7829 + 0.0003)	= £1.7832 per €
Euro value of net receipt = 1,00,000/ 1.7832	= €56,079
Receipt in 3 months	= £3,00,000
Wenden Co needs to sell Sterlings at an exchange rate of 1.7846 + 0.0004	= £1.7850 per €
Euro value of receipt in 3 months = 3,00,000/ 1.7850	= €1,68,067

(b) Evaluation of money-market hedge

Expected receipt after 3 months	= £300,000
Sterling interest rate over three months	= 5.4/ 4 = 1.35%
Sterlings to borrow now to have £300,000 liability	
after 3 months = 300,000/ 1.0135	= £296,004
Spot rate for selling Sterling = 1.7820 + 0.0002	= £1.7822 per €
Euro deposit from borrowed Sterling at spot = 296,004/ 1.7822	= €166,089
Euro interest rate over three months = 4.6/ 4	= 1.15%
Value in 3 months of Euro deposit = 166,089 x 1.0115	= €167,999

The forward market is marginally preferable to the money market hedge for the Sterling receipt expected after 3 months.

3. Money market hedge

CQS plc should place sufficient Euros on deposit now so that, with accumulated interest, the six-month liability of €250,000 can be met. Since the company has no surplus cash at the present time, the cost of these Euros must be met by a short-term Pound Sterling loan.

Six-month Euro deposit rate = 3·5/2	= 1·75%
Current spot selling rate = € 1·998 – 0·002	= €1·996 per £
Six-month Pound Sterling borrowing rate = 6·1/2	= 3·05%
Euros deposited now = 250,000/1·0175	= € 2,45,700
Cost of these Euros at spot = 245,700/1·996	= £ 1,23,096
Pound Sterling value of loan in six months' time = 123,096 x 1·0305	= £ 1,26,850

Forward market hedge

Six months forward selling rate =€ 1·979 – € 0·004	= € 1·975 per £
Pound Sterling cost using forward market hedge = € 2,50,000/1·975	= £ 1,26,582

Lead payment

Since the Euro is appreciating against the Pound Sterling, a lead payment may be worthwhile.

Pound Sterling cost now = € 2,50,000/1·996	= £ 1,25,251

This cost must be met by a short-term loan at a six-month interest rate of 3·05%

Pound Sterling value of loan in six months' time = £ 1,25,251 x 1·0305	= £1,29,071

Evaluation of hedges

The relative costs of the three hedges can be compared since they have been referenced to the same point in time, i.e. six months in the future. The most expensive hedge is the lead payment, while the cheapest is the forward market hedge. Using the forward market to hedge the account payable currency risk can therefore be recommended.

4.

(A) Forward Market

(i)	Exposure	= $ 3,64,897
(ii)	Forward Rate 1£ = $1.5455	
(iii)	Outflow (6 month later) $3,64,897/$1.5455	= £ 2,36,103

(B) Cash (Money Market)

(i)	Maturity in $ after 6 months	= $3,64,897
(ii)	Present value of {$364897/(1+(0.045/2))}	= $3,56,867
(iii)	Borrow at spot to make up $3,56,867 (at 1£ = $1.5617)	= £ 2,28,512
(iv)	Amount to be discharged including interest £2,28,512 (1+0.07/2)	= £ 2,36,510

(C) Currency options =17.17 contracts

(i)	Number of contracts 3,64,897/21,250 (can be rounded off to 17 contracts)	
(ii)	Exposure covered through put option 17*21,250	=$3,61,250
(iii)	Balance to be covered through forward market	$3647
(iv)	Premia payable in (17X12,500X0.096)	$20,400
(v)	premia payable in £13,063 [use spot Bid]	

	Put option	Forward
Exposure covered	$361250	$3647
	£	£
Premia	13,063	-
17 contract pyt.	2,12,500	-
($3,61,250/$1.70)		
Forward pyt.		2,360

3,647/1.5455

	2,25,563	2,360
Total outflow		£2,27,923

Students may improve upon the above solution with 18 contracts that would result in excess dollars to be sold in the forward. The final answer is £2,27,554.

Strategy: Choose currency option because of lower cash outflow

Note :

- The quote is indirect one.
- the quote is for per pound, expressed in dollars
- one unit or contract is equal to £12,500 of $21,250 (12,500 x 1.70)
- Normally under direct quote situations, importing firm would hedge the positions by holding calloptions whereas UK based importing company would hedge by holding put option.
- [Rationale: Instead of claiming purchase of dollars to settle the supplier, the UK company would sell pounds]
- Similarly importing company used to purchase foreign currency at offer rate [selling price of Authorised dealer is the purchase price of importing company]. But in London on account of indirect quote, importers use bid rate.
- Time value of money for the payment of premia is ignored.
- For 18 contracts. The premia would be £13,831 [(13,063÷17) x 18]. For excess dollars realised through put option, the importing company would buy pounds resulting in inflow.

When the put option lapses, the situation would be more favourable for the company and the maturity spot result in fewer outflows of pounds.

5. Report on the proposed Internet auction investment.

(a) Normally IT infrastructure requires major new investment after six years, therefore our period of the financial evaluation is six years. The adjusted present value technique (APV) will be used for the evaluation of the proposal requiring the estimation of the base case NPV of operating cash flows, and, separately, the present value of any financing side effects.

Assumptions:

(i) The market research is a sunk cost.

(iii) Working capital is assumed to be released at the end of year 6. Working capital in year 5 is assumed to increase by the 2% inflation rate in India.

(iii) The financing side effects of the investment are the tax relief on interest payments, the issue costs and the benefit from the government subsidy.

Workings:

(i) The discount rate for the base case NPV should be the ungeared cost of equity, taking into account the risk of the investment. In order to reflect the risk of the investment, the ungeared equity beta of the Internet auction sector will be used.

Assuming corporate debt to be virtually risk free:

$$\text{Beta ungeared} = \text{Beta equity x } \frac{E}{E+D(1-t)}$$

$$\text{Beta ungeared} = 1{\cdot}42 \text{ x } \frac{67}{67+33(1\text{-}0245)} = 1.035$$

Using CAPM

$K_{eug} = R_f + (R_m - R_f)$ Beta

K_{eug} = 4% + (9·5% – 4%) 1·035 = 9·69% rounded to 10%

10% will be used as the discount rate to estimate the base case NPV.

(ii) Tax relief on interest payments

The benefit from the tax shield will be estimated based upon the debt used for the investment, although it could be argued that this should be based upon the percentage debt capacity of the company.

Total borrowing for the investment is Rs.31,00,000

Annual tax relief on borrowing Rs.31,00,000 x 4·5% (net of the subsidy) x 0·245 = Rs. 34,177.

The discount rate used will be the risk free rate as the tax relief is offered by a highly stable government in India.

The present value of tax relief for 6 years is: Rs. 34,177 x 5·242 = Rs.1,79,158

(iii) Government subsidy

The benefit from the government subsidy is an interest saving of 1% per year.

Rs. 31,00,000 x 1% = Rs.31,000

The present value for six years, discounted at the risk free rate, is Rs.31,000 x 5·242 = Rs.162,502

(iv) Issue costs

Issues costs are Rs.31,00,000 x 1·5% = Rs.46,500

The estimated present value of the financial side effects is:

Rs. 1,79,158 + Rs. 1,62,502 – Rs. 46,500 = Rs. 2,95,160

Revised financial data:

Internet auctions project

Rs. '000

Year	0	1	2	3	4	5	6
Auction fees	–	4,300	6,620	8,100	8,200	8,364	8,531
Outflows:							
IT Maintenance costs	–	1,210	1,850	1,920	2,125	2,168	2,211
Telephone costs	–	1,215	1,910	2,230	2,420	2,468	2,518
Wages	–	1,460	1,520	1,680	1,730	1,765	1,800
Salaries	–	400	550	600	650	663	676
Allocated head office overhead	–	50	55	60	65	66	68
Marketing	500	420	200	200	–	–	–
Royalty payments for use of technology	680	500	300	200	200	200	200
Lost contribution		80	80	80	–	–	–
Rental of premises		280	290	300	310	316	323
Tax allowable depreciation		540	432	432	432	432	432
Total outflows	1,180	6,155	7,187	7,702	7,932	8,078	8,228
Profit before tax	(1,180)	(1,855)	(567)	398	268	286	303
Tax (24·5%)	289	454	139	(98)	(66)	(70)	(74)
	(891)	(1,401)	(428)	300	202	216	229
Add back depreciation		540	432	432	432	432	432
Other outflows							
IT infrastructure	(2,700)						
Working capital	(400)	(24)	(24)	(25)	(26)	(10)	509
Net flows	(3,991)	(885)	(20)	708	608	638	1,170
Discount factors (10%)		0·909	0·826	0·751	0·683	0·621	0·564
Present values	(3,991)	(804)	(17)	531	415	396	660

The expected base case NPV is (Rs. 2,810,000)

The estimated APV of the investment is (Rs.28,10,000) – Rs.2,95,160 = (Rs.25,14,840)

From a financial perspective this appears to be a very poor investment.

However, there are a number of other factors to consider. The data contains no information about what happens after four years, or in the case of the revised estimates, six years. Although major new investment would be needed after six years there is likely to be a realisable value or going concern value at that time which could be substantial. Several real options could exist at year six, including the option to reinvest and possibly expand operations, or perhaps to use the existing Internet auction clientele for other purposes such as Internet marketing. The initial investment decision should ideally take into account the expected present value from real call options such as these, although even if sophisticated option pricing models are used, real options are very difficult to accurately value. It would also be useful to investigate the effect on cash flow of the option to abandon the project part way through its expected life (effectively a put option).

(b) Although from financial perspective this proposal appears to be a very poor investment. However, there are other important factors which need to be considered is as follows:

(i) The accuracy of data. How confident is Soft True that the forecast sales and costs will occur?

(ii) Sensitivity and/or simulation analysis would be useful to investigate the impact of different assumptions on net cash flows.

(iii) Has the risk of the venture been accurately assessed? The discount rate of the operating cash flows is based on CAPM, and is subject to its theoretical and practical problems.

(iv) Are there new technologies involved in the investment which are not yet fully developed and proven?

(v) What will be the reaction of other Internet auction providers? Will they cut auction listing costs?

(vi) Are there alternative investments that would provide a better strategic fit for Trosoft?

(vii) Are there existing or possible future government regulations that would affect the investment?

6 *Step 1:* Solve for the cost of capital used by the analyst by applying Free Cash Flow to Firm (FCFF) Model as follows:

of Firm = $V_0 = \dfrac{FCFF_1}{k_c - g_n}$

where

$FCFF_1$ = Expected FCFF

k_c = Cost of Capital

g_n = Growth rate forever

Thus

Rs. 750 lakhs = Rs. 30 lakhs / (k_c - g)

Since g = 5%

then k_c = 9%

Step 2: Let X be the weight of Debt

Given Cost of equity = 12%; Cost of debt = 6%

then

12% (1-X) + 6% X = 9%

Hence X = 0.50 : So book value weight for debt was 50%

Step3: Correct weights should be 75% of equity and 25% of debt

Cost of capital = k_c = 12 %(0.75) + 6% (0.25) = 10.50%

Step 4: Correct firm value = Rs. 30 Lakhs /(0.105-0.05) = Rs. 545.45 lakhs

7. i. Computation of tax rate

EBIT	= Rs. 245 lakh
Interest	= Rs. 218.125 lakh
PBT	= Rs. 26.875 lakh
PAT	= Rs. 17.2 lakh
Tax paid	= Rs. 9.675 lakh
Tax rate	= Rs. 9.675 /26.875 = 0.36 =36%

ii. Computation for increase in working capital

Working capital (2009)	= Rs. 44 lakh
Increase in 2010	= Rs. 44 X 0.08 = Rs. 3.52 lakh

It will continue to increase @ 8% per annum.

iii. Weighted average cost of capital

Present debt	= Rs. 1934 lakh
Interest cost	= Rs. 218.125 lakh / Rs. 1934 = 11.28 %
Equity capital	= Rs. 75 lakh X Rs. 66 = 4950 lakh

$$Kc = \frac{4950}{1934+4950} \times 16\% + \frac{1934}{1934+4950} \times 11.28\,(1-0.36)$$

= 11.51 + 2.028 = 13.54

iv. As capital expenditure and depreciation are equal, they will not influence the free cash flows of the company.

v. Computation of free cash flows upto 2012

Year	*2010*	*2011*	*2012*	*2013*	*2014*
	Rs.	*Rs.*	*Rs.*	*Rs.*	*Rs.*
EBIT (1-t)	169.344 lakh	182.89 lakh	197.52 lakh	213.32 lakh	230.39 lakh
Increase in working capital	3.52 lakh	3.80 lakh	4.11 lakh	4.43 lakh	4.79 lakh
Debt repayment	-	-	-	-	1934 × 0.30 = 580.2 lakh
Free cash flows	165.824 lakh	179.09 lakh	193.41 lakh	208.89 lakh	-354.6 lakh
PVF @ 13.54%	0.8807	0.7757	0.6832	0.6017	0.53
PV of free cash flow @ 13.54%	146.10 lakh	138.97 lakh	132.10 lakh	125.75 lakh	-187.93 lakh

Present value of free cash flows upto 2014 = Rs. 354.99 lakh

vi. Cost of capital

Debt = 0.7 X Rs. 1934 = Rs. 1353.8 lakh

Equity = Rs. 4950 lakh

$$Kc = \frac{4950}{4950+1353.8} \times 16\% + \frac{1353.8}{4950+1353.8} \times 13.54\,(1-0.36) = 14.42\%$$

viii. Continuing value

$$\frac{240.336}{0.1442-0.06} \times (1/1.1354)^5$$

= Rs. 1,512.735 lakh

(a) Value of the firm = PV of free cash flows upto 2005 + continuing value – Market value of outstanding debt

= Rs. 354.99 lakh + Rs. 1,512.735 lakh – Rs. 1,353.80 lakh

= Rs. 513.925 lakh

(b) Value per share = Rs. 513.925 lakh/ 75 lakh = Rs. 6.852 < Rs. 66 (present market price)

Therefore, the share price is overvalued in the market.

8. In order to convert obligation from fixed to floating Indian National Bank will have to pay 9 year Government of India security rate + 75 bp. Accordingly, the cost of interest over next 9 years will be as under:-

The current Government of India security price plus 75 bp will be the applicable rate for swap transaction. Therefore, effective cost during the current year will be

15% – (10.5% + 0.75%) + 11.25%

Further, the cost will change based on expected changes only in T-Bills.

Effective cost of funds

$(1.15 \times 1.148 \times 1.1485 \times 1.1490 \times 1.1495 \times 1.15 \times 1.1505 \times 1.151 \times 1.1515)^{1/9} - 1$

= .14977 say 14.98%

9. Firm's after-tax borrowing rate: 0.65 X 0.09 = 0.0585 = 5.85%

Consider first the choice between buying and a five-year financial lease. Ignoring salvage value, the incremental cash flows from leasing are shown in the following table:

€'000

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Buy: 0.80 probability that contract will be renewed for 5 years						
Initial cost of plane	500.00					
Depreciation tax shield		-35.00	-35.00	-35.00	-35.00	-35.00
Lease payment	-75.00	-75.00	-75.00	-75.00	-75.00	-
Lease payment tax shield	26.25	26.25	26.25	26.25	26.25	-
Total cash flow (1)	451.25	-83.75	-83.75	-83.75	-83.75	-35.00
Buy: 0.20 probability that contract will not be renewed						
Initial cost of plane	500.00	-	-	-	-	-
Depreciation tax shield	-	-35.00	-	-	-	-
Lease payment	-75.00	-	-	-	-	-
Lease payment tax shield	26.25	-	-	-	-	-
Total cash flow (2)	451.25	-35.00	-	-	-	-
			-	-	-	-
Expected cash flow = 0.80(1) + 0.20 (2)	451.25	-74.00	-67.00	-67.00	-67.00	-28.00

PVF (at 5.85%)	1	0.9447	0.8925	0.8432	0.7966	0.7526
PV (at 5.85%)	451.25	-69.91	-59.80	-56.49	-53.37	-21.07

Total PV(at 5.85%) = €190.61

The table above shows an apparent net advantage to leasing of €190610.

However, if Ageit buys the plane, it receives the salvage value. There is an 80% probability that the plane will be kept for five years and then sold for € 3,00,000 (less taxes) and there is a 20% probability that the plane will be sold for € 4,00,000 in one year. Discounting the expected cash flows at the company cost of capital (these are risky flows) gives:

$$0.80\,X\left(\frac{3{,}00{,}000X(1-0.35)}{(1.14)^5}\right)+0.20X\left(\frac{4{,}00{,}000}{(1.14)^1}\right)=151200$$

The net gain to a financial lease is: (€ 1,90,610 - € 1,51,200) = € 39,410

(Note that the above calculations assume that, if the contract is not renewed, Ageit can, with certainty, charge the same rent on the plane that it is paying, and thereby zero-out all subsequent lease payments. This is an optimistic assumption.)

The after-tax cost of the operating lease for the first year is:

(1-0.35) X €1,18,000 = €76,700

Assume that a five-year old plane is as productive as a new plane, and that plane prices increase at the inflation rate (i.e., 4% per year). Then the expected payment on an operating lease will also increase by 4% per year. Since there is an 80% probability that the plane will be leased for five years, and a 20% probability that it will be leased for only one year, the expected cash flows for the operating lease are as shown in the table below:

€'000

	Year 0	*Year 1*	*Year 2*	*Year 3*	*Year 4*	*Year 5*
Lease: 0.80 probability that contract will be renewed for 5 years						
After-tax lease payment	-76.70	-79.77	-82.96	-86.28	-89.73	0.00
Lease: 0.20 probability that contract will not be renewed						
After-tax lease payment	-76.70					
Expected cash flow	-76.70	-63.81	-66.37	-69.02	-71.78	0.00
PVF (at 14%)	1	0.8772	0.7695	0.6750	0.5921	0.5194

PV (at 14%)	-76.70	-55.97	-51.07	-46.59	-42.50	0.00

Total PV (at 14%) =
€-272.83

These cash flows are risky and depend on the demand for light aircraft. Therefore, we discount these cash flows at the company cost of capital (i.e., 14%). The present value of these payments is greater than the present value of the payments from the financial lease, so it appears that the financial lease is the lower cost alternative. Notice, however, our assumption about future operating lease costs. If old planes are less productive than new ones, the lessor would not be able to increase lease charges by 4% per year.

10. (i) (a) With Exchange Controls

Year	Profit after tax SA$000	OJ share SA$000	50% div SA$000	OJ Share £000	Disc Factor @ 16%	Disc Cash flow £ 000
0				(450)	1.000	(450)
1	4,250	2,125	1,062	106	0.862	91
2	6,500	3,250	1,625	108	0.743	80
3	8,350	4,175	2,088	100	0.641	64
			4,775	227	0.641	146
Net Present Value						(69)

(b) Exchange controls removed and all earnings distributed as dividends

Year	Profit after tax SA$000	OJ Share SA $000	OJ Share £000	Disc Factor @16%	Disc Cash flow £000
0			(450)	(1.000)	(450)
1	4,250	2,125	212	0.862	183
2	6,500	3,250	217	0.743	161
3	8.350	4,175	199	0.641	127
Net Present Value					21

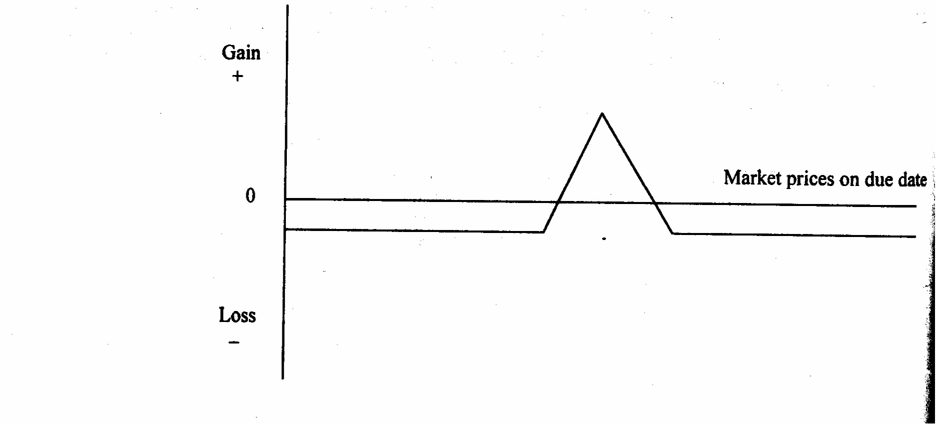
(ii) If exchange controls exist in the south American Country the project has a negative and should not be undertaken, Investing in countries with a history of high inflation and political volatility adds to the risk of the project and OJ Ltd should proceeds with caution.

11. A butterfly spread can be constructed by buying a call option with a relatively low exercise price (Rs. 30) and buying a call with a relatively high strike price (Rs. 40) and also selling two call options with a strike price (Rs. 35/-) in between the high (Rs. 40) and low (Rs. 30). The pattern of pay off can be shown in tabular form as under:

Stock price range	Payoff from first long call	Payoff from second long call	Payoff from two short calls	Total payoff
$S_T<X_1$	0	0	0	0
$X_1<S_T<X_2$	$S_T - X_1$	0	0	$S_T - X_1$
$X_2< S_T <X_3$	$S_T - X_1$	0	$-2(S_T - X_2)$	$X_3 - S_T$
$S_T > X_3$	$S_T - X_1$	$S_T – X_3$	$-2(S_T - X_2)$	0

Market Price on due date	Pay off				Net Premium $-4 + (2 \times 2) - 1 = -1$	Total
	E = Rs.30, one Contract purchased	E = Rs.35, two Contract sold	E = Rs.40, one Contract purchased	Total Pay-off		
Rs.					Rs.	Rs.
20	0	0	0	0	– 1	– 1
22	0	0	0	0	– 1	– 1
24	0	0	0	0	– 1	– 1
26	0	0	0	0	– 1	– 1
28	0	0	0	0	– 1	– 1
30	0	0	0	0	– 1	– 1
32	2	0	0	2	– 1	+ 1
34	4	0	0	4	– 1	+ 3
35	5	0	0	5	– 1	+ 4
36	6	-2	0	4	– 1	+ 3
38	8	-6	0	2	– 1	+ 1
40	10	-10	0	0	– 1	– 1
42	12	-14	2	0	– 1	– 1
44	14	-18	4	0	– 1	– 1
46	16	-22	6	0	– 1	– 1
48	18	-26	8	0	– 1	– 1
50	20	-30	10	0	– 1	– 1

Diagrammatically



12. Applying the Black Scholes Formula,

Value of the Call option now:

The Formula $C = S.N(d_1) - Ke^{(-Rt)} N(d_2)$

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

$$d_1 = \frac{\ln(S/K) + Rt}{\sigma\sqrt{t}} + 0.5\sigma\sqrt{t}$$

$$d_2 = \frac{\ln(S/K) + Rt}{\sigma\sqrt{t}} - 0.5\sigma\sqrt{t}$$

Where,

C = Theoretical call premium

S = Current stock price

t = time until option expiration

K = option striking price

R = risk-free interest rate

N = Cumulative standard normal distribution

E = exponential term

σ = Standard deviation of continuous compound rate.

In = natural logarithim

$$d_1 = \frac{\ln(1.0667) + (12\%)\,0.5}{0.40\sqrt{0.5}} + 0.5X0.40X\sqrt{0.50}$$

$$= \frac{0.0645 + 0.06}{0.40 X 0.7071} + 0.1414$$

$$= \frac{0.1245}{0.2828} + 0.1414$$

= 0.5817

d_2 = 0.5817 – 0.2828

= 0.2989

$N(d_1)$ = N (0.5817) = 0.7195

$N(d_2)$ = N (0.2989) = 0.6175

Value of option

$$C = S.N(d_1) - Ke^{(-Rt)}N(d_2)$$

= Rs. 80 x $N(d_1)$ – [Rs.75/(1.0060)] x $N(d_2)$

Price = Rs. 80 x 0.7195 $- \frac{75}{1.0060} \times 0.6175$

= Rs.57.56 – Rs.74.55 x 0.6175

= Rs.57.56 – Rs.46.04

= Rs.11.52

13. cD_t = dividend per share for the current year

c = weightage given to the current earnings of the firm

r = target payout ratio

EPS_t = earnings per share for the current year

D_{t-1} = dividend per share for the previous year

$D_t - D_{t-1}$ = target change

D_t =target ratio X ($EPS_t - D_{t-1}$)

12.9 = 0.55×0.4×EPS_t + (1–0.55)11.1

EPS_t = $35.93

Market capitalization = $ 35.93×8 ×10,00,000= $ 28,74,40,000

14. (a)

Projected net income	£2,000,000
Less projected capital investments	(800,000)
Available residual	£1,200,000
Shares outstanding	200,000

DPS =£1,200,000/200,000 shares =£6 = D_1

(b) EPS = £2,000,000/200,000 shares = £10

Payout ratio = DPS/EPS = £6/£10 = 60% or

Total dividends/NI = £1,200,000/£2,000,000 = 60%

(c) Currently, $P_0 = \frac{D_1}{K_e - g} = \frac{£6}{0.14 - 0.05} = \frac{£6}{0.09} = £66.67$

Under the former circumstances, D_1 would be based on a 20% payout on £10 EPS, or £2. With K_S = 14% and g=12%, we solve for P_0 :

$$P_0 = \frac{D_1}{K_e - g} = \frac{£2}{0.14 - 0.12} = \frac{£2}{0.02} = £100$$

Although CMC has suffered a server setback, its existing assets will continue to provide a good income stream. More of these earnings should now be passed on to the shareholders, as the slowed internal growth has reduced the need for funds. However, the net result is a 33 % decrease in the value of the shares.

(d) If the payout ratio were continued at 20%, even after internal investment opportunities had declined, the price of the stock would drop to £2/(0.14-0.06) =£25 rather than to £66.67. Thus, an increase in the dividend payout is consistent with maximizing shareholder wealth.

Because of the downward-sloping IOS curve, the greater the firm's level of investment, the lower the average ROE. Thus, the more money CMC retains and invests, the lower its average ROE will be. We can determine the average ROE under different conditions as follows.

Old situation (with founder active and 20% payout):

g = (1.0-Payout ratio)(Average ROE)

12%= (1.0-0.2) (Average ROE)

Average ROE = 12%/0.8 = 15% > k_e = 14%

Note that the *average* ROE is 15 %, whereas the *marginal* ROE is presumably equal to 14 %.

New situation (with founder retired and a 60 % payout)

g = 6 %=(1.0-0.6) (ROE)

ROE=6%/0.4=15% > k_s=14%

This suggests that the new payout is appropriate and that the firm is taking on investments down to the point at which marginal returns are equal to the cost of capital.

15. Assumption: Though in the question it is assumed that there is no operating synergy and so no increase on the combined earnings; it is unlikely a bid would be launched if substantial synergy was not estimated.

Share for share offer

	AB Ltd.	**YZ Ltd.**	**Combined**
Profit before tax (Rs. lakh)	1,266.00	1,125.00	2,391.00
Less: Tax @ 30%	379.80	337.50	717.30
Profit after Tax	886.20	787.50	1,673.70
Number of shares (lakh)	25.00	18.00	40.00
Earnings Per Share (Rs.)	35.45	43.75	41.84
P/E ratio	11	7	
Share price (pre bid) (Rs.)	389.93	306.25	381.52*
Market Value of company (Rs. lakh)	9,748.20	5,512.50	15,260.70

* $\dfrac{\text{Rs.15,260.70 lakh}}{\text{40 lakh}}$ = Rs. 381.52

Post Bid Price (Combined Entity)

Rs. 41.84 X 11 = Rs. 460 per share

Share for Cash offer

Rs. 460 per share

Thus cash offer is more beneficial for AB Ltd.

Reasons (partially) for the fall in the market price of the shares in the market

Wealth of a shareholder of YZ Ltd. holding 6 shares in YZ Ltd. (Rs.306.25 X 6) Rs. 1,837.50

Wealth of a shareholder of YZ Ltd. holding 5 shares in combined entity (Rs.381.52 X 5) Rs. 1,907.60

Thus there seems to be transfer of wealth from the AB Ltd. to YZ Ltd.

Value of shares using the Dividend Growth Model

$$AB = \frac{(35.45 X 1.04)}{(0.13 - 0.04)} = Rs.409.66$$

$$YZ = \frac{(43.75 X 1.04)}{(0.11 - 0.04)} = Rs.650.00$$

This would suggest that AB is slightly undervalued, but that YZ is hugely undervalued in the marketplace. It is possible that the market does not believe YZ's growth estimates, given its poor performance to date.

16. The rates of return in different scenarios should be changed in to rupee pay – off per share as indicated below:

Stock	Price	Price under various Macroeconomic Scenarios		
	Rs.	Recession	Moderate Growth	Boom
Him Ice Ltd.	12	12(1-0.12) = 10.56	12(1+0.15) = 13.8	12(1+0.35) = 16.20
Kalahari Biotech	18	18(1+0.20) = 21.60	18(1+0.12)=20.16	18(1-0.05)=17.10
Puma Softech	60	60(1+0.18)=70.80	60(1+0.20)=72.00	60(1+0.15)=69.00

Construction of an arbitrage portfolio requires formation of a zero investment portfolio. The essential condition is that portfolio must not give a negative return.

If we short sell two stocks each of the Him Ice Ltd and Kalahari Biotech one stock of Puma Softech can be purchased and this portfolio will qualify as zero investment portfolio.

(-2) x Rs.12 + (-2) x Rs.18 + Rs.60 = 0

The payoff from this arbitrage portfolio under different market conditions:

	Price	*No. of Shares*	*Investment*	*Scenarios*		
				Recession	Moderate Growth	Boom
	Rs.		*Rs.*	*Rs.*	*Rs.*	*Rs.*
Him Ice Ltd.	12	-2	-24	-21.12	-27.60	-32.40
Kalahari Biotech	18	-2	36	-43.20	-40.32	-34.20
Puma Softech	60	+1	+60	+70.80	+72.00	+69.00
Net Payoff			0	+6.48	+4.08	+2.40

Net payoff from the portfolio clearly shows that this is an arbitrage portfolio as it has produced positive return in all the market scenarios.

17. a.

Year	Return on Stock A(Y)	Return on Market (X)	XY	X^2
2005	0.29	(0.10)	(0.029)	0.01
2006	0.31	0.24	0.0744	0.0576
2007	0.10	0.11	0.011	0.0121
2008	0.06	(0.08)	(0.0048)	0.0064
2009	(0.07)	0.03	(0.0021)	0.0009
	$\Sigma Y = 0.69$	$\Sigma X = 0.20$	$\Sigma XY = 0.0495$	$\Sigma X^2 = 0.087$

n = 5; $\overline{Y} = 0.138$; $\overline{X} = 0.04$

$y = \alpha + \beta x$

$$\beta = \frac{n\Sigma xy - (\Sigma X)(\Sigma Y)}{n\Sigma X^2 - (\Sigma X)^2} = \frac{5(0.0495) - (0.69)(0.2)}{5(0.087) - (0.2)^2} = 0.277$$

Alpha = $\overline{Y} - \beta\,\overline{X}$ = 0.138 – 0.277(0.04) = 0.1269

$\therefore$ Regression equation Y = 0.1269 + 0.277 X

Return on Market (X)	Return on Stock A (Y)	$(R_X - \overline{R}_X)$	$(R_X - \overline{R}_X)^2$	$(R_Y - \overline{R}_Y)$	$(R_Y - \overline{R}_Y)^2$	$(R_X - \overline{R}_X)(R_Y - \overline{R}_Y)$
(0.10)	0.29	-0.14	0.0196	0.152	0.023104	-0.02128
0.24	0.31	0.20	0.0400	0.172	0.029584	0.0344
0.11	0.10	0.07	0.0049	-0.038	0.001444	-0.00266
(0.08)	0.06	-0.12	0.0144	-0.078	0.006084	0.00936
0.03	(0.07)	-0.01	0.0001	-0.208	0.043264	0.00208
			0.0790		0.103480	0.0219

$$\sigma_X = \sqrt{\frac{1}{N}(R_X - \overline{R}_X)^2} = 0.1256$$

$$\sigma_Y = \sqrt{\frac{1}{N}(R_Y - \overline{R}_Y)^2} = 0.1439$$

Total risk (Variance of the security return)

$(R_Y - \overline{R}_Y)^2$ /N = 0.0207

$$Cov_{xy} = \frac{1}{N}\sum^{N}\left[R_X - \overline{R}_X\right]\left[R_Y - \overline{R}_Y\right] = 0.00438$$

$$R = \frac{Cov_{xy}}{\sigma_X \sigma_Y} = 0.242$$

r^2 = Coefficient of determination = 0.059

Unsystematic risk = (1- 0.059) x 0.0207 = 0.019

b. Total variance for Stock A is $\frac{1}{N}(R_Y - \overline{R}_Y)^2$ = 0.0207

Explained by Index = 0.059 x 0.0207 = 0.0012

18. Constant Ratio Plan:

Stock Portfolio NAV (Rs.)	Value of buy – hold strategy (Rs.)	Value of Conservative Portfolio (Rs.)	Value of aggressive Portfolio (Rs.)	Total value of Constant Ratio Plan (Rs.)	Revaluation Action	Total No. of units in aggressive portfolio
40.00	2,00,000	1,00,000	1,00,000	2,00,000	-	2500
25.00	1,25,000	1,00,000	62,500	1,62,500	-	2500
	1,25,000	81,250	81,250	1,62,500	Buy 750 units	3250
36.00	1,80,000	81,250	1,17,000	1,98,250	-	3250
	1,80,000	99,125	99,125	1,98,250	Sell 496.53 units	2753.47
32.00	1,60,000	99,125	88,111.04	1,87,236.04	-	2753.47
38.00	1,90,000	99,125	1,04,631.86	2,03,756.86	-	2753.47
	1,90,000	1,01,878.43	1,01,878.43	2,03,756.86	Sell 72.46 units	2681.01
37.00	1,85,000	1,01,878.50	99,197.37	2,01,075.87	-	2681.01
42.00	2,10,000	1,01,878.50	1,12,602.42	2,14,480.92	-	2681.01
43.00	2,15,000	1,01,878.50	1,15,283.43	2,17,161.93	-	2681.01
50.00	2,50,000	1,01,878.50	1,34,050.50	2,35,929	-	2681.01
	2,50,000	1,17,964.50	1,17,964.50	2,35,929	Sell 321.72 units	2359.29
52.00	2,60,000	1,17,964.50	1,22,683.08	2,40,647.58	-	2359.29

Hence, the ending value of the mechanical strategy is Rs.2,40,647.58 and buy & hold strategy is Rs.2,60,000.

19.

Scheme	*Investment*	*Unit Nos.*	*Unit NAV 31.3.2009*	*Total NAV 31.3.2009*
	Rs.		*Rs.*	*Rs.*
MFA	50,000	4761.905	10.40	49,523.812
MFB	1,00,000	10,000	10.10	1,01,000
MFC	50,000	5,000	9.80	49,000

Scheme	*NAV (+) / (–)*	*Dividend Received*	*Total Yield*	*Number of days*	*Effective Yield (% P.A.)*
	Rs.	*Rs.*	*Rs.*		
MFA	(–)476.188	950	473.812	121	2.858%
MFB	(+)1,000	1,500	2,500	90	10.139%
MFC	(–)1,000	Nil	(–)1,000	31	(–)24%

20. The Expected Return of the equity share may be found as follows:

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

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

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

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

$V\ SD = 0.25\ (24 - 12)^2 + 0.50\ (12 - 12)^2 + 0.25\ (0 - 12)^2$

$= 0.25\ (12)^2 + 0.50\ (0)^2 + 0.25\ (-12)^2$

$= 36 + 0 + 36$

$SD = \sqrt{72}$

SD = 8.485 or say 8.49

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

M/s X Finance company has offered the buyback of debenture at face value. There is reasonable 10% rate of interest compared to expected return 12% from the market.

Considering the dividend rate and market price the creditworthiness of the company seems to be very good. The decision regarding buy-back should be taken considering the maturity period and opportunity in the market. Normally, if the maturity period is low say up to 1 year better to wait otherwise to opt buy back option.

21. EVA = Income earned – (Cost of capital x Total Investment)

Total Investments

Particulars	**Amount**
Working capital	Rs. 20 lakhs
Property, plant, and equipment	Rs. 80 lakhs
Patent rights	Rs. 40 lakhs
Total	**Rs. 140 lakhs**
Cost of Capital	15%

EVA = Rs. 12 lakh – (0.15 x Rs. 140 lakhs) = Rs. 12 lakh – Rs. 21 lakh = -Rs. 9 lakh

Thus Herbal Gyan has a negative EVA of Rs. 9 lakhs.

22. a. Base case NPV = -Rs. 10,00,00,000 + (Rs. 85,00,000/0.10) = -Rs. 1,50,00,000

PV (tax shields) = 0.35 × Rs. 4,00,00,000 = Rs. 1,40,00,000

APV = -Rs. 1,50,00,000+ Rs. 1,40,00,000= -Rs. 10,00,000

b. PV(tax shields, approximate) = (0.35 × 0.07 × Rs. 4,00,00,000)/0.10 = Rs. 98,00,000

APV = -Rs. 1,50,00,000+ Rs. 98,00,000= -Rs. 52,00,000

PV (tax shields, exact) = Rs. 98,00,000 × (1.10/1.07) = Rs. 1,00,74,766

APV = -Rs. 1,50,00,000 + Rs. 1,00,74,766 = -Rs. 49,25,234

The present value of the tax shield is higher when the debt is fixed and therefore the tax shield is certain. When borrowing a constant proportion of the market value of the project, the interest tax shields are as uncertain as the value of the project, and therefore must be discounted at the project's opportunity cost of capital.

23. (i) Semi-annual fixed payment = (N) (A/c) (Period)

Where N = Notional Principal amount = Rs.5,00,000

A/c = All-in-cost = 8% = 0.08

$$= 5,00,000 \times 0.08 \left(\frac{180}{360}\right)$$

= 5,00,000 × 0.08 (0.5)

= 5,00,000 × 0.04

= Rs.20,000/-

(ii) Floating Rate Payment

$$= N\ (LIBOR)\left(\frac{dt}{360}\right)$$

$$= 5,00,000 \times 0.06 \times \frac{181}{360}$$

$= 5,00,000 \times 0.06\ (0.502777)$

$= 5,00,000 \times 0.30166$

= Rs. 15,083

(iii) Net Amount

= (i) – (ii)

= Rs.20,000 – Rs. 15,083 = Rs. 4,917

24. Lintner developed a simple model which is consistent with following "stylized facts":

1. Firms have long-run target dividend payout ratios. Mature companies with stable earnings generally pay out a high proportion of earnings; growth companies have low payouts (if they pay any dividends at all).
2. Managers focus more on dividend changes than on absolute levels. Thus, paying a $2.00 dividend is an important financial decision if last year's dividend was $1.00, but no big deal if last year's dividend was $2.00.
3. Dividend changes follow shifts in long-run, sustainable earnings. Managers "smooth" dividends. Temporary earnings changes are unlikely to affect dividend payouts.
4. Managers are reluctant to make dividend changes that might have to be reversed. They are particularly worried about having to rescind a dividend increase.

This model explains the dividend as follows:

Suppose that a firm always stuck to its target payout ratio. Then the dividend payment in the coming year (DIV_1) would equal a constant proportion of earnings per share (EPS_1):

$$DIV_1 = \text{target dividend}$$
$$= \text{target ratio X } EPS_1$$

The dividend *change* would equal

$$DIV_1 - DIV_0 = \text{target change}$$
$$= \text{target ratio X } EPS_1 - DIV_0$$

A firm that always stuck to its target payout ratio would have to change its dividend whenever earnings changed. But as per Lintner's survey managers were reluctant to do this. They believed that shareholders prefer a steady progression in dividends. Therefore, even if circumstances appeared to warrant a large increase in their company's dividend, they would move only partway toward their target payment. Their dividend changes therefore seemed to conform to the following model:

$DIV_1 - DIV_0$ = adjustment rate X target change

= adjustment rate X (target ratio X $EPS_1 - DIV_0$)

The more conservative the company, the more slowly it would move toward its target and, therefore, the *lower* would be its adjustment rate.

Lintner's simple model suggests that the dividend depends in part on the firm's current earnings and in part on the dividend for the previous year, which in turn depends on that year's earnings and the dividend in the year before. Therefore, if Lintner is correct, we should be able to describe dividends in terms of a weighted average of current and past earnings as follows:

$DIV_t = aT(EPS_t) + (1 – a) DIV_{t-1}$

Where DIV_t = Dividend for the Current Year

DIV_{t-1}= Dividend for the Previous Year

T = Target Payout Ratio

a= Adjustment Rate

EPS_t = Earning Per Share of the Current Year

The probability of an increase in the dividend rate should be greatest when *current* earnings have increased; it should be somewhat less when only the earnings from the previous year have increased; and so on.

The model establishing the relationship between current year's DPS with current year's EPS and previous year's DPS otherwise known as lagged dividend is explained below:

$D_t = a + b1E_t + b2D_{t-1} + e_{ti}$

Where,

D_t = DPS in period t,

E_t = EPS in period t,

D_{t-1} = DPS in period t-1,

e = error term,

a, b, c are constants and subscript i represents the company.

The essential elements of Lintner's "partial adjustment model"of dividends are:

– Managers have target dividend/profits payout ratios

– Mangers believe shareholders prefer pay-outs to remain constant or rise slowly

– Managers therefore will move only partly toward their target payout ratio each year

Tests have found his model constitutes a very good predictor of dividend behavior. Of three dividend polices, the stable rupee dividend is by far the most common. In a study by Lintner, corporate managers were found to be reluctant to change the dollar amount of the dividend in response to temporary fluctuations in earning from year to year. This aversion was particularly evident when it came to decreasing the amount of the dividend from the previous level. Thus, a corporate manager makes every effort to avoid a dividend cut, attempting instead to develop a gradually increasing dividends series over the long-term future. However, if a dividend reduction is absolutely necessary, the cut should be large enough to reduce the probability of future cuts.

25. (i) Drawbacks of investment in mutual funds

(a) There is no guarantee of return as some Mutual Funds may under perform and Mutual Fund Investment may depreciate in value which may even effect erosion / Depletion of principal amount

(b) Diversification may minimize risk but does not guarantee higher return.

(c) Mutual funds performance is judged on the basis of past performance record of various companies. But this can not take care of or guarantee future performance.

(d) Mutual Fund cost is involved like entry load, exit load, fees paid to Asset Management Company etc.

(e) There may be unethical Practices e.g. diversion of Mutual Fund amounts by Mutual Fund /s to their sister concerns for making gains for them.

(f) MFs, systems do not maintain the kind of transparency, they should maintain

(g) Many MF scheme are, at times, subject to lock in period, therefore, deny the market drawn benefits

(h) At times, the investments are subject to different kind of hidden costs.

(i) Redressal of grievances, if any , is not easy

(ii) ESOS and ESPS

	ESOS	ESPS
1.	**Meaning**	
	Employee Stock Option Scheme means a scheme under which the company grants option to employees.	Employee Stock Purchase Scheme means a scheme under which the company offers shares to employees as a part of public issue.
2.	**Auditors' Certificate**	
	Auditors' Certificate to be placed at each AGM stating that the scheme has been implemented as per the guidelines and in accordance with	No such Certificate is required.

the special resolution passed.	
3. Transferability	
It is not transferable.	It is transferable after lock in period.
4. Consequences of failure	
The amount payable may be forfeited. If the option are not vested due to non-fulfillment of condition relating to vesting of option then the amount may be refunded to the employees.	Not applicable.
5. Lock in period	
Minimum period of 1 year shall be there between the grant and vesting of options. Company is free to specify the lock in period for the shares issued pursuant to exercise of option.	One year from the date of allotment. If the ESPS is part of public issue and the shares are issued to employees at the same price as in the public issue, the shares issued to employees pursuant to ESPS shall not be subject to any lock in.

(iii) Factoring and Bill discounting: The main differences between Factoring and Bill discounting are:

(1) While factoring is management of book-debts, bill discounting is a sort of borrowing from commercial banks.

(2) In factoring no grace period is given, whereas in bill discounting grace period is 3 days.

(3) For factoring there is no Specific Act, whereas in case of bill discounting Negotiable Instruments Act applies.

(4) Factoring is a portfolio of complementary financial services whereas bill discounting is usually on case to case basis.

(5) In factoring the basis of financing is turnover. Whereas in bill discounting it is the security provision as well as the requirement of finance which determine the amount of financing.

(6) In factoring the risk of bad debts is passed on to the factor, whereas in bill discounting it is still retained by the business.

PAPER – 3 : ADVANCED AUDITING

QUESTION

1. Discuss the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

   (a) A Chartered Accountant in practice has been suspended from practice for a period of 6 months and he had surrendered his Certificate of Practice for the said period. During the said period of suspension, though the member did not undertake any audit assignments, he undertook representation assignments for income tax whereby he would appear before the tax authorities in his capacity as a Chartered Accountant.

   (b) Mr. L, a Chartered Accountant in practice has been elected as the treasurer of a Regional Council of the Institute. The Regional Council had organized an international tour through a tour operator during the year for its members. During the audit of the Regional Council, it was found that Mr. L had received a personal benefit of Rs.50,000 from the tour operator.

   (c) Mr. M a Chartered Accountant in practice as a proprietor died in a road accident. His widow sold the practice of her husband to another Chartered Accountant in practice for Rs.5 lakhs. The price also included right to use the firm name of Mr. M.

   (d) M/s Surya, a firm in practice, develops a website "surya.com". The colour chosen for the website was a very bright green and the web-site was to run on a "push" technology where the names of the partners of the firm and the major clients were to be displayed on the web-site.

2. Comment on the following:

   (a) You are the internal auditor of Amarnath Manufacturing Co. Ltd. The MD has asked you to enquire into the causes of abnormal wastage of raw materials during the month of September, 2009. The wastage percentages are 1.2%, 1.1%, 1.3% and 3.6% for June, July, August and September, 2009 respectively. How will you proceed to carry out the assignment?

   (b) An auditor of a limited company did not verify the investment; he inserted a note in the balance sheet – "investments not verified". The shareholders approved and adopted the accounts at the annual general meeting. Subsequently, it transpired that the investments were misappropriated and the company suffered a loss. Can the auditor be sued for damages for negligence or otherwise in the discharge of his duties?

   (c) While auditing the accounts of a company, you are unable to verify the cash in hand at the date of the balance sheet. How would you satisfy yourself as to its correctness?

   (d) You have been appointed the sole statutory auditor of a company where you were one of the joint auditors in the immediately preceding year. The concerned joint auditor has not been reappointed. What are the various steps you would take to ascertain the compliance of the requirements of the Companies Act, 1956 before accepting the audit?

3. Sriram is above 75 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. M Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business.

   What procedures you would adopt before you could render any advice to M Ltd.?

4. As Chartered Accountant you are required to give your reports on various financial statements under Companies Act, 1956 which are as under:

   (i) Report to the shareholders under Section 227;

   (ii) Report to be set out in prospectus under Section 60(3);

   (iii) Report to be given on voluntary winding up under Section 488(1)

   Explain the significance of each of these reports and your functional approach very briefly.

5. (a) Your client, proprietor of a big retail store, wants protection against losses of sale proceeds.

   The client deals mainly in cash sales. Suggest a suitable system of internal check for the same.

   (b) As a Statutory Auditor, of a bank, how would you verify the "Sacrifice" on Non-Performing Assets for which Corporate Debt Restructuring has been undertaken?

   (c) Indicate the matters to be included in a Cost Audit Programme.

6. Answer the following:

   (a) What are the steps for the Audit under the State level 'Value Added Tax' (VAT)?

   (b) Illustrate, as a statutory auditor, how would you give a report where all qualifications are *not quantifiable.*

   (c) Under CARO, 2003 how, as a statutory auditor would you comment on the following:

      (i) Fixed assets comprising 1/3rd of the total assets have been disposed off during the year.

      (ii) A Term Loan was obtained from a bank for Rs.75 lakhs for acquiring R&D equipment, out of which Rs.12 lakhs was used to buy a car for use of the concerned director, who was overlooking the R&D activities.

7. (a) Enumerate the steps to be taken by an auditor for the verification of the premium income received by a general insurance company.

   (b) Disclosure under "Basis of Issue Price" in prospectus.

   (c) What are the important steps involved while conducting investigation on behalf of an incoming partner?

8. (a) A limited company having turnover of approximately Rs.50 crores uses a tailor made accounting software package. In the said package, all transactions are recorded, processed and the final accounts generated from the system. The management tells you that in view of the voluminous nature of day books, there is no need to print them and that audit can be conducted on the computer itself. The management further assures you that any 'query based reports' as required can be generated and printed. As a statutory auditor of the company, enumerate the procedures you would adopt to conduct the audit.

   (b) What are the main aspects covered in the probable format of environmental statement ?

9. Write short notes on of the following:

   (a) Financial indications to be considered for evaluating the assumption of going concern

   (b) Auditor's responsibilities regarding comparatives.

   (c) Sampling Risk

   (d) Reporting on a compilation engagements

   (e) Maintenance of branch offices by a Chartered Accountants in practice.

   (f) Other Misconduct.

10. As an auditor of a company, state your views on the following:

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

   (a) During the course of audit of ABC Ltd. it is noticed that out of Rs. 12 lakhs of provident fund contribution accounted in the books, only Rs. 2 lakhs has been remitted to the authorities during the year. On enquiry the Chief Accountant informed that due to financial problems they have not remitted but will remit the same as and when the position improves.

   (b) National Tourism Ltd., a wholly owned Government Company approaches you to give a revised report on the revised accounts, as the original accounts has undergone changes consequent to the audit of Comptroller and Auditor General of India.

   (c) M/s. XYZ 's group gratuity scheme's valuation by actuary shows wide variation compared to the previous year's figures.

   (d) In the books of accounts of M/s CDE Ltd. huge differences are noticed between the control accounts and subsidiary records. The Chief Accountant informs that this is common due to huge volume of business done by the company during the year.

11. Comment on the following with reference to the Chartered Accountants Act, 1949, Code of Ethics and Schedules to the Act:

   (a) P, a Chartered Accountant in practice provides management consultancy and other services to his clients. During 2008, looking to the growing needs of his clients to invest in the stock markets, he also advised them on Portfolio Management Services whereby he managed portfolios of some of his clients.

(b) B, a Chartered Accountant in practice is a partner in 3 firms. While printing his personal letter heads, B gave the names of all the firms in which he is a partner.

(c) M/s Meera & Associates, a firm of Chartered Accountants responded to a tender from a State Government for computerization of land revenue records. For this purpose, the firm also paid Rs.70,000 as earnest deposit as part of the terms of the tender.

12. (a) What are the specific advantages could be reaped by government due to Cost Audit.

(b) Report to be given to the Central Government as special auditor under Section 233A;

Explain the significance of the report and your functional approach very briefly.

13. Briefly furnish your views in connection with the following:

(a) T Pvt. Ltd.'s paid up Capital & Reserves are less than Rs. 50 lakhs and it has no outstanding loan exceeding Rs. 25 lakhs from any bank or financial institution. Its sales are Rs. 6 crores before deducting Trade discount Rs. 10 lakhs and Sales returns Rs.95 lakhs. The services rendered by the company amounted to Rs. 10 lakhs. The company contends that reporting under Companies Auditor's Reports Order (CARO) is not applicable. Discuss.

(b) List the matters to be included in the 'Auditors' report' in the case of Non Banking Financial Companies (NBFCs) accepting or holding public deposits.

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

(b) Briefly list the specific areas, the auditor has to examine on Areas of propriety audit under Section 227(1A) of the Companies Act, 1956.

15. (a) Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward by a General Insurance Company.

(b) What are the procedures to be followed while Reporting on the compilation engagement.

(c) Mr. Clean who proposes to buy the proprietary business of Mr. Perfect, engages you as investigating accountant. Specify the areas which you will cover in your investigation.

16. (a) Write short note on Vostro and Nostro Accounts.

(b) Briefly discuss the compliance procedures and their use in evaluation of internal controls.

17. In the context of Audit of members of Stock Exchanges, explain what is Rolling Settlement?

18. How are investments to be classified in the financial statements of a Bank?

19. Auditor's liability to third parties in relation to issue of Prospectus.
20. Write short notes on the following:
    (a) Decision Tree
    (b) Utility Routine
    (c) Test Packs
    (d) Record of Audit Assignments (as required by ICAI regulations)
    (e) Environmental audit.
    (f) Steps involved in the Indirect Tax Audit.

SUGGESTED ANSWERS/HINTS

1. (a) Undertaking Tax Representation Work: In the instant case, a chartered accountant not holding certificate of practice cannot take up any other work because it would amount to violation of the relevant provisions of the Chartered Accountants Act, 1949. In case a member is suspended and is not holding Certificate of Practice, he cannot in any other capacity take up any practice separable from his capacity to practises as a member of the Institute. This is because once a member becomes a member of the Institute, he is bound by the provisions of the Chartered Accountants Act, 1949 and its Regulations. If he appears before the income tax authorities, he is only doing so in his capacity as a chartered accountant and a member of the Institute. Having bound himself by the said Act and its Regulations made thereunder, he cannot then set the Regulations at naught by contending that even though he continues to be a member and has been punished by suspension, he would be entitled to practice in some other capacity. Thus in the instant case, a chartered accountant would not be allowed to represent before the income tax authorities for the period he remains suspended.

(b) Embezzlement of Funds: Section 21 of the Chartered Accountants Act, 1949 provides that a member is liable for disciplinary action if he is guilty of any professional or "Other Misconduct." Though the term "Other Misconduct" has not been defined in the said Act, this provision enables the Council to enquire into any misconduct of a member even if it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards even in his non-professional work, would expose him to disciplinary action. The Council has also laid down that among other things "misappropriation by an office-bearer of a Regional Council of the Institute of a large amount and utilization thereof for his personal use" would amount to "other misconduct". Thus, in the instant case, Mr. L would be liable for disciplinary action.

(c) Sale of Goodwill: The Council of the Instituted considered the issue whether the goodwill of a proprietary firm of chartered accountant can be sold/transferred to another eligible member of the Institute, after the death of the proprietor concerned and came to the view that the same is permissible. The Council resolved that the sale/transfer of goodwill in the case of a proprietary firm of chartered accountant to another eligible member of the Institute shall be permitted. It further laid down that in cases where the death of proprietor occurs after 30/8/1998, the goodwill of the deceased member's practice can be sold to another member and permission of the Institute has to be obtained within a year of the death of the proprietor concerned. It is even laid down that in such cases the name of the proprietary firm concerned would not be removed upto a period of one year from the death of the proprietor. Thus, in the instant case, when the widow of Mr. M sells the practice to another member, it is nothing but goodwill sold to another member. The sale of the practice and the right to use the name is also allowed in terms of the above decision of the Council. Thus the above act of the widow of Mr. M is permissible.

(d) **Posting of Particulars on Website:** The Council of the Institute had approved posting of particulars on website by Chartered Accountants in practice under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949 subject to the prescribed guidelines. The relevant guidelines in the context of the website hosted by M/s Surya are:

- No restriction on the colours used in the website;
- The websites are run on a "pull" technology and not a "push" technology
- Names of clients and fees charged not to be given.

In view of the above, M/s Surya would have no restriction on the colours used in the website but failed to satisfy the other two guidelines. Thus, the firm would be liable for professional misconduct since it would amount to soliciting work by advertisement.

2. **(a)** (i) Get a list of raw materials used by the company; (ii) obtain the standard consumption figures and ascertain the basis for working out normal wastage figures; (iii) assess whether the personnel employed are properly trained and working efficiently; (iv) examine the quality control techniques and preventive maintenance programme of machinery; (v) examine the laboratory reports and inspection reports as to the quality of raw materials procured; (vi) check the machine utilization statements; (vii) examine the possibility of theft, fine or other losses in storage; (vii) examine if any new production line has been taken up for which the standard input output norms have yet to be laid down.

(b) In case of audit of a limited company, an auditor has to comply with the statutory duties as prescribed in the Companies Act, 1956. Verification of investments is a very important function of an auditor, since, it is an important asset shown in the balance sheet. The auditor cannot be expected to give a report on the 'truth and fairness' of the financial statements of the company without verifying its investment. If he specifically mentions in his audit report the fact that, he did not verify the investments, he would not be relieved from his statutory duties. Such statutory duties can never be curbed, though they may be extended.

Under Section 543 of the Companies Act, 1956 the auditor may also be held guilty for misfeasance or breach of duty in relation to the company in the event of winding up, provided such misfeasance has directly resulted in damages to the company.

Thus, the auditor will be held liable in this case as the company suffered a loss because of such breach of duty.

(c) If it is not at all possible to verify the cash in hand at the end of the year, it would be better for the auditor to instruct the client to deposit the whole amount of cash in hand into the bank on that date and withdraw the amount on the next day. But, if the time is over and such instruction cannot be communicated to the client, the cash book of the next period up to the date of the audit should be vouched and cash in hand on that date should be verified. If required, there should be a surprise check of the balance of cash in hand on some other date.

(d) Compliance with Requirements of Companies Act, 1956: When one of the joint auditors of the previous year is appointed as the sole auditor for the next year, it is similar to new re-appointment of one of the retiring joint auditors. The provisions of Section 225 of the Companies Act, 1956, relating to non-reappointment of the other person also need to be considered. The following points should be taken into account:

(i) Special notice u/s 225(1) was duly received by the company from a member at least 14 days before AGM containing a proposal for appointing a sole auditor expressly.

(ii) Verify notice sent to all the members at least 7 days before the AGM. [u/s 190(2)]

(iii) Verify that special notice has been sent to retiring auditor forthwith. [u/s 225(2)]

(iii) Any representation received from the retiring auditor was sent to the members [u/s 225(3)].

(iv) Verify from the minutes whether the representation received from the retiring joint auditor was considered at the AGM.

(v) Examine that proposed resolution was properly passed.

(vi) Ensure that provisions of Section 224(2) are complied fully.

(vii) Ascertain special resolution u/s 224A, if any, is passed accordingly.

(viii) Obtain a certified copy of the relevant minutes of AGM and a written communication of the appointment within 7 days.

3. A due diligence audit on behalf of M Ltd. with a view to acquiring the business shall involve following steps:

(1) **Studying Business History:** The principal objective of financial due diligence, is usually to look behind the initial information provided by the entity and to assess the benefits and costs of the proposed acquisition by inquiring into all relevant aspects of the past, present and future of the business to be acquired. The accountants

should begin the financial due diligence review by looking into the history of the entity and the background of the promoters. The details of how the company was set up and who were the original promoters has to be gone into, before verification of financial data in detail. An eye into the history of the target may reveal its turning points, survival strategies adopted by the entity from time to time, the market share enjoyed by the entity and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the entity. Broadly, the accountant should make relevant enquiries about the history of business – products, markets, suppliers, expenses and operations.

(2) **Studying the Overall Picture:** It is necessary to see whether the business is engaged in manufacture of one or two important lines of products; whether raw material is available without difficulty; whether products are marketable and have a ready market; whether there is scope for expansion of the market; whether full capacity is being utilised or whether there is scope for utilisation of idle capacity – all those factors are non-financial in nature but an enquiry into them is essential for formulation of a decision to buy or not.

(3) **Economic environment:** The study of the impact of economic forces is important for determining factors that have been responsible for the rise or fall in the sales and profits of the business. At times, political or economic factors also may affect the fortunes of a business; for example, labour distrubances, changes in government policies in the matter of levy of excise and custom duties, imports, etc. It is therefore necessary that the impact of all these factors should be studied and their effect on the business judged on a consideration of the profits in the past.

(4) **Examining Profit and Loss Account:** The Profit and Loss Account for the last few years should be considered – exceptional or non-recurring expenses, incomes should be eliminated to know normal profit and trends in profits. Also to be seen is the trend in sales whether the same is on the increase or decrease after allowing for unusual factors influencing sales. It should be seen whether the business is regular in payment of taxes; both Central and State Taxes; whether taxes are in arrears; whether what arrangement are to be made to clear off the arrears; if taxes and duties are in arrear whether the vendor will undertake to pay the taxes upto the point of sale.

(5) **Examining Net-worth:** The net worth of the business should be ascertained. If the accounts are regularly audited, reliance can be placed on the books; for valuation of tangible assets, the assistance of known expert in the field may be sought; enquiries should be made whether there are unrecorded liabilities of the business; similarly about unrecorded assets. On the basis of net worth of the business, the purchase consideration may be agreed upon.

In addition to the above steps, the following further points have to be seen:

(i) Reason for sale of business and the effect on turnover and profits due to the exist of the present proprietor.

(ii) The length of the lease under which business has been operating.

(iii) The unexpired period of patents if any held by the vendors.

(iv) The age of managerial staff and prospects of their continuing in service in the new environment; the effect of trained managerial staff learning the organisation in production/sales/administrative and the financial liability to pay terminal benefits/compensation, etc.

(v) If bulk sales are to a few limited customers, the profitability should be discounted greatly, because any substantial withdrawal of customers might cause business crashes.

(vi) A company with a sound financial structure can better withstand the stresses and strains of business. A low debt-equity ratio would indicate an ability to grow through debt financing without raising equity.

(vii) The cash generated from operations; the need for redeployment of resources and funds needed for repayment of loans become major factors in determining growth potential.

(viii) The valuation of goodwill if any should be on reasonable basis having regards to all factors mentioned above.

4. (a) Auditor's report on the Companies Act, 1956 (the Act)

(i) Report to Shareholders U/s 227: Section 227 of the Act lays down powers and duties of the auditor. Sub-sections (2), (3), (4) and (4A) of Section 227 deal with reporting requirements. Sub-section (2) states that the auditor of a company shall make a report to the members on the accounts examined by him and on every balance sheet and profit and loss account which are laid before company in general meeting during the tenure of his office. The significance of the report lies in the fact that it requires that the report shall state whether in his opinion and to the best of his information and according to the explanations given to him the said accounts give the information required by the Act in the manner so required and give a true and fair view.

The functional approach by the auditor for making a report u/s 227 of the Act, requires him to perform compliance and substantive audit procedures to verify the information contained in the financial statements. Having regard to the materiality of the items involved, the auditor also determines whether the relevant information is properly disclosed in the financial statements.

(ii) Report to be set out in the prospectus u/s 60(3): Section 60(3) of the Act provides that a prospectus should be accompanied *inter alia* by the consent in writing of the person named therein as the auditor of the company or intended company to act in that capacity. Part II of Schedule II to the Act prescribes the reports to be set out in a prospectus. The report contains particulars about profit and losses of the company for five preceding year, assets and liabilities, rates of dividend, etc. The significance of the report lies in the fact that a prospectus is issued by a company when it seeks to raise funds from the public and gives detailed information about the company to enable prospective investors to take a well-informed decision. The functional approach on the part of auditor involves obtaining information from the management, particularly, in respect of estimation of current and future profits. He has to also ensure that all adjustments have been made properly.

(iii) Report on the accounts prepared on voluntarily winding up u/s 488 (1): Section 488(1) of the Act requires that where it is proposed to wind up a company voluntarily, its directors, or in case the company has more than two directors, the majority of the directors, may at a meeting of the Board, make a declaration verified by an affidavit, to the effect that they have made a full inquiry into the affairs of the company, and that, having done so, they have formed the opinion that the company has no debts, or that it will be able to pay its debts in full within such period not exceeding three years from the commencement of the winding up as may be specified in the declaration. Such declaration has to be accompanied by a copy of the report of the auditors of the company (prepared, as far as circumstances admit, in accordance with the provisions of this Act) on the profit and loss account of the company for the period commencing from the date up to which the last such account was prepared and ending with the latest practicable date immediately before the making of the declaration and the balance sheet of the company made out as on the last mentioned date and also embodies a statement of the company's assets and liabilities as at the date.

5 (a) With a view to protect against the misappropriation of cash out of the sale proceeds by the salesmen, the following system of internal check is suggested :

(i) There should be complete segregation of responsibilities of the salesmen, the cashier and the accountant. Nobody should be allowed to do the job of others.

(ii) For each section, counter or department, separate salesman should be appointed.

(iii) As far as possible, mechanical cash register should be maintained.

(iv) The salesman should issue sales bills in triplicate. He should hand over two copies to the customer and retain the other copy.

(v) These two copies of the bill should be presented by the customer to the cashier.

(vi) The cashier should check the bill, receive the payment and stamp the bill as 'Paid'. Original copy of the bill should be handed over to the customer.

(vii) The customer should collect the goods purchased on presentation of the original bill, stamped as paid from another counter near the gate.

(viii) Each salesman should prepare the summary sheet with the help of the copy of the bill that remains with him and submit it to the accountant.

(ix) The cashier should enter the day's total sales in the cash sales sheet with the help of bill retained by him and report it to the accountant.

(x) Any discrepancy found by the accountant should be immediately reported to the general manager.

(b) Corporate Debt Restructuring and Sacrifice Element: The Revised Guidelines on Corporate Debt Restructuring (CDR) Mechanism specified that in case of rescheduling of accounts, the element of interest to be computed in present value terms. The guidelines state that the sacrifice should be computed as the difference between the present value of future interest income reckoned based on the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring and the interest charged as per the restructuring package discounted by the current BPLR as on the date of restructuring plus appropriate term premium and credit risk premium as on the date of restructuring. Accordingly, the following steps may be taken in this regard:

(i) Check that the appropriate credit risk premium for the specific borrower category for all restructured accounts.

(ii) Ascertain appropriate rate of discount.

(iii) Check the computation of present value interest and the sacrifice amount.

(iv) See that the entire amount should be written off or provided for in case sacrifice is positive.

(v) Verify provision of adequate security coverage of the loan in case restructuring of principal amounts.

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

(i) Review of Cost accounting record: This will include:

- Method of costing in use
- Method of accounting for raw material, stores and spares, wastage
- System of recording wages, salary, etc.
- Basic of allocation of overheads to cost centres and absorption by product and services
- Treatment of expenses on finance, R&D, royalty, etc.
- Method for depreciation accounting
- Method of stocktaking and valuation
- System of budgetary control

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

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

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

6. (a) VAT is a tax on the value added to the commodity at each stage in the production and distribution chain. VAT is an indirect Tax on consumption. It is a tax on the value at the retail point of sale which is collected at each stage of sale.

The essence of VAT is that it provides credit set off for input tax i.e. tax paid on purchases against the output tax i.e. tax payable on sales.

The following steps have to be taken by the auditors while auditing under VAT:

(i) ***Knowledge of Business**:* The Auditor should familiarize himself with the business of the Auditee.

(ii) ***Knowledge about VAT Law and Allied Laws**:* The Auditor should study the VAT Law particularly definitions, procedures to be adopted, provision regarding issues of invoices, claiming of input tax credit etc.

(iii) ***Major Accounting Policies**:* The Auditor should ascertainable major accounting policies with regard to sales purchases and valuation of inventory.

(iv) ***Accounting Records maintained by Auditee**:* The auditor should obtain a complete list of all the accounting records relating to sales/purchase of goods, stock, various registers ledgers etc, maintained in which, the transactions are recorded.

(v) ***Evaluation of Internal control**:* The Auditor should evaluate the internal controls prevalent in the entity with respect to sales, Purchases, Production and Accounting. He must examine the adequacy and effectiveness of the controls in order to plan the nature and timing of his audit procedures.

The following provisions of VAT need to be understood:

- Credit for inputs/supplies (and its accounting).
- Credit in case of capital goods.
- Utilising VAT credit for set off.
- Valuation of inventories/capital goods.
- Credit for goods lying in stock at inception of VAT scheme.
- VAT on sales.

(b) An illustrative Format of Audit Report: SA 700 "The Auditor's Report on Financial Statements", states that there may be circumstances when it is not practicable to quantify the effect of modification in the audit report accurately, the auditor may do so on the basis of estimates made by the management after carrying out such audit tests as are possible and clearly indicate the fact that the figures are based on management estimates. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

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

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

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

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

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

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

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

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

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

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

7. (a) Verification of Premium Income

(1) Review the internal control procedures and its compliance. This would ensure that in respect of all risks assumed, proper cover notes are issued and that no cover note/policy is omitted. Also find out whether all the cover notes are serially numbered and also the existence of adequate internal check on issue of stamps, stationery, etc. Depending on the assurance obtained from such initial evaluation, decide the extent of substantive checking to be carried out.

(2) Ensure that all premiums in respect of risks incepting during the relevant accounting year has been accounted as the premium income of that year.

(3) Verify the premium received and recorded during the year for fire, marine, motor and miscellaneous insurance business in the relevant books of account.

(4) Check that in respect of risks commencing after the year end, where the premium is received in advance, the same has been shown as "Premium Received in Advance" and see whether the similar advance of last year is accounted this year as income.

(5) Ensure that the company is not at risk in case policy documents have not been issued for any reason like dishonour of cheque and ensure that the risk has not commenced.

(6) Ensure that the company is not under risk in respect of amounts lying at credit and outstanding at the year end by verification and also obtaining a confirmation from the manager to that effect.

(7) Check whether the premium collected is recorded at gross figure without providing for unexpired risks and reinsurance.

(8) Verify that in case of co-insurance, the company's share of premium have been properly booked in the books of account in case the risk has commenced.

(b) Disclosures under 'Basis of Issue Price': Under this heading, the following information is to be disclosed:

(i) (a) Earnings per share, i.e., EPS pre-issue for the last three years (as adjusted for changes in capital);

(b) P/E pre-issue and comparison thereof with industry P/E where available (giving the source from which industry P/E has been taken);

(c) Average return on net worth in the last three years;

(d) Minimum return on the increased net worth required to maintain pre-issue EPS;

(e) Net Asset Value per share based on last balance sheet;

(f) Net Asset Value per share after issue and comparison thereof with the issue price.

Provided that projective earnings shall not be used as a justification for the issue price in the offer document.

(ii) The accounting ratios disclosed in the offer document in support of basis of the issue price shall be calculated after giving effect to the consequent increase of capital on account of compulsory conversions outstanding, as well as on the assumption that the options outstanding, if any, to subscribe for additional capital will be exercised.

(c) Steps involved while conducting investigation on behalf of an incoming partner: The general approach of the investigating accountant in this type of investigation would be more or less similar, irrespective of the nature of business of the firm-manufacturing, trading or rendering a service. Primarily, an incoming partner would be interested to know whether the terms offered to him are reasonable having regard to the nature of the business, profit records, capital distribution, personal capability of existing partners, socio-economic setting, etc. and whether he would be capable for services to be rendered, which can be justified by the overall economic conditions prevailing and other considerations considering his own personality and achievements. In addition, he would be interested to ascertain whether the capital to be contributed by him would be safe and applied usefully. Broadly, the steps involved are as under :

(a) Ascertaining the history of the firm since inception and growth of the firm.

(b) Studies of the provisions of the Deed of Partnership, particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, etc.

(c) Scrutiny of the record of profitability of the firm's business over a suitable number of years, with usual adjustments that are necessary in ascertaining the true record of business profits. Particular attention should, however, be paid to the nature and profitability of the business, qualification and expertise of the partners and such others as may be relevant.

(d) Examination of the asset and liability position to determine the tangible asset, partners, investment, appraisal of the value of intangibles like goodwill, know-how, patents, etc impending liabilities including contingent liabilities and those for pending tax assessment.

(e) Assess position of order at hand and the range and quality of clientele should be thoroughly examined under which the firm is presently operating.

(f) Scrutinise terms of loan finance to assess its usefulness and the implication for the overall financial position.

(g) Study important contractual and legal obligations should be ascertained and their nature studied. It may be the case that the firm has standing agreement with the employees as regards salary and wages, bonus, gratuity and other incidental benefits. Full import of such standing agreements would be gauged before a final decision is reached.

(h) Study the composition and quality of key personnel employed by the firm and any likelihood of their leaning the organisation.

(i) Ascertain reasons for the offer of admission to a new partner and it should be determined whether the same synchronizes with the retirement of any senior partner whose association may have had considerable impact having on the firm's successes.

(j) Appraisal of the record of capital employed and the rate of returns. It is necessary to have a comparison with alternative business avenues for investments and evaluation of possible results on a changed capital and organisation structure.

(k) Ascertain manner of computation of goodwill on admission as also on retirement, if any.

(l) Examine whether any special clause exist in the Deed of Partnership to allow admission in future a new partner.

8. (a) A key feature of the accounting software package used by the company definitely involves the absence of a clear audit trail. In other words, transactions cannot be easily traced or co-related from the individual supporting documents of those transactions. Moreover, the management does not wish to print the daybooks in view of the voluminous nature since it may involve extensive costs. This has naturally led to extensive dependence by management upon the "exception reporting" principle.

From the auditor's point of view, it must also be conceded, the exception reports in the form of 'query-based reports' which isolate the above data provide him with the very material that he requires for most of his verification work. The only problem which it raises, and it is a serious one, is that he cannot simply assume that the programmes which produce the exception reports are reliable in respect of the following factors:

(i) operating accurately;

(ii) printing out all the exceptions which exist; and

(iii) bound by programmed control parameters which meet the company's genuine internal control requirements.

In view of the above, whether management relies upon exception reports, it effectively eliminated the audit trail between input and output and the auditor is forced to test the invisible processes which purport to embody the controls, and produce the output such as it is. These tests, which invariably involve the use by the auditor of the computer itself, are known as tests through the machine. In the 'through the machine' approach, the auditor starts by proving the accuracy of the input data, and then thoroughly examines (by applying tests) the processing procedures with a view to establishing the following that:

(i) all input is actually entered into the computer.

(ii) neither the computer nor the operators can cause undetected irregularities in the final reports.

(iii) the programmes appear, on the evidence of rejection and exception routines, to be functioning correctly.

(iv) all operator intervention during processing is logged and scrutinised by the DP manager.

The auditor in such circumstances will have to first evaluate the existing controls. For the same, he has to do the following:

(i) Evaluate the internal control system especially the controls and checks existing for recording the transactions, i.e., he has to verify at what level transactions can be entered into the system and what checks are available to prevent any unauthorised data entry and for rectifying errors/omissions in the transactions entered.

(ii) Evaluate at what level there is authority given for modification of transactions already entered. Is there any authority given only to a senior employee to carry out modifications? Or is it that once transactions are entered and validated no further modifications are possible thereto.

(iii) Whether there is a provision in the software for carrying out an on line audit of transactions, i.e. whether there a separate module in the package, where a separate password given to the auditor and once he has seen and approved a particular transaction/set of transactions, the same would be locked and no modifications would be possible by anyone (including the senior most employee) in the company.

(iv) Whether there are proper procedures for backup of data on a regular basis and whether the said procedures are being strictly followed.

(v) In case of any loss of data whether there is a clear defined recovery procedure to minimise the loss of data due to power failures or any human errors.

(vi) The auditor may introduce some dummy data into the system and see the results obtained.

After the auditor has evaluated the above procedures, he has to prepare an audit plan depending on the results obtained from his earlier evaluation. Since the daybooks are not being printed, the plan can contain procedures wherein data is verified directly on the computer from the vouchers/invoices, etc. The audit plan will also require a lot of analytical procedures to be performed. Depending on the importance of various expense heads and other important account heads, the auditor will also obtain various reports from the system depending on various queries that he would have to identify. Some illustrative reports can be:

(i) To check whether proper classification is done for revenue/capital - a report can be obtained of all purchases (not being raw materials or other routine purchases) exceeding Rs. one lakh.

(ii) To check whether all freight outward bills are accounted for a report containing a month-wise co-relation between goods despatched and freight amount paid. The same can be further co-related with the freight rates obtained from the bills.

Once the auditor has performed the above procedures, he would be able to form an opinion whether reliance can be placed on the accounting systems and the data recorded. If the auditor finds that reliance cannot be placed on the systems he can inform the management about the fact and also that the daybooks, etc., will need to printed to allow him to conduct the audit. The finalisation procedures to be followed even under this system would remain more or less similar to other accounting systems. The auditor can obtain reports of depreciation on fixed assets, inventory valuation and using the normal procedures find out whether reliance can be placed on them, e.g., if while valuing stocks the system is using the LIFO method, the same would not be acceptable and will need to be modified. Similarly depreciation calculations will have to verified on a random basis to find out its reliability.

(b) Probable format of "Environmental Statement": The following are the main aspects which may be covered in the probable format of Environmental Statement :

a. Name and address of the owner/occupier of the industry, operation or process.

b. Date of last environmental audit report submitted.

c. Consumption of water and other raw materials during current and previous year.

d. Pollution generated in the air and water along with the output and the types of pollutants and the deviation from standards.

e. Generation of hazardous waste in current year and previous year from processes.

f. Quantity of solid waste generated during current year and previous year and from recycling or reutilisation of waste, etc.

g. Disposal practice for different type of waste.

h. Practice in operation for conservation of natural resources.

i. Additional investment proposal for environmental protection including abatement of pollution.

9. (a) **Financial Indications and Going Concern:** SA 570 on "Going Concern", aims to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements. The following are the financial indications be considered:

- ♦ Negative net worth or negative working capital.
- ♦ Fixed-term borrowings approaching maturity without realistic prospects or renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets.
- ♦ Adverse key financial ratios.
- ♦ Substantial operating losses.
- ♦ Substantial negative cash flows from operations.
- ♦ Arrears or discontinuance of dividends.
- ♦ Inability to pay creditors on due dates.
- ♦ Difficulty in complying with the terms of loan agreements.
- ♦ Change from credit to cash-on-delivery transactions with suppliers.
- ♦ Inability to obtain financing for essential new product development or other essential investments.
- ♦ Entering into a scheme of arrangement with creditors for reduction of liability.

(b) **Auditor's responsibilities regarding comparatives:** SA 710, "Comparatives", establishes standards on the auditor's responsibilities regarding comparatives.

The auditor responsibilities laid down are as under:

(i) The auditor should determine whether the comparatives comply, in all material respects with the financial reporting framework relevant to the financial statements being audited. Further, the auditor should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the financial reporting framework.

(ii) When the comparatives are presented as corresponding figures, the auditor's report should not specifically identify comparatives because the auditors opinion is on the current period financial statements as a whole, including the corresponding figures.

(iii) When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification in the audit report is:

(a) unresolved and results in a modification of the auditor's report regarding the current period figures, the auditor's report should also be modified regarding the corresponding figures; or

(b) unresolved, but does not result in a modification of the auditor's report regarding the current period figures, the auditor's report should be modified regarding the corresponding figures.

In such circumstances, the auditor should examine that appropriate disclosures have been made or if appropriate disclosures have not been made, the auditor should issue a modification report on the current period financial modified with respect to the corresponding figures included therein.

(iv) When the prior period financial statements are not audited, the incoming auditor should state in the auditors report that the corresponding figures are unaudited.

(c) Sampling Risk: Sampling Risk arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. The auditor is faced with sampling risk in both tests of control and substantive procedures as follows:

(a) Tests of Control:

(i) *Risk of Under Reliance*: The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.

(ii) *Risk of Over Reliance*: The risk that, although the sample result supports the auditor's assessment to control risk, the actual compliance rate would not support such an assessment.

(b) Substantive Procedures:

(i) *Risk of Incorrect Rejection*: The risk that, although the sample result supports the conclusion that a recorded amount balance or class of transactions is materially mis-stated, in fact it is not material mis-stated.

(ii) Risk of Incorrect Acceptance: The risk that, although the sample result supports the conclusion that a recorded amount balance or class of transactions is no materially mis-stated, in fact it is materially mis-stated.

The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements then either the risk of under reliance or the risk of incorrect rejection.

Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

(d) Reporting on a compilation engagements: The report on compilation engagements should ordinarily, be in the following layout:

(i) Title – The title of the report should be "Accountants Report on compilation of un-audited financial Statements."

(ii) Addressee: The report should ordinarily be addressed to the appointing authority.

(iii) Identification of the financial information also noting that it is based on the information provided by the management.

(iv) When relevant, a statement that the accountant is not independent of the entity;

(v) A statement that the Management is responsible for:

   * Completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant;

   * Maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;

   * Preparation and presentation of financial statements or other financial information in accordance with the applicable laws and regulation, if any;

   * Establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities.

   * Establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non-compliance.

(vi) A statement that the engagement was performed in accordance with the Auditing and Assurance Standards.

(vii) A statement that the neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information.

(viii) A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework.

(ix) Date of the report

(x) Place of signature

(xi) Accountant's signature.

(e) Maintenance of Branch Offices by a Chartered Accountants in Practice: Section 27 of the Chartered Accountants Act, 1949 requires that if a chartered accountant in practice or a firm of chartered accountants has more than one office in India, i.e., a branch, each of such offices should be in the separate charge of a member of the Institute. Failure on the part of a member or a firm, to have a member in charge of its branch office and a separate member in case of the branches, if more than one, would constitute professional misconduct. However, exemption from the above has been given to members practising in the hilly areas subject to the certain conditions. It is necessary to mention that the Chartered Accountant in charge of the branch of another firm should be associated with him or with the firm either as a partner or as a paid assistant. If he is a paid assistant, he must be in whole time employment with him. The above rule applies in case additional office is situated at a place beyond 50 Kms. from the municipal limits in which the office is situated. The exemption may be granted under proviso to Section 27(1) of the Chartered Accountants Act, 1949 to a member or a firm of Chartered Accountants in practice to have a second office without such second office being under the separate charge of a member of the Institute, provided (a) the second office is located in the same premises, in which the first office is located or (b) the second office is located in the same city, in which the first office is located or (c) the second office is located within a distance of 50 km. from the municipal limits of a city, in which the first office is located. A member having two offices of the type referred to above, shall have to declare, which of the two offices is his main office, which would constitute his professional address.

(f) A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, 1949 if he is found guilty of any professional or "Other Misconduct". Other Misconduct has not been defined in the Act. This provision empowers the Council to enquire into any misconduct of a member even if it does not raise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviations from these standards, even in his non-professional work, would expose him to disciplinary action. For example, a member who is found to have forged the will of a relative, would be liable to disciplinary action even though the forgery may not have been done in the course of his professional duty. Other misconduct would also relate to conviction by a competent court for an offence involving moral turpitude punishable with cause transportation on imprisonment to an offence not of a technical nature committed by the member in his professional capacity.

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

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

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

(i) Where a chartered accountant retains the books of accounts and documents of the client and fails to return these to the client on request without a reasonable cause.

(ii) Where a chartered accountant makes a material misrepresentation.

(iii) Where a chartered accountant uses the services of his articled or audit clerk for purposes other than professional practice.

(iv) Conviction by a competent court of law for any offence under Section 8 (v) of the Chartered Accountants Act, 1949.

(v) Misappropriation by office-bearer of a Regional Council of the Institute, of a large amount and utilisation thereof for his personal use.

(vi) Non-replying within a reasonable time and without a good cause to the letter of the public authorities.

10. (a) Depositing Provident Fund Dues: The Companies Audit Report's Order, 2003 required the auditor to state whether the dues of provident fund have been regularly deposited with the appropriate authorities and, if not, the extent of arrears shall have to be indicated by the auditor. A company is required to deposit provident fund dues to appropriate authorities with in the period prescribed under the Rules governing it. In the case of fund constituted by the company, the company is required to follow provisions of section 418 of the Act. In this case there is a default in not depositing the provident fund contribution to the extent of Rs. 10 lakhs which is a lapse on the part of the company. The reason put forward by the Chief Accountant that the amount has not been deposited due to financial problems faced by the Company is no excuse for not remitting the provident fund. In fact, the company has not at all been regular in depositing the amount. Thus, the auditor shall include this in his report indicating the extent of arrears.

(Note: The Companies (Auditor's Report) Order, 2003 requires the auditor to comment upon the regularity aspects as also the extent of arrears in case the same has been outstanding for a period of more than six months. In the given case, it may be noted that M/s ABC Ltd. has failed to deposit the provident funds regularly and the major part of it has been outstanding for more than six months.)

(b) Auditor's Report on Revised Accounts: The Guidance Note on Auditor's Report on Revised Accounts of Companies before circulation to Shareholders deals with those situations wherein the statutory auditor is required to give report on the revised accounts. The auditors of National Tourism Ltd. have been asked to give revised report on the revised accounts as the original accounts have undergone changes consequent to audit of the C & AG. The Guidance Note requires that the statutory auditor must observe the following steps while issuing the revised report:

(i) All copies of the original accounts and reports thereon are returned to the auditor.

(ii) The adequate disclosure has to be made that the accounts which were earlier approved by the Board of Directors and reported by the auditors have been revised and re-approved by the Board of Directors as a specific note on the amended accounts.

(iii) In case the notes to accounts do not contain any note on revision or such a note is not considered adequate or comprehensive, the statutory auditor shall have to indicate that accounts have been revised based on the audit report of C&AG. The auditors at the time of issue of revised report has to bring these facts in his report if not included as a note in the revised accounts.

(iv) Finally, the auditor's report (revised) should clearly draw the attention to their earlier audit report.

(c) Valuation by Actuary: SA 620, "Using the Work of an Expert" states that the auditor has to evaluate the work of an expert, say, actuary, before adopting the same. This becomes more crucial since M/s XYZ's group gratuity scheme's valuation by actuary shows wide variation compared to previous year figures. There is no doubt that appropriateness, reasonableness of assumptions and methods used are the responsibility of the expert, but the auditor has to determine whether they are reasonable based on the auditor's knowledge of the client's business and result of his audit procedures. In the present case, the auditor must verify the reasonableness of assumptions made and methods adopted by the actuary in the evaluation particularly with reference to factors such as rate of return on investments, retirement age, number and salary of employees, etc. Accordingly, the auditor has to satisfy himself whether valuation done by the actuary can be adopted, otherwise he may report on his findings for wide variation.

(d) Difference Between Control Accounts and Subsidiary Records: The huge differences found between control accounts and subsidiary records in the books of M/s CDE Ltd. indicate that there may be material misstatements requiring detailed examination by the auditor to ascertain the cause. The contention of Chief Accountant cannot be accepted simply because the company has done huge volume of business. Such a phenomenon indicates that recording of transactions is not being done properly or the accounting system in the company which might have several branches spread over the country fails to capture all transactions in time. It would also be interesting to see whether it is a recurring phenomenon or such reconciliation could not be done at a subsequent date. Having regard to all these circumstances, it appears from the facts of the case that these difference indicate the possibility of some kind of material misstatements. As per SA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements" when the auditor encounters circumstances that there is material misstatement, the auditor should perform procedures to determine whether the financial statements are materially misstated. If as a result of such examination the auditor comes across any material information involving fraud or gross irregularity the same shall be reported by him appropriately.

11. (a) Advising on Portfolio Management Services: The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting "Management Consultancy and other Services" by a Chartered Accountant in practice. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, etc. It is, however, specifically stated that CAs in practice are not permitted to undertake the activities of broking, underwriting and portfolio management Services. Thus, a chartered accountant in practice is not permitted to manage portfolios of his clients.

In view of this, P would be guilty of misconduct under the Chartered Accountants Act, 1949.

(b) **Advertisement of Professional Attainments:** Clause 7 of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public. Even a member is not permitted to specify the date of setting up of practice or establishment of firm. However, there is no prohibition for printing names of all the three firms on the personal letterheads in which a member holding Certificate of Practice is a partner. Thus B is not guilty of any misconduct under the Chartered Accountants Act, 1949.

(c) **Responding to Tenders:** Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down guidelines for responding to tenders, etc. As per the guidelines if a matter relates to any services other than audit, members can respond to any tender. Further, in respect of a non-exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposits.

In the instance case, since computerization of land revenue records does not fall within exclusive areas for chartered accountants, M/s Meera & Associates can respond to tender as well as deposit Rs.70,000 as earnest deposit and shall not have committed any professional misconduct.

12. (a) Advantages of Cost Audit to Government: Cost auditor's approach is to ensure that the cost accounting plan is in consonance with the objectives set by the organisation and the system of accounting is geared towards the attainment of the objectives. A cost accounting system designed to exercise control over cost may be different from the one if the objective is to fix price. Accordingly, over a period of time particularly in view of administered pricing system the cost accounting becomes quite important. Some of the specific advantages which can be reaped by the Government are:

(i) It helps in the fixation of selling prices of essential commodities and thereby avoiding undue profiteering.

(ii) In the case of cost plus contracts of Government, it helps to fix the price at reasonable level.

(iii) It enables the Government to focus the attention on inefficient units.

(iv) It enables the Government to lay down policies in favour of protecting certain industries.

(v) It facilitates the settlement of disputes brought to the Government.

(vi) It creates healthy competition in the industry.

(b) Special Audit Report U/s 233A: Under Section 233A of the Act, the Central Government has a power to order a special audit of the accounts of a company for a specified period. An order to conduct special audit of the accounts of a company may be made where the Central Government is of the opinion that:

(a) the affairs of the company are not being managed in accordance with sound business principles or prudent commercial practices; or

(b) the company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or

(c) the financial position of the company is such as to endanger its solvency.

The main objective of such an audit is to provide a critical review of the company's working and state of affairs to the government. Special audit should be distinguished from 'investigation' into the affairs of a company under Section 235 of the Act. The special auditor has the same powers and duties which a company auditor has under Section 227 of the Act, with the difference, however, the instead of making his report to the members of the company, the special auditor makes the report to the central government. The special audit report should, as far as possible, include all the information required to be included in an audit report under Section 227 of the Act. However, the central government may direct that the special audit report shall also include a statement on any other matter referred to the special auditor by the government.

13. (a) Since paid up capital and reserves of T Pvt. Ltd. is less than Rs. 50 lakhs and has no loan outstanding exceeding rupees 25 lakhs from any bank or financial institution, the only other condition is whether turnover exceeds rupees five crores. Turnover is not defined in the CARO. Part II of Schedule VI defines the term "turnover" as the aggregate amount for which sales are affected by the company. "Sales affected" would include sale of goods as well as services rendered by the company.

For ascertaining turnover though trade discount and sales returns should be deducted, the inclusion of services rendered would result in a turnover of Rs. 5.05 crores (i.e. 6 - 0.10 - 0.95 + 0.10 crore) Hence CARO will apply to T. Pvt. Ltd.

(b) The auditors are required to make a separate report to the Board of Directors and the RBI for every financial year as per the Non Banking Companies Auditors' Report (RBI) Direction 1998, in addition to the reporting obligations under section 227 of the Companies Act, 1956.

(1) *Reporting Requirements:* The auditor shall make –a statement on the following matters, together with reasons in case of any unfavourable or qualified statement:

(a) *Registration:* Whether the NBFC has obtained certificate of Registration or applied for registration.

(b) *Communication from RBI:* Whether the NBFC has received any communication from RBI refusing grant of Certificate of Registration.

(2) **NBFCs accepting/holding public deposits**

(i) ***Limit on Public Deposits****:* Whether the public deposits and the following borrowings are within the permissible limits

(a) Borrowing from public by issue of unsecured non-convertible Debentures/Bonds.

(b) Borrowing from its share holders by a public limited company and

(c) Other deposits within the definition of "Public Deposit" in the NBFC (Reserve Bank) Direction, 1998.

(ii) ***Credit Rating****:* Whether Credit rating for fixed Deposits, assigned by the credit rating agency is in force.

(iii) ***Limit on Fixed Deposits****:* Whether aggregate amount of Deposit outstanding at any point during the year has exceeded the limit specified by the Credit Rating Agency.

(iv) ***Default:*** Whether the NBFC has defaulted in paying to its Depositors the interest and/or principal amount of the deposits after such interest and/or principal became due.

(v) ***Prudential Norms****:* Whether the NBFC has complied with NBFC Prudential Norms (Reserve Bank) Direction, 1998 in relation to Income Recognition. According standards, classification, Provisioning for bad and doubtful debts and concentration of Credit/Investment.

(vi) ***Capital Adequacy****:* Whether the capital Adequacy Ratio disclosed in the return submitted to the RBI is correctly determined and whether such ratio is in compliance with the minimum capital to Risk Asset Ratio prescribed by the RBI.

(vii) ***Liquidity****:* Whether the NBFC has complied with the prescribed liquidity requirement and kept the approved securities with designated Bank.

(viii) ***Return of Deposits****:* Whether the NBFC has furnished the return of deposits to the RBI within the stipulated period as required under First Schedule to NBFC Prudential Norms (Reserve Bank) Directions, 1998.

14. (a) Scope of concurrent audit of banks with reference to RBI guidelines

The following are the areas to be covered:

(i) Daily cash transactions with reference to abnormal receipts and payments. This will include currency chest transactions, major expenses met by cash, high value receipts and disbursements.

(ii) Purchase and sale of shares securities etc. Physical verification of investments and rates at which they are entered into.

(iii) Verification of procedure and documentation to open new current, savings, term deposit accounts, etc. Unusual operations noticed have to be thoroughly examined.

(iv) Verification of advances, overdrafts, temporary OD, Cash credit accounts, term loans, bills purchase, letters of credit etc. Procedure for sanction and documentation to be verified. Any deviation noticed to be examined in great detail.

(v) Foreign exchange transactions to be verified with reference to RBI guidelines.

(vi) Verification of balancing of all ledgers and registers, inter branch reconciliation calculation and verification of interest, discount, commission etc.

(vii) Revenue leakage to be detected.

(viii) Special efforts to be made in all fraud prone areas. The attempt should be to ensure that all effective measures are taken to prevent frauds.

(ix) Verification of high value transactions.

(x) Procedure for safe custody of security forms with the branch.

(xi) Whether all procedures for tax deduction at source are followed and the tax so deducted are deposited into Government Account within the time fixed.

(xii) Verification of returns, statements, calculation of capital adequacy ratio and compliance with requirements of government business.

(xiii) Study of RBI and Internal Inspection reports statutory auditors report and compliance thereto.

(xiv) Whether the customers' complaints are dealt with promptly.

(b) Areas of propriety audit under Section 227(1A)

Section 227(1A) of the Companies Act, 1956 requires the auditor to make an enquiry into certain specific areas. In some of the areas, the auditor has to examine the same from propriety angle as to:

(i) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members;

(ii) whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;

(iii) where the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the securities have been sold at a price less than that at which they were purchased by the company;

(iv) whether personal expenses have been charged to revenue

15. (a) Verification of Re-insurance outward

1. Verify that re-insurance underwriting returns received from the operating units regarding premium, claims, paid, outstanding claims, tally with the audited figures of premium claims paid and outstanding claims.

2. Check whether the pattern of re-insurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.
3. Check whether cessions have been made as per the stipulation applicable to various categories of risk.
4. Verify whether the cessions have been made as per the agreements entered into with the various companies.
5. See whether the outward remittances to foreign re-insurance have been done as per the foreign exchange regulations.
6. Ascertain whether the commission has been calculated as per the terms of the agreement with the re-insurance.
7. Verify the computation of profit commission by various treaty arrangements in the figure of the periodical accounts rendered and in relation to outstanding less pertaining to the treaty.
8. Examine whether the cash loss recoveries have been claimed and accounted on a regular basis.
9. Verify whether the claims paid items appearing outstanding claims list by ever. This can be verified at least in respect of major claims.
10. See whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support was insisted and verified.
11. Accounting aspects of the re-insurance cession premium commission recoverable, paid claims recovered and outstanding losses recoverable on cessions have to be checked.
12. Check percentage pattern of gross to net premium, claim paid and outstanding claim to ensure comparative justifications.

(b) Reporting on the Compilation Engagement: The objective of a compilation engagement is to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarise financial information, This ordinarily entails reducing detailed data to a manageable and understandable form without the requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the member to express any opinion on the financial information. Therefore, it is essential that the member clearly brings out the nature of association with the financial statement and the nature of the work performed by him. The following may be noted in this regard.

i. The title of the report should be "Accountant's Report on Unaudited Financial Statement and not An Auditor's Report".
ii. The report should be addressed to the appointing authority.
iii. The report should identify the financial information compiled, also stating that it is based on the information provided by the management.
iv. The report should clearly state that the financial statements are not audited.

v. In describing the engagement, ambiguous terms such as review, general review, check, etc. should not be based.

vi. Date of the report should be mentioned.

vii. Name and address of the firm of the member appointed for carrying out the compilation engagement should be mentioned.

viii. Signature and the designation (sole proprietor/ partner) and membership number should appear in the report.

(c) Areas to be covered in the investigation: The first and foremost important aspect in any business investigation is to have an overall picture of the position of the business which is being investigated before the details are gone into. Further, it is important to know whether the business is engaged in the manufacture of one or two important lines of products, is principally processing materials or is concerned only with the sale of a single product. Also, whether it is a business which depends for its success on imported raw materials or supply of parts and components from ancillary businesses or uses indigenous materials and parts which are manufactured locally. If the business is labour - intensive, its future profitability would be dependent on availability of skilled labour and relations of the management with the trade unions. Labour relations thus can affect the future profitability of the business. The method of distribution of products, either through wholesalers or retailers also must be examined. For studying the economic and financial position of the business, the following should be considered:

(i) The adequacy or otherwise of fixed and working capital. Are these sufficient for the growth of the business?

(ii) What will be the trend of the sales and profits in the future? The success of a business in the future would depend on the position enjoyed by it in the past in relation to its competitors. A business may be successful because it enjoys a monopoly. In such a case, the possibility of emergence of competition must be examined. This may be ascertained on the basis of the trend in market share of the product and the licensing policy followed by the government. Establishing the trend of sales, product-wise and area-wise will ordinarily help in drawing a conclusion on whether the trend will be maintained in the future.

(iii) Whether the profit which the business could be expected to maintain in the future would yield an adequate return on the capital employed?

From the accountant's view point, the following specific areas need to be looked into:

Profit and Loss Account: To study the Profit and Loss Account of a concern and consider each item, included therein, in relation to the corresponding items in the Profit and Loss Account of the previous years. It is therefore, necessary that a summary, in a columnar form, should be prepared of the balances included in the Profit and Loss Accounts of the business for a period, say of 5 to 7 years.

Fixed Assets: Fixed assets, usually, are shown in accounts at cost less depreciation but the accounts do not show the ages of different assets. It is desirable, therefore, to obtain age analysis of various items of fixed assets. Assets which are old or are obsolete would naturally have to be replaced. It should be seen that their values are not in excess of the value of service that they could be expected to render to the business during the balance period of their active life and the amount they would fetch on sale as scrap.

Stock and work-in-progress: It should be seen that stocks have been valued consistently and that the basis of valuation was such that the value placed on stocks did not include any element of profit. Also, there should be due allowance for damaged, obsolete and slow moving stocks.

Other liquid assets: It should be ascertained that the assets so described are readily realisable. Money with a bank in liquidation should be taken only to the extent guaranteed by Deposit Insurance Scheme.

Idle assets: On a scrutiny, it may appear that certain assets are remaining idle and are not being properly applied in the business. For example, certain plant and machinery may have been put to use after a considerable period of time after acquisition. Some of the fixed assets may be awaiting installation even at the valuation time.

Liabilities: The important matter to investigate in this regard is whether those are stated fully or understated or overstated. In other words, whether the profits of the business have been inflated by suppression of liabilities or there are any free reserves included in the liabilities. In either case, an adjustment would be necessary. Secondly, it should be ascertained that liabilities are not unduly 'large or are not outstanding for a long time, in such cases, it would be necessary to pay off some of them which would cause a drain on the liquid resources of the concern. The fact should be stated in the report.

Taxation: Orders in respect of assessments completed should be studied and it should be verified that an adequate provision has been made in respect of liabilities for taxes which have not been assessed. Also, it should be seen that in the past there has been no reopening of assessments. If so, the company may be liable for an undisclosed sum of taxes plus penalties. Any temporary tax benefit should also be disregarded.

Apart from the above areas, the other factors relating to the management, skilled labour, etc. may also be covered in the investigation.

16. (a) Banks maintain stocks of foreign currencies in the form of Bank Accounts with their overseas branches/correspondents. Such foreign currency accounts maintained by Indian banks at other overseas centres is designated by it as "Nostro Account". For example, all banks in India would be maintaining a US Dollar Account". For example with their New York office/branch/correspondents, such account would be designated by the Indian Office as Nostro Account. "Vostro Account" is the opposite of Nostro accounts. Here a foreign bank in another country maintains stocks of Indian rupees with their Indian branch/correspondent/local bank. Such Indian Rupee Accounts are designated as a Vostro Account. For example, a German Bank might maintain a Vostro Account in rupees in terms with Indian Bank. While examining the transaction in foreign exchange, the auditor should also pay attention to reconciliation of Nostro Accounts with the respective minor account. The amount in the Nostro account is stock of foreign currency in the form of bank accounts with the overseas branches and correspondents. Unreconciled Nostro Accounts, on an examination, may reveal unauthorized payments from the foreign currency account, unauthorized withdrawals, and unauthorized minor account. The auditor should also evaluate the internal control with regard to inward/outward messages. The inward/outward messages should be properly authenticated and discrepancies noticed, should be properly dealt with, in the books of accounts. The auditor should also verify whether prescribed procedure in relation to inter bank confirmation in the Vostro account is followed or not, in case balance confirmation certificate have been received but the same have not been reconciled, or where confirmation has not been received the same should be reported, in respect of each Vostro Account.

(b) Compliance Procedures and Evaluation of Internal Controls: SA 200 on "Basic Principles Governing an Audit" states that, "the auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information. According to it, compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. Obtaining audit evidence from compliance procedures is intended to reasonably assure the auditor in respect of the following assertions :

Existence	-	that the internal control exists.
Effectiveness	-	that the internal control is operating effectively.
Continuity	-	that the internal control has so operated throughout the period of intended reliance.

The auditor formulating his opinion on financial information needs reasonable assurance that transactions are properly authorised and recorded in the accounting records and that the transactions have not been omitted. Internal controls, even if fairly simple, may contribute to the reasonable assurance the auditor seeks. The auditors' objective in studying and evaluating internal controls is to establish the reliance he can place thereon in determining the nature, timing and extent of his substantive auditing procedures.

Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in place and are also effective. Compliance procedures enable the auditor to determine the existence, effectiveness and continuous operation of the internal control system. These procedures include tests requiring inspection of documents supporting transactions to gain evidence that controls have operated properly. For example, the auditor may see that the documents have been properly authorised. The auditor may also make enquiries about the observation of controls, for example, determining who actually performs each function not merely who is supposed to perform it. Compliance procedures are conducted by the auditor to gain evidence that those internal controls on which he intends to rely operates generally as identified by him and they function effectively throughout the period of intended reliance. The concept of effective operation recognises that some deviations from prescribed controls may have occurred.

Based on the results of his compliance procedures, the auditor evaluates whether the internal controls are adequate for his purpose. If based on the results of the compliance procedures, the auditor concludes that it is not appropriate to rely on a particular internal control to the degree previously contemplated, he should ascertain whether there is another control which would satisfy his purpose and on which he might rely (after applying appropriate compliance procedures). Alternatively, he may modify the nature, timing or the extent of his substantive audit procedures.

17. **Rolling settlement:** A rolling settlement is one in which trades outstanding at the end of the day have to be settled (payments made for purchases or deliveries in the case of sale of securities) within 'X' business days from the transaction date.

In the rolling settlement, trades on each single day are settled separately from the trades done earlier or subsequent trade days. The netting of trades is done only for the day and not for multiple days.

SEBI has gradually mandated most of the scrips to be settled exclusively on Rolling Settlement basis [T+2]. Thus, in a T+2 rolling settlement, a transaction entered into on Monday, for instance, will be settled on Wednesday when the pay-in or pay-out takes place. The transaction in the Compulsory Rolling Settlement (CRS) are settled on T+2 basis i.e. both pay in and pay out of monies and securities for transactions in scrips on transaction day (T-Day) would take place on the day after immediately following day.

However, transactions in 'Z' group securities are settled only on trade to trade basis on T+2, i.e. the facility of netting up of buy and sell transactions of the same day, as available in other securities, is not available with securities falling under 'Z' group. In other words, if the investor buys and sells X number of shares on the same day , then he shall first have to actually deliver and then receive the securities on the settlement day.

Value at Risk (VaR) based margining approach has been adopted for transactions done in CRS scrips w.e.f. July 2, 2001. In the VaR system of margining, historical volatilities of scrips and overall market volatility is considered to arrive at a VaR margin percentage for a scrip. Further the mark-to-market difference are collected on a daily basis and the broker members are required to maintain a capital level, as prescribed by the exchange, adequate to support their exposure at all times.

In case, a member fails to deliver the shares sold in rolling settlement, the exchange conducts an auction session on T+2, to meet the shortfall created by non-delivery of shares. In this auction session, offers are invited from the other members to deliver the shares sold by originally selling member, since delivery has to be made to the buying member. In case no shares are received in auction, the sale transaction is closed-out at a close-out price, determined by higher of the following:

- Highest price, recorded in the scrip from the settlement in which the transaction took place upto a day prior to the auction OR
- 20% above the closing price on a day prior to the auction.

In this case, the auction price/ close-out and difference between sale price, if positive is payable by the seller who failed to deliver the scrips. In case, auction/ close out price is less than sale price, the difference is not given to the seller, but is credited to investor protection fund.

18. Classification of Investments in the Financial Statements of a Bank

The entire investment portfolio of the banks (including SLR securities and non-SLR securities) should be classified under three categories viz., 'Held to Maturity', 'Available for Sale' and 'Held for Trading'.

However, in the balance sheet, the investments will continue to be disclosed as per the existing six classifications viz., (a) Government securities; (b) Other approves securities; (c) Shares; (d) Debentures & Bonds; (e) Subsidiaries/Joint Ventures and (f) Other (CP, Mutual Fund Units, etc)

Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposals.

Held to maturity

(i) The securities acquired by the banks with the intention to hold them up to maturity will be classified under **Held to Maturity**.

(ii) The investments included under 'Held to maturity' should not exceed 25 per cent of the bank's total investments.

(iii) The following investments are to be classified under 'Held to Maturity' but will not be counted for the purpose of ceiling of 25% specified for the category:

   (a) Re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in their investment portfolio.

   (b) Investment in subsidiaries and joint ventures. [A joint venture would be one in which the bank, along with its subsidiaries, holds more than 25% of the equity.]

   (c) The investments in debentures/bonds, which are deemed to be in the nature of an advance.

(iv) Profit on sale of investments in this category should be first taken to the Profit & Loss Account and thereafter be appropriated to the 'Capital Reserve Account', Loss on sale will be recognized in the Profit & Loss Account.

Held for Trading

The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/interest rate movements will be classified under **Held for Trading**.

The investments classified under held for trading category would be those from which the bank expects to make a gain by the movement in the interest rates/market rates. These securities are to be sold within 90 days.

Available for Sale

The securities which do not fall within the above two categories will be classified under Available for Sale.

Profit or Loss on sale of investments in both the categories will be taken to the Profit & Loss Account.

19. Section 62 of the Companies Act, 1956 lays down the civil liability for misstatement in a prospectus issued to invite persons to subscribe for shares in or debentures of a company. The professional accountant will in such a case be liable to pay compensation to every person who subscribes for any shares or debentures on the faith of the prospectus for any loss or damage sustained because of an untrue statement made by him as an expert.

However, professional accountants will not be liable if they can prove that**:**

(a) the prospectus was issued without his knowledge or consent and that on becoming aware of its issue he forthwith gave reasonable public notice that it was issued without his knowledge or consent; or

(b) he withdrew his consent in writing before delivery of the prospectus for registration; or

(c) after the delivery of prospectus for registration but before allotment of shares, on becoming aware or the untrue statement , he withdrew his consent in writing and gave reasonable public notice of the withdrawal, and of the reasons therefore ; or

(d) he was competent to make the statement and that he had reasonable grounds to believe and did up to the time of allotment of the shares or debentures believe that the statement was true.

20. (a) Decision Tree: A decision tree is a graphic display of the relationship between the present position and future events; future events and their consequences. The sequence of events is mapped out over time in a format similar to the branches of a tree. The decision tree approach gets its name because of the resemblance with a tree having number of branches. A decision tree represents a decision problem as a series of decisions to be taken under conditions of uncertainty. A present decision depends upon the past decision and their outcomes. The decision trees are the diagrams that permit the various decision alternatives, their outcomes and probabilities of their occurrences to be mapped in a clear fashion.

In a typical decision tree, therefore, the project is broken down into clearly defined stages, and the possible outcomes at each stage are listed along with the probabilities and cash flows effect of each outcome. Important steps while constructing a decision tree in respect of an investment proposal are: definition of the investment proposal, identification of decision alternatives, identification of decision points, chance of events and other data, location on the decisions tree branches of the relevant data such as projected cash flow, expected present value, and selection of the best alternatives. This approach is extremely useful in handling sequential investments and working backwards, eliminating unprofitable branches and determination of optimum decision at various decision points.

The major advantage of a decision tree is that it brings out the implicit assumptions and calculations for all to see, raise questions and revise. It also allows a decision maker to visualise assumptions and alternatives in the graphic form which are easy to understand. The disadvantages, however, are that the diagram becomes complicated and cumbersome as more and more variables are added. The addition of interdependent alternatives and variables does not only present a queer picture but also makes calculation time consuming.

(b) Utility Routines: Utility Routines are generally supplied by the computer manufacturer and are available for call up by the operating system. These routines play a key role in an electronic data processing. These are generalised programmes that perform necessary but routine jobs in a computer installation. These routines are sufficiently flexible to handle needs of all users. They are controlled by parameters to indicate the particular characteristics of the data or the requirements. Generally, three types of utility routines are made available by computer vendors.

Data set utilities are used to manipulate files of stored data. One data set utility programme might merge or combine data from more than one file of stored data. Another might copy a file of data to another file. A third might instruct the computer to print selected portions of a set of data. A fourth might sort file records into a desired sequence.

System utilities are used to simplify the task of knowing where data are stored in a computer file. One utility routine might add data to a file, name the set of data, and catalogue the data set to distinguish it from other data sets. Another utility routine might list the catalogue of data sets, showing where particular data is stored in a file. A third might label magnetic tapes. A fourth might accumulate and report errors incurred during the processing of magnetic disk and tape.

Independent utilities perform such housekeeping functions as preparing a back up copy of the contents stored on a magnetic disk file or analysing a magnetic disk for defective tracks. This type of a utility routine performs the needed diagnostic tests.

(c) Test Packs: Test pack is a technique to determine the correctness of the computer programming used to record transactions through the computer. Preparation of test pack requires a great deal of expertise. It may be prepared by the auditor himself with the help of the entity's staff or by the Internal Control department of the entity. Normally test packs are used where:

(i) a significant part of the control system is embodied in the programme;

(ii) there are gaps in audit trail making it difficult to trace output from input and to verify intermediate calculation; and

(iii) the volume of records is large, so that it may be more economical and more effective to use test packs rather than to trace the transactions manually.

The operations of a test pack involve following steps:

(i) The auditor or the Internal Audit Department prepares a set of special data covering different types of transactions containing valid and invalid conditions.

(ii) Data will include both that falling outside the control parameters (and printed out as an error or conception) and that falling within the parameters (and hence should be processed normally).

(iii) The test data are seen on the clients' computer with the client's programme but under audit supervision.

(iv) The results of the test data are also prepared separately, independent of the computer/programme, and are compared with the results obtained by running the programme through the computer.

(v) If the results are identical, reliability of the computer programme is proved.

(d) Record of Audit assignments: In exercise of the powers conferred by clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India issued a notification which specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies under Section 224 and /or Section 228 of the Companies Act, 1956. As a part of this notification, to meet its requirements, a CA in practice as well as a firm in practice shall maintain a record of the audit assignments accepted as laid out in notification issued by the Council of the ICAI under Part II of Second Schedule to the Chartered Accountants Act, 1949 in respect of ceiling on audits containing following particulars:

(i) Name of Company Audit/ Assignment.

(ii) Regn. No.

(iii) Date of appointment with Registrar of Companies.

(iv) Date of acceptance.

(v) Date on which form 23B filed.

(e) Environmental Audit: Environmental reporting deals with the disclosure by an entity of environmentally related data, regarding environmental risks, environmental impacts, policies, strategies, targets, costs, liabilities or environmental performance to those who have an interest in such information as an aid to enabling/enriching their relationship with the reporting entity via either the annual report; a stand-alone corporate environmental performance report; or some other medium (e.g. staff newsletter, video, CD ROM, internet site). The reports that are generated after such audits can be either compliance-based reporting or impact-based performance reporting.

Environmental audit deals with verification of information contained in such reports with a view to expressing an opinion thereon. Environmental audit can be performed by external agencies or internal experts (including internal auditors). In practice, environmental audit is not done by a single agency but by various agencies who are experts in the field. Since the subject matter of environmental audit involves multi-disciplinary knowledge and skill, it is preferable to form a team of persons drawn from different disciplines who may assist the chartered accountant in performing the task in an effective manner, generally environmental audits are not required by any statute but are sometimes done at the request of the management to address issues like compliance with environmental laws and regulations, etc.

(f) Audit of Indirect Taxes: The components of central indirect tax which form a part of the materials cost could be basic customs duty, additional duty of customs, special additional duty, excise duty (Cenvat), special excise duty, additional duties of excise, etc. The various components have a relationship with each other and also with central and local sales tax. The audits of in this area are redirected to the audit under sections 14A and 14AA of the Central Excise Act, 1944. All these audits are conducted by or on behalf of the Government. The steps involved in conducting indirect tax audit are as under:

1. Evaluate the internal control systems in general with specific weight given to the strength of the systems in aiming at the quantification and discharge of the indirect taxes. Internal control questionnaire may be designed specifically for the area of indirect taxation.
2. Obtains information about the company and the industry. Specific information on amount of imports, percentage of customs, amount of removals, quantum of cenvat-proportion of credit could also be calculated. The walk through of the process from the point of ordering of materials till the receipt of the payment from the customer is advisable.
3. Formulating an audit programme to assist in the actual conduct of the audit. The actual extent of verification would be dependent on the results of the evaluation of the internal controls.
4. Ensure that the audit staff is knowledgeable in the law and the procedures governing the indirect taxes. The examination of the documents, physical verification, reconciliation tracing techniques, comparison of ratios, observation of the activities and discussions of the weaknesses observed should be part of an effective audit.
5. Prepare a report on the indirect tax audit providing specific comments on the statutory information, material matters reported by way of an executive summary and the assertion/qualification that the acceptable accounting policies are in vogue.

PAPER – 4 : CORPORATE LAWS AND SECRETARIAL PRACTICE

UPDATES

SL.No.	Name of the Act	Gist of the Updates	Reference to the Updates	Applicability for the May 2010 Exam
1.	**The Companies Act, 1956** **Companies Bill, 2009**	The Companies Bill, 2009 which was introduced in the Lok Sabha has made extensive changes in the existing Companies Act, 1956. At present, it is in the form of a Bill only and pending before parliamentary Standing Committee on Finance.	www.mca.gov.in	Not Applicable
2. (I)	**Securities and Exchange Board of India** Notification of Securities and Exchange Board of India(Issue of Capital and Disclosure Requirements) Regulations, 2009	Accordingly, in exercise of powers conferred by section 30 of the Act, the Board has framed the SEBI (Issue of Capital and Disclosure Requirements)Regulations,2009 (hereinafter referred to as "the ICDR Regulations"), which have been notified on August 26, 2009. The ICDR Regulations have been made primarily by conversion of the SEBI (Disclosure and Investor Protection) Guidelines, 2000 (since rescinded) (hereinafter referred to as "the rescinded Guidelines"). While incorporating the provisions of the rescinded Guidelines into the ICDR Regulations, certain changes have been made by removing the redundant	Circular No. CFD/DIL/ICDRR/1/2009/03/09 dated 03.09.2009 www.sebi.gov.in under the Categories "Legal Framework" and "Issues and Listing".	Not applicable

		provisions, modifying certain provisions on account of changes necessitated. ***For highlights on ICDR vis – a vis SEBI (DIP) Guidelines 2000 (now rescinded. See ANNEXURE-I)***		
(II)	Amendments to SEBI (Employee Stock Option Purchase Scheme) Guidelines, 1999	There are certain provisions in the SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999 (hereinafter referred to as "the Guidelines") which are required to be complied with by an unlisted issuer at the time of making an initial public offer. Since these provisions pertain to matters relating to issue of capital, the same have now been incorporated in the ICDR Regulations and consequently, it has been decided to amend the Guidelines to remove these provisions as well as the redundant provisions pertaining to application to Central Listing Authority.	Circular No. CFD/DIL/ESOP/ 5/2009/03/09 dated 03.09.2009 on www.sebi.gov.in	Students may study from their knowledge point of view.
3.	**The Competition Act,2002** The Competition. (Amendment) Act, 2009	The Ministry of Commerce and Affairs promulgated the Competition (Amendment) Ordinance, 2009 to further amend the Competition Act, 2002 on October 14, 2009. The Ordinance amended section 66(1), (3), (4), (5),&(7) of the Competition Act, 2002. ***For text of amendments see ANNEXURE - II***	www.mca.gov.in	In view of the new amendment, full Act, 2002 will be applicable.

4. (I)	**Foreign Exchange Management Act,1999** Foreign Exchange Management (Transfer or Issue of Any Foreign Security) (Fourth Amendment) Regulations, 2009	In exercise of the powers conferred by clause (a) of sub-section (3) of Section 6 and Section 47 of the Foreign Exchange Management Act, 1999 (42 of 1999), the Reserve Bank of India made the amendments in the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004.Amendment made in regulation 7 which says that an Indian Party engaged in financial services sector in India may make investment in an entity outside India but subject to certain limitations.	Notification No. FEMA 196 / 2009-RB, dated July 28,2009 www.rbi.gov.in	Students may study from their knowledge point of view.
(II)	Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) (Second Amendment) Regulations, 2009	The Reserve Bank of India made the amendments in the Schedule I and Schedule II of the Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000 relating to "Borrowings in foreign exchange per borrower company per financial year up to such amounts not exceeding US Dollars 500 million or its equivalent as directed by the Reserve Bank from time to time shall be permitted for such permissible end-uses as indicated by Reserve Bank from time to time"(Schedule I) and Borrowings in foreign exchange per borrower company per financial year up to such amounts as	Notification No. FEMA 194 / 2009-RB. Dated June 17, 2009 www.rbi.gov.in	Students may study from their knowledge point of view.

		directed by the Reserve Bank from time to time shall be permitted for such permissible end-uses as indicated by Reserve Bank from time to time"(Schedule II).		
(III).	Foreign Exchange Management (Deposit) (Amendment) Regulations, 2009	The Reserve Bank of India makes the following amendments in the Foreign Exchange Management (Deposit) Regulations, 2000 in Regulation 4, in sub-regulation (3), for clause (a), that " credits to the account shall be only by way of -(i) proceeds of inward remittances received from outside India through normal banking channels; and(ii) transfer of funds, from the rupee account of the diplomatic mission in India, which are collected in India as visa fees and credited to such account."	Notification No. FEMA 191/RB-2009 Dated May 20, 2009 www.rbi.gov.in	Students may study from their knowledge point of view.
(iv)	Foreign Exchange Management (Foreign Exchange Derivative Contracts) (Amendment) Regulations, 2009	The Reserve Bank made the amendments in the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000.The new regulation relating to " Freight" hedge is inserted as regulation 6A which says that Reserve Bank may, on an application permit a person resident in India to enter in to a freight derivative contract in an exchange or a market out side India to hedge the freight risk such person is exposed to.	Notification No. FEMA 191/RB-2009 Dated May 20, 2009 www.rbi.gov.in	Students may study from their knowledge point of view.

ANNEXURE I

Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 w.e.f. August 26,2009.

[Students may read from the knowledge point of view but this regulations are not applicable for May 2010 Examination]

SEBI has been empowered in terms of section 11A(1)(a) of the Securities and Exchange Board of India Act, 1992 to specify by regulations, for the protection of investors, the matters relating to issue of capital, the manner in which such matters shall be disclosed and other matters incidental thereto. Accordingly, in exercise of powers conferred by section 30 of the Act, the Board has framed the SEBI (Issue of Capital and Disclosure Requirements)Regulations,2009 (hereinafter referred to as “the ICDR Regulations”), which have been notified on August 26, 2009. The ICDR Regulations have been made primarily by conversion of the SEBI (Disclosure and Investor Protection) Guidelines, 2000 (since rescinded)(hereinafter referred to as “the rescinded Guidelines”). While incorporating the provisions of the rescinded Guidelines into the ICDR Regulations, certain changes have been made by removing the redundant provisions, modifying certain provisions on account of changes necessitated due to market design and bringing more clarity to the provisions of the rescinded Guidelines.

SIGNIFICANT CHANGES IN SEBI ICDR, REGULATION 2009 VIS-À-VIS SEBI(DIP)GUIDELINES 2000.

Sr. No.	Subject Matter	Provision under the rescindedGuidelines	Provision under the ICDR Regulations
1.	Exemption from eligibility norms formaking an IPO	Exemption available to banking company, corres-ponding new bank and infrastructure company.	Exemption removed. Eligibility norms made applicable uniformly to all types of issuers.
2.	Debarment	Company prohibited from making an issue of securities if it had been prohibited from accessing the capital market under any order or direction passed by the Board.	Issuer not to make public issue or rights issue of specified securities if: (a) the issuer, any of its promoters, promoter group or directors or persons in control of the issuer are debarred from accessing the capital market by the Board; (b) if any of the promoters, directors or persons in control of the issuer was or also is a promoter, director or person

			in control of any other company which is debarred from accessing the capital market under any order or directions made by the Board.
3.	Offer for sale by listed companies	No provision.	Provided for.
4.	OTCEI Issues and E-IPO	Contained in Chapter XIV and Chapter XI A.	Omitted.
5.	Firm allotment in public issues	Permitted.	Omitted.
6.	Reservation on competitive basis in public issues	(a) For Indian and multilateral development financial institutions, Indian mutual funds, foreign institutional investors and scheduled banks. (b) For shareholders of the promoting companies in the case of anew company and shareholders of group companies in the case of an existing company.	(a) Omitted. (b) For shareholders (other than promoters) in respect of listed promoting companies, in case of a new issuer and listed group companies, in case of an existing issuer.
7.	Book building process	Book building process through 75% or 100% of issue size.	75% book building route omitted.
8.	Allotment/ refund period in public issues	30 days for fixed price issues and 15 days for book built issues.	15 days for both fixed price and book built issues.
9.	Disclosure of price or price band	Required in draft prospectus in case of fixed price public issues.	Not required to be disclosed in draft prospectus.
10.	Transfer of surplus money in Green Shoe Option (GSO) Bank Account	Surplus money to be transferred to Investor Protection Fund ofStock Exchanges.	Surplus money to be transferred to Investor Protection and Education Fund (IPEF) established by the Board.

11.	Issue period for Infrastructure companies in public issues	21 days, as against 10 days for other issues.	Uniform period of 10 days for all types of issuers.
12.	Currency of financial statements disclosed in the offer document	Particulars as per audited financial statements not to be more than 6 months old from the issue opening date for all issuers, except Government companies.	Government and non-government issuers treated at par.
13.	Definition of "Key Management Personnel"	Not defined.	Defined.
14.	Disclosure on pledge of shares by promoters	Not provided.	Provided for.
15.	Extent of underwriting obligation	Not explicit.	Where 100% of the offer through offer document is underwritten, underwriting obligations shall be for the entire amount underwritten.
16.	Financial institution as a monitoring agency	The term "Financial Institution" open to interpretation.	The term "financial Institution" replaced by" public financial institution or a scheduled commercial bank".
17.	Definition of "employee"	Includes permanent employee/director of subsidiary or holding company of the issuer.	Excludes permanent employee/ director of subsidiary or holding company of the issuer and promoters and immediate relatives of promoters.
18.	Restrictions on advertisements	If issue opening and closing advertisement contained highlights, then the advertisement required to contain risk factors.	If advertisement contains information other than the details specified in the format for issue advertisement, the advertisement shall contain risk factors.
19.	Forfeiture of money on un-exercised warrants in preferential issues	Open to interpretation.	Where the warrant holder exercises his option to convert only some of the warrants held by him, upfront payment made against only such

			warrants can be adjusted. The balance upfront payment made against the remaining unexercised warrants shall be forfeited.
20.	Outstanding convertible instruments in case of initial public offer (IPO)	Compulsory conversion of outstanding convertible instruments and other rights held by promoters or share-holders.	Compulsory conversion of all outstanding convertible instruments held by any person.
21.	Minimum promoters' contribution	Could be brought in by promoters/ persons belonging to promoter group/friends, relatives and associates of promoters.	Shall be brought in only by promoters whose identity, photograph, etc are disclosed in the offer document.
22.	Issue period in case of public issues	Issue period not clear in case of revision in price band in book built public issues.	Total issue period not to exceed 10 days, including any revision in price band.
23.	Timing of pre-issue advertisement for public issues	Pre-issue advertisement to be made immediately after receipt of observations from the Board.	Pre-issue advertisement to be made after registering of prospectus/ red herring prospectus with Registrar of Companies before opening of the issue.
24.	Documents to be attached with due diligence certificate	Documents such as memorandum of association and articles of association of the company, audited balance sheet, checklist for compliance with the rescinded Guidelines etc.	Only checklist to be attached.
25.	Group companies	The term "group companies" not explained.	The term "group companies" explained.

ANNEXURE II

[Applicable for May 2010 Examination]

EXTRAORDINARY

PART II — Section 1

PUBLISHED BY AUTHORITY

No. 40 NEW DELHI, WEDNESDAY, OCTOBER 14, 2009/ASVINA 22,1931

Separate paging is given to this Part in order that it may be filed as a separate compilation.

MINISTRY OF LAW AND JUSTICE

(Legislative Department)

New Delhi, the 14th October, 2009/Asvina 22, 1931 (Saka)

THE COMPETITION (AMENDMENT) ORDINANCE, 2009

No. 6 OF 2009

Promulgated by the President in the Sixtieth Year of the Republic of India. A Ordinance further to amend the Competition Act, 2002.

WHEREAS Parliament is not in session and the President is satisfied that circumstances exist which render it necessary for her to take immediate action;

Now, THEREFORE, in exercise of the powers conferred by clause (1) of article 123 of the Constitution, the President is pleased to promulgate the following Ordinance:—

Short title and Commencement

1. (1) This Ordinance maybe called the Competition (Amendment) Ordinance, 2009.
   (2) It shall come into force at once.

Amendment of section 66 of Act 12 of 2003

2. In section 66 of the Competition Act, 2002,—
   (a) in sub-section (1), the proviso and the Explanation thereto shall be omitted;
   (b) in sub-section (3), for the words, brackets and figure "after the expiry of two years referred to in the proviso to sub-section (1)", the words, brackets and figures "on the commencement of the Competition (Amendment) Ordinance, 2009" shall be substituted;
   (c) in sub-section (4), for the words, brackets and figure "on or before the expiry of two years referred to in the proviso to sub-section (1)", the words, brackets and figures "immediately-before the commencement of the Competition (Amendment) Ordinance, 2009, shall, on such commencement" shall be substituted;
   (d) in sub-section (5), for the words, brackets and figure "after the expiry of two years referred to in the proviso to sub-section (1)", the words brackets and figures "on the commencement of the Compaction (Amendment) Ordinance, 2009" shall be substituted.

QUESTIONS

THE COMPANIES ACT, 1956

Board of Meetings and Proceeding

1. State whether the acts done by the Board Meeting be invalid if it was found afterwards that there was some defect in the appointment of Directors or any person acting as a Director?
2. Can a Director assign his office by way of will to his son? Would it make any difference in case he assigns by will to someone else other than his son or relatives?
3. A Limited had four Directors. At one of its convened Board Meeting only two of them attended and they appointed two additional Directors who were their relatives. Is the appointment of those additional Directors valid?
4. In a public company the total number of Directors are 9 and 2 office of the Directors have fallen vacant. Referring to the relevant provisions of the Companies Act, 1956.
   (a) What would be the quorum for the Board Meeting?
   (b) Can the articles of a company fix the quorum (higher or lower) for the Board Meeting?
   (c) Assuming if there are 15 Directors in the company and of which 13 happen to be interested Directors, what would be the quorum?
   (d) How do you resolve the situation if all the Directors are interested in a particular transaction?

Directors

5. The Directors of X & Co. desire to authorise the MD to enter into the following transactions namely- (a) invest from time to time surplus funds in the purchase of shares of other companies; (b) borrow from banks money required for the purpose; (c) give loans to person, including firms in which Directors or their relatives are partners; (d) give donations to charitable trusts in which any of the Directors may be interested as trustees. Discuss.
6. A company is offering one of its flats on sale to one of its Directors on the condition that 50% of the price to be paid in cash and the rest in equated instalments. Comment on the situation, whether this could be treated as a loan under Section 295 of the Companies Act, 1956.
7. Mr. X is serving in a company in the dual capacity of a Director and an Employee? Referring to the provisions of the Companies Act, 1956. State:
   (a) Whether there is any prohibition/restriction serving in the dual capacity?

(b) If so whether a Director serving as an employee would amount to holding an office or place of profit?

(c) Whether the remuneration drawn by the Director as an employee of the company would be governed by the provisions relating to managerial remuneration?

(d) What would be your answer if the said Director is rendering services of a professional nature?

8. M/s ABC Ltd. was incorporated on 1st January 2007. On 1st November 2009 a political party approaches the company for a contribution of Rs. Ten lakhs for political purpose. Advise in respect of the following:

   (i) Is the company legally authorised to give this political contribution?

   (ii) Will it make any difference, if the company was in existence on 1st October 2006?

   (iii) Can the company be penalised for defiance of Rules of this regard?

Inter Corporate Loans and Investments

9. What is meant by oppression'? State whether the aggrieved party would succeed in obtaining relief from Company Law Board on the ground of oppression in the following cases:

   (i) The majority of the Board of Directors override the minority Directors and the minority Directors apply to Company Law Board complaining oppression by majority Directors.

   (ii) A petition by majority shareholders complaining oppression by minority shareholders

10. Discuss the process of providing loans, investments and gurantees to any body corporate in excess of prescribed limits.

Winding-up of Companies

11. M/s Info-line overtrading Ltd. was ordered to be wound up compulsorily by an order dated 15th Oct 2009 by the court. The official liquidator who has taken control of the assets and the other records of the company found that the Company had created a floating charge on 1st January, 2009 in favour of a private bank for the overdraft facility to the extent of Rs. 5 crores, by hypothecating the current assets .

    Examine what action can be taken by the official liquidator according to the provision of the Companies Act,1956.

12. M/s PQR Ltd. has been running into losses and as such company mortgaged its machinery to one of its creditor on 1st August 2008 against payment of his dues of Rs. 5 lakhs. The other creditor filed a petition for winding up the company on 31st Dec 2008.The company was ordered to be wound up on 30th April 2009. State whether the official liquidator can declare the transaction of mortgage with the creditor as invalid.

Some Relevant Miscellaneous Provisions of the Companies Act,1956

13. The paid up share capital of XYZ Ltd. is Rs. 10 crores consisting of 60 lakhs equity shares of Rs. 10 each fully paid up and 40 lakhs preference shares of Rs. 10 each, fully paid up. UTI and IDBI hold among themselves 40 lakhs equity shares and 15 lakhs preference shares. With reference to the provisions of the Companies Act,1956, examine whether XYZ Ltd is a Government company. Explain the manner of proceed in the matter of appointment of the auditors for the said company.

14. Examine with reference to the provisions of the Companies Act,1956 the company incorporated in Brazil having a Share registration office at Hyderabad is a foreign company?

15. Can a company utilize the moneys or securities received from its employees for the purpose of business?

16. Mr. Kumar having 'substantial interest' in ABC Ltd is appointed as a Sole selling agent by the Board of Directors for a period of 5 years. The company's paid-up share capital is Rs.49 crores. The Board did not place the matter in the AGM and communicated to Mr. Kumar about his appointment, who in turn accepted the offer.

    Examining the provisions of the Companies Act, 1956,

    (a) Whether the appointment is in order?

    (b) What course of action you would take as the Secretary of the company, in case Mr. Kumar does not have substantial interest.

Law relating to Producer Companies

17. Explain the circumstances in which the registration of a Producer Company may be cancelled by the registrar?

Foreign Exchange Management Act,1999

18. Mr. Z resided in India during the financial year 2007-2008. He left India on 1st August, 2008 for UAE for the treatment of his father for 3 years. What would be his residential status during financial year 2008-2009 and during 2009-2010?

19. What are the provisions for the regulations and management by the Reserve Bank of India in respect of possession of foreign exchange?

The Securities and Exchange Board of India (SEBI) Act,1992

20. State the circumstances under which Securities and Exchange Board of India may pass cease and desist order in respect of any listed company.

21. Explain the following terminologies in reference to SEBI Act, 1992.

    (a) Green Shoe Option

    (b) Designated Stock Exchange

    (c) Book Building

    (d) Composite Issues

The Competition Act,2002

22. (i) Define the following terms:

    (a) Cartel

    (b) Relevant Product Market

    (c) Service

    (d) Price

    (ii) Om Ltd. made an initial public offer of certain number of Equity shares. Examine whether these shares can be considered as 'Goods' under the Competition Act,2002 before allotment.

23. Write short notes on-

    (a) Competition Fund

    (b) Accounts and Audit of the Competition Commission.

Securities Contracts (Regulation)Act,1956

23. Working of the Delhi Stock Exchange Association Ltd. is not carried on by his governing Board in the public welfare. On receipt of representations from various investors and Investors' Association, the Central Government is thinking to withdraw the recognition granted to the said Stock Exchange. What are the circumstances for withdrawal of such recognisation as per the provisions of Securities Contracts (Regulation) Act,1956 in this regard. Also state the effect of such withdrawal on the contracts outstanding on the date of withdrawal.

Interpretation of Statutes and Corporate Secretarial Practice

25. (a) State the rules of Interpretation/Construction of deeds and documents.

    (b) What do you understand by resolution? Draft an ordinary resolution on winding up of the company by court.

SUGGESTED ANSWERS/HINTS

1. All Acts done by the Board Meeting by its committee Meeting or by any person acting as a Director shall be as valid as if every such Director or such person had been duly appointed and was qualified to be a Director. The validity of all such acts done is not affected even if it discovered later on that there was some defect in the appointment of any one or more of such Directors or of any person acting as a Director. The said acts will also remain unaffected even the Directors are later on discovered to be disqualified (Article 80). This provision has been intended to prevent the validity of transactions from being questioned where there has been a slip in the appointment of a Director. But the provision cannot be utilized to ignore or override the substantive provisions pertaining to such appointment. It is applicable only to acts of Directors whose appointment or qualification is later on discovered to be faulty. Where, however, their appointments have not taken place at all but they merely choose to act on the company's behalf, the protection prescribed by either Article 80 or Section 290 cannot be invoked *[Morris vs. Danssen (1964) I, A.I.R. 586 (H, L.)]* This is because the said subsequent discovery must be a discovery of the defect; it must not be discovery of facts which go to constitute the defect *[British Asbestos Co. vs. Body (1903) 2 Ch. 439].*

   Suppose a regulation like Articles 80 is included in the Article of Association of a company. What would be the possible impact of this? The impact has been summed up in Halsbury's Laws of England *(vide p. 277, 3rd Edition, Vol. VI)* thus: "An Article validating the acts of persons acting as Directors, though it is a afterwards discovered that there was a defect in their appointment or qualification, operates not only between the company and outsiders but also as between the company and its members; as where *defecto* Directors make a call, summon meetings of the company, elect other Directors or allot shares, A *defecto* Director may be ordered to furnish a statement of affairs in winding up. Directors can not take advantage of any infirmity in their proceedings in which they have themselves participated; they are stopped as between themselves and the company; they are also stopped from saying they have been improperly appointed if, they have acted after appointment, persons dealing with them who know of the invalidity are likewise stopped."

   It should also be noted that Section 290 applies to act of an individual Director, whereas Article 80 covers Act of the Board and of its committee.

2. Any assignment of office made after the commencement of the Act by any Director is void [Section 312]. It was held in Oriental Metal Pressing Works Private Ltd. vs. B.K. Thakoor (A.I.R.) 1960 Bom. 167 that the appointment of one as Managing Director by the will of one Director was void in view of the provisions contained in Section 312, since, according to the High Court, the words 'any assignment' were comprehensive enough to include every assignment to transfer of a Director or of the appointment by a Director of a

person to the office of a Director in his place, whether by a deed inter vivos or by will. But this ruling has been reversed by the Supreme Court (vide A.I.R. 1961 S.C. 573). The Court considers that the word 'assignment' in Section 312 does not mean or include appointment. From its every nature transfer inevitably imports the passing of a thing from one person to another. A transfer without the passage of the thing, even when that is an office is inconceivable. On the other hand, an 'appointment' has nothing to do with passing from one person to another; it connotes the putting in of someone in a vacancy. So transfer and appointment are dissimilar. It would be an unusual statute, which by using a single word intended to prohibit at the same time, two wholly different acts. A construction leading to such a result cannot be permitted.

3. Section 300 provides that a Director shall not take part in the discussion of or vote on any contract or arrangement entered into or to be entered into by or on behalf of the company if he is in anyway whether directly or in directly concerned or interested in the contract or arrangement. The Department of Company Affairs has clarified that the word interested as used in the section should be given a restrictive interpretation and thus excludes a Director who has no pecuniary interest. Accordingly, the relationship of the Director with the contracting party will not per se make the Director concerned or interested in the contract or arrangement.

The scope of the expression 'contract' or 'arrangement' was examined by the Madras High Court in *Madras Tube Co. Ltd. vs. Hari Krishan Somani, (1985) I Comp LJ 195 (Mad).* The question before the court was whether the appointment of an Additional Director would come within the scope of the word 'contract' or 'arrangement'. The company had four Directors. Only two of them attended the meeting. They appointed two Additional Directors who were related to them as brother and wife, respectively. The court came to the conclusion that although appointment as Director does not come within the scope of the expression 'contract' because the position of a Director may be conferred on a person by any method other than contract, became interested Directors. Without them there was no independent quorum. Consequently the appointments were a nullity.

The Bombay High Court re-examined the matter in *Shailesh Harilal Shah vs. Matushree Textiles Ltd., (1994)* and after giving due consideration to the authorities which influenced the Madras decision nevertheless came to the conclusion that the appointment as an additional Director of a person who is related to a Director does not violate the requirement of Section 300(1) because the position of a Director may be conferred on a person by any method other than contract but that it would amount to an arrangement. The attending Directors, therefore, became interested Directors. Without them there was no independent quorum. Consequently the appointments were nullity.

4. Where total number of Directors are 9 and 2 offices of the Directors have fallen vacant, we find: 1/3 of (9-2) = 1/3 of 7 = 21/3 Directors. If the fraction of 3rd were to be rounded off as one then 3, i.e. 2+1 Directors would constitute the quorum for the Board meetings. If at any time the number of the remaining Directors exceeds or is equal to two thirds of the total strength, the number of the remaining Directors who are non-interested but present at the meeting, not being less than two shall constitute the quorum. For example, there are in all 15 Directors and the Board Meeting commences with all the 15 Directors. During the commencing of the meeting, an item comes up for discussion in respect of which 13 happen to be "interested" Directors. In this case, in spite of the excess of the interested Directors being more than two-thirds, the prescribed minimum number of non-interested Directors constituting the quorum, namely, 2 present at the meeting are to transact the particular item of business.

5. **(a)** Although Section 292 empowers the Board of Directors of a company to delegate to the Managing Directors the power to invest, in general terms, the funds of the company, nevertheless because of the overriding provisions of Section 372(5) (which Section we shall discuss in detail in Study Paper 3), the transaction in the instant case would be invalid. Section 372(5) provides that no investment in shares of a company can be made by the Board of Directors of an investing company in pursuance of sub-section (2), unless it is sanctioned by a resolution passed at a meeting of the Board with the consent of all the Directors present at the meeting except those not entitled to vote thereat, and unless further notice of the resolution to be moved at the meeting has been given to every Director in the manner specified in Section 286. Since Section 372 does not provide for delegation of the power, the proposed delegation to be Managing Director in question, notwithstanding the general provision of Section 292, cannot be made.

   (b) In terms of Section 292 the Board of Directors may also delegate to the Managing Director the power to borrow money otherwise than on debentures which it can exercise only by means of resolutions passed at Board Meetings. As per Explanation to Section 292(1), it is the arrangement for an overdraft or cash credit that constitutes the exercise of the borrowing power and not the actual utilisation of the arrangement. In other words, an arrangement for an overdraft or cash credit to the tune of say Rs.5 lakhs constitutes the exercise of the borrowing power and not the actual drawing of this amount on the basis of the overdraft or cash credit. Consequently, the transaction in the instant case shall be valid. But before implementation of the proposal, the Board must pass a resolution at its meeting authorising the Managing Directors to borrow from banks money required for the purpose of the company's business. Also the resolution delegating this power shall specify the total amount outstanding at any one time up to which the delegate may borrow money.

   If, however, the moneys to be borrowed together with the money already borrowed by the company (apart from temporary loans obtained from the Company's bankers in the ordinary course of business) will exceed 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] the Board of Directors of the company in question must obtain the consent of the company in its General Meeting. Consequently, care should be taken to ensure that while delegating the power to the Managing Director the aforesaid provision has not been violated, also it should be ensured that the Memorandum of Association permits borrowing.

(c) Since according to Section 295(1), without obtaining prior approval of the Central Government in that behalf, a company cannot directly or indirectly lend money to persons including firms, in which Directors or their relatives are partners, the company in question must in the first instance seek the Central Government's approval. Secondly, since the power to make loans may be delegated under Section 292(1)(e), the Board of Directors of the company in question must pass a resolution therefore and every resolution delegating this power to the Managing Director shall specify the total amount up to which loans maybe made by the delegate, the purpose for which loans may be made and the maximum amount of loans which may be made for each such purpose in individual cases. Thirdly, by virtue of Section 291(1), the Board must see with reference to the memorandum and articles whether the company is authorised to exercise the power.

(d) Under Section 293(1)(e), the Board of Directors of a public company can contribute or donate to charitable and other funds not directly related to the business of the company or the welfare of its employees any amount the aggregate of which will not, in any financial year exceed Rs.50, 000 or 5% of its average net profits during the three financial years preceding whichever is greater. If this power of the company is not ultra virus the memorandum of the company, then only the Board can act in pursuance of the above-mentioned resolution of the company and in so acting, it can authorise the Managing Director to exercise the power on behalf of the Board.

It may be noted that the power of the Board to donate to general charities is not conditional to the existence of any profits. In such case, they may contribute up to the limit given in Section 293(1)(e).

6. (i) This transaction does not per se amount to a loan so as to violate Section 295 of the Companies Act, 1956. The burden of proving otherwise lies with the prosecution. (M.G. Electronics Components Ltd v. Asst. Registrar of Companies).

(ii) The deposit of the cost of purchase of property cannot be regarded as a loan or advance to the M.D. or book debt attracting the provisions of section 295 or section 296 of the Companies Act. It is no concern of the M.D. on what terms the company secures premises for residential accommodation for him.

(iii) In a petition in Dr. Fredie Ardeshir Mehta v. Union of India seeking quashing of a prosecution launched under Section 295, the Bombay High Court came to the conclusion that a company selling one of its flat to one of its Directors on receiving half price in cash and agreeing to accept the balance in instalments does not give a loan to the Director. It is a credit sale. It cannot continued be described even as an indirect loan. In view of this decision, the transaction in question does not amount to a loan to a Director requiring approval of the Central Government.

7. There is no prohibition contained in the Companies Act for a Director acting in the dual capacity of a Director and an employee. However, Section 314 puts a restriction for a Director while accepting office or place of profit in the company. For this purpose, the Director appointment in the office or place of profit need to be approved by the shareholders in the General Meeting. A Director however, without recourse to Section 314 can render services to the company in his professional capacity on one time basis.

8. (i) Since ABC Ltd. has not completed three years of existence on 2nd November 2007, it is not eligible to give political contribution.

(ii) Yes, because in that case, ABC limited shall complete three financial years of its existence, therefore, will be eligible to give political contribution subject to the condition that such a contravention of the provisions of this section will make a company liable to fine which may extend to three times the amount so contributed. Further every officer of the company in default would be liable to imprisonment for a term which may extend to three years and also to fine.

(iii) The amended section 293A seeks to impose an obligation on every company to disclose in its profit and loss account contributions made by it to any political party or for any political purpose. Contravention of the provisions of this section will make a company liable to fine which may extend to three times the amount so contributed. Further every officer of the company in default would be liable to imprisonment for a term which may extend to three years and also to fine.

9. Oppression: The term oppression' is not defined in the Companies Act, 1956. Oppression, according to the Dictionary meaning of the word, is any act exercised in a manner burdensome, harsh and wrongful. The meaning of the term 'oppression' was explained by Lord Cooper in the Scottish case of Elder v. Elder and Watson Ltd, as given below:

"The conduct complained of should be at the lowest involve or visible departure from the standards of fair dealing and a violation of the conditions of fair play or which every shareholder who entrusts his money to a company is entitled to rely.

(i) Oppression of a member as a Director: The oppression dealt with by section 397 is only oppression of members in their character as such; and it is only in that character they can involve section 397. The harsh treatment, for instance, of a member who is a Director or other officer or employee, by the Board of Directors or management does not come within (section 397). It has been held in *Re*. Bellador Silk Ltd. that if the majority of the Board of Directors override the minority Directors the latter cannot resort to section 397 and hence the minority Directors will not succeed in getting relief from CLB on the ground of oppression.

(ii) Right not confined to minority: According to section 399, the right to apply for relief under section 397/398 is given to 100 members or 1/10th of the total number of members or any member or members holding not less than 1/10th of the issued share capital of the company. There is nothing in this section which suggests even indirectly that unless the application is made by minority shareholders it is not maintainable.The right to apply is, therefore, not confined to oppressed minority of the shareholders alone. It was held by Calcutta High Court in *Re*. Sindhri Iron Foundry (P) Ltd. that the oppressed majority also might apply for relief under Section 397. Therefore, the petitioners are likely to succeed in getting relief provided the other condition laid down in section 397 (i.e. that to wind up the company would unfairly prejudice such members, but that otherwise the facts would justify the making of a winding-up order on just and equitable ground) is satisfied, even though the Delhi High Court held a contrary view in Suresh Kumar Sanghi v. Supreme Motors Ltd.

10. Loans, Investments and guarantees in excess of prescribed limits: As per provisions given in the sections 372 A of the Companies Act, 1956 where the aggregate of the loans and investments so far made, the amounts for which guarantee or security so far provided to or in all other bodies corporate, along with the investment, loan, guarantee or security proposed to be made or given by the Board, exceeds the aforesaid limits, no investment or loan shall be made or guarantee shall be given or security shall be provided unless previously authorised by a special resolution passed in a general meeting.

However, the Board may give guarantee, without being previously authorised by a special resolution if:

1. a resolution is passed in the meeting of the board authorising to give guarantee in accordance with the provisions of this section;
2. there exists exceptional circumstances which prevent the company from obtaining previous authorisation by a special resolution passed in a General Meeting for giving a guarantee;
3. the resolution of the Board under (1) as above is confirmed within twelve months, in a General Meeting of the company or the Annual General Meeting held immediately after passing of the Board Resolution, whichever is earlier.

11. The given problem relates to section 534 of the Companies Act,1956 as explained below:

As per Section 534, a floating charge created by the company within 12 months preceding the commencement of its winding up shall be invalid.

Exceptions-

(a) A floating charge shall not be invalid where it is proved that the company was solvent immediately after the creation of the charge.

(b) A floating charge shall be valid upto the amount of any cash paid to the company (whether at the time of creation of charge or thereafter) as a consideration for the charge. Also, interest shall be allowed on that amount at the rate of 5% per annum or such other rate as may be notified by the Central Government in the Official Gazette.

12. In case of a winding up by the court, the winding up shall be deemed to have commenced at the time of presentation of the petition for the winding up. Thus, where a petition is made to the court and the court orders the winding up, the order relates back to the date of the presentation of the petition.

As per the section 531, a transaction shall be deemed to be a fraudulent preference and consequently invalid if all the following conditions are fulfilled:

(a) The transaction relates to transfer of property, delivery of goods, payment of money or other act relating to the property of the company.

(b) It took place within 6 months before the commencement of the winding up of the company.

(c) It was an entirely voluntary act and not made under any pressure.

(d) The dominant motive was to give a creditor a preference over other creditors.

In the given case, the winding up of M/s PQR Ltd. commenced on 31st December 2008 that is the date of presentation of petition of winding up. M/s PQR Ltd. mortgaged its machinery in favour of the creditor on 1st August 2008, i.e.,within the 6 months before the commencement of winding up. The mortgage was made voluntarily by the company, without any consideration, and not under any pressure. Thus, the dominant motive behind the transaction was to give the preference to the creditor over the others. Since all the requirements of Section 531 are satisfied in the given case, the mortgage of the machinery made in the favour of the creditor amounts to fraudulent preference, and is therefore void. Therefore, the decision of the official liquidator to declare the mortgage in favour of creditor as void, is correct.

13. As per Section 617 ,Government Company means -

Any company in which not less than fifty-one percent of the paid-up share capital is held by the Central Government and partly by any State Government or Government or partly by the Central Government and partly by one or more State Governments. It also includes a company, which is a subsidiary of a Government company as thus defined.

As per Section 619 B ,the provisions relating to audit of Government Companies shall apply to a company in which not less than 51% of the paid up share capital is held by one or more corporations owned or controlled by the Central Government or the State Government.

Thus in the given problem the paid up share capital of XYZ Ltd. is Rs.10 crores (Paid up capital includes both equity share capital and preference share capital). Rs. 5.5 crores of paid up share capital of XYZ Ltd. is held by UTI and IDBI .However no share in XYZ Ltd. is held by the Central Government or any State Government and therefore XYZ Ltd. is not a Government Company.

UTI and IDBI are the corporations owned by the Central Government, which hold more than 51% of the paid up capital of XYZ Ltd. Therefore, the appointment of auditors of XYZ Ltd. will be made in the same manner in which auditors of a Government Company are appointed, i.e., the appointment of auditors shall be made by the Comptroller and Auditor General of India and the remuneration of auditors shall be determined in the General Meeting

14. As per Section 591, a company shall be a Foreign Company if-

(a) Company is incorporated in foreign countries/outside India; and

(b) have offices and places of business in India .

As per the above provision in the given problem a share transfer office or share registration office constitutes a place of business (section 602). Since, the company incorporated outside India has a share registration at Hyderabad, it is clear that the company has established a place of business in India and is therefore a Foreign Company.

15. Sections 417 Companies Act, 1956 deal with the Employees' Securities and Provident Funds which seeks to ensure that any money or security given by an employee to the company is not invested in the business of the company. Section 417 provides that-

Any money or security deposit made by an employee of a company under the terms of his contract of services, must be kept or deposited by the company within 15 days from the date of deposit in a Post Office Savings Bank Account or in a special account to be opened with the State Bank of India or a Scheduled Bank or, where the company itself is a Scheduled Bank, in a special account to or be opened by it at or with the State Bank of India or any other Scheduled Bank.

The Company must not utilise any portion of such moneys or securities except for the purposes agreed to, in the contracts of service.

16. Appointment of Sole Selling Agent**:** Section 294 and 294AA of the Companies Act, 1956 regulate the appointment of sole selling agents. These sections provide that:

1. No company shall appoint a sole selling agent for any areas for a term exceeding 5 years at a time and the term may be extended for another period but not exceeding 5 years on each occasion. [Section 294(1)].
2. The Board of Directors may appoint a sole selling agent but only subject to the condition that the appointment shall cease to be valid if it is not approved by the company in the first general meeting held after the date on which the appointment is made. In case, the company in General Meeting, as aforesaid, disapproved the appointment, it shall cease to be valid with effect from the date of that General Meeting [Section 294(2) and (2A)].
3. Where the Central Government is of opinion that the demand for goods of any category, to be specified by that government is substantially in excess of the production or supply of such goods and the services of sole selling agents will not be necessary to create a market for such goods, the Central Government may by notification in the Official Gazette, declare that sole selling agents shall not be appointed by a company for the sale of such goods, for such period, as may be specified in the declaration.
4. No company shall appoint any individual firm or body corporate, who or which has a substantial interest in the company as sole selling agent of that company unless such appointment has been previously approved by the Central Government.
5. A company having a paid-up share capital of Rs.50 lakhs or more shall not appoint a sole selling agent except with the consent of the company accorded by a special resolution and the approval of the Central Government.
6. The Central Government may vary the terms and condition of appointment of a sole selling agent if those are found to be prejudicial to the interest of the company.
7. In case a company has more than one selling agents in any area, the Central Government may declare any one of such agents as the sole selling agent for such area after obtaining from the company and considering the terms and conditions of appointment of the selling agents.

   Procedure for appointment of sole selling agents**:**

   1. Call a meeting of the Board of Directors and determine the name of the sole selling agent to be appointed. If the paid-up share capital of the company is less than Rs.50 lakhs and the appointee does not have a substantial interest in the company, the Board may also resolve to appoint him as sole selling agent subject to the approval of the general body meeting. Date for the general

meeting may also be fixed by the Board in its meeting, appointing the sole selling agent.

2. In case the appointee either has a substantial interest in the company, or the paid-up share capital of the company is Rs.50 lakhs or more, application for the approval of the Central Government should be made in Form 1 of the Companies (Appointment of Sole Agents) Rules, 1975.
3. See that the terms and conditions of appointment or reappointment do not contain the tenure exceeding 5 years, at a time.
4. Issue of notices for holding the General Meeting. Where the paid-up share capital of the company is Rs.50 lakhs or more, it shall require passing a special resolution; otherwise an ordinary resolution shall be sufficient.
5. Forward three copies of the notices and a copy of the proceedings of the General Meeting to the Stock Exchange(s) with which the shares of the company are listed (if listed).
6. If the proposed sole selling agent is to be appointed in a foreign country, he must obtain the prior permission of the RBI.

Thus applying the above provisions in the first part of the question the appointment of Mr. Kumar is not in order, as there have been a number of violation on the part of the company as per the Companies Act, 1956. Appointment without the approval of the general meeting and without the approval of the Central Government is not valid since the company's paid-up share capital is more than Rs.50 lakhs in this case. Moreover, since Mr. Kumar has substantial interest in the company, approval of Central Government in Form 1 is must. Thus, the appointment of Mr. Kumar is not in order.

In the second part of the question, the answer would not be different, as the capital (paid-up share capital) is more than 50 lakhs Rupees. In this case though the appointee (Mr. Kumar) does not have substantial interest, but the company's paid share capital is more than 50 lakhs, consent of the company in General Meeting (special resolution) and the approval of the Central Government is required

17. Section 581 ZP deals with cancellation of registration of a Producer Company. The provisions of section 581 ZP are explained as follows:

If a Producer Company fails to commence business within one year of its registration or ceases to transact business with the member or if the Registrar is satisfied, after making such inquiry as he thinks fit, that the Producer Company is not carrying any of its objects specified in Section 581B, he shall make an order striking off the name of the producer company, which shall thereupon cease to exist forthwith.

No such order cancelling the registration as aforesaid shall be passed until a notice to show cause has been given by the Registrar to the Producer Company with a copy to all its Directors on the proposed action and reasonable opportunity to represent its case has been given.

Where the Registrar has reasonable cause to believe that a Producer Company is not maintaining any of the mutual assistance principles specified, he shall strike its name off the register in accordance with the provisions contained in Section 560 of this Act.

Any member of a producer company, who is aggrieved by an order made under this Section, may appeal to the Company Law Board (Tribunal) within sixty days of the order. After disposing the appeal, if any, the order to striking off the name shall take effect.

18. Mr. Z had resided in India during financial year 2007-2008 for more than 182 days. Further, he has gone to UAE for Treatment of his father. In otherwords, he has not gone out of, or stayed outside India for or on taking up employment, or for carrying a business or any other purpose, in not circumstances as would indicate his intention to stay outside India for an uncertain period. Accordingly he would be 'person resident in India' during the financial year 2008-2009.

For the financial year 2009-2010, he would not have been in India in the preceding financial year (2008-2009) for period exceeding 182 days. Accordingly, he would not be 'person resident in India' during the financial year 2009-2010.

19. Holding of foreign exchange (Section 4)

No person resident in India shall acquire, but, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India.

This section restricts a resident in India from acquiring, holding, owing, possessing or transferring in any manner foreign exchange, foreign security or any immovable property situated outside India. However the acquisition of such immovable property outside India on lease for a period not exceeding five years is permissible provided such transactions are not specifically prohibited.

In terms of regulations relating to acquisition and transfer of immovable property outside India, such acquisition by a person resident in India would require prior approval of Reserve Bank except in the following cases:

- Property held outside India by a foreign citizen resident in India;
- Property acquired by a person on or before 8th July, 1947 and held with the permission of Reserve Bank;
- Property acquired by way of gift or inheritance from persons referred to in above
- Property purchased out of funds held in RFC account.

20. Section 11D empowers SEBI to pass an order requiring a person to cease and desist from committing or causing the violation of the act or rules made thereunder. SEBI may pass a cease and desist order by complying with the following two requirements:

(a) SEBI shall cause an inquiry to be made to determine whether any person has violated, or is likely to violate, any provisions of this act or any rules or regulations made thereunder.

(b) SEBI shall not pass a cease and desist order against any listed company or a public company which intends to get its securities listed on any recognized stock exchange, unless it has reasonable ground to believe that such company has indulged in insider trading or market manipulation

21. (a) "Green Shoe Option" means an option of allotting equity shares in excess of the equity shares offered in the public issue as a post-listing price stabilizing mechanism .

(b) "Designated Stock Exchange" means a stock exchange in which securities of the company are listed or proposed to be listed and which is choosen by the company for purposes of a particular issue under these guidelines.

Provided that where any of such stock exchange have a nation wide trading terminals, the company shall choose on e of them as the designated stock exchange.

Provided further that the company may choose a different exchange as a designated stock exchange for any subsequent issue, subject to the above clause.

(c) "Book Building" means a process undertaken to elicit demand and to assess the price for determination of the quantum or value of specified securities or Indian Depository Receipts, as the case may be, in accordance with these regulations;

(d) "Composite Issues" means an issue of securities by a listed company on a public cum rights basis offered through a single offer document wherein the allotment for both public and rights components of the issue is proposed to be made simultaneously.

22. **(i)** (a) "Cartel" includes an association of producers, sellers, distributors, traders or service providers who, by agreement amongst themselves, limit, control or attempt to control the production, distribution, sale or price of, or, trade in goods or provision of services;

The term cartel like agreement has been given an inclusive meaning. Thus an association for the welfare of the trade or formed for any other purpose not mentioned in the aforesaid definition will not be a cartel. It is only when an association, by agreement amongst themselves, limits control or attempts to control the production, distribution, sale or price of, or, trade in goods or provision of services, that it will be a cartel[Section2(c)].

(b) "Relevant Product Market" means a market comprising all those products or services which are regarded as interchangeable or substitutable by the consumer, by reason of characteristics of the products or services, their prices and intended use;

It is an area in which the sellers of particular product or service providers operate. This type of market may be local, national, or international. It involves identification of geographical areas within which competition take place. [Section 2(t)].

(c) "Service" means service of any description which is made available to potential users and includes the provision of services in connection with business of any industrial or commercial matters such as banking, communication, education, financing, insurance, chit funds, real estate, transport, storage, material treatment, processing, supply of electrical or other energy, boarding, lodging, entertainment, amusement, construction, repair, conveying of news or information and advertising.[Section 2(u)].

(d) "Price", in relation to the sale of any goods or to the performance of any services, includes every valuable consideration, whether direct or indirect, or deferred, and includes any consideration, which in effect relates to the sale of any goods or to the performance of any services although ostensibly relating to any other matter or thing.[Section 2(o)].

(ii) As per section 2(i),'goods' means goods as defined in the Sale of Goods Act,1930, and includes-

(a) products manufactured, processed or mined;

(b) debentures, stocks and shares after allotment; and

(c) goods imported in India.

Thus, 'shares after allotment' are goods, but 'shares before allotment' are not goods

23. (a) Competition Fund-There shall be constituted a fund to be called the "Competition Fund" and shall be credited thereto—

(a) all Government grants received by the Commission;

(b) the monies received as costs from parties to proceedings before the Commission;

(c) the fees received under this Act;

(d) the interest accrued on the amounts referred to in clauses (a) to (c).

The Fund shall be applied for meeting:—

(a) the salaries and allowances payable to the Chairperson and other Members and the administrative expenses including the salaries, allowances and pension payable to the Director General, Additional, Joint, Deputy or Assistant Directors General, the Registrar and" officers and other employees of the Commission;

(b) the other expenses of the Commission in connection with the discharge of its functions and for the purposes of this Act.

The Fund shall be administered by a committee of such Members of the Commission as may be by the Chairperson. The committee appointed under sub-section (3) shall spend monies out of the Fund for carrying out the objects for which the Fund has been constituted.[Section 51]

(b) Accounts and Audit

The Commission shall maintain proper accounts and other relevant records and prepare an annual statement of accounts in such form as may be prescribed by the Central Government in consultation with the Comptroller and Auditor-General of India.

The accounts of the Commission shall be audited by the Comptroller and Auditor-General of India at such intervals as may be specified by him and any expenditure incurred in connection with such audit shall be payable by the Commission to the Comptroller and Auditor-General of India.

However, the orders of the Commission, being matters appealable to the Supreme Court, shall not be subject to audit under this section.

The Comptroller and Auditor-General of India and any other person appointed by him in connection with the audit of the accounts of the Commission shall have the same rights, privileges and authority in connection with such audit as the Comptroller and Auditor-General of India generally has, in connection with the audit of the Government accounts and, in particular, shall have the right to demand the production of books, accounts, connected vouchers and other documents and papers and to inspect any of the offices of the Commission.

The accounts of the Commission as certified by the Comptroller and Auditor-General of India or any other person appointed by him in this behalf together with the audit report thereon shall be forwarded annually to the Central Government and that Government shall cause the same to be laid before each House of Parliament. [Section 52]

24. Withdrawal of Recognition:

As per Section 5 of the Securities Contracts (Regulation) Act,1956,Central Government is empowered to withdraw the recognition granted to a stock exchange.

The procedure for withdrawal of recognition is as follows:

If Central Government is of the opinion that recognition given to an Exchange must be withdrawn, it may withdraw the recognition after serving due notice on governing Board of the Exchange. Withdrawal however will not affect validity of Contracts entered into before the date of withdrawal notification. [Sub-section 1].

Sub-section 2 provides that, Where the recognised stock exchange has not been corporatised or demutualised or it fails to submit the scheme referred to in sub-section (1) of section 4B within the specified time therefore or the scheme has been rejected by the Securities and Exchange Board of India under sub-section (5) of section 4B, the recognition granted to such stock exchange under section 4, shall, notwithstanding anything to the contrary contained in this Act, stand withdrawn and the Central Government shall publish, by notification in the Official Gazette, such withdrawal of recognition:

Provided that no such withdrawal shall affect the validity of any contract entered into or made before the date of the notification, and the Securities and Exchange Board of India may, after consultation with the stock exchange, make such provisions as it deems fit in the order rejecting the scheme published in the Official Gazette under sub-section (5) of section 4B."

25. (a) Rules of Interpretation/Construction of Deeds and Documents

The first and foremost point that has to be borne in mind is that one has to find out what a reasonable man, who has taken care to inform himself of the surrounding circumstances of a deed or a document, and of its scope and intendments, would understand by the words used in that deed or document.

It is inexpedient to construe the terms of one deed by reference to the terms of another.

Further, it is well established that the same word can not have two different meanings in the same document, unless the context compels the adoption of such a rule.

The Golden Rule is to ascertain the intention of the parties to the instrument after considering all the words in the document/deed concerned in their ordinary, natural sense. For this purpose, the relevant portions of the document have to be considered as a whole. The circumstances in which the particular words had been used have also to be taken into account. Very often, the status and training of the parties using the words have also to be taken into account as the same words may be used by a ordinary person in one sense and by a trained person or a specialist in quite another in a special sense. It has also to be considered that very many words are used in more than one sense. It may happen that the same word understood in one sense will give effect to all the clauses in the deed while taken in another sense might render one or more of the clauses ineffective. In such a case the word should be understood in the former and not the latter sense.

It may also happen that there is a conflict between two or more clauses of the same document. An effort must be made to resolve the conflict by interpreting the clauses so that all the clauses are given effect to. If, however, it is not possible to give effect to all of them, then it is the earlier clause that will over-ride the latter one.

Similarly, if one part of the document is in conflict with another part, an attempt should always be made to read the two parts of the document harmoniously, if possible. If that is not possible, then the earlier part will prevail over the latter one which should, therefore, be disregarded.

(b) Resolution: The word 'resolution', is 'a formal proposal put before a public assembly or the formal determination of such proposal on any matter'. Derived from this meaning, a resolution is a formal agreement as to adoption of proposal put before an assembly of persons or meeting. In the context of company management, it is either a Board meeting or a General meeting of the members. The passing of a resolution should be construed as the manner in which a meeting formally acts expressing the intent and purpose of the meeting and if it is a meeting of members, it means the will of the company, and if it is a meeting of the Board of Directors, it means the exposition of the intent of the executive action initiated or to be initiated subject to the limiting and regulatory force of the different statute.

Draft of an Ordinary Resolution on winding up of the company by Court under Section 433:

Whereas the company has been incurring continued losses for the past several years and WHEREAS the assets of the company are insufficient to meet the liabilities and WHEREAS it is no longer possible to run the company except at a loss. Now therefore it is Resolved that the company be wound up by the Hon'ble High Court at Bombay, which will become effective from the date the Court declares the company to be wound up by such Court and that the Board of Directors be and is hereby authorised to make necessary applications therefor and take action for the winding up of the company by the said Court.