PRIME ACADEMY
30th SESSION MODEL EXAM – FINANCIAL REPORTING
QUESTION PAPER

Total No. of Questions: 6 **Total No. of Printed Pages: 6**
Time Allowed: 3 Hrs **FRG** **Maximum Marks: 100**

Answer all Questions
Working Notes should form part of the answers

1. The Balance Sheet as at 31st March 2009 of Sickness Ltd. was as under

Liabilities	Rs.	Assets		Rs.
Share Capital		Fixed Assets		
8,000 Equity Shares of Rs.100 each, Rs.50 per share paid up	4,00,000	Goodwill at cost	40,000	
		Others	8,50,000	
			8,90,000	
		Less: Depreciation	2,70,000	
4,000 11% cumulative pref. shares of Rs.100 each full paid up	4,00,000			6,20,000
		Investments		25,000
	40,000	Stock in Trade		2,10,000
	60,000	Sundry Debtors		2,55,000
Premium received on pref. shares	3,10,000	Cash & Bank Balances		1,00,000
General Reserve				
Current Liabilities				
Contingent liability not provided				
Preference dividends are in arrears for three years including the year ended 31st March 2009				
	12,10,000			12,10,000

The funds of the Company are sufficient to discharge its liabilities including Preference Dividends in arrears. However the company does not want to deplete its resources. It would also like to reflect the values of some of its assets in a realistic manner. The Board of Directors of the Company decided and proposed the following scheme of rehabilitation / reconstruction to be effective from 1st April 2009

(i) The cumulative preference shareholders are to be issued, in exchange of their holdings, 13% Debentures of the face value of Rs.100 each at a premium of 10%. Fractional holdings are to be paid off in cash.

(ii) Arrears in preference dividends to be converted into equity shares of Rs.100, Rs.50 per share paid up.

(iii) After the issue of the equity shares mentioned in (ii) above, the paid up value of all the equity shares is to be reduced to Rs.25 each.

(iv) The face value of all the equity shares to be reduced to Rs.50 each and the balance of the unpaid portion is to be called up fully.

(v) Goodwill has lost its value and has to be written off. Market value of other fixed assets is determined as at 31st March 2009 at Rs. 5, 00,000.

(vi) Investments have no market value and have to be written off.

(vii) Stock in trade is to be valued at 110% of its book value and Sundry debtors are to be discounted by 5%.

The scheme, as approved by the Directors, is duly accepted by all authorities and put into effect.

During the working for the half year ended 30th September 2009, it is noticed that the trading for the period has resulted in an increase of bank balances of Rs.55,100, Sundry Debtors by Rs.40,000. Trade Creditors by Rs.26,000 and a decrease in stock by Rs. 8,000. Depreciation for the half year on fixed assets at 10% per annum is to be provided. The increase in the bank balances was prior to the company paying the half yearly interest on the debentures and redeeming one half of the debentures on 30th September 2009.

From the above information, you are required: To prepare the Balance Sheet of Sickness Ltd. as on 30th September 2009.

All working notes, including journal entries, ledger accounts etc. are to form part of your answer. (20 Marks)

2. On 1st January 2007, A Ltd. acquired 8,000 shares of Rs.10 each of B Ltd. of Rs.90, 000. The respective Balance Sheets as on 31st December 2009 are given below:

Liabilities	*A Ltd Rs.*	*B Ltd Rs.*	*Assets*	*A Ltd Rs.*	*B Ltd Rs.*
Share Capital (Rs.10)	1,00,000	1,00,000	Fixed Assets	60,000	1,10,000
			Investments	1,00,000	15,000
Reserve	40,000	26,000	Debtors	25,000	20,000
Profit & Loss A/	36,000	35,000	Stock	30,000	40,000
Creditors	71,000	48,000	Bank	32,000	24,000
	2,47,000	2,09,000		2,47,000	2,09,000

Additional Information

(1) At the time of acquiring shares, B Ltd. had Rs.24, 000 in Reserve and Rs.15, 000 in Profit and Loss Account.

(2) B Ltd. paid 10% dividend in 2007, 12% in 2008, 15% in 2009 for 2006, 2007 and 2008 respectively. All dividends received have been credited to the Profit and Loss Account of A Ltd.

(3) Proposed Dividend of both the companies for 2009 is 10%.

(4) One bonus share of 5 fully paid shares held has been declared by B Ltd. out of pre acquisition reserve on 31st December 2009. No effect has been given to that in the above accounts.

(5) On 1st January 2007, Building of B Ltd. which stood in the books at Rs.50,000 was revalued at Rs.60,000, but no adjustment has been made in the books. Depreciation has been charged @ 10% per annum on reducing balance method.

(6) In 2009, A Ltd. purchased from B Ltd. goods for Rs.10,000 on which B Ltd. made a of 20% on sales, 25% of such goods are laying unsold on 31st December 2009.

Prepare the Consolidated Balance Sheet as at 31st December 2009. (16 Marks)

3(a) While closing its books of account on 31st March 2009, a Non Banking Finance Company has its advances classified as follows:

	Rs. In lakhs
Standard Assets	16,800
Sub-standard assets	1,340
Secured positions of doubtful debts	
Upto one year	320
One year to three years	90
More than three years	30
Unsecured portions of doubtful debts	97
Loss assets	48

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

(8 Marks)

3. (b). Anischit Finance Ltd. in non-banking finance company, it makes available to you the costs and market price of various investments held it as on 31.03.2008.

		Cost Rs.P	Market Price Rs.P
A.	Equity Shares		
	A	60.00	61.20
	B	31.50	24.00
	C	60.00	36.00
	D	60.00	120.00
	E	90.00	105.00
	F	75.00	90.00
	G	30.00	6.00
B.	Mutual Funds		
	MF-1	39.00	24.00
	MF-2	30.00	21.00
	MF-3	6.00	9.00
C.	Government Securities		
	GV-1	60.00	66.00
	GV-2	75.00	72.00

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

(ii) What should be the value of investments as on 31.3.2008?

(iii) Is it possible to off-set depreciation in investment in mutual funds against appreciation of the value of investment in equity shares and government securities? (8 Marks)

4. The following is the Balance Sheet of Star and Co. Ltd. as at 31st December 2009.

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	
Equity Shares of Rs.100	10,00,000	Goodwill	1,00,000
each	1,00,000	Machinery	5,00,000
Less: Calls in arrears	9,00,000	Factory Shed	5,50,000
(Rs.20 for final call)		Vehicle	1,50,000
		Furniture	50,000
10% Preference Shares of	4,00,000	Investments	2,00,000
Rs.10 each fully paid		Current Assets	
		Stock in Trade	4,00,000
Reserves and Surplus	4,00,000	Sundry Debtors	7,00,000
General Reserve	3,00,000	Cash at Bank	1,00,000
Profit & Loss Account		Miscellaneous Expenditure	
		Preliminary Expenses	50,000
Current Liabilities	2,00,000		
Bank Loan	6,00,000		
Sundry Creditors			
	28,00,000		28,00,000

Additional Information is as under:

(i) Fixed Assets are worth 20% above their book value. Depreciation on appreciated value of fixed assets not to be considered for valuation of goodwill.

(ii) Of the investment, 60% is non trading and the balance is trading. All trade investments are to be valued at 25% above cost. A uniform rate of dividend @ 15% is earned on all investments

(iii) For the purpose of valuation of shares, goodwill is to be considered on the basis of 4 years purchase of super profits based on average profit (after tax) of the last 3 years.
Profits (after tax) are as follows:

	Rs.
2007	4, 00,000
2008	4, 30,000
2009	4, 50,000

In a similar business, return on capital employed is 15% (after Tax).

(iv) In 2007 new machinery costing Rs.20,000 was purchased but wrongly charged to revenue (no effect has yet been given for rectifying the same).
Depreciation charged on machinery is @ 10% on reducing balance method.

Find out value of each fully paid and partly paid equity share on net assets basis. (16 Marks)

5. From the following Profit & Loss Account of Brightex Co. Ltd. prepare a gross value added statement for the year ended 31.12.2009. Show also the reconciliation between gross value added and profit before taxation.

Profit and Loss Account for the year ended 31.12.2009

	Notes	(Rs. 000)	(Rs. 000)
Income:			
Sales			6,240
Other Income			55

			6,295
Expenditure:			
Production and Operational expenses	1	4,320	
Administration Expenses (Factory)	2	180	
Interest & other charges	3	624	
Depreciation		16	
		--------	5,140

Profit before tax			1,155
Provision for taxation			55

			1,100
Balance as per last Balance Sheet			60

			1,160
Transferred to fixed assets replacement reserve		400	
Dividend paid		160	
		560	

Surplus carried to balance sheet			600

Note:

1. Production & Operational Expenses

Consumption of raw materials	3,210
Consumption of stores	40
Local Tax	8
Salaries to administrative staff	620
Other manufacturing expenses	442

	4,320
	--------

2. Administration expenses include salaries and commission to directors

3. Interest on other charges includes:

   a) Interest on bank overdraft (Overdraft is of temporary nature)
   b) Fixed loan from ICICI
   c) Working capital loan from IFCI
   d) Excise duties amount to one-tenth of total value added by manufacturing and

Trading activities

(16 Marks)

6 (a) On 3.6.2007, Asmitha Limited incurred Rs.2,00,000 net loss from disposal of a business segment. Also on 30.7.2007, the company paid Rs.60,000 for property taxes assessed for the calendar year 2007. How the above transactions should be included in determination of net income of Asmitha Ltd. for the six months interior period ended on 30.9.2007. (4 Marks)

6 (b) Himalayas Ltd. is showing an intangible Asset at Rs.72 lakhs on 01.04.2007 and that item was required for Rs.96 lakhs on 01.04.2004 And that item was available for use from that date. Himalayas Ltd. has been following the policy of amortization of the intangible asset over a period of 12 years on straight line basis. Comment on the accounting treatment of the above with reference to relevant accounting standard.

(4 Marks)

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

From the above data:

(i) Calculate impairment loss

(ii) Prepare journal entries for adjustment of impairment loss

(iii) Show, how impairment loss will be shown in the Balance Sheet. (4 Marks)

6. (d) Mr. Investor buys a stock option of ABC Ltd. in July 2006 with a strike price Rs.250 to be expired on 30th August 2006. The premium is Rs.20 per unit and the market lot is 100. The margin to be paid is Rs.120 per unit.

Show the accounting treatment in the books of Buyer when:

(i) The option is settled by delivery of the asset, and

(ii) The option is settled in cash and the Index price is Rs.260 per unit. (4 Marks)

PRIME ACADEMY
30th SESSION MODEL EXAM – FINANCIAL REPORTING
SUGGESTED ANSWERS

1. **Sickness Ltd.**

Balance Sheet as at 30th September 2009

Liabilities	Rs	Assets		Rs
Share Capital		**Fixed Assets**		
10,640 Equity shares of Rs.50		Gross	5,00,000	
each fully paid	5,32,000	Less : Depreciation	25,000	
				4,75,000
Reserves and Surplus				
Share Premium A/c	40,000	**Current Assets**		
Premium on issue of	36,360	Stock in Trade		2,23,000
Debentures A/c	57,250	Sundry Debtors		2,82,250
General Reserve	12,466	**Cash and Bank**		2,15,626
Profit & Loss A/c				
Secured Loans	1,81,800			
13 % Debentures	3,36,000			
Current Liabilities				
	11,95,876			**11,95,876**

Working Notes:

(1) Journal Entries

			Rs.	Rs.
(i)	11% Cumulative Preference Share Capital A/c	Dr.	4,00,000	
	To 13% Debentures A/c			3,63,600
	To Premium on Issue of Debentures A/c			36,360
	To Cash and Bank A/c			40
	(Issue of 3,636, 13% debentures of Rs.100 each at a premium of Rs.10 to cancel 4,000 11% cumulative preference shares of Rs.100 each, fraction Rs.40 was paid in cash)			
(ii)	Capital Reduction A/c	Dr.	1,32,000	
	To Equity Shares Capital A/c			1,32,000
	(Issue of 2,640 equity shares of Rs.100 each Rs.50 paid up for arrear preference dividend)			
(iii)	Equity Share Capital A/c	Dr.	2,66,000	
	To Capital Reduction A/c			2,66,000
	(Reduction of paid up value of Rs.10,640 equity shares of Rs.100 each, Rs.50 paid up to shares of Rs.50 each, Rs.25 paid up)			
(iv)	Cash and Bank A/c	Dr.	2,66,000	
	To Equity Share Capital A/c			2,66,000
	(Call money on 10,640 Equity shares @ Rs.25 to make the equity shares fully paid up)			
(v)	Capital Reduction A/c	Dr.	1,57,750	
	To Goodwill A/c			40,000
	To Investment A/c			25,000

	To Fixed Assets A/c (Rs.8,50,000-Rs.2,70,000)-Rs.5,00,000		80,000
	To Sundry Debtors A/c (Value of Sundry assets written down)		12,750
(vi)	Stock A/c Dr.	21,000	
	To Capital Reduction A/c (Value of Stock written up)		21,000
(vii)	General Reserve A/c Dr.	2,750	
	To Capital Reduction A/c (Transfer from General Reserve)		2,750

(2) Ledger Accounts:

Capital Reduction A/c

	Rs.			Rs.
To Equity Share Capital A/c To Sundries	1,32,000 1,57,750		By Equity Share Capital A/c By Stock By General Reserve	2,66,000 21,000 2,750
	2,89,750			2,89,750

Cash and Bank A/c

	Rs.			Rs.
To Balance B/d To Equity Share Capital A/c	1,00,000 2,66,000		By 11%Cumulative Preference Shares A/c By Balance C/d	40 3,65,960
	3,66,000			3,66,000

(3) Balance Sheet (after internal reconstruction)

Liabilities	**Rs.**	**Assets**	**Rs.**
Share Capital 10,640 Equity shares of Rs.50 each fully paid	 5,32,000	**Fixed Assets** **Current Assets** Stock in Trade Sundry Debtors **Cash and Bank**	5,00,000 2,31,000 2,42,250 3,65,900
Reserves and Surplus Share Premium A/c Premium on issue of Debentures A/c General Reserve	 40,000 36,360 57,250		
Secured Loans 13 % Debentures **Current Liabilities**	3,63,600 3,10,000		
	13,39,210		**13,39,210**

(4) Half Yearly

	Rs.	Rs.
Increase in bank balances	55,100	
Increase in sundry debtors	40,000	
	-----------	95,100
Less: Decrease in stock	8,000	
Increase in Trade creditors	26,000	
	----------	34,000

Trading Profit before interest and depreciation		61,100

Less : Interest for ½ year @ 13% on Rs.3,63,600	23,634	
Depreciation for ½ year on Rs.5,00,000 @ 10% p.a.	25,000	
	-----------	48,634

Net Profit		12,466
		------------

(5) Cash and Bank Balance as on 30.09.2009

	Rs.	Rs.
Balance as on 31.3.2009		3,65,960
Add : Increase		55,100

		4,21,060
Less : Interest	23,634	
Redemption of half of 13% debentures	1,81,800	
	-------------	2,05,434

		2,15,626
		-------------

2. Consolidated Balance Sheet of A Ltd. & its subsidiary B Ltd. as on 31st December 2009

Liabilities	Rs.	Rs.		Assets	Rs.	Rs.
Share Capital		1,00,000		**Fixed Assets**		
(each fully paid)				A Ltd.	60,000	
Capital Reserve		29,200		B Ltd.	1,20,000	
On Consolidation					1,80,000	
				Less : Depreciation	2,710	
Reserve						1,77,290
A Ltd.	40,000			**Investment**		
B Ld.	1,600			A Ltd.	10,000	
		41,600		B Ltd.	15,000	
Profit & Loss A/c		39,332				25,000
Sundry Creditors				**Debtors**		
A Ltd.	71,000			A Ltd.	25,000	
B Ltd.	48,000			B Ltd.	20,000	45,000
		1,19,000				
Minority Interest		33,658		**Stock**		
Proposed Dividend		10,000		A Ltd.	30,000	
				B Ltd.	40,000	
					70,000	
				Less:Reserve	500	69,500
				Bank		
				A Ltd.	32,000	
				B Ltd.	24,000	
						56,000
		3,72,790				**3,72,790**

Working Notes:

(i) Analysis of Profits

		Capital Profit Rs.	Revenue Reserve Rs.	Revenue Profits Rs.
Reserves on 1.1.2007		24,000		
Increase in Reserve			2,000	
Profit & Loss on 1.1.2007	15,000			
Less: Div for 2006	10,000			
	----------	5,000		
Appreciation in Building		10,000		
Increase in profit after Div in 2007, 2008 and 2009 (35,000-5,000)	30,000			
Less : Dep.@ 10% on WDV method on appreciation in building 1,000+900_+810	2,710			
	----------			27,290
		-----------	-----------	-------------
		39,000	2,000	27,290
Minority Interest @ 20%		7,800	400	5,458
		-----------	-----------	------------
		31,200	1,600	21,832
		-----------	-----------	-------------

(ii) Cost of Control / Capital Reserve

Cost of Investments		90,000
Less : Dividend for 2006		8,000

		82,000
Paid up value of shares	80,000	
Capital Profits	31,200	
	------------	1,11,200

		29,200

(iii) Minority Interest

Share Capital	20,000
Capital Profit	7,800
Revenue Reserve	400
Revenue Profit	5,458

	33,658

(iv) Profit & Loss A/c - A Ltd.

Balance	36,000
Less: Dividend for 2006 credited to investments	8,000

	28,000
Add: Revenue Profit for B Ltd.	21,832

	49,832
Less: Stock Reserve 20% on 2,500	500

	49,332
(Equal to 100% of unrealized profit)	
Less: Proposed Dividend	10,000

	39,332

3(a) Calculation of provision required on advances as on 31st March 2005.

	Amount Rs in lakhs	Percentage of provision	Provision Rs in lakhs
Standard assets	16,800	NIL	NIL
Sub-standard assets	1,340	10	134
Secured portions of doubtful debts			
Upto one years	320	20	64
One year to three years	90	30	27
More than three years	30	50	15
Unsecured portions of doubtful debts	97	100	97
Loss assets	48	100	48

			385

3(b) Quoted current investments for each category shall be valued at cost or market value, whichever is lower. For this purpose, the investments in each category shall be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored. Therefore, depreciation of a particular item of investments can be adjusted within the same category of investments.

Value of investments as on 31.03.2008

Type of Investment	Valuation Principle	Value, Rs. In lakhs
Equity Shares (Aggregated)	Lower of cost or market value	406.50
Mutual Funds	NAV (Market value assumed)	54.00
Government securities	Cost	135.00

		595.50

As per para 14 of AS 13 “Accounting for Investments” the carrying amount for current investments is the lower of cost and market price. Sometimes, the concern of an enterprise may be with the value of a category of related current investments and not with each individual investment and accordingly, the investments may be computed at the lower of cost and market value computed category wise.

Inter category adjustments of depreciation and depreciation in values of investments cannot be done. It is not possible to offset depreciation in investment in mutual funds against appreciation of the value of investments in equity shares and government securities.

4. Statement showing valuation of shares

	Rs.	Rs.
Net Tangible Assets (as per working note1)	20,17,496	
Less: Preference Capital	4,00,000	
	---------------	16,17,496
Add: Goodwill (as per working note 2)		4,69,892
Add: Non Trade Investment at cost		1,20,000
Add: Call in arrear (notional)		1,00,000

		23,07,388

No. of Equity Shares	10,000	
Value of a fully paid share	230.74	
Value of a partly paid share (230.74 - 20)	210.74	

Working Notes

(1) Computation of Net Tangible operating assets on 31st December 2009

	Rs.	Rs.
Machinery		5,00,000
Factory Shed		5,50,000
Vehicles		1,50,000
Furniture		50,000
Machinery - New Machinery purchased in 2007	20,000	
Less: Depreciation (see note below)	5,420	
	-----------	14,580

		12,64,580
Add: Appreciation 20%		2,52,916

		15,17,496
Trade Investment (80,000 + 20,000)		1,00,000
Stock in Hand		4,00,000
Sundry Debtors		7,00,000
Cash at Bank		1,00,000

		28,17,496
Less: Bank Loan	2,00,000	
Less: Sundry Creditors	6,00,000	
	-------------	8,00,000

Net Tangible Assets		20,17,496

Note: Roughly half of the profits for the current year have been distributed as dividend. Hence capital as on 31st December 2009 has been taken as average capital employed.

Depreciation of new machinery purchased in 2007	Rs.
Cost	20,000

Less: Depreciation @ 10% for 2007	2,000
	18,000
Less: Depreciation @ 10% for 2008	1,800
	16,200
Less: Depreciation @ 10% for 2009	1,620
	14,580

In the absence of information about date of purchase, full years depreciation has been charged for 2007.

(2) Calculation of super profits and valuation of goodwill

	Rs.
Average profit (as per working note 3)	4,20,097
Normal Profit @ 15% on capital employed Rs.20,17,496	3,02,624
Super Profits	1,17,473
Goodwill at 4 years purchase of super profit	4,69,892

(3) Average annual profit

	2007 Rs.	2008 Rs.	2009 Rs.
Reported profits	4,00,000	4,30,000	4,50,000
Add: Machinery Purchased charged to revenue Net of Tax @ 50%	10,000		
	4,10,000		
Less: Dividend net of Tax @ 50%	1,000	900	810
	4,09,000	4,29,100	4,49,190
Dividend on non-Trade investment Net of Tax @ 50 %	9,000	9,000	9,000
Average Profit	4,00,000	4,20,100	4,40,190
			4,20,097

Note: Since it is specifically mentioned in the question, simple average profit has been considered as future maintainable profit. Otherwise, in case of increasing trend of profit generally weighted average is taken.

5

Brightex Co. Ltd.
Value Added Statement
For the year ended 31st December 2009

	(Rs.000)	(Rs.000)	%
Sales	6,240		
Less: Cost of bought in material and services			
Production and operation expenses (4,320-8,620)	3,692		
Administration Expenses (180 - 5)	175		
Interest on bank overdraft	109		
Interest on working capital loan	20		
Excise duties (refer to working note)	180		
Other / miscellaneous charges (444 - 180)	264		
	-------	4,440	

Value added by manufacturing and trading activities		1,800	
Add: Other income		55	

Total Value added		1,855	

Application of value added:			
To Pay employees:			
Salaries to Administrative staff		620	33.42
To Pay Directors:			
Salaries and Commission		5	0.27
To Pay Government:			
Local Tax			
Income Tax	55		
	----	63	3.40
To Pay Providers of Capital:			
Interest on Fixed Loan	51		
Dividend	160		
	-----	211	11.37
To Provide for Maintenance and Expansion of the Company			
Depreciation	16		
Fixed Assets Replacement Reserve	400		
Retained Profit (600 - 60)	540		
	------	956	51.54
		-------	---------
		1,855	100.00
		-------	--------

Reconciliation Between Total Value Added and Profit before Taxation:

	(Rs. 000)	(Rs. 000)
Profit before Tax		1,155
Add back :		
Depreciation	16	
Salaries to Administrative Staff	620	
Director's Remuneration	5	
Interest on Fixed Loan	51	
Local Tax	8	
	------	700

Total Value Added		1,855

Work Note:
Calculation of Excise Duty

	(Rs. 000)	(Rs.000)
Interest and other charges		624
Less : Interest on bank overdraft	109	
Interest on loan from ICICI	51	
Interest on loan from IFCI	20	
	-----	180

Excise duties and other / miscellaneous charges		444

Assuming that these miscellaneous charges have to be taken for arriving at Value Added (in the first part of Value Added Statement), the Excise Duty will be computed as follows:

Let Excise Duty be X: thus miscellaneous / other charges = 444 - x

Thus x = 1/10 x [6,240 - {3692 + 175 + 109 + 20 + x + (444 - x)}]
= 1/10 x [6,240 - 4,440] = 180

Other / miscellaneous charges = 444 - 180 = 264

The above solution is given accordingly. However, if other/miscellaneous charges are taken as any type of application of Value Added. (i.e. to be taken in the application part), then excise duty (x) will be computed as follows :

X = 1/10 x [6,240 - (3,692 + 175 + 109 + 20 + x)]
X = 1/10 x [2240 - x]
11x = 2244
X = 204

And thus total value added will be 2040 + 55 (other income) = 2095
And accordingly, application part will be prepared, taking miscellaneous charges.
Rs. (000) 240 (i.e. 444 - 204) as the application of value added.

6(a) According to Para 10 of AS 25 “Interim Financial Reporting”, if an enterprise prepares } and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements. As on 30.9.2007, Asmitha Ltd. would report the entire Rs.2,00,000 loss on the disposal of its business segment since the loss was incurred during interim period. A cost charged as an expense in an annual period should be allocated to Interim periods on accrual basis. Since Rs.60,000 Property Tax payment relates to entire calendar year 2007, Rs.30,00 would be reported as an expense for six months ended on 30th September 2007 while remaining Rs.30,000 would be reported as prepaid expenses.

(b) As per Para 63 of AS 26 “Intangible Assets”, the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

Himalayas Ltd. has been following the policy of amortization of the intangible asset over a period of 12 years on straight line basis. The period of 12 years is more than the maximum period of 10 years specified under AS 26. Accordingly, Himalayas Ltd. would be required to restate the carrying amount of intangible asset as on 1.4.2007 at Rs.906 lakhs less RS.28.8 lakhs (Rs.9.6 lakhs x 3 years) = Rs.67.2 lakhs. If amortisastion had been as per AS 26, the carrying amount would have been Rs. 67.2 lakhs. The difference of Rs.4.8 lakhs i.e. (Rs.72 lakhs - 67.2 lakhs) would be required to be adjusted against the opening balance of revenue reserves. The carrying amount of Rs.67.2 lakhs would be amortised over 7 (10 less 3) years in future.

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

Thus, impairment loss = Carried amount - Recoverable amount
= Rs.500 lakhs - Rs.400 lakhs = Rs.100 lakhs

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

Recoverable amount = Rs.400 lakhs

(ii) Journal Entries

Particulars		Dr. Amount Rs. In lakhs	Cr. Amount Rs. In lakhs
i) Impairment loss account	Dr.	100	
To Asset account			100
(Being the journal entry for Accounting of impairment loss)			
ii) Profit and Loss Account	Dr.	100	
To impairment loss account			100
(Being the journal entry to transfer Impairment loss to the profit and loss account)			

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

	Rs. In lakhs
Asset less depreciation	500
Less : Impairment loss	100

	400

(d) Accounting entries in the books of buyer

Date	Particulars		Rs.	Rs.
July 2006	Equity Stock option Premium Account	Dr.	2,000	
	To Bank Account			2,000
	(Being premium paid to acquire stock option)			
	Equity Stock option Margin Account	Dr.	12,000	
	To Bank Account			12,000
	(Being initial margin paid on option)			
	(i) Option is setted by delivery of assets			
August 2006	Equity Shares of ABC Ltd. Account	Dr.	25,000	
	To Equity Stock Option Margin A/c			12,000
	To Bank Account			13,000
	(Being option exercised and shares acquired. Margin adjusted and the balance amount was paid)			
	Profit and Loss Account	Dr.	2,000	
	To Equity Stock Option Premium A/c			2,000
	(Being the premium transferred to profit and loss account on exercise of option)			
	Bank Account	Dr.	12,000	
	To Equity Stock Option Margin A/c			12,000
	(Being margin on equity stock option received back on exercise / expiry of option)			

PRIME ACADEMY
30th SESSION MODEL EXAM - STRATEGIC FINANCIAL MANAGEMENT
QUESTION PAPER

Total No. of Questions: 5 **Total No. of Printed Pages: 3**
Time Allowed: 3 Hrs **SLM** **Maximum Marks: 100**

All are compulsory
Working Notes should form part of the answers

1(a) Consider two bonds, one with 5 years to maturity and the other with 20 years to maturity. Both the bonds have a face value of Rs. 1,000 and coupon rate of 8% (with annual interest payments) and both are selling at par. Assume that the yields of both the bonds fall to 6%, whether the price of bond will increase or decrease? What percentage of this increase/decrease comes from a change in the present value of bond's principal amount and what percentage of this increase/decrease comes from a change in the present value of bond's interest payments? (8 Marks)

(b) Consider a bond selling at its par value of Rs. 1,000, with 6 years to maturity and a 7% coupon rate (with annual interest payment), what is bond's duration? (4 Marks)

(c) If the YTM of the bond in (b) above increases to 11%, how it affects the bond's duration? And why? (4 Marks)

(d) A company has a book value of Rs. 137.80. Its return on equity is 15% and it follows a policy of retaining 60% of its earnings. If the opportunity cost of capital is 18% what is the price of the share today. Use Gordon's model. (4 Marks)

2 (a) Why should the duration of a coupon carrying bond always be less than the time to its maturity? (3 Marks)

(b) Armada Leasing Company is considering a proposal to lease out a school bus. The bus can be purchased for Rs. 500000 and in turn be leased out at Rs. 125000 per year for 8 years with payments occurring at the end of each year.

I. Estimate the internal rate of return for the company assuming tax is ignored.
II. What should be the yearly lease payment charged by the company in order to earn 20% annual compounded rate of return before expenses and taxes?
III. Calculate the annual lease rent to be charged so as to amount to 20% after tax annual compounded rate of return based on the following assumptions.
   I) Tax rate is 40%
   II) Straight line depreciation
   III) Annual expenses of Rs. 50000 and
   IV) Resale value Rs. 100000 after the turn. (12 Marks)

(c) Consider the following information on two stocks, A and B:

Year	Return on A (%)	Return on B (%)
2006	10	12
2007	16	18

You are required to determine:

I. The expected return on a portfolio containing A and B in the proportion of 40% and 60% respectively.
II. The Standard deviation of return from each of the two stocks.
III. The covariance of returns from the two stocks.
IV. Correlation coefficient between the returns of the two stocks.
V. The risk of a portfolio containing A and B in the proportion of 40% and 60%.

(5 Marks)

3(a) An exporter is a UK based company. Invoice amount is $3,50,000. Credit period is three months. Exchange rates in London are:

Spot Rate	($/£) 1.5865 – 1.5905
3-month Forward Rate	($/£) 1.6100 – 1.6140

Rates of interest in Money Market:

	Deposit	Loan
$	7%	9%
£	5%	8%

Compute and show how a money market hedge can be put in place. Compare and contrast the outcome with a forward contract. (6 Marks)

(b)(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.

(3 Marks)

(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? (3 Marks)

(c) On 19th April following are the spot rates
Spot EUR/USD 1.20000 USD/INR 44.8000
Following are the quotes of European Options:

Currency Pair	Call/Put	Strike Price	Premium	Expiry date
EUR/USD	Call	1.2000	$ 0.035	July 19
EUR/USD	Put	1.2000	$ 0.04	July 19
USD/INR	Call	44.8000	Rs. 0.12	Sep. 19
USD/INR	Put	44.8000	Rs. 0.04	Sep. 19

I. A trader sells an at-the-money spot straddle expiring at three months (July 19). Calculate gain or loss if three months later the spot rate is EUR/USD 1.2900.
II. Which strategy gives a profit to the dealer if five months later (Sep. 19) expected spot rate is USD/INR 45.00. Also calculate profit for a transaction USD 1.5 million.

(8 Marks)

4(a) Yatra Tours and Resorts Ltd. are investing in a holiday resort at a cost of Rs. 200 lacs. Project life is estimated at 20 years, during which, the annual cash flows will be Rs. 30lacs each.

Indications are that, there is a probability (0.25) of government imposing a luxury tax on revenues. This will however be known only after one year from now. If imposed net cash flows will come down to Rs. 24 lacs. If the tax is not imposed the cash flows will be Rs. 32 lacs each year thereafter.

Required:

i. Ascertain the NPV of the project if the discount rate is 12%
ii. Determine whether Tours and Resorts can wait for one year and proceed thereafter.

(8 Marks)

(b) K. Ltd. is considering acquiring N. Ltd., the following information is available:

Company	Profit after tax Rs	Number of Equity Shares	Market value per shares Rs
K. Ltd.	50,00,000	10,00,000	200.00
N. Ltd.	15,00,000	2,50,000	160.00

Exchange of equity shares for acquisition is based on current market value as above. There is no synergy advantage available:

Find the earning per share for company K. Ltd. after merger.

Find the exchange ratio so that shareholders of N. Ltd. would not be at a loss. (9 Marks)

(c) 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.

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. (3 Marks)

5) Write short notes on the following:

(a) Collars and Floors
(b) Embedded derivatives
(c) Rolling settlement.
(d) Money market mutual funds
(e) Factors influencing dividend decision (5 x 4= 20 Marks)

PRIME ACADEMY
30th SESSION MODEL EXAM - STRATEGIC FINANCIAL MANAGEMENT
SUGGESTED ANSWERS

1(a) IF YIELD FALLS TO 6%

Price of 5yr. bond
Rs. 80 (PVIFA 6%, 5yrs.) + Rs. 1000 (PVIF 6%, 5yrs.)
Rs. 80 (4.212) + Rs. 1000 (0.747)
Rs. 336.96 + Rs. 747 = Rs. 1,083.96
Increase in 5 year's bond price = Rs. 83.96

Current price of 20 year bond
Rs. 80 (PVIFA 6%, 20) + Rs. 1,000 (PVIF 6%, 20)
Rs. 80 (11.47) + Rs. 1,000 (0.312)
Rs. 917.60 + Rs. 312.00 = Rs. 1229.60
So increase in bond price is Rs. 229.60

PRICE INCREASE DUE TO CHANGE IN PV OF PRINCIPAL
5 yrs. Bond
Rs. 1,000 (PVIF 6%, 5) – Rs. 1,000 (PVIF 8%, 5)
Rs. 1,000 (0.747) – Rs. 1,000 (0.681)
Rs. 747.00 – Rs. 681.00 = Rs. 66.00
& change in price due to change in PV of Principal
(Rs. 66/ Rs. 83.96) x 100 = 78.6%)

20 yrs. Bond
Rs. 1,000 (PVIF 6%, 20) – Rs. 1,000 (PVIF 8%, 20)
Rs. 1,000 (0.312) – Rs. 1,000 (0.214)
Rs. 312.00 – Rs. 214.00 = Rs. 98.00
& change in price due to change in PV of Principal
(Rs. 98/ Rs. 229.60) x 100 = 42.68%)

PRICE CHANGE DUE TO CHANGE IN PV OF INTEREST

5 yrs. Bond
Rs. 80 (PVIFA 6%, 5) – Rs. 80 (PVIFA 8%, 5)
Rs. 80 (4.212) – Rs. 80 (3.993)
Rs. 336.96 – Rs. 319.44 = Rs. 17.52
% change in price Rs. 17.52 / Rs. 83.96 X 100 = 20.86%

20 yrs. Bond
Rs. 80 (PVIFA 6%, 20) – Rs. 80 (PVIFA 8%,20)
Rs. 80 (11.47) – Rs. 80 (9.82)
Rs. 917.60 – Rs. 785.60 = Rs. 132
& change in price = Rs. 132 / Rs. 229.60 X 100 = 57.49%

(b) Duration in the average time taken to recollect back the investment

Years (A)	Coupon Payments (Rs.)	Redemption (Rs.)	Total (B) Rs.	PVIF @ 7% (C)(Rs.)	(A)x(B)x (C) (Rs.)
1	70	-	70	0.935	65.45
2	70	-	70	0.873	122.22
3	70	-	70	0.816	171.36
4	70	-	70	0.763	213.64
5	70	-	70	0.713	249.55
6	70	1000	1070	0.666	4,275.72
				∑ABC	5,097.94

$$\text{Duration} = \frac{\sum ABC}{\text{Purchase Price}}$$

$$\frac{\text{Rs.}5097.94}{\text{Rs.}1000} = 5.098 \text{ years}$$

(c) If YTM goes up to 11%, current price of the bond will decreases to
Rs. 70 X PVIFA (11%, 6) + Rs. 1000 PVIF (11%, 6)
Rs. 296.17 + 535 = Rs. 831.17

Year (A)	Inflow (Rs.) (B)	PVIF @ 11% (C)	(A) X (B) X (C) (Rs.)
1	70	0.901	63.07
2	70	0.812	113.68
3	70	0.731	153.51
4	70	0.659	184.52
5	70	0.593	207.55
6	1070	0.535	3434.70
		4.231	4157.03

Now duration Rs. 4157.03 / 831.17 = 5 years
The duration of the bond decreases, reason being the receipt of slightly higher portion of one's investment on the same intervals

(d) **W.N: 1** Calculation of earnings
Earnings = 137.80 X 15% = Rs. 20.67
(This earnings will take place a year later)

W.N: 2 Dividends
Retention ratio is 60%
Hence payments is 40%
Dividends = 20.67 X 40% = Rs. 8.268
(This dividends will take place a year later)

W.N: 3 Growth rate
G = b x r = 0.60 X 0.15 = 0.09 is 9%

W.N: 4 Current share ratio

$$P0 = \frac{D1}{ke - g}$$

$$= \frac{8.268}{18\% - 19\%} = Rs.\ 91.87$$

Note: if the earnings are assumed to take place today the dividend of Rs. 8.268 is of today. A year later dividend will then be Rs. 8.268 (1.09) = Rs. 9.012. Consequently, the current market price would be $\frac{9.012}{18\% - 19\%}$ = Rs. 100.

2(a) Duration is nothing but the average time taken by an investor to collect his/her investment. If an investor receives a part of his/her investment over the time on specific intervals before maturity, the investment will offer him the duration which would be lesser than the maturity of the instrument. Higher the coupon rate, lesser would be the duration.

(b) (i) Estimation of IRR

IRR can be estimated based on payback period.

Payback period = Rs. 500000 / Rs. 125000 = 4

PV factor closet to 4 in 8 years is in 18% (4.078) and 19% (3.954). Therefore IRR is between 18% and 19%.

		18%		19%	
Year	Cash Flow Rs.	DF	DCF Rs.	DF	DCF Rs.
0	(500000)	1.000	(500000)	1.000	(500000)
1-8	125000	4.078	509750	3.954	494250
		NPV	9750		(5750)

$$IRR = L1 + \frac{NPVL1}{NPVL1 - NPV2}(L2 - L1) = 18\% + \frac{9750}{9750 + 5750} X\ 1 = 18+0.6 = 18.63\%$$

(ii) Computation of desired lease to earn 20% rate of return before expenses and taxes.

$$\text{Lease rent} = \frac{\text{Purchase Price}}{\text{PVAF 8 years 20\%}} = \frac{500000}{3.837} = Rs.\ 130310.14$$

Therefore the desired lease rental is 130310.14

(iii) Revised lease rental

I. Initial outflow

Purchase price of bus Rs. 500000

II. Operational flows

	(In Rs.)
a. Annual lease rental	X
b. Less: Expenses	(50000)
c. Less: Depreciation	(50000)
d. Lease rental before tax	X – 100000
e. Less Tax @ 4%	0.4X -- 40000
f. Lease rental after tax	0.6X -- 60000
g. Add: Depreciation	50000
h. Cash inflow after tax	0.6X -- 10000

III. Terminal cash flow
Resale value of bus Rs. 100000

IV. Capital budgeting analysis statement

Year	CF (RS.)	DCF @ 20 %	DCF Rs.
0	(500000)	1.000	(500000)
1-8	0.6X – 10000	3.837	2.3022X – 38370
8	100000	0.233	23300
		NPV	NIL

Therefore (500000) + 2.3022X – 38370 + 23300 = 0
2.3022 X = 515070
Therefore X = Rs. 223729.47
Therefore the revised lease rental is Rs. 223729.47

(c)(i) Expected return of the portfolio A and B
E (A) = (10 + 16) / 2 = 13%
E (B) = (12 + 18) / 2 = 15%

$$Rp = \sum_{i-l}^{N} X\ i\ R\ i\ X\ R\ 0.4(13)\ 0.6(15)\ 14.2\%$$

(ii) Stock A:
Variance = 0.5 $(10 – 13)^2$ + 0.5 $(16 – 13)^2$ = 9
Standard deviation = $\sqrt{9}$ = 3%

Stock B:
Variance = 0.5 $(12 – 15)^2$ + 0.5 $(18 – 15)^2$ = 9
Standard deviation = 3%

(iii) Covariance of stocks A and B
COV*AB* = 0.5 (10 – 13) (12 – 15) + 0.5 (16 – 13) (18 – 15) = 9

(iv) Correlation of coefficient

$$rAB = \frac{COV_{AB}}{\sigma A\ \sigma B} = \frac{9}{3 \times 3} = 1$$

(v) Portfolio Risk

$$\sigma P = \sqrt{X^2 A\sigma^2 A + B\sigma^2 B + 2\, XA\, XB\, (\sigma A \sigma B \sigma AB)}$$

$$\sqrt{(0.4)^2 (3)^2 + (0.6)^2 (3)^2 + 2\,(0.4)\,(0.6)\,(3)\,(3)}\ (1)$$

$$\sqrt{1.44 + 3.24 + 4.32} \quad = 3\%$$

3(a)

Identify : Foreign currency is an asset. Amount $ 3,50,000.

Create : $ Liability.

Borrow : In $. The borrowing rate is 9% per annum or 2.25% per quarter.

Amount to be borrowed : 3,50,000 / 1.0225 = $ 3,42,298.29

Conver : Sell $ and buy £.

The relevant rate is the Ask rate, namely, 1.5905 per £,

(**Note**: This is an indirect quote). Amount of £s received on conversion is

2,15,214.27 (3,42,298.29 / 1.5905).

Invest : £ 2,15,214.27 will be invested at 5% for 3 months to get £ 2,17,904.45

Settle : The liability of $3,42,298.29 at interest of 2.25 per cent quarter matures to $3,50,000 receivable from customer.

Using forward rate, amount receivable is = 3,50,000 / 1.6140 = £2,16,852.54

Amount received through money market hedge = £2,17,904.45

Gain = 2,17,904.45 – 2,16,852.54 = £1,051.91

So, money market hedge is beneficial for the exporter

(b) **(i)** According to Purchasing Power Parity forward rate is

$$\text{Spot rate } [1 + r_H / 1 + r_F]^t$$

So spot rate after one year

$$43.40\ [1 + 0.065 / 1 + 0.03]^1$$
$$= 43.4\ (1.03399)$$
$$= 44.8751$$

After 3 years

$$43.40\ [1 + 0.065 / 1 + 0.03]^3$$

$= 43.40 (1.03398)^3$
$= 43.40 (1.10544)$
= Rs.47.9762

(ii) As per interest rate parity

S1 = S0 [1 + in A / 1 + in B]

S1 = 0.7570 [1 + (0.075) 3/12 / 1 + (0.035) 3/12]

= 0.7570 [1.00875 / 1.01875]

= 0.7570 × 1.0099 = 0.7645

S1 = UK £0.7645 / US$

(c)(i) Straddle is a portfolio of a CALL & a PUT option with identical Strike Price. A trader sells Straddle of At the Money Straddle will be selling a Call option & a put option with Strike Price of USD per EUR.

He will receive premium of $ 0.035 + $ 0.040 = $ 0.075

At the expiry of three months Spot rate is 1.2900 i.e. higher than Strike Price Hence, Buyer of the Call option will exercise the option, but buyer of Put option will allow the option to lapse.

Profit or Loss to a trader is	
Premium received	$0.075
Loss on call option exercised 1.2900 – 1.2000	$0.090
Net Loss of	$ 0.015 per EUR

(ii) BUY Strategy i.e. either Call or Put

Price is expected to go up then call option is beneficial.

On 19th April to pay Premium		
	15,00,000 @ Rs. 0.12 i.e.	INR 1,80,000
On 19th September exercise call option to gain.		
	15,00,000 @ Rs 0.20	INR 3,00,000
Net Gain or Profit		INR 1,20,000

4(a) (i) Computing the NPV of the project – if commenced immediately

Amount / Rs. Lacs

Year	Cash flow	Disc. Factor @ 12%	PV
0	(200.00)	1	(200.00)
1-20	30.00	PVAF 7.469	224.07
		NPV	**24.07**

(ii) Evaluating the option of commencing after one year

Year	Cash flow in Rs.	Dis.Fact.12%	Product	Probability	PV Rs. Lacs
1	(200.00)	1	(200.00)	1	(200.00)
1-21 (a) Luxury tax is imposed (b) No tax	24.00 32.00	PVAF 7.469 PVAF 7.469	179.256 239.008	0.25 239.008	44.814 179.256
Discontinued further down NPV at the end of year 1 24.07 To current year 0 value: 0.893 21.49					

Evaluation of the project implementation

Project implementation	NPV: Amount/Rs. Lacs
If commenced now	Rs. 24.07
If commenced one year later	Rs. 21.49
Recommendation	**COMMENCE NOW**

(b) (i) Earning per share for company K. Ltd. after Merger :
Exchange Ratio 160 : 200 = 4: 5
That is 4 shares of K. Ltd. for every 5 shares of N. Ltd

$\therefore$ Total number of shares to be issued = $\frac{4}{5} \times 2{,}50{,}000 = 2{,}00{,}000$ shares

$\therefore$ Total number of shares of K. Ltd. and N .Ltd. = 10,00,000 K. Ltd.
+ 2,00,000 N. Ltd
12,00,000

Total profit after Tax = Rs. 50,00,000 K. Ltd.
Rs. 15,00,000 N Ltd.
Rs. 65,00,000

$\therefore$ E.P.S. (Earning per share) of K. Ltd. after Merger = Rs. $\frac{65{,}00{,}000}{12{,}00{,}000}$ = Rs.5.42 Per Share

(ii) To find the Exchange Ratio so that shareholders of N. Ltd. would not be at a Loss:
Present Earnings per share for company K. Ltd. = $\frac{\text{Rs.}50{,}00{,}000}{\text{Rs.}10{,}00{,}000}$ = Rs.5.00

Present Earnings Per share for company N. Ltd = $\frac{\text{Rs.}15{,}00{,}000}{\text{Rs.}2{,}50{,}000}$ = Rs.6.00
$\therefore$ Exchange Ratio should be 6 shares of K. Ltd. for every 5 shares of N Ltd.

$\therefore$ Shares to be issued to N. Ltd.

$= \frac{2,50,000}{5} \times 6 = 3,00,000$ Shares

$\therefore$ Total No. of Shares of K.Ltd. and N. Ltd.

= 10,00,000 K. Ltd.

<u>+ 3,00,000</u> N. Ltd

<u>13,00,000</u>

$\therefore$ E.P.S. After Merger $\frac{65,00,000}{13,00,000}$ = Rs.5.00 Per Share

Total Earnings Available to Shareholders of N. Ltd. after Merger

= Rs.3,00,000 × Rs.5.00 = Rs.15,00,000

This is equal to Earnings prior Merger for N. Ltd.

$\therefore$ Exchange Ratio on the Basis of Earnings per Share is recommended.

(c) All-in costs include the spread, commission, interest payments, and any other fees resulting from the transaction. Some banks, for example, may quote an all-in cost of a loan, expressed as a percentage of the loan's face value.

(i) Semi-annual fixed payment
= (N) (AIC) (Period)
Where N = Notional Principal amount = Rs.5,00,000
AIC = All-in-cost = 8% = 0.08
= 5,00,000 × 0.08 (180 / 360)
= 5,00,000 × 0.08 (0.5)
= 5,00,000 × 0.04
= Rs.20,000/-

(ii) Floating Rate Payment
= N (LIBOR) (dt / 360)
= 5,00,000 × 0.06 × (181 / 360)
= 5,00,000 × 0.06 (0.503) or 5,00,000 × 0.06 (0.502777)
= 5,00,000 × 0.03018 or 0.30166
= Rs.15090 or 15083
Both are correct

(iii) Net Amount
= (i) – (ii)
= Rs.20,000 – 15090 = 4910 or
= Rs.20,000 – 15083 = 4917

5(a) Collars

1. A protective options strategy that is implemented after a long position in a stock has experienced substantial gains. It is created by purchasing an out of the money put option while simultaneously writing an out of the money call option.

This is also known as "hedge wrapper".

2. It will act as a general restriction on market activities.

3. The purchase of an out-of-the money put option is what protects the underlying shares from a large downward move and locks in the profit. The price paid to buy the puts is lowered by amount of premium that is collect by selling the out of the money call. The ultimate goal of this position is that the underlying stock continues to rise until the written strike is reached.

4. An example is a circuit breaker which is meant to prevent extreme losses (or gains) once an index reaches a certain level.

   Collars can protect against massive losses, but they also prevent massive gains

Floors
- The lowest acceptable limit as restricted by the controlling parties.

A floor, or bottom, is the minimum allowable limit. An example of a floor occurs in underwriting. The issuing corporation will declare a minimum acceptable amount at which the investment bank can purchase the securities. This way the corporation ensures sufficient capital acquisition.

(b) Embedded Derivatives: An embedded derivative is a derivative instrument that is embedded in another contract - the host contract. The host contract might be a debt or equity instrument, a lease, an insurance contract or a sale or purchase contract. Derivatives require being marked-to-market through the income statement, other than qualifying hedging Instruments. This requirement on embedded derivatives is designed to ensure that market-to-market through the income statement cannot be avoided by including embedding - a derivative in another contract or financial instrument that is not market-to market through the income statement.

An embedded derivative can arise from deliberate financial engineering and intentional shifting of certain risks between parties. Many embedded derivatives, however, arise inadvertently through market practices and common contracting arrangements. Even purchase and sale contracts that qualify for executory contract treatment may contain embedded derivatives. An embedded derivative causes modification to a contract's cash flow, based on changes in a specified variable

(c) Rolling Settlement: SEBI introduced a new settlement cycle known as the 'rolling settlement cycle'. This cycle starts and ends on the same day and the settlement take place on the 'T+5' day, which is 5 business days from the date of the transaction. Hence, the transaction done on Monday will be settled on the following Monday and the transaction done on Tuesday will be settled on the following -Tuesday and so on. Hence unlike a BSE or NSE weekly settlement cycle, in the rolling settlement cycle, the decision has to be made at the conclusion of the trading session, on the same day, rolling settlement cycles were introduced in both exchanges on January 12, 2000. Internationally, most developed countries follow the rolling settlement system. For instance both the US and the UK follow a roiling settlement (T+3) system, while the German stock exchanges follow a (T+2) settlement cycle.

(d) Money market mutual funds:

An open-end mutual fund which invests only in money markets. These funds invest in short term (one day to one year) debt obligations such as Treasury bills, certificates of deposit, and commercial paper. The main goal is the preservation of principal, accompanied by modest dividends. The fund's Net Asset Value remains a constant $1 per share to simplify accounting, but the interest rate does fluctuate. Money market funds are very liquid investments, and therefore are often used by financial institutions to store money that is not currently invested. Unlike bank accounts and money market accounts, most deposits are not FDIC insured, but the risk is extremely low (only those funds administered by banks are FDIC-insured, but some others are privately insured). Although money market mutual funds are among the safest types of mutual funds, it still is possible for money market funds to fail, but it is unlikely. In fact, the biggest risk involved in investing in money market funds is the risk that inflation will outpace the funds' returns, thereby eroding the purchasing power of the investor's money. (**also called** money fund or money market fund)

(e) Dividend decision:

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

Liquidity: Dividends involves cash payments.

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

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

Taxes: Tax rate for dividend income are different from those of capital gains. The former is at 12.5% and the later is at 10% in the case of long term capital gains without indexation and 20% with indexation and the normal rates in the case of short-term capital gain.

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

PRIME ACADEMY
30^{TH} SESSION MODEL EXAM
ADVANCED AUDITING AND PROFESSIONAL ETHICS
QUESTION PAPER

Total No. of Questions: 6 **Total No. of Printed Pages: 2**
Time Allowed: 3 Hrs **AGE** **Maximum Marks: 100**
All are Compulsory

1. As a Statutory Auditor, how would you deal with the following? Comment as per AAS/SA
   a. While commencing the statutory audit of B Company Limited, the auditor undertook the risk assessment and found that the detection risk relating to certain class of transactions cannot be reduced to acceptance level. (4 Marks)
   b. While auditing accounts of a public limited company for the year ended 31st March 2009, an auditor found out an error in the valuation of inventory, which affects the financial statement materially. (5 Marks)
   c. Enumerate the 'Basic Elements of Audit Report' as enshrined in SA 700 (7 Marks)
   d. What are 'Initial Audit Engagements'? (2 marks)

2. Comment with reference to the Chartered Accountants Act, 1949 and Schedules thereto:
   a. Mr. L, a Chartered Accountant in practice as a sole proprietor has an office in Bangalore near Trinity Circle. Due to increase in professional work, he opens another office in a suburb of Bangalore which is approximately 60 kilometers away from his existing office. For running the new office he employs three retired Income-tax Officers.
   b. Mr. X, a chartered accountant in practice, enters into a partnership with a non- chartered accountant. However, the firm does not undertake any professional assignment and is dissolved after a few months
   c. A practicing Chartered Accountant uses a visiting card in which he designates himself, besides as Chartered Accountant, as
      a. Tax Consultant
      b. Cost Accountant.

   d. A Chartered Accountant in practice takes up the appointment as Managing Director of a Public Limited Company. (4+4+6+4=18 Marks)

3.
   a. State the salient features of Investor's Education and Protection Fund.
   b. Section 274 of the Companies Act, 1956 is applicable to appointment of Directors. Briefly explain your duty as a statutory auditor in this connection. (8+8=16 Marks)

4.
   a. Audit Certificate as distinguished from Audit Report
   b. Write short notes on the following:
      i. Decision Tree
      ii. Test Packs (8+4+4=16 Marks)

5. Answer any ***two*** of the following:
   a. As an internal auditor of a Cement Manufacturing Company, draft an audit programme for verification of Transportation charges for dispatches from the factory.
   b. Explain Solvency margin in case of an insurer carrying on general insurance business
   c. Briefly describe the auditor's responsibility regarding subsequent events

(8+8=16 Marks)

6. Write short notes ***on any two of*** the following:
   a. Walk Through Tests
   b. Factors relevant in evaluation of Inherent Risk
   c. Books of account required to be maintained by a Stock Broker.
   d. Underwriting function and its internal control procedures. (8+8=16 Marks)

PRIME ACADEMY
30TH SESSION MODEL EXAM
ADVANCED AUDITING AND PROFESSIONAL ETHICS
SUGGESTED ANSWERS

1

a. Assessment of Risk and Acceptable Level

SA 315 and SA 330 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" and "The Auditor's Responses to Assessed Risks" establishes standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk. SAs 315 and 330 requires that the auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. "Detection risk" is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material. The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. The auditor should use his professional judgment to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. If it cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.

b. Errors in Valuation of Inventories and Auditor's Responsibilities

SA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements", requires that if circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. SA 240 also requires that the auditor should consider the implications of the misstatement in relation to other aspects of the audit, particularly, the reliability of management representations. Further, SA 320 also requires that in such circumstances, the auditor should consider requesting the management to adjust the financial information or consider extending his audit procedures. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should express a qualified or adverse opinion, as appropriate. I n the instant case, the auditor has detected the material errors affecting the financial statements; the auditor should communicate his findings to the management on a timely basis, consider the implications on true and fair view and also ensure that appropriate disclosures have been made.

c. Basic Elements of Auditor's Report: As per SA 700, "The Auditor's Report on financial Statements", the auditor's report includes the following basic elements:

1. *Title:* It is appropriate to use the term "Auditor's Report' in the title so as to distinguish the same from other reports, e.g., Board of Directors' Report, etc.
2. *Addressee:* Ordinarily, the auditor's report is addressed to the authority appointing the auditor.
3. *Opening or Introductory Paragraph:* The auditor's report should identify the financial statements of the enterprise that has been audited including the date of and period covered by the financial statements. This introductory paragraph must state that the preparation of

financial statements is the responsibility of the management and that the auditor's responsibility is to express an opinion based on audit.

4. *Scope Paragraph:* The auditor's report should describe the scope of the audit stating that the audit was conducted in accordance with auditing standards generally accepted in India. It must also lay own briefly the work performed by the auditor and the constraints involved in discharge of his attest function.

5. *Opinion Paragraph:* This paragraph is mainly devoted for expression of opinion as to whether the financial statements give a true and fair view and whether they comply with the statutory requirements.

6. *Date of Report:* The date of an auditor's report on the financial statements is the date on which the auditor signs the report expressing an opinion on the financial statements. The date of report informs the reader that the auditor has considered the effect on the financial statements and on the report of the events and transactions of which the auditor became aware and that occurred up to that date. Since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.

7. *Place of Signature*: The report should name specific location, which is ordinarily the city where the audit report is signed.

8. *Auditor's Signature*: The report should be signed by the auditor in his personal name. Where the firm is appointed as the auditor, the firm name should also be mentioned. The proprietor or partner signing the report should also mention his membership number.

d. Initial Engagement – Opening Balances: As per SA 510 'Initial Engagements - Opening Balances' initial audit engagements mean

(i) When the auditor is engaged to carry out the audit of financial statements of an entity for the first time; or

(ii) When the financial statements of the entity for the preceding period were audited by another auditor.

The situation mentioned in (i) above is obviously when the auditor is appointed to take up the audit for the first time or no audit was carried out of the financial statements of the entity for the immediately preceding period. The situation mentioned in (ii) above arises whenever there is a change of auditor.

2

a. In terms of section 27 of the Chartered Accountants Act, 1949 if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. There is however an exemption for the above if the second office is located in the same premises, in which the first office is located; or the second office is located in the same city, in which the first office is located; or the second office is located within a distance of 50 kms from the municipal limits of a city, in which the first office is located. Since the second office is situated beyond 50 kms of municipal limits of Bangalore city. Thus Mr. L would be liable for committing a professional mis-conduct.

b. According to Clause 4 of the First Schedule (Part-I) of the Chartered Accountants Act, 1949 Mr. X is guilty of professional misconduct, because a chartered accountant is restricted to enter into professional partnerships with non-chartered accountants. It is immaterial whether any professional assignment has been undertaken or not.

c. Tax Consultant: Section 7 of the Chartered Accountants Act, 1949 read with Clause 7 of Part I of the First Schedule to the said Act 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. Under the clause, use of any designation or expression other than chartered accountant for a chartered accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognized by the Central Government or the Council. Thus, it is improper to use designation "Tax Consultant" since neither it is a degree of a University established by law in India or recognized by the Central Government nor it is a recognized professional membership by the Central Government or the Council.

   Cost Accountant: As stated in the preceding paragraph, this would also constitute misconduct under section 7 of the Act read with Clause (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949. A chartered accountant in practice cannot use any other designation than that of a chartered accountant.

   Nevertheless, a member in practice may use any other letters or descriptions indicating membership of accountancy bodies which have been approved by the Council. Thus, it is improper for a chartered accountant to state in his documents that he is a “Cost Accountant”. However as per Appendix 8 to the Chartered Accountants Act, 1949 the Council has resolved that the members are permitted to use letters indicating membership of the Institute of Cost and Works Accountants but not the designation "Cost Accountant".

d. Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949 aims to restrain a member in practice from engaging himself in any business or occupation other than that of a Chartered accountant except when permitted by the Council to be so engaged. Regulation 190A of the Chartered Accountants Regulation, 1988 provides that a chartered accountant in practice shall not engage in any business or occupation other than the profession of accountancy, except with the permission granted in accordance with a resolution of the Council. Appendix 10 to Chartered Accountants’ Regulations, 1988 provides that a member of the Institute in practice may hold the office of a Managing Director or a whole-time Director of a body corporate within the meaning of the Companies Act, 1956, provided that the member and/or his relatives do not hold substantial interest in such concern, after obtaining the specific and prior approval of the Council. Accordingly, in the absence of specific and prior approval chartered accountant would be held guilty of professional misconduct.

3

a. Salient features of Investors Education and Protection Fund: Section 205(C) of the Act empowers the Central Government to establish a fund to be called the Investor Education and Protection Fund to be utilized for the promotion of investor awareness and protection of the interest of the investors. The following amounts shall be credited to the fund, namely,
   a. amounts in unpaid dividends accounts of companies;
   b. matured deposits with companies; (c) application moneys received by companies for allotment of any securities and due for refund;
   c. matured debentures with companies;
   d. interest, if any, accrued on the above items, i.e. (a) to (d);
   e. Grants and donations given to the Fund by the Government or any other institutions, etc.
   f. The interest or other incomes received out of the investments made from the fund.

It may be noted that in respect of four items, i.e., unpaid dividends, application moneys, matured deposits and debentures shall be transferred to Fund only if such amounts shall remained unclaimed and unpaid for seven years from the date they became due for payment. In fact, after lapses of seven years, no claims are tenable against the company or the Fund.

b. Appointment of Directors – Auditor's Duty: As per section 274(1)(g) of the Companies Act, 1956, a person is disqualified to be appointed as a director in case such person is a director of a public company which has not filed the annual accounts for any continuous period of three years; or such company has failed to repay its deposits or interest thereon on due date or pay dividend and such failure continues for one year or more.

Section 227(3)(f) of the Companies Act, 1956 requires the statutory auditor to state whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274. Further, the Department (now Ministry of Company Affairs) has also issued the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003. Rule 4 requires that the statutory auditors of both the appointing as well as the disqualifying company to:

(i) report under section 227(3)(f) of the Act to the members of the respective companies as to whether any director is disqualified from being appointed as a director under clause (g) of section 274(1) of the Companies Act, 1956; and

(ii) Furnish a certificate every year as to whether on the basis of his examination of the books and records of the company, any director of the company is disqualified as a director or not. The auditor is required to obtain written representation as to names of directors, particulars of appointment, default by the company, etc. As a part of audit procedures, the auditor is required to obtain the necessary information before giving his report. The auditor is required to obtain evidence in the form of written representation from a director in respect of each such company has not defaulted in terms of the section 274(1)(g).

The written representation should also be noted and taken on record by the Board. The auditor should also verify the information provided by the management and direction from the information contained in the register mentioned u/s 303(1) of the Act. Accordingly, the auditor is required to report appropriately.

4

a. Audit Certificate as distinguished from Audit Report: A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. The term 'certificate' is, therefore, used where the auditor verifies the accuracy of facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain figures and is in a position to vouchsafe their accuracy as per his examination of documents and books of account. A report, on the other hand, is a formal statement usually made after an enquiry, examination or reviews of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill. The 'report' involves expression of opinion which may differ from one professional to another. There is no question of exactitude in case of a report since the information contained therein is based on estimates and involves judgment element.

b. i) 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 visualize 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

(ii) 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 programmer is proved.

5

a. Procedure for Audit of Transportation Charges

(i) Check rates contracted with transporters for carriage of goods.

(ii) Check whether the rates mentioned as per the contract are correctly taken in the Transporter's invoice.

(iii) In case of discrepancy, check whether the same is authorized by the appropriate sanctioning authority.

(iv) Check that the transporter's invoice includes a delivery challan which has customers stamp indicating the receipt of goods.

(v) In case there is no stamp on the delivery challan, check whether the goods are received back and there is a corresponding inward note.

(vi) Check whether all the goods to be dispatched have a transport booking order reference.

(vii) Check whether each transporter's invoice mentions the transport booking order reference.

(viii) Check whether all the transport booking orders have corresponding transporters names.

(ix) Check whether the transport booking orders are pre-numbered.

(x) Check whether all the invoices are correctly booked in the books of accounts.

(xi) In case there is an additional charge by the transporter due to extra carriage, check for the relevant supporting records (like material inward note/customer rejection note) and necessary authorization by the sanctioning authority.

(xii) Check whether service-tax on the transporters is correctly calculated and accounted.

(xiii) Verify that for there is a mechanism for linking all the transport bills to the sale invoices.

b. Solvency margin in case of an insurer carrying on general insurance business: In case of an insurer carrying on general insurance business, the solvency margin should be the highest of the following amounts:

i. fifty crore rupees (one hundred crores of rupees in case of reinsurer), or
ii. a sum equivalent to twenty percent of the net premium income; or
iii. a sum equivalent to thirty percent of net incurred claims.

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

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

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

c. Subsequent Events and Auditor's Responsibility: When the auditor draws up his audit plan, checking of subsequent events is an important audit procedure irrespective of the level of test checks employed for checking of the transactions during the year. In fact more detailed check is normally required for subsequent events to confirm certain assertions contained in the financial statements, e.g., the payment made by debtors after the close of accounting period would confirm that outstanding debtors on the date of the balance sheet date have been realized. SA 560 on "Subsequent Events" establishes standards on the auditor's responsibility regarding subsequent events. SA 560 on "Subsequent Events" states that the term "subsequent events" refers to significant events occurring between the balance sheet date and the date of the auditor's report. AS 4 on "Contingencies and Events occurring after the Balance Sheet Date" deals with all those significant events, both favorable and unfavorable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and by the corresponding approving authority in the case of any other entity. As per AS 4, events can be identified as adjustable events which provide further evidence of conditions that existed at the balance sheet date; and, non-adjusting events are those which are indicative of conditions that arose subsequent to the balance sheet date. SA 560 lays down that the "auditor should consider the effect of subsequent events on the financial statements and on the auditor's report". When the time between the close of the year-end and the adoption of accounts is about to take place, examination of subsequent events gains more importance.SA 560 further requires that the auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified.

The procedures to identify events that may require adjustment of, or disclosure in, the financial statements would be performed as near as practicable to the date of the auditor's report and ordinarily include the following:

(i) Reviewing procedures that the management has established to ensure that subsequent events are identified.

(ii) Reading minutes of the meetings of shareholders, the board of directors and audit and executive committees held after the balance sheet date and inquiring about matters discussed at meetings for which minutes are not yet recorded.

(iii) Reading the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports.

(iv) Inquiring, or extending previous oral or written inquiries, of the entity's lawyers concerning litigation and claims.

(v) Inquiring of management as to whether any subsequent events have occurred after the balance sheet date which might affect the financial statements.

When the auditor becomes aware of events which materially affect the financial statements, the auditor should consider whether such events are properly accounted for in the financial statements. When the management does not account for such events that the auditor believes should be accounted for, the auditor should express a qualified opinion or an adverse opinion as appropriate.

6

a) Walk Through Tests: A walk through is a procedure in which an auditor traces a transaction from its initiation through the company's information systems to the point when it is reflected in the financial reports. The auditor should perform one walk through, at a minimum, for each major class of transactions. A walk-through provides evidence to confirm that the auditor understands

(1) the process flow of transactions,

(2) the design of identified controls for internal control components, including those related to preventing and detecting fraud, and

(3) whether all points in the process have been identified at which misstatements related to relevant financial statement assertion could occur. Walk through also provide evidence to evaluate the effectiveness of the controls' design and confirm that the controls have been placed in operation. When performing a walk-through, the auditor should:

   (i) Be sure that the walk-through encompasses the complete process (initiation, authorization, recording, processing and reporting) for each significant process identified, Including controls intended to address fraud risk.

   (ii) Ask the entity's personnel, at each of key stage in the process, about their understanding of what the company's prescribed procedures require.

   (iii) Determine whether processing procedures are performed as expected on a timely basis, and look for any exceptions to prescribed procedures and controls.

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

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

whether it is necessary to walk through transactions that were processed both before and after the change.

b) Relevant Factors in evaluation of inherent risk: While developing an overall audit plan, the auditor is required to assess inherent risk at financial statement level and is then required to relate his assessment to material account balances and the class of transactions. To assess inherent risk, the auditor would use professional judgment to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment. Normally an auditor evaluates inherent risk by assessing factors such as integrity of the management, experience and knowledge of the management, turnover of key management personnel, circumstances which may motivate the management to misstate the financial statement when its financial performance is not satisfactory, nature of entity’s business prone to rapid technological obsolescence, dealing with large number of related parties etc.

c) 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 valance 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.

d) Underwriting function and its internal control procedures: The underwriting function, which comprises of examination and evaluation of applications for insurance, the rating of risks and the establishment of premiums, is fundamental to the operations of a general insurance company. The prime objectives of an internal control system for underwriting is adherence to guidelines for acceptances of insurance, proper recording of insurance risk and its evaluation. The following, therefore, may be the internal control procedures with regard to the underwriting:

(i) Appropriate and clear underwriting guidelines are framed and communicated to the underwriting department and the intermediaries where such guidelines are executed with a reasonable certainty without providing substantial flexibility to the underwriters. The adherence to these guidelines should be monitored by an appropriate official of the company.

(ii) Firm procedures are instituted to ensure adequate investigation of the risks assumed (e.g., medical or other investigative reports are duly obtained from the insured).

(iii) There is an effective communication between claims and underwriting department.

(iv) The relevant information is processed on a timely basis to avoid processing backlogs.

(v) Suspense/ unreconciled account balances are reviewed and analyzed on a timely basis by responsible officials.

(vi) Guidelines for reinsurance are established and monitored by a responsible officer

(vii) Adequate systems are developed to identify existence of premium deficiency, if any, and the calculation in respect thereof is regularly performed and approved by an appropriate official.

PRIME ACADEMY
30th SESSION MODEL EXAM - CORPORATE & ALLIED LAWS
QUESTION PAPER

Total No. of Questions: 7 **Total No. of Printed Pages: 3**
Time Allowed: 3 Hrs **CAL** **Maximum Marks: 100**
All are compulsory

1. Answer the following:

   (a) An application was filed by Mr X under Sec.403 of the Companies Act, 1956 seeking direction to an annual general meeting scheduled to be held on October 28, 2009 at the factory premises instead of the Registered Office and also to adopt the accounts and reappointments of auditors at the annual general meeting in accordance with the outcome of his petition. The respondents submitted that the applicant was a party to the meeting held for the amendment of articles 15 and 16 and to substitute a new article 16 and necessary Form 23 was filed with the Registrar of companies for shifting the registered office to its new location. Is the claim of the applicant tenable?

   (b) Managing Director of a Company, filed a petition under Sec.399, 402 and 403 of the Companies Act, 1956 contesting the maintainability of the petition filed under sec.397 and 398 of the Act, on the ground that the first respondent held less than 10% of the share capital of the company on the date of filing the petition. The respondent challenged various receipts stated to have been issued by the applicant to him towards sale consideration of 200 shares but could not produce the valid share certificates for the same. Under these circumstances, is the application filed by the Managing Director tenable? (6+6 =12 Marks)

2. Answer the following:

   a) The petitioner was engaged in a tea brokerage business and was acting as an agent of the respondent-company and used to buy and sell tea on behalf of the company to various customers. The petitioner contended that in the year 1997, a reconciliation statement was preferred after verification of the accounts of both the petitioner and the respondent; that the respondent through its managing director on Nov.27th 1997, confirmed that a sum of over Rs.100 lakhs was due and payable to the petitioner and on Dec.15th 1997, the respondent made part payment of Rs.60 lakhs and no further payments were received. In spite of petitioner's reminders, there was no response as the respondent had become commercially insolvent, the petitioner sought winding up of the respondent. On the other hand, the company contented that it was financially sound and there was no debt due to the petitioner but on the contrary, the petitioner owed to it about Rs.37 lakhs as per the revised statement of accounts and in the previous management, two of the partners of the petitioner were directors and there was a collusion between the petitioner and the previous management of the respondent. In the light of Sec.433(c), can the above petition be upheld? Discuss.

   b) The Board meeting was convened by a single director on account of resignation of two directors of the company and appointment two additional directors as independent non-executive directors and non-independent executive director on the Board of the company with immediate effect was approved. The applicant submitted that the convening of the Board meeting by a single director of the company constituting a single member quorum was not in accordance with Sec.287 (2) of the Act and was non est. in the eyes of law. The respondent- company contented that the Board meeting was convened in accordance with regulation 75 of Table A of Schedule I to the Act and also in accordance with article 97 of the articles of association, which provided that when the number of directors of the company falls below the requisite quorum, a single director present could be a quorum for the purpose of increasing the number of directors required to have a quorum and that the meeting was legal and valid in the eyes of law. Discuss the validity of the contention of the company in this case. (6+6 =12 Marks)

3. Answer the following:

a) The petitioner – company sought the sanction of the court to a scheme of amalgamation by which a 75 per cent subsidiary was to be merged with it. The scheme was approved by the majority of the equity shareholders, all of the secured creditors and unsecured creditors, in the meeting convened for that purpose. The Regional Director and the Registrar of companies approved the scheme. However, objections were raised by three objectors. It was contended that (1) the scheme had been moved in undue haste and the valuation report was also prepared in hurry. (2) That the valuation report lacked details and due diligence had not been carried out. (3) that the share exchange ratio determined was unfair to the shareholders (4) that certain proceedings and investigations were pending against the petitioner- company and the attempt of propounding the scheme was to frustrate the pending actions. The objectors suggested different method of valuation which would benefit the shareholders and sought a direction for revaluation. Discuss the merits of the objection and offer your comments.

b) The petitioner resigned as the honorary secretary of a company with effect from July 27, 1971. He sent his letter of resignation the registered office of the company and copy of it to Registrar of companies. Upon failure of the company of it to file balance sheets etc., with the Registrar for the period covering 1982 to 1986, complaints were lodged by the Registrar and the petitioner was convicted and sentenced. The petitioner challenged the conviction on the grounds that (i) the complaints were instituted beyond the limitation prescribed by law and did not disclose sufficient ground or material to proceed against him. (ii) As per circular No.42 (400)-CL-II-59 DT. Dec.29th, 1959, sending the letter or resignation to the Registrar of companies was sufficient resignation (iii) that in the proceedings for winding up of the company the Registrar had admitted the receipt of the resignation letter from the petitioner (iv) that violations were for the period after his resignation. Discuss the legal status of the petitioner's contention. (6+6 =12 Marks)

4 Good corporate governance practices enhance companies' value and stakeholders' trust resulting into robust development of capital market, the economy and also help in the evolution of a vibrant and constructive shareholders' activism. Elucidate this statement in the light of the recent voluntary guidelines for good Corporate Governance 2009 brought out by Ministry of Company Affairs. (16 Marks)

5 Is preference share holder a member of a company? What are the ways in which a person can become a member of a Company? (16 Marks)

6 What the consequences of violation of FDI Regulations are as covered under FEMA 1999. (16 Marks)

7 Make a comparison between Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 vis-à-vis the SEBI (Disclosure and Investor Protection) Guidelines, 2000? (16 Marks)

PRIME ACADEMY
30th SESSION MODEL EXAM - CORPORATE & ALLIED LAWS
SUGGESTED ANSWERS

1 a) No. The applicant is not correct in his claim. Since all the formalities for shifting the Registered office of the Company were undertaken duly taking the approval of the shareholders in a properly convened meeting in which the applicant also had participated and signed in the minutes for the alteration of articles, his present request for changing of venue of AGM is not tenable. As per Sec. 166(2), the Company has to hold the AGM only at its Registered Office and there is no reason to shift the proposed meeting to a new location.

It was so held in MYLSAMY V SRI GAJENDIRA PAPER AND BOARDS P.LTD [2010] and the application was dismissed.

b) Yes. Though the respondent challenged receipts of various share certificates towards the sale consideration 200 shares, he filed to produce them and hence, on the date of petition he was holding less than 10% of the share capital of the company. Due to the above fact his application under Sec.397 and 398 cannot be entertained. The burden of proof regarding the shareholding of the respondent fulfilling the minimum requirement as stipulated in Sec.399 of the Act had not been duly discharged by him. Therefore, he had no locus standi to file the petition under Sec.397 and 398 of the Act.

It was so held in S. PEER MOHAMED V S.M.MOHIDEEN AHAMED SHAW [2010]

2 a) The petition cannot be entertained as per the following argument:

It is the duty of the petitioner to prove by production of accounts and other documents that amounts. Though there was a dispute, which is bonafide too, regarding the amount to be settled between the petitioner and the respondent, the same shall not be a ground for winding up of the company. The collusion between the previous management of the company with the petitioner cannot be decided now and it is to be established in a properly instituted suit. If the condition of the respondent is not weak or unsound, no winding up can be ordered against the company.

In SAMPAT TRADING CO. V. TALAYAR TEA CO. LTD. [2010], the above was discussed and the petition was dismissed.

b) In RANBAXY LABORATORIES LTD., V DR.JAYARAM CHIGURUPATI [2010] that the meeting held by a single director was in accordance with sec.260 of the Act which was legal and valid in the eyes of law. There was no violation of the provisions of sec.287 (2) of the Act. consequently, all the decisions taken by the Board of directors at the Board meeting were legal and valid in the eyes of law.

3 a) In RELIANCE INDUSTIRES LTD. IN RE. [2009], it was held that the companies had appointed a renowned firm to undertake the determination of the share exchange ratio of the respective shares. No one had doubted the integrity or honesty of the expert. Moreover, the opinion of the expert was verified and approved by two other independent firms, who agreed that the determination was fair. The creditors and members were furnished with the relevant materials at the meetings to enable them to arrive at an informed decision for approving the scheme. All the requisite materials envisaged under sec.391 (2) were placed before the court and the scheme was not prejudicial either to the shareholders or the public. The Registrar of companies as well as the Regional Director and the concerned stock exchanges had given approval/consent to the proposed scheme. The scheme was neither violative of any provisions of law nor against the public policy. Merely because some other method of valuation could be resorted to and would be slightly more favourable to the shareholders, that alone would not militate against granting approval to the scheme propounded by the petitioner company. The objectors were unable to demonstrate as to how the valuation reports were unfair and due to whom.

b) The petitioner had tendered his resignation 11 to 15 years prior to the alleged violations. The receipt of the resignation letter was admitted by the Registrar and no material had been placed on record to show that it was not accepted or was objected to either by the company or by the Registrar of companies. The complaints were initiated more than 22 years after the letter of resignation had been communicated to the Registrar of companies by the petitioner and which had been accepted in terms of the Department's circular. The order of conviction and sentence has to be set aside.

4 PREAMBLE

Good corporate governance practices enhance companies' value and stakeholders' trust resulting into robust development of capital market, the economy and also help in the evolution of a vibrant and constructive shareholders' activism. The Ministry of Corporate Affairs has examined committee reports as well as suggestions received from various stakeholders on issues related to corporate governance. Keeping in mind that the subject of corporate governance may go well beyond the Law and that there are inherent limitations in enforcing many aspects of corporate governance through legislative or regulatory means, it has been considered necessary that a set of voluntary guidelines called "Corporate Governance -Voluntary Guidelines 2009" which are relevant in the present context, are prepared and disseminated for consideration and adoption by corporates.

1) These guidelines provide for a set of good practices which may be voluntarily adopted by the Public companies. Private companies, particularly the bigger ones, may also like to adopt these guidelines. The guidelines are not intended to be a substitute for or addition to the existing laws but is recommendatory in nature.

2) While it is expected that more and more corporates should make sincere efforts to consider adoption of the guidelines, there may be genuine reasons for some companies in not being able to do so completely. In such a case it is expected that such companies should inform their shareholders about the reasons for not adopting these guidelines either fully or partially. It is hoped that "India Inc." would respond to these guidelines with keen interest. It is also hoped that by following good governance practices, the Indian corporate sector would be in a better position to enhance not only the economic value of enterprise but also the value for every stakeholder who has contributed in the success of the enterprise, and while doing so, it would be setting the global benchmarks for good corporate governance.

3) After taking into account the experience of voluntary adoption of these guidelines by the corporates and consideration of relevant feedback, the Government would initiate the exercise for review of these guidelines for further improvement after one year.

4) **GUIDELINES**

I. BOARD OF DIRECTORS

A. APPOINTMENT OF DIRECTORS

A.1 Appointments to the Board

(i) Companies should issue formal letters of appointment to Non-Executive Directors (NEDs) and Independent Directors - as is done by them while appointing employees and Executive Directors. The letter should specify:

- The term of the appointment;

- The expectation of the Board from the appointed director; the Board-level committee(s) in which the director is expected to serve and its tasks;
- The fiduciary duties that come with such an appointment along with accompanying liabilities;
- Provision for Directors and Officers (D&O) insurance, if any;
- The Code of Business Ethics that the company expects its directors and employees to follow;
- The list of actions that a director should not do while functioning as such in the company; and
- The remuneration, including sitting fees and stock options etc., if any.

(ii) Such formal letter should form a part of the disclosure to shareholders at the time of the ratification of his/her appointment or re-appointment to the Board. This letter should also be placed by the company on its website, if any, and in case the company is a listed company, also on the website of the stock exchange where the securities of the company are listed.

A.2 Separation of Offices of Chairman & Chief Executive Officer

To prevent unfettered decision making power with a single individual, there should be a clear demarcation of the roles and responsibilities of the Chairman of the Board and that of the Managing Director/Chief Executive Officer (CEO). The roles and offices of Chairman and CEO should be separated, as far as possible, to promote balance of power.

A.3 Nomination Committee

(i) The companies may have a Nomination Committee comprising of majority of Independent Directors, including its Chairman. This Committee should consider:
- proposals for searching, evaluating, and recommending appropriate Independent Directors and Non-Executive Directors [NEDs], based on an objective and transparent set of guidelines which should be disclosed and should, inter alia, include the criteria for determining qualifications, positive attributes, independence of a director and availability of time with him or her to devote to the job;
- determining processes for evaluating the skill, knowledge, experience and effectiveness of individual directors as well as the Board as a whole.

(ii) With a view to enable Board to take proper and reasoned decisions, Nomination Committee should ensure that the Board comprises of a balanced combination of Executive Directors and Non-Executive Directors.

(iii) The Nomination Committee should also evaluate and recommend the appointment of Executive Directors.

(iv) A separate section in the Annual Report should outline the guidelines being followed by the Nomination Committee and the role and work done by it during the year under consideration.

A.4 Number of Companies in which an Individual may become a Director

(i) For reckoning the maximum limit of directorships, the following categories of companies should be included:—
- public limited companies,
- private companies that are either holding or subsidiary companies of public companies.

(ii) In case an individual is a Managing Director or Whole-time Director in a public company the maximum number of companies in which such an individual can serve as a Non-Executive Director or Independent Director should be restricted to seven.

B. INDEPENDENT DIRECTORS

B.1 Attributes for Independent Directors

(i) The Board should put in place a policy for specifying positive attributes of Independent Directors such as integrity, experience and expertise, foresight, managerial qualities and ability to read and understand financial statements. Disclosure about such policy should be made by the Board in its report to the shareholders. Such a policy may be subject to approval by shareholders.

(ii) All Independent Directors should provide a detailed Certificate of Independence at the time of their appointment, and thereafter annually. This certificate should be placed by the company on its website, if any, and in case the company is a listed company, also on the website of the stock exchange where the securities of the company are listed.

B.2 Tenure for Independent Director

(i) An Individual may not remain as an Independent Director in a company for more than six years.

(ii) A period of three years should elapse before such an individual is inducted in the same company in any capacity.

(iii) No individual may be allowed to have more than three tenures as Independent Director in the manner suggested in 'i' and 'ii' above.

(iv) The maximum number of public companies in which an individual may serve as an Independent Director should be restricted to seven.

B.3 Independent Directors to have the Option and Freedom to meet Company Management periodically

(i) In order to enable Independent Directors to perform their functions effectively, they should have the option and freedom to interact with the company management periodically.

(ii) Independent Directors should be provided with adequate independent office space and other resources and support by the companies including the power to have access to additional information to enable them to study and analyze various information and data provided by the company management.

C. REMUNERATION OF DIRECTORS

C.1 Remuneration

C.1.1 Guiding Principles-Linking Corporate and Individual Performance

(i) The companies should ensure that the level and composition of remuneration is reasonable and sufficient to attract, retain and motivate directors of the quality required to run the company successfully, it should also be ensured that relationship of remuneration to performance is clear. Incentive schemes should be designed around appropriate performance benchmarks and provide rewards for materially improved company performance. Benchmarks for performance laid down by the company should be disclosed to the members annually.

(ii) Remuneration Policy for the members of the Board and Key Executives should be clearly laid down and disclosed. Remuneration packages should involve a balance between fixed and incentive pay, reflecting short and long term performance objectives appropriate to the company's circumstances and goal.

(iii) The performance-related elements of remuneration should form a significant proportion of the total remuneration package of Executive Directors and should be designed to align their interests with those of shareholders and to give these Directors keen incentives to perform at the highest levels.

C.1.2 Remuneration of Non-Executive Directors (NEDs):

(i) The companies should have the option of giving a fixed contractual remuneration, not linked to profits, to NEDs. The companies should have the option to:

  (a) Pay a fixed contractual remuneration to its NEDs, subject to an appropriate ceiling depending on the size of the company; or

  (b) Pay up to an appropriate per cent of the net profits of the company.

(ii) The choice should be uniform for all NEDs, i.e. some should not be paid a commission on profits while others are paid a fixed amount.

(iii) If the option chosen is 'i(a)' above, then the NEDs should not be eligible for any commission on profits.

(iv) If stock options are granted as a form of payment to NEDs, then these should be held by the concerned director until three years of his exit from the Board.

C.1.3 Structure of Compensation to NEDs

(i) The companies may use the following manner in structuring remuneration to NEDs:

- Fixed component : This should be relatively low, so as to align NEDs to a greater share of variable pay. These should not be more than one-third of the total remuneration package.
- Variable component : Based on attendance of Board and Committee meetings (at least 75% of all meetings should be an eligibility pre-condition).
- Additional variable payment(s) for being:
- the Chairman of the Board, especially if he/she is a non-executive chairman
- the Chairman of the Audit Committee and/or other committees
- members of Board committees.

(ii) If such a structure (or any similar structure) of remuneration is adopted by the Board, it should be disclosed to the shareholders in the Annual Report of the company.

C.1.4 Remuneration of Independent Directors (IDs)

(i) In order to attract, retain and motivate Independent Directors of quality to contribute to the company, they should be paid adequate sitting fees which may depend upon the twin criteria of Net Worth and Turnover of companies.

(ii) The IDs may not be allowed to be paid stock options or profit based commissions, so that their independence is not compromised.

C.2 Remuneration Committee

(i) Companies should have Remuneration Committee of the Board. This Committee should comprise of at least three members, majority of whom should be non executive directors with at least one being an Independent Director.

(ii) This Committee should have responsibility for determining the remuneration for all executive directors and the executive chairman, including any compensation payments, such as retirement benefits or stock options. It should be ensured that no director is involved in deciding his or her own remuneration.

(iii) This Committee should also determine principles, criteria and the basis of remuneration policy of the company which should be disclosed to shareholders and their comments, if any, considered suitably. Whenever, there is any deviation from such policy, the justification/reasons should also be indicated/disclosed adequately.

(iv) This Committee should also recommend and monitor the level and structure of pay for senior management, i.e. one level below the Board.

(v) This Committee should make available its terms of reference, its role, the authority delegated to it by the Board, and what it has done for the year under review to the shareholders in the Annual Report.

II. RESPONSIBILITIES OF THE BOARD

A. Training of Directors

(i) The companies should ensure that directors are inducted through a suitable familiarization process covering, inter alia, their roles, responsibilities and liabilities. Efforts should be made to ensure that every director has the ability to understand basic financial statements and information and related documents/papers. There should be a statement to this effect by the Board in the Annual Report.

(ii) Besides this, the Board should also adopt suitable methods to enrich the skills of directors from time to time.

B. Enabling Quality Decision making

The Board should ensure that there are systems, procedures and resources available to ensure that every Director is supplied, in a timely manner, with precise and concise information in a form and of a quality appropriate to effectively enable/discharge his duties. The Directors should be given substantial time to study the data and contribute effectively to Board discussions.

C. Risk Management

(i) The Board, its Audit Committee and its executive management should collectively identify the risks impacting the company's business and document their process of risk identification, risk minimization, risk optimization as a part of a risk management policy or strategy.

(ii)The Board should also affirm and disclose in its report to members that it has put in place critical risk management framework across the company, which is overseen once every six months by the Board. The disclosure should also include a statement of those elements of risk, that the Board feels, may threaten the existence of the company.

D. Evaluation of Performance of Board of Directors, Committees thereof and of Individual Directors

The Board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors. The Board should state in the Annual Report how performance evaluation of the Board, its committees and its individual directors has been conducted.

E. Board to place Systems to ensure Compliance with Laws

(i) In order to safeguard shareholders' investment and the company's assets, the Board should, at least annually, conduct a review of the effectiveness of the company's system of Internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.

(ii) The Directors' Responsibility Statement should also include a statement that proper systems are in place to ensure compliance of all laws applicable to the company. It should follow the "comply or explain" principle.

(iii) For every agenda item at the Board meeting, there should be attached an "Impact Analysis on Minority Shareholders" proactively stating if the agenda item has any impact on the rights of minority shareholders. The Independent Directors should discuss such Impact Analysis and offer their comments which should be suitably recorded.

III. AUDIT COMMITTEE OF BOARD

A. Audit Committee - Constitution

The companies should have at least a three-member Audit Committee, with Independent Directors constituting the majority. The Chairman of such Committee should be an Independent Director. All the members of audit committee should have knowledge of financial management, audit or accounts.

B. Audit Committee - Enabling Powers:

(i) The Audit Committee should have the power to -
  - o have independent back office support and other resources from the company;
  - o have access to information contained in the records of the company; and
  - o obtain professional advice from external sources.

(ii) The Audit Committee should also have the facility of separate discussions with both internal and external auditors as well as the management.

C. Audit Committee - Role and Responsibilities

(i) The Audit Committee should have the responsibility to—
- monitor the integrity of the financial statements of the company;
- review the company's internal financial controls, internal audit function and risk management systems;
- make recommendations in relation to the appointment, reappointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process.

(ii) The Audit Committee should also monitor and approve all Related Party Transactions including any modification/amendment in any such transaction.

(iii) A statement in a prescribed/structured format giving details about all related party transactions taken place in a particular year should be included in the Board's report for that year for disclosure to various stakeholders.

IV. AUDITORS

A. Appointment of Auditors

(i) The Audit Committee of the Board should be the first point of reference regarding the appointment of auditors.

(ii) The Audit Committee should have regard to the profile of the audit firm, qualifications and experience of audit partners, strengths and weaknesses, if any, of the audit firm and other related aspects.

(iii) To discharge its duty, the Audit Committee should:
- discuss the annual work programme and the depth and detailing of the audit plan to be undertaken by the auditor, with the auditor;
- examine and review the documentation and the certificate for proof of independence of the audit firm, and
- recommend to the Board, with reasons, either the appointment/re-appointment or removal of the statutory auditor, along with the annual audit remuneration.

B. Certificate of Independence

(i) Every company should obtain a certificate from the auditor certifying his/its independence and arm's length relationship with the client company.

(ii) The Certificate of Independence should certify that the auditor together with its consulting and specialized services affiliates, subsidiaries and associated companies or network or group entities has not/have not undertaken any prohibited non-audit assignments for the company and are independent vis-a-vis the client company.

C. Rotation of Audit Partners and Firms

(i) In order to maintain independence of auditors with a view to look at an issue (financial or non-financial) from a different perspective and to carry out the audit exercise with a fresh outlook, the company may adopt a policy of rotation of auditors which may be as under:—
- Audit partner - to be rotated once every three years

- Audit firm - to be rotated once every five years.

(ii) A cooling off period of three years should elapse before a partner can resume the same audit assignment. This period should be five years for the firm.

D. Need for clarity on information to be sought by auditor and/or provided by the company to him/it

(i) With a view to ensure proper and accountable audit, there should be clarity between company management and auditors on the nature and amount of information/documents/records etc and periodicity/frequency for supply/obtaining such information/documents/records etc.

(ii) In any case the auditor concerned should be under an obligation to certify whether he had obtained all the information he sought from the company or not. In the latter case, he should specifically indicate the effect of such non receipt of information on the financial statements.

E. Appointment of Internal Auditor

In order to ensure the independence and credibility of the internal audit process, the Board may appoint an internal auditor and such auditor, where appointed, should not be an employee of the company.

V. SECRETARIAL AUDIT

Since the Board has the overarching responsibility of ensuring transparent, ethical and responsible governance of the company, it is important that the Board processes and compliance mechanisms of the company are robust. To ensure this, the companies may get the Secretarial Audit conducted by a competent professional. The Board should give its comments on the Secretarial Audit in its report to the shareholders.

VI. INSTITUTION OF MECHANISM FOR WHISTLE BLOWING

(i) The companies should ensure the institution of a mechanism for employees to report concerns about unethical behaviour, actual or suspected fraud, or violation of the company's code of conduct or ethics policy.

(ii) The companies should also provide for adequate safeguards against victimization of employees who avail of the mechanism, and also allow direct access to the Chairperson of the Audit Committee in exceptional cases.

5. On a plain reading of the companies Act, 1956, it is evident that a preference shareholder is not a member but he can be treated as a member on the following interpretation arising out of Sec.41 (2):

1) A person agrees in writing to take the shares in a company and as per Sec.85 the preference share capital is treated as one of the kinds of capital and as required under sec.113 a share certificate has to be issued within 3 months from the date of allotment of shares and in case a share certificate is issued then as per rule 7(1) of The Companies (Issue of Share Certificate) Rules, 1960, particulars of the share certificate has to be entered in the Register of Members and as per Sec.41(2) since the person has agreed to take shares, his name has to be entered in the Register of Members in the form as laid down in Sec.150 and by virtue of his name appearing in the Register of Members a preference shareholder is a member. Hence a preference shareholder is a member since any person whose name is entered in the Register of Members is a member.
2) One other issue namely whether preference shareholder is counted for purpose of calculating 50 members under sec.3(i)(iii) of the Act, it is felt that if the same person subscribes to both equity and preference shares, such person will be treated as one member and not two members provided all the particulars furnished by the person

subscribing to both preference and equity share capital are same for the purpose of entering the details in the Register of Members as per sec.150 of the Act.

3) It should also be noted that such person's name will be removed in case the preference shares are redeemed and the total share holding of such person stands nullified alternatively in case the preference shares are converted into equity shares the fresh allotment will be credited into such person's existing folio number and the shareholding will stand increased.
4) To conclude, preference shareholders are members within the meaning of the Act and will be counted for the purpose of calculating 50 members under sec.3(i)(iii) of the Act. All the more a preference share is more a strategic capital structuring tool and as a member only a sense of ownership is given without parting with the rights.

Sec. 2(27) of the Companies Act, 1956, defines "member". In relation to a company, 'member' does not include a bearer of share warrant f the company issued in pursuance of section 114. An analysis of this section still does not give the answer to the question as to whether preference shareholders are members. Sec. 41 of the Act defines the term member as:

(1) The subscriber of the memorandum of the company shall be deemed to have agreed to become members of the company and on its registration, shall be entered as members in its register of members.
(2) Every other person who agrees in writing to become a member of a company and whose name is entered in its register of members shall be a member of the company.
(3) Every person holding equity share capital of the company and whose name is entered as beneficial owner in the records of the depository shall be deemed to be a member of the concerned company.

There are 3 instances whereby a person can become a member:

A) Depositary and Member"

Sec 41(3) says that equity shareholders holding shares in dematerialized form will be construed as member. There seems to an anomaly in this provision, which provides that only equity shareholder holding shares in dematerialized form can be considered as member. A strict interpretation of this provision would mean that a preference shareholder holding his preference shares I dematerialized form cannot be considered as a member. This may lead to another debatable question as to "can preference share held in dematerialized form at all" . The reference in the Depositories Act, 1996, is to the word "security" which is defined to mean those securities as may be prescribed by SEBI from time to time. While it is not clear whether preference shares have been prescribed by SEBI to be a "security", an observation of the prevalent practice by both the depositories NSDL & CDSL would lead to the conclusion that preference shares can be held in Demat mode. Alternatively it may be that the law makers did not foresee a situation where preference shares would be held in dematerialized form or it may have possibly been as unintentional error in framing the phrase as "holder of equity shares" rather than 'holder of Shares" in Sec.41(3). Taking this view, a liberal construction may be imputed to the section to include those preference shareholders holding their preference shares in dematerialized form as members.

B) Subscribers as Member:

The other mode is by subscribing to the memorandum of association. Subscribers can be deemed members even though they have not paid the consideration. On a separate note can a company be incorporated with only preference shareholders In general practice the registering authorities do not allow for a company to be incorporated with the authorized and paid-up capital as preference capital. The reason is that a preference shareholder is not entitled to call for a meeting on its own and in case a meeting is called for by the company a preference shareholder cannot vote at a meeting to transact valid business.

C) Any person who agrees in writing:

The third mode is that any person who agrees in writing to become a member and whose name is entered in the register of members is a member of the company. A preference shareholder can in writing agree to become a member, but whether his name is required to be entered in Register of members. As per section 150(1) every company shall keep in one or more books a register of its members, and enter therein the following particulars.

a) The name and address, and the occupation, if nay of each member;
b) In the case of a company having share capital, the shares held by each member, the amount paid or agreed to be considered as paid on those shares;
c) The date at which each person was entered in the register as a member; and
d) The date at which any person ceased to be a member

6 FDI is a current account transaction and thus any violation of FDI regulations are covered by the penal provisions of the FEMA 1999. Reserve Bank of India administers the FEMA 1999 and Directorate of Enforcement under the Ministry of Finance established by the Government of India is the authority for the enforcement of FEMA 1999. The Directorate takes up investigation in any contravention of FEMA.

The penalties:

If any person contravenes any provision of FEMA 1999 vis-à-vis FDI regulations violations, by way of contravening any rule, regulation, notification, direction or order issued in exercise of the powers under this Act or contravenes any conditions subject to which an authorization is issued by the RBI, he shall, upon adjudication, be liable to penalty upto to thrice the sum involved in such contraventions where such amount is quantifiable, or up to two lac rupees where the amount is not quantifiable and where such contraventions is a continuing one, further penalty which may extend to five thousand Rupees for every day after the first day during which the contraventions continues.

Where a person committing a contravention of any provisions of this Act or of any rule, direction or order made there under is a company, every person who, at the time the contravention was committed, was in charge of, and was responsible to, the company for the conduct of the business of the company as well as the company, shall be deemed to be guilty of the contravention and shall be liable to be proceeded against and punished accordingly.

Any adjudicating authority adjudging any contraventions under 25.1.1, may, if he thinks fit in addition to any penalty which he may impose for such contravention direct that any currency, security or any other money or property in respect of which the contravention has taken place shall be confiscated to the Government of India.

7 SALIENT FEATURES OF LLP

1. The LLP Act does not restrict the benefit of LLP structure to certain classes of professionals only and would be available for use by any enterprise which fulfils the requirements of the LLP Act.
2. While the LLP has a separate legal entity, liable to the full extent of its assets, the liability of the partners would be limited to their agreed contribution in the LLP. Further, no partner would be liable on account of the independent or unauthorized actions of other partners, thus allowing individual partners to be shielded from joint liability created by another partner's wrongful business decisions or misconduct.
3. LLP shall be a body corporate and a legal entity separate from its partners. It will have perpetual succession.
4. The minimum number of partners is two whereas there is no upper limit on number of partners in an LLP unlike an ordinary partnership firm where the maximum number of partners cannot exceed 20.
5. Foreign entities can also setup their business / profession in India as the term body corporate has been defined to include an LLP incorporated outside India etc.

6. There should be at least two designated partners who shall be responsible for compliance of the provisions of the LP Act and to the penalties imposed on the LLP on contravention of the provisions of the LLP Act.
7. The taxation of LLPs as proposed by the Finance bill 2009, would be at par with a partnership firm, i.e., the LLP would be taxed whereas the share of profits would be exempt in the hands of the partners.
8. Provisions have been made for corporate actions like mergers, amalgamations etc.
9. While enabling provisions in respect of winding up and dissolutions of LLPs have been made, detailed provisions in this regard are made by way of rules under the LLP Act.
10. The LLP Act also provides for conversion of existing partnership firm, private limited company and unlisted public company into an LLP by registering the same with the Registrar of Companies (ROC).
11. Nothing contained in the Partnership Act 1932 shall affect an LLP.
12. The ROC shall register and control LLPs also.
13. The governance of LLPs shall be in electronic mode in the successful model of the present Ministry of Corporate Affairs portal.
14. With a view to facilitate a more efficient and vigilant corporate governance, there is a provision to provide protection to employees, partners etc. who act as whistle blowers.

LLPs are primarily intended as alternative business organisations for small scale industries and service sector enterprises, such as lawyers, chartered accountants, etc. which at present are primarily constituted as partnership firms in India.

8 The Securities and Exchange Board of India is turning a stricter eye on company promoters who have been issued preferential warrants, saying that they will have to forfeit the upfront payment made on unexercised warrants. This is contained in its recently notified Issue of Capital and Disclosure Requirements (ICDR) Regulations 2009, which SEBI made public on Thursday 3rd September 2009.

These regulations replace the Disclosure and Investor Protection (DIP) Guidelines 2000 that now stand rescinded. In the matter of preferential warrants, SEBI's new norms are probably meant to contain the situation following January 2008, when the stock market crash brought the price of several shares below the warrant exercise price for promoters, several of whom decided not to exercise their warrants in full. Promoters will now have to be more careful, as their upfront payment made only against exercised warrants will now be adjusted, said an expert familiar with regulatory matters.

The ICDR Regulations have been primarily created by conversion of the SEBI (Disclosure and Investor Protection) Guidelines 2000, a SEBI circular said.

The main highlights / significant changes incorporated in the new Regulations as compared to the old Guidelines are herein given below along with proposed implications of the suggested changes:

Sl. No	**Subject Matter**	**Changes brought about by the new regulations vis-à-vis the old Guidelines.**	**Remarks/ Rationale behind the Change**
1.	Preferential Warrants	Promoters now will have to forfeit the upfront payment made on unexercised warrants.	Promoters will now have to be more careful, as their upfront payment made only against exercised warrants will now be adjusted, said an expert familiar with regulatory matters. Provision modified in the ICDR Regulations provide that in preferential issue of warrants, where the warrant holder exercises his option to convert only some of the warrants held by him,

			margin money paid against only such warrants can be adjusted. The balance amount against the remaining warrants/ margin money payable against the unexercised warrants shall be forfeited. Also, taking note of the fact that due to lack of clarity, there have been different interpretations. It is therefore decided to provide the same clearly in ICDR regulations , that Warrant holder is allowed to adjust payment only against that many warrants on which he decides to exercise the option to get equity shares and not against all the warrants which were initially allotted to him.
2.	Group Companies	Under the new Regulations, if the promoter of a debarred company is also a promoter, director or person in control of any other company, even that company would now be barred from accessing the capital markets.	SEBI has made some alterations in the matter of group companies and also explained the term in order to avoid confusions that had surfaced under the old Guidelines. The new norms also ban firm allotment to privileged people, who generally used to be relatives, associates or friends of promoters or promoters' group. Even these categories have to apply through the regular process. Promoters with majority shareholding in a listed company can offer shares to the public straightaway. This would help the Government, as it is keen on dis-investment opportunities.
3.	Public Issues	1. Mandatory provisions for inclusion of the option of offer for sale by listed companies, and omissions of provisions pertaining to OCTEI issues, E-IPO, reservation on competitive basis in public issues for institutions, MFs, FIIs and scheduled banks and firm allotment of public issues.	By adopting the new inclusions the new Regulations have gone a long way to ensure a credible and stable framework for disclosure and investor protection, which would go a long way in streamlining the process of issue of capital.
		1. Compulsory conversion of all outstanding convertible instruments held by any person, as	By mandating compulsory conversion the new Regulations, have broadened the scope of scrutiny and also ensured that all investors and holders of instruments be treated at par. SEBI has also sought to ensure that there are no additional equity

		compared to promoters and shareholders (according to DIP Guidelines).	shares after IPO irrespective of who is holding the outstanding convertible instruments.
		1. The allotment/refund period in public issues has been reduced to 15 days for both fixed-price and book-built issues.	This is a welcome change in comparison to the old Guidelines wherein the time limit was fixed at 30 days for fixed price issue and 15 days for book-built issues, thereby making it more time taking and cumbersome a process. Moreover, there was no valid reason for giving extra 15 days to complete the process in case of a fixed price issue.
		1. Removal exemption available to banking companies for IPOs.	These companies had until now enjoyed exemptions on norms such as track record, minimum tangible assets, distributable profits, etc and hence now with the new Regulations in force, they will be subject to stricter scrutiny. However, this is a welcome change especially in the present Market scenario, with many weak companies seeking to utilize the exemptions for bringing out IPO much to the suffering of shareholders.
		1. The issue period for infrastructure companies has now been brought on a par with that for other companies, and is now down to 10 days from 21, including any revision in price band.	SEBI has noted that is no apparent reason for giving more period for subscription to only issuers of one sector more so when most of the subscription come at the fag end of the issuer period irrespective of the length of issue period. Longer issue period is not desirable for issuer as well as for investors. Hence, in the proposed ICDR Regulations, the existing provision of DIP Guidelines has not been retained and the issue period provisions have been made applicable uniformly to all issuers. Also by stipulating the total issue period not to exceed 10 days, including any revision in price band, SEBI has clarified its stand on issue period in case of Public issues, which under the old Guidelines was not clear in case of revision of Price band in book-built public issues.
		1. As institutional and mutual funds have a separate window for allotment through QIPs now, SEBI has removed mandatory firm allotment to	Currently, the features of firm allotment are contained in pre-IPO placement, wherein shares can be allotted on firm basis during the period from filing of draft offer document with SEBI till filing of offer document with ROC, except that such pre- IPO placement is subject to

		them as it has become redundant. However, a shareholder of a listed company whose group/sister concern is coming out with IPO will have a special reservation window.	lock-in. The issuers are not using this facility of firm allotment and therefore in the new market design, the same has become redundant. The ICDR Regulations would therefore, empower the regulator to deal with non-compliance with appropriate enforcement actions, which would be legally sustainable.
		1. In the case of follow-on offers SEBI has introduced a sub-clause to Clause 19 in the equity listing agreement, saying minimum 48-hour intimation should be given to the bourses of any proposed Board meeting for determination of issue price. Earlier Clause 19 was about prior notification to the stock exchanges, while it directed companies to give 7 days' prior notification to stock exchanges in case of buyback of securities, declaration/recommending of Dividends, Rights Issue, Issue of Convertible Debentures.	By including provisions under the earlier DIP guidelines (now rescinded) into the equity listing agreement, SEBI has tried to ensure coherent working amongst all streams of working affecting public issues and thereby mandated that all Guidelines are in sync. It has also noted the important fact that the equity listing agreement entered into by them is much more comprehensive than the listing agreement signed for listing other instruments such as debt.
		1. As per the new norms, the requirement pertaining to the issue of Disclosure of Price or Price band of public issues has been done away with and the same is not required to be disclosed in draft prospectus.	SEBI has taken note of all redundant provisions of the draft prospectus, which were not providing any futility, and hence these exemptions will go a long way in making draft prospectuses crisp and valuable. This has also been done with the view allow the issuer to announce the price of any type of the issue as close as possible to the issue opening date to contain the market risk.
		1. The extent of underwriting	By ensuring that the obligation of underwriters must be for the entire net

		obligations have been clarified under the new Regulations, to include that where 100% of the offer through offer document is underwritten, the underwriting obligations shall be for the entire amount underwritten.	offer to public and must not be limited to the extent of minimum subscription an issuer may agree to have the issue underwritten with an understanding to get the full amount of funds.
		1. Pre-issue advertisement now to be made after registering of prospectus/ red herring prospectus with Registrar of Companies before opening of the issue, as compared to the old Guidelines which mandated that Pre-issue advertisement be made immediately after receipt of observations from the Board	By mandating such a change, SEBI has ensured that advertisements be made only once the prospectus/ red herring prospectus is finalized and thereby the prospective shareholders are intimated about the correct position of the proposed IPO of the company, before the issue opens.
4.	Book Building Issue	The option of a 75% book building and 25% fixed price issue — which was rarely exercised — has been done away with. It has to be either a fixed price issue or a book-built one.	SEBI has observed that, though 75% book building option has been provided in the DIP Guidelines since inception of book building guidelines, there has not been any issue for last 10 years using 75% BB route. Further, 75% BB route has been found to be very inefficient in terms of time and other operational problems. **Hence, the same has been removed from the ICDR Regulations.**
5.	Disclosure Norms	a) SEBI has directed stock exchanges to disclose details of complaints lodged by investors against trading members and companies listed on the exchange, on their website. These disclosures would also include details pertaining to arbitration and penal action against trading members.	This is a welcome change and an important move to bring in more transparency in the grievance redress mechanism.
		b) Further, with respect	Presently there are different provisions

		to the issue of disclosure of currency of financial statements disclosed in the offer document, the old Guidelines mandated that 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. Also, the new Regulations mandate that disclosure of pledge of shares by promoters – a feature that was not provided in the old Guidelines.	for Government companies and non-government companies. The provision enables a government companies to access the market with audited financials, which can be as old as nine months whereas for non- government companies this period is 6 months. A need is felt to bring uniformity so that all issuers access market with audited accounts not older than 6 months at the time of issue opening. Hence, the new Regulations, with a view to ensure smooth working of both various Government agencies and private bodies have mandated that Government and non-government issuers be treated at par.
		c) New norms pertaining to Minimum promoters' contribution to mandate that the same shall be brought in only by promoters whose identity photograph, etc are disclosed in the offer document.	Apart from ensuring stricter disclosure norms this also gels with the objective of showing continued commitment to the company or project by the main promoters.
6.	Monetary Control	The new regulations also gives SEBI the control of the surplus money in green shoe option bank account, as this money would have to be transferred to SEBI's Investor Protection and Education Fund (IPEF). Earlier, this surplus money was transferred to the Investor Protection Fund of stock exchanges.	Transferring surplus funds to IPEF of SEBI instead of stock Exchanges will augment the IEPF of SEBI.
7.	Other Highlights	a) The new guidelines have also clarified the definition of employees, key management personnel, restrictions on advertisements, and the documents that have to be attached with the due diligence certificate.	These changes have been brought to bring about more clarity as compared to the rescinded Guidelines and also to harmonize the definition with the definition provided under the SEBI (PIT) Regulations, 1992.
		b) The term "Financial Institution" is no longer open to interpretation and has been replaced under the new Regulations by "public financial institution or a	The word "financial institution" is not defined anywhere. Hence the term "public financial institution" is used, which is defined in section 4A of the Companies Act. Also, SEBI is of the view that since the entity is expected to

		scheduled commercial bank".	monitor the issue proceeds, it is felt that banks can also do this job more effectively.
		c) Under the new Regulations, a company making a public offer can allot shares only to its own employees and not to employees of its parent organization or subsidiary under the employee quota.	In the new ICDR Regulations, the term "employee" is used mainly for reservation for employees of the issuer and to give benefit of no-lock-in on options allotted to employees of the issuer before an IPO. Therefore, it was felt that, this benefit should be confined to only employees of the issuer company. Hence, employees and directors of subsidiary or holding company of the issuer have been excluded from the definition of the term.