MOCK TEST PAPER – 1

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

Question No. 1 is compulsory.

*Attempt any **five** questions from the remaining **six** questions.*

Working notes should form part of the answer.

Wherever necessary, suitable assumptions may be made by the candidates.

Time Allowed – 3 Hours | Maximum Marks – 100

1. (a) Super Fast Construction Ltd. has recognised contract revenue on a contract awarded in the financial year 2013-14. The target period of completion is 5 years. The contract provides for incentives for early completion at the rate of Rs. 1,000 per day subject to a maximum of Rs. 3,00,000. The company has included this amount in contract revenue on the ground that based on the previous experience in similar contracts, it is confident of completing the contract in 4 years. The company's past track record shows that company was able to complete such contracts well in time and earn incentives. Comment on the company's accounting policy for recognition of such incentives.

(b) A company is engaged in the manufacture of electronic products and systems. As per Chief Accountant a prototype system was installed at one of the customer's locations in June 2013 for getting acceptance on the performance of the system. The Chief Accountant has stated that the ownership of the system installed for field trials was vested with the company. Hence, for accounting & control purposes, the prototype system installed at customer's location in 2013 was capitalized in the accounts for the year 2013-14 at its bought-out cost. State whether the accounting treatment adopted by the company is correct or not?

(c) Advise Ltd. (a Public Sector Company) provides consultancy and engineering services to its clients. In the year 2013-14 the Government has set up a commission to decide about the pay revision. The pay will be revised with respect from 1-1-2009 based on the recommendations of the commission. The company makes the provision of Rs. 680 lakhs for pay revision in the financial year 2013-14 on the estimated basis as the report of the commission is yet to come. As per the contracts with the client on cost plus job, the billing is done on the actual payment made to the employees and allocated to jobs based on hours booked by these employees on each job.

The company discloses through notes to accounts:

"Salaries and benefits include the provision of Rs. 680 lakhs in respect of pay revision. The amount chargeable from reimbursable jobs will be billed as per the contract when the actual payment is made".

The accountant feels that the company should also book/recognise the income by Rs. 680 lakhs in Profit and Loss Account as per the terms of the contract. Otherwise, it will be the violation of matching concept & understatement of profit.

(d) On January 1, 2013, S Ltd. sold equipment to B Ltd. for Rs. 6,14,460. The carrying amount of the equipment on that date was Rs. 1,00,000. The sale was a part of the package under which B Ltd. leased the asset to S Ltd. for a ten-year term. The economic life of the asset is estimated at 10 years. The minimum lease rent payable by the lesser has been fixed at Rs. 1,00,000 payable annually beginning December 31, 2013. The incremental borrowing interest rate of S Ltd. is estimated at 10% per annum. Calculate the net effect on the profit and loss account?

(4 × 5 = 20 Marks)

2. (a) At the beginning of year 1, the enterprise grants 100 stock options to each of its 500 employees, conditional upon the employees remaining in the employment of the enterprise during the vesting period. The options will vest at the end of year 1 if the earnings of the enterprise is 18 per cent; at the end of year 2 if the earnings of the enterprise is an average of 13 per cent per year over the two year period; and at the end of year 3 if the earnings of the enterprise is an average of 10 per cent per year over the three year period. The fair value of the options, calculated at the grant date using an option pricing model, is Rs. 30 per option. No dividends are expected to be paid over the three-year period.

By the end of year 1, the earnings of the enterprise was 14 per cent, and 30 employees had left. The enterprise expected that earnings will continue at a similar rate in year 2, and, therefore, expected that the options will vest at the end of year 2. The enterprise expected on the basis of a weighted average probability, that a further 30 employees will leave during the year 2, and, therefore, assumed that options will vest in 440 employees at the end of the year 2.

By the end of year 2, the earnings of the enterprise was only 10 per cent. 28 employees have left during the year. The enterprise expected that a further 25 employees will leave during year 3, and that the earnings of the enterprise will be at least 6 per cent, thereby achieving the average of 10 per cent per year.

By the end of the year 3, 23 employees had left and the earnings of the enterprise had been 8 per cent. You are required to determine the compensation expense to be recognised each year.

(b) Mahindra Finance Ltd. is a non-banking finance company. The extracts of its balance sheet are given below:

Liabilities	*Rs. in lakhs*	*Assets*	*Rs. in lakhs*
Paid-up equity capital	100	Leased out assets	800
Free reserves	500	Investment:	
Loans	400	In shares of subsidiaries and	
Deposits	400	group companies	100
		In debentures of subsidiaries and group companies	100
		Cash and bank balances	200
		Deferred expenditure	200
	1,400		1,400

You are required to compute Tier I' of Mahindra Finance Ltd. as per the NBFC (Deposit Accepting or Holding) Companies Prudential Norms (RBI) Directions 2007.

(10+6=16 Marks)

3. (a) You are given the following information about Add-on Ltd.:

(i) Beta for the year 2013-14 — 1.05

(ii) Risk Free Rate — 12%

(iii) Long term Market Rate (based on BSE Sensex) — 15.14%

(iv) Extracts from the liability side of Balance Sheet as at 31st March, 2014.

	(Rs. in lakhs)
Equity	29,160
Reserves and surplus	43,740
Shareholder's fund	72,900
Loan fund	8,100
Total funds (long-term)	81,000

(v) Profit after tax — Rs. 20,394.16 lakhs

(vi) Interest deducted from profit — Rs. 487.00 lakhs

(viii) Effective tax rate (i.e. (Provision for Tax/PBT) x 100) — 24.45%

Calculate Economic Value Added (EVA) of Add-on Ltd. as on 31st March 2014.

(b) Blue Chip Mutual Fund has invested in 2,00,000 shares of Gain Ltd. No quotation is available for last thirty days prior to the valuation date. The P/E ratio of a comparable company, which is regularly traded, is 12. Earning per share of Gain Ltd. is Rs. 20. The Net Asset Value of Gain Ltd. is Rs. 160 and the comparable company is Rs. 200. The current market price of comparable equity share is Rs. 240. A policy is taken to give 40% weightage to net assets value and to reduce from comparable P/E ratio for relatively less liquidity of Gain Ltd. stock.

Required:

(a) Explain whether the investment in Gain Ltd. will be classified as 'trade investment' or 'non-trade investment' giving the reason for the stand taken by you.

(b) What do you think, to be the appropriate criteria for selection of comparable stock?

(c) How much discounting should be made from comparable P/E ratio for valuing investment in non- traded scrip?

(d) What should be the value of 2,00,000 equity shares of Gain Ltd.?

(8 + 8 = 16 Marks)

4. NRPL (Nuclear Reactors Private Limited) is engaged in the business of design and construction of nuclear reactors that are supplied exclusively to the Atomic Energy Department. The core component of such reactors is outsourced by NRPL from FIL (Fusion Industrials Ltd.) the sole manufacturer of this item. NRPL wants to gain leadership in this industry and seeks to take over FIL. NRPL estimates that its Goodwill in the industry will increase by a minimum of Rs. 300 crores consequent on the acquisition. NRPL has made the following calculation of the economic benefits presently available and that foreseen as a result of the acquisition.

(i) Projected Cash Flows of NRPL for the next 5 years:

Year	*1*	*2*	3	*4*	5
Cash flow (Rs. in crores)	1,000	1,500	2,000	2,500	3,000

(ii) Projected Cash Flow of FIL for the next 5 years.

Year	*1*	*2*	3	*4*	5
Cash flow (Rs. in crores)	400	400	600	800	1,000

(iii) Audited net worth of FIL

	Rs. in Crores
Fixed assets	2,000
Investments (non-trade)	1,000
Current assets	1,000
Total	4,000
Current liabilities	(1,000)
Net worth	3,000

(iv) Other information:

(a) 10% of the fixed assets of FIL will not be required in the event of the acquisition and the same has ready buyers for Rs. 100 crore.

(b) Current Assets include surplus inventory of Rs. 20 crore that can realize Rs. 30 crore.

(c) Investments have a ready marked for Rs. 1,500 crore.

(d) The current liabilities are to be paid off immediately; Rs. 510 crores are payable on account of a compensation claim awarded against FIL, which has been treated as a contingent liability in the accounts on which 20 percent was provided for.

(v) NRPL has estimated the combined cash flows post merger as under:

Year	*1*	*2*	*3*	*4*	*5*
Cash flow (Rs. in crores)	1,500	2,000	2,500	3,000	3,500

You are required to advise NRPL the maximum value it can pay for takeover of FIL; also show the current valuation of FIL as a 'Stands Alone' entity. The Discount rate of 15% is advised appropriate, values for which are given below:

Year	*P.V*
1	0.870
2	0.756
3	0.658
4	0.572
5	0.497

(16 Marks)

5. Alpha Ltd. agreed to acquire the business of Beta Ltd. as on 31st March, 2014. On that date, balance sheet of Beta Ltd. was summarised as follows:

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital (fully paid shares of Rs. 10 each)	3,00,000	Goodwill	50,000
		Land, Buildings and Plant	3,20,000
General Reserve	1,35,000	Inventories	84,000
Profit and Loss Account	55,000	Trade Receivables	18,000
Trade Payables	10,000	Cash and Bank balances	28,000
	5,00,000		5,00,000

The shareholders in Beta Ltd. were to receive Rs. 2.50 in cash per share and 3 shares in Alpha Ltd. for every two shares held - the shares in Alpha Ltd. being considered as worth Rs. 12.50 each.

There were fractions equalling 50 shares of Alpha Ltd. for which cash was paid. The directors of Alpha Ltd. considered the various assets as on 31.3.12 to be valued as follows:

	Rs.
Land	1,00,000
Buildings	2,50,000
Plant	3,50,000
Inventories	80,000
Trade receivables	18,000

The cost of liquidation of Beta Ltd. ultimately was Rs. 5,000. Due to a technical hitch, the transaction could be completed only on 1st October, 2014. Till that date, Beta Ltd. carried on trading which resulted in a profit of Rs. 20,000 (subject to interest) after providing Rs. 15,000 as depreciation. On October 1, 2014, inventory was Rs. 90,000; Trade receivables were Rs. 25,000 and trade payables were Rs. 15,000. There was no addition to or sale of fixed assets. However, for the purpose of amalgamation, stock on October 1, 2014 was taken at Rs. 86,000 only. It was agreed that the profit will belong to Alpha Ltd.

You are required to

(i) Prepare Realisation Account and the Shareholders Account in the books of Beta Ltd., and

(ii) Give journal entries in the books of Alpha Ltd. as on October, 1, 2014. *(16 Marks)*

6. On 31st March, 2014, the abridged Balance Sheets of H Ltd. and S Ltd. stood as follows:

	H Ltd. (Rs. in 000's)	S Ltd. (Rs. in 000's)
Capital and Liabilities		
Equity Share Capital – Authorised	5,000	3,000
Issued and subscribed in Equity Shares of Rs. 10 each fully paid	4,000	2,400
General Reserve	928	690
Profit and Loss Account	1,305	810
Trade payables	611	507
Provision for Taxation	220	180
Other Provisions	65	17
	7,129	4,604

Assets:		
Plant and Machinery	2,541	2,450
Furniture and Fittings	615	298
Investment in the Equity Shares of S Ltd.	1,500	–
Inventory	983	786
Trade receivables	820	778
Cash and Bank Balances	410	102
Sundry Advances	260	190
	7,129	4,604

Following additional information is available:

(a) H Ltd. purchased 90 thousand Equity Shares in S Ltd. on 1st April, 2013 at which date the following balances stood in the books of S Ltd.

General Reserve Rs. 1,500 thousand; Profit and Loss Account Rs. 633 thousand.

(b) On 14th July, 2013, S Ltd. declared a dividend of 20% out of pre-acquisition profits and paid corporate dividend tax (including surcharge) at 11%. H Ltd. credited the dividend received to its Profit and Loss Account.

(c) On 1st November, 2013, S Ltd. issued 3 fully paid Equity Shares of Rs. 10 each, for every 5 shares held as bonus shares out of pre-acquisition General Reserve.

(d) On 31st March, 2014, Inventory of S Ltd. included goods purchased for Rs. 50 thousand from H Ltd., which had made a profit of 25% on cost.

(e) Details of Trade payables and Trade receivables:

	H Ltd. (Rs. in 000's)	S Ltd. (Rs. in 000's)
Trade payables		
Bills Payable	124	80
Sundry creditors	487	427
	611	507
Trade receivables		
Debtors	700	683
Bills Receivables	120	95
	820	778

Prepare a Consolidated Balance Sheet as on 31st March, 2014. *(16 Marks)*

7. Answer any **four** of the following:

(a) XYZ Ltd., with a turnover of Rs. 35 lakhs and borrowings of Rs. 10 lakhs during any time in the previous year, wants to avail the exemptions available in adoption of

Accounting Standards applicable to companies for the year ended 31.3.2014. Advise the management on the exemptions that are available as per the Companies (AS) Rules, 2006.

If XYZ is a partnership firm is there any other exemptions additionally available.

(b) On 30-6-2014, X Limited incurred Rs. 3,00,000 net loss from disposal of a business segment. Also on 31-7-2014, the company paid Rs. 80,000 for property taxes assessed for the calendar year 2014. How should the above transactions be included in determination of net income of X Limited for the six months interim period ended on 30-9-2014?

(c) From the following information, determine the possible value of brand as per potential earning model:

		Rs. in lakhs
(i)	Profit After Tax (PAT)	2,500
(ii)	Tangible fixed assets	10,000
(iii)	Identifiable intangilble other than brand	1,500
(iv)	Weighted average cost of capital (%)	14%
(v)	Expected normal return on tangible assets weighted average cost (14%) + normal spread 4%	18%
(vi)	Appropriate capitalisation factor for intangibles	25%

(d) Write short note on some key differences between IFRS and AS (applicable in India) with respect to 'Accounting Policies, Changes in Accounting Estimates and Errors'.

(e) Huge Ltd. issued Rs. 1,00,00,000 worth of 8% Debentures of face value Rs. 100 each on par value basis on 1^{st} January, 2014. These debentures are redeemable at 12% premium at the end of 2017 or exchangeable for ordinary shares of Huge Ltd. on 1:1 basis. The interest rate for similar debentures that do not carry conversion entitlement is 12%. You are required to calculate the value of the debt portion of the above compound financial instrument. The present value of the rupee at the end of years 1 to 4 at 8% and 12% are supplied to you as:

	8%	*12%*
End of year 1	0.926	0.893
End of year 2	0.857	0.797
End of year 3	0.794	0.712
End of year 4	0.735	0.636

(4 x 4 =16 Marks)

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

SUGGESTED ANSWERS/HINTS

1. (a) According to para 14 of AS 7 (Revised), 'Construction Contracts', incentive payments are included in contract revenue only when

- the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and
- the amount of the incentive payment can be measured reliably.

In the given case, the contract is not sufficiently advanced as it is in the first year of construction and its normal time for cnstruction is 4 to 5 years.

Further, the past track record is not the criteria for recognition of incentive payments receivable for early completion of the contract.

Since, the recognition criterias are not met, it is inappropriate to recognise incentive payments in the current year as part of contract revenue. Therefore, Super Fast Construction Ltd.'s accounting policy to recognise incentive payments in the first year of construction as contract revenue, based on past performance, is not in accordance with AS 7 (Revised).

(b) As per para 3 of AS 2 'Valuation of Inventories', inventories mean assets held for sale in the ordinary course of business, or in the process of production for such sale, or for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares.

And as per para 6 of AS 10 'Accounting for Fixed Assets', fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

Accordingly, the system installed by the company at customer's site for his acceptance, based on the field trials of the system, is an item of inventory, and is not a fixed asset. Installation of such prototype system at customers' sites for their acceptance is akin to sale of goods on approval basis. Therefore, the capitalisation of such prototype system at its bought-out-cost is not correct.

At the time of installation of such systems at the customers' site, value of the same should be transferred to a separate account such as 'Goods sent for approval account'.

Since the prototype system does not qualify the definition of fixed asset, no depreciation will be charged on it.

(c) As per para 46 of AS 29, 'Provisions, Contingent Liabilities and Contingent Assets', where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

Accordingly, potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists.

In this case the provision of salary to employees of Rs. 680 lakhs will be ultimately collected from the client as per the terms of the contract. Therefore, the liability of Rs. 680 lakhs is matched by the counter claim from the client. Hence, the provision for salary of employees should be made reducing the claim to be made from the client. It appears that the whole amount of Rs. 680 lakhs is recoverable from client and there is no significant uncertainty about the collection. Hence, the net charge to profit and loss account should be nil.

The opinion of the accountant regarding non-recognition of income of Rs. 680 lakhs is not as per AS 29 and AS 9. However, the concept of prudence will not be followed if Rs. 680 lakhs is simultaneously recognized as income. Rs. 680 lakhs is not the revenue at present but only reimbursement of claim. However the accountant is correct to the extent that non- recognition of Rs. 680 lakhs as income will result in the under statement of profit.

(d) The PV of minimum lease payments at 10% discount rate:

= Rs. 1,00,000 X 6.1446 = Rs. 6,14,460

S Ltd. should recognize the asset and the liability at Rs. 6,14,460.

The excess of sales proceeds over carrying amount

= Rs. 6,14,460 – Rs. 1,00,000 = Rs. 5,14,460

As per para 48 of AS 19 'Leases', if a sale and leaseback transaction results in a finance lease, any excess or deficiency of sale proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

Therefore, assuming that S Ltd. has decided to charge depreciation on straight line basis, AS 19 requires S Ltd. to:

a. Recognize depreciation of Rs. 61,446 per annum for 10 years

b. Allocate excess of Rs. 5,14,460 over the lease term at the rate of Rs. 51,446 p.a.

The net effect is a debit of (Rs. 61,446 – Rs. 51,446) Rs. 10,000 per annum to the profit and loss account for 10 years, as covered under the lease term.

Had there been no sale and lease back transaction, the profit and loss account for each year covered in the lease term would have been charged by (Rs. 1,00,000/10) or Rs. 10,000, towards depreciation. Thus, the sale and lease back transaction has no impact on profit or loss to be reported by the lessee (vendor in the sale transaction) over the lease period.

The deferred income (excess) should be presented as a deduction from the carrying amount of the asset. Thus, the asset should be presented by S Ltd. in its Balance Sheet dated December 31, 2013 as follows:

	Rs.
Gross Block	6,14,460
Less: Accumulated depreciation	(61,446)
Net Block	5,53,014
Less : Deferred Income (5,14,460 – 51,446)	(4,63,014)
Net Block	90,000

In effect, the carrying amount of the equipment does not change with the sale and lease back transaction. In substance, the sale and lease back transaction is a borrowing transaction resulting in recognition of a liability in the balance sheet and recognition of interest expense in the profit and loss account.

2. (a) In the given case, the length of the vesting period varies, depending on when the performance condition is satisfied. In such a situation, as per paragraph 14 of the text of the Guidance Note on 'Accounting for Employee Share Based Payments', the enterprise estimates the length of the expected vesting period, based on the most likely outcome of the performance condition, and revises that estimate, if necessary, if subsequent information indicates that the length of the vesting period is likely to differ from previous estimates.

Statement showing determination of the compensation expense to be recognised each year

Particulars	*Year 1*	*Year 2*	*Year 3*
Vesting condition (earnings)	18%	13% (avg.)	10% (avg.)
Actual earnings	14%	12% (avg.)	10.67% (avg.)
Length of the expected vesting period (at the end of the year)	2 years	3 years	3 years

No. of employees expected to meet vesting conditions	440 employees	417 employees	419 employees
No. of options expected to vest	44,000	41,700	41,900
Fair value of options expected to vest @ Rs. 30 per option (Rs.)	13,20,000	12,51,000	12,57,000
Compensation expense accrued at the end of year (Rs.)	6,60,000 [13,20,000/2]	8,34,000 (12,51,000 × 2/3)	12,57,000
Compensation expense recognised till the end of previous year (Rs.)	Nil	6,60,000	8,34,000
Compensation expense to be recognized for the year (Rs.)	6,60,000	1,74,000	4,23,000

(b) Statement showing computation of 'Tier I Capital'

		Rs. in lakhs
Paid up Equity Capital		100
Free Reserves		500
		600
Less: Deferred expenditure		(200)
Owned Fund	A	400
Investments		
In shares of subsidiaries and group companies		100
In debentures of subsidiaries and group companies		100
	B	200
10% of A i.e. Owned Fund		40
Excess of Investment over 10% of A (200-40)	C	160
Tier I Capital [(A) - (C)] (400-160)		240

3. (a) (i) NOPAT

Profit After Tax	Rs. 20,394.16 lakhs
Add: Interest (net of tax) [Rs. 487 lakhs (1-0.2445)]	Rs. 367.93 lakhs
NOPAT	Rs. 20,762.09 lakhs

(ii) **Cost of Equity**

Cost of Equity = Risk free Rate + β [Market Rate – Risk Free Return]

= 12% + 1.05 x (15.14 -12.00) = 12% + 3.30% = 15.30%

(iii) **Cost of Debt**

$$\text{Cost of Debt} = \frac{\text{Interest on Loan Funds } (1 - \text{Tax Rate})}{\text{Loan funds}} \times 100$$

$$\text{Cost of Debt} = \frac{487 \text{x} (1 - 0.2445)}{8{,}100} \times 100 = 4.54\%$$

(iv) Weighted Average Cost of Capital (WACC)

	Amount (Rs. in lakhs)	*Weight*	*Cost*	*WACC %*
Equity	72,900	.90	15.30	13.77
Debt	8,100	.10	4.54	0.454
	81,000	1.00		14.224

(v) Cost of Capital Employed= Rs. 81,000 x 14.224% = Rs. 11,521.44 lakhs

(vi) EVA = NOPAT – Cost of Capital Employed

= Rs. 20,762.09 lakhs – Rs. 11,521.44 lakhs = Rs. 9,240.65 lakhs

(b) (a) A scrip is treated as non-traded, if it is not traded in stock exchange for a period of more than 30 days (Eighth schedule of SEBI (Mutual Funds) Regulations 1996). In the given case, investment in Gain Ltd. will be a 'non-traded investment', as no quotation is available for last thirty days prior the valuation date.

(b) A comparable stock is generally selected from the same industry. It should be of same size and the return of capital employed should be in the same range.

(c) The valuation of investment should be linked both to degree of liquidity and also the level of current net assets value. In case the comparable stock is quoted at a discount to net assets value, the same discount can be used to estimate the applicable discount factor to P/E Ratio.

In the given case, market value of the comparable equity is 20% [i.e. {(240 - 200) / 200} x 100] above the net asset value. So, market value of Gain Ltd.'s share should be Rs. 160 + 20% of Rs. 160 i.e. Rs. 192. Given EPS of Rs. 20, the P/E ratio of Gain Ltd. can be derived as Rs. 192/20 = 9.6, which is 2.4 less than the P/E ratio of 12 of the comparable firm.

(d) Value per equity share of Gain Ltd. = (Rs. 192 + Rs. 160) / 2 = Rs. 176

Total Value = 2,00,000 x Rs. 176 = Rs. 3,52,00,000.

4. (1) Calculation of operational synergy expected to arise out of merger

(Rs. in crores)

Year	*1*	*2*	*3*	*4*	*5*
Projected cash flows of NRPL after merger with FIL	1,500	2,000	2,500	3,000	3,500
Less: Projected cash flows of NRPL Ltd. without merger	(1,000)	(1,500)	(2,000)	(2,500)	(3,000)
	500	500	500	500	500

(2) Valuation of FIL in case of merger

Year	*Cash Flows from operations (Rs. in crores)*	*Discount Factor*	*Discounted Cash Flow (Rs. in crores)*
1	500	0.870	435.00
2	500	0.756	378.00
3	500	0.658	329.00
4	500	0.572	286.00
5	500	0.497	248.50
			1,676.50

(3) Maximum value to be quoted

	Rs. in crores	*Rs. in crores*
Value as per discounted cash flows from operations		1,676.50
Add: Increase in goodwill of NRPL on acquisition of FIL		300
		1,976.50
Add: Cash to be collected immediately by disposal of assets:		
Fixed Assets	100	
Investments	1,500	
Inventory	30	1,630.00
		3,606.50
Less: Current liabilities (1,000 – 102) (See Note below)	898	
Compensations claim	510	(1,408.00)
		2,198.50

So, NRPL can quote as high as Rs. 2,198.50 crores for taking over the business of FIL.

(4) Valuation of FIL ignoring merger (as a 'Stand Alone' entity)

Year	*Cash Flows (Rs. in crores)*	*Discount Factor*	*Discounted Cash Flow (Rs. in crores)*
1	400	0.870	348.00
2	400	0.756	302.40
3	600	0.658	394.80
4	800	0.572	457.60
5	1,000	0.497	497.00
			1,999.80

5. (i)

In the books of Beta Ltd.

Realisation Account

2014		*Rs.*	*2014*		*Rs.*
Oct. 1	To Goodwill	50,000	Oct. 1	By Trade Payables	15,000
	To Land, Buildings, Plant, etc.	3,20,000		By Provision for Depreciation	15,000
	To Inventory	90,000		By Alpha Ltd. - consideration (W.N.2)	6,37,500
	To Trade Receivables	25,000			
	To Cash & Bank Balance (W.N.1)	55,000		By Alpha Ltd. (for profit) (W.N.3)	20,000
	To Shareholders - profit	1,47,500			
		6,87,500			6,87,500

Shareholders Account

2014		*Rs.*	*2014*		*Rs.*
Oct. 1	To Cash and Bank A/c	75,625	Oct. 1	By Share Capital A/c	3,00,000
	To Shares in Alpha Ltd.	5,61,875		By General Reserve A/c	1,35,000
				By Profit & Loss A/c	55,000
				By Realisation A/c	1,47,500
		6,37,500			6,37,500

(ii) Journal of Alpha Ltd.

2014			Dr. (*Rs.*)	Cr. (*Rs.*)
Oct. 1	Business Purchase Account	Dr.	6,37,500	
	To Liquidator of Beta Ltd.			6,37,500
	(The consideration settled as per agreement dated…. for the purchase of business of Beta Ltd.)			
	Land Account	Dr.	1,00,000	
	Buildings Account	Dr.	2,50,000	
	Plant Account	Dr.	3,50,000	
	Inventory Account	Dr.	86,000	
	Trade Receivables Account	Dr.	25,000	
	Bank Account	Dr.	55,000	
	To Provision for depreciation Account			15,000
	To Profit & Loss Suspense Account			20,000
	To Trade Payables Account			15,000
	To Business Purchase Account			6,37,500
	To Capital Reserve Account			1,78,500
	(Various assets and liabilities taken over from Beta Ltd. and profit up to September 30, 2014 being credited to Profit and Loss Suspense Account)			
	Liquidator of Beta Ltd.	Dr.	6,37,500	
	To Share Capital Account			4,49,500
	To Securities Premium Account			1,12,375
	To Cash and Bank Account			75,625
	(Allotment of shares at a premium and payment of cash in discharge of consideration for the business taken over)			
	Capital Reserve Account	Dr.	5,000	
	To Cash and Bank Account			5,000
	(Expenses of liquidation)			

Working Notes:

(1) Calculation of cash balance as on 1st October, 2014		*Rs.*	*Rs.*
Cash and Bank balances as on April 1, 2014			28,000
Add: Profit earned		20,000	
Depreciation (no cash payment)		15,000	
Increase in Trade Payables		5,000	
		40,000	
Less: Increase in Inventory	6,000		
Increase in Trade Receivables	7,000	(13,000)	
Cash profit earned between 1.4.14 to 30.9.14			27,000
Cash balance as on 1st October, 2014			55,000

(2) Calculation of Purchase Consideration	*Rs.*	*Rs.*
Cash (Rs. 2.50 x 30,000 shares)		75,000
Shares [Rs.12.50 x (30,000 x 3/2 -50)]		5,61,875
Cash for fractions (Rs.12.50 x 50 shares)		625
		6,37,500

(3) Since, the business of Beta Ltd. is acquired on 31st March, 2014, the profit of Rs. 20,000 for the period of 1st April, 2014 to 30th September, 2014, should be standing to the credit of Alpha Ltd.

6. Consolidated Balance Sheet of H Ltd. with its subsidiary S Ltd. as on 31st March, 2014

Particulars	*Note No.*	*(Rs. in 000's)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	4,000
(b) Reserves and Surplus	2	3,063
(2) **Minority Interest (W.N.6)**		1,560
(3) **Current Liabilities**		
Trade payables	3	1,118
Short term provisions	4	482
Total		10,223
II. **Assets**		
(1) **Non-current assets**		
Fixed assets		
Tangible assets	5	5,904

(2) Current assets			
(a) Inventories		6	1,759
(b) Trade receivables		7	1,598
(c) Cash and cash equivalents		8	512
(d) Short term loans and advances		9	450
	Total		10,223

Notes to Accounts

					(Rs. in 000's)	(Rs. in 000's)
1.	Share Capital					
	Authorised share capital					
	5 lakhs equity shares of Rs. 10 each					5,000
	Issued, Subscribed and Paid up					
	4 lakhs equity shares of Rs. 10 each fully paid					4,000
2.	Reserves and surplus					
	Capital Reserve (Note 5)				660	
	General Reserve (*Rs.* 928+*Rs.* 54)				982	
	Profit and Loss Account:					
		H Ltd.	*Rs.*	1,305		
	Add: Share in	S Ltd	*Rs.*	306		
			Rs.	1,611		
	Less: Dividend wrongly credited		*Rs.*	(180)		
			Rs.	1,431		
	Less: Unrealised profit (50 X 1/5)		*Rs.*	(10)	1,421	3,063
3.	Trade payables					
		H Ltd.			611	
		S Ltd.			507	1,118
4.	Short –term provisions					
	Provision for Taxation	H Ltd.	*Rs.*	220		
		S Ltd.	*Rs.*	180	400	
	Other Provisions	H Ltd	*Rs.*	65		
		S Ltd.	*Rs.*	17	82	482
5.	Tangible Assets					
	Plant and Machinery					
		H Ltd.	*Rs.*	2,541		

	S Ltd.	*Rs.* 2,450	4,991	
	Furniture and fittings			
	H Ltd.	*Rs.* 615		
	S Ltd.	*Rs.* 298	913	5,904
6.	**Inventories**			
	Inventory H Ltd.	*Rs.* 983		
	S Ltd.	*Rs.* 786	1,769	
	Less: Unrealised profit (Rs. 50 x 1/5)		(10)	1,759
7.	**Trade receivables**			
	H Ltd.		820	
	S Ltd.		778	1,598
8.	**Cash and cash equivalents**			
	Cash and Bank Balances H Ltd		410	
	S Ltd.		102	512
9.	**Short term loans and advances**			
	Sundry Advances H Ltd.		260	
	S Ltd.		190	450

Working Notes:

Share holding pattern

Particulars	*Number of Shares*	*% of holding*
a. S Ltd.	90,000	
(i) Purchased on 01.04.2013		
(ii) Bonus Issue (90,000/5X3)	54,000	
Total	1,44,000	60 %
b. Minority Interest	96,000	40%

1. S Ltd.'s General Reserve

	(Rs. in 000)		*(Rs. in 000)*
To Bonus to equity shareholders $\left(\frac{2{,}400 \times 3}{8}\right)$	900	By Balance b/d	1,500
		By Profit and Loss A/c	
To Balance c/d	690	(Balancing figure)	90
	1,590		1,590

2. S Ltd.'s Profit and Loss Account

	(Rs. in 000)		*(Rs. in 000)*
To General Reserve	90	By Balance b/d	633
To Dividend paid on 14.7.2013 $\frac{₹1,500 \times 20}{100}$	300	By Net Profit for the year (Balancing figure)	600*
To Corporate Dividend Tax (11% of Rs. 300)	33		
To Balance c/d	810		
	1,233		1,233

* Out of Rs. 6,00,000 profit for the year, Rs. 90,000 has been transferred to reserves by S Ltd.

3. Distribution of Revenue Profits

	Rs. in '000
Revenue Profit as above	600
Share of H Ltd. (60%)	360
Share of Minority shareholders (Rs. 600 – Rs. 360)	240

4. Computation of Capital Profits

	Rs. in 000	*Rs. in 000*
General Reserve on the date of acquisition		1,500
Less: Bonus issue of shares		(900)
		600
Profit and Loss Account balance on the date of acquisition	633	
Less: Dividends paid *Rs.* 300		
Corporate tax paid *Rs.* 33	(333)	300
		900
Share of H Ltd. (60%)		540
Share of Minority shareholders		360

5. Computation of Capital Reserve

		Rs. in '000
60% of share capital of S Ltd.		1,440
Add: Share of H Ltd. in the capital profits as in working note (4)		540
		1,980
Less: Investments in S Ltd.	1,500	

Less: Dividends received out of pre- acquisition profits $\frac{₹ 300 \times 60}{100}$	(180)	(1,320)
		660

6. Calculation of Minority Interest

		Rs. in '000
40% of share capital of S Ltd.		960
Add: Share of Revenue Profits (Note 3)		240
Share of Capital Profits (Note 4)		360
		1,560

7. (a) The question deals with the issue of Applicability of Accounting Standards for Corporates & Non-corporates.

The companies can be classified under two categories viz SMCs and Non SMCs under the Companies (AS) Rules, 2006.

As per the Companies (AS) Rules, 2006, criteria for above classification as SMCs, are:

"Small and Medium Sized Company" (SMC) means, a company-

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank, financial institution or an insurance company;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Since, XYZ Ltd.'s turnover of Rs. 35 lakhs does not exceed Rs. 50 crores & borrowings of Rs. 10 lakhs is less than Rs. 10 crores, it is a small and medium sized company

Being an SMC, following relaxations and exemptions are available to XYZ Ltd.

1. AS 3 "Cash Flow Statements" is not mandatory.
2. AS 17 "Segment Reporting" is not mandatory.
3. SMCs are exempt from certain paragraphs of AS 19 "Leases" related to disclosures.
4. SMCs are exempt from disclosures of diluted EPS (both including and

excluding extraordinary items).

5. SMCs are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique under AS 28 "Impairment of Assets".

6. SMCs are exempt from disclosure requirements of paragraphs 66 and 67 of AS 29 "Provisions, Contingent Liabilities and Contingent Assets".

7. SMCs are exempt from certain requirements of AS 15 "Employee Benefits".

8. Accounting Standards 21, 23, 27 are not applicable to SMCs.

However, if XYZ is a partnership firm and not a corporate, then its classification will be done on the basis of the classification of non-corporate entities as prescribed by the ICAI. According to ICAI, non-corporate entities can be clasiified under 3 levels viz Level I, Level II (SMEs) and Level III (SMEs).

Since, turnover of M/s. XYZ, a partnership firm is less than Rs. 1 crore & borrowings of Rs. 10 lakhs is less than Rs. 1 crore, therefore, it will be classified as Level III SME. In this case, AS 3, AS 17, AS 18, AS 21, AS 23, AS 24, AS 27 will not be applicable to M/s. XYZ (a partnership firm). Relaxations from certain requirements in respect of AS 15, AS 19, AS 20, AS 25, AS 28 and AS 29 will also be available to M/s. XYZ.

(b) Para 28 of AS 25 "Interim Financial Reporting" states that revenues and gains should be recognised in interim reports on the same basis as used in annual reports. As at September 30, 2014, X Ltd. would report the entire Rs. 3,00,000 loss on the disposal of its business segment since the loss was incurred during the interim period.

A cost charged as an expense in an annual period should be allocated among the interim periods, which are clearly benefited from the expense, through the use of accruals and/or deferrals. Since Rs. 80,000 property tax payment relates to the entire 2014 calendar year, only Rs. 40,000 of the payment would be reported as an expense at September 30, 2014, while out of the remaining Rs. 40,000, Rs. 20,000 for Jan. 2014 to March, 2014 would be shown as payment of the outstanding amount of previous year and another Rs. 20,000 related to quarter October, 2014 to December, 2014, would be reported as a prepaid expense.

(c) Calculation of possible value of brand

	Rs. in lakhs
Profit after Tax	2,500
Less: Profit allocated to tangible assets [18% of *Rs.* 10,000]	(1,800)
Profit allocated to intangible assets including brand	700

Capitalisation factor 25%	
Capitalised value of intangibles including brand $\left[\frac{700}{25} \times 100\right]$	2,800
Less: Identifiable intangibles other than brand	(1,500)
Brand value	1,300

(d)

	AS	*IFRS*
Accounting Policies, Changes in Accounting Estimates and Errors	AS 5 allows change in an accounting policy in case the change is required by the Statute.	IAS 8 does not permit an entity to change an accounting policy even if it is required by the statute.
	This standard is silent that whether a change in accounting policy to be accounted for either retrospectively or prospectively. Any change in an accounting policy, which has a material effect, should be disclosed. Where the effect of such change is not ascertainable wholly or in part, the fact should be indicated.	If an entity changes an accounting policy voluntarily, it needs to apply the change retrospectively. When a change in an accounting policy is applied retrospectively, an entity should adjust the opening balance of each affected component of equity for the earliest prior period presented and disclose the comparative amounts for each prior period presented.
	AS 5 deals with "Prior period items" which basically cover income and expenses only. AS 5 does not consider fraud as an error i.e. errors are unintentional mistakes which may arise due to several reasons.	IAS 8 uses the term "Prior period errors" which covers all items in the financial statements including assets and liabilities. As per IAS 8, errors also include fraud within its scope. Standard says errors may be intentional or unintentional.

	Since AS 5 does not deal with intentional errors, no such disclosures are discussed in it.	IAS 8 requires disclosure if financial statements do not comply with IFRSs i.e. if they contain either material errors or immaterial errors made **intentionally** to achieve a particular presentation of an entity's financial position, financial performance or cash flows.
	Prior period items are included in the Statement of Profit or Loss of the current period i.e. the period in which the error is discovered. Such errors are separately disclosed in the statement of profit and loss in a manner that the impact on current profit or loss can be perceived. There is no requirement of restating the comparatives of the prior periods.	As per IAS 8, material prior period errors shall be corrected retrospectively in the first set of financial statements authorised for issue after their discovery by: (a) Restating the comparative amounts for the prior period(s) presented in which the error occurred; or (b) If the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

(e) Present value of Debentures redeemable in 2017 Rs. 71,23,200

[Rs. 1,00,00,000 x 1.12 x 0.636]

Present value of interest on debentures

[Rs. 8,00,000* x 3.038 (sum of 4 years discount factors @12%)] Rs. 24,30,400

Value of Debt component of the convertible debentures Rs. 95,53,600

* Interest payable on debentures every year = Rs. 1,00,00,000 x 8% = Rs. 8,00,000.

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

Question No. 1 is compulsory.

Attempt any **five** questions from the remaining **six** questions.

Working notes should form part of the answer.

Wherever necessary, suitable assumptions may be made and disclosed by the candidates.

Time Allowed – 3 Hours | Maximum Marks – 100

1. (a) High Ltd.'s balance sheet shows an intangible asset at Rs. 72 lakhs as on 01.04.2013, which was acquired for Rs. 96 lakhs on 01.04.2010 and was available for use from the same date. High Ltd. has been following the policy of amortisation 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 the relevant accounting standard.

(b) Milton Ltd. is a full tax free enterprise for the first 10 years of its existence and is in the second year of its operations. Depreciation timing difference resulting in a deferred tax liability in years 1 and 2 is Rs. 200 lakhs and 400 lakhs respectively. From the 3rd year onwards, it is expected that the timing difference would reverse each year by Rs. 10 lakhs. Assuming tax rate @ 35%, find out the deferred tax liability at the end of the second year and any charge to the profit and loss account.

(c) State the treatment of Acquired intangible assets with reference to Indian Accounting Standards and IFRS.

(d) From the following information compute diluted earnings per share:

Net profit for the year 2013-14	Rs. 12,00,000
Weighted average number of equity shares outstanding during year 2013-14	5,00,000 shares
Average fair value of one equity share during the year 2013-14	Rs. 20
Weighted average number of shares under option during the year 2013-14	1,00,000 shares
Exercise price per share under option during the year 2013-14	Rs. 15

(4 × 5 = 20 Marks)

2. From the following details, prepare a Consolidated Balance Sheet of We Ltd. and its subsidiaries as on 31st March, 2014:

	(Rs. in Lakhs)		
Assets:	We Ltd.	You Ltd.	Me Ltd.
Fixed assets (net)	816	312	126
Investment (at cost)			
7,50,000, Equity shares of You Ltd.	75	-	-
2,40,000 Equity shares of Me Ltd.	24	-	-
4,80,000 Equity shares of Me Ltd.	-	60	-
30,000 Cumulative preference shares of We Ltd.	-	-	30
4,500 Mortgage debentures of We Ltd.	-	-	42
Current assets	1,059	369	336
Profit and loss account	288	108	63
	2,262	849	597
Liabilities:			
Equity share capital (Rs. 10 each fully paid up)	180	144	120
7.5% Cumulative non-convertible preference share capital (Rs. 100 each fully paid)	45	36	30
Capital reserve (revaluation of fixed assets)	360	-	-
General reserve	75	45	30
7,500, 8% Mortgage debenture bonds of Rs. 1,000 each	75	-	-
Secured loans and advances:			
From banks	513	249	165
Unsecured loans:			
From You Ltd.	-	-	36
From Me Ltd.	45	-	-
Current liabilities and provisions:			
Inter-company balances	27	-	-
Other liabilities	942	375	216
	2,262	849	597

Other information are as follows:

(a) You Ltd. subscribed for 2,40,000 shares of Me Ltd. at par at the time of first issue and further acquired 2,40,000 shares from the market at Rs. 15 each, when the Reserve and Surplus account of Me Ltd. stood at Rs. 15 lakhs.

(b) We Ltd. subscribed for shares of You Ltd. and Me Ltd. at par at the time of first issue of shares by both the companies.

(c) Current assets of You Ltd. and Me Ltd. includes Rs. 12 lakhs and Rs. 18 lakhs respectively being current account balance against We Ltd. *(16 Marks)*

3. Following is the Balance Sheet of Momentous Ltd. as on 31st March, 2014:

Liabilities	Rs.	Assets	Rs.
1,00,000 equity shares of Rs. 10 each	10,00,000	Goodwill	5,00,000
10,000, 12% preference shares of Rs. 100 each	10,00,000	Buildings	15,00,000
		Plant	10,00,000
General reserve	6,00,000	Investment in 10% stock	4,80,000
Profit and Loss account	1,80,000	Stock-in-trade	6,00,000
15% Debentures	10,00,000	Debtors	4,00,000
Creditors	8,00,000	Cash	1,00,000
	45,80,000		45,80,000

Additional information are given below:

(a) Nominal value of investment is Rs. 5,00,000 and its market value is Rs. 5,20,000.

(b) Following assets are revalued:

		Rs.
(i)	Building	32,00,000
(ii)	Plant	18,00,000
(iii)	Stock-in-trade	4,50,000
(iv)	Debtors	3,60,000

(c) Average profit before tax of the company is Rs. 12,00,000 and 12.50% of the profit is transferred to general reserve, rate of taxation being 50%.

(d) Normal dividend expected on equity shares is 8% while fair return on closing capital employed is 10%.

(e) Goodwill may be valued at three year's purchase of super profits.

Ascertain the value of an equity share under

(i) Intrinsic value method

(ii) Yield method

(iii) Fair value method. *(16 Marks)*

4. (a) The following information (as of 31-03-2014) is supplied to you by Add-on Ltd.:

			(Rs. in crores)
(i)	Profit after tax (PAT)		205.90
(ii)	Interest		4.85

(iii)	Equity Share Capital	40.00	
	Accumulated surplus	700.00	
	Shareholders fund	740.00	
	Loans (Long term)	37.00	
	Total long term funds		777.00
(iv)	Market capitalization		2,892.00
Additional information:			
(a)	Risk free rate		12.00 percent
(b)	Long Term Market Rate (Based on BSE Sensex)		15.50 percent
(c)	Effective tax rate for the company		25.00 percent
(d)	Beta (β) for last few years		
	Year		
	1	0.48	
	2	0.52	
	3	0.60	
	4	1.10	
	5	0.99	

Using the above data you are requested to calculate the Economic Value Added of Add-on Ltd. as on 31st March, 2014.

(b) (i) Examine classification of term deposit worth Rs. 800 lakhs, having original maturity of 5 years with banks in the Schedule III to the Companies Act, 2013, when its remaining maturity is:

(1) 3 months;

(2) 8 months; or

(3) 2 years.

(ii) An entity has acquired a leasehold land for 30 years. Remaining lease period of that land is 6 months as on the reporting date i.e. 31.3.2014. What will be the classification of the said leasehold land in Schedule III ? *(10 + 6 = 16 Marks)*

5. The summarized Balance Sheet of M Ltd. as on 31st March, 2014 is as follows:

Liabilities	Rs.	Assets	Rs.
Authorised and issued share capital		Goodwill	2,00,000
20,000 Equity shares of Rs.100	20,00,000	Plant & Machinery	18,00,000

each, fully paid			
10,000, 7% Preference shares of Rs.100 each	10,00,000	Stock	3,00,000
Sundry creditors	7,00,000	Debtors	7,50,000
Bank overdraft	3,00,000	Cash	1,50,000
		Profit and Loss A/c	8,00,000
	40,00,000		40,00,000

Additional Information:

Two years' preference share dividend is in arrears. The company had bad time during the last two years and hopes for better business in future, earning profit and paying dividend, provided the capital base is reduced.

An internal reconstruction scheme, agreed to by all concerned, is as follows:

(i) Creditors agreed to forego 50% of their claim.

(ii) Preference shareholders withdrew arrear dividend claim. They also agreed to lower down their capital claim by 20% by reducing nominal value in consideration of 9% dividend effective after reconstruction, in case equity shareholder's loss exceeded 50% on the application of the scheme.

(iii) Bank has agreed to convert overdraft into term loan to the extent required for making current ratio to 2:1.

(iv) Revalued amount for plant and machinery was accepted as Rs. 15,00,000.

(v) Debtors to the extent of Rs. 4,00,000 were considered as good.

(vi) Equity shares shall be exchanged for the same number of equity shares at a revised denomination as required after the reconstruction.

You are required to show the following:

(a) Total loss to be borne by the equity and preference shareholders for the reconstruction

(b) Share of loss to the individual class of shareholders

(c) New structure of share capital after reconstruction

(d) Working capital of the reconstructed company, and

(e) A Performa Balance Sheet after reconstruction. *(16 Marks)*

6. (a) On the basis of the following income statement pertaining to B Ltd., you are required to prepare:

(i) Gross value added statement; and

(ii) Statement showing reconciliation of gross value added with Profit Before Taxation.

Profit and Loss Account of B Ltd.
for the year ended 31st March, 2014

	(Rs. in thousands)	(Rs. in thousands)
Income		
Sales less returns		15,27,956
Dividends and interest		130
Miscellaneous income		474
(A)		15,28,560
Expenditure		
Production and operational expenses:		
Decreases in inventory of finished goods	26,054	
Consumption of raw materials	7,40,821	
Power and lighting	1,20,030	
Wages, salaries and bonus	3,81,760	
Staff welfare expenses	26,240	
Excise duty	14,540	
Other manufacturing expenses	32,565	13,42,010
Administrative expenses:		
Directors' remuneration	7,810	
Other administrative expenses	32,640	40,450
Interest on:		
9% Mortgage debentures	14,400	
Long-term loan from financial institution	10,000	
Bank overdraft	100	24,500
Depreciation on fixed assets		50,600
(B)		14,57,560
Profit before Taxation (A) — (B)		71,000
Provision for Income-tax		25,470
Profit after Taxation		45,530
Balance of account as per last Balance Sheet		6,300
		51,830

Transferred to:		
General reserve 40% of Rs. 45,530	18,212	
Proposed dividend @ 22%	22,000	
Tax on distributed profits @ 12.81%	2,818	(43,030)
Surplus carried to Balance Sheet		8,800

(b) A Mutual Fund raised 100 lakh on April 1, 2013 by issue of 10 lakh units of Rs. 10 per unit. The fund invested in several capital market instruments to build a portfolio of Rs. 90 lakhs. The initial expenses amounted to Rs. 7 lakh. During April, 2013, the fund sold certain securities of cost Rs. 38 lakhs for Rs. 40 lakhs and purchased certain other securities for Rs. 28.20 lakhs. The fund management expenses for the month amounted to Rs. 4.50 lakhs of which Rs. 0.25 lakh was in arrears. The dividend earned was Rs. 1.20 lakhs. 75% of the realized earnings were distributed. The market value of the portfolio on 30.04.2013 was Rs. 101.90 lakh. Determine NAV per unit. *(10 + 6 = 16 Marks)*

7. Answer any **four** of the following:

(a) On 1st April, 2014, a company offered 100 shares to each of its 500 employees at Rs. 50 per share. The employees are given a month to decide whether or not to accept the offer. The shares issued under the plan (ESPP) shall be subject to lock-in on transfers for three years from grant date. The market price of shares of the company on the grant date is Rs. 60 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at Rs. 56 per share.

On 30th April, 2014, 400 employees accepted the offer and paid Rs. 30 per share purchased. Nominal value of each share is Rs. 10.

Record the issue of shares in the books of the company under the aforesaid plan.

(b) During the course of the last three years, a company owning and operating Helicopters lost four Helicopters. The company's accountant felt that after the crash, the maintenance provision created in respect of the respective helicopters was no longer required, and proposed to write it back to the Profit and Loss account as a prior period item.

Is the Accountant's proposed accounting treatment correct? Discuss.

(c) F Ltd. borrows a sum of Rs. 20 crore from C Ltd., repayable as a single bullet payment at the end of 5 years. The interest thereon @ 5% p.a. is payable at yearly rests. Since the market rate is 8%, F Ltd. paid an origination fee of Rs. 2.40 crores to C Ltd. to compensate C Ltd. for the lower rate of interest. Apart from the above, there are no other transactions between the two parties. You are required to show the value at which C Ltd., would recognize the loan and the annual interest thereon.

(d) An asset does not meet the requirements of environment laws which have been recently enacted. Therefore, it has to be destroyed as per the law. The asset is carried in the Balance Sheet at the year end at Rs. 6,00,000. The estimated cost of destroying the asset is Rs. 70,000. How should the asset be accounted for?

(e) Safe Ltd. has taken a Transit Insurance Policy. Suddenly in the year 2013-2014 the percentage of accident has gone up to 7% and the company wants to recognize insurance claim as revenue in 2013-2014 in accordance with the relevant Accounting Standard. Do you agree? Explain in brief, as per the relevant Accounting Standard. *(4 x 4 =16 Marks)*

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

SUGGESTED ANSWERS/HINTS

1. (a) 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.

High Ltd. has been following the policy of amortisation of 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, High Ltd. would be required to restate the carrying amount of intangible asset as on 1.4.2013 at Rs. 96 lakhs less Rs. 28.8 lakhs [(Rs. 96 lakhs/10 years) × 3 years] = Rs. 67.2 lakhs. If amortisation had been as per AS 26, the carrying amount would have been Rs. 67.2 lakhs only. The difference of Rs. 4.8 lakhs i.e. (Rs. 72 lakhs – Rs. 67.2 lakhs) would be adjusted against the opening balance of revenue reserve. The carrying amount of Rs. 67.2 lakhs would be amortised over 7 (10 less 3) years in future instead of 9 years.

(b) In the case of tax free companies, no deferred tax liability is recognized, in respect of timing differences that originate and reverse in the tax holiday period. Deferred tax liability or asset is created in respect of timing differences that originate in a tax holiday period but are expected to reverse after the tax holiday period. For this purpose, adjustments are done in accordance with the FIFO method.

Of Rs. 200 lakhs, Rs. 80 lakhs will reverse in the tax holiday period. Therefore, Deferred Tax Liability will be created on Rs. 120 lakhs @ 35% i.e. Rs. 42 lakhs.

In the second year, the entire Rs. 400 lakhs will reverse only after the tax holiday period.

Therefore, deferred tax charge in the Profit and Loss Account will be Rs. 400 x 35% = Rs. 140 lakhs and deferred tax liability in the Balance Sheet will be (42+140) = Rs. 182 lakhs.

(c) Treatment under Indian Accounting Standard and IFRS

	Indian Accounting Standards	*IFRS*
Acquired intangible assets	If recognition criteria are satisfied then it can be capitalized. All intangibles are	If recognition criteria are satisfied then it can be capitalized. It is amortized

	amortized over useful life with rebuttable presumption of not exceeding 10 years. Revaluations are not permitted. Intangible assets acquired free of charge or for nominal consideration by way of government grant is recognised **at nominal value or at acquisition cost**, as appropriate, plus any expenditure that is attributable to making the asset ready for intended use.	over useful life. Intangibles assigned an indefinite useful life are not amortized but reviewed at least annually for impairment. Revaluations are permitted in rare circumstances. When intangible assets are acquired free of charge or for nominal consideration by way of government grant an entity should record both the grant and the intangible asset **at fair value.** If an entity chooses not to recognise the asset initially at fair value, the entity may recognise the asset initially **at a nominal amount** plus any expenditure that is directly attributable to preparing the asset for its intended use.

(d) Computation of diluted earnings per share

	Earnings (Rs.)	Shares	Earnings per share (Rs.)
Net profit for the year 2013-14	12,00,000		
Weighted average number of equity shares outstanding during the year 2013-14		5,00,000	
Weighted average number of shares under option		1,00,000	
Number of shares that would have been issued at fair value [(1,00,000 × 15.00)/20.00]	*	(75,000)	
Diluted earnings per share	12,00,000	5,25,000	2.29

*The earnings have not been increased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of computation to have been issued for no consideration (Para 37(b) of AS 20).

2. Consolidated Balance Sheet of We Limited and its subsidiaries as on 31st March, 2014

Particulars	Note No.	(Rs.)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	1,95,00,000
(b) Reserves and Surplus	2	95,81,250
(2) Minority Interest		1,32,18,750
(3) Non-current Liabilities		
Long-term borrowings	3	9,57,00,000
(4) Current Liabilities	4	15,33,00,000
Total		29,13,00,000
II. Assets		
(1) Non-current assets		
Fixed assets		
Tangible assets		12,54,00,000
Intangible assets	5	3,00,000
(2) Current assets	6	16,56,00,000
Total		29,13,00,000

Notes to Accounts

			Rs.
1.	Share Capital		
	18,00,000, Equity Shares of Rs. 10 each	1,80,00,000	
	15,000, 7½% Cumulative Non-convertible Preference shares of Rs. 100 each	15,00,000	1,95,00,000
2.	Reserves and Surplus		
	Capital reserve	3,60,00,000	
	Profit and loss account	(2,64,18,750)	95,81,250
3.	Long Term Borrowings		
	8% Mortgage debentures	30,00,000	
	Secured loan from bank	9,27,00,000	9,57,00,000

4.	Current Liabilities		
	We Ltd.	9,42,00,000	
	You Ltd.	3,75,00,000	
	Me Ltd.	2,16,00,000	15,33,00,000
5.	Intangible assets		
	Goodwill		3,00,000
6.	Current assets		
	Balances of		
	We Ltd.	10,59,00,000	
	You Ltd.	3,69,00,000	
	Me Ltd.	3,36,00,000	
		17,64,00,000	
	Less: Inter-company owing	(81,00,000)	
		16,83,00,000	
	Less: Inter-company balances	(27,00,000)	16,56,00,000

Working Notes:

			In You Ltd.	In Me Ltd.
(1)	**Shareholding Pattern**			
	(i) We Limited		$\frac{25}{48}$	$\frac{2}{10}$
	(ii) You Limited			$\frac{4}{10}$
	(iii) Minority Interest		$\frac{23}{48}$	$\frac{4}{10}$
			Capital	Revenue
			Rs.	Rs.
(2)	**Analysis of Profits**			
	(a) Me Limited			
	Balance at acquisition		15,00,000	
	Balance as per P&L A/c	(63,00,000)		
	Less: General reserve	30,00,000		
	Less: Profit on debentures	3,00,000		
	Net loss as on 31.3.2014	(30,00,000)		
	Less: Capital profit	15,00,000		
		(45,00,000)		(45,00,000)

	Minority interest (4/10)		6,00,000	(18,00,000)
	Share of You Limited (4/10)		6,00,000	(18,00,000)
	Share of We Limited (2/10)		3,00,000	(9,00,000)
	(b) **You Limited**			
	P&L A/c as on 31.3.2014			(1,08,00,000)
	General Reserve			45,00,000
				(63,00,000)
	Share of revenue loss in Me Ltd.			(18,00,000)
				(81,00,000)
	Minority Interest (23/48)			(38,81,250)
	We Ltd. (25/48)			(42,18,750)
			You Ltd.	Me Ltd.
(3)	**Goodwill / Capital Reserve**			
	Cost of investment		75,00,000	84,00,000
	Less: Share capital		(75,00,000)	(72,00,000)
	Capital profit		(3,00,000)	(6,00,000)
	Capital reserve/Goodwill		(3,00,000)	6,00,000
	Goodwill Rs. 6,00,000 less Rs. 3,00,000		3,00,000	
(4)	**Minority Interest**			
	Share capital		69,00,000	48,00,000
	Capital profit		-	6,00,000
	Revenue profit		(38,81,250)	(18,00,000)
	Preference shares (36,00,000+30,00,000)		-	66,00,000
			30,18,750	1,02,00,000
	Total			1,32,18,750
(5)	**Profit and Loss Account – We Ltd.**			
	Balance as on 31.03.2014		(2,88,00,000)	
	General reserve		75,00,000	
	Share of Me Limited		(9,00,000)	
	Share of You Limited		(42,18,750)	(2,64,18,750)

3. (i) **Value per Share (Intrinsic Value Method)**

$$= \text{Rs. } 40,82,000 \div 1,00,000 = \text{Rs. } 40.82$$

(ii) **Value per Share (Yield Method)**

$$\text{Yield on equity shares} = \frac{\text{Profit for Equity Shareholders}}{\text{Equity Capital}} \times 100$$

$$= \frac{\text{Rs. } 3,83,125}{10,00,000} \times 100 = 38.31\%$$

$$\text{Value per Share (Yield Method)} = \frac{38.31}{8} \times 10 = \text{Rs. } 47.89$$

Value of equity share under Fair Value Method

$$\frac{(\text{Intrinsic Value} + \text{Yield Value})}{2} = \frac{(40.82 + 47.89)}{2} = \text{Rs. } 44.36 \text{ (approx.)}$$

Working Notes:

		Rs.	Rs.
1.	**Capital Employed**		
	Assets:		
	Buildings		32,00,000
	Plant		18,00,000
	Stock		4,50,000
	Debtors		3,60,000
	Cash		1,00,000
			59,10,000
	Less: Liabilities:		
	Creditors	8,00,000	
	Debentures	10,00,000	(18,00,000)
	Capital Employed		41,10,000
2.	**Actual Profit**		
	Average Profit		12,00,000
	Less: Income from investment		(50,000)
			11,50,000
	Less: Income Tax @ 50%		(5,75,000)
	Actual Profit		5,75,000

3.	**Profit for Equity Shareholders**		
	Actual Profit		5,75,000
	Less: Transfer to Reserve @ 12.50%		(71,875)
	Less: Preference Dividend		(1,20,000)
	Profit available to Equity Shareholders		3,83,125
4.	**Normal Profit** = 10% of Capital Employed = 10% of Rs. 41,10,000 = Rs. 4,11,000		
5.	**Super Profit** = Actual profit – Normal profit = Rs. 5,75,000 – Rs. 4,11,000 = Rs. 1,64,000		
6.	**Goodwill** = Rs. 1,64,000 × 3 = Rs. 4,92,000		
7.	**Net Assets for equity shareholders** = Capital Employed + Goodwill + Investment – Preference Share Capital = Rs. (41,10,000 + 4,92,000 + 4,80,000 – 10,00,000) = Rs. 40,82,000		

4. (a) Net Operating Profit After Tax (NOPAT) = Profit After Tax (PAT) + Interest (net of tax)

= 205.90 + 4.85 x (1-0.25) = Rs. 209.54 crores

Debt Capital		Rs. 37 crores
Equity capital (40 + 700)	=	Rs. 740 crores
Capital employed	=	37 + 740 = Rs. 777 crores
Debt to capital employed	=	Rs. 37 crores/Rs. 777 crores = 0.0476
Equity to capital employed	=	Rs. 740 crores /Rs. 777 crores =0.952
Interest cost before Tax		Rs. 4.85 crores
Less: Tax (25% of Rs. 4.85 crores)		(Rs. 1.21 crores)
Interest cost after tax		Rs. 3.64 crores
Cost of debt	=	(Rs. 3.64 crores/ Rs. 37 crores) x 100
	=	9.83%

According to Capital Asset Pricing Model (CAPM), Beta for calculation of EVA should be the highest of the given beta for the last few years. Accordingly,

Cost of Equity Capital = Risk Free Rate + Beta (Market Rate – Risk Free Rate)

= 12% + 1.10 × (15.50% - 12%)

= 12% + 1.10 × 3.5% = 15.85%

Weighted Average Cost of Capital (WACC) = Equity to Capital Employed (CE) x Cost of Equity Capital + Debt to CE x Cost of Debt

= 0.952× 15.85% + 0.0476 × 9.83%

$$= 15.09\% + 0.47\% = 15.56\%$$

Cost of Capital Employed (COCE) = WACC $\times$ Capital Employed

$$= 15.56\% \times \text{Rs. } 777 \text{ crores} = \text{Rs. } 120.90 \text{ crores}$$

Economic Value Added (E.V.A.) = NOPAT – COCE

$$= \text{Rs. } 209.54 \text{ crores} - \text{Rs. } 120.90 \text{ crores} = \text{Rs. } 88.64 \text{ crores}$$

(b) (i) Considering definition of cash and cash equivalents under AS 3 "Cash Flow Statements", deposits with original maturity of three months or less can be classified as cash equivalents. Accordingly, term deposit with remaining maturity of three months as on balance sheet date should be included under 'cash and cash equivalents' under 'current assets'.

As per Schedule III to the Companies Act, 2013, the bank deposits with more than 12 months maturity are to be shown separately under cash and cash equivalents. This is in conflict with the provisions of AS 3 as stated above. The solution in this regard has been provided under Guidance Note on Revised Schedule VI* issued by the ICAI, which states that the caption 'cash and cash equivalents' should be changed to 'cash and bank balances' which may have two sub-heading viz 'cash and cash equivalents' and 'other bank balances'.

Accordingly, term deposit (whose remaining period is 8 months) should be shown as "other bank balances" under cash and bank balances. However, the term deposit whose remaining maturity period is two years should be shown as non-current asset as the same is not realizable within 12 months from the balance sheet date.

(ii) All fixed assets (tangible and intangible assets) including leasehold assets will be classified as fixed asset even if its balance estimated useful life is below 12 months as on the reporting date. Only the fixed assets held for sale are classified as a current asset since the intent of the company to sell it is established.

5. (a) Loss to be borne by Equity and Preference Shareholders

	Rs.
Profit and loss account (debit balance)	8,00,000
Goodwill	2,00,000
Plant & Machinery	3,00,000
Debtors	3,50,000

* Now Schedule III to the Companies Act, 2013.

Amount to be written off	16,50,000
Less: 50% of Creditors	3,50,000
Recorded loss borne by the share holders	13,00,000
Add: Arrears of preference dividend of 2 years forgone by the preference shareholders	1,40,000
Total sacrifice by the shareholders of M Ltd.	14,40,000

(b) Share of loss to be borne by the equity and preference shareholders

	Rs.	Rs.
Total recorded loss of Rs. 13,00,000		
Preference shareholders' share of loss = 20% of Rs. 10,00,000	2,00,000	
Add: Arrears of preference dividend	1,40,000	3,40,000
Equity shareholders' share of loss (Rs.13,00,000 – Rs. 2,00,000) being more than 51% of equity share capital		11,00,000
		14,40,000

(c) New structure of share capital after reorganisation

Equity shares:	Rs.
20,000 equity shares of Rs. 45 each, fully paid up (Rs. 20,00,000 – Rs. 11,00,000)	9,00,000
Preference shares:	
10,000, 9% preference shares of Rs. 80 each, fully paid up (Rs. 10,00,000 – Rs. 2,00,000)	8,00,000
	17,00,000

(d) Working capital of the reorganized company

Current Assets:	Rs.	Rs.
Stock		3,00,000
Debtors		4,00,000
Cash		1,50,000
		8,50,000
Less: Current liabilities:		
Creditors	3,50,000	

Bank overdraft **	75,000	(4,25,000)
Working capital		4,25,000

(e) Balance Sheet of M Ltd. (and reduced)

as on 31st March, 2014

Particulars	Note No.	Rs.
I. Equity and Liabilities		
(1) Shareholder's Funds		
Share Capital	1	17,00,000
(2) Non-current Liabilities		
Long-term borrowings	2	2,25,000
(3) Current Liabilities		
(a) Trade Payables		3,50,000
(b) Other Current Liabilities	3	75,000
Total		23,50,000
II. Assets		
(1) Non-current assets		
Fixed assets		
Tangible Assets	4	15,00,000
(2) Current assets		
(a) Inventories		3,00,000
(b) Trade receivables		4,00,000
(c) Cash and cash equivalents	5	1,50,000
Total		23,50,000

Notes to Accounts

		Rs.	Rs.
1.	Share Capital		
	Equity share capital		
	20,000 Equity shares of Rs.45 each, fully paid up	9,00,000	
	9% Preference share capital		

** Current ratio shall be 2 : 1, i.e. total current liabilities shall be 50% of Rs. 8,50,000 (i.e. Rs. 3,00,000 + 4,00,000 + 1,50,000) = Rs. 4,25,000. Therefore, Bank overdraft = Rs. 75,000 (Rs. 4,25,000 less creditors Rs. 3,50,000).

	10,000 shares of Rs. 80 each	8,00,000	17,00,000
2.	Long Term Borrowings		
	Unsecured:		
	Term loan with Bank		2,25,000
3.	Other Current Liabilities		
	Bank overdraft		75,000
4.	Tangible Assets		
	Plant and machinery		15,00,000
5.	Cash & cash equivalents		
	Cash		1,50,000

6. (a) B Ltd.

Value Added Statement for the year ended 31st March, 2014

	(Rs. in thousands)	*(Rs. in thousands)*
Sales less returns		15,27,956
Less: Cost of bought in materials and services, as per working note	9,19,470	
Administrative expenses	32,640	
Interest on bank overdraft	100	(9,52,210)
Value added by manufacturing and trading activities		5,75,746
Add: Dividends and interest		130
Miscellaneous income		474
Total value added		5,76,350

Application of value added

	(Rs. in thousands)	*(Rs. in thousands)*	*%*
To pay Employees:			
Wages, salaries and bonus	3,81,760		
Staff welfare expenses	26,240	4,08,000	70.79
To pay Directors:			
Directors' remuneration		7,810	1.36
To pay Government:			
Excise duty	14,540		

Income tax	25,470		
Tax on distributed profits	2,818	42,828	7.43
To pay providers of capital:			
Interest on 9% debentures	14,400		
Interest on long-term loan from financial institution	10,000		
Dividend to shareholders	22,000	46,400	8.05
To provide for maintenance and expansion of the company:			
Depreciation on Fixed assets	50,600		
Transfer to General reserve	18,212		
Retained profit (8,800-6,300)	2,500	71,312	12.37
		5,76,350	100.00

Statement showing reconciliation of total value added with Profit before taxation

	(Rs. in thousands)	*(Rs. in thousands)*
Profit Before Taxation		71,000
Add back:		
Wages, salaries and bonus	3,81,760	
Staff welfare expenses	26,240	
Excise duty	14,540	
Directors' remuneration	7,810	
Interest on 9% mortgage debentures	14,400	
Interest on long-term loan from financial institution	10,000	
Depreciation on fixed assets	50,600	5,05,350
Total Value Added		5,76,350

Working Note:

Calculation of cost of bought in materials and services:

	(Rs. in thousands)
Decrease in inventory of finished goods	26,054
Consumption of raw materials	7,40,821
Power and lighting	1,20,030

Other manufacturing expenses	32,565
	9,19,470

(b)

	Rs. in lakhs	*Rs. in lakhs*	
Opening bank balance [(100- 90-7) Rs. lakhs]	3.00		
Add: Proceeds from sale of securities	40.00		
Dividend received	1.20	44.20	
Less:			
Cost of securities	28.20		
Fund management expenses [(4.50–0.25) Rs. lakhs]	4.25		
Capital gains distributed [75% of (40.00 – 38.00) Rs. lakhs]	1.50		
Dividends distributed (75% of Rs. 1.20 lakhs)	0.90	(34.85)	
Closing bank balance		9.35	
Closing market value of portfolio		101.90	
		111.25	
Less: Arrears of expenses		0.25	
Closing net assets		111.00	
Number of units			10,00,000
Closing Net Assets Value (NAV)			Rs. 11.10

7. (a) Fair value of an ESPP = Rs. 56 – Rs. 50 = Rs. 6

Number of shares issued = 400 employees x 100 shares/employee = 40,000 shares

Fair value of ESPP which will be recognized as expenses in the year 2014-15

= 40,000 shares x Rs. 6 = Rs. 2,40,000

Vesting period = 1 month

Expenses to be recognized in 2014-15 = Rs. 2,40,000

Journal Entry

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
30.04.2014	Bank A/c (40,000 shares x Rs. 50)	Dr.	20,00,000	

	Employees compensation expense A/c Dr.	2,40,000	
	To Share Capital A/c (40,000 shares x Rs. 10)		4,00,000
	To Securities Premium (40,000 shares x Rs. 46)		18,40,000
	(Being shares issued under ESPP @ Rs. 50)		

(b) The balance amount of maintenance provision written back to profit and loss account, no longer required due to crash of the helicopters, is not a prior period item because there was no error in the preparation of previous periods' financial statements. The term 'prior period items', as defined in AS 5 (revised) "Net Profit or Loss for the Period, Prior Period Items and Changes In Accounting Policies", refer only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

As per para 8 of AS 5, extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived. The amount so written-back (if material) should be disclosed as an extraordinary item as per AS 5.

(c) The fair value of the Loan to C Ltd. is the present value of the interest it will receive over the next 5 years and the present value of repayment at the end of 5th year.

P.V. of interest discounted @ 8% = [(20,00,00,000 × 5%) × 3.9926] = Rs. 3,99,26,000 (A)

P.V. of principal amount = Rs. 20,00,00,000 discounted @ 8%

= Rs. 20,00,00,000 × 0.6806 =13,61,20,000 (B)

Fair Value of Loan (A + B) i.e. Rs. 17,60,46,000 (i.e. approximately Rs. 17,60,00,000 which is loan amount net of origination fee)

Therefore, C Ltd. will recognize the loan at Rs. 17.60 crores only.

C Ltd. will recognize the interest using the effective interest rate method as worked out below:

Year	Amortised Cost (Opening Balance)	Interest income @ 8% to be recognised	Total	Payment received	Amortised Cost (Closing Balance)
	(1)	(2)	(3)	(4)	(5) = (3) – (4)
1	17,60,00,000	1,40,80,000	19,00,80,000	1,00,00,000	18,00,80,000
2	18,00,80,000	1,44,06,400	19,44,86,400	1,00,00,000	18,44,86,400

3	18,44,86,400	1,47,58,912	19,92,45,312	1,00,00,000	18,92,45,312
4	18,92,45,312	1,51,39,625	20,43,84,937	1,00,00,000	19,43,84,937
5	19,43,84,937	1,56,15,063*	21,00,00,000	21,00,00,000	Nil

*Note: The interest in the 5th year has been adjusted in accordance to the value received on closure.

(d) As per AS 28 “Impairment of Assets”, impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount, where, recoverable amount is the higher of an asset’s net selling price* and its value in use•. In the given case, recoverable amount will be nil [higher of value in use (nil) and net selling price (Rs. 70,000)]. Thus impairment loss will be calculated as Rs. 6,00,000 [carrying amount (Rs. 6,00,000) – recoverable amount (nil)]. Therefore, asset is to be fully impaired and impairment loss of Rs. 6,00,000 has to be recognized as an expense immediately in the Statement of Profit and Loss as per para 58 of AS 28.

(e) As per AS 9 ‘Revenue Recognition’, revenue recognition is mainly concerned with the timing of recognition of revenue in the profit and loss account. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of services, as the case may be even though payments are made in installments. Also, the amount of revenue is usually determined by agreement between the parties to the transaction.

In the given case, Safe Ltd. wants to recognize insurance claim as revenue in advance, because percentage of accidents has increased over the previous year. But, there are uncertainties involved in the settlement of the claim. Also, the claim does not occur in the course of ordinary activity of the company.

Hence, Safe Ltd. is not advised to recognize the insurance claim as revenue.

*Net selling price is the amount obtainable from the sale of an asset in an arm’s length transaction between knowledgeable, willing parties, less the costs of disposal. In the given case, Net Selling Price = Selling price – Cost of disposal = Nil – Rs.70,000 = (Rs. 70,000)

• Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. In the given case, value in use is nil.

MOCK TEST PAPER –1

FINAL COURSE: GROUP – I

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

*Question No. 1 is compulsory. Attempt any **five** questions from the remaining **six** questions. Working notes should form part of the answer.*

Time Allowed – 3 Hours Maximum Marks – 100

1. (a) BSE 5000

Value of portfolio	Rs. 10,10,000
Risk free interest rate	9% p.a.
Dividend yield on Index	6% p.a.
Beta of portfolio	1.5

We assume that a future contract on the BSE index with four months maturity is used to hedge the value of portfolio over next three months. One future contract is for delivery of 50 times the index.

Based on the above information calculate:

(i) Price of future contract.

(ii) The gain on short futures position if index turns out to be 4,500 in three months.

(5 Marks)

(b) You as a forex dealer have dealing position in your account in London:

Particulars	£
Opening Balance (Oversold)	187,500
Purchase of cheques not credited to the account	164,000
Outstanding Forward Contracts	
Sales	4,096,500
Purchases	3,651,500
DD issued not yet presented for payment	610,040
Bill purchased in hand not due for	1,442,820

What must you do to square up your position? *(5 Marks)*

(c) A company is considering Projects X and Y with following information:

Project	Expected NPV (Rs.)	Standard deviation
X	1,22,000	90,000
Y	2,25,000	1,20,000

(i) Which project will you recommend based on the above data?

(ii) Explain whether your opinion will change, if you use coefficient of variation as a measure of risk.

(iii) Which measure is more appropriate in this situation and why? *(5 Marks)*

(d) M Ltd. has to make a payment on 30th January, 2014 of Rs. 80 lakhs. It has surplus cash today, i.e. 31st October, 2013; and has decided to invest sufficient cash in a bank's Certificate of Deposit scheme offering an yield of 8% p.a. on simple interest basis. What is the amount to be invested now? *(5 Marks)*

2. (a) DEF Ltd has been regularly paying a dividend of Rs. 19,20,000 per annum for several years and it is expected that same dividend would continue at this level in near future. There are 12,00,000 equity shares of Rs. 10 each and the share is traded at par.

The company has an opportunity to invest Rs. 8,00,000 in one year's time as well as further Rs. 8,00,000 in two year's time in a project as it is estimated that the project will generate cash inflow of Rs. 3,00,000 per annum in three year's time and four year's time and Rs. 3,60,000 in five year's time which will continue forever. This investment is possible if dividend is reduced for next two years.

Whether the company should accept the project? Also analyze the effect on the market price of the share, if the company decides to accept the project. *(8 Marks)*

(b) The following information is extracted from Steady Mutual Fund's Scheme:

- Asset Value at the beginning of the month - Rs. 65.78
- Annualised return -15 %
- Distributions made in the nature of Income - Rs. 0.50 and Rs. 0.32 & Capital gain (per unit respectively).

You are required to:

(1) Calculate the month end net asset value of the mutual fund scheme (limit your answers to two decimals).

(2) Provide a brief comment on the month end NAV. *(8 Marks)*

3. (a) XY Limited is engaged in large retail business in India. It is contemplating for expansion into a country of Africa by acquiring a group of stores having the same

line of operation as that of India.

The exchange rate for the currency of the proposed African country is extremely volatile. Rate of inflation is presently 40% a year. Inflation in India is currently 10% a year. Management of XY Limited expects these rates likely to continue for the foreseeable future.

Estimated projected cash flows, in real terms, in India as well as African country for the first three years of the project are as follows:

	Year – 0	Year – 1	Year – 2	Year - 3
Cashflowsin Indian Rs. (000)	-50,000	-1,500	-2,000	-2,500
Cash flows in African Rands (000)	-2,00,000	+50,000	+70,000	+90,000

XY Ltd. assumes the year 3 nominal cash flows will continue to be earned each year indefinitely. It evaluates all investments using nominal cash flows and a nominal discounting rate. The present exchange rate is African Rand 6 to Rs. 1.

You are required to calculate the net present value of the proposed investment considering the following:

(i) African Rand cash flows are converted into rupees and discounted at a risk adjusted rate.

(ii) All cash flows for these projects will be discounted at a rate of 20% to reflect it's high risk.

(iii) Ignore taxation.

	Year - 1	Year - 2	Year - 3
PVIF @ 20%	.833	.694	.579

(8 Marks)

(b) Given the following information:

Exchange rate – Canadian dollar 0.665 per DM (spot)

Canadian dollar 0.670 per DM (3 months)

Interest rates – DM 7% p.a.

Canadian Dollar – 9% p.a.

What operations would be carried out to take the possible arbitrage gains? *(8 Marks)*

4. (a) XYZ Ltd.'s bond (Face Value of Rs. 1000) with 4 years maturity is currently trading at Rs. 900 carrying a coupon rate of 15%. Assuming that the reinvestment rate is

16%, you are required to calculate Realized Yield to Maturity of the bond. *(8 Marks)*

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

Year	Return on A (%)	Return on B (%)
2012	10	12
2013	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%.*(8 Marks)*

5. (a) A Ltd. has an export sale of Rs. 50 crore of which 20% is paid by importer in advance of dispatch and for balance the average collection period is 60 days. However, it has been observed that these payments have been running late by 18 days. The past experience indicates that bad debt losses are 0.6% on Sales. The expenditure incurred for efforts in receivable collection are Rs. 60,00,000 p.a.

So far A Ltd. had no specific arrangements to deal with export receivables, following two proposals are under consideration:

(i) A non-recourse export factoring agency is ready to buy A Ltd.'s receivables by charging 2% commission. The factor will pay an advance to the firm at an interest rate of MIBOR + 2.00% after withholding 20% as reserve.

(ii) Insu Ltd. an insurance company has offered a comprehensive insurance policy at a premium of 0.45% of the sum insured covering 85% of risk of non-payment. A Ltd. can assign its right to a bank in return of an advance of 75% of the value insured at MIBOR+1.75%.

Assuming that MIBOR is 6% and A Ltd. can borrow from its bank at MIBOR+2.25% by using existing overdraft facility determine the which of the two proposal should be accepted by A Ltd. (1 Year = 360 days). *(10 Marks)*

(b) A company is long on 10 MT of copper @ Rs. 474 per kg (spot) and intends to remain so for the ensuing quarter. The standard deviation of changes of its spot and future prices are 4% and 6% respectively, having correlation coefficient of 0.75.

What is its hedge ratio? What is the amount of the copper future it should short to achieve a perfect hedge? *(6 Marks)*

6. (a) The following information is provided related to the acquiring Firm Mark Limited and the target Firm Mask Limited:

	Firm Mark Limited	Firm Mask Limited
Earning after tax (Rs.)	2,000 lakhs	400 lakhs
Number of shares outstanding	200 lakhs	100 lakhs
P/E ratio (times)	10	5

Required:

(i) What is the Swap Ratio based on current market prices?

(ii) What is the EPS of Mark Limited after acquisition?

(iii) What is the expected market price per share of Mark Limited after acquisition, assuming P/E ratio of Mark Limited remains unchanged?

(iv) Determine the market value of the merged firm.

(v) Calculate gain/loss for shareholders of the two independent companies after acquisition. *(8 Marks)*

(b) X Limited, just declared a dividend of Rs. 14.00 per share. Mr. B is planning to purchase the share of X Limited, anticipating increase in growth rate from 8% to 9%, which will continue for three years. He also expects the market price of this share to be Rs. 360.00 after three years.

You are required to determine:

(i) the maximum amount Mr. B should pay for shares, if he requires a rate of return of 13% per annum.

(ii) the maximum price Mr. B will be willing to pay for share, if he is of the opinion that the 9% growth can be maintained indefinitely and require 13% rate of return per annum.

(iii) the price of share at the end of three years, if 9% growth rate is achieved and assuming other conditions remaining same as in (ii) above.

Calculate rupee amount up to two decimal points.

	Year-1	Year-2	Year-3
FVIF @ 9%	1.090	1.188	1.295
FVIF @ 13%	1.130	1.277	1.443
PVIF @ 13%	0.885	0.783	0.693

(8 Marks)

7. Write short notes on any of **four** of the following:

(a) Financial and Operating Lease

(b) Euro Convertible Bonds (ECBs)

(c) CAMEL Model in Credit Rating

(d) Random Walk Theory

(e) Modigliani and Miller (MM) Hypothesis of Dividend *(4 ×4 = 16 Marks)*

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – I

PAPER – 2: STRATEGIC FINANCIAL MANAGEMENT

SUGGESTED ANSWERS/HINTS

1. (a)

(i) Current future price of the index = $5000 + 5000\,(0.09\text{-}0.06)\frac{4}{12} = 5000 + 50$
= 5,050

$\therefore$ Price of the future contract = Rs. 50 x 5,050 = Rs. 2,52,500

(ii) Hedge ratio = $\frac{1010000}{252500}\times 1.5$ = 6 contracts

Index after three months turns out to be 4500

Future price will be = $4500 + 4500\,(0.09\text{-}0.06)\times\frac{1}{3} = 4{,}511.25$

Therefore, Gain from the short futures position is = 6 x (5050 – 4511.25) x 50
= Rs. 1,61,625

Note: Alternatively we can also use daily compounding (exponential) formula.

(b)

	Purchases (£)	Sale (£)
Balance (Oversold)		187,500
Cheques purchased	164,000	
Forward Sales		4,096,500
Forward Purchases	3,651,500	
DD issued		610,040
Bill purchased	1,442,820	
	5,258,320	4,894,040
Balance (Overbought)		364,280
	5,258,320	5,258,320

Since dealer has overbought position of £364,280, it will sell this amount (nearest amount £364,000 because it have to buy in interbank market where the deals are available in rounding off.

(c) (i) On the basis of standard deviation project X be chosen because it is less risky than Project Y having higher standard deviation.

(ii) $CV_x = \frac{SD}{ENPV} = \frac{90,000}{1,22,000} = 0.738$

$CV_y = \frac{1,20,000}{2,25,000} = 0.533$

On the basis of Co-efficient of Variation (C.V.) Project X appears to be more risky and Y should be accepted.

(iii) However, the NPV method in such conflicting situation is best because the NPV method is in compatibility of the objective of wealth maximisation in terms of time value.

(d) Calculation of Investment Amount

Amount required for making payment on 30th January, 2014 = Rs. 80,00,000

Investment in Certificates of Deposit (CDs) on 31st October, 2013

Rate of interest	= 8% p.a.
No. of days to maturity	= 91 days
Interest on Rs. 1 of 91 days	
(Re. 1 × 0.08 × 91/365)	= 0.0199452
Amount to be received for Re. 1	
(Re.1.00 + Rs. 0.0199452)	= 1.0199452

Calculation of amount to be invested now to get Rs. 80 lakhs after 91 days:

$$= \frac{₹\ 80,00,000}{₹\ 1.0199452} = \text{Rs. } 78,43,558.65$$

Or, Rs. 78,43,600 or Rs. 78,44,000 approximately.

2. (a) First we calculate cost of Equity (K_e)/PE Ratio

$$D_1 = \frac{19,20,000}{12,00,000} = \text{Rs. } 1.6$$

P_0 = Rs. 10

$$P/E = \frac{10}{1.6} = 6.25$$

$$K_e = \frac{1}{P/E} = \frac{1}{6.25} = 16\%$$

Now we shall compute NPV of the project

$$\text{NPV}=\frac{-800000}{(1+0.16)}+\frac{-800000}{(1+0.16)^2}+\frac{300000}{(1+0.16)^3}+\frac{300000}{(1+0.16)^4}+\frac{360000}{0.16}\times\frac{1}{(1+0.16)^4}$$

= -6,89,655 – 5,94,530 + 1,92,197 + 1,65,687 + 12,42,655

= 3,16,354

As NPV of the project is positive, the value of the firm will increase by Rs. 3,16,354 and spread over the number of shares e.g. 12,00,000, the market price per share will increase by 26 paisa.

(b) (1) Calculation of NAV at the end of month:

Given Annual Return = 15%

Hence Monthly Return = 1.25% (r)

$$r=\frac{(NAV_t - NAV_{t-1})+I_t+G_t}{NAV_{t-1}}$$

$$0.0125=\frac{\left(NAV_t-\text{Rs. }65.78\right)+\ \text{Rs.}0.50+\text{Rs. }0.32}{\text{Rs. }65.78}$$

$0.82 = NAV_t$ - Rs. 64.96

NAV_t = Rs. 65.78

(2) There is no change in NAV.

3. (a) Calculation of NPV

Year	0	1	2	3
Inflation factor in India	1.00	1.10	1.21	1.331
Inflation factor in Africa	1.00	1.40	1.96	2.744
Exchange Rate (as per IRP)	6.00	7.6364	9.7190	12.3696
Cash Flows in Rs.'000				
Real	-50000	-1500	-2000	-2500
Nominal (1)	-50000	-1650	-2420	-3327.50
Cash Flows in African Rand '000				
Real	-200000	50000	70000	90000
Nominal	-200000	70000	137200	246960
In Indian Rs.'000 (2)	-33333	9167	14117	19965
Net Cash Flow in Rs. '000 (1)+(2)	-83333	7517	11697	16637
PVF@20%	1	0.833	0.694	0.579
PV	-83333	6262	8118	9633

NPV of 3 years = -59320 (Rs. '000)

NPV of Terminal Value = $\frac{16637}{0.20} \times 0.579 = 48164\ (\text{Rs.'000})$

Total NPV of the Project = -59320 (Rs. '000) + 48164 (Rs.'000) = -11156 (Rs.'000)

(b) In this case, DM is at a premium against the Can$.

Premium = [(0.67 – 0.665) /0.665] x (12/3) x 100 = 3.01 per cent

Interest rate differential = 9% - 7% = 2 per cent.

Since the interest rate differential is smaller than the premium, it will be profitable to place money in Deutschmarks the currency whose 3-months interest is lower.

The following operations are carried out:

(i) Borrow Can$ 1000 at 9 per cent for 3- months;

(ii) Change this sum into DM at the spot rate to obtain DM

= (1000/0.665) = 1503.76

(iii) Place DM 1503.76 in the money market for 3 months to obtain a sum of DM

Principal:	1503.76
Add: Interest @ 7% for 3 months =	26.32
Total	1530.08

(iv) Sell DM at 3-months forward to obtain Can$= (1530.08x0.67) = 1025.15

(v) Refund the debt taken in Can$ with the interest due on it, i.e.,

	Can$
Principal	1000.00
Add: Interest @9% for 3 months	22.50
Total	1022.50

Net arbitrage gain = 1025.15 – 1022.50 = Can$ 2.65

4. (a) We shall compute r* (Realized Yield to Maturity) by using following equation:

PV $(1+r^*)^4$ = Future Value of Benefits and Future Value of Benefits shall be computed as follows:

	0	1	2	3	4
Investment (Rs.)	900				
Annual Interest (Rs.)		150	150	150	150
Compound Factor @ 16%		1.56	1.35	1.16	1.00
Future Value of Intermediate Cash Flows (Rs.)		234.00	202.50	174.00	150

Maturity Value (Rs.)					1000.00
	900	234.00	202.50	174.00	1150.00
				Total of Future Benefits	1760.50

Accordingly,

$900\ (1+r^*)^4 = 1760.50$

$(1+r^*)^4 = 1760.50/900$

$(1+r^*)^4 = 1.956$

$(1+r^*) = (1.956)^{¼}$

$(1+r^*) = (1.1826)$

$r^* = 0.1826$ say 18.26%

(b) (i) Expected return of the portfolio A and B

E (A) = (10 + 16) / 2 = 13%

E (B) = (12 + 18) / 2 = 15%

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

(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

$$r_{AB} = \frac{Cov_{AB}}{\sigma_A \sigma_B} = \frac{9}{3 \times 3} = 1$$

(v) Portfolio Risk

$$\sigma_P = \sqrt{X^2{}_A \sigma^2{}_A + X^2{}_B \sigma^2{}_B + 2X_A X_B (\sigma_A \sigma_B \sigma_{AB})}$$

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

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

5. (a) Working Notes:

Total Annual Export Sales	Rs. 50 crore
Cash Received in Advance (20%)	Rs. 10 crore
Balance on 60 days credit (80%)	Rs. 40 crore
Bad Debts 0.6% x Rs. 40 crore	Rs. 0.24 crore
Average Export Debtors Rs. 40 crore x $\frac{78}{360}$	Rs. 8.67 crore

Proposal I – Factoring Services

Due to non-recourse factoring agreement there will be saving of bad debt. A Ltd. can choose one option out of two options:

(i) Using Factoring Services (Debt Collection) only.

(ii) Using Factoring and Finance Services i.e. above services in combination of cash advance.

Since, cash advance rate is lower by 0.25% (2.25% - 2.00%), A Ltd. should take advantage of the same.

Particulars	Amount (Rs.)
Annual Factoring Commission (2% x Rs. 40 crore)	(0.80000 crore)
Saving of Administrative Cost	0.60000 crore
Saving of Bad Debts	0.24000 crore
Interest Saving on 80% of Debtors (8.67 crore x 80% x 0.25%)	0.01734 crore
Net Saving to A Ltd.	0.05734 crore

Proposal II – Insurance of Receivables

Particulars	Amount (Rs.)
Insurance Premium (0.45% x Rs. 40 crore)	(0.18000 crore)
Saving of Bad Debts (85% x Rs. 0.24 crore)	0.20400 crore
Interest Saving on 75% of Debtors (0.5% x 75% x Rs. 8.67 crore)	0.03251 crore
Net Saving to A Ltd.	0.05651 crore

Since saving in Factoring is marginally higher it should be accepted.

(b) The optional hedge ratio to minimize the variance of Hedger's position is given by:

$$H = \rho\frac{\sigma S}{\sigma F}$$

Where

σS= Standard deviation of ΔS

σF=Standard deviation of ΔF

ρ= coefficient of correlation between ΔS and ΔF

H= Hedge Ratio

ΔS = change in Spot price.

ΔF= change in Future price.

Accordingly

$$H = 0.75 \times \frac{0.04}{0.06} = 0.5$$

No. of contract to be short = 10 x 0.5 = 5

Amount = 5000 x Rs. 474 = Rs. 23,70,000

6. (a)

Particulars	Mark Ltd.	Mask Ltd.
EPS	Rs. 2,000 Lakhs/ 200 lakhs	Rs. 400 lakhs / 100 lakhs
	= Rs. 10	Rs. 4
Market Price	Rs. 10 × 10 = Rs. 100	Rs. 4 × 5 = Rs. 20

(i) The Swap ratio based on current market price is

Rs. 20 / Rs. 100 = 0.2 or 1 share of Mark Ltd. for 5 shares of Mask Ltd.

No. of shares to be issued = 100 lakh × 0.2 = 20 lakhs.

(ii) EPS after merger

$$= \frac{\text{Rs. } 2{,}000 \text{ lakhs} + \text{Rs. } 400 \text{ lakhs}}{200 \text{ lakhs} + 20 \text{ lakhs}} = \text{Rs. } 10.91$$

(iii) Expected market price after merger assuming P / E 10 times.

= Rs. 10.91 × 10 = Rs. 109.10

(iv) Market value of merged firm

= Rs. 109.10 market price × 220 lakhs shares = 240.02 crores

(v) Gain from the merger

Post merger market value of the merged firm	Rs. 240.02 crores

Less: Pre-merger market value

Mark Ltd. 200 Lakhs $\times$ Rs. 100 = 200 crores

Mask Ltd. 100 Lakhs $\times$ Rs. 20 = 20 crores Rs. 220.00 crores

Gain from merger Rs. 20.02 crores

Appropriation of gains from the merger among shareholders:

	Mark Ltd.	*Mask Ltd.*
Post merger value	218.20 crores	21.82 crores
Less: Pre-merger market value	200.00 crores	20.00 crores
Gain to Shareholders	18.20 crores	1.82 crores

(b) (i) Expected dividend for next 3 years.

Year 1 (D_1) Rs. 14.00 (1.09) = Rs. 15.26

Year 2 (D_2) Rs. 14.00 $(1.09)^2$ = Rs. 16.63

Year 3 (D_3) Rs. 14.00 $(1.09)^3$ = Rs. 18.13

Required rate of return = 13% (Ke)

Market price of share after 3 years = (P_3) = Rs. 360

The present value of share

$$P_0 = \frac{D_1}{(1+ke)} + \frac{D_2}{(1+ke)^2} + \frac{D_3}{(1+ke)^3} + \frac{P_3}{(1+ke)^3}$$

$$P_0 = \frac{15.26}{(1+0.13)} + \frac{16.63}{(1+0.13)^2} + \frac{18.13}{(1+0.13)^3} + \frac{360}{(1+0.13)^3}$$

P_0 = 15.26(0.885) + 16.63(0.783) +18.13(0.693) + 360(0.693)

P_0 = 13.50 + 13.02 + 12.56 + 249.48

P_0 = Rs. 288.56

(ii) If growth rate 9% is achieved for indefinite period, then maximum price of share should Mr. A willing be to pay is

$$P_0 = \frac{D_1}{(ke-g)} = \frac{\text{Rs. } 15.26}{0.13\text{-}0.09} = \frac{\text{Rs.}15.26}{0.04} = \text{Rs. } 381.50$$

(iii) Assuming that conditions mentioned above remain same, the price expected after 3 years will be:

$$P_3 = \frac{D_4}{k_e - g} = \frac{D_3(1.09)}{0.13-0.09} = \frac{18.13\times 1.09}{0.04} = \frac{19.76}{0.04} = \text{Rs. } 494$$

7. (a) Salient features of Financial Lease

(i) It is an intermediate term to long-term arrangement.

(ii) During the primary lease period, the lease cannot be cancelled.

(iii) The lease is more or less fully amortized during the primary lease period.

(iv) The costs of maintenance, taxes, insurance etc., are to be incurred by the lessee unless the contract provides otherwise.

(v) The lessee is required to take the risk of obsolescence.

(vi) The lessor is only the Financier and is not interested in the asset.

Salient features of Operating Lease

(i) The lease term is significantly less than the economic life of the equipment.

(ii) It can be cancelled by the lessee prior to its expiration date.

(iii) The lease rental is generally not sufficient to fully amortize the cost of the asset.

(iv) The cost of maintenance, taxes, insurance are the responsibility of the lessor.

(v) The lessee is protected against the risk of obsolescence.

(vi) The lessor has the option to recover the cost of the asset from another party on cancellation of the lease by leasing out the asset.

(b) Euro Convertible Bonds: They are bonds issued by Indian companies in foreign market with the option to convert them into pre-determined number of equity shares of the company. Usually price of equity shares at the time of conversion will fetch premium. The Bonds carry fixed rate of interest.

The issue of bonds may carry two options:

Call option: Under this the issuer can call the bonds for redemption before the date of maturity. Where the issuer's share price has appreciated substantially, i.e., far in excess of the redemption value of bonds, the issuer company can exercise the option. This call option forces the investors to convert the bonds into equity. Usually, such a case arises when the share prices reach a stage near 130% to 150% of the conversion price.

Put option: It enables the buyer of the bond a right to sell his bonds to the issuer company at a pre-determined price and date. The payment of interest and the redemption of the bonds will be made by the issuer-company in US dollars.

(c) CAMEL Model in Credit Rating: Camel stands for Capital, Assets, Management, Earnings and Liquidity. The CAMEL model adopted by the rating agencies deserves special attention; it focuses on the following aspects-

(i) *Capital*- Composition of external funds raised and retained earnings, fixed dividends component for preference shares and fluctuating dividends component for equity shares and adequacy of long term funds adjusted to gearing levels, ability of issuer to raise further borrowings.

(ii) *Assets*- Revenue generating capacity of existing/proposed assets, fair values, technological/physical obsolescence, linkage of asset values to turnover, consistency, appropriation of methods of depreciation and adequacy of charge to revenues, size, ageing and recoverability of monetary assets like receivables and its linkage with turnover.

(iii) *Management*- Extent of involvement of management personnel, team-work, authority, timeliness, effectiveness and appropriateness of decision making along with directing management to achieve corporate goals.

(iv) *Earnings*- Absolute levels, trends, stability, adaptability to cyclical fluctuations, ability of the entity to service existing and additional debts proposed.

(v) *Liquidity*- Effectiveness of working capital management, corporate policies for stock and creditors, management and the ability of the corporate to meet their commitment in the short run.

These five aspects form the five core bases for estimating credit worthiness of an issuer which leads to the rating of an instrument. Rating agencies determine the pre-dominance of positive/negative aspects under each of these five categories and these are factored in for making the overall rating decision.

(d) Many investment managers and stock market analysts believe that stock market prices can never be predicted because they are not a result of any underlying factors but are mere statistical ups and downs. This hypothesis is known as Random Walk hypothesis which states that the behaviour of stock market prices is unpredictable and that there is no relationship between the present prices of the shares and their future prices. Proponents of this hypothesis argue that stock market prices are independent. A British statistician, M. G. Kendell, found that changes in security prices behave nearly as if they are generated by a suitably designed roulette wheel for which each outcome is statistically independent of the past history. In other words, the fact that there are peaks and troughs in stock exchange prices is a mere statistical happening – successive peaks and troughs are unconnected. In the layman's language it may be said that prices on the stock exchange behave exactly the way a drunk would behave while walking in a blind lane, i.e., up and down, with an unsteady way going in any direction he likes, bending on the side once and on the other side the second time.

The supporters of this theory put out a simple argument. It follows that:

(i) Prices of shares in stock market can never be predicted. The reason is that the price trends are not the result of any underlying factors, but that they represent a statistical expression of past data.

(ii) There may be periodical ups or downs in share prices, but no connection can be established between two successive peaks (high price of stocks) and troughs (low price of stocks).

(e) Modigliani and Miller Hypothesis is in support of the irrelevance of dividends. Modigiliani and Miller argue that firm's dividend policy has no effect on its value of assets and is, therefore of no consequence i.e. dividends are irrelevant to shareholders wealth. According to them, *'Under conditions of perfect capital markets, rational investors, absence of tax discrimination between dividend income and capital appreciation, given the firm's investment policy, its dividend policy may have no influence on the market price of shares'.*

The hypothesis is based on the following assumptions:

The firm operates in perfect capital markets in which all investors are rational and information is freely available to all.

There are no taxes. Alternatively, there are no differences in the tax rates applicable to capital gains and dividends.

The firm has a fixed investment policy.

There are no floatation or transaction costs.

Risk of uncertainty does not exist. Investors are able to forecast future prices and dividends with certainty, and one discount rate is appropriate for all securities and all time periods. Thus, $r = k = k_t$ for all t.

MM Hypothesis is primarily based on the arbitrage argument. Through the arbitrage process, the MM Hypothesis discusses how the value of the firm remains same whether the firm pays dividend or not. It argues that the value depends on the earnings of the firm and is unaffected by the pattern of income distribution. Suppose, a firm which pays dividends will have to raise funds externally to finance its investment plans, MM's argument, that dividend policy does not affect the wealth of the shareholders, implies that when the firm pays dividends, its advantage is offset by external financing. This means that the terminal value of the share declines when dividends are paid. Thus, the wealth of the shareholders - dividends plus terminal price - remains unchanged. As a result, the present value per share after dividends and external financing is equal to the present value per share before the payments of dividends. Thus, the shareholders are indifferent between payment of dividends and retention of earnings.

Market price of a share after dividend declared on the basis of MM model is shown below:

$$P_o = \frac{P_1 + D_1}{1 + K_e}$$

Where,

P_o = The prevailing market price of a share

K_e = The cost of equity capital

D_1 = Dividend to be received at the end of period one

P_1 = Market price of a share at the end of period one.

If the firm were to finance all investment proposals, the total amount raised through new shares will be ascertained with the help of the following formula:

$$\Delta N = \frac{I - (E - nD_1)}{P_1}$$

Where,

ΔN = Change in the number of shares outstanding during the period

n = Number of shares outstanding at the beginning of the period

I = Total investment amount required for capital budget

E = Earnings of net income of the firm during the period.

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

*Question No. 1 is compulsory. Attempt any **five** questions from the remaining **six** questions. Working notes should form part of the answer.*

Time Allowed – 3 Hours | Maximum Marks – 100

1. (a) The BSE's Market Index is currently trading at 27,000 whose 6 months future's value is trading at 27,810. The Current price of Anand Ltd.'s share listed on BSE is Rs. 1,800. The beta of share is 1.80.

   Assuming it is possible to borrow money in the market for transactions in securities at 10% per annum, you are required:

   (i) To calculate 6 months future's value and the theoretical minimum price of a 6-months forward purchase of Anand Ltd.'s share; and

   (ii) To find arbitrate opportunity, if any possible. *(5 Marks)*

   (b) Sun Ltd. is planning to import equipment from Japan at a cost of 3,400 lakh yen. The company may avail loans at 18 percent per annum with which it can import the equipment. The company has also an offer from Osaka branch of an India based bank extending credit of 180 days at 2 percent per annum against opening of an irrecoverable letter of credit.

   Additional information:

Present exchange rate	Rs. 100 = 340 yen
180 day's forward rate	Rs. 100 = 345 yen

   Commission charges for letter of credit at 2 per cent per 12 months.

   Advice the company whether the offer from the foreign branch should be accepted.

   (5 Marks)

   (c) Assuming lease amortised in 5 years, calculate alternate rental structure from the following:

Investment Outlay	Rs. 100 Lakh
Pre Tax Rate	20%
Scrap Value	Nil

   Calculate Lease Rentals as per Schemes, assuming that if rent is payable in year end:

(a) Equal Annual Plan

(b) Stepped Up Plan (15% increase per annum) *(5 Marks)*

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

Date of issue	:	16th January, 2009
Date of maturity	:	17th April, 2009
No. of days	:	91
Interest rate		12.04% p.a

What was the net amount received by the company on issue of CP? (Charges of intermediary may be ignored). *(5 Marks)*

2. (a) From the following details relating to a project, analyse the sensitivity of the project to changes in initial project cost, annual cash inflow and cost of capital:

Initial Project Cost (Rs.)	1,20,000
Annual Cash Inflow (Rs.)	45,000
Project Life (Years)	4
Cost of Capital	10%

To which of the three factors, the project is most sensitive? (Use annuity factors: for 10% ... 3.169 and 11% ... 3.103). *(10 Marks)*

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

(i) Pay Rs.0.75 per unit as dividend and Rs.0.60 per unit as a capital gain, or

(ii) These distributions are to be reinvested at an average NAV of Rs.8.65 per unit.

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

3. (a) XY Limited is engaged in large retail business in India. It is contemplating for expansion into a country of Africa by acquiring a group of stores having the same line of operation as that of India.

The exchange rate for the currency of the proposed African country is extremely volatile. Rate of inflation is presently 40% a year. Inflation in India is currently 10% a year. Management of XY Limited expects these rates likely to continue for the foreseeable future.

Estimated projected cash flows, in real terms, in India as well as African country for the first three years of the project are as follows:

	Year – 0	Year – 1	Year – 2	Year - 3
Cashflowsin Indian Rs. (000)	-50,000	-1,500	-2,000	-2,500
Cash flows in African Rands (000)	-2,00,000	+1,80,000	+1,60,000	+1,50,000

It evaluates all investments using nominal cash flows and a nominal discounting rate. The present exchange rate is African Rand 6 to Rs. 1.

You are required to calculate the net present value of the proposed investment considering the following:

(i) African Rand cash flows are converted into rupees and discounted at a risk adjusted rate.

(ii) All cash flows for these projects will be discounted at a rate of 20% to reflect it's high risk.

(iii) Ignore taxation.

	Year - 1	Year - 2	Year - 3
PVIF @ 20%	.833	.694	.579

(8 Marks)

(b) XYZ Ltd. is an export oriented business house based in Mumbai. The Company invoices in customers' currency. Its receipt of US $ 1,00,000 is due on September 1, 2009.

Market information as at June 1, 2009 is:

Exchange Rates		Currency Futures	
US $/Rs.		US $/Rs.	Contract Size Rs.4,72,000
Spot	0.02140	June	0.02126
1 Month Forward	0.02136	September	0.02118
3 Months Forward	0.02127		
		Initial Margin	Interest Rates in India
June		Rs.10,000	7.50%
September		Rs.15,000	8.00%

On September 1, 2009 the spot rate US $/ Rs. is 0.02133 and currency future rate is 0.02134. Comment which of the following methods would be most advantageous for XYZ Ltd.

(a) Using forward contract

(b) Using currency futures

(c) Not hedging currency risks.

It may be assumed that variation in margin would be settled on the maturity of the futures contract. *(8 Marks)*

4. (a) Calculate economic value added (EVA) with the help of the following information of Hypothetical Limited:

Financial leverage	:	1.4 times
Capital structure	:	Equity Capital Rs. 170 lakhs
		Reserves and surplus Rs. 130 lakhs
		10% Debentures Rs. 400 lakhs
Cost of Equity	:	17.5%
Income Tax Rate	:	30%.

(6 Marks)

(b) John inherited the following securities on his uncle's death:

Types of Security	Nos.	Annual Coupon %	Maturity Years	Yield %
Bond A (Rs. 1,000)	10	9	3	12
Bond B (Rs. 1,000)	10	10	5	12
Preference shares C (Rs. 100)	100	11	*	13*
Preference shares D (Rs. 100)	100	12	*	13*

*likelihood of being called at a premium over par.

Tax Rate applicable on John is 20% and dividend incomes are tax free. Compute the current value of his uncle's portfolio. *(10 Marks)*

5. (a) MSN Ltd. has total sales of Rs. 4.50 crores and its average collection period is 120 days. The past experience indicates that bad debt losses are 2 percent on sales. The expenditure incurred by the company in administering its receivable collection efforts are Rs. 6,00,000. A Factor is prepared to buy the company's receivables by charging 2 percent commission. The factor will pay advance on receivables to the company at an interest rate of 18 percent per annum after withholding 10 percent as reserve.

You are required to calculate effective cost of factoring to the company. *(10 Marks)*

(b) The market received rumour about ABC corporation's tie-up with a multinational company. This has induced the market price to move up. If the rumour is false, the ABC corporation stock price will probably fall dramatically. To protect from this an investor has bought the call and put options.

He purchased one 3 months call with a striking price of Rs.42 for Rs.2 premium, and paid Re.1 per share premium for a 3 months put with a striking price of Rs.40.

(i) Determine the Investor's position if the tie up offer bids the price of ABC Corporation's stock up to Rs.43 in 3 months.

(ii) Determine the Investor's ending position, if the tie up programme fails and the price of the stocks falls to Rs.36 in 3 months. *(6 Marks)*

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

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

Required:

(i) What is the swap ratio based on current market prices?

(ii) What is the EPS of Mani Ltd. after the acquisition?

(iii) What is the expected market price per share of Mani Ltd. after the acquisition, assuming its P/E ratio is adversely affected by 10%?

(iv) Determine the market value of the merged Co.

(v) Calculate gain/loss for the shareholders of the two independent entities, due to the merger. *(10 Marks)*

(b) RST Ltd. has a capital of Rs. 10,00,000 in equity shares of Rs. 100 each. The shares are currently quoted at par. The company proposes to declare a dividend of Rs.10 per share at the end of the current financial year. The capitalization rate for the risk class of which the company belongs is 12%. What will be the market price of the share at the end of the year, if

(i) a dividend is not declared ?

(ii) a dividend is declared ?

(iii) assuming that the company pays the dividend and has net profits of Rs.5,00,000 and makes new investments of Rs.10,00,000 during the period, how many new shares must be issued? Use the MM model. *(6 Marks)*

7. Write short notes on any of **four** of the following:

(a) Bower-Herringer-Williamson Method in lease financing

(b) Advantages of Foreign Currency Convertible Bonds (FCCBs)

(c) Uses of Credit Rating

(d) Takeover by Reverse Bid.

(e) Modigliani and Miller (MM) Hypothesis of Dividend *(4 ×4 = 16 Marks)*

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 2: STRATEGIC FINANCIAL MANAGEMENT

SUGGESTED ANSWERS/HINTS

1. (a) (i) Change in BSE's Market index over six months = [(27,810 – 27,000)/27,000] x 100

= 3.00%

Beta value of Anand Ltd's share = 1.80

Anticipated Change in Share value over six months = 3.00% x 1.80

= 5.40%

Hence, Anand Ltd.'s share's 6 months future's value

= Rs. 1,800(1+0.0540) = Rs. 1,897.20

Calculation of theoretical minimum price of a 6 months forward contract-

Theoretical minimum price = Rs. 1,800 + (Rs. 1,800 x 10/100 x 6/12)

= Rs. 1,890.00

(ii) Arbitrage Opportunity-

The arbitrageur can borrow money @ 10 % for 6 months and buy the shares at Rs. 1,800. At the same time he can sell the shares in the futures market at Rs. 1,897.20. On the expiry date 6 months later, he could deliver the share and collect Rs. 1,897.20, pay off Rs. 1,890.00 and record a profit of Rs. 7.20 (Rs. 1,897.20 – Rs. 1,890.00).

(b)

Option I (To finance the purchases by availing loan at 18% per annum):

Cost of equipment	Rs. in lakhs
3400 lakh yen at Rs.100 = 340 yen	1,000.00
Add: Interest at 18% (on Rs.1000 lakhs) for 6 months	90.00
Total outflow in Rupees	1,090.00

Option II (To accept the offer from foreign branch):

Cost of letter of credit	Rs. in lakhs
At 1 % on 3400 lakhs yen at Rs.100 = 340 yen	10.00
Add: Interest	0.90
(A)	10.90

Payment at the end of 180 days:

Cost	3400.00 lakhs yen
Interest at 2% p.a. [3400 × 2/100 × 180/365]	33.53 lakhs yen
	3433.53 lakhs yen
Conversion at Rs.100 = 345 yen [3433.53 / 345 × 100] (B)	= Rs.995.23
Total Cost: (A) + (B)	= Rs.1006.13 lakhs

Advise: Option 2 is cheaper by (1090.00 – 1006.13) lakh or Rs. 83.87 lakh. Hence, the offer may be accepted.

(c) Scheme (a)

100 = LR × PVIF (20,1) + LR × PVIF (20,2) + LR × PVIF (20,3) + LR × PVIF (20,4) + LR × PVIF (20,5)

100 = LR × PVIFA (20,5)

100 = LR × 2.991

LR = Rs. 33.434 lakhs per year.

Scheme (b)

100 = LR × PVIF (20,1) + (1.15) LR × PVIF (20,2) + $(1.15)^2$ LR × PVIF(20,3) + $(1.15)^3$ LR × PVIF (20,4) + $(1.15)^4$ LR × PVIF(20,5)

LR = Rs.26.09 lakhs in the first year.

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

No. of days Involves	= 91 days
Interest rate applicable	= 12.04 % p.a.
Interest for 91 days	= 12.04% x [91 days/365 days]
	= 3.001%
	= or Rs. 10 crores x [3.001/(100+3.001)]
	= Rs. 29,13,563
	or 29.1356 lacs

∴ Net amount received at the time of issue:-

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

2. (a) <u>CALCULATION OF NPV</u>

	Rs.
PV of cash inflows (Rs. 45,000 x 3.169)	1,42,605
Initial Project Cost	1,20,000

NPV	22,605
If initial project cost is varied adversely by 10%*	
NPV (Revised) (Rs. 1,42,605 - Rs. 1,32,000)	(+) Rs. 10,605
Change in NPV (Rs. 22,605 – Rs. 10,605)/ Rs. 22,605 i.e	53.08%
If annual cash inflow is varied adversely by 10%*	
Revised annual inflow	Rs. 40,500
NPV (Revised) (Rs. 40,500 x 3.169) – (Rs. 1,20,000)	(+) Rs. 8,345
Change in NPV (Rs. 22,605 – Rs. 8,345) / Rs. 22,605	63.08%
If cost of capital is varied adversely by 10%*	
NPV (Revised) (Rs. 45,000 x 3.103) – Rs. 1,20,000	(+) Rs. 19,635
Change in NPV (Rs. 22,605 – Rs. 19,635) / Rs. 22,605	13.14%

Conclusion: Project is most sensitive to 'annual cash inflow'.

*Note: Students may please note that they may assume any other percentage rate other than 10% say 15% , 20% 25% etc.

(b) (i) Returns for the year

(All changes on a Per -Unit Basis)

Change in Price:	Rs.9.45 – Rs.8.75	Re.0.70
Dividends received:		Re. 0.75
Capital gains distribution		Re. 0.60
Total reward		Rs. 2.05

Holding period reward: (Rs. 2.05/Rs. 8.75) x 100 = 23.43%

(ii) When all dividends and capital gains distributions are re-invested into additional units of the fund @ (Rs. 8.65/unit)

Dividend + Capital Gains per unit = Re.0.75 + Re. 0.60 = Rs. 1.35

Total received from 300 units = Rs.1.35 x 300 = Rs.405/-.

Additional Units Acquired = Rs.405/Rs.8.65 = 46.82 Units.

Total No. of Units = 300 units + 46.82 units = 346.82 units.

Value of 346.82 units held at the end of the year

= 346.82 units x Rs.9.45 = Rs.3277.45

Price Paid for 300 Units at the beginning of the year

= 300 units x Rs.8.75 = Rs.2,625.00

Holding Period Reward

Rs. (3277.45 – 2625.00) = Rs.652.45

Holding Period Reward = (Rs. 652.45/Rs. 2625.00) x 100 = 24.85%

Conclusion: Since the holding period reward is more in terms of percentage in option-two i.e., reinvestment of distributions at an average NAV of Rs.8.65 per unit, this option is preferable.

3. (a) Calculation of NPV

Year	0	1	2	3
Inflation factor in India	1.00	1.10	1.21	1.331
Inflation factor in Africa	1.00	1.40	1.96	2.744
Exchange Rate (as per IRP)	6.00	7.6364	9.7190	12.3696
Cash Flows in Rs.'000				
Real	-50000	-1500	-2000	-2500
Nominal (1)	-50000	-1650	-2420	-3327.50
Cash Flows in African Rand '000				
Real	-200000	180000	160000	150000
Nominal	-200000	252000	313600	411600
In Indian Rs.'000 (2)	-33333	33000	32267	33275
Net Cash Flow in Rs. '000 (1)+(2)	-83333	31350	29847	29947
PVF@20%	1	0.833	0.694	0.579
PV	-83333	26115	20714	17339

NPV of 3 years = -19165 (Rs. '000)

(b) **Receipts using a forward contract** (1,00,000/0.02127) = Rs.47,01,457

Receipts using currency futures

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

Initial margin payable is 10 x Rs.15,000 = Rs.1,50,000

On September 1 Close at 0.02133

Receipts = US$1,00,000/0.02133 = Rs.46,88,233

Variation Margin = [(0.02134 – 0.02118) x 10 x 472000]/0.02133

OR (0.00016x10x472000)/.02133 = 755.2/0.02133 Rs.35,406

Rs.47,23,639

Less: Interest Cost – 1,50,000 x 0.08 x 3/12 Rs.3,000

Net Receipts Rs.47,20,639

Receipts under different methods of hedging

Forward contract	Rs.47,01,457
Futures	Rs.47,20,639
No Hedge	
US$ 1,00,000/0.02133	Rs.46,88,233

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

4. (a) Financial Leverage = PBIT/PBT

1.4 = PBIT / (PBIT – Interest)

1.4 = PBIT / (PBIT – 40)

1.4 (PBIT – 40) = PBIT

1.4 PBIT – 56 = PBIT

1.4 PBIT – PBIT = 56

0.4 PBIT = 56

$$\text{or PBIT} = \frac{56}{0.4} = ₹\,140 \text{ lakhs}$$

NOPAT = PBIT – Tax = Rs. 140 lakhs (1 – 0.30) = Rs. 98 lakhs.

Weighted average cost of capital (WACC) = 17.5% × (300 / 700)+ (1 – 0.30) × (10%) × (400 / 700)

= 11.5%

EVA = NOPAT – (WACC × Total Capital)

= Rs. 98 lakhs – 0.115 × Rs. 700 lakhs

= Rs. 17.5 lakhs

(b) Computation of current value of John's portfolio

			Rs.
(i)	10 Nos. Bond A, Rs. 1,000 par value, 9% Bonds maturity 3 years:		
	Current value of interest on bond A		
	1-3 years: Rs. 900(1–0.20) × Cumulative P.V. @ 12% (1-3 years)		
	= Rs. 720 × 2.402		1,729
	Add: Current value of amount received on maturity of Bond A		
	End of 3rd year: Rs. 1,000 × 10 × P.V. @ 12% (3rd year)		
	= Rs. 10,000 × 0.712	7,120	8,849
(ii)	10 Nos. Bond B, Rs. 1,000 par value, 10% Bonds maturity 5 years:		
	Current value of interest on bond B		

1-5 years: Rs. 1,000(1–0.20) × Cumulative P.V. @ 12% (1-5 years)

= Rs. 800 × 3.605 2,884

Add: Current value of amount received on maturity of Bond B

End of 5th year: Rs. 1,000 × 10 × P.V. @ 12% (5th year)

= Rs. 10,000 × 0.567 5,670 8,554

(iii) 100 Preference shares C, Rs. 100 par value, 11% coupon

$= \frac{11\% \times 100 \text{ Nos.} \times \text{Rs. } 100}{13\%}$ 8,462

(iv) 100 Preference shares D, Rs. 100 par value, 12% coupon

$= \frac{12\% \times 100 \text{ Nos.} \times \text{Rs. } 100}{13\%}$ 9,231 17,693

Total Current value of his portfolio [(i) + (ii) + (iii) + (iv)] Rs. 35,096

5. (a) MSN Ltd.

Particulars		Rs.
Average level of Receivables	Rs. 4,50,00,000 × 120 / 360	1,50,00,000
Factoring commission	Rs. 1,50,00,000 × 2%	3,00,000
Factoring Reserve	Rs. 1,50,00,000 × 10%	15,00,000
Amount available for advance	Rs. 1,50,00,000 – (3,00,000 + 15,00,000)	1,32,00,000
Factor will deduct interest @ 18%		
Interest (Rs. 1,32,00,000 × 18 × 120) / 100 × 360		7,92,000
Advance to be paid = Rs. 1,32,00,000 – 7,92,000		1,24,08,000
Annual cost of factoring to the firm:		
Factoring commission (Rs. 300000 × 360 / 120)		9,00,000
Interest Charges (Rs. 792,000 × 360 / 120)		23,76,000
		32,76,000
Firms savings on taking factoring service:		
Cost of credit administration saved		6,00,000
Cost of bad debts (Rs. 4,50,00,000 × 2%)		9,00,000
Total savings		15,00,000

Net cost to the firm = Rs. 32,76,000 – Rs. 15,00,000 = Rs. 17,76,000

Effective rate of interest to the firm = Rs. 17,76,000 × 100 / Rs. 1,24,08,000 = 14.31%

Note: The number of days in a year is assumed to be 360 days.

(b) Cost of Call and Put Options

= (Rs.2 per share) x (100 share call) + (Re.1 per share) x (100 share put)

= Rs.2 x 100 + 1 x 100

= Rs.300

(i) Price increases to Rs.43. Since the market price is higher than the strike price of the call, the investor will exercise it.

Ending position = (- Rs.300 cost of 2 option)+(Rs. 1 per share gain on call) x 100

= - Rs.300 + 100

Net Loss = - Rs.200

(ii) The price of the stock falls to Rs.36. Since the market price is lower than the strike price, the investor may not exercise the call option.

Ending Position: = (- Rs.300 cost of 2 options) + (Rs.4 per stock gain on put) x 100

= - Rs.300 + 400

Gain = Rs.100

6. (a) (i) **SWAP ratio based on current market prices:**

EPS before acquisition:

Mani Ltd. : Rs.2,000 lakhs / 200 lakhs:	Rs. 10
Ratnam Ltd.: Rs.4,000 lakhs / 1,000 lakhs:	Rs. 4

Market price before acquisition:

Mani Ltd.: Rs.10 × 10	Rs. 100
Ratnam Ltd.: Rs.4 × 5	Rs. 20

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

(ii) **EPS after acquisition:**

Rs. [(2,000 + 4,000) lakhs] / [200 + 200] lakhs	Rs. 15.00

(iii) **Market Price after acquisition:**

EPS after acquisition :	Rs.15.00
P/E ratio after acquisition 10 × 0.9	9
Market price of share (Rs. 15 X 9)	Rs.135.00

(iv) Market value of the merged Co.:

Rs.135 × 400 lakhs shares — Rs. 540.00 Crores

or Rs. 54,000 Lakhs

(v) Gain/loss per share:

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

(b) As per MM model, the current market price of equity share is:

$$P_0 = \frac{1}{1+k_e} \times (D_1 + P_1)$$

(i) If the dividend is not declared:

$$100 = \frac{1}{1+0.12} \times (0 + P_1)$$

$$100 = \frac{P_1}{1.12}$$

P_1 = Rs. 112

The market price of the equity share at the end of the year would be Rs. 112.

(ii) If the dividend is declared:

$$100 = \frac{1}{1+0.12} \times (10 + P_1)$$

$$100 = \frac{10 + P_1}{1.12}$$

P_1 = Rs. 112 – 10 = Rs. 102

The market price of the equity share at the end of the year would be Rs. 102.

(iii) In case the firm pays dividend of Rs.10 per share out of total profits of Rs. 5,00,000 and plans to make new investment of Rs. 10,00,000, the number of shares to be issued may be found as follows:

Total Earnings	Rs.5,00,000
- Dividends paid	1,00,000
Retained earnings	4,00,000
Total funds required	10,00,000
Fresh funds to be raised	6,00,000
Market price of the share	102

Number of shares to be issued (Rs.6,00,000 / 102) 5,882.35

or, the firm would issue 5,883 shares at the rate of Rs.102

7. (a) Bower-Herringer-Williamson Method segregates the financial and tax aspects of lease financing. If the operating advantage of a lease is more than its financial disadvantage or vice-versa lease will be preferred.

The procedure of evaluation is briefly as follows :

1. Compare the present value of debt with the discounted value of lease payments (gross), the rate of discount being the gross cost of debt capital. The net present value is the financial advantage (or disadvantage).
2. Work out the comparative tax benefit during the period and discount it at an appropriate cost of capital. The present value is the operating advantage (or disadvantage) of leasing.
3. If the net result is an advantage, select leasing.

(b) Advantages of Foreign Currency Convertible Bonds (FCCBs)

(i) The convertible bond gives the investor the flexibility to convert the bond into equity at a price or redeem the bond at the end of a specified period, normally three years if the price of the share has not met his expectations.

(ii) Companies prefer bonds as it leads to delayed dilution of equity and allows company to avoid any current dilution in earnings per share that a further issuance of equity would cause.

(iii) FCCBs are easily marketable as investors enjoys option of conversion into equity if resulting to capital appreciation. Further investor is assured of a minimum fixed interest earnings.

(c) Uses of Credit Rating

For users –

(i) Aids in investment decisions.

(ii) Helps in fulfilling regulatory obligations.

(iii) Provides analysts in Mutual Funds to use credit ratings as one of the valuable inputs to their independent evaluation system.

For issuers –

(i) Requirement of meeting regulatory obligations as per SEBI guidelines.

(ii) Recognition given by prospective investors of providing value to the ratings which helps them to raise debt / equity capital.

The rating process gives a viable market driven system which helps individuals to invest in financial instruments which are productive assets.

(d) Takeover by Reverse Bid: Generally, a big company takes over a small company. When the smaller company gains control of a larger one then it is called “Take-over by reverse bid”. In case of reverse take-over, a small company takes over a big company. This concept has been successfully followed for revival of sick industries.

The acquired company is said to be big if any one of the following conditions is satisfied:

(i) The assets of the transferor company are greater than the transferee company;

(ii) Equity capital to be issued by the transferee company pursuant to the acquisition exceeds its original issued capital, and

(iii) The change of control in the transferee company will be through the introduction of minority holder or group of holders.

Reverse takeover takes place in the following cases:

(1) When the acquired company (big company) is a financially weak company

(2) When the acquirer (the small company) already holds a significant proportion of shares of the acquired company (small company)

(3) When the people holding top management positions in the acquirer company want to be relived off of their responsibilities.

The concept of take-over by reverse bid, or of reverse merger, is thus not the usual case of amalgamation of a sick unit which is non-viable with a healthy or prosperous unit but is a case whereby the entire undertaking of the healthy and prosperous company is to be merged and vested in the sick company which is non-viable.

(e) Modigliani and Miller Hypothesis is in support of the irrelevance of dividends. Modigiliani and Miller argue that firm’s dividend policy has no effect on its value of assets and is, therefore of no consequence i.e. dividends are irrelevant to shareholders wealth.

The hypothesis is based on the following assumptions:

- The firm operates in perfect capital markets in which all investors are rational and information is freely available to all.

- There are no taxes. Alternatively, there are no differences in the tax rates applicable to capital gains and dividends.
- The firm has a fixed investment policy.
- There are no floatation or transaction costs.
- Risk of uncertainty does not exist. Investors are able to forecast future prices and dividends with certainty, and one discount rate is appropriate for all securities and all time periods. Thus, $r = k = k_t$ for all t.

Market price of a share after dividend declared on the basis of MM model is shown below:

$$P_o = \frac{P_1 + D_1}{1 + K_e}$$

Where,

Po = The prevailing market price of a share

Ke = The cost of equity capital

D1 = Dividend to be received at the end of period one

P1 = Market price of a share at the end of period one.

If the firm were to finance all investment proposals, the total amount raised through new shares will be ascertained with the help of the following formula:

$$\Delta N = \frac{I - (E - nD_1)}{P_1}$$

Where,

ΔN = Change in the number of shares outstanding during the period

n = Number of shares outstanding at the beginning of the period

I = Total investment amount required for capital budget

E = Earnings of net income of the firm during the period.

The concept of 'home made dividends' supports the argument for irrelevance of dividend policy in shareholder wealth maximization. Due to reduction in the price of a share when it goes 'ex-dividend', the value of a shareholder's wealth is always the same irrespective of the amount of dividend declared. A shareholder can always sell his portion of equity to realize the dividend income.

MOCK TEST PAPER -1

FINAL COURSE: GROUP – I

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory

*Answer any **five** from the rest*

Time Allowed- 3 Hours Maximum Marks -100

1. (a) You are the auditor of Stock Ltd. for the year 2013–14. The inventory as at the end of the year i.e. 31.3.14 was Rs. 1.05 lakhs. Due to unavoidable circumstances, you could not be present at the time of annual physical verification. How would you ensure that the physical verification conducted by the management was in order?

   (b) You have been appointed as an Auditor of a Manufacturing Company, whose year ends on 31st March. An event occurred after the year ended, but before you complete the audit. The audit report issued by you is dated 25th July. The Sales Ledger balance at 31st March was Rs. 1,95,000. By 25th July Rs. 65,000 only had been received against this amount as full and final payment. How would you deal with the situation?

   (c) Wealthy Ltd., holding 65% of the equity shares in Poor Ltd., purchased goods worth Rs. 25,000 from Poor Ltd. during the financial year 2013-14. The Manager of Wealthy Ltd. is of the opinion that it is a normal business activity and in addition the amount of transaction is very minute comparative to the other purchases of the company, therefore there is no need to disclose the same in the final accounts of the Company. Comment.

   (d) Mr. CA, a practicing chartered accountant, has been appointed as an internal auditor of Textile Ltd. He conducted the physical verification of the inventory at the year end and handed over the report of such verification to Mr. AC, the statutory auditor of the Company, for his view and reporting. Can Mr. AC, the statutory auditor of the Company, rely on such report? *($5 \times 4 = 20$ Marks)*

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

   (a) Mr. A, a practicing Chartered Accountant, took over as the executive chairman of Software Company on 1.4.2014. On 10.4.2014 he applied to the Council for permission.

   (b) CA XY who conducted the audit of a Gujarati daily ‘21st Century’ certified the circulation figures based on Management Information System Report (M.I.S Report) without examining the books of Account.

(c) Mr. A, a practicing Chartered Accountant agreed to prepare, project reports and feasibility studies along with the consideration of tax implications while rendering such services, for and on behalf of a client.

(d) Mr. Superior, a Chartered Accountant in practice, wrote several letters to Government Department, pointing out seniority of his firm, sending his life sketch and stating that he had a glorious record of service to the nation as well as to the organization of accountancy profession with a view to get the audit work.

(4 $\times$ 4 = 16 Marks)

3. (a) The first auditors of Healthy and Wealthy Ltd., a Government company, was appointed by the Board of Directors. Comment. *(4 Marks)*

(b) ABC & Associates, a firm of Chartered Accountants, has three partners A, B and C. The firm is already having audit of 45 companies. The firm is offered 20 company audits. Decide and advise whether ABC & Associates will exceed the ceiling prescribed under the Companies Act, 2013 by accepting the above audit assignments? *(4 Marks)*

(c) Outstanding Ltd. appointed CA Premium, as an auditor for the company for the current financial year. Further the company offered him the services of investment banking, rendering of outsourced financial services and management services which was also approved by the Board of Directors. Advise. *(4 Marks)*

(d) Briefly mention the provisions relating to Cost Audit as per the Companies Act, 2013. *(4 Marks)*

4. (a) A limited company has Rs. 65 lakhs of paid up Capital and Rs. 4 crore of average Annual Turnover of past three years preceeding the Financial year under Audit. The company does not have any Internal Audit system because the Management does not think it necessary. As an Auditor how would you react to the given situation.

(4 Marks)

(b) State the matters to be specified in Auditor’s Report in terms of provisions of Section 143(3) of the Companies Act, 2013. *(6 Marks)*

(c) Mention the duties of Auditor of Co-operative Societies in regard to the following:

(i) Over-due interest.

(ii) Compliance with provisions of Co-operative Act and Rules there under.

(iii) Special Report to Registrar of Co-operative Societies. *(6 Marks)*

5. (a) Zen Ltd. is intending to acquire Adi Ltd. It hires Bhola & Co., a firm of Chartered Accountants to conduct a due diligence. Bhola & Co., wants to reduce the risk of over valuation of assets in its due diligence exercise. Kindly guide Bhola & Co.

(5 Marks)

(b) CA Mack, a practicing Chartered Accountant, is the Statutory Auditor of an investment company dealing in securities. While performing the audit procedure, the company officials did not provide the investments held by the company at the Balance Sheet date for verification and also did not provide the details for valuation of unlisted shares as on the Balance Sheet date. CA Mack, in his final audit report to the shareholders, reported as follows:

"Subject to the verification of the existence and value of the investments, the Balance Sheet shows a true and fair view."

You are required to guide the Auditor of this Company by discussing the concept of "True and Fair" view in the context of Companies Act, 2013. *(6 Marks)*

(c) DNC Pvt. Ltd. is a private company having paid up share capital of rupees twenty crore but having public borrowing from nationalized banks and financial institutions of rupees fifty crore. The company appointed CA Ram as an auditor in its AGM dated 29th September, 2014.

You are required to state whether provisions related to rotation of auditor are applicable on DNC Pvt. Ltd. If yes than after how many years it will be required to rotate as per section 139 of the Companies Act, 2013. *(5 Marks)*

6. (a) You have been appointed as an auditor of a Hire-Purchase Finance Company. Enumerate the verification procedures in relation to audit of this Non Banking Finance Company (NBFC). *(6 Marks)*

(b) Enumerate some of the areas of concern in an audit of indirect taxes. *(4 Marks)*

(c) State the items contained in the SEBI's check list for auditors in respect of contract notes issued by a Stock Broker. *(3 Marks)*

(d) What are the audit procedures to be followed while verifying the outstanding premium and agents' balances? *(3 Marks)*

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

(a) Vostro and Nostro Accounts

(b) Performance Audit

(c) Objectives of Peer Review

(d) Concurrent Audit

(e) General Steps in the Conduct of Risk- Based Audit. *(4×4 = 16 Marks)*

MOCK TEST PAPER -1

FINAL COURSE: GROUP – I

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

SUGGESTED ANSWERS/ HINTS

1. (a) **Physical verification of Inventory:** SA 500 on "Audit Evidence" requires the auditor to design and perform audit procedures in such a way as to enable him to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. The audit procedures to be performed should be appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

The auditor should perform audit procedures, designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting. If the auditor is unable to be present at the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded. The auditor would also verify the procedure adopted, treatment given for the discrepancies noticed during the physical count. The auditor would also ensure that appropriate cut off procedures were followed by the management. He should also get management's written representation on (1) the completeness of information provided regarding the inventory and (2) assurance with regard to adherence to laid down procedures for physical inventory.

By following the above procedure it will be ensured that the physical verification conducted by the management was in order.

(b) **Consideration of Subsequent Events:** SA 560 on "Subsequent Events" requires that the auditor should consider the effect of subsequent events on the financial statements and the auditor's report. Depending upon the nature of subsequent event, i.e., adjusting event or non-adjusting event, the auditor has to examine the impact on financial statements.

AS 4 "Contingencies and Events Occurring After the Balance Sheet Date" also classifies an adjusting event which provides further evidence of conditions that existed at the balance sheet date after balance sheet date, the effect of such events have to be seen by the auditor on figures contained in the financial statements. The facts indicated in the question clearly reveal that subsequent realisation has been good. Such consideration helps the auditor in assuring the existence of trade receivables as also the realisability aspect. The auditor's duties in respect of trade receivables remaining uncollected at the time of giving audit report involves examination of actual past experience of collections from trade receivables. Further the auditor has to see that how much provision was assessed in respect of bad and doubtful debts having regard to recovery position, due date, legal cases, cheques dishonoured, etc. as on March 31. Accordingly, the auditor would have to see that in respect of outstanding amount of Rs. 1,30,000, whether the amount of provision needs any revision.

(c) **Related Party Disclosures:** As per definition given in the AS 18 " Related Party Disclosures" parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

Wealthy Ltd. is the holding company of Poor Ltd. as it holds more than 50% of the voting power of Poor Ltd. and thus should be treated as related parties as per AS-18.

According to AS-18, in the case of related party transactions, the reporting enterprise should disclose the following:

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties."

Further, SA 550 on "Related Parties", also prescribes the auditor's responsibilities and audit procedures regarding related party transactions.

In this case, the related party relationship is absolutely clear and accordingly the auditor must examine that the disclosure requirements as laid down in AS 18, "Related Party Disclosures" has been followed.

Since there is related party transaction the contention of Manager of Wealthy Ltd. is not correct and the auditor should insist to make proper disclosure as required by AS-18 and if the management refuses, the auditor should express a qualified opinion.

(d) **Using the Work of Internal Auditor:** As per SA 610 "Using the Work of Internal Auditors", while determining whether the work of the internal auditors is likely to be adequate for the purpose of the audit, the external auditor shall evaluate:

(i) the objectivity of the internal audit function;

(ii) technical competence of the internal auditors;

(iii) whether the work of the internal auditors is likely to be carried out with due professional care; and

(iv) whether there is likely to be effective communication between the internal auditors and the external auditor.

To determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether the internal auditors have adequate technical training and proficiency; work was properly supervised, reviewed and documented; any reports prepared are consistent with the results of the work performed etc.

In the instant case, the statutory auditor should ascertain the internal auditor's scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible he should also test check few items and he can also observe the procedures performed by the internal auditors.

If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order, he has to decide otherwise. The final responsibility to express opinion on the financial statement remains with the statutory auditor.

2. (a) As per Clause (11) of Part I of Schedule I of the Chartered Accountant Act, 1949 a Chartered Accountant in practice, will be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

Thus, Mr. A took over as the executive chairman on 01.04.2014 and applied for permission on 10.04.2014, on the basis of these facts he was engaged in other occupation between the period 01.04.2014 and 10.04.2014, without the permission of the Council and is guilty of misconduct in terms of this clause.

(b) As per Clause (7) of Part I of Second Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

In the given case, CA XY certified the circulation figures without examining the books of accounts. To ascertain the number of paid copies; verification of remittances from the agents; credit allowed to the agents for unsold copies returned, examination of books of account is essential. He did not exercise due diligence and is grossly negligent in the conduct of his professional duties.

Further, certification of circulation figures based on statistical information without cross verification with financial records amounts to gross negligence and failure to exercise due diligence.

Thus, CA XY will be held guilty of professional misconduct under Clause (7) of Part I of Second Schedule of Chartered Accountants Act, 1949.

(c) As per Section 2(2)(iv) of the Chartered Accountants Act, 1949, a member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice. Pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services".

The definition of the expression "Management Consultancy and other Services" includes preparing project reports and feasibility studies. Consideration of tax implications while rendering above services will be considered as part of "Management Consultancy and other Services".

Therefore, Mr. A will not be held guilty of professional misconduct in pursuant to the provisions of the Section 2(2)(iv) of the Chartered Accountants Act, 1949 and further resolutions passed in this regard.

(d) As per Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

In the given case, Mr. Superior, a Chartered Accountant in practice, wrote several letters to Government Department pointing out the seniority of his firm and sending his life sketch and stating that he had rendered glorious service to the nation and to the accountancy profession with a view to getting the audit work.

Since these letters were clearly in the nature of advertising professional attainments, Mr. Superior will be held guilty of professional misconduct under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949.

3. (a) Appointment of the First Auditor by the Board of Directors: Section 139(6) of the Companies Act, 2013 lays down that "the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company". Thus, the first auditor of a company can be appointed by the Board of Directors within 30 days from the date of registration of the company. However, in the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013. This section provides that in the case of a Government company or any other company owned or controlled, directly

or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company. Hence in the case of Healthy and Wealthy Ltd., being a government company, the first auditor shall be appointed by the Comptroller and Auditor General of India.

Thus, the appointment of first auditors made by the Board of Directors of M/s Health and Wealth Ltd., is null and void.

(b) **Ceiling on number of audits:** Before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in section 141(3)(g) of the Companies Act, 2013, which prescribes that a person shall not be eligible for appointment as an auditor of a company who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies.

In the case of a firm of auditors, it has been further provided that ‘specified number of companies’ shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

If Mr. A, B and C do not hold any audits in their personal capacity or as partners of other firms, the total number of company audits that can be accepted by M/s ABC & Associates is 60. But, the firm is already having audit of 45 companies. So the firm can accept the audit of 15 companies only, which is well within the limit, specified by Section 141(3)(g) of the Companies Act, 2013.

(c) **Services not to be Rendered by the Auditor:** Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:

(i) accounting and book keeping services;

(ii) internal audit;

(iii) design and implementation of any financial information system;

(iv) actuarial services;

(v) investment advisory services;

(vi) investment banking services;

(vii) rendering of outsourced financial services;

(viii) management services; and

(ix) any other kind of services as may be prescribed.

Further section 141(3)(i) of the Companies Act, 2013 also disqualifies a person for appointment as an auditor of a company who is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

In the given case, CA Premium was appointed as an auditor of Outstanding Ltd. He was offered additional services of investment banking, rendering of outsourced financial services and management services which was also approved by the Board of Directors. The auditor is advised not to accept the services as these services are specifically covered in the services not to be rendered by him as an auditor as per section 144 of the Companies Act, 2013.

(d) **Cost Audit:** Cost Audit is covered by Section 148 of the Companies Act, 2013. The audit conducted under this section shall be in addition to the audit conducted under section 143 of the Companies Act, 2013.

As per the section 148 the Central Government may by order specify audit of items of cost in respect of certain companies.

Further, the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies.

It is provided that the Central Government shall, before issuing such order in respect of any class of companies regulated under a special Act, consult the regulatory body constituted or established under such special Act.

The audit shall be conducted by a Cost Accountant in Practice who shall be appointed by the Board of such remuneration as may be determined by the members in such manner as may be prescribed.

Provided that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records.

Provided further that the auditor conducting the cost audit shall comply with the cost auditing standards ("cost auditing standards" mean such standards as are issued by the Institute of Cost and Works Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government).

As per rule 14 of the Companies (Audit and Auditors) Rules, 2014

(a) in the case of companies which are required to constitute an audit committee-

(i) the Board shall appoint an individual, who is a cost accountant in practice, or a firm of cost accountants in practice, as cost auditor on the recommendations of the Audit committee, which shall also recommend remuneration for such cost auditor;

(ii) the remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders;

(b) in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant in practice or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter X of the Companies Act, 2013 shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

It is provided that the report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company.

A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein.

4. (a) Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013 the following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

(a) every listed company;

(b) every unlisted public company having-

(i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(ii) turnover of two hundred crore rupees or more during the preceding financial year; or

(iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(c) every private company having-

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

Thus, any of the condition is required to be satisfied for the applicability of the provision. The internal auditor to be appointed shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies auditor may or may not be an employee of the company.

In the instant case, the company is having paid up capital less than Rs. 50 crore and turnover less than Rs. 200 hundred crore. Further, maximum outstanding loan or borrowing from public financial institution has not been given. Therefore, assuming that outstanding loans or borrowings from banks or public financial institutions are also not exceeding Rs. 100 crore during the previous financial year. Therefore, any of the condition in respect of paid up capital, turnover or outstanding loans is not satisfied. So the company is not liable for internal audit as per section 138 of the Companies Act, 2013.

(b) **Matters to be specified in the Auditor's Report:** As per sub section 3 of section 143 of the Companies Act, 2013, the auditor's report shall state –

(i) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(ii) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(iii) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(iv) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

(v) whether, in his opinion, the financial statements comply with the accounting standards;

(vi) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(vii) whether any direct is disqualified from being appointed as a director under sub-section (2) of the section 164;

(viii) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(ix) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

(x) such other matters as may be prescribed.

Further, Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditors report. The auditor's report shall also include their views and comments on the following matters, namely:-

(i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

(iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

(c) **Duties of Auditor of Co-operative Societies with regard to-**

(i) **Overdue interest:** Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.

(ii) **Compliance with provisions of the Act and Rules:** An auditor of a co-operative society is required to point out the infringement with the provisions of the relevant Co-operative Act Rules and bye-laws. The auditor of a co-operative society is also required to point out various irregularities, improprieties, and departure from the provision of the Act, rules framed there under and the bye-laws of the society. The financial implications of such infringements should be properly assessed and quantified by the auditor and they should be reported. Some of the State laws contain restrictions on the payment of dividends, which should be noted by the auditor and if dividend is declared in excess of the prescribed percentage, the fact should be reported by the auditor. Auditor should also ensure that various provisions in the Co-operative Societies Act, such as, restriction on borrowings, investment of funds, contribution to education funds, restriction on loans, etc are also complied with.

(iii) **Special Report to the Registrar:** The auditors are required to report on number of matters as prescribed in various states. In addition to the main report, the auditors are also required to submit by way of schedules/audit memorandum information on the working of the company as well. During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar, drawing his specific attention to the points. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance a special report may become necessary:

(a) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.

(b) Detection of fraud relating to expenses, purchases, property and stores of the society.

(c) Specific examples of mis-management. Decisions of management against co-operative principles.

(d) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

5. (a) **Due Diligence Exercise in case of Overvalued Assets:** Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any overvalued assets are concerned, this shall form part of such a review. Normally, overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does involve examination from the view point of extraordinary items, analysis of significant deviations, etc. However, in order to reduce the risk of over valuation of assets, the auditor should pay his attention to the following areas:

In the case of overvalued assets, the auditor shall have to specifically examine the following areas:

(i) Uncollected/uncollectable receivables.

(ii) Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with the name of company.

(iii) Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.

(iv) Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.

(v) Litigated assets and property.

(vi) Investments carried at cost though realizable value is much lower.

(vii) Investments carrying a very low rate of income / return.

(viii) Infructuous project expenditure/deferred revenue expenditure etc.

(ix) Group Company balances under reconciliation etc.

(x) Intangibles of no value.

(b) **Significance of "True and Fair":** The concept of true and fair is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.

This requires that the auditor should examine the accounts with a view to verify that all assets, liabilities, income and expenses are stated as amounts which are in accordance with accounting principles and policies which are relevant and no material amount, item or transaction has been omitted.

(1) As per section 129 of the Companies Act, 2013, the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 of the Companies Act, 2013, (in which the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority) and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III.

Provided that the items contained in such financial statements shall be in accordance with the accounting standards.

Provided further that nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.

(2) At every annual general meeting of a company, the Board of Directors of the company shall lay before such meeting financial statements for the financial year.

(3) Where a company has one or more subsidiaries, it shall, in addition to financial statements provided under sub-section (2), prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own which shall also be laid before the annual

general meeting of the company along with the laying of its financial statement under sub-section (2).

Provided that the company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in such form as may be prescribed.

Provided further that the Central Government may provide for the consolidation of accounts of companies in such manner as may be prescribed.

Explanation.—For the purposes of this sub-section, the word “subsidiary” shall include associate company and joint venture.

(4) The provisions of this Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, apply to the consolidated financial statements referred to in sub-section (3).

(5) Without prejudice to sub-section (1), where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

(6) The Central Government may, on its own or on an application by a class or classes of companies, by notification, exempt any class or classes of companies from complying with any of the requirements of this section or the rules made there under, if it is considered necessary to grant such exemption in the public interest and any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification.

(7) If a company contravenes the provisions of this section, the managing director, the whole-time director in charge of finance, the Chief Financial Officer or any other person charged by the Board with the duty of complying with the requirements of this section and in the absence of any of the officers mentioned above, all the directors shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

Explanation.—For the purposes of this section, except where the context otherwise requires, any reference to the financial statement shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under this Act.

(c) Rotation of Auditor: The answer of the question requires two parts i.e. applicability of provisions of auditor’s rotation and secondly provision of rotation of auditor in case of individual or an audit firm.

1. **Applicability of provisions of Auditor's Rotation** :The provisions related to rotation of auditor are applicable to those companies which are prescribed in Companies (Audit and Auditors) Rules, 2014, which prescribes the following classes of companies excluding one person companies and small companies, namely:-

   (a) all unlisted public companies having paid up share capital of rupees ten crore or more;

   (b) all private limited companies having paid up share capital of rupees twenty crore or more;

   (c) all companies having paid up share capital of below threshold limit mentioned in (a) and (b) above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.

2. **Provision of Rotation of Auditor** :As per Section 139(2) of the Companies Act, 2013, no listed company or a company belonging to such class or classes of companies as mentioned above, shall appoint or re-appoint-

   (a) an individual as auditor for more than one term of five consecutive years; and

   (b) an audit firm as auditor for more than two terms of five consecutive years.

   In the given case, DNC Pvt. Ltd. is a private company having paid up share capital of rupees twenty crore and public borrowings from nationalized banks and financial institutions of rupees fifty crore. The company appointed CA Ram as an auditor in its AGM dated 29th September, 2014.

   The provisions relating to rotation of auditor will be applicable as paid up share capital is Rs. 20 crore and public borrowings from nationalized banks and financial institutions is rupees fifty crore. Therefore, provisions of rotation of auditor will apply. Thus, DNC Pvt. Ltd. shall appoint CA Ram as an auditor of the company for not more than one term of five consecutive years and CA Ram will hold office of Auditor from the conclusion of this meeting upto the conclusion of sixth AGM i.e. AGM to be held in the year 2019.

6. (a) **Verification Procedures in relation to an audit of a Hire Purchase Finance company (HPFC):**

   (i) Ascertain whether the NBFC has an adequate appraisal system for extending hire purchase finance. The system of appraisal is basically concerned with obtaining information regarding the credit worthiness of the hirer, his experience in the field, assets owned, his past track record and future projections of his income.

   (ii) Verify that the payment for acquiring an asset should be made directly to the supplier/dealer and that the original invoice has been drawn out in the name of the NBFC.

(iii) In the case of high value hire purchase items relating to machinery/equipment, an auditor should ascertain whether the valuation reports and installation reports are called for. In case of some high value items, he should also physically verify the asset in possession of the hirers, particularly in a situation where he has any doubts as regards the genuineness of the transaction.

(iv) If the hire purchase finance is against vehicles, check whether the registration certificate contains an endorsement in favour of the hire purchase company.

(v) The auditor should verify whether the NBFC has a system in place for verifying the hire purchase assets periodically to ensure that the hirers have not sold the assets or otherwise encumbered them.

(vi) Check whether hire purchase instalments are being received regularly as and when they fall due. Check whether adequate provision has been made for overdue hire purchase instalments as required by the NBFC Prudential Norms directions.

(vii) Examine the method of accounting followed by the hire purchase finance company for appropriation of finance charges over the period of the hire purchase contract. Ascertain that there is no change in the method of accounting as compared to the immediately preceding previous year.

(viii) Verify that the assets given on hire purchase have been adequately insured against.

(ix) In case the goods are repossessed by the hire purchase finance company on account of non-repayment of hire purchase instalments, verify that the repossessed goods have been valued on a realistic basis by the hire purchase finance company.

(b) Audit of Indirect Taxes: Some areas of concern in an audit of indirect taxes would be:

(i) Non availment or short / excess availment of export incentives.

(ii) Goods imported duty free or payment at concessional rates without properly complying with conditions.

(iii) Valuation Issues – valuation not in line with customs rules.

(iv) Applicability of the relevant export /excise exemptions.

(v) Valuation of goods not removed in normal course using valuation methods not in line with Central Excise Valuation Rules.

(vi) Ignoring Liability under Service Tax on services provided or availed.

(vii) Procedural non-compliance.

(viii) Passing on of duty suffered on imported goods and of locally manufactured goods in excess of actual.

(ix) Utilisation / Availability of credit of duty/ tax paid on inputs, capital goods of input services.

(c) SEBI's check list for auditors in respect of contract notes issued by a Stock Broker:

(i) Members should issue Contract Notes to his clients for all trades executed by him on their behalf.

(ii) The member should stamp his order sheets/records and the order time should be reflected in the Contract Note along with the time of execution of order.

(iii) The Contract Notes should bear SEBI Registration number of the member. If should be pre printed and issued within 24 hours of trade execution. Appropriate stamps should be affixed on the contract Note. Duplicate copies of the contract note should be maintained.

(iv) The Contract Note should be signed by the member or his constituted attorney.

(v) Contract note issued to the clients should show the brokerage separately.

(vi) In case the broker acts as a principal, the Contract Note should be in Form B.

(vii) Consent of the client should be taken for any trade done by the broker while acting as a principal.

(viii) Brokerage should be within the limits prescribed by the exchange.

(d) Outstanding Premium and Agents' Balances -The following are the audit procedures to be followed for verification of outstanding premium and agents' balances:

(i) Scrutinise and review control account debit balances and their nature should be enquired into.

(ii) Examine inoperative balances and treatment given for old balances with reference to company rules.

(iii) Enquire into the reasons for retaining the old balances

(iv) Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.

(v) Check age-wise, sector-wise analysis of outstanding premium.

(vi) Verify whether outstanding premiums have since been collected.

(vii) Check the availability of adequate bank guarantee or premium deposit for outstanding premium.

7. (a) Vostro and Nostro Accounts: Bank's maintain stocks of foreign currencies in the form of Bank Accounts with their overseas branches/correspondents. Such foreign

currency accounts maintained by Indian banks at other overseas centres is designated by it as "Nostro Account". For example all banks in India would be maintaining a US Dollar Account with their New York office/branch/correspondents, such account would be designated by the Indian office as Nostro Account. "Vostro Account" is the opposite of Nostro accounts. Here a foreign bank in another country maintains stocks of Indian rupees with their Indian branch/correspondent/local bank. Such Indian Rupee Accounts are designated as a Vostro Account. For example a German Bank might maintain a Vostro Account in rupees in terms with Indian Bank. While examining the transaction in foreign exchange, the auditor should also pay attention to reconciliation of Nostro Accounts with the respective minor account. The amount in the Nostro account is stock of foreign currency in the form of bank accounts with the overseas branches and correspondents. Unreconciled Nostro Accounts, on an examination, may reveal unauthorized payments from the foreign currency account, unauthorized withdrawals, and unauthorized debit to minor account. The auditor should also evaluate the internal control with regard to inward/ outward messages. The inward/ outward messages should be properly authenticated and discrepancies noticed, should be properly dealt with, in the books of accounts.

The auditor should also verify whether prescribed procedure in relation to inter bank confirmation in the Vostro account is followed or not. In case balance confirmation certificate have been received but the same have not been reconciled, or where confirmation has not been received the same should be reported, in respect of each Vostro Account.

(b) **Performance Audit:** A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.

Performance audits include economy and efficiency and program audits:

(i) Economy and efficiency audits include determining (1) whether the entity is acquiring, protecting, and using its resources (such as personnel, property, and space) economically and efficiently, (2) the causes of inefficiencies or uneconomical practices, and (3) whether the entity has complied with laws and regulations on matters of economy and efficiency.

(ii) Program audits include determining (1) the extent to which the desired results or benefits established by the legislature or other authorizing body are being achieved, (2) the effectiveness of organizations, programs, activities, or functions, and (3) whether the entity has complied with significant laws and regulations applicable to the program.

(c) **Objectives of Peer Review:** The main objective of Peer Review is to ensure that in carrying out the assurance service assignments, the members of the Institute-

(i) comply with Technical, Professional and Ethical Standards as applicable including other regulatory requirements thereto and

(ii) have in place proper systems including documentation thereof, to amply demonstrate the quality of the assurance services.

Thus the primary objective of peer review is not to find out deficiencies but to improve the quality of services rendered by members of the profession. The Statement of Peer Review also makes it clear that the peer review, "does not seek to redefine the scope and authority of the Technical Standards specified by the Council but seeks to enforce them within the parameters prescribed by the Technical Standards". The peer review is directed towards maintenance as well as enhancement of quality of assurance services and to provide guidance to members to improve their performance and adherence to various statutory and other regulatory requirements. Such an objective of the peer review process makes it amply clear that the reviewer is not going to sit on the judgement of the practice unit while rendering assurance services but to evaluate the procedure followed by the practice unit in rendering such a service.

(d) **Concurrent Audit:** Concurrent audit, as the name suggests, is an audit or verification of transactions or activities of an organisation concurrently as the transaction/activity takes place. It is not a pre-audit. The concept in this audit is to verify the authenticity of the transaction/activity within the shortest possible time after the same takes place.

The concept of concurrent audit in the public as well as the private sector banks has gained acceptance in recent years. It hardly needs to be stressed that the concurrent audit system is to be regarded as part of a bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions at branches. It is, therefore, necessary for the bank's management to bestow serious attention to the implementation of various aspects of the system such as selection of branches/coverage of business operations, appointment of auditors, appropriate reporting procedures, follow-up/rectification processes and utilisation of the feedback from the system for appropriate and quick management decisions.

The bank should once in a year review the effectiveness of the system and take necessary measures to correct the lacunae in the implementation of the programme.

(e) **General Steps in the Conduct of Risk- Based Audit:** Risk- Based Audit consists of four main phases starting with the identification and prioritization of risks, to the determination of residual risk, reduction of residual risk to acceptable level and the reporting to auditee of audit results. These are achieved through the following:

(i) Understand auditee operations to identify and prioritize risks. This involves processes for reviewing and understanding the audited organization's risk management processes for its strategies, framework of operations etc., in order to identify and prioritize the error and fraud risks that impact the audit of financial statements.

(ii) Assess auditee management strategies and controls to determine residual audit risk. The role of internal audit in promoting a sound accounting system and internal control is recognized, thus the SAI should evaluate the effectiveness of internal audit.

(iii) Manage residual risk to reduce it to acceptable level. This includes the design and execution of necessary audit procedures and substantive testing to obtain evidence in support of transactions and balances.

(iv) Inform auditee of audit results through appropriate report, such as weaknesses in the internal control system, deficiencies in the design and operation of internal controls.

MOCK TEST PAPER -2

FINAL COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory

Answer any ***five*** *from the rest*

Time Allowed- 3 Hours | Maximum Marks -100

1. As a Statutory Auditor, how would you deal with the following:

   (a) It was decided for the first time that the accounts of the branch office of CL Company Limited be audited by a qualified Chartered Accountant(s) other than the company auditor for the year 2013-14. Accordingly, the Board had appointed branch auditors for the ensuing year. One of the shareholders complained to the Central Government that the appointments made was not valid as the Board of Directors do not have power to appoint auditors, be they Company Auditor or Branch Auditors.

   (b) The Managing Director of a Company has committed a "Teeming and Lading" Fraud. However, subsequently, after the year end, the amount involved has been deposited in the company.

   (c) SAA Ltd. owns 51% voting power in REY Ltd. It however holds and discloses all the shares as "Stock-in-trade" in its accounts. The shares are held exclusively with a view to their subsequent disposal in the near future. SAA Ltd. represents that while preparing Consolidated Financial Statements, REY Ltd. can be excluded from the consolidation.

   (d) Auditor of Future India (P) Ltd. was changed for the accounting year 2013-14. The closing inventory of the company as on 31.3.2013 amounting to Rs. 200 lacs continued as it is and became closing inventory as on 31.3.2014. The auditor of the company propose to exclude from their audit programme the audit of closing inventory of Rs. 200 lacs on the understanding that it pertains to the preceding year which was audited by another auditor. *(5×4 = 20 Marks)*

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

   (a) CA Sushi, a practicing Chartered Accountant gave 60% of the audit fees received by her to Mr. Sushil, who was not a Chartered Accountant, under the nomenclature of office allowances.

   (b) Mr. Rahul, a Chartered Accountant in practice approached Manager of a Nationalised Bank for a loan of Rs. 36 lakhs. He has also informed the Manager that if the loan is sanctioned, the Income Tax return of the Manager and Manager's wife will be filed for free of cost, as quid Pro quo for the loan sanctioned.

(c) Mr. CA, a Chartered Accountant in practice is a partner in 4 firms. On the personal Letter Heads, he mentioned the names and address of all the 4 firms in small fonts.

(d) CA Lazy, a practicing Chartered Accountant, did not complete his work relating to the audit of the accounts of a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirements.

(4×4 = 16 Marks)

3. (a) You are appointed to compile financial statements of XY & Co. for tax purposes. During the course of work, you came to know that the inventory is grossly understated. On pointing the same, the partners of XY & Co. tell you that since you are not conducting an audit, the said figures duly certified by the firm should be accepted. Describe, in brief, the procedure you will follow in the above. *(4 Marks)*

(b) CA Ratan has been appointed as an auditor of Ratna Ltd. He was not able to get the confirmation about the existence and value of certain machineries. However, the management gave him a certificate to prove the existence and value of the machinery as appearing in the books of account. The auditor accepted the same without any further procedure and signed the audit report. Whether the approach adopted by CA Ratan tenable? *(4 Marks)*

(c) While auditing a company, you observed certain material financial statement assertions that have been based on estimates made by the management. As the auditor how do you minimise the risk of material misstatements? *(4 Marks)*

(d) Mr. Guilty, a Chartered Accountant, bought a Harley bike financed at Rs. 10,00,000 by Principal Finance Ltd., which is a holding company of Giant Ltd. and Superior Ltd. He has been the statutory auditor of Superior Ltd. and continues to hold office of auditor even after taking the loan. Comment. *(4 Marks)*

4. (a) What are the criteria to be applied for determining the status of various type of credit facilities as Non-Performing Assets in the case of Banks? *(4 Marks)*

(b) State the provisions relating to filling of casual vacancies, in case of government companies as well as non-government companies, as per section 139(8) of the Companies Act, 2013. *(6 Marks)*

(c) Explain in brief the behavioural aspects encountered in the management audit and state the ways to solve them. *(6 Marks)*

5. (a) Briefly mention the matters that an Auditor is required to inquire while performing his duties as per Section 143(1) of the Companies Act, 2013. *(5 Marks)*

(b) What are the steps for the Audit under the State level 'Value Added Tax'? *(6 Marks)*

(c) Parry Industries Ltd. has a paid up capital of Rs. 40 crores divided into equity shares of Rs. 10 each as on 31.03.2013. During the financial year 2013-14 it has issued bonus shares in the ratio 1 : 1. The net profit after tax for the years 31-

03.2013 and 31.3.2014 is Rs. 20 crores and Rs. 30 crores respectively. The Earnings Per Share disclosed in the financial statements for the above two years is Rs. 5.00 and Rs. 3.75 respectively. Is the disclosure correct? *(5 Marks)*

6. (a) While auditing the claims paid in respect of a General Insurance Company, what are the specific areas will you give your attention? *(6 Marks)*

   (b) What are the important aspects to be looked into a due diligence review of Cash flow? *(4 Marks)*

   (c) In the audit of a company, its auditor wants to use CAATs for performing various audit procedures. What procedures can be performed by the auditor using CAATs?

   (3 Marks)

   (d) You have been appointed as an auditor of a NBFC (registered with RBI). How would you proceed to ensure the compliance of Prudential Norms directions by it? *(3 Marks)*

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

   (a) Mark to Market margins

   (b) Advantages of Cost Audit to Government

   (c) Special features involved in the audit of a Co-operative Society.

   (d) Technical, professional and ethical standards as per statement on peer review

   (e) Environmental Audit. *(4×4 = 16 Marks)*

MOCK TEST PAPER -2

FINAL COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

SUGGESTED ANSWERS/ HINTS

1. (a) **Appointment of Branch Auditor:** The Companies Act, 2013 leaves it to the company to designate or not to designate any establishment of the company as 'branch office'. Under the Companies Act, 2013, only establishment "described as such by the company" shall be treated as a 'branch office'.

Further, as per Section 143(8) of the Companies Act, 2013, where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139 and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed.

Section 139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

The shareholders in general meeting, instead of appointing branch auditor, may authorize the board of directors to appoint branch auditors.

In the present case, the board of CL Company Limited has appointed branch auditors without obtaining authorization from the shareholders in general meeting. The board had appointed the auditor where it did not have authority to do so. As such, the appointment is invalid. The shareholder's complaint is tenable.

(b) **Fraud Committed by Managing Director:** The Managing Director of the company has committed a "Teeming and Lading" fraud. The fact that the amount involved has been subsequently deposited after the year end is not important because the auditor is required to perform his responsibilities as laid down in SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements". First of all, as per SA 240, the auditor needs to perform procedures whether the financial statements are materially misstated. Because an instance of fraud cannot be considered as an isolated occurrence and it becomes important for the auditor to perform audit procedures and revise the audit risk assessment. Secondly, the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. Thirdly, the auditor should communicate the matter to the Chairman and Board of Directors. Finally, in view of the fact that the fraud has been committed at the highest level of management, it affects the reliability of audit evidence previously obtained since there is a genuine doubt about representations of management.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

(c) **Consolidation of Financial Statement:** AS 21 "Consolidated Financial Statements", states that a subsidiary should be excluded from consolidation when:

(i) Control is intended to be temporary because the shares are acquired and held exclusively with a view to its subsequent disposal in the near future or

(ii) Subsidiary operates under severe long term restrictions which significantly impair its ability to transfer funds to the parent.

Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares held as 'stock-in-trade' are acquired and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise would be considered temporary and the investments in such subsidiaries should be accounted for in accordance with AS 13 "Accounting for Investments".

However, as per Section 129(3) of the Companies Act, 2013 read with rule 6 of the Companies (Accounts) Rules, 2014, where a company having subsidiary, which is not required to prepare consolidated financial statements under the Accounting standards, it shall be sufficient if the company complies with the provisions on consolidated financial statements provided in Schedule III to the Act.

In the given case, SAA Ltd's intention is to dispose off the shares of REY Ltd. in the near future as shares are being held as stock in trade and it is quite clear that the control is temporary, however for the compliance of provisions related to consolidation of financial statements given under the Section 129(3) of the Companies Act, 2013 read with Companies (Accounts) Rules, 2014, SAA Ltd. is required to consolidate the financial statements as per the provisions on consolidated financial statements provided in Schedule III to the said Act.

(d) **Verification of Inventory:** As per SA 510 "Initial Audit Engagements – Opening Balances", while conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

(i) Opening balances contain misstatements that materially affect the current period's financial statements; and

(ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the balance sheet date. It forms part of normal duties of auditor to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the inventory lying as it is might have deteriorated and the same need to be examined. The auditor of Future India (P) Ltd. is advised not to exclude the audit procedure of closing inventory from his audit programme.

2. (a) **Sharing of Audit Fees with non-member:** As per Clause (2) of Part I of First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services to time in or outside India.

In the instant case, CA Sushi, a practicing Chartered Accountant gave 60% of the audit fees received by her to Mr. Sushil, who was not a Chartered Accountant, under the nomenclature of office allowance. In this case, it is not the nomenclature to a transaction that is material but it is the substance of the transaction, which has to be looked into.

Therefore, CA Sushi will be held guilty of professional misconduct under clause (2) of Part I of First Schedule of Chartered Accountants Act, 1949.

(b) **Disrepute to the Profession:** As per Clause (2) of Part IV of First Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he, in the opinion of the Council, brings disrepute to the profession or to the Institute as a result of his action whether or not related to his professional work.

Accordingly, a Chartered Accountant is also expected to maintain the highest standards and integrity even in his personal affairs and any deviation from these standards calls for disciplinary action.

In the given case, Mr. Rahul, a Chartered Accountant in practice approached Manager of a Nationalised Bank for a loan and offered for filing Income tax Returns without any fees. This approach of Mr. Rahul brings disrepute to the profession of a Chartered Accountant.

Hence, Mr. Rahul will be held guilty of other misconduct under Clause (2) of Part IV of the First Schedule of the Chartered Accountants Act, 1949.

(c) **Advertisement:** As per Clause (7) of Part I of First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he (i) advertises his professional attainments or services or (ii) uses any designation or expressions other than "Chartered Accountant" on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a university established by law in India or recognized by the Central Government or a title indicating membership of the ICAI or of any other institution that has been recognized by the Central Government or may be recognized by the council.

Here there is no prohibition for printing names on the personal letter heads in which a member holding certificate of practice is a partner.

In the given case, Mr. CA mentioned the names and address of all the 4 firms in which he is a partner on the personal letter heads. Therefore, Mr. CA will not be held guilty of any professional misconduct in pursuant to Clause (7) of Part I of First Schedule of the Chartered Accountants Act, 1949.

(d) **Not exercising due diligence:** According to Clause (7) of Part I of Second Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

It is a vital clause which unusually gets attracted whenever it is necessary to judge whether the accountant has honestly and reasonably discharged his duties. The expression negligence covers a wide field and extends from the frontiers of fraud to collateral minor negligence.

Where a Chartered Accountant had not completed his work relating to the audit of the accounts a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirement in this regard, it was held, under a case, that he was guilty of professional misconduct under Clause (7).

In the given case, Mr. Lazy has not completed his audit work in time and consequently could not submit audit report in due time and consequently, company could not comply with the statutory requirements.

Therefore, Mr. Lazy will be held guilty of professional misconduct under Clause (7) of Part I of the Second Schedule of the Chartered Accountants Act, 1949.

3. (a) **Compilation of Financial Information:** According to SRS 4410 "Engagements to Compile Financial Information", an accountant would normally have to rely upon the management for information to compile the financial statements in a compilation engagement. If in the course of compilation of financial statements, it is observed that the information supplied by the entity is incorrect, incomplete or otherwise unsatisfactory, the accountant should perform following procedures:

(i) Make any enquiries of management to assess the reliability and completeness of the information provided;

(ii) Assess internal controls prevailing in the entity; and

(iii) Verify any matters or explanations.

The accountant may also request the management to provide additional information. This may be asked in the form of management representation letter. If the management refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for such withdrawal.

If one or more accounting standards are not complied with, the same should be brought to the notice of the management and if the same is not rectified by the management, the accountant should include the same in notes to the accounts and the compilation report to the management.

In the given case, inventory of XY & Co. is grossly understated. Therefore, XY & Co. should be asked to provide additional information. If the company refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for such withdrawal.

(b) **Validity of Written Representation:** The physical verification of fixed assets is the primary responsibility of the management. The auditor, however, is required to examine the verification programme adopted by the management. He must satisfy himself about the existence, ownership and valuation of fixed assets. In the case of Ratna Ltd., CA Ratan, the auditor has not been able to verify the existence and value of some machinery despite the verification procedure followed in routine audit. He accepted the certificate given to him by the management without making any further enquiry. As per SA 580 "Written Representations", when representation relate to matters which are material to the financial information, then the auditor should seek corroborative audit evidence for other sources inside or outside the entity. He should evaluate whether such representations are reasonable and consistent with other evidences and should consider whether individuals making such representations can be expected to be well informed on the matter. "Written Representations" cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter, which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter. Therefore, the approach adopted by CA Ratan is not tenable.

(c) **Minimising the risk of material misstatements:** As per SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates-

(i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.

(ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed, in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

(iii) The estimation making process adopted by the management including

(1) The method, including where applicable the model, used in making the accounting estimates;

(2) Relevant controls;

(3) Whether management has used an expert;

(4) The assumptions underlying the accounting estimates;

(5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and

(6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.

(d) **Disqualification of an Auditor:** According to section 141(3)(d)(ii) of the Companies Act, 2013, a person is not eligible for appointment as auditor of a company, if he or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees five lakh.

In the given case, Mr. Guilty has been the statutory auditor of Superior Ltd. He also bought a bike and gets it financed by Principal Finance Ltd., which is a holding company of Giant Ltd. and Superior Ltd.

Therefore, he is disqualified to act as an auditor under section 141(3)(d)(ii) of the Companies Act, 2013 as he is indebted to Principal Finance Ltd. for more than Rs. 5,00,000. Also according to Section 141(3)(d)(ii) of the said Act, he cannot act as an auditor of any subsidiary of Principal Finance Ltd. i.e. he is also disqualified to work in Giant Ltd. and Superior Ltd. Therefore he has to vacate his office in Superior Ltd. even though it is a subsidiary of Principal Finance Ltd.

Hence audit work performed by Mr. Guilty as an auditor is invalid, he should vacate his office immediately and such vacation shall be deemed to be a casual vacancy in the office of the Auditor as per Section 141(4) of the Companies Act, 2013. Now, Superior Ltd. must have to appoint any other CA as an auditor of the company.

4. (a) **Classifying Non-performing Assets:** Following are the Criteria applied for determining the classification of various type of credit facilities as Non-Performing Assets in the case of Banks:

(i) Interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan.

(ii) The account remains "out of order" in respect of an Overdraft/Cash Credit (OD/CC).

(iii) The bill remains overdue and unpaid for a period of more than 90 days in the case of bills purchased and discounted.

(iv) The instalments of principal or interest thereon remain overdue for two crop seasons for short duration crops.

(v) The instalment of principal or interest thereon remains overdue for one crop season for long duration crops.

(vi) The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitization dated 1st February, 2006.

(vii) In respect of derivative transactions, the overdue receivables representing positive mark to Market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

(b) **Casual Vacancy:** As per Section 139(8) of the Companies Act, 2013, any casual vacancy in the office of an auditor shall-

(i) **In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Board of Directors within thirty days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

(ii) **In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Comptroller and Auditor-General of India within thirty days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period the Board of Directors shall fill the vacancy within next thirty days.

Casual Vacancy by Resignation: As per section 140(2) of the Companies Act, 2013, the auditor who has resigned from the company shall file within a period of thirty days from the date of resignation, a statement in the prescribed form ADT–3 (as per Rule 8 of Companies (Audit and Auditors) Rules, 2014) with the company and the Registrar, and in case of the companies referred to in section 139(5) i.e. subsequent auditor of Government company, the auditor shall also file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees as per section 140(3) of the said Act.

(c) **Behavioural aspects encountered in Management Audit:** Financial auditors deal mainly with figures. Management auditors deal mainly with people. There are many causes for behavioural problems arising in the review function of management audit. Particularly, when management auditors performs comprehensive audit of operations, they cannot be as well informed about such operations as a financial auditor in a financial department. Operating processes may be unfamiliar and complex. The operating people may be speaking a language and using terms that are foreign to the auditor's experience. The nature and causes of behavioural problems that the management auditor is likely to face in the discharge of the review function that is expected of him and possible solutions to overcome these problems are discussed below:

(1) **Staff / Line conflict**: Management auditors are staff people while the members of other departments are line people. Management auditors tend to discount the difficulties the line staff may face, if called on to act on the ideas of management auditors. Management auditors are specialists in their field and they may think their approach and solutions are the only answers.

(2) **Control**: The management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee that the report of the auditor may affect them. There is a fear that the action taken based on the management audit report will affect the line people. It breeds antagonism. The causes are under:

(i) Fear of criticism stemming from adverse audit findings.

(ii) Fear of change in day to day working habits because of changes resulting from audit recommendations.

(iii) Punitive action by superior prompted by reported deficiencies.

(iv) Insensitive audit practices.

(v) Hostile audit style.

Solution to behavioural problems: The following steps may be taken to overcome the aforesaid problems:

(i) To demonstrate that audit is part of an overall programme of review for protective and constructive benefit.

(ii) To demonstrate the objective of review is to provide maximum service in all feasible managerial dimensions.

(iii) To demonstrate the review will be with minimum interference with regular operation.

(iv) The responsible officers will be involved in the process of review of the findings and recommendations before the audit report is formally released.

It is essential to create an atmosphere of trust and friendliness so that audit reports will be understood in their proper perspective.

Finally, it needs hardly any emphasis that there should be right management culture, enlightened auditees and auditors of the right calibre. May be to expect a combination at all times of all the three is asking for the impossible. But, a concerted effort by the management, auditors and auditees to achieve a more acceptable climate would go a long way to achieve the goal.

5. (a) **Audit Inquiry under Section 143(1) of the Companies Act, 2013:** An Auditor is required to make an inquiry and report under Section 143(1) of the Companies Act, 2013 if he is not satisfied in respect of the following matters:

(i) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(ii) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(iii) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(iv) whether loans and advances made by the company have been shown as deposits;

(v) whether personal expenses have been charged to revenue account;

(vi) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

(b) **Major steps required for Tax audit under VAT:** VAT is a tax on the value added to the commodity at each stage in the production and distribution chain. VAT is an indirect Tax on consumption. It is a tax on the value at the retail point of sale which is collected at each stage of sale. The essence of VAT is that it provides credit set off for input tax i.e. tax paid on purchases against the output tax i.e. tax payable on sales. A tax auditor has to make certain preliminary preparations before the actual execution of tax audit under the VAT law. The major steps required to be undertaken for the preparation are as under:

(i) **Knowledge of business:** After accepting the audit assignment the auditor should familiarize himself with the business of the auditee. In this regard, the auditor should refer to the SA 315 - "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment" issued by the Council of the Institute of Chartered Accountants of India. Before starting the audit, the auditor should have a preliminary knowledge of the industry/ business and of the nature of ownership, management etc. More detailed information should be obtained and should be assessed and updated during the course of audit. For this purpose the various sources of information may be tapped. The knowledge of business is important not only to the auditor but also to his staff engaged in the audit. The auditor has to ensure that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to carry out the audit work delegated to them and further they should make effective use of the knowledge about the business and should consider how it affects the tax liability reported in the return. The facts and figures in the returns should be consistent with the auditor's knowledge of the business. The auditor should also make himself familiar with the process of production and the distribution chain. The auditor should also obtain information about whether the auditee is a manufacturer/ importer/ retailer, the details of major customers to whom the sales are effected and the details of sales which are outside the scope of VAT law. Similarly the sources of purchase and the items sold should be listed out. Further it should be ascertained whether the auditee has opted for the composition scheme or not.

(ii) **Obtaining a list of all the accounting records maintained by the auditee:** The auditor should obtain a complete list of all the accounting records relating to sale/purchase of goods, stocks, the various registers, the ledgers etc. maintained, in which the transactions are recorded, the various source documents in which the entries are recorded in the books of account and the process of their generation.

(iii) **Ascertaining the major accounting policies adopted by the auditee:** The auditor should know the major accounting polices based on which books of account have been recorded. The accounting policy regarding recording of sales, purchases and valuation of inventory must be made known and the auditor should also find out whether there has been any change in those policies during the year covered by audit. If there is any significant change in the accounting policy giving rise to some material effect on the tax liability, the same should be invariably reported.

(iv) **Evaluation of internal control etc.:** Before determining the extent of audit checks to be applied i.e. whether to go in- depth or to do only test check, the auditor should ascertain whether there is an internal check system in operation in the entity. He should particularly find out how the purchases and sales gets initiated. For example, in case of purchase, receipt of indent by the purchase department, determining the need for purchases, initiation of purchase order, receipt of material, preparation of MRN, entries made in the books of accounts etc. should be verified. For sales, receipt of inquiry, acceptance of sales order, execution of sales, preparation of sale invoice and realization of transaction. If the internal control is reliable, the extent of audit may be reduced and should be focused only on those areas where the auditor feels that greater degree of audit risk is involved.

(v) **Knowledge about the VAT law and allied laws:** The auditor and his staff should obtain a thorough knowledge of the State VAT law under which the audit is to be conducted. The auditor should study the VAT law starting from the definition of various terms, the procedure to be adopted, the provisions regarding issue of invoices, claiming of input tax credit, composition schedule in the VAT law, the manner in which the output tax is to be calculated the provisions of audit, the contents of the audit report, the periodicity of the return to be filed, the format of the forms of returns, and the various notifications issued. Further the auditor should know the Central Sales-tax law as he has to comment on the liability under that law also. The auditor should also have some knowledge about the judicial pronouncements made by the Tribunals and the Courts on the various facets of these laws.

(c) **Disclosure of Earnings Per Share:** AS 20 on Earning Per Share (EPS) prescribes principles for the determination and presentation of EPS. As per AS 20, the earnings per share have to be disclosed as basic and diluted earnings per share on the face of the Statement of Profit and Loss for each class of equity shares that has a different right to share in the net profit for the period. In the instant case, Parry Industries Ltd., both the basic as well as the diluted earnings per share would be the same since there are no dilutive instruments that have been issued by the company. As per AS 20, in the case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration and thus would lead to increase in number of equity shares without any adjustment to outstanding capital amount. Therefore, the number of equity shares outstanding is increased without an increase in resources. The standard further requires that the number of equity shares outstanding before the event of a bonus issue to be adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. Hence the EPS calculated as on 31-03-2013 would be Adjusted EPS and the same would be disclosed. In view of the above, the EPS will be calculated as under:

As on 31.03.2013 $\dfrac{\text{Profits}}{\text{Adjusted No. of Shares}}$ = Adjusted EPS

$\dfrac{20,00,00,000}{8,00,00,000}$ = Rs. 2.5

As on 31.03.2014 $\dfrac{\text{Profits}}{\text{No. of shares}}$ = EPS

$\dfrac{30,00,00,000}{8,00,00,000}$ = Rs. 3.75

Since the above figures of EPS have not been disclosed, Parry Industries Ltd. has not complied with the provisions of AS 20. Therefore, the auditor would have to qualify his report stating the reasons thereof, in terms of section 143(3)(e) read with section 143(4) of the Companies Act, 2013, for non compliance of financial statements with the accounting standards.

6. (a) **Examination of claims paid:** The auditor may determine the extent of checking of claims paid on the same line as suggested for outstanding claims. Other aspects in respect of claims paid to be examined by the auditors are as follows:

(i) that in case of co-insurance arrangements, claims paid have been booked only in respect of company's share and the balance has been debited to other insurance companies.

(ii) that in case of claims paid on the basis of advices from other insurance companies (where the company is not the leader in co-insurance arrangements), whether share of premium was also received by the company. Such claims which have been communicated after the year-end for losses which occurred prior to the yearend must be accounted for in the year of audit.

(iii) that the claims payments have been duly sanctioned by the authority concerned and the payments of the amounts are duly acknowledged by the claimants;

(iv) that the salvage recovered has been duly accounted for in accordance with the procedure applicable to the company and a letter of subrogation has been obtained in accordance with the laid down procedure;

(v) that the amounts of the nature of pure advances/deposits with Courts, etc., in matters under litigation/arbitration have not been treated as claims paid but are held as assets till final disposal of such claims. In such cases, full provision should be made for outstanding claims;

(vi) that payment made against claims partially settled have been duly vouched. In such cases, the sanctioning authority should be the same as the one which has powers in respect of the total claimed amount;

(vii) that in case of final settlement of claims, the claimant has given an unqualified discharge note, not involving the company in any further liability in respect of the claim; and

(viii) that the figures of claims, wherever communicated for the year by the Division to the Head Office for purposes of reinsurance claims, have been reconciled with the trial balance-figure.

(b) Due Diligence review of cash flow:

(i) Review the historical pattern of cash flows of the organization and look for change in trends.

(ii) See whether the company is able to meet its cash requirements from internal generations/accruals or does it seek outside sources from time to time.

(iii) Check whether the company honours its commitments to creditors, Government and other stock holders.

(iv) Verify the ability of the company to turn its stock into Debtors i.e. sale ability of its products.

(v) Ensure that the company follows up with Debtors and that the Debtors collection period is not very large.

(vi) Check the ability of the company to deploy its funds in profitable investment opportunities.

(vii) Look into the investment pattern of the company, whether they give maximum benefits to the company and are easily realizable.

(c) Auditing procedures using CAATs: CAATs may be used in performing various auditing procedures, including the following:

(i) Tests of details of transactions and balances, for example, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records;

(ii) Analytical procedures, for example, identifying inconsistencies or significant fluctuations;

(iii) Tests of general controls, for example, testing the set-up or configuration of the operating system or access procedures to the program libraries or by using code comparison software to check that the version of the program in use is the version approved by management;

(iv) Sampling programs to extract data for audit testing;

(v) Tests of application controls, for example, testing the functioning of a programmed control; and

(vi) Re-performing calculations performed by the entity's accounting systems.

(d) Compliance of Prudential Norms by NBFC:

(i) The auditor has to verify the compliance of prudential norms relating to (1) income recognition; (2) Income from investments; (3) Asset classification; (4) Provision for bad and doubtful debts; (5) Capital adequacy norm; (6) Prohibition of granting loans against its own shares; (7) Prohibition on loans and investments for failure to repay public deposits and (8) Norms for concentration of credit etc.

(ii) The auditor shall ensure that Board of the NBFC shall frame a policy for granting demand/call loans and implement the same.

(iii) The auditor should verify the classification of advances and loans as standard/ substandard/ doubtful/ loss and that proper provision has been made in accordance with the directions.

(iv) Auditor should ensure that unrealised income from non-performing assets has not been taken to Statement of Profit and Loss.

(v) The auditor should check all NPAs of the previous years to verify whether during the current year any payments have been received or still they continue to be NPA during the current year also.

7. (a) **Mark to Market Margin (MTM):** MTM margin is the notional loss, which a stock member or his client would incur, if the net cumulative outstanding positions in all securities were closed out at the closing price of the relevant trading day, which is different from the price at which the transaction had been entered into. For each security, this is worked out by multiplying the difference between the closing price and the price at which the trade was executed by the cumulative buy and sell open position (for buy position the close price being lower than actual trade price and for sell position the close price being higher than actual trade price). The aggregate amount computed across all securities is MTM margin payable by a member. The mark-to-market margin is payable with reference to net position at client's level.

(b) **Advantages of Cost Audit to Government:** Cost auditor's approach is to ensure that the cost accounting plan is in consonance with the objectives set by the organisation and the system of accounting is geared towards the attainment of the objectives. A cost accounting system designed to exercise control over cost may be different from the one if the objective is to fix price. Accordingly, over a period of time particularly in view of administered pricing system the cost accounting becomes quite important. Some of the specific advantages which can be reaped by the Government are:

(i) Where the Government enters into a cost-plus contract, cost audit helps government to fix the price of the contract at a reasonable level.

(ii) Cost audit helps in the fixation of selling prices of essential commodities and thus undue profiteering is checked.

(iii) Cost audit enables the government to focus its attention on inefficient units.

(iv) Cost audit enables the government to decide in favour of giving protection to certain industries.

(v) Cost audit facilitates settlement of trade disputes brought to the government.

(vi) Cost audit and consequent management action can create a healthy competition among the various units in an industry. This imposes an automatic check on inflation.

(c) **Audit of a Co-operative Society:** Special features to be borne in mind in general while conducting the audit of a Co-operative Society are as follows-

(i) Examination of overdue debts.

(ii) Special treatment of overdue interest in the determination of profit.

(iii) Certification of bad debts before being written off.

(iv) Valuation of Assets and Liabilities.

(v) Adherence to co-operative Principles.

(vi) Observations of the Provisions of the Act and Rules.

(vii) Verification of members' Register and examination of their pass books.

(viii) Special report to the registrar on fraud, mismanagement and personal profiteering.

(ix) Audit classification of society based on the audit findings.

(x) Discussion of draft audit report with the managing committee.

(d) **Technical, Professional and Ethical Standards as per statement on peer review:** As per the Statement on Peer Review, Technical, Professional and Ethical Standards means-

(i) Accounting Standards issued by ICAI and /or prescribed and notified by the Central Government of India;

(ii) Standards issued by the Institute of Chartered Accountants of India including

  (a) Engagement standards

  (b) Statements

  (c) Guidance notes

  (d) Standards on Internal Audit

  (e) Statements on Quality Control

  (f) Notifications/ Directions/ Announcements/ Guidelines/ Pronouncements/ Professional standards issued from time to time by the Council or any of its committees.

(iii) Framework for the Preparation and presentation of financial statements, framework of statements and Standard on Auditing, Standard on Assurance Engagements, Standards on Quality Control and Guidance Notes on related services issued, from time to time, by the Institute of Chartered Accountants of India and framework for assurance engagements;

(iv) Provisions of the various relevant statutes and / or regulations which are applicable in the context of the specific engagements being Reviewed including instructions, guidelines, notifications, directions issued by regulatory bodies as covered in the scope of assurance engagements.

(e) **Environmental Audit:** Environmental reporting deals with the disclosure by an entity of environmentally related data, regarding environmental risks, environmental impacts, policies, strategies, targets, costs, liabilities or environmental performance to those who have an interest in such information as an aid to enabling/enriching their relationship with the reporting entity via either the annual report; a stand-alone corporate environmental performance report; or some other medium (e.g. staff newsletter, video, CD ROM, internet site). The reports that are generated after such audits can be either compliance-based reporting or impact-based performance reporting.

Environmental audit deals with verification of information contained in such reports with a view to expressing an opinion thereon. Environmental audit can be performed by external agencies or internal experts (including internal auditors). In practice, environmental audit is not done by a single agency but by various agencies who are experts in the field. Since the subject matter of environmental audit involves multi-disciplinary knowledge and skill, it is preferable to form a team of persons drawn from different disciplines who may assist the chartered accountant in performing the task in an effective manner, generally environmental audits are not required by any statute but are sometimes done at the request of the management to address issues like compliance with environmental laws and regulations, etc.

MOCK TEST PAPER 1

FINAL COURSE: GROUP – I

PAPER – 4 : CORPORATE AND ALLIED LAWS

Question No.1 is compulsory.

*Attempt any **five** questions from the remaining **six** Questions.*

Time Allowed – 3 Hours Maximum Marks – 100

1. (a) Flora Construction Limited in its General Meeting appointed all its directors by passing one single resolution. No objection was made to the resolution. Examine the validity of appointment of directors explaining the relevant provisions of the Companies Act, 2013. *(5 Marks)*

(b) The Annual General Meeting of Bhaskar Electronics Limited declared a dividend at the rate of 30 percent payable on paid up equity share capital of the Company as recommended by Board of Directors on 30th April, 2014. But the Company was unable to post the dividend warrant to Mr. Sanjay, an equity shareholder of the Company, up to 30th June, 2014. Mr. Sanjay filed a suit against the Company for the payment of dividend along with interest at the rate of 20 percent per annum for default period. Decide in the light of provisions of the Companies Act, 2013, whether Mr. Sanjay would succeed? *(5 Marks)*

(c) Impression Ltd. is holding 33% of the paid up equity capital of Thyag Stock Exchange. The company appoints Tilt Ltd. as its proxy who is not a member of the Thyag Stock Exchange, to attend the vote at the meeting of the stock exchange. Examine whether the Thyag Stock Exchange can restrict the appointment of Tilt ltd. as proxy for Impression Ltd. and further restrict, the voting rights of Impression Ltd. in the Thyag Stock Exchange. *(5 Marks)*

(d) The Articles of Association of a company fixed 3 as the quorum for a meeting of the Board. At a meeting of the Board, all the 5 directors were present. They allotted the shares of the company to 3 of the directors. Is it valid? *(5 Marks)*

2. (a) A scheme of reconstruction of Southern Stone Company Limited was, approved by its shareholders and creditors in their meeting and resolutions to that effect were passed. Afterwards a few shareholders and creditors of the company raised objections against the said arrangements of reconstruction. The entire paid up capital of the company was wiped out by the accumulated losses. Advise the Directors of the said company about the steps to be taken, to give effect to the proposed scheme under the Companies Act, 1956. *(8 Marks)*

(b) With reference to provisions laid down under the Companies Act, 2013, advice on the following:

(i) Which Company is required to constitute CSR (Corporate Social Responsibility) committee?

(ii) Minimum amount of contribution towards CSR?

(iii) Activities which are not considered as CSR activities? *(8 Marks)*

3. (a) A company proposes to appoint a Sole Selling Agent for its products. State the cases in which such appointment requires approval of Central Government. Draft a Board Resolution to appoint a sole selling agent in a case where such appointment does not require approval of Central Government. *(8 Marks)*

(b) Galaxy Medicare Limited was incorporated in the year 2008. The management of the company decides to make donation to recognized political party in the year 2014. Advise the management about the restrictions and the extent up to which such donation can be made under the Companies Act, 2013. Will it make any difference if Galaxy Medicare Limited was incorporated in the year 2012? *(8 Marks)*

4. (a) Mr. A, a Chartered accountant is an auditor of Laxman Ltd. Subsequently, from 1st June, 2014, he has started to render actuarial services to Laxman Ltd. Advice the company keeping in view the provisions of the Companies Act, 2013. *(8 Marks)*

(b) The Directors of Shubra Fabrics Ltd. desire to proceed for voluntary winding up of the company and hence they are required to File 'Declaration of Solvency'. Your advice is sought about the procedure to be followed for the said purpose. *(8 Marks)*

5. (a) The Managing Director of a large public company confessed that he was responsible for manipulation of the accounts and window dressing of the published accounts of the company. In view of this, the Central Government proposes to appoint its nominees as Directors of the company. Explain briefly the powers of the Central Government under the Companies Act, 1956 to appoint its nominees as Directors of a company to prevent oppression or mismanagement and the role of the Central Government with regard to the affairs of such a company. *(8 Marks)*

(b) A company proposes to make a public issue of equity shares for financing its project through book building process. It proposes to fix the floor price of the share at Rs. 500 for a share of Rs. 10. Answer the following with reference to SEBI (ICDR) Regulations.

What is the price band that may be indicated in the red herring prospectus?

If the company wants to lower the floor price during the bidding period in order to increase the response to the issue, state the conditions subject to which such revision can be made. *(8 Marks)*

6. (a) RST Ltd. is a securitization and reconstruction company under SRFAESI Act, 2002.

The certificate of registration granted to it was cancelled. State the authority which can cancel the registration and the right of RST Ltd. against such cancellation.

(8 Marks)

(b) Explain the provisions regarding prohibition on insider trading of securities as covered under the Companies Act, 2013. *(8 Marks)*

7. Attempt any **four:**

(a) The Reserve Bank of India issued certain directions to Dream Construction Limited, an authorised person under the Foreign Exchange Management Act, 1999 to file certain returns. The Company failed to file the said returns. Decide, as to what penal provisions are applicable against the said authorised person under the said Act.

(4 Marks)

(b) Avish Ltd. and Latik Ltd. both dealing in chemicals and fertilizers have entered into an agreement to jointly promote the sale of their products. A complaint has been received by the Competition Commission of India (CCI) stating that the agreement between the two is anti-competitive and against the interests of others in the trade. Examine with reference to the Provisions of the Competition Act, 2002, what are factors the CCI will take into account to determine whether the agreement in question will have any appreciable adverse effect on competition in the market.

(4 Marks)

(c) Kashyap Producer Company Limited was incorporated on 1st April, 2008. At present it has got 200 members and its board consists of 10 Directors. The Board of directors of the company seeks your advice on the following proposals:

(i) Appointment of one expert Director and one Additional Director by the Board for a period of four years.

(ii) Donation of Rs. 10,000 to a Political Party.

Advise the Board of directors explaining the relevant provisions of the Companies Act, 1956. *(4 Marks)*

(d) Does an explanation added to a section widen the ambit of a section? Support your answer with an example from the Companies Act, 1956. *(4 Marks)*

(e) "Money Laundering" does not mean just siphoning of fund." Comment on this statement explaining the significance and aim of the Prevention of Money Laundering Act, 2002. *(4 Marks)*

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – I

PAPER – 4 : CORPORATE AND ALLIED LAWS
SUGGESTED ANSWERS/HINTS

1. (a) Section 162(1) of the Companies Act, 2013, requires that the appointment of every director shall be voted on individually. Thus, two or more directors cannot be appointed by a single resolution. However, an exception has been carried out where under if a resolution has been first passed to the effect that all the directors shall be appointed by a single resolution without any vote being against it.

Any resolution, as per section 162(2) of the Companies Act, 2013, in contravention of the aforesaid provisions shall be void whether or not objection was taken at the time of its being so moved.

Hence, the appointments of all directors by passing one single resolution by Flora Construction Limited in its general meeting are void.

(b) Liability for failure to pay/post dividend within prescribed time

According to Section 127 of the Companies Act, 2013, dividend has to be paid within 30 days from the date of its declaration. The posting of dividend warrant by the company within 30 days will be deemed to be payment irrespective of the fact whether the shareholder has encashed it or not. Failure to pay or post dividend warrant within 30 days constitutes an offence under the Act and the company shall be liable to pay simple interest at the rate of eighteen percent per annum during the period for which such default continues.

In the instant case, the Annual General Meeting of Bhaskar Electronics Limited declared a dividend at the rate of 30% payable on paid up equity share capital of the company as recommended by the Board of Directors on 30th April, 2014. But the company was unable to post the dividend warrant to Mr. Sanjay, an equity shareholder of the company, up to 30th June, 2014.

In view of the above provisions, Mr. Sanjay can file a suit against the company for the payment of dividend because failure to pay or post dividend warrant within 30 days constitutes an offence under the Act. Thus, he would succeed but he is entitled for simple interest at the rate of 18% per annum (and not 20% as claimed) during the period for which such default continues.

(c) Section 7A of the Securities (Contracts) Regulation Act, 1956 provides that a recognised stock exchange is empowered to amend rules to provide for all or any of the following matters:

(a) Restriction of voting right to members only.

(b) Regulation of voting rights by specifying that each member is entitled to one vote only irrespective of number of shares held.

(c) Restriction on right of members to appoint proxy and proxy to attend and vote at a meeting of the stock exchange.

As such Thyag Stock Exchange can restrict the appointment of Tilt Ltd., as proxy, if rules of the exchange so provide. If it is not so provided, rules may be amended and after getting approval of the Central Government regarding amendment, it can restrict appointment of proxies.

Thyag Stock Exchange can also restrict the voting rights of Impression Ltd. as proxy if rules of the exchange so provide. If it is not so provided, rules may be amended and after getting approval of Central Government regarding amendment, it can restrict appointment of proxies.

Thyag Stock Exchange can also restrict the voting rights of Impression Ltd.

(d) The provisions in regard to quorum for a Board meeting are contained in section 287 of the Companies Act, 1956. It is provided therein that the quorum for a Board meeting shall be one-third of the total number of directors of a company (any fraction contained in that one-third shall be rounded off as one) or two directors, whichever is higher. It is further provided that where at any time the number of interested directors exceeds or is equal to two thirds of the total strength, the number of disinterested directors present at the meeting being not less than two shall form the quorum. The company is, however, free to fix a higher quorum for the Board meeting.

Viewed in the context of the above provisions, the company has fixed the quorum for a Board meeting at 3. In this case, out of five directors present at the meeting, the number of interested directors is three. As such, the remaining two directors who are not interested do not constitute a quorum and hence the meeting cannot be validly convened. Therefore, the allotment of shares at the aforesaid meeting is not valid.

The proviso to section 287(2) cannot also be availed of as the interested directors, who are three, are not equal to or more than two-thirds of the total strength of directors. The figure representing two-thirds will be 4 by rounding off fraction, if any. Hence, it can be assumed that the allotment made at the Board meeting will not be valid.

2. (a) **Scheme of reconstruction:** The Company is a sick company and therefore can be considered as a company liable to be wound up with the meaning of section 390 of the Companies Act, 1956. The proposed scheme involves a compromise or arrangement with members and creditors and attracts section 391 of the said Act. An application be submitted before the High Court under section 391 of the said Act. On such application the court may order that a meeting of creditors and/or

members be called and held as per the directions of the court.

The company must send notice of meeting to every creditor/member containing a statement setting forth the terms of compromise explaining its effects. At the meetings convened as per directions of the court majority in number representing atleast ¾ in value of creditors/members present and voting must agree in compromise or arrangements. Thereafter, the company must present a petition to the court for confirmation of the compromise or arrangement.

The notice of application made by the company will be served on the Central Government and the court will take into consideration representation, if any, made by the Central Government (Section 394A). The court will sanction the scheme, if satisfied, after consideration of all relevant matters. Copy of order issued by the court must be filed with the Registrar of Companies and then only the order will come into effect. Copy of the said order must be annexed to memorandum of Association issued thereafter. The scheme sanctioned by the court shall be binding on all members and creditors even on those who were dissenting.

(b) (i) **Which Company is required to constitute CSR committee:**

(A) Every company including its holding or subsidiary, and a foreign company defined under section 2(42) of the Companies Act, 2013 having its branch office or project office in India, having

(1) net worth of rupees 500 crore or more, or

(2) turnover of rupees 1000 crore or more or

(3) a net profit of rupees 5 crore or more

during any financial year shall constitute a Corporate Social Responsibility Committee of the Board.

(B) The CSR Committee shall institute a transparent monitoring mechanism for implementation of the CSR projects or programs or activities undertaken by the company.

(C) However, the net worth, turnover or net profit of a foreign company shall be computed in accordance with balance sheet and profit and loss account of such company as prepared in accordance with the provisions of section 381(1)(a) and section 198 of the Act.

(ii) **Amount of contribution towards CSR:**

(A) The Board of every company shall ensure that the company spends, in every financial year, at least two per cent. of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its CSR Policy.

(B) The company shall give preference to the local area and areas around it where it operates, for spending the amount earmarked for CSR activities.

(C) If the company fails to spend such amount, the Board shall, in its report, specify the reasons for not spending the amount.

(D) Companies may build CSR capacities of their own personnel as well as those of their Implementing agencies through Institutions with established track records of at least three financial years. However, such expenditure shall not exceed five percent. of total CSR expenditure of the company in one financial year.

(iii) **Activities which are not considered as CSR activities:**

The *Companies (CSR Policy) Rules, 2014* provides for some activities which are not considered as CSR activities:

(A) The CSR projects or programs or activities undertaken outside India.

(B) The CSR projects or programs or activities that benefit only the employees of the company and their families.

(C) Contribution of any amount directly or indirectly to any political party under section 182 of the Act.

3. (a) **Appointment of sole selling agents:** Under Section 294AA of the Companies Act, 1956, in following cases, appointment of sole selling agents will require approval of Central Government:

(i) According to section 294AA(2), an individual firm or body corporate who has a substantial interest in the company cannot be appointed as a sole selling agent without prior approval of Central Government. Substantial interest means shareholding of Rs.5 lakhs or 5% paid up capital of the company, whichever is less. The shareholding may be singly or together with relatives (in the case proposed Sole Selling Agent being an individual), partners and their relatives (in the case of a firm) directors and relatives of directors (in the case of a body corporate as per Explanation (b) to Section 294AA).

(ii) According to section 294AA(3), any company having paid up share capital of Rs.50 lakhs or more cannot appoint sole selling agent without approval in general meeting by a special resolution and also approval of Central Government. These restrictions apply to all Companies i.e. both private and public companies.

Board Resolution: "*Resolved* that pursuant to the provisions of section 294 of the Companies Act, 1956, and subject to the approval of the Company at a general meeting by ordinary resolution, the Board approves the appointment of 'X' as the company's sole selling agent for the sale of ….. in the territory of …. for a period of five years with effect from …… on the terms and conditions set out in the draft agreement produced to this meeting and initiated by the chairman for purposes of identification or with such modifications (not being less advantageous to the company) as may be mutually agreed by the Board and 'X'."

(b) **Donation to Recognized Political Party**: According to section 182 of the Companies Act, 2013, notwithstanding anything contained in any other provision of this Act, no Government Company and no other company which has been in existence for less than three financial years shall contribute any amount or amounts directly or indirectly to any political party. Any other company may however, contribute any amount directly or indirectly to any political party, provided that the aggregate of the amount so contributed by the company in any financial year shall not exceed 7.5% of the its average net profits during the three immediately preceding financial years.

Thus, Galaxy Medicare Limited in the present case, can contribute to the recognized political party since it is not a Government Company and it is in existence for more than three financial years at the time of making the donation. Further, political donations can be made by Galaxy Medicare Limited only out of its profits.

Further, the political donation is required to be authorized by a resolution passed at a Board of Directors' meeting. The Company, in addition, shall disclose in its profit and loss account any amount or amounts contributed by it to any political party during the financial year to which that account relates, giving particulars of the total amount contributed and the name of the party to which such amount has been contributed.

If Galaxy Medicare Limited was registered in the year 2012, it cannot make political donations because the company has not been in existence for three financial years.

4. (a) **Prohibited services**: An auditor appointed under the Companies Act, 2013 shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be. But such services shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:—

(a) accounting and book keeping services;

(b) internal audit;

(c) design and implementation of any financial information system;

(d) actuarial services;

(e) investment advisory services;

(f) investment banking services;

(g) rendering of outsourced financial services;

(h) management services; and

(i) any other kind of services as may be prescribed.

In the instant case, Mr. A, a chartered accountant is an auditor of Laxman Ltd. and subsequently from 1st June, 2014, he has started to render actuarial services to Laxman Ltd. which falls under the prohibited services as per section 144 of the Companies Act, 2013. Therefore Mr. A is liable for the penalty under section 147 of the Companies Act, 2013.

Penalty for providing prohibited services:

(i) Penalty on company [Section 147(1)]:

If any of the provisions of section 144 is contravened, the company shall be punishable with fine which shall not be less than Rs. 25,000 but which may extend to Rs. 5 Lacs.

(ii) Penalty on officers [Section 147(1)]:

If any of the provisions of section 144 is contravened, every officer of the company who is in default shall be punishable with:

(1) Imprisonment for a term which may extend to 1 year or

(2) With fine which shall not be less than Rs. 10,000 but which may extend to Rs. 1 Lacs; or

(3) Both with imprisonment and fine.

(iii) Penalty on auditor [Section 147(2) & (3)]:

(a) If an auditor of a company contravenes any of the provisions of section 144, the auditor shall be punishable with fine which shall not be less than Rs. 25,000 but which may extend to Rs. 5 Lacs.

(b) If an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with

(1) imprisonment for a term which may extend to 1 year and

(2) fine which shall not be less than Rs. 1 Lac but which may extend to Rs. 25 Lacs.

(c) Further, where an auditor has been convicted as above, he shall be liable to—

(1) refund the remuneration received by him to the company; and

(2) pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.

(b) **Declaration of Solvency:** Chapter III of part VII of the Companies Act, 1956 deals with "Voluntary winding up" of companies and in this relation section 488 of the said Act provides for filing of "declaration of solvency" on the part of the directors of the company when there is proposal for voluntary winding up of the company.

The analysis of Section 488 of the Companies Act, 1956 discloses that a declaration of solvency contains the following features -

1. It is a declaration duly supported by an affidavit, verified by a competent authority.
2. A meeting of Board of Directors is required for the purpose.
3. The declaration is made by the directors or where there are more than two directors, by the majority of the directors that they have made full inquiry into the affairs of the company and
4. That they have formed opinion that the company has no debts or that if it will be able to pay its debt in full within a period not exceeding three years from the date of commencement of winding up as may be specified in the said declaration.
5. In order that the above declaration in valid, it should be made within five weeks immediately preceding the date of passing the resolution for winding up of the company and must be delivered to the Registrar before that date.
6. Further, the said declaration should be accompanied by a copy of the auditors report on the profit and loss account of the company for the period commencing from the date of the last audited accounts upto a date practicable immediately before the date of the declaration and a balance sheet on the last mentioned date and also a statement of company's assets and liabilities as on the date of the declaration made out in accordance with the requirements laid down by clause (2) of section 488 of the Companies Act, 1956.
7. Any director of a company making a declaration under this section without having reasonable grounds for the opinion that the company will be able to pay its debts in full within the period specified in the declaration, shall be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to Rs. 50,000, or with both.
8. If the company is wound-up in pursuance of a resolution passed within the period of five weeks after the making of the declaration but its debts are not paid or provided for in full, within the period specified in the declaration, it shall be presumed, until the contrary is shown, that the director did not have reasonable grounds for his opinion.

5. (a) **Power of Central Government to prevent oppression or mismanagement**: The Central Government is empowered to appoint its nominees as directors of a

company to effectively safeguard the interest of the company or its shareholders or the public interest. If the Central Government wants to appoint its nominees as Directors of such a company then it has to make a reference to the Company Law Board (CLB) and if the CLB is satisfied that the affairs of the company have been conducted in a manner oppressive to any member of the company or in a manner prejudicial to the interests of the company or to public interest, it may pass an order asking the Central Government to appoint directors for a period not exceeding three years on any one occasion. There is no limit as to the number of directors that can be appointed. The CLB may also pass similar orders on an application of not less than 100 members or members holding atleast one tenth of the total voting power. Hence Central Government can appoint its nominees as directors of the company only on an order passed by CLB in this regard and not on its own.

Notwithstanding anything contained in the Companies Act or in any other law for the time being in force, where any person is appointed by the Central Government to hold office as director or additional director, Section 408 (6) of the Companies Act, 1956, empowers the Central Government to issue such directions to the company as it may consider appropriate in regard to its affairs. Such directions may include directions to remove an auditor already appointed and to appoint another auditor in his place or to alter the articles of the company. When such directions are given, the appointment, removal or alteration, as the case may be shall be deemed to have come into effect as if the provisions of the Companies Act in this behalf have been complied without requiring any further act or thing to be done. Though these powers are substantial, yet the same do not empower the Central Government to interfere in the day to day management of the company.

Further, Section 408(7) empowers the Central Government to require the persons appointed as directors to report to the Central Government from time to time with regard to affairs of the company.

(b) The price band is the range within which the price can move. The cap of the price band shall not be more than 20% of the floor price. If the floor price is Rs. 500 the cap of the price shall be Rs. 600 and the company may indicate a price band of Rs. 500 to 600 in the red herring prospectus (Schedule XI, Clause 8(b) SEBI (ICDR) Regulations, 2009.

The price band can be revised during the bidding period in which case the maximum revision on either side shall not exceed 20% i.e. floor of the price band can move up or down to the extent of 20% of the floor price. Hence the revised price band may be Rs. 400 (Rs. 500 less 20%) to Rs. 480 (120% of Rs. 400).

Any revision in the price band shall be widely disseminated by informing the stock exchange, by issuing press releases and also indicating the change on the relevant website and terminals of syndicate members. The bidding period shall be extended for a further period of 3 days subject to the total bidding period not exceeding 10 days. The manner in which the shortfall, if any in the project financing arising on account of lowering of price band will be met shall be disclosed in the red- herring prospectus. It shall also be disclosed that the allotment shall not be made unless the financing is tied up. These are the conditions subject to which the price the price band may be lowered.

6. (a) **Cancellation of Certificate of Registration under SRFAESI Act, 2002:**

The Reserve Bank of India may cancel a certificate of registration granted to a securitisation and reconstruction company for the reasons stated in Section 4 of SRFAESI Act, 2002.

RST Ltd., can prefer an appeal to the Central Government (Secretary, Ministry of Finance, Government of India) within a period of 30 days from the date on which order of cancellation was communicated to it. The Central Government must also give such company a reasonable opportunity of being heard before rejecting the appeal. If RST Ltd., is holding investments of qualified institutional buyers at the time of cancellation of certificate of registration, it shall be deemed to be a securitisation and reconstruction company until it repays the entire investments held by it, together with interest if any, within such period as may be specified by the Reserve Bank.

(b) **Prohibition on insider trading of securities (Section 195 of the Companies Act, 2013)**

There was no provision under the Companies Act, 1956 for prohibition on insider trading of securities. A new section 195 of the Companies Act, 2013 which came into force on 12th September, 2013 provides for prohibition on insider trading of securities. According to section 195 of the Companies Act, 2013:

(i) No person including any director or key managerial personnel of a company shall enter into insider trading. But if any communication is required in the ordinary course of business or profession or employment or under any law, then the above prohibition does not apply.

(ii) “Insider trading” means—

(a) an act of subscribing, buying, selling, dealing or agreeing to subscribe, buy, sell or deal in any securities by any director or key managerial personnel or any other officer of a company either as principal or agent if such director or key managerial personnel or any other officer of the company is reasonably expected to have access to any non-public price sensitive information in respect of securities of company; or

(b) An act of counselling about procuring or communicating directly or indirectly any non-public price-sensitive information to any person.

(iii) “price-sensitive information” means any information which relates, directly or indirectly, to a company and which if published is likely to materially affect the price of securities of the company.

(iv) If any person contravenes the provisions of this section, he shall be punishable with imprisonment for a term which may extend to five years or with fine which shall not be less than five lakh rupees but which may extend to twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher, or with both.

7. (a) **Penal provisions**: Section 11(3) of the Foreign Exchange Management Act, 1999 states that where any authorized person contravenes any direction given by the Reserve Bank of India under the said Act or fails to file any return as directed by the Reserve Bank of India, the Reserve Bank of India may, after giving reasonable opportunity of being heard impose a penalty which may extend to Rs. 10,000/- and in the case continuing contraventions with an additional penalty which may extend to Rs. 2,000/- for every day during which such contravention continues.

(b) **Factors determining appreciable adverse effect on competition:**

It is not be lawful for any enterprise or association of enterprises or person or association of enterprises or persons or association of persons to 'enter' into an agreement in respect of production, supply, storage, distribution, acquisition or control of goods or provision of service, which causes or is likely to cause an appreciable adverse effect on competition within India. All such agreements entered into in contravention of the aforesaid prohibition shall be void.

According to section 3 of the Competition Act, 2002, any agreement entered into between enterprises or associations of enterprises or persons or associations of persons or between any person and enterprise or practice carried on, or decision taken by, any association of enterprises or association of persons, including cartels, engaged in identical or similar trade of goods or provision of services, shall be presumed to have an appreciable adverse effect on Competition, which—

(a) directly or indirectly determines purchase or sale prices;

(b) limits or controls production, supply, markets, technical development, investment or provision of services;

(c) shares the market or source of production or provision of services by way of allocation of geographical area of market, or type of goods or services, or number of customers in the market or any other similar way;

(d) directly or indirectly results in bid rigging or collusive bidding.

However, any agreement entered into by way of joint ventures, if such agreement increases efficiency in production, supply, distribution, storage, acquisition or control of goods or provision of services, shall not be considered to be an anti-competitive agreement.

(c) **Appointment of expert director or additional director:** Section 581P(6) of the Companies Act, 1956 empowers the Board of directors of a producer company to co-opt one or more expert directors or an additional director not exceeding one fifth of the total number of directors for such period as the Board may deem fit. But the maximum period shall not exceed the period specified in the Articles of the company (Second Proviso to section 581P(6).

The number of directors proposed to be co-opted is only 2 and it does not exceed one-fifth of the total number of directors (10*1/5 = 2). They can hold office for the period specified by the Board provided it does not exceed the period specified in the Articles. Hence, the proposed appointment of one expert director and one additional director is in order.

Donation to a Political Party: According to second proviso to section 581ZH, a producer company shall not make directly or indirectly to any political party or for any political purpose to any person any contribution or subscription or make available any facilities including personnel or material. As the donation to a political party is prohibited, the company cannot donate Rs.10,000 to a political party.

(d) Sometimes an explanation is added to a section of an Act for the purpose of explaining the main provisions contained in that section. If there is some ambiguity in the provisions of the main section, the explanation is inserted to harmonise and clear up any ambiguity in the main section. Something may be added to or something may be excluded from the main provision by insertion of an explanation. But the explanation should not be construed to widen the ambit of the section.

For example, section 294AA of the Companies Act, 1956 gives power to the Central Government to prohibit the appointment of Sole Selling Agents of a company in certain cases. An explanation has been added to that section which states that an "appointment" includes "re-appointment". By inclusion of this explanation, the legislature has only clarified the main provisions of that section and has not widened the ambit of the powers of the Central Government.

(e) **"Money laundering" does not mean just siphoning of fund:** Money Laundering is a moving of illegally acquired cash through financial systems so that it appears to be legally acquired. Thus, money laundering is not just the siphoning of fund but it is the conversion of money which is illegally obtained.

Prevention of Money Laundering Act, 2002 has been enacted with aim for combating channelizing of money into illegal activities.

Significance and Aim of Prevention of Money Laundering Act, 2002: The preamble to the Act provides that it aims to prevent money–laundering and to provide for confiscation of property derived from, or involved in, money–laundering and for matters connected therewith or incidental thereto.

In order to further strengthen the existing legal framework and to effectively combat money laundering, terror financing and cross-border economic offences, an Amendment Act, 2009 was passed. The new law seeks to check use of black money for financing terror activities. Financial intermediaries like full-fledged money changers, money transfer service providers and credit card operators have also been brought under the ambit of The Prevention of Money-Laundering Act. Consequently, these intermediaries, as also casinos, have been brought under the reporting regime of the enforcement authorities. It also checks the misuse of promissory notes by FIIs, who would now be required to furnish all details of their source. The new law would check misuse of “proceeds of crime” be it from sale of banned narcotic substances or breach of the Unlawful Activities (Prevention) Act. The passage of the Prevention of Money Laundering (Amendment), 2009 have enabled India’s entry into Financial Action Task Force (FATF), an inter-governmental body that has the mandate to combat money laundering and terrorist financing.

Test Series: October, 2014

MOCK TEST PAPER - 2

FINAL COURSE: GROUP – I

PAPER – 4 : CORPORATE AND ALLIED LAWS

Question No.1 is compulsory.

*Attempt any **five** questions from the remaining **six** Questions.*

Time Allowed – 3 Hours　　　　　　　　　　　　　　　　　　　　Maximum Marks – 100

1. (a) Apex Ltd. is having its registered office in the city of Madurai, has its manufacturing plant (Factory) located in the industrial area of the city Mumbai. The Board wants to keep all its books of accounts at Mumbai (Factory) instead of the registered office. Kindly advise as per the provisions of the Companies Act, 2013, can the Board of Directors do so? *(5 Marks)*

   (b) M/s. USD Industries Limited has constituted "Investor Education and Protection Fund" as required under the Companies Act, 1956 but so far no amounts have been deposited into the said account. Explain with reference to the above said enactment, the amounts payable to the credit of the said account. *(5 Marks)*

   (c) The governing body of Jaipur Stock Exchange desires to establish an additional trading floor at Bikaner. Advise, whether additional trading floor can be established by the said stock exchange under the provisions of the Securities Contracts (Regulation) Act, 1956. *(5 Marks)*

   (d) Mr. Ravi, a Director of Anant Limited proceeding on a long foreign tour, appointed Mr. Rajesh as an alternate director to act for him during his absence. The articles of the company provide for appointment of alternate directors. Mr. Ravi claims that he has a right to appoint alternate director. *(5 Marks)*

2. (a) M/s Slow Ltd. proposes to acquire the majority shares of M/s Fast Industries Ltd. by way of Amalgamation. Briefly enumerate the steps that should be taken by the Transferee Company to achieve the objective under the Companies Act, 1956. *(8 Marks)*

   (b) What are contents of the Directors' Responsibility Statement as per the provisions of the Companies Act, 2013 *(8 Marks)*

3. (a) A complaint was received by the Central Government from some shareholders of a public company that a person had been appointed as the Managing Director of the company without seeking the approval of the Central Government when such approval was required. State as to what action can be taken by the Central Government under the Companies Act, 1956. Also examine the validity of the acts of the Managing Director, if the complaint is found true. *(8 Marks)*

(b) Mr. Amrendra was appointed as a director at the Annual General Meeting of a limited company held on 23rd September, 2013 and he carried on his duties and functions as a director. In the month of August, 2014, it was found out that there were certain irregularities in his appointment and on 31st August, 2014, his appointment was declared invalid. But Mr. Amrendra continued to act as director even after 31st August, 2014.

You are required to state, with reference to the provisions of the Companies Act, 2013, whether the acts done by Mr. Amrendra are valid and binding upon the company ? *(8 Marks)*

4. (a) XYZ Limited, over years, enjoys high reputation and its General Reserve is many times more than the paid up capital of the company. There is apprehension of cornering the shares of the company by some persons likely to result in change in the Board of directors which may be prejudicial to the Public interest.

Advise, as to how can XYZ Limited block the transfer of shares of the company under the provisions of the Companies Act, 1956.

(b) By an order of the Court M/s Meeta Limited was wound up with effect from 15.3.2012. Ms. Vijaya, who ceased to be a member of the Company from 1.6.2011 received a notice from the liquidator to deposit a sum of Rs. 15,000 as her contribution towards the liability on the shares previously held by her. Ms. Vijaya seeks your opinion about her liability. *(8 Marks)*

5. (a) Certain Members of Givo Company Limited having share capital feel that the affairs of the company are being mismanaged by Directors. Members therefore, decide to move the Company Law Board, complaining the mismanagement of company affairs by Directors of the Company. Examine the provisions of the Companies Act, 1956 and state

(i) Whether members are entitled to complain to the Company Law Board.

(ii) Whether the following acts of the Board of Directors amount to mismanagement:

(A) Continuation of Directors in their office after expiry of their tenure and infighting continues among them.

(B) Non-declaration of dividend when it does not lead to devaluation of shares. *(8 Marks)*

(b) State the guidelines issued by SEBI in respect of the “Price and price band” in case of pricing in Public issue. *(8 Marks)*

6. (a) The Central Government acquired a Banking Company. The scheme of acquisition, apart from other matters, provided for the quantum of compensation payable to the shareholders of acquired bank. Some shareholders are not satisfied with the amount of compensation fixed under the scheme of acquisition.

Is there any remedy available to the share holders under the provisions of the Banking Regulation Act, 1949? *(8 Marks)*

(b) Explain the provisions regarding 'Prohibition on forward dealings in securities of company by director or key managerial personnel' as covered under the Companies Act, 2013. *(8 Marks)*

7. Attempt any four:

(a) During the financial year 2013-14 Mr. Bobby resided in India for a period of 180 days and thereafter went abroad. On 1st April, 2014 Mr. Bobby came back to India as an employee of a business organization. Decide the residential status of Mr. Bobby during the financial year 2013-14 under the provisions of the Foreign Exchange management Act, 1999. *(4 Marks)*

(b) Mr. Alexander was a member of the Competition Commission of India. On the basis of information that he had acquired such financial interest as was likely to affect prejudicially his functions as a member of the Commission, the Central Government appointed an officer to hold an inquiry. On the basis of report of the said officer the Central Government issued an order of removal of Mr. Alexander. Decide whether the action of the Central Government is in order under the provisions of the Competition Act, 2002? *(4 Marks)*

(c) Mr. Zaidi, son of Managing Director of a Public Company, is proposed to be appointed as Chief Executive of the company on a monthly remuneration of Rs. 2,75,000. State the provisions of the Companies Act, 1956 which are required to be complied with by the company in this regard? *(4 Marks)*

(d) In what way are the following terms considered as 'internal aid' in the interpretation of statutes?

(i) Illustrations

(ii) Explanation *(4 Marks)*

(e) How the trials under PMLA are conducted in special courts? Is the offence under PMLA are bailable? *(4 Marks)*

MOCK TEST PAPER - 2

FINAL COURSE: GROUP – I

PAPER – 4 : CORPORATE AND ALLIED LAWS

Question No.1 is compulsory.

*Attempt any **five** questions from the remaining **six** Questions.*

Time Allowed – 3 Hours Maximum Marks – 100

1. (a) **Maintaining the books of accounts at a place other than Registered office of the company:** According to section 128(1) of the Companies Act, 2013, every company shall prepare and keep at its registered office, books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any.

The company may also keep all or any of the books of accounts at any other place in India as the Board of directors may decide. In such a case, the company should file with the Registrar of Companies, a notice in writing giving the full address of that place within 7 days of the Boards' decision.

Thus, in the present case, Apex Ltd. can follow the above procedure and keep its books of accounts at Mumbai instead of the Registered office of the company.

(b) **Investor Education & Protection Fund:** The Central Government has established a fund, called as Investor Education and Protection Fund. The Fund shall be utilized for promotion of investors' awareness and protection of the interest of investors in accordance with the prescribed rules.

The following amounts shall be credited to the Fund:

(a) amounts in the unpaid dividend accounts of companies;

(b) the application moneys received by companies for allotment of any securities and due for refund;

(c) matured deposits with companies;

(d) matured debentures with companies;

(e) the interest accrued on the amounts referred to in (a) to (d) as above;

(f) grants and donations given to the Fund by the Central Government, State Governments, companies or any other institutions for the purposes of the Fund; and

(g) the interest or other income received out of the investments made from the Fund.

No such amounts referred to in points (a) to (d) shall form part of the Fund unless such amounts have remained unclaimed and unpaid for a period of seven years from the date they became due for payment.

(c) **Additional Trading Floor:** According to Section 13A of the Securities Contracts (Regulation) Act, 1956 a stock exchange may establish additional trading floor with the prior approval of the Securities Exchange Board of India (SEBI) with the terms and conditions stipulated by the said Board.

Additional Trading Floor means a trading ring or trading facility offered by a recognized stock exchange outside its area of operation to enable the investors to buy and sell securities through such trading floor under the regulatory frame work of that stock exchange.

In view of the above, Jaipur Stock Exchange may establish an additional trading floor at Bikaner with prior approval of the SEBI.

(d) Section 313 of the Companies Act, 1956 provides that the Board of directors of a company may, if authorised by its articles or by resolution passed by the company in general meeting, appoint an alternate director to act for a director during his absence for a period of not less than 3 months from the State in which the meetings of the Board are ordinarily held. The alternate director can be appointed only by the Board of directors and only in cases where the Board is authorised by Articles or by the company in general meeting. Hence Mr. Ravi, the director in question, is not competent to appoint alternate director and the appointment of Mr. Rajesh as alternate director is not valid.

2. (a) Slow LTD., the transferee company should take the following steps to achieve the objective of acquiring the majority shares of Fast Industries Ltd.:

(i) to check up whether the memorandum of association of the transferee company contains the power of amalgamation. If not, to take steps to alter the objects clauses suitably to acquire the said power.

(ii) to prepare the draft scheme of amalgamation including the exchange ratio and get it approved by a meeting of the Board of directors.

(iii) to apply to the High Court for direction to convene the general meeting by way of Judges' summons as provided in Companies (Court) Rules, 1959.

(iv) to send notice of general meeting to every member along with the details of the scheme of amalgamation.

(v) to hold the general meeting and to pass the resolution approving the draft scheme of amalgamation subject to the confirmation of the High Court. The resolution is to be passed by a majority in number representing $3/4^{th}$ in value of the members as required by section 391 of the Companies Act, 1956.

(vi) to move the High Court for approval of the scheme.

(vii) on receipt of the court order, to file the certified copy thereof to the Registrar of Companies within 30 days after making the order.

(viii) A copy of the order of the court to be annexed to every copy of the memorandum issuedafter the certified copy of the order has been filed with the Registrar.

(ix) To effect the scheme of amalgamation as per the scheme approved and the directions given by the High Court and to allot shares of the transferee company to the shareholders of transferor company i.e., Fast Industries Ltd.

(b) The Directors' Responsibility Statement shall state that—

(1) in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;

(2) the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;

(3) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(4) the directors had prepared the annual accounts on a going concern basis; and

(5) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

The term "internal financial controls" means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information;

(6) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

3. (a) Improper appointment of Managing Director:

1. According to Section 269(6) of the Companies Act, 1956, if the appointment or re-appointment is not approved by the Central Government the appointee shall

vacate office immediately on communication of the decision by the Central Government, otherwise he shall be punishable with fine up to ₹ 5,000/- for every day during which he fails to vacate such office.

2. According to Section 269(7), on receipt of the complaint, if the Central Government is prima facie, of the opinion that the Managing Director has been appointed without approval of the Central Government, when in fact such approval was necessary, the Central Government may refer the matter to the Company Law Board for decision.

3. According to Section 269(8), the Company Law Board will issue show-cause notice to the Company as well as the concerned Managing Director.

4. According to Section 269(9), the Company Law Board will hear the case, and if it comes to a conclusion that the appointment is in contravention of requirements of Schedule XIII, it will make an order to that effect.

5. On such order, the appointment of the concerned Managing Director shall be deemed to have come to an end. The person so appointed shall in addition to being liable to pay a fine of ₹ 1 lakh, refund to the company the entire remuneration received by him between the date of his appointment and the passing of such an order [Section 269(10)]. But all acts done by him prior to the declaration of invalidity will be valid, if they are otherwise valid [Section 269(12)].

(b) In accordance with the provision of the Companies Act, 2013 as contained in section 176, acts done by a person as a director shall be valid, notwithstanding that it may afterwards be discovered that his appointment was invalid by reason of any defect or disqualification or had terminated by virtue of any provision contained in this Act or in the articles:

The Proviso to section 176 of the Companies Act, 2013, further provide that nothing in this section shall be deemed to give validity to acts done by a director after his appointment has been shown to the company to be invalid or to have terminated.

In view of the provision of section 176 of the Companies Act, 2013, the acts done by Mr. Amrendra prior to 31st August, 2014 are to be treated as valid and binding on the Company.

However in view of the Proviso to the said section 176 of the Companies Act, 2013, the acts done by Mr. Amrendra after 31st August, 2013 shall be deemed to be invalid and not binding upon the Company.

4. (a) **Restrictions and Prohibition of transfer of shares or debentures:** As per provisions of section 250(4) of the Companies Act, 1956, where the Company Law Board (referred to as CLB hereinafter) has reasonable grounds to believe that a transfer of shares in a company is likely to take place whereby a change in the composition of the Board of directors of a company is likely to take place and the CLB is of the opinion that any such change would be prejudicial to the public interest, the CLB may, by an order, direct that any transfer of shares in the concerned company during such period not exceeding three years, as may be specified in the order, shall be void.

As per section 250 (1) & (2) of the Companies Act, 1956, if the CLB is of the view that there are good reasons to find out the relevant facts about any shares and the CLB is of the opinion that such facts cannot be found out unless the restrictions are imposed, as an interim measure, it may, by an order, direct that transfer of any such shares shall be void and no voting rights shall be exercised in respect of such shares. However, the CLB is empowered to vary or rescind its order any time.

The facts given in the question squarely fall within the provisions of section 250 of the Companies Act, 1956. The management of XYZ Ltd. may make a complaint to the CLB and convince it that the transfer of shares in favour of the group of unscrupulous persons would change the composition of the Board of directors of the company which shall be prejudicial to the public interest and if the CLB is convinced with the plea of the company, it may pass an order as stated above which would block the transfer of shares as stated in the question.

(b) **Liability of Contributory:** 'Contributory' is a term used in the case of winding up of a company. A Contributory can be past or present member and is liable to contribute to the assets of the company in the event of winding up.

In the instant case, Ms. Vijaya ceased to be a member of the Company when it went into liquidation from 15.3.2012. Thus, Ms. Vijaya will be treated as a past member. She will not be required to contribute to the assets of the company if the following conditions are fulfilled:

(1) If Ms. Vijaya had ceased to be a member of the company for a period of one year or upwards before the commencement of the winding up. In this case, since one year has not elapsed, Ms. Vijaya will be liable to contribute to the assets of the company.

(2) If the debt or liability of the company was contracted or incurred after she ceased to be a member.

(3) If the present members are able to satisfy the contributions required to be made by them under the Act.

In any case, the liability of the past or present member cannot exceed the unpaid amount on the shares and if the shares are fully paid up, no contribution is required to be made by the members past or present.

5. (a) Section 398 of the Companies Act, 1956 provides that a requisite number of members of the company as laid down in section 399 may apply to Company Law Board for appropriate relief on the ground of mismanagement of the company.

(i) **Conditions Precedent:** Section 398 can be invoked in either of the two circumstances:

(a) that affairs of the company are being conducted in a manner prejudicial to the interests of the company [Section 398(1)(a)]; or

(b) that a material change has taken place in the management or control of the company and as a consequence the affairs of the company may be conducted in a manner prejudicial to the public interest or in a manner prejudicial to the interests of the company [Section 398(1)(b)].

(ii) **Considering the above, the questions as asked can be answered as under:**

(A) Continuation of directors in their office after the expiry of their term and infighting among them has been held to be the act of mismanagement. (Ranjan Dutta vs. Bhola Nath Paper House Ltd. (1983)).

(B) Non-declaration of dividend when it does not lead to devaluation of shares is not an act of mismanagement. (V.J. Thomas Vettom vs. Kuttanad Rubber Co. Ltd. (1984)).

(b) (1) The issuer may mention a price or price band in the draft prospectus (in case of a fixed price issue) and floor price or price band in the red herring prospectus (in case of a book built issue) and determine the price at a later date before registering the prospectus with the Registrar of Companies: Provided that the prospectus registered with the Registrar of companies shall contain only one price or the specific coupon rate, as the case may be.

(2) The issuer shall announce the floor price or price band at least five working days before the opening of the bid (in case of an initial public offer) and at least one working day before the opening of the bid (in case of a further public offer), in all the newspapers in which the pre issue advertisement was released.

(3) The announcement referred to in sub-regulation (2) shall contain relevant financial ratios computed for both upper and lower end of the price band and also a statement drawing attention of the investors to the section titled "basis of issue price" in the prospectus.

(3A) The announcement referred to in sub-regulation (2) and the relevant financial ratios referred to in sub-regulation (3) shall be disclosed on the websites of those stock exchanges where the securities are proposed to be listed and shall also be pre-filled in the application forms available on the websites of the stock exchanges.

(4) The cap on the price band shall be less than or equal to one hundred and twenty per cent. of the floor price.

(5) The floor price or the final price shall not be less than the face value of the specified securities.

Explanation: For the purposes of sub-regulation (4), the "cap on the price band" includes cap on the coupon rate in case of convertible debt instruments.

6. (a) Compensation to shareholders of the acquired bank:

1. Under section 36AE of the Banking Regulation Act, 1949, the Central Government has power to acquire the undertaking of Banking Companies. When a bank is acquired by the Central Government, a scheme for the acquired bank is made in consultation with the Reserve Bank of India.

2. Such Scheme also provides for compensation payable to the registered shareholders of the acquired Bank (Section 36AF).

3. Section 36AG of the Banking Regulation Act, 1949 states that compensation is paid to the registered shareholders in accordance with the principles as contained in the Fifth Schedule.

4. Any shareholder aggrieved with the amount of compensation may request the Central Government to refer the matter to Tribunal to be constituted under section 36AH of the Act.

5. If the number of representation received is not less than one-fourth of the total number of shareholders holding not less than one-fourth in value of the paid-up share capital of the acquired Bank, the Central Government shall constitute a Tribunal for the purpose. Thus, such matters can be resolved through the Tribunal by the Central Government and the amount of compensation determined by the Tribunal is final and binding on all concerned parties.

(b) There was no provision under the Companies Act, 1956 for prohibition on forward dealings in securities of company by director or key managerial personnel. A new section 194 of the Companies Act, 2013 which came into force on 12th September, 2013 provides for prohibition on forward dealings in securities of company by director or key managerial personnel.

According to section 194 of the Companies Act, 2013:

(i) No director of a company or any of its key managerial personnel shall buy in the company, or in its holding, subsidiary or associate company—

(a) a right to call for delivery or a right to make delivery at a specified price and within a specified time, of a specified number of relevant shares or a specified amount of relevant debentures; or

(b) a right, as he may elect, to call for delivery or to make delivery at a specified price and within a specified time, of a specified number of relevant shares or a specified amount of relevant debentures.

(ii) If a director or any key managerial personnel of the company contravenes the above provisions, such director or key managerial personnel shall be punishable with imprisonment for a term which may extend to 2 years or with fine which shall not be less than one lakh rupees but which may extend to 5 lakh rupees, or with both.

(iii) Where a director or other key managerial personnel acquires any securities in contravention, he shall along with fine and imprisonment mentioned above, also be liable to surrender the same to the company and the company shall not register the securities so acquired in his name in the register, and if they are in dematerialised form, it shall inform the depository not to record such acquisition and such securities, in both the cases, shall continue to remain in the names of the transferors.

(iv) ''relevant shares'' and ''relevant debentures'' mean shares and debentures of the company in which the concerned person is a whole-time director or other key managerial personnel or shares and debentures of its holding and subsidiary companies.

7. (a) Residential Status under Section 2(v) of Foreign Exchange Management Act, 1999: In accordance with the provisions of the Foreign Exchange Management Act, 1999, as contained in section 2(v), a person in order to qualify for the purpose of being treated as a 'Person Resident in India'' in any financial year, must reside in India for a period of more than 182 days during the preceding financial year.

Mr. Bobby did not reside in India during the year 2013-2014 for more than 182 days and his residential status during the next year, i.e. 2014-2015 is non-resident even though he stayed in India from 1st April, 2014 as an employee. His residential status in 2013-2014 cannot be ascertained as his stay in India during the previous year 2012-2013 is not known.

(b) Removal of Member of Competition Commission: Section 11(2)(d) of the Competition Act, 2002 empowers the Central Government to remove, by an order, a member of the Competition Commission of India from his office if such member has acquired such financial interest as is likely to affect prejudicially his functions as a member of the Competition Commission.

However, provisions of Section 11(3) of the said Act put some restrictions on such power of the Central Government. According to this Section, the Central Government has to make a reference to the Supreme Court of India.

The Supreme Court shall hold an enquiry in accordance with the procedure formulated by it and then report that the member in question ought to be removed from his office on such ground.

Thus, the Central Government can remove a member of the Competition Commission of India only after following the procedure established by Section 11 of the Competition Act, 2002.

In view of the above the action of the Central Government is not in order and removal of Mr. Alexander is not valid.

(c) Under section 314(1B) of the Companies Act, 1956, in case relative of a Director holds office or place of profit under the Company on a monthly remuneration of ₹ 2,50,000 or more, the Company is required to obtain prior consent by special resolution and approval of Central Government. In the present case, the Company is accordingly required to pass a special resolution and obtain approval of the Central Government.

(d) (i) **Illustrations:** Illustrations form a part of the statute and considered to be of relevance and value in construing the text of the section. However, illustration can not have the effect of modifying the language of the section and can neither curtail nor expand the ambit of the section.

(ii) **Explanation:** An Explanation may be added to include something or to exclude something from it. Explanation should normally be read as to harmonise with and clear up any ambiguity in the main section. It should be construed as to widen the ambit of the section.

(e) Sections 43 – 47 deals with provision relating to Special Courts. Section 43 empowers the Central Government (in consultation with the Chief Justice of the High Court) for trial of offence of money laundering, to notify one or more Courts of Sessions as Special Court or Special Courts for such area or areas or for such cases or class or group of cases as may be specified in the notification to this effect. Section 44 clearly provides for the offences triable by Special Courts. It overrides the provisions of the Code of Criminal Procedure, 1973 and provides that–

(i) the scheduled offence and the offence punishable under section 4 shall be triable only by the Special Court constituted for the area in which the offence has been committed;

(ii) a Special Court may, upon a complaint made by an authority authorised in this behalf under this Act take cognizance of the offence for which the accused is committed to it for trial. The requirement of police report of the facts which constitute an offence under this Act is no more applicable.

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – II

PAPER – 5: ADVANCED MANAGEMENT ACCOUNTING

Question No. 1 is compulsory
*Answer any **five** questions from the remaining **six** questions*

Time Allowed – 3 Hours | Maximum Marks – 100

1. (a) Global Multinational Ltd. (GML) has two Divisions 'Dx' and 'Dz' with full profit responsibility. The Division 'Dx' produces Component 'X' which it sells to 'outside' customers only. The Division 'Dz' produces a product called the 'Z' which incorporates Component 'X' in its design. 'Dz' Division is currently purchasing required units of Component 'X' per year from an outside supplier at market price.

New CEO for Indian Operations has explored that 'Dx' Division has enough capacity to meet entire requirements of Division 'Dz' and accordingly he requires internal transfer between the divisions at marginal cost from the overall company's perspective.

Manager of Division 'Dx' claims that transfer at marginal cost are unsuitable for performance evaluation since they don't provide an incentive to the division to transfer goods internally. He stressed that transfer price should be 'Cost plus a Mark-Up'.

New CEO worries that transfer price suggested by the manager of Division 'Dx' will not induce managers of both Divisions to make optimum decisions. You are requested to help him out of the problem. *(5 Marks)*

(b) "Hard Rock Coconut" is an exclusive resort located in a famous Island of Pacific Ocean that vows to isolate its guests from the hustle and bustle of everyday life. Its leading principle is "all contemporary amenity wrapped in old-world charisma". Each of the resort's 18 villas has a separate theme like Castle, Majestic, Ambassador, Royal Chateau, Coconut, Lemon, Balinese etc and guests often ask for a specific villa when they make reservations. Villas are Ideal for families or friends travelling together and these villas feature luxurious accommodation spanning two floors. Since it is located within a 300-acre estate on white sand beach, the resort offers its guests a wide variety of outdoor activities such as horseback riding, hiking, diving, snorkeling, sailing, golf and so on. Guests could also while away the day relaxing in the pool and availing themselves of the resort's world-famous spa "Hard Coco Spa". The dining room, which only has three tables for the public, is acceptable proud of its 4-star rating.

You are required to develop a balanced scorecard for "Hard Rock Coconut". It is sufficient to give two measures in each of the four perspectives. *(5 Marks)*

(c) Find the dual problem for the following:

Minimize

$$Z = 2x_1 - 3x_2 + 4x_3$$

Subject to the constraints

$$\begin{aligned}
3x_1 + 2x_2 + 4x_3 &\geq 9 \\
2x_1 + 3x_2 + 2x_3 &\geq 5 \\
7x_1 - 2x_2 - 4x_3 &\leq 10 \\
6x_1 - 3x_2 + 4x_3 &\geq 4 \\
2x_1 + 5x_2 - 3x_3 &= 3 \\
x_1, x_2, x_3 &\geq 0
\end{aligned}$$

(5 Marks)

(d) State the validity of following statements along with the reasons:

(i) Two activities have common predecessor and successor activities. So, they can have common initial and final nodes.

(ii) In respect of any activity whether real or dummy, the terminal node should bear a number higher than the initial node number.

(iii) The difference between the latest event time and the earliest event time is termed as free float.

(iv) For every critical activity in a network, the earliest start and the earliest finish time as well as the latest finish time and the latest start time are the same.

(v) The optimal duration of a project is the minimum time in which it can be completed. *(5 Marks)*

2. (a) Great Eastern Appliances Ltd. (GEAL) manufactures consumer durable products in a very highly competitive market. GEAL is considering launching a new product 'Kitchen Care' into the market and gathered the following data:

Expected Market Price- Rs. 5,000 per unit

Direct Material Cost- Rs. 1,850 per unit

Direct Labour Cost- Rs. 80 per hour

Variable Overhead Cost- Rs. 1,000 per unit

Packing Machine Cost (specially to be purchased for this product)- Rs.5,00,000

GEAL expects the selling price for the new product will continue throughout the product's life and a total of 1,000 units can be sold over the entire lifetime of the product.

Direct labour costs are expected to reduce as the volume of output increases due to the effects of 80% learning curve (index is -0.3219). The expected time to be taken for the first unit is 30 hours and the learning effect is expected to end after 250 units have been produced. Units produced after first 250 units will take the same time as the 250th unit.

You are required to-

(i) Calculate the expected total labour hours over the life time of the product 'Kitchen Care'.

(ii) Profitability of product 'Kitchen Care' that GEAL will earn over the life time of the product.

(iii) Average target labour cost per unit over the life time of the product if GEAL requires average profit of Rs. 800 per unit, to achieve its long term objectives.

Note: $250^{-0.3219} = 0.1691$, $249^{-0.3219} = 0.1693$ *(8 Marks)*

(b) Edward Ltd. manufactures weighing machines of standard size and sells its products to two industrial customers namely MT Ltd. and KG Ltd. and to a dealer MG Bros. having shops in different cities. The maximum retail price per unit of weighing machine is Rs. 11,000 and per unit average cost of production is Rs. 5,500 (40% is general fixed overhead cost).

The Finance Officer has been asked to undertake a customer profitability analysis and calculate and compare the profit margin per customer (before deducting general fixed overhead) to know about the real customer profitability.

Following are the additional overhead information:

Delivery costs	Rs. 200 per kilometer
Emergency delivery cost (in addition to delivery cost)	Rs. 21,000 per delivery
Order processing cost	Rs. 6,000 per order
Specific discount and sales commission	As per negotiation
Product Advertisement cost	Actual cost

The following data are available for each customer

Particulars	MT Ltd.	KG Ltd.	MG Bros.
Sales (in units)	2,000	1,000	800
Total delivery kilometer travelled	1,000	800	900
No. of emergency delivery	2	1	0
No. of orders processed	4	2	8

Specific Discount (percentage of sales revenue)	25%	20%	15%
Sales Commission (percentage of sales revenue)	15%	10%	5%
Advertisement Costs (Rs.)	8,75,000	6,15,000	4,30,000

You are required to analyse the profitability for each customer, which customer is the most profitable. *(8 Marks)*

3. (a) Identify the type of cost along with the reasons.

(i) An advertising program has been set and management has signed the non negotiable contract for a year with an agency. Under the terms of contract, agency will create 5 advertisements within the contract duration for the company and company will pay Rs.12,00,000 for each advertisement.

(ii) A manager has to decide to run a fully automated operation that produces 100,000 widgets per year at a cost of Rs.1,200,000, or of using direct labour to manually produce the same number of widgets for Rs.1,400,000.

(iii) A Company had paid Rs.5,00,000 a Marketing Research company to find expected demand of the newly developed product of the company.

(iv) A company has invested Rs.25 lacs in a project. Company could have earned Rs.2 lacs by investing the amount in Government securities.

(v) A Oil Refining Co. has paid a salary of Rs.20,00,000 to the chairman for a particular year. The Company has sold 25 MT of Oil in that particular year.

(vi) Accountant of a cloth factory paid Rs.25,000 for water that has been used for washing clothes before they go for final drying process. *(6 Marks)*

(b) Fine Manufacturers Ltd. (FML) is specialist in the manufacturing of Industrial Products. They manufacture and market two types of products under the name 'X' and 'Y'. Company produces two products from three basic raw materials 'A', 'B', and 'C'. Company follows a 13-period reporting cycle for budgeting purpose. Each period is four weeks long and has 20 working days. Data relating to the purchase of raw materials are presented below:

Raw Material	Purchase Price (Per Kg)	Standard Purchase Lot (Kg)	Reorder Point (Kg)	Projected Inventory Status *at the end of 5th period* (Kg)		Lead Time in Working Days
				On Hand	On Order	
A	Rs. 1.00	90,000	72,000	96,000	90,000	10
B	Rs. 2.00	30,000	45,000	54,000	-	25
C	Rs. 1.00	60,000	60,000	84,000	60,000	20

Past experience has shown that adequate inventory levels for 'X' and 'Y' can be maintained if 40 percent of the next period's projected sales are on hand at the end of a reporting period. Other relevant information is as follows:

Product	Raw Material Specifications			Projected Inventory Levels	Projected Sales		
	A	B	C	At the end of current (5th) period	6th Period	7th Period	8th Period
	Kg	Kg	Kg	Units	Units	Units	Units
X	1.25	0.50	-	18,000	45,000	52,500	57,000
Y	2.00	-	1.50	16,800	42,000	27,000	24,000

The sales of 'X' and 'Y' do not vary significantly from month to month. Consequently, the safety stock incorporated into the reorder point for each of the raw materials in adequate to compensate for variations in the sales of the finished products.

Raw materials orders are placed the day the quantity on hand falls below the reorder point. FML's suppliers are very trustworthy so that the given lead times are reliable.

The outstanding orders for raw materials 'A' and 'C' are due to arrive on the 10th and 4th working day of the 6th period, respectively. Payments for all raw material orders are remitted by the 10th day of the delivery.

You are required to determine the following items for raw materials 'A', 'B', and 'C' for inclusion in the 6th period report to management:

1. Projected quantities (in Kg) to be issued to production.
2. Projected quantities (in Kg) ordered and the date (in terms of working days) the order is to be placed.
3. The projected inventory balance (in Kg) at the end of the period.
4. The payments for purchases with due date. *(10 Marks)*

4. (a) Golden Bird Airlines Ltd. operates its services under the brand 'Golden Bird'. The 'Golden Bird' route network spans prominent business metropolis as well as key leisure destinations across the Indian subcontinent. 'Golden Bird', a low-fare carrier launched with the objective of commoditizing air travel, offers airline seats at marginal premium to train fares across India.

Profits of the 'Golden Bird' have been decreasing for several years. In an effort to improve the company's performance, consideration is being given to dropping several flights that appear to be unprofitable.

Income statement for one such flight from ‘New Delhi’ to ‘Leh’ (GB - 022) is given below (per flight):

	Rs.	Rs.
Ticket Revenue (175 seats x 60% Occupancy x Rs. 7,000 ticket price)		7,35,000
Less: Variable Expenses (Rs.1,400 per person)		1,47,000
Contribution Margin		5,88,000
*Less:*Flight Expenses:		
Salaries, Flight Crew	1,70,000	
Salaries, Flight Assistants	31,500	
Baggage Loading and Flight Preparation	63,000	
Overnight Costs for Flight Crew and Assistants *at destination*	12,600	
Fuel for Aircraft	2,38,000	
Depreciation on Aircraft	49,000*	
Liability Insurance	1,47,000	
Flight Promotion	28,000	
Hanger Parking Fee for Aircraft *at destination*	7,000	7,46,100
Net Gain / (Loss)		(1,58,100)

** Based on obsolescence*

The following additional information is available about flight GB-022.

1. Members of the flight crew are paid fixed annual salaries, whereas the flight assistants are paid by the flight.
2. The baggage loading and flight preparation expense is an allocation of ground crew’s salaries and depreciation of ground equipment.
3. One third of the liability insurance is a special charge assessed against flight GB-022 because in the opinion of insurance company, the destination of the flight is in a “high-risk” area.
4. The hanger parking fee is a standard fee charged for aircraft at all airports.
5. If flight GB-022 is dropped, ‘Golden Bird’ Airlines has no authorization at present to replace it with another flight.

Required

Using the data available, prepare an analysis showing what impact dropping flight GB-022 would have on the airline's profit. *(8 Marks)*

(b) An organization producing 4 different products, viz., WW, WX, WY, and WZ having 4 operators, viz., A,B, C and D who are capable of producing any of the four products, works effectively 7 hours a day. The time (in minutes) required for each operator for producing each of the products are given in the cells of the following matrix along with profit (Rs. per unit):

Operator	Product			
	WW	WX	WY	WZ
A	3.0	5.0	7.0	6.0
B	3.5	2.5	1.5	2.0
C	3.0	3.5	5.0	5.0
D	10.0	5.0	7.5	7.5
Profit	1.5	1.0	2.0	0.5

Find out the assignment of operators to product which will maximize the profit.

(8 Marks)

5. (a) Managing Director of Superb-Tech Product Ltd (STPL) thinks that Standard Costing has little to offer in the reporting of material variances due to frequently change in price of materials.

STPL can utilize one of two equally suitable raw materials and always plan to utilize the raw material which will lead to cheapest total production costs. However STPL is frequently trapped by price changes and the material actually used often provides, after the event, to have been more expensive than the alternative which was originally rejected.

During last accounting period, to produce a unit of 'X' STPL could use either 2.50 Kg of 'XG' or 2.50 kg of 'XD'. STPL planned to use 'XG' as it appeared it would be cheaper of the two and plans were based on a cost of 'XG' of Rs. 1.50 per Kg. Due to market movements the actual prices changed and if STPL had purchased efficiently the cost would have been:

'XG' Rs. 2.25 Kg; 'XD' Rs. 2.00 Kg

Production of 'X' was 1,000 units and usage of 'XG' amounted to 2,700 Kg at a total cost of Rs. 6,480/-

You are required to analyze the material variance for 'X' by:

(i) Traditional Variance Analysis; and

(ii) An approach which distinguishes between Planning and Operational Variances. *(8 Marks)*

(b) "Cost is not the only criterion for deciding in favour of shut down" – Briefly explain.

(4 Marks)

(c) Arnav Automobiles Ltd. is a leading manufacturer of commercial vehicles in India. It uses Standard Costing and Variance Analysis to measure its operating performance. Now management of Arnav Automobiles Ltd. wants to compete globally and changed its performance measurement system to Kaizen Costing. State why Kaizen Costing could be more useful for performance measurement than the Standard Costing and Variance Analysis. *(4 Marks)*

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

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

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

The maximum sales in the external market are:

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

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

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

(b) Fiona is a news reporter and feature writer for an economic daily. Her assignment is to develop a feature article on 'Product Life-Cycle Costing', including interviews with the Chief Financial Officers (CFO) and Operating Managers. Fiona has been given a liberal budget for travel so as to research into company's history, operations, and market analysis for the firm she selects for the article.

Required:

Fiona has asked you to recommend industries and firms that would be good candidates for the article. What would you advice? Explain your recommendations.

(4 Marks)

(c) A public company responsible for the supply of domestic gas has been approached by several prospective customers in a rural area adjacent to a high-pressure main. As a condition of its license to operate as a utility, the company is obliged to respond positively to current needs provided the financial viability of the company is not put at risk. New customers are charged Rs. 250 each for connection to the system.

Once a meter is installed, a standing charge of Rs. 10 per quarter is billed. Charges for gas are levied at Rs. 400 per 1,000 metered units.

A postal survey of the area containing, according to the rating authority, 5,000 domestic units, elicited a 40% response rate. 95% of those who responded confirmed that they wished to become gas users and expressed their willingness to pay the connection charge.

Although it is recognized that a small percentage of those willing to pay for connection may not actually choose to use gas, it is expected that the average household will burn 50 metered units per month. There will be some seasonal differences.

The company's marginal cost of capital is 17% pa and supplies of bulk gas cost the company Rs. 0.065 per metered unit. Wastage of 15% has to be allowed to determine what the maximum capital project cost can be to allow the company to provide the service required. *(4 Marks)*

(d) In an assignment problem to assign jobs to men to minimize the time taken, suppose that one man does not know how to do a particular job, how will you eliminate this allocation from the solution? *(2 Marks)*

7. Answer any 4 out of the following 5 questions:

(a) The product mix of a Delta Ltd. is as under:

	Products	
	M	N
Units	54,000	18,000
Selling Price	Rs. 7.5	Rs. 15
Variable Cost	Rs. 6	Rs. 4.5

Find the break-even points in units, if the company discontinues product 'M' and replace with product 'O'. The quantity of product 'O' is 9,000 units and its selling price and variable costs respectively are Rs. 18 and Rs. 9. Fixed Cost is Rs. 15,000. *(4 Marks)*

(b) Classify the following items under appropriate categories of equality costs viz. Prevention Costs, Appraisal Cost, Internal Failure Costs and External Failure costs:

(i) Rework

(ii) Disposal of scrap

(iii) Warranty Repairs

(iv) Repair to manufacturing equipments

(v) Discount on defective sale

(vi) Raw material inspection

(vii) Finished product inspection

(viii) Establishment of quality circles *(4 Marks)*

(c) (i) Briefly explain-"All activities of a firm are not subject to learning effect"*(2 Marks)*

(ii) Two companies, Beta and Gama, have the same values for turnover and net profit and make a similar product. Beta has a higher P/V ratio than Gama. Which company will perform better when: (i) the market demand is high? (ii) the market demand is low? *(2 Marks)*

(d) X Limited is engaged in manufacturing activities. It has received a request from one of its important customers to supply a product which will require conversion of material 'KM', which is a non-moving item.

The following details are available:

Book value of material 'KM'	Rs. 30
Realisable value of material 'KM'	Rs. 40
Replacement cost of material 'KM'	Rs. 50

It is estimated that conversion of one unit of 'KM' into one unit of the finished product will require one labour hour. At present, labour is paid at the rate of Rs. 10 per hour. Other costs are as follows:

Out-of-pocket expenses	Rs.15 per unit
Allocated overheads	Rs.5 per unit

The labour will be re-deployed from other activities. It is estimated that the temporary redeployment will not result in loss of contribution. The employees to be re-deployed are permanent employees of the company.

Required:

Estimate the minimum price to be charged from the customer so that the company is not worse off by executing the order. *(4 Marks)*

(e) State the limitations of Uniform Costing? *(4 Marks)*

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – II

PAPER – 5: ADVANCED MANAGEMENT ACCOUNTING

SUGGESTED ANSWERS/HINTS

1. (a) To overcome the optimum decision making and performance evaluation conflicts that can occur with marginal cost-based transfer pricing following methods has been proposed:

Dual Rate Transfer Pricing System

"With a 'Dual Rate Transfer Pricing System' the '<u>Receiving Division' is charged with marginal cost of the intermediate product</u> and '<u>Supplying Division' is credited with full cost per unit plus a profit margin</u>".

Accordingly Division 'Dx' should be allowed to record the transactions at *full cost per unit* plus *a profit margin*. On the other hand Division 'Dz' may be charged only *marginal cost*. Any inter divisional profits can be eliminated by accounting adjustment.

Impact:

- Division 'Dx' will earn a profit on inter Division transfers.
- Division 'Dz' can chose the output level at which the marginal cost of the product 'X' is equal to the net marginal revenue of the product 'Z'.

Two Part Transfer Pricing System:

"The 'Two Part Transfer Pricing System' involves <u>transfers being made at the marginal cost per unit of output of the supplying Division plus a lump-sum fixed fee charged by the supplying Division to the receiving Division</u> for the use of the capacity allocated to the intermediate product."

Accordingly Division 'Dx' can transfer its products to Division 'Dz' at *marginal cost per unit* and *a lump-sum fixed fee*.

Impact:

- 'Two Part Transfer Pricing System' will inspire the Division 'Dz' to choose the optimal output level.
- This pricing system also enable the Division 'Dx' to obtain a profit on inter Division transfer.

(b) The following is a possible scorecard for "Hard Rock Coconut"

Financial Perspective	Economic Value Added
	Revenue per villa
Customer Perspective	% repeat customers
	Number of customer complaints
Internal Business	Service rating of spa
	Staff hours per guest
	% cost spent for maintenance Travel guide rank for restaurant
Innovation and Learning	Employee retention
	Number of new services offered

(c) Primal

Minimize $Z = 2x_1 - 3x_2 + 4x_3$

Subject to the constraints

$$
\begin{aligned}
3x_1 + 2x_2 + 4x_3 &\geq 9 \\
2x_1 + 3x_2 + 2x_3 &\geq 5 \\
-7x_1 + 2x_2 + 4x_3 &\geq -10 \\
6x_1 - 3x_2 + 4x_3 &\geq 4 \\
2x_1 + 5x_2 - 3x_3 &\geq 3 \\
-2x_1 - 5x_2 + 3x_3 &\geq -3 \\
x_1, x_2, x_3 &\geq 0
\end{aligned}
$$

Dual

Maximize $Z = 9y_1 + 5y_2 - 10y_3 + 4y_4 + 3y_5 - 3y_6$

Subject to constraints

$$
\begin{aligned}
3y_1 + 2y_2 - 7y_3 + 6y_4 + 2y_5 - 2y_6 &\leq 2 \\
2y_1 + 3y_2 + 2y_3 - 3y_4 + 5y_5 - 5y_6 &\leq -3 \\
4y_1 + 2y_2 + 4y_3 + 4y_4 - 3y_5 + 3y_6 &\leq 4 \\
y_1, y_2, y_3, y_4, y_5, y_6 &\geq 0
\end{aligned}
$$

By substituting $y_5 - y_6 = y_7$ the dual can alternatively be expressed as:

Maximize $Z = 9y_1 + 5y_2 - 10y_3 + 4y_4 + 3y_7$

Subject to constraints

$$3y_1 + 2y_2 - 7y_3 + 6y_4 + 2y_7 \leq 2$$

$$-2y_1 - 3y_2 - 2y_3 + 3y_4 - 5y_7 \geq 3$$
$$4y_1 + 2y_2 + 4y_3 + 4y_4 - 3y_7 \leq 4$$
$$y_1, y_2, y_3, y_4 \geq 0, \; y_7 \text{ unrestricted in sign.}$$

(d) (i) Invalid

Reason: As per the rules of network construction, parallel activities between two events, without intervening events, are prohibited. Dummy activities are needed when two or more activities have same initial and terminal events. Dummy activities do not consume time or resources.

(ii) Valid

Reason: As per the conventions adopted in drawing networks, the head event or terminal node always has a number higher than that of initial node or tail event.

(iii) Invalid

Reason: The difference between the latest event time and the earliest event time is termed as slack of an event. Free float is determined by subtracting head event slack from the total float of an activity.

(iv) Invalid

Reason: For every critical activity in a network, the earliest start time and the latest start time is same and also the earliest finish time and the latest finish time is same.

(v) Invalid

Reason: The optimum duration is the time period in which the total cost of the project is minimum.

2. (a) Calculation of Total Labour Hours Over the Life Time of The Product 'Kitchen Care'

The average time per unit for 250 units

$$Y_x = ax^b$$

Or, $$Y_{250} = 30 \times 250^{-0.3219}$$

Or, $$Y_{250} = 30 \times 0.1691$$

Or, $$Y_{250} = 5.073 \text{ hours}$$

$$\text{Total time for 250 units} = 5.073 \times 250 \text{ units}$$

$$= 1{,}268.25 \text{ hours}$$

The average time per unit for 249 units

$$Y_{249} = 30 \times 249^{-0.3219}$$

Or, $$Y_{249} = 30 \times 0.1693$$

Or, $$Y_{249} = 5.079 \text{ hours}$$

$$\text{Total time for 249 units} = 5.079 \times 249 \text{ units}$$

$$= 1{,}264.67 \text{ hours}$$

Time for 250th unit

$$= 1{,}268.25 \text{ hours} – 1{,}264.67 \text{ hours}$$

$$= 3.58 \text{ hours}$$

Total Time for 1,000 units

$$= (750 \times 3.58 \text{ hours}) + 1{,}268.25 \text{ hours}$$

$$= 3{,}953.25 \text{ hours}$$

Profitability of the Product 'Kitchen Care'

Sales 1,000 Units

Particulars	Amount (Rs.)
Sales	50,00,000
Less: Direct Material	18,50,000
Direct Labour (3,953.25 hours × Rs. 80)	3,16,260
Variable Overheads (1,000 units× Rs. 1,000)	10,00,000
Contribution	18,33,740
Less: Packing Machine Cost	5,00,000
Profit	13,33,740

Average Target Labour Cost *per unit*

Particulars	Amount (Rs.)
Expected Sales Value	50,00,000
Less: Desired Profit (1,000 units × Rs. 800)	8,00,000
Target Cost	42,00,000
Less: Direct Material (1,000 units × Rs. 1,850)	18,50,000
Variable Cost (1,000 units × Rs. 1,000)	10,00,000
Packing Machine Cost	5,00,000

Target Labour Cost	8,50,000
Average Target Labour Cost *per unit* (Rs. 8,50,000 ÷ 1,000 units)	850

(b) **Customer Profitability Statement**

Particulars	MT Ltd.	KG Ltd.	MG Bros.
Sales (units)	2,000	1,000	800
	(Rs.)	(Rs.)	(Rs.)
Sales Revenue (A)	2,20,00,000	1,10,00,000	88,00,000
Less: Average Variable Cost (B) (Rs. 5,500 × 60% = 3,300 p.u.)	66,00,000	33,00,000	26,40,000
Contribution [70%of Sales] (A)-(B)	1,54,00,000	77,00,000	61,60,000
Less: Additional Overheads			
Delivery Cost (No. of K.M. × Rs. 200)	2,00,000	1,60,000	1,80,000
Emergency Delivery Cost (No. of Emerg. Delivery × Rs. 21,000)	42,000	21,000	-
Order Processing Cost (No. of Orders × Rs. 6,000)	24,000	12,000	48,000
Specific Discount	55,00,000	22,00,000	13,20,000
Sales Commission	33,00,000	11,00,000	4,40,000
Advertisement Cost	8,75,000	6,15,000	4,30,000
Profit *per customer**	54,59,000	35,92,000	37,42,000
Profit Margin *per customer** (%)	24.81%	32.65%	42.52%
Rank	III	II	I

** Before deducting general fixed overhead cost*

The contribution margin is 70% for each customer but when the other overheads costs per customer is included in the above profitability statement the profitability of the three customers become different. MG Bros. is the most profitable customer.

3. (a) Cost Classification

(i) Committed Cost

Reason: Company cannot negotiate the price of advertisement in future and it has to make payment as soon as advertisement is prepared.

(ii) Differential Cost

Reason: In case of decision making among two alternatives, every manager has to compare the difference in cost involved.

(iii) Sunk Cost

Reason: Research expense has already been incurred and it will not affect any decision making in future.

(iv) Opportunity Cost

Reason: Income from government securities is the amount that company has forgone to earn income from its investment in the project.

(v) Period Cost

Reason: Salary of chairman is paid irrespective of productivity of the company.

(vi) Direct Cost

Reason: Amount paid for water can be directly attributed to the cost of finished product that is clothes.

(b) Projected Raw Material Issues (Kg)

	'A'	'B'	'C'
'X' (48,000 units-Refer Note)	60,000	24,000	---
'Y' (36,000 units-Refer Note)	72,000	-	54,000
Projected Raw Material Issues	1,32,000	24,000	54,000

Note:

- Based on this experience and the projected sales, the FML has budgeted production of 48,000 units of 'X' and 36,000 units of 'Y' in the sixth period.

  =52,500 x 40% + 45,000 – 18,000 = 48,000

  =27,000 x 40% + 42,000 – 16,800 = 36,000

- Production is assumed to be uniform for both products within each four-week period.

Projected Inventory Activity and Ending Balance (Kg)

	'A'	'B'	'C'
Average Daily Usage	6,600	1,200	2,700
Beginning Inventory	96,000	54,000	84,000
Orders received:			
Ordered in 5th period	90,000	-	60,000
Ordered in 6th period	90,000	-	-
Sub Total	276,000	54,000	144,000
Issues	132,000	24,000	54,000
Projected ending inventory balance	144,000	30,000	90,000

Note:

- Ordered 90,000 Kg of 'A' on fourth working day.
- Order for 90,000 Kg of 'A' ordered during fifth period received on tenth working day.
- Order for 90,000 Kg of 'A' ordered on fourth working day of sixth period received on fourteenth working day.
- Ordered 30,000 Kg of 'B' on eighth working day.
- Order for 60,000 Kg of 'C' ordered during fifth period received on fourth working day.
- No orders for 'C' would be placed during the sixth period.

Projected Payments for Raw Material Purchases

Raw Material	Day/Period Ordered	Day/Period Received	Quantity Ordered	Amount Due	Day/Period Due
'A'	$20^{th}/5^{th}$	$10^{th}/6^{th}$	90,000 Kg	Rs. 90,000	$20^{th}/6^{th}$
'C'	$4^{th}/5^{th}$	$4^{th}/6^{th}$	60,000 Kg	Rs. 60,000	$14^{th}/6^{th}$
'A'	$4^{th}/6^{th}$	$14^{th}/6^{th}$	90,000 Kg	Rs. 90,000	$4^{th}/7^{th}$
'B'	$8^{th}/6^{th}$	$13^{th}/7^{th}$	30,000 Kg	Rs. 60,000	$3^{rd}/8^{th}$

4. (a) **Statement Showing Impact on Airline's Profit if Flight GB-022 is Discontinued**

		Rs.
Contribution Margin lost if the flight is discontinued		(5,88,000)
Less: Flight Costs which can be avoided if the flight is discontinued:		
	Rs.	
Flight Promotion	28,000	
Fuel for Aircraft	2,38,000	
Liability Insurance (1/3 x Rs. 1,47,000)	49,000	
Salaries, Flight Assistants	31,500	
Overnight Costs for Flight Crew and Assistants	12,600	3,59,100
		(2,28,900)

If Golden Bird Airlines Ltd. goes for discontinuation of flight GB-022, its profit will go down by Rs. 2, 28,900.

Following costs are not relevant to the decision:

- Salaries, flight crew - Fixed annual salaries which will not change
- Baggage loading and flight preparation- This is an allocated cost, which will continue even if the flight is discontinued.

- Depreciation of aircraft -Sunk Cost
- Liability insurance (two third) - Sunk Cost
- Hanger parking fee- This cost will be incurred regardless of whether the flight is made.

(b) Given that the unit (factory) works effectively for 7 hours and the processing time (in minutes) for each of the four products by different operators, we obtain the production and profit matrices as follows:

Production Matrix

Operator	Product			
	WW	WX	WY	WZ
A	140	84	60	70
B	120	168	280	210
C	140	120	84	84
D	42	84	56	56

Profit Matrix:

Operator	Product			
	WW	WX	WY	WZ
A	210	84	120	35
B	180	168	560	105
C	210	120	168	42
D	63	84	112	28

Subtract all the elements from the highest value and obtain the following matrix:

Operator	Product			
	WW	WX	WY	WZ
A	350	476	440	525
B	380	392	0	455
C	350	440	392	518
D	497	476	448	532

Subtracting row minimum, we obtain:

Operator	Product			
	WW	WX	WY	WZ
A	0	126	90	175
B	380	392	0	455
C	0	90	42	168
D	49	28	0	84

Subtracting column minimum and after assignment, we get:

Operator	Product			
	WW	WX	WY	WZ
A	$\boxed{0}$	98	90	91
B	380	364	$\boxed{0}$	371
C	0	62	42	84
D	49	$\boxed{0}$	0	0

Since required number of assignments could not be made, proceed further:

Operator	Product			
	WW	WX	WY	WZ
A	$\boxed{0}$	36	90	29
B	380	302	$\boxed{0}$	309
C	0	$\boxed{0}$	42	22
D	111	0	62	$\boxed{0}$

The optimum solution is:

Operator	Product	Profit (Rs.)
A	WW	210
B	WY	560
C	WX	120
D	WZ	28
Total Profit		918

5. (a) **Traditional Variance (Actual Vs Original Budget)**

Usage Variance	=	(Standard Quantity – Actual Quantity) x Standard Price
	=	(2,500 Kg – 2,700 Kg) x Rs. 1.50
	=	Rs. 300 (A)
Price Variance	=	(Standard Price – Actual Price) x Actual Quantity
	=	(Rs. 1.50 – Rs. 2.40) x 2,700 Kg
	=	Rs. 2,430 (A)
Total Variance	=	Rs. 300 (A) + Rs. 2,430 (A)
	=	Rs. 2,730 (A)

Operational Variance (Actual Vs Revised)

Usage Variance	=	(2,500 Kg – 2,700 Kg) x Rs. 2.25
	=	Rs. 450 (A)
Price Variance	=	(Rs. 2.25 – Rs. 2.40) x 2,700 Kg
	=	Rs. 405 (A)
Total Variance	=	Rs. 450 (A) + Rs. 405 (A)
	=	Rs. 855 (A)

Planning Variance (Revised Vs Original Budget)

Controllable Variance	=	(Rs. 2.00 – Rs. 2.25) x 2,500 Kg
	=	625 (A)
Uncontrollable Variance	=	(Rs. 1.50 – Rs. 2.00) x 2,500 Kg
	=	1,250 (A)
Total Variance	=	Rs. 625 (A) + Rs. 1,250 (A)
	=	Rs. 1,875 (A)
Traditional Variance	=	**Operational Variance + Planning Variance**
	=	855 (A) + 1,875 (A)
	=	2,730 (A)

(b) Cost is not only criterion for deciding in the favour of shut down. Non-cost factors worthy of consideration in this regard are as follows:

(i) Interest of workers, if the workers are discharged, it may become difficult to get skilled workers later, on reopening of the factory. Also shut-down may create problems.

(ii) In the face of competition it may difficult to re-establish the market for the product.

(iii) Plant may become obsolete or depreciate at a faster rate or get rusted. Thus, heavy capital expenditure may have to be incurred on re-opening.

(c) Both Standard Costing and Kaizen Costing are helpful and used for *measurement of performance of a company* but there are differences in approach between the two systems.

Under Standard Costing system standards of all important variables like cost and quantity of materials, labours and overheads are set at the beginning of the year or activity. These set standards are compared with the actual performance to analyse the variances. As a step further all variances are classified as planning and operational variances to distinguish variances that are within the manager's control and beyond their effort. In brief Standard Costing and Variance Analysis helps in determine the variances and *take post event measures to stop recurrences*.

On the other hand Kaizen Costing *emphasises on continual improvement*. Targets once set at the beginning of the year or activities are updated continuously to reflect the improvement that has already been achieved and that are yet to be achieved.

As a continuous improvement measure Kaizen Costing set new challenges before the workers and managers and helps to improve and control the situation to achieve desired target results. Therefore, if Kaizen costing is used in place of Standard Costing and Variance analysis to measure performance then definitely it will keep Arnav Automobile Ltd. competent enough to head on with the global automobile players.

6. (a) Ranking of Products When Availability of Time is the Key Factor

Products	A	B	C	D
Market Price (Rs.)	150	146	140	130
Less: Variable Cost (Rs.)	130	100	90	85
Contribution *per unit* (Rs.)	20	46	50	45
Labour Hours *per unit*	3 hrs.	4 hrs.	2 hrs.	3 hrs.
Contribution *per Labour Hour*	6.67	11.50	25.00	15.00
Ranking	IV	III	I	II
Maximum Demand (units)	2,800	2,500	2,300	1,600
Total No. of Hours	8,400	10,000	4,600	4,800
Allocation of 20,000 Hours on the Basis of Ranking	600*	10,000	4,600	4,800

(*) Balancing Figure

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

$$\text{Transfer Price} = \text{Variable Cost + Opportunity Cost}$$

$$= \text{Rs.}85 + \frac{(6{,}900\text{ hrs.}\times\text{Rs.}11.5 + 600\text{ hrs.}\times\text{Rs.}6.66)}{2{,}500\text{ units}}$$

$$= \text{Rs.}85 + \frac{\text{Rs.}79{,}350 + \text{Rs.}4{,}000}{2{,}500\text{units}}$$

$$= \text{Rs. }85 + \text{Rs. }33.34 = \text{Rs. }118.34$$

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

Life Cycle Costing technique is particularly important when:

(i) High percentage of total life-cycle costs are incurred before production begins and revenue are earned over several years and

(ii) High fraction of the life cycle costs are locked in at the R & D and design stages.

Fiona should identify those industries and then companies belonging to those industries where above mentioned feature are prevalent. For example, Automobile and Pharmaceutical Industries companies like Tata Motors Ltd., Ranbaxy Laboratories Ltd., and Dabur India Ltd. will be good candidates for study on product life cycle costing.

(c) Working Notes

1. No. of Customer = 1,900

(5,000 × 40% × 95%)

2. Consumption of Gas = 11,40,000 Metered units
(1,900 × 50 mt.× 12 months)

Gas Supply = 13,41,176 Metered units

{11,40,000 × (100 ÷ 85)}

3. Cash Inflow:

	(Rs.)
Rent (1,900 × 4 Quarters × Rs. 10)	76,000
Add: Consumption Charge (11,40,000 × Rs. 0.4)	4,56,000

Less: Cost of Company (13,41,176 × Rs. 0.065)	87,176
Cash Inflow p.a.	4,44,824

One Time Connection Charge = Rs. 4,75,000

(Rs. 250 × 1,900 customers)

Maximum Capital Project Cost Can be to Allow the Company to Provide the Service Required

By Following the Concept of Perpetuity

(Investment − Rs. 4,75,000) × 17% = Rs. 4,44,824

∴ Investment = Rs. 30,91,612

(d) In an assignment minimization problem, if one task cannot be assigned to one person, introduce a prohibitively large cost for that allocation, say M, where M has a high the value. Then, while doing the row minimum and column minimum operations, automatically this allocation will get eliminated.

7. (a) N = 18,000 units

O = 9,000 units

Ratio (N : O) = 2:1

Let

t = No. of units of 'O' for BEP

N = 2t No. of units for BEP

Contribution of 'N' = Rs. 10.5 per unit

Contribution of 'O' = Rs. 9 per unit

At Break Even Point:

$\Rightarrow 10.5 \times (2t) + 9 \times t - 15,000 = 0$

$\Rightarrow 30t = 15,000$

$\Rightarrow t = 500$ units

BEP of 'N' = 2t

= 1,000 units

BEP of 'O' = t

= 500 units

(b) (i) Rework Internal Failure

(ii) Disposal of scrap Internal Failure

(iii)	Warranty Repairs	External Failure
(iv)	Repair to manufacturing equipments	Internal Failure
(v)	Discount on defective sale	External Failure
(vi)	Raw material inspection	Prevention Cost
(vii)	Finished product inspection	Appraisal Cost
(viii)	Establishment of quality circles	Prevention Cost

(c) (i) All activities of a firm are not subject to learning effect. (Activities that have not been performed in the present operational mode, those performed by new or unfamiliar employees are subjected to learning effect, while those performed by familiar or experienced workmen will not be subjected to learning effect)

(ii) (i) In case Market Demand is High – Product Beta (Lower Variable Cost and Higher Fixed Cost)

(ii) In case Market Demand is Low – Product Gama

(d) Relevant costs of producing one unit of the finished product

	Rs.
Cost of material 'KM' (realisable value)	40
Cost of labour (Being sunk cost)	-
Out-of-pocket expenses	15
	55

Allocated overhead is not relevant for the decision. The customer should be charged Rs. 55 per unit.

(e) Limitations of Uniform Costing are:

(i) Sometimes it is not possible to adopt uniform standards, methods and procedures of costing in different firms due to differing circumstances in which they operate. Hence, the adoption of uniform costing becomes difficult in such firms.

(ii) Disclosure of cost information and other data is an essential requirement of a uniform costing system. Many firms do not wish to share such information with their competitors in the same industry.

(iii) Small firms in an industry believe that uniform costing system is only meant for big and medium size firms, because they cannot afford it.

(iv) It induces monopolistic trend in the business, due to which prices may be increased artificially and supplies withheld.

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – II

PAPER – 5: ADVANCED MANAGEMENT ACCOUNTING

Question No. 1 is compulsory
*Answer any **five** questions from the remaining **six** questions*

Time Allowed – 3 Hours | Maximum Marks – 100

1. (a) A Pharmaceutical company produces formulations having a shelf life of one year. The company has an opening stock of 30,000 boxes on 1st January, 2005 and expected to produce 1,30,000 boxes as was in the just ended year of 2004. Expected sale would be 1,50,000 boxes. Costing department has worked out escalation in cost by 25% on variable cost and 10% on fixed cost. Fixed cost for the year 2004 is ₹40 per unit. New price announced for 2005 is ₹100 per box. Variable cost on opening stock is ₹40 per box. You are required to compute breakeven volume for the year 2005. *(5 Marks)*

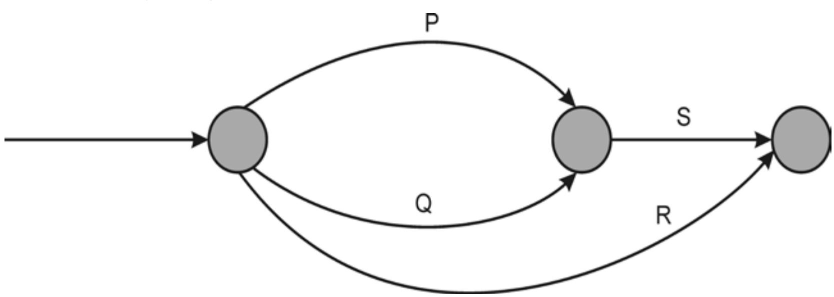
(b) Determine the selling price per unit to earn a return of 12% net on capital employed (net of Tax @ 40%).

The cost of production and sales of 80,000 units per annum are:

Material	₹ 4,80,000	Labour	₹ 1,60,000
Variable Overhead	₹ 3,20,000	Fixed overhead	₹ 5,00,000

The fixed portion of capital employed is ₹12 lacs and the varying portion is 50% of sales turnover. *(5 Marks)*

(c) The following is a part of a network.



What are activities P and Q called? How would you rectify the situation? *(5 Marks)*

(d) Answer the following independent situations relating to an assignment problem with a minimization objective:

(i) Just after row and column minimum operations, we find that a particular row has 2 zeroes. Does this imply that the 2 corresponding numbers in the original matrix before any operation were equal? Why?

(ii) Under the usual notation, where a_{32} means the element at the intersection of the 3rd row and 2nd column, we have, in a 4 × 4 assignment problem, a_{24} and a_{32} figuring in the optimal solution. What can you conclude about the remaining assignments? Why? *(5 Marks)*

2. (a) Global Bank is in the process of formulating a loan policy that involves a maximum of ₹ 25 lakhs. The following table provides the pertinent data about available types of loans.

Type of Loan	Interest Rate	Bad-Debt Ratio
Personal	0.135	0.09
Credit Card	0.145	0.12
Home	0.115	0.02
Farm	0.120	0.04
Commercial	0.105	0.01

Competition with other financial institution requires that the bank allocate at least 30% of the funds to farm and commercial loans. To assist the housing industry in the region, home loans must equal at least 50% of the personal, credit card and home loans. The bank also has a stated policy of not allowing the overall ratio of bad debts on all loans to exceed 5%. Formulate this as a Linear Programming Problem. *(8 Marks)*

(b) A company following standard marginal costing system has the following interim trading statement for the quarter ending 30th June, 2013, which reveals a loss of ₹ 17,000, detailed below:

	₹
Sales	4,99,200
Closing Stock	18,000
Direct Material	1,68,000
Direct Labour	1,05,000
Variable Factory Overhead	42,000
Fixed Factory Overhead	1,20,000

Fixed Administration Overhead	40,000
Variable Distribution Overhead	19,200
Fixed Selling Overhead	40,000
Loss	17,000

Additional information is as follows:

(i) Sales for the quarter were 1,200 units. Production was 1,400 units, of which 100 units were scrapped after complete manufacture. The factory capacity is estimated at 2,000 units.

(ii) Because of low production, labour efficiency during the quarter is estimated to be 20% below normal level.

(iii) Variable Factory Overhead Cost is driven by the number of units produced.

You are required to analyse the above and report to the management giving the reasons for the loss. *(8 Marks)*

3. (a) The following are the information regarding overheads of a company:

Overheads cost variance = ₹ 2,800 (A)

Overheads volume variance = ₹ 2,000 (A)

Budgeted overheads = ₹ 12,000

Actual overhead recovery rate = ₹ 8 per hour

Budgeted hours for the period = 2,400 hours

You are required to compute the following:

(i) Overheads expenditure variance.

(ii) Actual incurred overheads.

(iii) Actual hours for actual production.

(iv) Overheads capacity variance.

(v) Overheads efficiency variance.

(vi) Standard hours for actual production. *(8 Marks)*

(b) Fox Ltd has Division A and Division B. The Division A produces Components which it sells to 'outside' customers and also transfers to the Division B. The Division B produces a product called the 'Zoom' which incorporates a Fox component in its design.

Details of the production and operating costs for the next year are forecasted to be as follows.

Division A	Division B
Annual Fixed Costs - ₹ 15,00,000	Annual Fixed Costs - ₹ 25,000
Variable Cost - ₹ 175 (per component)	Variable Cost per 'Zoom' - ₹ 350 (excludes transfer costs)

Both Divisions have surplus capacity. Market analysis has indicated that the demand from 'outside' customers for Fox Ltd's products is as follows:

(i) 4,500 components are sold at a unit selling price of ₹ 350; sales change by an average of 5 components for each ₹ 1 change in the selling price, per component;

(ii) 500 'Zoom' are sold at a unit selling price of ₹ 1,100; sales change by an average of 125 'Zoom' for each ₹ 75 changes in the selling price per 'Zoom'. It is an established practice for the Division A to transfer components to the Division B at 'market selling price'.

You are required to calculate the, Unit selling price of a 'Zoom' that should be set in order to maximize Fox Ltd's profit. Selling price should also be exact to the nearest paisa. [Note: If P = a - bQ then MR = a – 2bQ] *(4 Marks)*

(c) Examine the validity of following statements along with the reasons:

(i) The concepts, tools and techniques of value chain analysis apply only to all those organizations which produce and sell a product.

(ii) Procurement activities are included in the Primary activities as classified by Porter under value chain analysis concept.

(iii) As per Porter's five forces model, bargaining power of buyers does influence the profitability of an industry or market.

(iv) Value chain analysis in the strategic framework consists of single cost driver concept. *(4 Marks)*

4. (a) MFG Ltd. is producing a component called 'KDK'. Estimated costs are:

	Fixed Cost per year (₹ '000)	Variable Cost per 'KDK' (₹)
Production	32,000	3,600
Distribution	2,000	200

Direct labour costs are 40% of the variable production costs. In the production department machining and assembling of 'KDK', 90 men work 8 hours per day for 300 days in a year. Each worker can machine and assemble 1 'KDK' per uninterrupted 180 minutes time frame. In each 8 hours working day, 20 minutes are allowed for coffee-break, 30 minutes on an average for training and 22 minutes for supervisory instructions. Besides 10% of each day is booked as idle time to cover checking in and checking out changing operations, getting materials and other miscellaneous matters.

MFG Ltd. has been facing industrial relations problem as the workers of company have a very strong union. Company is faced with the possibility of a strike by direct production workers engaged on the assembly of 'KDK'. The trade union is demanding an increase of 15%, back-dated from the beginning of financial year, but the company expects that if a strike does take place, it will last 25 Days after which the union will settle for an increase of 10% similarly back-dated. The only product of the company is being sold at ₹6,000.

If the strike takes place, Sales of 1,300 'KDK' would be lost. The balance that would ordinarily have been produced during the strike period could, however be sold, but these 'KDK' would have to be made up in overtime working which would be at an efficiency rate of 90% of normal. This would entail additional fixed cost of ₹1,00,000 and wage payments at time and one-half.

You are required to state, whether you would advise the management to allow the strike to go ahead, rather than to the union's demand. *(8 Marks)*

(b) The following table gives the activities in a construction project and the time durations with associated probability of each activity:

Activity	Predecessors	Time (in Days)	Probability
A	---	6	0.50
		8	0.50
B	---	4	0.30
		5	0.20
		6	0.50
C	A	8	0.50
		16	0.50
D	A, B	8	0.30
		10	0.70
E	C, D	2	0.20
		4	0.80

Required:

To simulate the project, use the following random numbers taking the first five random numbers digits (representing the five activities) for each trial and so on:

11, 16, 23, 72, 94; 83, 83, 02, 97, 99; 83, 10, 93, 4, 33; 53, 49, 94, 37, 7.

Determine the critical path and the project duration for each trial. *(8 Marks)*

5. (a) Jigyasa India Ltd. (JIL) has 30 retail stores of uniform sizes 'Fruity & Sweety Retails' across the country. Mainly three products namely 'Butter Jelly', 'Fruits & Nuts' and 'Icy Cool' are sold through these retail stores. JIL maintains stocks for all retail stores in a centralised warehouse. Goods are released from the warehouse to the retail stores as per requisition raised by the stores. Goods are transported to the stores through two types of vans i.e. normal and refrigerated. These vans are to be hired by the JIL.

Costs per month of JIL are as follows:

	(₹)
Warehouse Costs:	
Labour & Staff Costs	27,000
Refrigeration Costs	1,52,000
Material Handling Costs	28,000
Total	2,07,000
Head Office Cost:	
Salary & Wages to Head Office Staff	50,000
Office Administration Costs	1,27,000
Total	1,77,000
Retail Stores Costs:	
Labour Related Costs	33,000
Refrigeration Costs	1,09,000
Other Costs	47,000
Total	1,89,000

Average transportation cost of JIL per trip to any retail stores are as follows:

Normal Van	₹3,200
Refrigerated Van	₹4,900

The Chief Financial Manager asked his Finance managers to calculate profitability based on three products sold through Fruity & Sweety retail stores rather than traditional method of calculating profitability.

The following information regarding retail stores are gathered:

	Butter Jelly	Fruits & Nuts	Icy Cool
No. of Cartons *per cubic metre* (m^3)	42	28	40
No. of Items *per cartons* (units)	300	144	72
Sales *per month* (units)	18,000	4,608	1,152
Time in Warehouse (in months)	1	1.5	0.5
Time in Retail Stores (in months)	1	2	1
Selling Price *per unit* (₹)	84	42	26
Purchase Price *per unit* (₹)	76	34	22

Butter Jelly and Icy-Cool are required to be kept under refrigerated conditions.

Additional information:

Total Volume of All Goods Sold *per month*	40,000 m^3
Total Volume of Refrigerated Goods Sold *per month*	25,000 m^3
Carrying Volume of *each van*	64 m^3

Required:

Calculate the Profit *per unit* using Direct Product Profitability (DPP) method.

(12 Marks)

(b) State whether the learning curve theory can be applied to .the following independent situations briefly justifying your decision:

(i) A labour intensive sculpted product is carved from the metal provided to the staff. The metal is sourced from different suppliers since it is scarce. The alloy composition of the input metal is quite different among the suppliers.

(ii) Pieces of hand-made furniture are assembled by the company in a far off location. The labourers do not know anything about the final product which utilizes their work. As a matter of further precaution, rotation of labour is done frequently.

(iii) Skilled workers have been employed for a long time. The company has adequate market for the craft pieces done by these experts.

(iv) A company finds that it always has an adverse usage of indirect material. It wants to apply learning curve theory to improve the way standards have been set. *(4 Marks)*

6. (a) SK Roadways Services Pvt. Ltd. is planning to run a fleet of 15 buses in Birpur City on a fixed route. Company has estimated a total of 2,51,85,000 passenger kilometers per annum. It is estimated buses to have 100% load factor. Buses are purchased at a price of ₹ 40,00,000 per unit whose scrape value at the end of 5 years life is ₹ 5,00,000. Seating capacity of a bus excluding a Driver's seat is 42. Each bus can give a mileage of 5 kmpl. Average cost of fuel is ₹ 60 per liter. Cost of Lubricants & Sundries per 1,000 km would be ₹ 3,000. Company will pay ₹ 25,000 per month to Driver and two attendants for each bus.

Other annual charges per bus: Insurance ₹ 50,000, Garage Charges ₹ 30,000, Repairs & Maintenance ₹ 50,000. Route Permit Charges upto 20,000 km is ₹ 5,000 and ₹ 2,000 for every additional 5,000 km or part Thereof.

(i) You are required to calculate a suggested fare per passenger/km taking into account markup on cost @20% to cover general overheads and sufficient profit.

(ii) The Transport Sector of Birpur is highly regulated. The Government has fixed the fare @ ₹ 1.20 for next 2 years. Comment on the two year's profitability taking into consideration the inflation rate of 8%.
Note: Route permit charges is not subject to Inflation. *(8 Marks)*

(b) SamKum Telecom Ltd. is a leading cellular service provider having a global presence. It aims to be the most innovative and trusted telecom company in the world. To achieve this aim, it is constantly working on its overall functioning. It is trying to adopt best managements practices in the world. Following are some information related to the company's performance for a particular period:

Particulars	Current Year	Base Year	Target
Operating Ratio	60%	54%	Reduce it to 50%
Average Revenue per User	₹ 225	₹ 210	Increase it to ₹250
Unresolved consumer complaints	27,500	25,000	Reduce it by 20%
Customer Relationship Centres	280	200	Take the total to 250
Employee coverage under Training Programme	10%	8%	At least 15%

Evaluate the performance of the company using Balance Scorecard approach.

(8 Marks)

7. Answer any **four** of the following questions:

(a) Discuss briefly two methods of costing in the service sector and give examples.

(4 Marks)

(b) ABC Ltd. is planning to introduce Kaizen Costing approach in its manufacturing plant. State whether and why the following are valid or not in respect of Kaizen Costing.

(i) VP(Finance) is of the view that company has to make a huge initial investment to bring a large scale modification in production process.

(ii) Head (Personnel) has made a point that introduction of Kaizen Costing does not eliminate the training requirement of employees.

(iii) General Manager (Manufacturing) firmly believes that only shop floor employees and workers' involvement is prerequisite of Kaizen Costing approach.

(iv) Manager (Operations) has concerns about creation of confusion among employees and workers regarding their roles and degradation in quality of production. *(4 Marks)*

(c) Define the following terms in relation to a transportation problem:

(i) Degeneracy

(ii) Prohibited routes *(4 Marks)*

(d) State the type of cost in the following cases:

(i) Cost associated with the acquisition and conversion of material into finished product.

(ii) Cost arising from a prior decision which cannot be changed in the short run.

(iii) Increase in cost resulting from selection of one alternative instead of another.

(iv) Accountant of a cloth factory paid ₹25,000 for water that has been used for washing clothes before they go for final drying process. *(4 Marks)*

(e) In each of the following independent situations, state with a brief reason whether 'Zero Base Budgeting' (ZBB) or 'Traditional Budgeting' (TB) would be more appropriate for year II.

(i) A company producing a certain product has done extensive ZBB exercise in year I. The activity level is expected to marginally increase in year II.

(ii) The sales manager of a company selling three products has the intuitive feeling that in year II, sales will increase for one product and decrease for the other two. His expectation cannot be substantiated with figures.

(iii) The top management would like to delegate responsibility to the functional managers for their results during year II.

(iv) Resources are heavily constrained and allocation for budget requirements is very strict. *(4 Marks)*

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – II

PAPER – 5: ADVANCED MANAGEMENT ACCOUNTING

SUGGESTED ANSWERS/HINTS

1. (a) Shelf life is one year hence opening stock of 30,000 boxes is to be sold first. Contribution on these boxes is Rs.18,00,000 [30,000 boxes × (Rs.100 – Rs.40)].

In the question production of 2004 is same as in 2005. Hence fixed cost for the year 2004 is Rs.52,00,000 (1,30,000 boxes × Rs.40). Therefore fixed cost for the year 2005 is Rs.57, 20,000 (Rs.52, 00,000 + 10% of Rs.52,00,000).

Variable Cost for the year 2005, Rs.50 per unit (Rs.40 + 25% of Rs.40).

Hence Contribution per unit during 2005 is Rs.50 (Rs.100 – Rs.50).

Break even volume is the volume to meet the fixed cost i.e. fixed cost equals to contribution. Therefore, remaining fixed cost of Rs.39,20,000 (Rs.57, 20,000 – Rs.18, 00,000) to be recovered from production during 2005.

Production in 2005 to reach BEP, 78,400 units (Rs.39,20,000 / Rs.50).

Therefore BEP for the year 2005 is 1,08,400 boxes (30,000 boxes + 78,400 boxes)

(b) Return of 12% Net (after tax of 40%) on Capital Employed is equivalent to 20% (Gross) [12% ÷ (1 – 0.4)] on Capital Employed.

Let Selling Price *per unit* to be 'K'

Since Total Sales = Total Cost + Profit

$$80{,}000\text{ K} = 14{,}60{,}000 + 20\%\,(12{,}00{,}000 + 0.5 \times 80{,}000\text{K})$$

Or, $$80{,}000\text{ K} = 14{,}60{,}000 + 2{,}40{,}000 + 8{,}000\text{K}$$

Or, $$72{,}000\text{ K} = 17{,}00{,}000$$

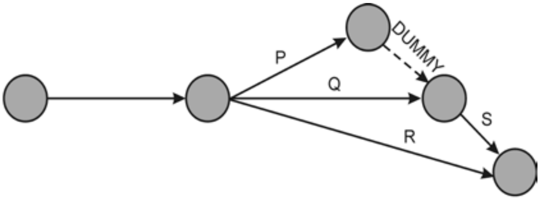
Or, $$\text{'K'} = \frac{17{,}00{,}000}{72{,}000}$$

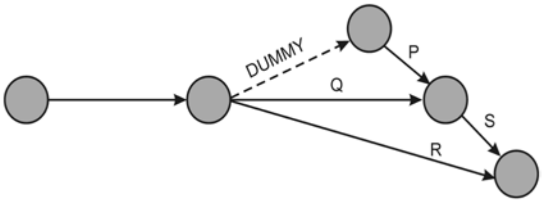
$$= \text{Rs.}23.61$$

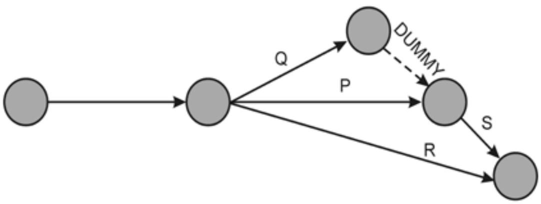
Hence Selling Price *per unit* will be Rs.23.61.

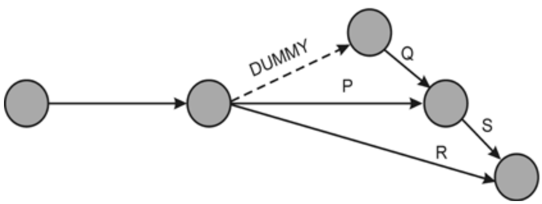
(c) Activities P and Q are called duplicate activities (or parallel activities) since they have the same head and tail events. The situation may be rectified by introducing a dummy either between P and S or between Q and S or before P or before Q (i.e. introduce the dummy before the tail event and after the duplicate activity or

Introduce the dummy activity between the head event and the duplicate activity). Possible situations are given below:









(d) (i) Under the Hungarian Assignment Method, the prerequisite to assign any job is that each row and column must have a zero value in its corresponding cells. If any row or column does not have any zero value then to obtain zero value, each cell values in the row or column is subtracted by the corresponding minimum cell value of respective rows or columns by performing row or column operation. This means *if any row or column have two or more cells having same minimum value then these row or column will have more than one zero.* However, having two zeros does not necessarily imply two equal values in the original assignment matrix just before row and column operations. *Two zeroes in a same row can also be possible by two different operations i.e. one zero from row operation and one zero from column operation*.

(ii) The order of matrix in the assignment problem is 4 × 4. The total assignment (allocations) will be four. In the assignment problem when any allocation is made in any cell then the corresponding row and column become unavailable for further allocation. Hence, these corresponding row and column are crossed mark to show unavailability. In the given assignment matrix two allocations have been made in a_{24} (2nd row and 4th column) and a_{32} (3rd row and 2nd column). This implies that 2nd and 3rd row and 4th and 2nd column are unavailable for further allocation.

Therefore, the other allocations are at either at a_{11} and a_{43} or at a_{13} and a_{41}.

2. (a) Let

$$\left.\begin{aligned} y_1 &= \text{Personal Loan} \\ y_2 &= \text{Credit Card Loan} \\ y_3 &= \text{Home Loan} \\ y_4 &= \text{Farm Loan} \\ y_5 &= \text{Commercial Loan} \end{aligned}\right\} \text{(in Lakhs Rs.)}$$

Objective function:

Total Interest = $0.135 \times 0.91 \times y_1 + 0.145 \times 0.88 \times y_2 + 0.115 \times 0.98 \times y_3 + 0.120 \times 0.96 \times y_4 + 0.105 \times 0.99 \times y_5$

= $0.1229y_1 + 0.1276y_2 + 0.1127y_3 + 0.1152y_4 + 0.1040y_5$

Bad Debts = $0.09y_1 + 0.12y_2 + 0.02y_3 + 0.04y_4 + 0.01y_5$

Maximize Z = Total Interest − Bad Debt

= $0.1229y_1 + 0.1276y_2 + 0.1127y_3 + 0.1152y_4 + 0.1040y_5 - (0.09y_1 + 0.12y_2 + 0.02y_3 + 0.04y_4 + 0.01y_5)$

= $0.0329y_1 + 0.0076y_2 + 0.0927y_3 + 0.0752y_4 + 0.094y_5$

Condition-1:

Total fund should not exceed Rs. 25 Lakhs.

$$y_1 + y_2 + y_3 + y_4 + y_5 \leq 25$$

Condition-2:

Farm and commercial loans equal at least 30% of all loans.

$$y_4 + y_5 \geq 0.30 \text{ x } (y_1 + y_2 + y_3 + y_4 + y_5)$$

Or $$0.30y_1 + 0.30y_2 + 0.30y_3 - 0.70y_4 - 0.70y_5 \leq 0$$

Condition-3:

Home loans should equal at least 50% of personal, credit card and home loans.

$$y_3 \geq 0.50 \text{ x } (y_1 + y_2 + y_3)$$

Or $$0.50y_1 + 0.50y_2 - 0.50y_3 \leq 0$$

Condition-4:

Bad Debts should not exceed 5% of all loans.

$$0.09y_1 + 0.12y_2 + 0.02y_3 + 0.04y_4 + 0.01y_5 \leq 0.05\,(y_1 + y_2 + y_3 + y_4 + y_5)$$

Or $$0.04y_1 + 0.07y_2 - 0.03y_3 - 0.01y_4 - 0.04y_5 \leq 0$$

The linear programming model can be formulated as follows:

Maximize

$$Z = 0.0329y_1 + 0.0076y_2 + 0.0927y_3 + 0.0752y_4 + 0.094y_5$$

Subject to the Constraints-

$$\begin{aligned} y_1 + y_2 + y_3 + y_4 + y_5 &\leq 25 \\ 0.30y_1 + 0.30y_2 + 0.30y_3 - 0.70y_4 - 0.70y_5 &\leq 0 \\ 0.50y_1 + 0.50y_2 - 0.50y_3 &\leq 0 \\ 0.04y_1 + 0.07y_2 - 0.03y_3 - 0.01y_4 - 0.04y_5 &\leq 0 \\ y_1, y_2, y_3, y_4, y_5 &\geq 0 \end{aligned}$$

(b) Working Note

Details	Working	Amount (Rs.)
Selling Price	$\frac{₹4,99,200}{1,200\text{units}}$	416
Raw Materials	$\frac{₹1,68,000}{1,400\text{units}}$	120
Labour	$\frac{₹1,05,000}{1,750\text{units}^*}$	60
Variable Overhead	$\frac{₹42,000}{1,400\text{units}}$	30
Manufacturing Cost (Variable)		210
Distribution Overhead	$\frac{₹19,200}{1,200\text{units}}$	16
Total Variable Cost		226
Contribution		190

Fixed Cost Factory Administration Selling	 Rs. 1,20,000 Rs. 40,000 Rs. 40,000	 2,00,000

**Equivalent units (1,400 units / 80%)*

Standard Profit for 1,200 Units Sold

Details	Working	Amount (Rs.)
Contribution	1,200 units × Rs. 190	2,28,000
Less: Fixed Costs		2,00,000
Profit		28,000

Reconciliation between Budgeted and Actual Profit

Details	Working	Amount (Rs.)
Budgeted Profit	(2,000 units × Rs. 190 – Rs. 2,00,000)	1,80,000
Less: Volume Variance	(800 units× Rs.190)	1,52,000
Standard Profit		28,000
Factors causing loss:		
Units Scrapped	(100 units × Rs.210)	21,000
Labour Inefficiency	(350 units × Rs.60)	21,000
Undervaluation of Closing Stock	{100 units × (Rs.210 – Rs.180)}	3,000
Actual Profit		(-)17,000

3. (a) Basic Workings

Overheads Cost Variance	=	Rs. 2,800 (A)
Overheads Volume Variance	=	Rs. 2,000 (A)
Budgeted Overheads	=	Rs. 12,000
Actual Overhead Recovery Rate	=	Rs. 8 per hour
Budgeted Hours *for the period*	=	2,400 hours

Computation of Requirements

Overheads expenditure variance:

Overheads Expenditure Variance	=	Overheads Cost Variance (–) Overheads Volume Variance
	=	Rs. 2,800 (A) – Rs. 2,000 (A)
	=	Rs. 800 (A)

Actual incurred overheads:

Overheads Expenditure Variance	=	Budgeted Overheads (–) Actual Overheads
⇒ Rs. 800(A)	=	Rs. 12,000 (–) Actual Overheads
Therefore, Actual Overheads	=	Rs. 12,800

Actual hours for actual production:

$$\text{Actual hours for actual production} = \frac{\text{Actual Overheads}}{\text{Actual Overhead Recovery Rate Per Hour}}$$

$$= \frac{₹\,12{,}800}{₹\,8}$$

$$= 1{,}600 \text{ hours}$$

Overheads capacity variance:

Overheads Capacity Variance	=	Budgeted Overheads for Actual Hours (–) Budgeted Overheads
	=	Rs. 5 × 1,600 hrs. – Rs. 12,000
	=	Rs. 8,000 – Rs. 12,000
	=	Rs. 4,000 (A)

Overheads efficiency variance:

Overheads Efficiency Variance	=	Absorbed Overheads (–) Budgeted Overheads for Actual Hours
	=	Rs. 10,000 – Rs. 5 × 1,600 hours
	=	Rs. 2,000 (F)

Standard hours for actual production:

$$\text{Standard hours for actual output} = \frac{\text{AbsorbedOverheads}}{\text{Standard Overhead Rate per hour}}$$

$$= \frac{₹\,10{,}000}{₹\,5}$$

$$= 2{,}000 \text{ hours}$$

Working Note

Overhead Cost Variance = Absorbed Overheads (–) Actual Overheads

$\Rightarrow$ Rs. 2,800 (A) = Absorbed Overheads (–) Rs.12,800

$\Rightarrow$ Absorbed Overheads = Rs.10,000

$$\text{Standard Overhead Rate } \textit{per hour} = \frac{\text{BudgetedOverheads}}{\text{Budgeted Hours}}$$

$$= \frac{₹\,12{,}000}{2{,}400\text{hours}}$$

= Rs. 5

(b) Assumed Selling Price 'P', Quantity 'Q'

The Marginal Cost of a 'Zoom' is Rs. 525 i.e. (Rs.175 + Rs.350)

Demand Function for 'Zoom'

P = 1,400 – (75/125) × Q [Refer to Working Note]

Revenue (R) = Q x [1,400 – 3/5 × Q]

Marginal Revenue (MR) = 1,400 – (6/5) × Q

Marginal Cost (MC) = 525

Profit is Maximum where Marginal Revenue (MR) equals to Marginal Cost (MC)

1,400 – (6/5) × Q = 525

Q = 729.17 Units

P = 962.50

Unit Selling Price should be Rs.962.50 to get *maximum profit*.

Working Note

Price at which,

There will be no Sale = 1,100 + {(75/125) × 500}

= Rs.1,400

(c) (i) Invalid

The concepts, tools and techniques of value chain analysis apply to organizations which produce and sell a product and also to organizations which provide a service.

(ii) Invalid

Procurement activities are included in the support activities rather than primary activities.

(iii) Valid

Bargaining power of buyers is one of the factor or force that influences the profitability of a market or industry. More the bargaining power buyers have, more the pressure on the industry to not increase the price of product or service. They may even have to reduce the price sometimes.

(iv) Invalid

Value chain analysis in the strategic framework consists of multiple cost drivers concept. In value chain analysis, a set of unique cost drivers is identified for each value activity instead of single cost driver application at the overall firm level. Multiple cost drivers may be classified into Structural drivers and Executional drivers.

4. (a) **Alternative-1 with No Strike:** (Refer W.N.-2, 3)

Cost of Settlement is 15% Increase i.e. Rs.216 per unit

Annual Cost of Settlement

= 54,000 units × Rs.216

= Rs.1,16,64,000

Alternative 2 i.e. if Strike Goes Ahead: (Refer W.N.-1, 2, 3)

Extra Cost	(Rs.)
Annual Incremental Labour Cost (Ex. Strike Days Production) [{54,000 units – (25Days × 180 units per Day)} × Rs.144.00]	71,28,000
Loss of Contribution *due to loss of sales* [1,300 units × Rs. 2,200]	28,60,000
Incremental Labour Cost for Balance 3,200 units [(25 Days × 180 units per Day) – 1,300 units} × Rs.144.00]	4,60,800
Overtime Premium [3,200 units × 1,584 × 0.5]	25,34,400
Payment for Efficiency [3,200 units × 1/9 × 1,584 × 1.5]	8,44,800
Additional Fixed Cost	1,00,000
	1,39,28,000

If there is no strike, it will yield a financial benefit of Rs.22,64,000 (Rs.1,39,28,000 – Rs. 1,16,64,000). Management should accept union's demand.

Working Note

(1) Statement Showing Contribution *per unit* of 'KDK':

	(Rs.)
Selling Price	6,000
Less: Variable Costs:	
Labour Cost	1,440
Production Ex. Wages (Rs.3,600 – Rs.1,440)	2,160
Distribution	200
Contribution	2,200

(2) Calculation of Labour Cost:

Direct Labour (40% of production costs of Rs.3,600) = Rs.1,440 *per unit*

With 15% Increase, Revised Labour Cost (Rs.1,440 + Rs.216) = Rs.1,656

With 10% Increase, Revised Labour Cost (Rs.1,440 + Rs.144) = Rs.1,584

(3) Statement Showing Budgeted Production:

Total Time in a Day: (8hrs. × 60 minutes)	=	480 minutes
Less: Idle Time	=	48 minutes
Coffee Break	=	20 minutes
Instructions	=	22 minutes
Training	=	30 minutes
Productive Time *per day*	=	360 minutes

Therefore, 'KDK' to be produced per man per day: (360/180 × 1)

= 2 units

Since 'KDK' are produced at the rate of 2 'KDK' per man day, so total yearly production will be 54,000 units (2 units × 90 men × 300 days) of 'KDK'

☞ This question has been solved by comparing 'Existing Situation' with both 'Alternatives (Strike or Non-Strike)' *independently*. However this question can also be solved by comparing 'Alternatives (Strike or Non-Strike)' *only* and final answer would be the same.

(b) Random Numbers Allocation for *each activity*:

Activity	Time (in Days)	Probability	Cumulative Probability	Allocated Random Number
A	6	0.50	0.50	00-49
	8	0.50	1.00	50-99
B	4	0.30	0.30	00-29
	5	0.20	0.50	30-49
	6	0.50	1.00	50-99
C	8	0.50	0.50	00-49
	16	0.50	1.00	50-99
D	8	0.30	0.30	00-29
	10	0.70	1.00	30-99
E	2	0.20	0.20	00-19
	4	0.80	1.00	20-99

Simulation Table:

Trial	A		B		C		D		E	
	R. No.	Time	R. No.	Time	R. No.	Time	R. No.	Time	R. No.	Time
1	11	6	16	4	23	8	72	10	94	4
2	83	8	83	6	02	8	97	10	99	4
3	83	8	10	4	93	16	4	8	33	4
4	53	8	49	5	94	16	37	10	7	2

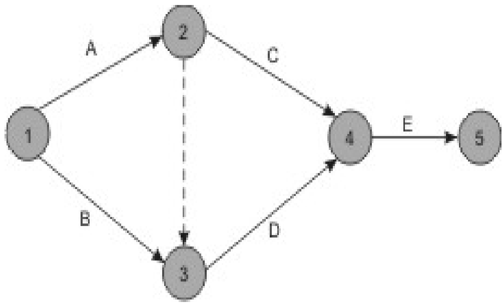
Determination of Critical Path and Project Duration for *each trial*:

Trial	Project Duration			Critical Path
	1–2–4–5 (A–C–E)	1–2–3–4–5 (A–D–E)	1–3–4–5 (B–D–E)	
1	18	20	18	1–2–3–4–5 (A–D–E)
2	20	22	20	1–2–3–4–5 (A–D–E)

3	28	20	16	1–2–4–5 (A–C–E)
4	26	20	17	1–2–4–5 (A–C–E)

Working Note

The Network for the given problem:



5. (a) Direct Product Profitability (DPP) Statement

(Amount in Rs.)

		Butter Jelly	Fruits & Nuts	Icy Cool
Selling Price *per unit*		84.00	42.00	26.00
Less: Purchase Price *per unit*		76.00	34.00	22.00
Gross Profit	(A)	8.00	8.00	4.00
Direct Product Costs:				
Warehouse Costs *per* m^3 [W.N.-1]		7.46	2.07	3.73
Retail Stores Costs *per* m^3 [W.N.-2]		6.36	4.00	6.36
Transportation Costs [W.N.-3]		76.56	50.00	76.56
Total DPP costs *per* m^3		90.38	56.07	86.65
Items *per* m^3 [W.N.-4]		12,600	4,032	2,880
Cost *per item*	(B)	0.007	0.014	0.030
Direct Product Profit	(A) - (B)	7.993	7.986	3.97

Working Notes

(1) Warehouse Related Costs

	General Costs (Rs.)	Cost Related with Refrigerated Goods (Rs.)
Labour & Staff Costs	27,000	---
Refrigeration Costs	---	1,52,000
Material Handling Costs	28,000	---
Total	55,000	1,52,000
Volume of Goods Sold	40,000 m^3	25,000 m^3
Cost *per* m^3 *per month*	1.38	6.08

Products	Time in Warehouse	Cost *per* m^3 *per month* (Rs.)	Total Cost (Rs.)
Butter Jelly	1 Month	7.46 (1.38 + 6.08)	7.46
Fruits & Nuts	1.5 Months	1.38	2.07
Icy-cool	0.5 Months	7.46 (1.38 + 6.08)	3.73

(2) Retail Stores Related Costs

	General Costs (Rs.)	Cost Related with Refrigerated Goods (Rs.)
Labour Related Costs	33,000	---
Refrigeration Costs	---	1,09,000
Other Costs	47,000	---
Total	80,000	1,09,000
Volume of Goods Sold	40,000 m^3	25,000 m^3
Cost *per* m^3 *per month*	2.00	4.36

Products	Time in Retail Stores	Cost *per m³ per month*	Total Cost
Butter Jelly	1 Month	Rs.6.36 (Rs.2.00 + Rs.4.36)	Rs.6.36
Fruits & Nuts	2 Months	Rs.2.00	Rs.4.00
Icy-Cool	1 Month	Rs.6.36 (Rs.2.00 +Rs.4.36)	Rs.6.36

(3) Transportation Costs

	Normal Van Costs	Refrigerated Van Costs
Cost *per trip*	Rs.3,200	Rs.4,900
Volume of Van	64 m^3	64 m^3
Cost *per* m^3 *per trip*	Rs.50.00	Rs.76.56

(4) No. of Items *per* m^3

Products	No. of Cartons (m^3)	No. of Items *per Cartons* (units)	No. of Items *per* m^3
Butter Jelly	42	300	12,600 (42 × 300)
Fruits & Nuts	28	144	4,032 (28 × 144)
Icy - Cool	40	72	2,880 (40 × 72)

(b) (i) 'Learning Curve Theory' will not be applicable as alloy combination of the input metal is quite different among the suppliers hence learning experience with one type of metal may not be beneficial for the workers to deal with other metal with separate alloy composition.

(ii) 'Learning Curve Theory' will not be applicable as in this situation rotation of labour is done frequently, labours will not be able to get the benefit of learning and apply their learning. Hence, learning curve theory can not be applied.

(iii) 'Learning Curve Theory' will not be applicable as in this situation as workers are skilled and employed for a long time, they have already achieved maximum level of expertise by taking advantage of learning. Hence, at this point of time learning curve theory can not be applied.

(iv) 'Learning Curve Theory' will not be applicable as indirect materials are the materials which are not used directly in the production (not directly proportionate with volume of output) and usually used machines (e.g. lubricants, spares parts etc.) with less human interactions. Adverse usage of indirect materials can be controlled through proper monitoring and appropriate standard settings and not from applying learning curve theory.

6. (a) (i) Statement Suggesting Fare *per passenger – km* (Each Bus)

Particulars	Cost per annum (Rs.)
Fixed Expenses:	
Insurance	50,000.00
Garage Charges	30,000.00
Depreciation	7,00,000.00
Running Expenses:	
Repair and Maintenance	50,000.00
Cost of Lubricants and Sundries	1,25,925.00
Fuel Cost	5,03,700.00
Salary of Driver and Two Attendants	3,00,000.00
Route Permit Charges	15,000.00
Total Cost *per annum*	17,74,625
Add: Markup @ 20% of Total Cost or 16.67% of Total Revenue	3,54,925
Total Revenue	21,29,550

Rate *per passenger- km* equals to Rs.1.268

Workings

Total Passenger Kms = 2,51,85,000

Total Buses = 15

Passenger Kms *per bus* = 16,79,000 (2,51,85,000 Kms / 15)

Total Passenger Capacity *per bus* = 42 – 2 = 40

Annual Distance Covered *by a bus* = 41,975 Kms (16,79,000Kms / 40)

(ii) Regulated Fare *per passenger km* is Rs.1.20

Profitability Statement for *Each Bus*

Particulars		Year 1 (Rs.)	Year 2 (Rs.)
Fixed Expenses:			
Insurance		54,000.00	58,320.00
Garage Charges		32,400.00	34,992.00
Depreciation		7,00,000.00	7,00,000.00
Running Expenses:			
Repair and Maintenance		54,000.00	58,320.00
Cost of Lubricants and Sundries		1,35,999.00	1,46,879.00
Fuel Cost		5,43,996.00	5,87,516.00
Salary of Driver and Two Attendants		3,24,000.00	3,49,920.00
Route Permit Charges		15,000.00	15,000.00
Total Cost	...[A]	18,59,395.00	19,50,947.00
Total Revenue (Regulated)	...[B]	20,14,800.00	20,14,800.00
Profit	...[B] – [A]	1,55,405.00	63,853.00
Profit to Total Revenue		7.71%	3.17%

The gross margin is showing a downward trend because the cost components have taken into the effect of inflation hence increasing year by year but the total revenue has remained stagnant due to Government regulations which resulted in reduction in gross margin per bus.

The company's gross margin to total revenue ratio has came out to be 7.71% and 3.17% in first and second year respectively but initially the company's desired gross margin to total revenue ratio is 16.67% to cover general overheads and sufficient profit. Though the amount of general overheads is not given but we can safely assume that they may also subject to inflation i.e. increase year by year then in such case the company needs to maintain or increase its gross margin per bus to maintain its net profit after general overheads which is not possible in regulated environment. The information about regulated fare in the given case is regarding first two years only but if this regulated fare scenario persists for further years then the project may not be viable for the company.

(b) The balanced scorecard is a method which displays organisation's performance into four dimensions namely financial, customer, internal and innovation. The four dimensions acknowledge the interest of shareholders, customers and employees taking into account of both long-term and short-term goals. The detailed analysis of performance of the company using Balance Scorecard approach as follows:

(i) Financial Perspective

Operating ratio and average revenue will be covered in this prospective.

Company is unable to achieve its target of reducing operating ratio to 50% instead it has increased to 60%. Company is required to take appropriate steps to control and manage its operating expenses. Average revenue per user has increased from Rs. 210 to Rs. 225 but remains short of targeted Rs. 250. This is also one of the reasons of swelled operating ratio. Company can boost up its average revenue per user either by increasing the price of its services or by providing more paid value added services.

(ii) Customer Perspective

Service complaints will be covered under this perspective. The company had set a target of reducing unresolved complaints by 20% instead unresolved complaints have risen by 10%[(27,500-25,000)/(25,000) × 100]. It shows dissatisfaction is increasing among the consumers which would adversely impact the consumer's general perception about the company and company may lose its consumers in long run.

(iii) Internal Business Perspective

Establishing customer relationship centres will be covered under this perspective. Company has established 80 relationship centres in the current period exceeding its target of 50 (250-200) to cater to the needs of existing consumers as well as soliciting new consumers. This shows the seriousness of the company towards the consumer satisfaction and would help them in the long run.

(iv) Learning and Growth Perspective

Employee training programmes are covered under this perspective.

Company had set a target to cover at least 15% employee under its training programmes but covered only 10%. This could hurt capabilities of the employees which are needed for long term growth of the organisation necessary to achieve the objectives set in the previous three perspectives. People or the human resource of the company is one of the three principle sources where organisational learning and growth comes.

7. (a) Methods of Costing in the service sector are as follows:

(i) **Job costing method**: In job costing method the cost of a particular service is obtained by assigning costs to a distinct identifiable service. In service sector like Accounting firm, Advertising campaigns etc. job costing method is used. For assigning indirect costs (overheads) models such as Activity Based Costing may be used.

(ii) **Process costing method:** In process costing system the cost of a service is obtained by assigning costs to masses of similar unit and then computing unit cost on an average basis. Retail banking, Postal delivery, Credit card etc. uses process costing method.

(iii) **Hybrid costing method:** Many companies uses a method of costing which is neither job costing nor process costing method. They in fact uses a hybrid costing method which combines elements of both job costing and process costing methods.

(b) (i) Invalid

Kaizen costing is the system of cost reduction procedures which involves making small and continuous improvements to the production processes rather than innovations or large-scale investment.

(ii) Valid

The training of employees is very much a long-term and ongoing process in the Kaizen costing approach. Training enhances the abilities of employees.

(iii) Invalid

Kaizen Costing approach involves everyone from top management level to the shop floor employees. Every employee's active participation is a must requirement.

(iv) Invalid

Though the aim of Kaizen Costing is to reduce the cost but at the same time it also aims to maintain the quality. Kaizen costing also aims to bring the clarity in roles and responsibilities for all employees.

(c) (i) **Degeneracy**: When the number of positive allocations at any stage of the feasible solution is less than the required number (rows + columns -1), the solution is said to be *degenerate solution*. Such a situation is handled by introducing an infinitesimally small allocation 'e' in the least cost and independent cell. If the number of occupied cells < m+n-1 by one, then only one *'e'* needs to be introduced. If the number of occupied cells is less by more than one, to the extent of shortage, *'e''s* will have to be introduced till the condition that number of occupied cells = m+n-1.

(ii) **Prohibited Routes**: Sometimes in a given transportation problem, some routes may not be available. There could be several reasons for this such as bad road conditions or strike etc. In such situations, there is a restriction on the route available for transportation. To handle such type of a situation, a very large cost (or a negative profit for the maximization problem) represented by ∞ or 'M' is assigned to each of such routes which are not available. Due to assignment of very large cost, such routes would automatically be eliminated in the final solution. The problem is the solved in its usual way.

(d)

Cases		Type of Cost
(i)	Cost associated with the acquisition and conversion of material into finished product.	Product Cost
(ii)	Cost arising from a prior decision which cannot be changed in the short run.	Committed Cost
(iii)	Increase in cost resulting from selection of one alternative instead of another.	Differential/Incremental Cost
(iv)	Accountant of a cloth factory paid Rs.25,000 for water that has been used for washing clothes before they go for final drying process.	Direct Cost

(e) (i) The company has done extensive exercise in year-I that can be used as a basis for budgeting in year-II by incorporating increase in costs / revenue at expected activity level. Hence, **Traditional Budgeting** would be more appropriate for the company in year-II.

(ii) In Traditional Budgeting system budgets are prepared on the basis of previous year's budget figures with expected change in activity level and corresponding adjustment in the cost and prices. But under Zero Base Budgeting (ZBB) the estimations or projections are converted into figures. Since, sales manager is unable to substantiate his expectations into figures so **Traditional Budgeting** would be preferred against Zero Base Budgeting.

(iii) **Zero Base Budgeting** would be appropriate as ZBB allows top-level strategic goals to be implemented into the budgeting process by tying them to specific functional areas of the organization, where costs can be first grouped, then measured against previous results and current expectations.

(iv) Zero Base Budgeting allocates resources based on order of priority up to the spending cut-off level (maximum level upto which spending can be made). In an organisation where resources are constrained and budget is allocated on requirement basis, **Zero Base Budgeting** is more appropriate method of budgeting.

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – II

PAPER – 6: INFORMATION SYSTEMS CONTROL & AUDIT

Question No. 1 is compulsory.

*Attempt any **five** questions from the remaining **six** Questions.*

Time Allowed – 3 Hours | Maximum Marks – 100

1. (a) Mr. A has received some information about Mr. B on his cell phone. He knows that this information has been stolen by the sender. He not only retained this information but also sends it to Mr. B and his friends. Because of this act, Mr. B is annoyed and his life is in danger.

   (i) Mr. B seeks your advice, under what sections of Information Technology (Amendment) Act, 2008; can he file an FIR with police? *(4 Marks)*

   (ii) Advise Mr. B detailing the applicable sections of the Act. *(8 Marks)*

   (b) Discuss some of the major techniques to commit cyber frauds. *(8 Marks)*

2. (a) Discuss different attributes of useful and effective Information? *(8 Marks)*

   (b) How Audit Trail can be used to support security objectives? *(4 Marks)*

   (c) Discuss various fact-finding techniques/tools are used by the system analyst for determining the needs/requirements of the system to be built. *(4 Marks)*

3. (a) Name the different phases of methodology for developing a BCP. What are the major points on which a methodology mainly emphasizes upon? *(8 Marks)*

   (b) What are the characteristics of a good coded application and program? *(4 Marks)*

   (c) Discuss the goals of Cloud Computing. *(4 Marks)*

4. (a) Discuss various Output Controls in detail. *(8 Marks)*

   (b) What are the key governance practices of Governance of Enterprise IT (GEIT)? *(4 Marks)*

   (c) What are Detective Controls? *(4 Marks)*

5. (a) What do you understand by the terms COBIT 5? Describe its practices in brief. *(8 Marks)*

   (b) What are the basic features of Transaction Processing System (TPS)? *(4 Marks)*

   (c) Describe major advantages of continuous audit techniques. *(4 Marks)*

6. (a) Discuss different types of Back-up plans used in Business Continuity Planning?

(8 Marks)

(b) Discuss the various categories of IS Audit. *(4 Marks)*

(c) Discuss various Information Systems that serve different organizational levels.

(4 Marks)

7. Write short notes on any **four** of the following:

(a) Key management practices for implementing risk management.

(b) Components of Internal Controls.

(c) Phases of Information Security Management Systems (ISMS).

(d) Mobile Computing Benefits.

(e) Weaknesses of Agile model. *(4 × 4 = 16 Marks)*

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – II

PAPER – 6: INFORMATION SYSTEMS CONTROL & AUDIT

SUGGESTED ANSWERS/HINTS

1. (a) (i) Mr. B wants to file an FIR against Mr. A, then he may file the same under the following Section of Information Technology (Amendment) Act, 2008:

- Section 66 A: Punishment for sending offensive messages through communication service, etc.;
- Section 66 B: Punishment for dishonestly receiving stolen computer resource or communication device; and
- Section 66 E: Punishment for violation of privacy.

(ii) All these applicable sections in this case are given as follows:

[Section 66 A] Punishment for sending offensive messages through communication service, etc.

Any person who sends, by means of a computer resource or a communication device,-

(a) any **information** that is grossly offensive or has menacing character; or

(b) any **information** which he knows to be false, but for the purpose of causing annoyance, inconvenience, danger, obstruction, insult, injury, criminal intimidation, enmity, hatred, or ill will, persistently **by making** use of such computer resource or a communication device,

(c) any electronic mail or electronic mail message for the purpose of causing annoyance or inconvenience or to deceive or to mislead the addressee or recipient about the origin of such messages shall be punishable with imprisonment for a term which may extend to three years and with fine.

Explanation: For the purposes of this section, terms "Electronic mail" and "Electronic Mail Message" means a message or information created or transmitted or received on a computer, computer system, computer resource or communication device including attachments in text, image, audio, video and any other electronic record, which may be transmitted with the message.

[Section 66 B] Punishment for dishonestly receiving stolen computer resource or communication device.

Whoever dishonestly receives or retains any stolen computer resource or communication device knowing or having reason to believe the same to be stolen computer resource or communication device, shall be punished with imprisonment of either description for a term which may extend to three years or with fine which may extend to rupees one lakh or with both.

[Section 66E] Punishment for violation of privacy

Whoever, intentionally or knowingly captures, publishes or transmits the image of a private area of any person without his or her consent, under circumstances violating the privacy of that person, shall be punished with imprisonment which may extend to three years or with fine not exceeding two lakh rupees, or with both.

(b) Following are the major techniques to commit cyber frauds:

- Hacking: It refers to unauthorized access and use of computer systems, usually by means of personal computer and a telecommunication network. Normally, hackers do not intend to cause any damage.
- Cracking: Crackers are hackers with malicious intentions, which means, un-authorized entry. Now across the world hacking is a general term, with two nomenclatures namely: Ethical and Un-ethical hacking. Un-ethical hacking is classified as Cracking.
- Data Diddling: Changing data before, during, or after it is entered into the system in order to delete, alter, or add key system data is referred as data diddling.
- Data Leakage: It refers to the unauthorized copying of company data such as computer files.
- Denial of Service (DoS) Attack: It refers to an action or series of actions that prevents access to a software system by its intended/authorized users; causes the delay of its time-critical operations; or prevents any part of the system from functioning.
- Internet Terrorism: It refers to the using Internet to disrupt electronic commerce and to destroy company and individual communications.
- Logic Time Bombs: These are the program that lies idle until some specified circumstances or a particular time triggers it. Once triggered, the bomb sabotages the system by destroying programs, data or both.
- Masquerading or Impersonation: In this case, perpetrator gains access to the system by pretending to be an authorized user.
- Password Cracking: Intruder penetrates a system’s defense, steals the file containing valid passwords, decrypts them and then uses them to gain access to system resources such as programs, files and data.
- Piggybacking: It refers to the tapping into a telecommunication line and latching on to a legitimate user before s/he logs into the system.

- **Round Down:** Computer rounds down all interest calculations to 2 decimal places. Remaining fraction is placed in account controlled by perpetrator.

2. (a) **Attributes of Information:** Some of the important attributes of useful and effective information are given as follows:

- **Availability -** It is a very important aspect of information. Information is useless if it is not available at the time of need. Database is a collection of files which is collection of records and data from where the required information is derived for useful purpose.
- **Purpose/Objective -** Information must have purpose/objective at the time it is transmitted to a person or machine, otherwise it is simple data. The basic objective of information is to inform, evaluate, persuade, and organize. This indeed helps in decision making, generating new concepts and ideas, identify and solve problems, planning, and controlling which are needed to direct human activity in business enterprises.
- **Mode and format -** The mode of communicating information to humans should be in such a way that it can be easily understood by the people. The mode may be in the form of voice, text and combination of these two and is designed in such a way that it assists in decision making, solving problems, initiating planning, controlling and searching. According to the type of information, the different formats can be used e.g. diagrams, graphs, curves are best suited for representing the statistical data. Format of information should be simple, relevant and should highlight important points but should not be too cluttered up.
- **Current/Updated -** The information should be refreshed from time to time as it usually rots with time and usage.
- **Rate -** The rate of transmission/reception of information may be represented by the time required to understand a particular situation. Useful information is the one which is transmitted at a rate which matches with the rate at which the recipient wants to receive.
- **Frequency -** The frequency with which information is transmitted or received affects its value.
- **Completeness and Adequacy -** The information provided should be complete and adequate in itself because only complete information can be used in policy making.
- **Reliability -** It is a measure of failure or success of using information for decision-making. If information leads to correct decision on many occasions, we say the information is reliable.

- **Validity -** It measures how close the information is to the purpose for which it asserts to serve. For example, the experience of employee supports in evaluating his performance.
- **Quality -** It means the correctness of information. For example, an over-optimistic manager may give too high estimates of the profit of product which may create problem in inventory and marketing.

(b) Audit trails can be used to support security objectives in three ways:

- **Detecting Unauthorized Access:** Detecting unauthorized access can occur in real time or after the fact. The primary objective of real-time detection is to protect the system from outsiders who are attempting to breach system controls. A real-time audit trail can also be used to report on changes in system performance that may indicate infestation by a virus or worm.
- **Reconstructing Events:** Audit analysis can be used to reconstruct the steps that led to events such as system failures, security violations by individuals, or application processing errors. Audit trail analysis also plays an important role in accounting control.
- **Personal Accountability:** Audit trails can be used to monitor user activity at the lowest level of detail. This capability is a preventive control that can be used to influence behavior. Individuals are likely to violate an organization's security policy if they know that their actions are not recorded in an audit log.

(c) Various fact-finding techniques/tools used by the system analyst for determining the needs/ requirements of the system to be built are given as below:

- **Documents:** Document means manuals, input forms, output forms, diagrams of how the current system works, organization charts showing hierarchy of users and manager responsibilities, job descriptions for the people, who work with the current system, procedure manuals, program codes for the applications associated with the current system, etc. Documents are a very good source of information about user needs and the current system.
- **Interviews:** Users and managers may also be interviewed to extract information in depth. The data gathered through interviews often provide system developers with a larger picture of the problems and opportunities. Interviews also give analyst the opportunity to observe and record first-hand user reaction and to probe for further information.
- **Observation:** In general and particularly in prototyping approaches, observation plays a central role in requirement analysis. Only by observing how users react to prototypes of a new system, the system can be successfully developed.

3. (a) The methodology for developing a BCP can be sub-divided into eight different phases. The extent of applicability of each of the phases has to be tailored to the respective organization.

The eight phases are given as follows:

(i) Pre-Planning Activities (Business Continuity Plan Initiation)

(ii) Vulnerability Assessment and General Definition of Requirements

(iii) Business Impact Analysis

(iv) Detailed Definition of Requirements

(v) Plan Development

(vi) Testing Program

(vii) Maintenance Program

(viii) Initial Plan Testing and Plan Implementation

The methodology mainly emphasizes on the following:

- Providing management with a comprehensive understanding of the total efforts required to develop and maintain an effective recovery plan;
- Obtaining commitment from appropriate management to support and participate in the effort;
- Defining recovery requirements from the perspective of business functions;
- Documenting the impact of an extended loss to operations and key business functions;
- Focusing appropriately on disaster prevention and impact minimization, as well as orderly recovery;
- Selecting business continuity teams that ensure the proper balance required for plan development;
- Developing a business continuity plan that is understandable, easy to use and maintain; and
- Defining how business continuity considerations must be integrated into ongoing business planning and system development processes in order that the plan remains viable over time.

(b) A good coded application and program should have the following characteristics:

- **Reliability:** It refers to the consistency with which a program operates over a period of time. However, poor setting of parameters and hard coding of some data subsequently could result in the failure of a program after some time.
- **Robustness:** It refers to the applications' strength to uphold its operations in adverse situations by taking into account all possible inputs and outputs of a program in case of least likely situations.

- **Accuracy:** It refers not only to 'what program is supposed to do', but should also take care of 'what it should not do'. The second part becomes more challenging for quality control personnel and auditors.

- **Efficiency:** It refers to the performance per unit cost with respect to relevant parameters and it should not be unduly affected with the increase in input values.

- **Usability:** It refers to a user-friendly interface and easy-to-understand internal/external documentation.

- **Readability:** It refers to the ease of maintenance of program even in the absence of the program developer.

(c) The core goals of Cloud Computing are to pool available resources together into a highly efficient infrastructure whose costs are aligned with what resources are actually used but to the services accessible and available from anywhere at any time. However, the infrastructure can be quickly and easily scaled as an organization's business requirements evolve. To meet the requirements, some of the pertinent objectives in order to achieve the goals are as follows:

- To create a highly efficient IT ecosystem, where resources are pooled together and costs are aligned with what resources are actually used;

- To access services and data from anywhere at any time;

- To scale the IT ecosystem quickly, easily and cost-effectively based on the evolving business needs;

- To consolidate IT infrastructure into a more integrated and manageable environment;

- To reduce costs related to IT energy/power consumption;

- To enable or improve "Anywhere Access" (AA) for ever increasing users; and

- To enable rapidly provision resources as needed.

4. (a) Various Output Controls are given as follows:

- **Storage and logging of sensitive, critical forms:** Pre-printed stationery should be stored securely to prevent unauthorized destruction or removal and usage. Only authorized persons should be allowed access to stationery supplies such as security forms, negotiable instruments, etc.

- **Logging of output program executions:** When programs used for output of data are executed, these should be logged and monitored; otherwise confidentiality/integrity of the data may be compromised.

- **Spooling/queuing:** "Spool" is an acronym for "Simultaneous Peripherals Operations Online". This is a process used to ensure that the user is able to continue working, while the print operation is getting completed. When a file is to be printed, the operating system stores the data stream to be sent to the printer in a temporary file on the hard disk. This file is then "spooled" to the printer as soon as the printer is ready to accept the data. This intermediate storage of output could lead to unauthorized disclosure and/or modification. A queue is the list of documents waiting to be printed on a particular printer; this should not be subject to unauthorized modifications.

- **Controls over printing:** Outputs should be made on the correct printer and it should be ensured that unauthorized disclosure of information printed does not take place. Users must be trained to select the correct printer and access restrictions may be placed on the workstations that can be used for printing.
- **Report distribution and collection controls:** Distribution of reports should be made in a secure way to prevent unauthorized disclosure of data. It should be made immediately after printing to ensure that the time gap between generation and distribution is reduced. A log should be maintained for reports that were generated and to whom these were distributed. Uncollected reports should be stored securely.
- **Retention controls:** Retention controls consider the duration for which outputs should be retained before being destroyed. Retention control requires that a date should be determined for each output item produced. Various factors ranging from the need of the output, use of the output, to legislative requirements would affect the retention period.

(b) The key governance practices of Governance of Enterprise IT (GEIT) area as follows:

- **Evaluate the Governance System:** Continually identify and engage with the enterprise's stakeholders, document an understanding of the requirements, and make judgment on the current and future design of governance of enterprise IT;
- **Direct the Governance System:** Inform leadership and obtain their support, buy-in and commitment. Guide the structures, processes and practices for the governance of IT in line with agreed governance design principles, decision-making models and authority levels. Define the information required for informed decision making; and
- **Monitor the Governance System:** Monitor the effectiveness and performance of the enterprise's governance of IT. Assess whether the governance system and implemented mechanisms (including structures, principles and processes) are operating effectively and provide appropriate oversight of IT.

(c) **Detective Controls:** These controls are designed to detect errors, omissions or malicious acts that occur and report the occurrence. An example of a detective control would be a use of automatic expenditure profiling where management gets regular reports of spend to date against profiled spend. The main characteristics of such controls are given as follows:

- Clear understanding of lawful activities so that anything which deviates from these is reported as unlawful, malicious, etc;
- An established mechanism to refer the reported unlawful activities to the appropriate person or group;
- Interaction with the preventive control to prevent such acts from occurring; and
- Surprise checks by supervisor.

Examples of detective controls include Hash totals, Check points in production jobs, Echo control in telecommunications, Error message over tape labels, Duplicate checking of calculations, Periodic performance reporting with variances, Past-due accounts report, The internal audit functions, Intrusion detection system, Cash counts and bank reconciliation, and Monitoring expenditures against budgeted amount.

5. (a) COBIT 5 is a globally recognized framework that acts as a benchmark for reviewing and implementing governance and management of enterprise IT. It explains how it can be used as an effective tool to help enterprises to simplify complex issues, deliver trust and value, manage risk, reduce potential public embarrassment, protect intellectual property and maximize opportunities.

COBIT 5 provides key management practices for ensuring compliance with external compliances as relevant to the enterprise. The practices are given as follows:

- **Identify External Compliance Requirements:** On a continuous basis, identify and monitor for changes in local and international laws, regulations, and other external requirements that must be complied with from an IT perspective.
- **Optimize Response to External Requirements:** Review and adjust policies, principles, standards, procedures and methodologies to ensure that legal, regulatory and contractual requirements are addressed and communicated. Consider industry standards, codes of good practice, and best practice guidance for adoption and adaptation.
- **Confirm External Compliance:** Confirm compliance of policies, principles, standards, procedures and methodologies with legal, regulatory and contractual requirements.
- **Obtain Assurance of External Compliance:** Obtain and report assurance of compliance and adherence with policies, principles, standards, procedures and methodologies. Confirm that corrective actions to address compliance gaps are closed in a timely manner.

(b) Basic features of Transaction Processing System (TPS) are given as follows:

- **Large volume of data -** As TPS is transaction oriented and generally consists of large volumes of data, it requires greater storage capacity. Their primary objective is to ensure that the data regarding the economic events in the enterprises are captured quickly and correctly.

- **Automation of basic operations -** Any TPS aims at automating the basic operations of a business enterprise and plays a critical role in the day-to-day functioning of the enterprise. Any failure in the TPS for a short period of time can play havoc with the functioning of the enterprise. Thus, TPS is an important source of up-to-date information regarding the operations in the enterprise.

- **Benefits are easily measurable -** TPS reduces the workload of the people associated with the operations and improves their efficiency by automating some of the operations. Most of these benefits of the TPS are tangible and easily measurable. Therefore, cost benefit analysis regarding the desirability of TPS is easy to conduct. As the benefits from TPS are mainly tangible, the user acceptance is easy to obtain.

- **Source of input for other systems -** TPS is the basic source of internal information for other information systems. Heavy reliance by other information systems on TPS for this purpose makes TPS important for tactical and strategic decisions as well.

(c) Major advantages of continuous audit techniques are given as follows:

- **Timely, Comprehensive and Detailed Auditing –** Evidence would be available more timely and in a comprehensive manner. The entire processing can be evaluated and analyzed rather than examining the inputs and the outputs only.

- **Surprise test capability –** As evidences are collected from the system itself by using continuous audit techniques, auditors can gather evidence without the systems staff and application system users being aware that evidence is being collected at that particular moment. This brings in the surprise test advantages.

- **Information to system staff on meeting of objectives –** Continuous audit techniques provides information to systems staff regarding the test vehicle to be used in evaluating whether an application system meets the objectives of asset safeguarding, data integrity, effectiveness, and efficiency.

- **Training for new users –** Using the ITFs, new users can submit data to the application system, and obtain feedback on any mistakes they make via the system's error reports.

6. (a) Various types of back-ups are as follows:

- **Full Backup:** A full backup captures all files on the disk or within the folder selected for backup. With a full backup system, every backup generation contains every file in the backup set. However, the amount of time and space such a backup takes prevents it from being a realistic proposition for backing up a large amount of data.

- **Incremental Backup:** An incremental backup captures files that were created or changed since the last backup, regardless of backup type. This is the most economical method, as only the files that changed since the last backup are backed up. This saves a lot of backup time and space. Normally, incremental backup are very difficult to restore. One will have to start with recovering the last full backup, and then recovering from every incremental backup taken since.

- **Differential Backup:** A differential backup stores files that have changed since the last full backup. Therefore, if a file is changed after the previous full backup, a differential backup takes less time to complete than a full back up. Comparing with full backup, differential backup is obviously faster and more economical in using the backup space, as only the files that have changed since the last full backup are saved.

  Restoring from a differential backup is a two-step operation: Restoring from the last full backup; and then restoring the appropriate differential backup. The downside to using differential backup is that each differential backup probably includes files that were already included in earlier differential backups.

- **Mirror back-up:** A mirror backup is identical to a full backup, with the exception that the files are not compressed in zip files and they cannot be protected with a password. A mirror backup is most frequently used to create an exact copy of the backup data.

(b) IS Audits has been categorized into five types:

(i) **Systems and Application:** An audit to verify that systems and applications are appropriate, are efficient, and are adequately controlled to ensure valid, reliable, timely, and secure input, processing, and output at all levels of a system's activity.

(ii) **Information Processing Facilities:** An audit to verify that the processing facility is controlled to ensure timely, accurate, and efficient processing of applications under normal and potentially disruptive conditions.

(iii) **Systems Development:** An audit to verify that the systems under development meet the objectives of the organization and to ensure that the systems are developed in accordance with generally accepted standards for systems development.

(iv) **Management of IT and Enterprise Architecture:** An audit to verify that IT management has developed an organizational structure and procedures to ensure a controlled and efficient environment for information processing.

(v) **Telecommunications, Intranets, and Extranets:** An audit to verify that controls are in place on the client (end point device), server, and on the network connecting the clients and servers.

(c) Different Information Systems that serve different organizational levels are given as follows:

(i) **Operational Level Systems-** This supports operational managers by keeping track of the elementary activities and transactions of the enterprises e.g. sales, payroll, receipts etc. These are primarily needed to answer routine questions and keep track of flow of transactions though the enterprises.

(ii) **Knowledge Level Systems-** This type of system support the business to integrate new knowledge into the business and control the flow of paperwork. It helps the organization's knowledge and data workers and is especially in the form of workstations. It is the fastest growing application in business today.

(iii) **Management Level Systems-** It supports the middle managers in monitoring, decision making and administrative activities. It provides periodic reports rather than instant information on operations. For example- a college control system gives report on the number of leaves availed by the staff, salary paid to the staff, funds generated by the fees, finance planning etc.

(iv) **Strategic Level Systems-**It supports the senior level management to tackle and address strategic issues and long term trends, both inside organization and the outside world. It answers questions like what products should be launched to increase the profit and capture the market. It helps in long term planning.

7. (a) Key Management Practices for implementing Risk Management are given as follows:

- **Collect Data:** Identify and collect relevant data to enable effective IT related risk identification, analysis and reporting.
- **Analyze Risk:** Develop useful information to support risk decisions that take into account the business relevance of risk factors.
- **Maintain a Risk Profile:** Maintain an inventory of known risks and risk attributes, including expected frequency, potential impact, and responses, and of related resources, capabilities, and current control activities.
- **Articulate Risk:** Provide information on the current state of IT- related exposures and opportunities in a timely manner to all required stakeholders for appropriate response.
- **Define a Risk Management Action Portfolio:** Manage opportunities and reduce risk to an acceptable level as a portfolio.
- **Respond to Risk:** Respond in a timely manner with effective measures to limit the magnitude of loss from IT related events.

(b) Internal controls comprise of the following five interrelated components which are as under:

- **Control Environment:** Elements that establish the control context in which specific accounting systems and control procedures must operate. The control environment is manifested in management's operating style, the ways authority and responsibility are assigned, the functional method of the audit committee, the methods used to plan and monitor performance and so on.

- **Risk Assessment***:* Elements that identify and analyze the risks faced by an organization and the way the risk can be managed. Both external and internal auditors are concerned with errors or irregularities that cause material losses to an organization.

- **Control Activities:** Elements that operate to ensure transactions are authorized, duties are segregated, adequate documents and records are maintained, assets and records are safeguarded, and independent checks on performance and valuation of records.

- **Information and Communication:** Elements, in which information is identified, captured and exchanged in a timely and appropriate form to allow personnel to discharge their responsibilities.

- **Monitoring:** Elements that ensure internal controls operate reliably over time.

(c) Four phases of Information Security Management Systems (ISMS) are given as follows:

- **The Plan Phase –** This phase serves to plan the basic organization of information security, set objectives for information security and choose the appropriate security controls (the standard contains a catalogue of 133 possible controls).

- **The Do Phase –** This phase includes carrying out everything that was planned during the previous phase.

- **The Check Phase –** The purpose of this phase is to monitor the functioning of the ISMS through various "channels", and check whether the results meet the set objectives.

- **The Act Phase –** The purpose of this phase is to improve everything that was identified as non-compliant in the previous phase.

(d) **Mobile Computing Benefits:** In general, the mobile computing is a versatile and strategic technology that increases information quality and accessibility, enhances operational efficiency, and improves management effectiveness. But, more specifically, it leads to a range of tangible benefits that include the following:

- It provides mobile workforce with remote access to work order details, such as work order location, contact information, required completion date, asset history relevant warranties/ service contracts.

- It enables mobile sales personnel to update work order status in real-time, facilitating excellent communication.
- It facilitates access to corporate services and information at any time, from anywhere.
- It provides remote access to the corporate Knowledge base at the job location.
- It enables to improve management effectiveness by enhancing information quality, information flow, and ability to control a mobile workforce.

(e) **Weaknesses of the Agile Model:** Some of the weaknesses identified by the experts and practitioners include the following:

- In case of some software deliverables, especially the large ones, it is difficult to assess the efforts required at the beginning of the software development life cycle.
- There is lack of emphasis on necessary designing and documentation.
- Agile increases potential threats to business continuity and knowledge transfer. By nature, Agile projects are extremely light on documentation because the team focuses on verbal communication with the customer rather than on documents or manuals.
- Agile requires more re-work and due to the lack of long-term planning and the lightweight approach to architecture, re-work is often required on Agile projects when the various components of the software are combined and forced to interact.
- The project can easily be taken off track if the customer representative is not clear about the final outcome.
- Agile lacks the attention to outside integration.

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – II

PAPER – 6: INFORMATION SYSTEMS CONTROL & AUDIT

Question No. 1 is compulsory.

*Attempt any **five** questions from the remaining **six** Questions.*

Time Allowed – 3 Hours Maximum Marks – 100

1. (a) ASK International proposes to launch a new subsidiary to provide e-consultancy services for organizations throughout the world, to assist them in system development, strategic planning and e-governance areas. The fundamental guidelines, programme modules and draft agreements are all preserved and administered in e-form only.

The company intends to utilize the services of a professional analyst to conduct a preliminary investigation and present a report on smooth implementation of the ideas of the new subsidiary. Based on the report submitted by the analyst, the company decides to proceed further with three specific objectives - reduce operational risk, increase business efficiency and ensure that information security is being rationally applied. The company has been advised to adopt ISO 27001 for achieving the same.

(i) What are the two primary methods through which the analyst would have collected the data ? *(8 Marks)*

(ii) To retain their e-documents for specified period, what are the conditions laid down in Section 7, Chapter III of Information Technology Act, 2000? *(4 Marks)*

(b) What do you understand by Financial Controls? Explain major financial control techniques in brief. *(8 Marks)*

2. (a) What do mean by Expert Systems? What are the need and benefits of Expert systems? *(6 Marks)*

(b) Discuss major tasks performed by Operating System? *(6 Marks)*

(c) Discuss various dimensions under which the phase 'Feasibility Study' of SDLC is evaluated. *(4 Marks)*

3. (a) What are the objectives and goals of Business Continuity Planning(BCP)? *(6 Marks)*

(b) Differentiate between Black Box Testing and White Box Testing. *(6 Marks)*

(c) Discuss the advantages of Cloud Computing. *(4 Marks)*

4. (a) Discuss computer crime exposures in brief. *(6 Marks)*

   (b) Discuss in brief various steps involved in Information Systems Audit. *(6 Marks)*

   (c) What are Compensatory Controls? *(4 Marks)*

5. (a) Discuss the seven enablers of COBIT 5. *(6 Marks)*

   (b) Discuss characteristics of Decision Support System (DSS). *(6 Marks)*

   (c) What do you understand by the term "Corporate Governance"? *(4 Marks)*

6. (a) Discuss objectives and goals of Business Continuity Planning? *(6 Marks)*

   (b) Discuss the impact of Information Systems audit on organizations. *(6 Marks)*

   (c) Discuss Office Automation System. *(4 Marks)*

7. Write short notes on any **four** of the following:

   (a) Key governance practices for evaluating risk management.

   (b) Impact of technology on Internal Controls.

   (c) SA 402.

   (d) Platform as a Service in Cloud Computing.

   (e) Strength of Agile model. *(4 × 4 = 16 Marks)*

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – II

PAPER – 6: INFORMATION SYSTEMS CONTROL & AUDIT

SUGGESTED ANSWERS/HINTS

1. (a) (i) Two primary methods through which the analyst would have collected the data are given as follows:

- **Reviewing Internal Documents:** The analyst first tries to learn about the organization involved in or affected by the project. For example, the subsidiary's activities based on its business and operation plans. S/he will also examine proposed organization charts and functions of positions mentioned in it.
- **Conducting Interviews:** Written documents tell the analyst 'how the system should operate' but they may not include enough details to allow a decision to be made about the merits of a system proposal nor do they present users' views about current operations. To learn these details, analysts use interviews. Preliminary investigation interviews involve only management and supervisory personnel. The analyst may conduct interviews with persons who are scheduled to occupy various positions in the subsidiary.

(ii) Section 7, Chapter III of Information Technology Act, 2000 provides that the documents, records or information which is to be retained for any specified period shall be deemed to have been retained if the same is retained in the electronic form provided the following conditions are satisfied:

(1) Where any law provides that documents, records or information shall be retained for any specific period, then, that requirement shall be deemed to have been satisfied if such documents, records or information are retained in the electronic form, –

(a) the information contained therein remains accessible so as to be usable for a subsequent reference;

(b) the electronic record is retained in the format in which it was originally generated, sent or received or in a format, which can be demonstrated to represent accurately the information originally generated, sent or received;

(c) The details, which will facilitate the identification of the origin, destination, date and time of dispatch or receipt of such electronic record are available in the electronic record.

E.g. Company may include clause in its contracts with customers that electronic documents and correspondence will be considered valid; Electronic documents will have to be preserved till the contract and all liabilities are discharged; Documents may be digitally signed with hash values to assure that they have not been altered; All correspondence with clients may be saved with dates of transmission / receipt; In case the company changes / upgrades its email or other systems, the new system should be able to read the old data and retain all data without change etc.

(b) **Financial Controls:** These controls are generally defined as the procedures exercised by the system user personnel over source, or transactions origination, documents before system input. These areas exercise control over transactions processing using reports generated by the computer applications to reflect un-posted items, non-monetary changes, item counts and amounts of transactions for settlement of transactions processed and reconciliation of the applications (subsystem) to general ledger.

Major financial control techniques are given as follows:

- **Authorization:** This entails obtaining the authority to perform some act typically accessing such assets as accounting or application entries.
- **Budgets:** These are estimates of the amount of time or money expected to be spent during a particular period, project, or event. The budget alone is not an effective control. Budgets must be compared with the actual performance, including isolating differences and researching them for a cause and possible resolution.
- **Cancellation of documents:** This marks a document in such a way to prevent its reuse. This is a typical control over invoices marking them with a “paid” or “processed” stamp or punching a hole in the document.
- **Documentation:** This includes written or typed explanations of actions taken on specific transactions; it also refers to written or typed instructions, which explain the performance of tasks.
- **Dual control:** This entails having two people simultaneously access an asset. For example, the depositories of banks’ 24-hour teller machines should be accessed and emptied with two people present, many people confuse dual control with dual access, but these are distinct and different. Dual access divides the access function between two people: once access is achieved, only one person handles the asset. With teller-machines, for example, two tellers would open the depository vault door together, but only one would retrieve the deposit envelopes.

- **Input/output verification:** This entails comparing the information provided by a computer system with the input documents. This is an expensive control that tends to be over recommended by auditors.
- **Safekeeping:** This entails physically securing assets, such as computer disks, under lock and key, in a desk drawer, file cabinet storeroom, or vault.
- **Sequentially numbered documents:** These are working documents with preprinted sequential numbers, which enables the detection of missing documents.
- **Supervisory review:** This refers to review of specific work by a supervisor but this control requires a sign-off on the documents by the supervisor, in order to provide evidence that the supervisor at least handled them. This is an extremely difficult control to test after the fact because the auditor cannot judge the quality of the review unless he or she witnesses it, and, even then, the auditor cannot attest to what the supervisor did when the auditor was not watching.

2. (a) **Expert System -** An Expert System is highly developed DSS that utilizes knowledge generally possessed by an expert to share a problem. Expert Systems are software systems that imitate the reasoning processes of human experts and provide decision makers with the type of advice they would normally receive from such expert systems.

Need for Expert Systems – Major reasons for the need of Expert Systems is given as follows:

- Expert labor is expensive and scarce. Knowledge workers employee, who routinely work with data and information to carry out their day-to-day duties are not easy to find and keep and companies are often faced with a shortage of talent in key positions.
- Moreover, no matter how bright or knowledgeable certain people are, they often can handle only a few factors at a time.
- Both these limitations imposed by human information processing capability and the rushed pace at which business is conducted today put a practical limit on the quality of human decision making this putting a need for expert systems.

Benefits of Expert Systems – The key benefit of Expert Systems are given as follows:

- Expert Systems preserve knowledge that might be lost through retirement, resignation or death of an acknowledged company expert.
- Expert Systems put information into an active-form so it can be summoned almost as a real-life expert might be summoned.
- Expert Systems assist novices in thinking the way experienced professional do.

- Expert Systems are not subjected to such human fallings as fatigue, being too busy, or being emotional.
- Expert Systems can be effectively used as a strategic tool in the areas of marketing products, cutting costs and improving products.

(b) Operating system performs the following major tasks:

- **Scheduling Jobs:** They can determine the sequence in which jobs are executed, using priorities established.
- **Managing Hardware and Software Resources:** They can first cause the user's application program to be executed by loading it into primary storage and then cause the various hardware units to perform as specified by the application.
- **Maintaining System Security:** They may require users to enter a password - a group of characters that identifies users as being authorized to have access to the system.
- **Enabling Multiple User Resource Sharing:** They can handle the scheduling and execution of the application programs for many users at the same time, a feature called multiprogramming.
- **Handling Interrupts:** An interrupt is a technique used by the operating system to temporarily suspend the processing of one program in order to allow another program to be executed. Interrupts are issued when a program requests an operation that does not require the CPU, such as input or output, or when the program exceeds some predetermined time limit.
- **Maintaining Usage Records:** They can keep track of the amount of time used by each user for each system unit - the CPU, secondary storage, and input and output devices. Such information is usually maintained for the purpose of charging users' departments for their use of the organization's computing resources.

(c) **Feasibility Study:** After possible solution options are identified, project feasibility i.e. the likelihood that these systems will be useful for the organization is determined. A feasibility study is carried out by the system analysts, which refers to a process of evaluating alternative systems through cost/benefit analysis so that the most feasible and desirable system can be selected for development. The Feasibility Study of a system is evaluated under following dimensions described briefly as follows:

- **Technical:** Is the technology needed available?
- **Financial:** Is the solution viable financially?
- **Economic:** Return on Investment?
- **Schedule/Time:** Can the system be delivered on time?

- **Resources:** Are human resources reluctant for the solution?
- **Operational:** How will the solution work?
- **Behavioral:** Is the solution going to bring any adverse effect on quality of work life?
- **Legal:** Is the solution valid in legal terms?

3. (a) The primary objective of a Business Continuity Plan (BCP) is to minimize loss by minimizing the cost associated with disruptions and enable an organization to survive a disaster and to reestablish normal business operations. The key objectives of the contingency plan should be to:

- Provide the safety and well-being of people on the premises at the time of disaster;
- Continue critical business operations;
- Minimize the duration of a serious disruption to operations and resources (both information processing and other resources);
- Minimize immediate damage and losses;
- Establish management succession and emergency powers;
- Facilitate effective co-ordination of recovery tasks;
- Reduce the complexity of the recovery effort; and
- Identify critical lines of business and supporting functions.

Therefore, the goals of the business continuity plan should be to:

- Identify weaknesses and implement a disaster prevention program;
- minimize the duration of a serious disruption to business operations;
- facilitate effective co-ordination of recovery tasks; and
- reduce the complexity of the recovery effort.

(b) **Black Box Testing:** Black Box Testing takes an external perspective of the test object, to derive test cases. These tests can be functional or non- functional, though usually functional. The test designer selects typical inputs including simple, knowledge of the test object's internal structure. This method of test design is applicable to all levels of software testing i.e. unit, integration, functional testing, system and acceptance. The higher the level, hence the bigger and more complex the box, the more one is forced to use black box testing to simplify. While this method can uncover unimplemented parts of the specification, one cannot be sure that all existent paths are tested. If a module performs a function, which is not supposed to, the black box test does not identify it.

White Box Testing: It uses an internal perspective of the system to design test cases based on internal structure. It requires programming skills to identify all paths through the software. The tester chooses test case inputs to exercise paths through the code and determines the appropriate outputs. Since the tests are based on the actual implementation, if the implementation changes, the tests probably will need to change, too. It is applicable at the unit, integration and system levels of the testing process; it is typically applied to the unit. While it normally tests paths within a unit, it can also test paths between units during integration, and between subsystems during a system level test. After obtaining a clear picture of the internal workings of a product, tests can be conducted to ensure that the internal operation of the product conforms to specifications and all the internal components are adequately exercised.

(c) Major advantages of Cloud Computing are given as follows:

- Cost Efficiency: Cloud computing is probably the most cost efficient method to use, maintain and upgrade. Traditional desktop software costs companies a lot in terms of finance. Adding up the licensing fees for multiple users can prove to be very expensive for the establishment concerned. The cloud, on the other hand, is available at much cheaper rates and hence, can significantly lower the company's IT expenses. Besides, there are many one-time-payments, pay-as-you-go and other scalable options available, which make it very reasonable for the company.

- Almost Unlimited Storage: Storing information in the cloud gives us almost unlimited storage capacity. Hence, one no more need to worry about running out of storage space or increasing the current storage space availability.

- Backup and Recovery: Since all the data is stored in the cloud, backing it up and restoring the same is relatively much easier than storing the same on a physical device. Furthermore, most cloud service providers are usually competent enough to handle recovery of information. Hence, this makes the entire process of backup and recovery much simpler than other traditional methods of data storage.

- Automatic Software Integration: In the cloud, software integration is usually something that occurs automatically. This means that we do not need to take additional efforts to customize and integrate the applications as per our preferences. This aspect usually takes care of itself. Not only that, cloud computing allows us to customize the options with great ease. Hence, one can handpick just those services and software applications that s/he thinks will best suit his/her particular enterprise.

- Easy Access to Information: Once registered in the cloud, one can access the information from anywhere, where there is an Internet connection. This convenient feature lets one move beyond time zone and geographic location issues.

- Quick Deployment: Lastly and most importantly, cloud computing gives us the advantage of quick deployment. Once we opt for this method of functioning, the entire system can be fully functional in a matter of a few minutes. Of course, the amount of time taken here will depend on the exact kind of technology that we need for your business.

4. (a) **Computer Crime Exposures**: Computers can be utilized both constructively and destructively. Computer systems are used to steal money, goods, software or corporate information. Crimes are also committed when false data or unauthorized transaction is made. Crimes are committed by using computers and can damage the reputation, morale and even the existence of an organization. Computer crimes generally result in Loss of customers, embarrassment to management and legal actions against the organizations.

These are given as follows:

(i) **Financial Loss:** Financial losses may be direct like loss of electronic funds or indirect like expenditure towards repair of damaged electronic components.

(ii) **Legal Repercussions:** An organization has to adhere to many laws while developing security policies and procedures. These laws protect both the perpetrator and organization from trial. The organizations will be exposed to lawsuits from investors and insurers if there have no proper security measures. The IS auditor should take legal counsel while reviewing the issues associated with computer security.

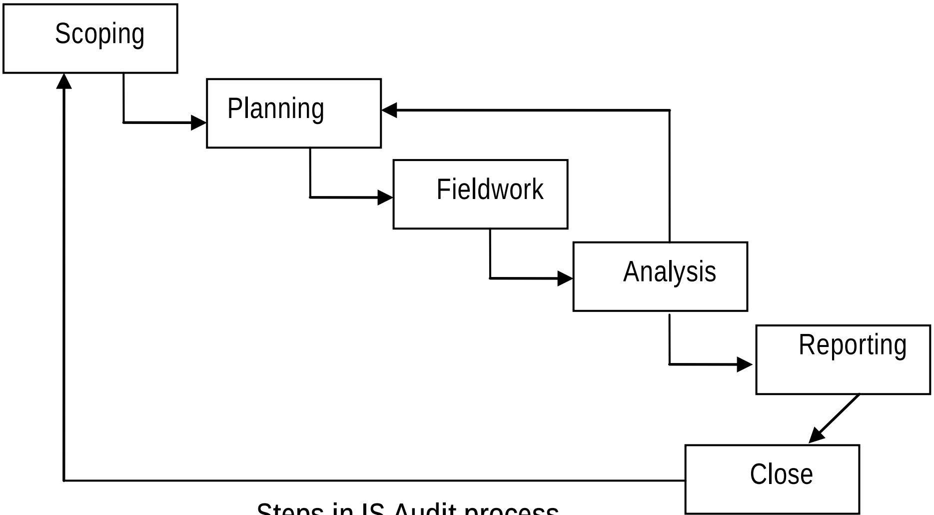
(iii) **Loss of Credibility or Competitive Edge:** In order to maintain competitive edge, many companies, especially service firms such as banks and investment firms, needs credibility and public trust. This credibility will be shattered resulting in loss of business and prestige if security violation occurs.

(iv) **Blackmail/Industrial Espionage:** By knowing the confidential information, the perpetrator can obtain money from the organization by threatening and exploiting the security violation.

(v) **Disclosure of Confidential, Sensitive or Embarrassing Information:** These events can spoil the reputation of the organization. Legal or regulatory actions against the company may be also a result of disclosure.

(vi) **Sabotage:** People, who may not be interested in financial gain but who want to spoil the credibility of the company or to will involve in such activities. They do it because of their dislike towards the organization or for their intemperance.

(b) Steps in Information System Audit are depicted in the figure.



Steps in IS Audit process

(i) **Scoping and pre-audit survey:** Auditors determine the main area/s of focus and any areas that are explicitly out-of-scope, based on the scope-definitions agreed with management. Information sources at this stage include background reading and web browsing, previous audit reports, pre audit interview, observations and, sometimes, subjective impressions that simply deserve further investigation.

(ii) **Planning and preparation:** During which the scope is broken down into greater levels of detail, usually involving the generation of an audit work plan or risk-control-matrix.

(iii) **Fieldwork:** Gathering evidence by interviewing staff and managers, reviewing documents, and observing processes etc.

(iv) **Analysis:** This step involves desperately sorting out, reviewing and trying to make sense of all that evidence gathered earlier. SWOT (Strengths, Weaknesses, Opportunities, Threats) or PEST (Political, Economic, Social, Technological) techniques can be used for analysis.

(v) **Reporting:** Reporting to the management is done after analysis of evidence gathered and analyzed

(vi) **Closure:** Closure involves preparing notes for future audits and follow up with management to complete the actions they promised after previous audits.

(c) **Compensatory Controls:** Controls are basically designed to reduce the probability of threats, which can exploit the vulnerabilities of an asset and cause a loss to that asset. While designing the appropriate control one thing should be kept in mind—*the cost of the lock should not be more than the cost of the assets it protects*.

Sometimes, while designing and implementing controls, organizations because of different constraints like financial, administrative or operational, may not be able to implement appropriate controls. In such a scenario, there should be adequate compensatory measures, which may although not be as efficient as the appropriate control, but reduce the probability of loss to the assets. Such measures are called compensatory controls.

5. (a) Enablers are factors that, individually and collectively, influence whether something will work; in this case, governance and management over enterprise IT. Enablers are driven by the goals cascade, i.e., higher-level IT related goals defining 'what the different enablers should achieve'. The COBIT 5 framework describes seven categories of enablers, which are discussed as follows:

- **Principles, Policies and Frameworks** are the vehicle to translate the desired behaviour into practical guidance for day-to-day management.
- **Processes** describe an organized set of practices and activities to achieve certain objectives and produce a set of outputs in support of achieving overall IT-related goals.
- **Organizational structures** are the key decision-making entities in an enterprise.
- **Culture, Ethics and Behaviour** of individuals and of the enterprise are very often underestimated as a success factor in governance and management activities.
- **Information** is pervasive throughout any organization and includes all information produced and used by the enterprise. Information is required for keeping the organization running and well governed, but at the operational level, information is very often the key product of the enterprise itself.
- **Services, Infrastructure and Applications** include the infrastructure, technology and applications that provide the enterprise with information technology processing and services.
- **People, Skills and Competencies** are linked to people and are required for successful completion of all activities and for making correct decisions and taking corrective actions.

(b) **Characteristics of DSS –** The key characteristics of DSS are given as follows:

- This supports decision making and occurs at all levels of management.
- Instead of helping individuals working on independent tasks, it should be able to help group making decisions.
- It should be flexible and adaptable. i.e. it should be able to fit itself in the style of a particular manager and ready to change according to changes in the environment.

- DSS focuses on decision rather than data and information.
- It should be easy to use. A user should not have knowledge of computer programming to generate reports that helps in decision making.
- DSS can be used for structured problems.
- DSS should be user-friendly.
- DSS should be extensible and evolve overtime.
- DSSs are used mainly for decision making rather than communicating decisions and training purposes.
- The impact of DSS should be on decision where the manager's judgment is essential and there is sufficient structure for computers.

(c) **Corporate Governance:** Corporate governance is defined as the system by which a company or enterprise is directed and controlled to achieve the objective of increasing shareholder value by enhancing economic performance. Corporate governance refers to the structures and processes for the direction and control of companies. Corporate governance concerns the relationships among the management, Board of Directors, the controlling shareholders and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital. It is about doing good business to protect shareholders' interest.

6. (a) The primary objective of a business continuity plan is to minimize loss by minimizing the cost associated with disruptions and enable an organization to survive a disaster and to reestablish normal business operations. In order to survive, the organization must assure that critical operations can resume normal processing within a reasonable time frame. The key objectives of the contingency plan should be to:

- Provide the safety and well-being of people on the premises at the time of disaster;
- Continue critical business operations;
- Minimize the duration of a serious disruption to operations and resources (both information processing and other resources);
- Minimize immediate damage and losses;
- Establish management succession and emergency powers;
- Facilitate effective co-ordination of recovery tasks;
- Reduce the complexity of the recovery effort; and
- Identify critical lines of business and supporting functions.

Therefore, the goals of the business continuity plan should be to:

- Identify weaknesses and implement a disaster prevention program;
- minimize the duration of a serious disruption to business operations;
- facilitate effective co-ordination of recovery tasks; and
- reduce the complexity of the recovery effort.

(b) Impact of Information Systems audit on oorganizations are as below:

- Organisational Costs of Data Loss: Data is a critical resource of an organisation for its present and future process and its ability to adapt and survive in a changing environment.
- Incorrect Decision Making: Management and operational controls taken by managers involve detection, investigations and correction of the processes. These high level decisions require accurate data to make quality decision rules.
- Costs of Computer Abuse: Unauthorised access to computer systems, malwares, unauthorised physical access to computer facilities and unauthorised copies of sensitive data can lead to destruction of assets (hardware, software, data, information etc.)
- *V*alue of Computer Hardware, Software and Personnel: These are critical resources of an organisation, which has a credible impact on its infrastructure and business competitiveness.
- High Costs of Computer Error: In a computerised enterprise environment where many critical business processes are performed, a data error during entry or process would cause great damage.
- Maintenance of Privacy: Today, data collected in a business process contains private information about an individual too. These data were also collected before computers but now, there is a fear that privacy has eroded beyond acceptable levels.
- Controlled evolution of computer Use: Use of Technology and reliability of complex computer systems cannot be guaranteed and the consequences of using unreliable systems can be destructive.
- Information Systems Auditing: It is the process of attesting objectives (those of the external auditor) that focus on asset safeguarding and data integrity, and management objectives (those of the internal auditor) that include effectiveness and efficiency both.

- **Asset Safeguarding Objectives:** The information system assets (hardware, software, data information etc.) must be protected by a system of internal controls from unauthorised access.
- **Data Integrity Objectives:** It is a fundamental attribute of IS Auditing. The importance to maintain integrity of data of an organisation requires all the time. It is also important from the business perspective of the decision maker, competition and the market environment.
- **System Effectiveness Objectives:** Effectiveness of a system is evaluated by auditing the characteristics and objective of the system to meet business and user requirements.
- **System Efficiency Objectives:** To optimize the use of various information system resources (machine time, peripherals, system software and labour) along with the impact on its computing environment.

(c) **Office Automation Systems (OAS) –** It is most rapidly expanding computer based information systems. Different office activities can be broadly grouped into the following types of operations:

- **Document Capture –** Documents originating from outside sources like incoming mails, notes, handouts, charts, graphs etc. need to be preserved.
- **Document Creation –** This consists of preparation of documents, dictation, editing of texts etc. and takes up major part of the secretary's time.
- **Receipts and Distribution –** This basically includes distribution of correspondence to designated recipients.
- **Filling, Search, Retrieval and Follow up –** This is related to filling, indexing, searching of documents, which takes up significant time.
- **Calculations –** These include the usual calculator functions like routine arithmetic, operations for bill passing, interest calculations, working out the percentages and the like.
- **Recording Utilization of Resources –** This includes, where necessary, record keeping in respect to specific resources utilized by office personnel.

  All the activities mentioned have been made very simple, efficient and effective by the use of computers. The application of computers to handle the office activities is also termed as office automation.

7. (a) The key governance practices for evaluating risk management are given as follows:

- **Evaluate Risk Management:** Continually examine and make judgment on the effect of risk on the current and future use of IT in the enterprise. Consider whether the enterprise's risk appetite is appropriate and that risks to enterprise value related to the use of IT are identified and managed;

- **Direct Risk Management:** Direct the establishment of risk management practices to provide reasonable assurance that IT risk management practices are appropriate to ensure that the actual IT risk does not exceed the board's risk appetite; and
- **Monitor Risk Management:** Monitor the key goals and metrics of the risk management processes and establish how deviations or problems will be identified, tracked and reported on for remediation.

(b) Impact of Technology on Internal Controls are as follows:

- *Personnel*: Personnel should have proper skill and knowledge to discharge their duties.
- *Segregation of duties*: Within an IT environment, the staff in the IT department of an enterprise will have a detailed knowledge of the interrelationship between the source of data, how it is processed and distribution and use of output. IT staff may also be in a position to alter transaction data or even the financial applications which process the transactions.
- *Authorization procedures*: In some on-line transaction systems, written evidence of individual data entry authorization, e.g. a supervisor's signature, may be replaced by computerized authorization controls such as automated controls written into the computer programs (e.g. programmed credit limit approvals)
- *Record keeping*: There are various controls over the protection and storage of documents, transaction details, and audit trails etc.
- *Access to assets and records*: A client's financial data and computer programs are vulnerable to unauthorized amendment in the computer or from remote locations. The use of wide area networks, including the Internet, has increased the risk of unauthorized access.
- *Management supervision and review*: Management's supervision and review helps to deter and detect both errors and fraud.
- *Concentration of programs and data*: Transaction and master file data (e.g. pay rates, approved suppliers lists etc.) may be stored in a computer readable form on one computer installation or on a number of distributed installations. Therefore, in the absence of appropriate controls over these programs and utilities, there is an increased risk of unauthorized access and alteration of financial data.

(c) SA402: Audit Considerations Relating to an Entity using Service Organization, SA 402 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 24, "Audit Considerations Relating to Entities Using Service Organizations" issued by the ICAI in 2002. The revised Standard deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organizations. SA 402 also deals with the aspects like obtaining an understanding of the services provided by a service organization, including internal control, responding to the assessed risks of material misstatement, Type 1 and Type 2 reports, fraud, non-compliance with laws and regulations and uncorrected misstatements in relation to activities at the service organization and reporting by the user auditor. This SA is effective for audits of financial statements w.e.f. April 1, 2010.

(d) **Platform as a Service (PaaS):** in Cloud Computing Cloud providers deliver a computing platform including operating system, programming language execution environment, database, and web server. Application developers can develop and run their software solutions on a cloud platform without the cost and complexity of acquiring and managing the underlying hardware /software layers. In PaaS, one can make applications and software's on other's database. Thus, it gives us the platform to create, edit, run and manage the application programs we want. All the development tools are provided. Some of examples of PaaS include: AWS Elastic Beanstalk, Cloud Foundry, Heroku, Force.com, EngineYard etc.

(e) **Strength of Agile Model:** Some of the strengths identified by the experts and practitioners include the following:

- Agile methodology has the concept of an adaptive team, which enables to respond to the changing requirements.
- The team does not have to invest time and efforts and finally find that by the time they delivered the product, the requirement of the customer has changed.
- Face to face communication and continuous inputs from customer representative leaves a little space for guesswork.
- The documentation is crisp and to the point to save time.
- The end result is generally the high quality software in least possible time duration and satisfied customer.

MOCK TEST PAPER – 1

FINAL: GROUP – II

PAPER – 7: DIRECT TAX LAWS

Question 1 is compulsory

*Answer any **five** questions from the remaining **six** questions.*

Time Allowed – 3 Hours | Maximum Marks – 100

1. (a) The Net Profit of "Modern Tiles Ltd." for the year ended 31.3.2014 is Rs. 75 lacs after debit of the following:

(i)	Amount of Rs. 2,20,000 contributed to Employees Welfare Trust.
(ii)	Amount of Rs. 21,00,000 paid towards college fee and hostel expense for the MBA course of a close relative of a director.
(iii)	Amount of Rs. 4,25,000 incurred on installation of a traffic signal, so as to facilitate its employees coming to office to overcome traffic jam and save office time.
(iv)	Amount of Rs. 6,10,000 on the gift articles distributed to various dealers under sales incentive scheme.
(v)	Expenses of Rs. 8,50,000 incurred on the travelling of the wife of Managing Director, who accompanied him on a tour to UK on the invitation of Trade and Commerce Chamber, London.
(vi)	Amount of Rs. 4,00,000 paid on 31.5.2013 consequent upon change in currency rate due to exchange fluctuation in excess of the amount due to the suppliers of machinery.

Following further information are also provided by the company:

(i) Both the employees and employers contribution towards PF amounting to Rs. 3.5 lacs each for the month of March, 2014 were deposited on 1.7.2014.

(ii) Provision for audit fees of Rs.7.5 lacs made in the books for the year ended 31.03.2013 was paid to the auditors in September, 2013 after deducting tax under section 194J and the tax so deducted was remitted by 7.10.2013.

(iii) Lucky Transporter was paid in cash on 30.10.2013 by two vouchers No. 142 of Rs. 15,000 and No.155 of Rs. 12,000, towards lease charges for goods carriage.

(iv) TDS, out of payment of interest of Rs. 1.5 lac in February, 2013 and of Rs. 2.25 lacs in March, 2014, was remitted to the Government in July, 2014.

Compute the income chargeable to tax in A.Y. 2014-15 and work out the amount of tax payable on such income. Ignore MAT provisions. *(10 Marks)*

(b) A Cooperative Society formed for the purpose of construction of residential flats for its members acquired a large area of urban land for Rs. 2 crores. The society had a membership of 15 members, all having equal share. The Assessing Officer proposes to tax urban land in the hands of the society.

(i) What is meant by urban land?

(ii) Is the action of the Assessing Officer correct? *(5 Marks)*

(c) Fast Constructions Ltd. owns the following assets as on 31st March, 2014. State whether the assets are chargeable to wealth-tax, indicating reasons in brief.

(i) Three office flats at Delhi purchased in the financial year 2007-08 for resale.

(ii) Shares of group companies, break-up value of which is Rs. 8.50 lakhs.

(iii) Cash at construction site Rs. 3.50 lakhs, not recorded in the books of account.

(iv) Residential flat in occupation of company's whole time director drawing a salary of Rs. 12 lakhs per annum.

(v) Aircraft owned and used by a company for transportation of its goods. *(5 Marks)*

2. Shivani Ltd., engaged in the business of manufacturing, shows a net profit of Rs. 8 crores for the financial year ended 31-3-2014, after debiting/crediting the following items:

(i) On EPABX and mobile phones (exclusively used for the business purpose) purchased during the year, depreciation amounting to Rs. 24 lacs was claimed at higher rate of 60% treating them at par with computer.

(ii) Rs. 52 lacs paid to NatWest Ltd, towards feasibility study conducted for examining proposals for technological advancement relating to the existing business, where the project was abandoned without creating a new asset.

(iii) Rs. 48 lacs paid for the higher studies of the director's son abroad, with a stipulation that he would be appointed as a trainee in the company under "apprentice training scheme" where there is no evidence of existence of such scheme.

(iv) Payment of Rs. 32 lacs (without deducting tax at source) towards purchase of software from a non-resident, meant for subsequent resale in the Indian market, was ultimately sold at a profit during F.Y. 2013-14.

(v) Dividend of Rs. 13 lacs received from a foreign company in which this company holds 28% in nominal value of the equity share capital of the company. Rs. 0.45 lac expended on earning this income.

(vi) A machine in use since past 7 financial years having WDV amounting to Rs. 2.35 lacs on 01-04-2014 was discarded on 3rd September, 2012. The depreciation on the block at 15% has been provided and charged to profit and loss account for the previous year ended 31st March, 2014. The entire block is used for the purpose of business.

(vii) Rs. 63 lacs were paid on 3rd June, 2013 to a National Laboratory with a stipulation that the said contribution shall be used for the purpose of an approved scientific research programme only.

(viii) Secret commission of Rs. 19 lacs was paid and debited under commission account.

(ix) Purchased a brand new bus for Rs. 24 lacs and donated to a school where the employees' children were studying and debited the same to the Workmen and Staff Welfare Account.

Additional Information:

A debt of Rs. 12 lacs was claimed as bad debt in the previous year 2012-13. However, the Assessing Officer allowed only a sum of Rs. 6 lacs as bad debts. In the previous year 2013-14, a sum of Rs. 4 lacs is recovered ultimately in respect of the debt. The effect of the recovery of bad debt was not given in the books of account.

Compute total income of Shivani Ltd. for the Assessment Year 2014-15 and work out the amount of tax payable on such income, indicating reasons for treatment of each item. Ignore provision relating to minimum alternate tax. *(16 Marks)*

3. (a) A Limited is a company in which 70% shares are held by ABC Limited. A Limited, in its annual general meeting held on 30th May, 2013, declared a dividend amounting to Rs. 40 lacs to its shareholders for the year ended 31st March, 2013 and it paid dividend distribution tax on 2nd June, 2013. ABC Limited did not declare any dividend for the year ended 31st March, 2013. It, however, declared an interim dividend amounting to Rs. 60 lacs on 1st December, 2013 for the year ended 31St March, 2014.

(i) What is the amount of tax on dividend payable by ABC Limited?

(ii) What would be your answer, if 60% of shares in ABC Limited are held by XYZ Limited, a domestic company? *(6 Marks)*

(b) Spicy Airways Ltd. sold tickets to the travel agents in India at a minimum fixed commercial price. The agents were permitted to sell the tickets at a higher price, however, up to a maximum of published price. Commission at the rate of 9% of published price was payable to the agents of the airlines company, on which tax was deducted under section 194H by the company. The Assessing Officer raised the issue of further liability of tax deduction at source on the amount of difference between the published price and the minimum fixed commercial price by treating it as "additional special commission" in the hands of the agents.

Whether the contention raised by the Assessing Officer is tenable in law? Critically examine. *(6 Marks)*

(c) Mr. Himesh, aged 42 years, furnishes the following information relating to premium on mediclaim policy paid by cheque for the year ending 31.03.2014:

(i) for self – Rs. 3,000;

(ii) for spouse, aged 35 years – Rs. 3,000;

(iii) for non-dependent father, aged 70 years - Rs. 21,000;

(iv) for dependent mother-in-law, aged 65 years - Rs. 15,000.

In addition to above, Mr. Himesh paid Rs. 3,500, in cash, for himself and Rs. 5,500, by account payee cheque, for his wife on 01.8.2013 for Preventive Health Check up.

Compute his eligible deduction under section 80D for A.Y.2014-15. Would your answer be different, in case the premium was paid in cash? *(4 Marks)*

4. (a) Alok Housing Finance Co. Ltd., engaged in the business of providing long-term finance for construction or purchases of houses in India for residential purposes, provides you the following particulars from its accounts for the year ended on 31.3.2014 and seeks your opinion as to availability of deduction under section 36(1)(viii) and the amount thereof:

Profits from the business computed as per Part D of Chapter IV of the Income-tax Act, 1961, but before claiming deduction under section 36(1)(viii) is Rs. 640 lacs

-Paid-up share Capital Rs. 525 lacs

-General Reserve Rs. 140 lacs

-Balance in reserve created under section 36(1)(viii) on 31.3.2013 Rs. 1,250 lacs

(8 Marks)

(b) Aerostar, a partnership firm, transfers a piece of land situated in Gurgaon district on 30.9.2013 for Rs. 75 lacs. The land, purchased on 31.3.1980 for Rs. 1.5 lacs, was registered on 4.5.1986 on payment of stamp duty of Rs. 25,000. Expenses on land development and construction of boundary wall incurred in July, 1986 for Rs. 2,25,000. The charges for the transfer of land paid to the broker were 3% of the sale consideration. Fair market value of the land as on 1.4.1981 was Rs. 2,00,000.

The firm invested Rs. 35 lacs on 1.12.2013 in the bonds issued by National Highways Authority of India redeemable after 3 years. Compute the amount of capital gain chargeable to tax for Assessment Year 2014-15 with the help of cost inflation index for F.Y. 1986-87 and 2013-14 of 140 and 939, respectively. Also, give in brief, the reasons and the applicable provisions for each of the items dealt with.

(8 Marks)

5. Attempt any four questions out of the following questions:

(a) Ashok Traders, a partnership firm, for the assessment year 2012-13, filed its return of income disclosing an income of Rs. 50,000. The assessment was completed on an income of Rs. 1,50,000 in the month of June, 2013. The additions included (a) profit on suppressed sales of Rs. 45,000, (b) disallowance of expenses Rs. 55,000. The assessment became final as no appeal was preferred. Penalty proceedings were initiated on the charge of concealment of income of suppressed profits. After considering the explanation to the notice to the penalty, penalty was levied on the charge that inaccurate particulars were furnished. M/s. Ashok Traders contends that the order of penalty is bad in law. Is the contention justified?

(b) The Assessing Officer lodged a complaint against M/s. Kirorimal Das & Associates, a firm, under section 276CC of the Income-tax Act, 1961 for failure to furnish its return of income for the assessment year 2011-12 within the prescribed time. The tax payable on the assessed income, as reduced by the advance tax paid and tax deducted at source, was Rs. 60,000. The appeal filed by the firm against the order of assessment was allowed by the Commissioner (Appeals). The Assessing Officer passed an order giving effect to the order of the Commissioner (Appeals). The tax payable by the firm as per the said order of the Assessing Officer was Rs. 1,000. The Assessing Officer has accepted the order of the Commissioner (Appeals) and has not preferred an appeal against it to the Income Tax Appellate Tribunal. The firm desires to know of the maintainability of the prosecution proceedings in the facts and circumstances of the case.

(c) Laxmi Limited paid leave travel facility to its employees and considered exemption under section 10(5), based on the self-declaration furnished by the employees. The Assessing Officer held that the company as employer ought to have verified the genuineness of the claim of exemption by verifying the details of actual expenditure incurred for availing leave travel facility by the employees. Accordingly, the Assessing Officer treated the assessee company as assessee in default. Decide the correctness of action.

(d) Can stamp vendors be treated as agents of the Government for marketing stamp papers? If yes, can tax be deducted under section 194H in respect of discount given on sale of stamps by the Treasury to the stamp vendor?

(e) In the assessment of a firm, the Assessing Officer made two additions (i) Unexplained cash credits Rs. 1 lac. (ii) Disallowance under section 43B. The firm filed an appeal before the CIT and being unsuccessful before the Appellate Tribunal only on the addition of unexplained cash credits. It was not successful in either forum. With regard to the disallowance under section 43B, it did not file any appeal, but preferred a revision petition before the CIT under section 264, who dismissed it on the ground that the assessment was the subject matter of an appeal to the Appellate Tribunal. The assessee relies on the Board’s circular under which the CIT is empowered to accept such a petition. Is the petition maintainable? *(4×4=16 Marks)*

6. (a) Aarti Limited, an Indian company, is engaged in manufacturing electronic components. 74% of shares of the company are held by Alex Inc., incorporated in

USA. Aarti Limited has borrowed funds from Alex Inc. at LIBOR plus 150 points. The LIBOR prevalent at the time of borrowing is 4% for US $. The borrowings allowed under the External Commercial Borrowings guidelines issued under Foreign Exchange Management Act are LIBOR plus 200 basis points. Discuss whether the borrowing made by Aarti Limited is at arm's length ('LIBOR' means London Inter-Bank Offer Rate). *(5 Marks)*

(b) In the course of scrutiny assessment of Mr. Shahid, the Assessing Officer, on the basis of information available with him, sought an explanation for the source of the expenditure of Rs. 35 lakhs incurred on the wedding of his daughter. The said expenditure was neither recorded in the books of account maintained nor was the explanation offered by Mr. Shahid satisfactory. What are the consequences?

(5 Marks)

(c) Teachme Institute is a trust approved under section 10(23C)(vi) which runs various educational institutions. During the course of assessment under section 143(3), the Assessing Officer finds that the trust has carried out its activities in contravention of the section under which it was approved for exemption. Hence, the Assessing Officer wants to pass an order without giving exemption under section 10, which the assessee objects. You are required to examine the following with respect to the provisions of Income-tax Act, 1961.

(i) Whether the Assessing Officer can pass an order without giving exemption under section 10?

(ii) Can the Assessing Officer get any additional time limit in completing this assessment? *(6 Marks)*

7. (a) A petition for stay of demand was filed before ITAT by Xenos Ltd. in respect of a disputed demand for which appeal was pending before it, on which stay was granted by the ITAT vide order dated 1.1.2013. The bench could not function thereafter till 1.2.2014 and therefore, the disputed matter could not be disposed off. The Assessing Officer attached the bank account on 16.2.2014 and recovered the amount of Rs. 15 lacs against the arrear demand of Rs. 25 lacs. The assessee requested the Assessing Officer to refund back the amount as it holds stay over it. The Assessing Officer rejected the contention of the assessee. Now the assessee seeks your opinion. *(4 Marks)*

(b) Mr. Sukhiram is a non-resident. The appeal pertaining to the assessment year 2013-14 is pending before the Income-tax Appellate Tribunal, the issue involved being computation of export profit and tax thereon. The same issue persists for the assessment year 2014-15 as well. Mr. Sukhiram's brother Mr. Sohanlal has obtained an advance ruling under Chapter XIX - B of Income-tax Act, 1961 from the Authority for Advance Ruling on an identical issue.

Mr. Sukhiram proposes to use the said ruling for his assessment pertaining to the assessment year 2014-15. Can he do so? *(4 Marks)*

(c) Peter, an individual, has got his books of account for the year ending 31.3.2014 audited under section 44AB. His total income for the assessment year 2014-15 is Rs. 2,10,000. He desires to know if he can furnish his return of income for the assessment year 2014-15 through a Tax Return Preparer. *(4 Marks)*

(d) An assessee had credited a sum of Rs. 50,000 in cash in the account of Mohan, said to represent a loan obtained from him. The Assessing Officer, having gone into the genuineness of the transaction, disbelieved the story of loan and treated the sum of Rs. 50,000 as the income of the assessee from undisclosed sources. He also started proceedings under section 271D and levied a penalty of Rs. 60,000 on the assessee for having accepted the loan in contravention of section 269SS. Examine the correctness of the levy. *(4 Marks)*

MOCK TEST PAPER – 1
FINAL: GROUP – II
PAPER – 7 : DIRECT TAX LAWS
SUGGESTED ANSWERS/HINTS

1. (a) Computation of total income of Modern Tiles Ltd. for the A.Y.2014-15

Particulars	Rs.
Profits and gains of business or profession	
Net profit for the year as per P&L Account	75,00,000
Add: Expenses debited to Profit and Loss Account but not allowable	
(i) Contribution to Employees Welfare Trust disallowed under section 40A(9)	2,20,000
(ii) Expenses on the education of a relative of Director, who is not in employment of Modern Tiles Ltd., is not deductible under section 37 [Enkay (India) Rubber Co. Pvt. Ltd v. CIT (2003) 263 ITR 521 (Del)]. Hence, it should be added back to compute business income.	21,00,000
(iii) Expenses on installation of traffic signal, to facilitate its employees to overcome traffic jam and be on time, is an allowable expense under section 37(1)	--
(iv) Expenses on distribution of gift articles to dealers under sales incentive scheme would promote goodwill and is made in the interest of business. Such gifts are prompted by commercial expediency and hence, the expenditure is allowable under section 37(1) [*CIT v. Avery Cycle Industries Ltd. (2006) 157 Taxman 382/ 298 ITR 239 / 296 ITR 393 (Punjab & Haryana)]*	--
(v) Expenses on travelling to UK of the wife of Managing Director on the invitation of Trade and Commerce Chamber, London, is an allowable expense for the purposes of business	--
(vi) Increase in liability due to change in currency rate and paid to the suppliers of machine is to be added to cost of the asset irrespective of the method of accounting as per section 43A. Hence, it should be added back to compute business income.	4,00,000
	1,02,20,000
Add: Employees contribution to PF to be included in income	

	as per section 2(24)(x)		3,50,000
			1,05,70,000
Less:	Expenditure allowable as deduction but not debited to profit and loss account (See Note below)		
(i)	Employers contribution towards PF paid before due date for filing of return is allowable as per section 43B	3,50,000	
	Employees contribution to PF is not remitted before the due date under the PF Act. Therefore, it is not allowable as deduction under section 36(1)(va).	-	
(ii)	Provision for audit fees for the year ended 31.3.2013 for which tax was not deducted in the F.Y. 2012-13 but was deducted and paid in F.Y. 2013-14 is allowable in the year of payment as per the proviso to section 40(a)(ia).	7,50,000	
(iii)	Payment to a transporter for goods carriage in a day by two vouchers in cash, the aggregate not exceeding the limit of Rs. 35,000 is an allowable expense as per section 40A(3).	27,000	
(iv)	Interest for the month of February & March, 2014, on which TDS was remitted to the Government before the due date of filing of return, is allowable as per section 40(a)(ia) (1,50,000 + 2,25,000)	3,75,000	
(v)	Depreciation on the amount of Rs. 4 lacs added in cost of machine @ 15% for the year	60,000	15,62,000
	Total income		90,08,000

Computation of tax liability for A.Y.2014-15

Particulars		Rs.
Tax on Rs. 90,08,000 @ 30%		27,02,400
Add: Education cess @ 2%	Rs. 54,048	
Secondary and higher education cess @ 1%	Rs. 27,024	81,072
Total Tax Payable		27,83,472

Note –From a plain reading of the question, it is apparent that items of expenditure in serial nos. (i) to (iv) have not been debited to profit and loss account and employees' contribution to PF has not been credited to profit and loss account. Therefore, the deductibility or otherwise of these items of expenditure and taxability of employees' contribution to PF have to be considered while computing the business income. Accordingly, the items of expenditure in (i) to (iv), which are allowable as per the provisions of the Act, have to be deducted while computing business income and no adjustment is required of items of expenditure disallowed since they have not been debited to profit and loss account. Further, employees' contribution to PF has to be added while computing business income, since the same has not been credited to profit and loss account.

(b) (i) "Urban land" means -

(i) Land situated in any area which is comprised within the jurisdiction of a municipality or a cantonment board and which has a population of not less than 10,000.

(ii) Land situated in any area, within the distance, measured aerially, in relation to the range of population according to the last preceding census as shown hereunder –

Shortest aerial distance from the local limits of a municipality or cantonment board referred to in item (a)		Population according to the last preceding census of which the relevant figures have been published before the first day of the previous year.
(1)	≤ 2 kilometers	> 10,000 ≤ 1,00,000
(2)	≤ 6 kilometers	> 1,00,000 ≤ 10,00,000
(3)	≤ 8 kilometers	> 10,00,000

However, the following are specifically excluded from the definition of "urban land" -

(i) Land classified as agricultural land in the records of the Government and used for agricultural purposes;

(ii) Land on which construction of building is not permissible under any law for the time being in force in the area in which such land is situated;

(iii) Land occupied by a building which has been constructed with the approval of the appropriate authority;

(iv) Any unused land held by the assessee for industrial purposes for a period of two years from the date of its acquisition by him;

(v) Any land held by the assessee as stock-in-trade for a period of ten years from the date of its acquisition by him.

(ii) No wealth tax can be levied on a co-operative society, as section 45 specifically excludes co-operative societies from the purview of wealth tax. Therefore, the action of the Assessing Officer proposing to tax urban land in the hands of the cooperative society is incorrect.

(c) (i) **Office flats purchased for resale – Not chargeable to wealth-tax:** Though building or land appurtenant thereto is an asset under section 2(ea), **any house for residential or commercial purposes which forms part of stock-in-trade** is specifically excluded from the scope of "building". Hence, office flats purchased for resale do not fall within the meaning of "asset" under section 2(ea).

(ii) **Shares of group companies, breakup value of which is Rs. 8.50 lakhs – Not chargeable to wealth-tax:** Shares are not included in the definition of "asset" under section 2(ea). Hence, the value of shares of group companies is not chargeable to wealth-tax.

(iii) **Cash at construction site, not recorded in the books of account – Chargeable to wealth-tax:** In case of persons other than individuals and HUFs, any amount not recorded in the books of account is an asset under section 2(ea). Hence, Rs. 3.50 lakhs, representing cash at construction site, not recorded in the books of account, constitutes an asset under section 2(ea).

(iv) **Residential flat in occupation of company's whole time director drawing a salary of Rs. 12 lakhs per annum – Chargeable to wealth-tax:** Building and land appurtenant thereto is an asset chargeable to wealth-tax. However, a house meant exclusively for residential purposes, allotted by a company to, *inter alia,* a director who is in whole-time employment having a gross annual salary of less than Rs. 10 lakhs, is not chargeable to wealth-tax in the hands of the company.

Therefore, the residential flat in occupation of company's whole time director drawing a salary of Rs. 12 lakhs per annum is chargeable to wealth-tax in the hands of Fast Constructions Ltd.

(v) **Aircraft owned and used by a company for transportation of its goods – Not chargeable to wealth-tax:** The definition of asset under section 2(ea) includes, *inter alia*, aircrafts, other than those used by the assessee for commercial purposes. Aircraft owned and used by a company for transportation of its goods is construed as used for "commercial purposes", since it is used for the business of the company. Hence, such aircraft is not chargeable to wealth-tax.

2. Computation of total income of Shivani Ltd. for the A.Y. 2014-15

Particulars	Rs.	Rs.
Profits and gains of business or profession		
Net profit as per profit and loss account		8,00,00,000
Add: Excess depreciation provided on EPABX & Mobile phones not allowable as deduction [Note (i)]	18,00,000	
Payment for higher studies of director's son abroad not allowable as deduction [Note (iii)]	48,00,000	
Payment towards purchase of software from a non-resident made without deducting tax at source, not allowable as deduction [Note (iv)]	32,00,000	
Expenditure on earning dividend from foreign company not deductible [Note (v)]	45,000	
Secret commission paid not allowable [Note (viii)]	19,00,000	1,17,45,000
		9,17,45,000
Less: Dividend received from foreign company to be considered under the head "Income from other sources" [Note (v)]	13,00,000	
Payment to National Laboratory eligible for weighted deduction@ 200% under section 35(2AA) [Note (vii)]	63,00,000	
Bad debts allowable as deduction [Note (x)]	2,00,000	78,00,000
		8,39,45,000
Income from Other Sources		
Dividend from foreign company [Note (v)]		13,00,000
Total Income		8,52,45,000

Computation of tax liability of Shivani Ltd. for the A.Y.2014-15

Particulars	Rs.
Tax @15% on dividend from specified foreign company Rs. 13,00,000 [Note (v)]	1,95,000
Tax @30% on the balance total income of Rs. 8,39,45,000	2,51,83,500
	2,53,78,500
Add: Surcharge@5% (since total income exceeds Rs. 1,00,00,000)	12,68,925
	2,66,47,425
Add: Education cess@2%	5,32,949
Secondary and higher education cess@1%	2,66,474
Total tax liability	2,74,46,848

Notes:

(i) EPABX and mobile phones are not computers and therefore, are not entitled to higher depreciation@60%. It was so held by the Kerala High Court in *Federal Bank Ltd. v. ACIT (2011) 332 ITR 319*. Therefore, EPABX and mobile phones would be entitled to depreciation of Rs. 6,00,000, calculated by applying the rate of 15%, being the general rate applicable to plant and machinery, on the cost of Rs. 40,00,000 (Rs. 24,00,000 × 100/60). The excess depreciation of Rs. 18,00,000 (being Rs. 24,00,000 – Rs. 6,00,000), debited to profit and loss account, should be added back.

(ii) The issue is whether payment of Rs. 52 lakhs to NatWest Ltd. towards feasibility study conducted for examining proposals for technological advancement relating to the existing business, where the project was abandoned without creating a new asset, is allowable as revenue expenditure.

On this issue, the Delhi High Court, in *CIT v. Priya Village Roadshows Ltd. (2011) 332 ITR 594,* observed that in such cases, whether or not a new business/asset comes into existence would become the relevant factor. If there is no creation of a new asset, then the expenditure incurred would be of revenue nature. In this case, since the feasibility study was conducted by Shivani Ltd. for the existing business and the study was abandoned without creating a new asset, the expenses were of revenue nature.

Since the expenditure of Rs. 52 lakhs has already been debited to profit and loss account, no further adjustment is required.

(iii) In this case, since there is no evidence of existence of any "apprentice training scheme", the expenditure of Rs. 48 lakhs incurred in respect of higher studies abroad for the director's son is not allowable as deduction as there is no nexus between the education expenditure incurred abroad for the director's son and the business of Shivani Ltd. It was so held by the Bombay High Court in *Echjay Forgings Ltd. v. ACIT (2010) 328 ITR 286*.

(iv) The Finance Act, 2012 has inserted *Explanation 4* to section 9(1)(vi) retrospectively with effect from 1^{st} June, 1976, to clarify that consideration for use or right to use of computer software is royalty and consequently, tax has to be deducted at source under section 195 in respect of such payments. Since, Shivani Ltd. has not deducted tax at source on payment of Rs. 32 lakhs, it would be disallowed under section 40(a)(i). Therefore, the payment of Rs. 32 lakhs already debited to the profit and loss account, has been added back.

(v) Under section 115BBD, dividend received by an Indian company from a foreign company in which it holds 26% or more in nominal value of the equity share capital of the company, would be subject to a concessional tax rate of 15% as against the tax rate of 30% applicable to other income of a domestic company. This rate of

15% would be applied on gross dividend, in the sense, that no expenditure would be allowable in respect of such dividend.

Therefore, dividend of Rs. 13 lakhs received by Shivani Ltd. from a foreign company, in which it holds 28% in nominal value of equity share capital of the company, would be subject to tax@15% under section 115BBD. Such dividend would be taxable under the head "Income from other sources". No deduction is allowable in respect of Rs. 0.45 lakhs expended on earning this income.

Since such dividend has been credited to the profit and loss account, the same has to be reduced for computing income under the head "Profits and gains of business or profession. Likewise, Rs. 0.45 lakhs, representing expenditure for earning dividend income, which has been debited to profit and loss account, should be added back for computing business income.

(vi) The issue under consideration is whether depreciation is allowable on the written down value of the entire block, even though the block includes some machinery which has already been discarded and hence, cannot be put to use during the relevant previous year.

The expression "used for the purposes of the business" in section 32, when used with respect to discarded machinery, would mean the use in the business, not in the relevant financial year, but in the earlier financial years. Therefore, the condition for claiming depreciation in respect of the discarded machine would be satisfied if it is used in the earlier previous years for the business. It was so held by the Delhi High Court in *CIT vs. Yamaha Motor India Pvt. Ltd. (2010) 328 ITR 297*.

Since the depreciation, in this case, has been debited to profit and loss account, no further adjustment is required.

(vii) Under section 35(2AA), weighted deduction@200% is allowable in respect of amount paid to a National Laboratory with a specific direction that such sum shall be used for the purpose of an approved scientific research programme. Therefore, in this case, deduction of Rs. 126 lakhs (i.e., 200% of Rs. 63 lakhs) is allowable to Shivani Ltd under section 35(2AA). Since only the actual payment of Rs. 63 lakhs has been debited to profit and loss account, the balance of Rs. 63 lakhs has to be deducted.

(viii) As per *Explanation* to section 37(1), any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law, shall not be deemed to have been incurred for the purpose of business and no deduction or allowance shall be made in respect of such expenditure. Therefore, payment of secret commission, if it is established as a payment for any purpose which is an offence or which is prohibited by law, cannot be allowed as deduction. It was so held in *Tarini Tarpauline Productions v. CIT (2002) 254 ITR 495 (Ori.)*. Even in cases where it cannot be so established, it would be disallowed under section 40(a)(ia) for non-deduction of tax at source under section 194H.

(ix) The expenditure incurred for acquiring a new bus and donating it to the school is for the welfare of the children of staff/workmen of the company. Such expenditure is a part of employees' welfare expenses incurred for the purpose of securing healthy services for staff members. Therefore, such expenses were incurred wholly and exclusively for the purpose of the business. Since the bus had been donated to the school, no benefit of enduring nature was derived by Shivani Ltd. as the right of ownership was transferred to school. Hence, it is not a capital expenditure. Since such expenditure is incurred wholly and exclusively for the purpose of business and is not capital in nature, Shivani Ltd. is entitled to claim deduction in full under section 37(1). It was so held by the Rajasthan High Court in *CIT v. Rajasthan Spinning and Weaving Mills Ltd. (2006) 281 ITR 408*.

(x) In a case where the debt ultimately recovered is less than the difference between the amount of debt and bad debt allowed as deduction, such deficiency will be deductible in the previous year in which the ultimate recovery is made. Therefore, in this case, since the ultimate recovery of Rs. 4 lakhs is less than Rs. 6 lakhs (being the difference between the debt of Rs. 12 lakhs and the amount of Rs. 6 lakhs allowed as bad debts in the previous year 2012-13), the deficiency of Rs. 2 lakh will be deductible in the P.Y.2013-14, being the year in which the ultimate recovery of Rs. 4 lakhs is made. It may be noted that in a case where the net result is a deficiency, the amount recovered will not be taxable in the year of recovery. Since Rs. 4 lakhs is not credited to profit and loss account, no further adjustment is necessary.

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

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

(1) The subsidiary company should have paid the dividend distribution tax as payable on such dividend;

(2) The holding company should be a domestic company;

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

On the basis of the above

(a) Dividend distribution tax payable by ABC Limited shall be 16.995% of [(Rs. 60,00,000 - (Rs. 40,00,000 x 70%)] i.e. Rs. 5,43,840.

(b) If 60% of shares of ABC Limited are held by XYZ Limited, then ABC Limited is a subsidiary company of XYZ Limited. Section 115-O(1A) has been amended by the Finance Act, 2012 to remove the condition that the holding company should not be a subsidiary of any other company for claiming reduction of dividend received from the subsidiary company from the dividend declared, distributed or paid by the holding company. Therefore, even if ABC Limited is a subsidiary of XYZ Limited, it can reduce the amount of dividend received from A Limited for computation of dividend distribution tax. Hence, dividend distribution tax payable by ABC Limited shall be 16.995% of Rs. 32,00,000 i.e. Rs. 5,43,840.

(b) As per the provisions of section 194H, a person is liable to deduct tax at source at the time of credit or payment, whichever is earlier, of income in the nature of commission to any resident.

In the present case, Spicy Airways Ltd. correctly deducted tax at source under section 194H from the commission@9% of the published price paid to the travel agents, who were allowed to sell the air tickets at any price higher than the minimum fixed commercial price subject to a maximum of published price. However, the Assessing Officer raised a contention that the airline company was required to deduct tax at source on the difference between the published price and the minimum fixed commercial price by treating it as "additional special commission" in the hands of the agents.

The facts of the case are similar to the case of *CIT v. Qatar Airways (2011) 332 ITR 253,* where the Bombay High Court held that the difference between the published price and the minimum fixed commercial price of the tickets cannot be taken as "additional special commission" in the hands of the agents. This is because the published price was the maximum price and the airline company had granted permission to the agents to sell the tickets at a price lower than the published price. Further, the airline company would have no information about the exact rate at which the tickets were ultimately sold by its agents. In order to deduct tax at source on the difference between actual sale price and minimum fixed commercial price, the exact income in the hands of the agents must necessarily be ascertainable by the airline company. However, it is not so ascertainable in this case, since the agents had been given discretion to sell the tickets at any rate between the minimum fixed commercial price and the published price. It would be impracticable and unreasonable to expect the airline company to get a feedback from its numerous agents in respect of the price at which tickets were sold by them.

Applying the rationale of the above case to the case on hand, Spicy Airways Ltd. is not liable to deduct tax at source under section 194H on the difference between the published price and the minimum fixed commercial price, even though the amount earned by the agent over and above minimum fixed commercial price would be taxable as income in the hands of the agent.

Therefore, the contention raised by the Assessing Officer is not tenable in law.

(c) Mr. Himesh has paid Rs. 6,000 in aggregate towards self and spouse's mediclaim premium. He also paid Rs. 9,000 for Preventive Health Check up of himself and wife. It may be noted that payment made for Preventive Health Check is eligible for deduction upto a limit of Rs. 5,000 and it may be made in any mode including cash. Total deduction available under section 80D to an individual is restricted to Rs. 15,000.

Hence, deduction available is Rs. 11,000 (Rs. 6,000 for mediclaim premium + Rs. 5,000 for Preventive health Check up).

Mediclaim premium of Rs. 21,000 paid for insuring the health of his father, who is a senior citizen, is eligible for additional deduction of up to Rs. 20,000 even though his father is not dependent on him. Therefore, total deduction of Rs. 31,000 [i.e., Rs. 11,000 + Rs. 20,000] shall be allowed to Mr. Himesh under section 80D.

It may be noted that, Rs. 15,000 paid for dependent mother-in-law is not allowable, since the definition of the term 'family' does not include mother-in-law.

4. (a) According to section 36(1)(viii), a special deduction is allowed to specified entities engaged in eligible business. A housing finance company is a specified entity which is eligible for deduction under section 36(1)(viii) in respect of profits derived from the eligible business of providing long-term finance for construction or purchase of houses in India for residential purposes. The quantum of deduction, however, should not exceed 20% of the profits derived from eligible business computed under the head "Profits and gains of business or profession" (before making deduction under section 36(1)(viii)carried to a special reserve account.

However, where the aggregate amount carried to such reserve account exceeds twice the amount of paid up share capital and general reserve, no deduction shall be allowed in respect of such excess.

Alok Housing Finance Co. Ltd. is a specified entity engaged in carrying on the eligible business of providing long-term finance for the construction or purchase of houses in India for residential purposes and accordingly, it is entitled to claim the deduction under section 36(1)(viii).

The maximum deduction would be Rs. 128 lacs (20% of Rs. 640 lacs, being the profits for the year). However, in such a case, the aggregate amount carried to special reserve account i.e. Rs. 1,378 lacs (Rs. 1,250 lacs + Rs. 128 lacs) would exceed twice the amount of paid-up share capital and general reserve i.e., Rs. 1,330 lacs (2 x Rs. 665 lacs). Therefore, deduction will not be allowed under section 36(1)(viii) in respect of the excess Rs. 48 lacs (Rs. 1,378 lacs – Rs. 1,330 lacs). Deduction under section 36(1)(viii) for the A.Y. 2014-15 would be Rs. 80 lacs (Rs. 1,330 lacs – Rs. 1,250 lacs).

(b) Computation of Capital Gains chargeable to tax for A.Y.2014-15

Particulars	Rs.	Rs.
Gross sale consideration of the land		75,00,000
Less: Expenses on transfer of land paid to a broker @ 3% of the sale value [See Note 1]		2,25,000
Net Sale Consideration		72,75,000
Less: Indexed cost of acquisition and improvement		
A) Rs. 2,00,000 x 939/100 [See Notes 2 & 4]	18,78,000	
B) Rs. 2,50,000 x 939/140 [See Notes 3 & 4]	16,76,786	35,54,786
		37,20,214
Less: Investment in bonds of NHAI eligible for exemption under section 54EC [See Note 5]		35,00,000
Capital Gain		2,20,214

Notes:

(1) Brokerage paid is allowable as deduction under section 48(i) as held by Rajasthan High Court in the case of *Sah Roop Narain vs. CIT (1987) 32 Taxman 453*.

(2) Cost of acquisition of the capital asset can be claimed as deduction under section 48 while computing capital gains. As per section 55(2)(b)(i), the cost of acquisition in case of a capital asset acquired before 1.4.1981 shall be the actual cost of acquisition or the fair market value as on 1.4.1981, at the option of assessee. Accordingly, in this case, the cost of acquisition would be the fair market value of the land on 1.04.1981, as the same is more beneficial to the assessee.

(3) Cost of improvement of the capital asset can also be claimed as deduction under section 48. The cost of improvement, in this case, would include the expenditure of Rs. 2,25,000 on land development and construction of boundary wall and expenditure of Rs. 25,000 on payment of stamp duty. Therefore, the total cost of improvement would be Rs. 2,50,000.

(4) Since the asset transferred is a long-term capital asset, indexation benefit would be available and the indexed cost of acquisition and indexed cost of improvement are allowable as deduction while computing capital gains.

(5) Under section 54EC, exemption is available for investment, made within a period of 6 months from the date of transfer, in bonds of NHAI or RECL, redeemable after 3 years. In this case, the transfer took place on 30.9.2013 and the investment was made in bonds of NHAI, redeemable after 3 years, on 1.12.2013, which is within the 6 month period. Therefore, the investment of Rs. 35 lacs qualify for exemption under section 54EC.

5. (a) In the given facts of the case, the Assessing Officer has issued notice towards concealment of income in terms of suppression of sales. However, penalty was levied on the charge of furnishing of inaccurate particulars of income. Therefore, the penalty order is bad in law.

The Gujarat High Court had the occasion to consider a similar issue in the case of *A.M.Shah & Co v. CIT (1999) 238 ITR 415*. The High Court held that the charge and the levy of penalty should be for the same reason i.e., the basis for issue of notice and for imposition of penalty should be the same. In this case, penalty proceedings were initiated on the charge of concealment of income. However, the penalty was finally levied on the ground that the assessee has furnished inaccurate particulars. Such change of stand for imposition of penalty is not valid in law.

(b) Section 276CC provides for prosecution for willful failure to furnish a return of income within the prescribed time. However, prosecution proceedings will not be attracted if the tax payable by the assessee on the total income determined on regular assessment, as reduced by the advance tax, if any, paid and any tax deducted at source, does not exceed Rs. 3,000. Even though the tax liability of the firm as per the original order of assessment exceeded Rs. 3,000, however, as a result of the order of the Commissioner (Appeals), it got reduced to Rs. 1,000, which is, less than Rs. 3,000. Therefore, since the tax liability of the firm on final assessment was determined at Rs. 1,000, the prosecution proceedings are not maintainable.

In *Guru Nanak Enterprises v. ITO (2005) 279 ITR 30*, where the facts were similar, the Supreme Court held that prosecution as unwarranted.

(c) Section 192 casts liability on the employer to deduct tax at source from the salary paid to its employees.

In this case, the employer has paid leave travel concession / facility to its employees and the concession / facility is eligible for exemption subject to the conditions laid down in section 10(5) read with Rule 2B of the Income-tax Rules, 1962.

The Apex Court, in *CIT v. Larsen & Toubro Ltd (2009) 313 ITR 1,* held that the employer is not under any statutory obligation under the Income-tax Act, 1961, or Income-tax Rules, 1962, to collect evidence to show that the employee had actually utilized the amount towards leave travel concession. There is no such circular of the CBDT requiring the employer to collect and examine the evidence supporting the declaration submitted by the employees for the purpose of tax deduction under section 192.

Thus, the action of the Assessing Officer is not tenable in law.

(d) In *Kerala State Stamp Vendors Association v. Office of the Accountant-General (2006) 282 ITR 07*, the High Court held that stamp vendors cannot be treated as agents of the Government for marketing stamp papers. The discount given on sale of stamps by the Treasury to the stamp vendor is outside the scope of TDS provisions under section 194H.

The High Court observed that only commission and brokerage are subject to tax deduction under section 194H. Commission or brokerage is paid for services rendered in the course of sale. This implies services rendered by third parties like brokers or agents. It cannot mean services rendered by a buyer because a buyer is not rendering any service except buying. A price discount given by the seller to the buyer cannot be treated as commission or brokerage for services rendered in the course of buying and selling of goods. This is because the act of buying does not constitute rendering of any service. Therefore, stamp vendors cannot be treated as agents of the Government for marketing stamp papers and consequently, TDS provisions under section 194H are not attracted.

(e) The Supreme Court in *Hindustan Aeronatics Ltd v. CIT (248 ITR 898)* has laid at rest any controversy on this point. It has held that under section 264, the Commissioner has no power to revise any order which has been made the subject matter of an appeal to the Appellate Tribunal, even if the relief claimed in the petition is different from the relief claimed in appeal. With regard to the Board's circular, the instructions are, no doubt, binding on the authorities under the Act but where the Supreme Court or High Court has declared the law on the question arising for consideration, it will not be open to a court to direct that a circular would be given effect to, over-riding the order of the High Court or Supreme Court. Hence, the petition is not maintainable.

6. (a) One of the methods for determination of arm's length price in an international transaction is Comparable Uncontrolled Price method (CUP). Under the CUP method, the price charged or paid for property transferred or services rendered in a comparable uncontrolled transaction, or a number of such transactions, is identified. Such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions, which could materially affect the price in the open

market. The adjusted price so arrived at is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction.

Alex Inc., USA and Aarti Limited, the Indian company shall be deemed to be associated enterprises since the former holds more than 26% voting power in the latter.

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

(b) If any expenditure is incurred by an assessee in any financial year in respect of which he is not able to offer explanation about the source of such expenditure or the explanation offered by him is not satisfactory in the opinion of the Assessing Officer, then the amount of such unexplained expenditure may be deemed as income of the assessee for such financial year as per section 69C.

Therefore, in this case, the expenditure of Rs. 35 lakhs incurred by Mr. Shahid on the wedding of his daughter may be deemed as income of Mr. Shahid as per section 69C.

Further, such unexplained expenditure which is deemed as the income of Mr. Shahid shall not be allowed as deduction under any head of income.

Where the total income of Mr. Shahid includes such unexplained expenditure of Rs. 35 lakhs, which is deemed as his income under section 69C, such deemed income would be taxed at the maximum marginal rate of 30% as per section 115BBE (plus surcharge, education cess @2% and secondary and higher education cess @1%).

Further, no basic exemption or allowance or expenditure shall be allowed to Mr. Shahid under any provision of the Income-tax Act, 1961 in computing such deemed income.

Penalty under section 271(1)(c) shall be levied for concealment of income.

(c) (i) As per the first proviso to section 143(3), in the case of an institution approved under, *inter alia*, section 10(23C)(vi), which is required to furnish the return of income under section 139(4C), the Assessing Officer shall not pass an order of assessment under section 143(3) without giving effect to the provisions of section 10, unless he is of the view that the activities of the institution are being carried on in contravention to the provisions of that section and:

(1) he has intimated the Central Government or the prescribed authority, which had earlier approved the concerned institution, about the contravention of the relevant provisions by the institution; and

(2) the approval granted to such institution has been withdrawn or notification in that respect has been rescinded.

Therefore, in the aforesaid case, the Assessing Officer can pass an assessment order without giving exemption under section 10 to Teachme Institute, which is an educational institution approved under section 10(23C)(vi), only if he has intimated the contravention made by Teachme Institute to the Central Government or the prescribed authority, as the case may be, and its approval under section 10(23C)(vi) is withdrawn.

(ii) As per *Explanation 1* to section 153, in case the Assessing Officer intimates the contravention of provisions of section 10(23C)(vi) to the Central Government or the prescribed authority, the period commencing from the date of intimation of such contravention by the Assessing Officer and ending on the date on which the copy of the order of withdrawing the approval under section 10(23C)(vi) is received by the Assessing Officer, shall be excluded for computing the period of limitation for completing the assessment.

Further, in case the time limit available to the Assessing Officer for passing an assessment order, after such exclusion, is less than 60 days, such remaining period of assessment shall be deemed to have been extended to 60 days.

Therefore, the Assessing Officer will get the above mentioned additional time for completing the assessment of Teachme Institute.

7. (a) The Appellate Tribunal may, on merit, pass an order of stay in any proceedings relating to an appeal. However, such period of stay cannot exceed 180 days from the date of such order. The Appellate Tribunal has to dispose off the appeal within this period of stay. Where the appeal has not been disposed off within this period and the delay in disposing the appeal is not attributable to the assessee, the Appellate Tribunal can further extend the period of stay originally allowed. Section 254(2A) provides that the aggregate of the period originally allowed and the period or periods so extended or allowed shall not, in any case, exceed 365 days, even if the delay in disposing of the appeal is not attributable to the assessee. If the appeal is not disposed of within such period or periods, the order of stay shall stand vacated after the expiry of such period or periods.

Accordingly, even if an appeal is not heard by the bench, say, due to the bench not functioning or due to the department seeking adjournment, the stay granted by the Appellate Tribunal shall stand vacated after the period of 365 days, inspite of the assessee having taken all steps to ensure speedy disposal of the appeal and having a good prima facie case.

In the present case, the period of 365 days has expired on 31.12.2013, after which date the order of stay stands vacated. Accordingly, the recovery of Rs. 15 lacs against the arrear demand of Rs. 25 lacs made by the Assessing Officer is in order.

(b) As per section 245S(1), the advance ruling pronounced under section 245R by the Authority for Advance Ruling shall be binding only on the applicant who had sought it and in respect of the specific transaction in relation to which advance ruling was sought. It shall also be binding on the Commissioner and the income-tax authorities subordinate to him, in respect of the concerned applicant and the specific transaction.

In view of the above provision, Mr. Sukhiram cannot use the advance ruling, obtained on an identical issue by his brother, for his assessment pertaining to the assessment year 2014-15.

(c) Section 139B provides for submission of return of income through Tax Return Preparers. It empowers the Central Board of Direct Taxes (CBDT) to frame a scheme for the purpose of enabling any specified class or classes of persons to prepare and furnish their returns of income through Tax Return Preparers. Specified class or classes of persons have been defined to mean any person, other than a company or a person whose accounts are required to be audited under section 44AB or under any other existing law, who is required to furnish a return of income under the Act. Thus, companies and persons whose accounts are liable for tax audit under section 44AB do not fall within the definition of ‘specified class or classes of persons’ and consequently, cannot furnish their returns of income through Tax Return Preparers. In the instant case, the books of account of Peter for the year ending 31.3.2014 have been audited under section 44AB. As such, he cannot furnish his return of income for the assessment year 2014-15 through a Tax Return Preparer.

(d) There are several flaws in the penalty levied by the Assessing Officer. Firstly, the penalty leviable under section 271D cannot exceed the sum equal to the loan taken. Hence, the maximum penalty leviable would be Rs. 50,000. Secondly, any penalty imposable under section 271D shall be imposed by the Joint Commissioner. Hence, unless the Assessing officer happens to be a Joint Commissioner the levy of penalty will be invalid. Thirdly, the Assessing Officer cannot, on the one hand, treat the loan as undisclosed income of the assessee and on the other, treat it as a loan for the purpose of section 269SS read with section 271D. Such a treatment will be self contradictory. The moment the amount of Rs. 50,000 is treated as undisclosed income, it ceases to bear the character of loan and therefore, the foundation for the levy of penalty under section 271D disappears. *[Diwan Enterprises v. CIT and Others 246 ITR 571]*.

MOCK TEST PAPER – 2

FINAL: GROUP – II

PAPER – 7: DIRECT TAX LAWS

Question 1 is compulsory

*Answer any **five** questions from the remaining **six** questions.*

Time Allowed – 3 Hours Maximum Marks – 100

1. (a) Piyush, an employee with M/s Premium Solutions Ltd., provides the following information relating to his income for the financial year 2013-14:

(i) He received salary Rs. 25,000 per month including conveyance allowance @ Rs. 2,500 per month for official purposes.

(ii) He deposited Rs. 2,500 per month in his account under a pension scheme notified by the Central Government.

(iii) He paid a sum of Rs. 60,000 during the year as interest on loan taken in April, 2008 from bank for higher studies of his daughter.

(iv) He paid health insurance premium for himself and for his family members Rs. 8,500 in cash and Rs. 9,000 by credit card.

(v) He invested Rs. 40,000 in notified bonds issued by NABARD in July, 2013.

(vi) Equity shares having fair market price of Rs. 1,00,000 (on the date of exercise of option) were allotted to him by the company at a concessional price of Rs. 20,000 on 30.5.2013, which were sold by him for Rs. 1,80,000 on 28.2.2014.

Compute the total income of Piyush for assessment year 2014-15 and give reasons for treatment to each of the items. *(10 Marks)*

(b) Shradha Constructions Ltd. furnishes the following particulars of its wealth for the valuation date as on 31.3.2014:

		Rs. (in lacs)
(i)	Land in urban area (held as stock in trade since 2000).	81
(ii)	Motor cars (including one imported car, worth Rs. 18 lacs used for hiring)	38
(iii)	250 acres agricultural land acquired at Greater Noida Township on 27.8.2013 for construction of residential flats/commercial complex. However, Greater Noida Authority has reserved 25 acres land as green belt.	250

(iv)	Residential flats of 1500 sq feet each provided to 3 employees (salary of one employee exceeded Rs. 10 lacs per annum)	36
(v)	Farm house of 5 acre at a remote village beyond 25 kms from the local limits of Municipality	9
(vi)	Cash in hand as per cash book	3
	Liabilities:	
(i)	Loan for purchase of land at Urban area	30
(ii)	Loan for purchase of land at Greater Noida	120
(iii)	Wealth-tax liability for Assessment year 2013-14	12
(iv)	Loan for construction of residential flats	9

Compute the net wealth of the company as on valuation date 31.03.2014.

(10 Marks)

2. The Profit & Loss Account of Sunshine Private Limited for the year ended 31st March, 2014 shows a profit of Rs. 75 lakhs after debiting the following items:

(i) Rs. 2 lakhs contributed to Employees' Welfare Trust.

(ii) Rs. 12 lakhs paid towards course fee and hostel expenses for MBA course of a close relative of a director. The relative is not in employment with the company.

(iii) Rs. 3.50 lakhs, being expenses incurred on installation of a traffic signal, so as to facilitate its employees coming to office to overcome traffic jam and save office time.

(iv) Rs. 3 lakhs spent on gift items distributed to various dealers under the company's sales incentive scheme.

(v) Rs. 6 lakhs, being expenses incurred on the travelling of the wife of MD, who accompanied him on tour to Singapore on invitation of Trade and Commerce Chamber, Singapore.

(vi) Rs. 3 lakhs, being amount paid in March 2014 consequent upon change in currency rate due to exchange fluctuation in excess of the amount due to the supplier of machinery. Machinery was put to use in July 2013.

(vii) Rs. 18,000 and Rs. 9,000 paid in cash on 25th October, 2013 by two separate vouchers to a contractor who carried out certain repair work in the office premises.

(viii) Interest of Rs. 2 lakhs was paid in March, 2014 to a company on a loan taken from a company. Tax deducted at source from such interest was deposited in July, 2014.

Additional Information:

(a) Provision for audit fee of Rs. 6 lakhs was made in the books for the year ended 31st March, 2013 without deducting tax at source. Such fee was paid to the auditors in September, 2013 after deducting tax under section 194J and the tax so deducted was deposited on 7th October, 2013.

(b) During the year, the company purchased 10,000 shares of Best Private Limited at Rs. 40 per share. The fair market value of such shares on the date of transaction wasRs. 60 per share.

Compute total income of Sunshine Private Limited for Assessment Year 2014-15 and tax payable on such income indicating reasons for treatment of each item. Ignore the provisions relating to minimum alternate tax. *(16 Marks)*

3. (a) Brown Ltd. has two industrial undertakings. Unit I is engaged in the production of television sets and Unit II is engaged in the production of refrigerators. The company has, as part of its restructuring program, decided to sell Unit II as a going concern by way of slump sale for Rs. 260 lacs to a new company called Heat Ltd., in which it holds 85% equity shares. The following is the extract of the balance sheet of Brown Ltd. as on 31st March, 2014:

	Rs. (in lacs)	
	Unit – I	Unit – II
Fixed Assets	112	158
Debtors	88	67
Inventories	60	23
Liabilities	33	45

	Rs. (in lacs)
Paid-up share capital	231
General Reserve	160
Share Premium	39
Revaluation Reserve	105

The company set up Unit II on 1st April, 2009. The written down value of the block of assets for tax purpose as on 31st March, 2014 is Rs. 150 lacs of which Rs. 60 lacs are attributable to Unit II.

(i) Determine what would be the tax liability of Brown Ltd. on account of Slump sale;

(ii) How can the restructuring plan of Brown Ltd. be modified, without changing the amount of consideration, in order to make it more tax efficient? *(8 Marks)*

(b) A private limited company has share capital in the form of equity share capital. The shares were held up till 31st March, 2012 by four members Ashok, Vikash, Chetan and Dhruv equally. The company made losses/profits for the past three assessment years as follows:

Assessment Year	Business Loss Rs.	Unabsorbed Depreciation Rs.	Total Rs.
2010-2011	Nil	15,00,000	15,00,000
2011-2012	Nil	12,00,000	12,00,000
2012-2013	9,00,000	9,00,000	18,00,000
Total	9,00,000	36,00,000	45,00,000

The above figures have been accepted by the tax department.

During the previous year ended 31.3.2013, Ashok sold his shares to Suraj and during the previous year ended 31.3.2014, Vikas sold his shares to Raj. The profits for the past two previous years are as follows:

31.3.2013 Rs. 18,00,000 (before charging depreciation of Rs. 9,00,000)

31.3.2014 Rs. 45,00,000 (before charging depreciation of Rs. 7,50,000)

Compute taxable income for A.Y.2014-15. Workings must form part of your answer.

(8 Marks)

4. (a) Govind Public Charitable Trust (Registered under section 12A of the Income-tax Act, 1961) furnishes the following data for the financial year ending 31.3.2014.

S. No.	Particulars	Rs. (in Lacs)
(i)	Income from Engineering College (Gross receipts Rs. 100 Lacs)	10
(ii)	Income from properties held in trust (out of his Rs. 2 Lacs was not received during the year and Rs. 2 Lacs was received only on the last day of the year)	26
(iii)	Net income from business held under trust (As incidental to the main objects) as per books	2
(iv)	Amount spent on free scholarship, free meals and fee medical relief	9
(v)	Repayment of loan taken for construction of Health Care Centre	3

You are required to:

(i) Compute the taxable income of the Trust for the assessment year, 2014-15. Assume that option is exercised under explanation to section 11(1) of the Act.

(ii) Advise how the taxability on the computed income could be minimized or reduced. *(8 Marks)*

(b) A piece of land owned by Mr. Kalra located on Jaipur-Delhi highway was acquired by NHAI in the F.Y.2008-09, but the award ordered in F.Y. 2009-10 was paid in the F.Y. 2013-14. This land was purchased by him on 2.4.1978 for Rs. 10,000. The fair market value of the land as on 1.4.1981 was Rs. 9,000. Compensation paid was Rs. 15 lacs.

The other piece of land located in Chennai purchased in April, 2004 for Rs. 25 lacs was also sold by him in February, 2014 for Rs. 35 lacs, but sale deed thereof could not be executed by 31.3.2014. The value for the purpose of stamp duty to be applied by the stamp valuation authority was Rs. 40 lacs.

Compute the income chargeable to tax arising as a result of these transactions in the A.Y.2014-15. The CIIs for the F.Y: 2004-05, 2008-09, 2009-10 and 2013-14 are 480, 582, 632 and 939 respectively. *(8 Marks)*

5. Attempt any four questions out of the following questions:

(a) A company engaged in textile manufacturing, debited to its Profit & Loss Account a sum of Rs. 6,00,000, being the interest on loan of Rs. 60,00,000 taken for financing its expansion scheme. The plant and machinery purchased for the project with the loan were not received during the year and those were still in transit at the end of the year. A sum of Rs. 60,000 was paid to a broker who arranged the loan. Discuss the admissibility or otherwise of the interest and brokerage on borrowing.

(b) Girdhar purchased a residential flat from Dev in December 2013. However, the deed of conveyance has not been registered in the name of Girdhar till 31.03.2014. Girdhar has let out the flat at a monthly rent of Rs. 25,000 to Rakesh.

Girdhar claims that rent received is not chargeable under the head "Income from house property", but the same is chargeable under the head "Income from other sources" and he can claim deduction for expenses on repair and insurance premium on actual basis and also depreciation. Examine the correctness of Girdhar's claim.

(c) Mr. Chawla, a leading advocate on corporate law, decided to reduce his practice and to accept briefs only for paying his taxes and making charities with the fees received on such briefs. In a particular case, he agreed to appear to defend one company in the Supreme Court on the condition that he would be provided with Rs. 5 lacs for a public charitable trust that he would create. He defended the company and was paid the sum by the company. He created a trust of that sum by executing a trust deed. Decide whether the amount received by Mr. Chawla is assessable in his hands as income from profession.

(d) Neeraj is a fashion designer having lucrative business. His wife is a model. Neeraj pays her monthly salary of Rs. 10,000. The Assessing Officer while admitting that the salary is an admissible deduction, in computing the total income of Neeraj had applied the provisions of section 64(1), and had clubbed the income (salary) of his wife in Neeraj hands. Discuss the correctness of the action of the Assessing Officer.

(e) Rajan carrying on a business as sole proprietor, died on 31st March, 2013. On his death, the same business was continued by his legal heirs, by forming a firm. As on 31st March 2013, a determined business loss of Rs. 5 lacs is to be carried forward under the Income-tax Act, 1961.

Does the firm consisting of all legal heirs of Mr. Rajan, get a right to have this loss adjusted against its current income? *(4×4=16 Marks)*

6. (a) Mr. Goswami sought voluntary retirement from a Government of India Undertaking and received compensation of Rs. 40 Lacs on 31st January, 2014. He is planning to use the money as capital for a business dealership in electronic goods. The manufacturer of the product requires a security deposit of Rs. 15 Lacs, which would carry interest at 8% p.a. Goswami's wife is a graduate and has worked as marketing manager in a multinational company for 15 years. She now looks for a change in employment. She is willing to join her husband in running the business. She expects an annual income of Rs. 5 Lacs. Mr. Goswami would like to draw a monthly remuneration of Rs. 40,000 and also interest @10% p.a. on his capital in the business. Mr. Goswami has approached you for a tax efficient structure of the business.

Discuss the various issues, which are required to be considered for formulating your advice. Computation of income or tax liability is not required. *(6 Marks)*

(b) Mr. Bajaj, a resident Indian and aged 67 years, has derived the following income during the previous year 2013-14:

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

India has no double tax avoidance agreement with Hong Kong. Compute the income and tax payable by Mr. Bajaj for assessment year 2014-15. *(6 Marks)*

(c) Mr. Sujit, an individual whose total sales in the business of food grains for the year ending 31.3.2014 was Rs. 105 lacs, did not maintain books of account. The Assessing Officer levied penalty under section 271A for non-maintenance of books of account and section 271B for not getting the books audited as required by section 44AB. Is the Assessing Officer justified in levying penalty under section 271B? *(4 Marks)*

7. (a) Surya Motors Ltd., an Indian company declared income of Rs. 300 crores computed in accordance with Chapter IV-D but before making any adjustments in respect of the following transactions for the year ended on 31.3.2014:

(i) 10,000 cars sold to Thin Ltd. which holds 30% shares in Surya Motors Ltd. at a price which is less by $ 200 each car than the price charged from Shingto Ltd.

(ii) Royalty of $ 1,20,00,000 was paid to Kyoto Ltd. for use of technical know-how in the manufacturing of car. However, Kyoto Ltd. had provided the same know-how to another Indian company for $ 90,00,000.

(iii) Loan of Euro 1000 crores carrying interest @ 10% p.a. advanced by Dorf Ltd., a German company, was outstanding on 31.3.2014. The total book value of assets of Surya Motors Ltd. on the date was Rs. 90,000 crores. The said German company had also advanced a loan of similar amount to another Indian company @ 9% p.a. Total interest paid for the year was EURO 100 crores.

Explain in brief the provisions of the Act affecting all these transactions and compute the income of the company chargeable to tax for A.Y.2014-15 keeping in mind that the value of 1$ and of 1 EURO was Rs. 63 and Rs. 84, respectively, throughout the year. *(8 Marks)*

(b) Explain the applicability of the provision relating to the deduction of tax at source in the following transactions:

(i) Tall Limited pays Rs. 1 lac to Short Limited, a resident contractor who, under the contract dated 15th October, 2013, manufactures a product according to specification of Tall Limited by using materials purchased from Short Limited.

(ii) A company operating a television channel makes payment of Rs. 5 lacs to a former cricketer for making running commentary of a one-day cricket match.

(iii) SN Ltd., a foreign company, pays outside India, salary to its employee, Mr. David, a foreign national and a non-resident, for services rendered in India.

(iv) TPO Ltd., the employer, credited salary due for the financial year 2013-14 amounting to Rs. 2,40,000 to the account of Dinesh, an employee, in its books of account on 31.3.2014. Dinesh has not furnished any information about his income/loss from any other head or proof of investments/payments qualifying for deduction under section 80C. *(8 Marks)*

MOCK TEST PAPER – 2

FINAL: GROUP – II

PAPER – 7 : DIRECT TAX LAWS

SUGGESTED ANSWERS/HINTS

1. (a) Computation of total income of Mr. Piyush for the Assessment Year 2014-15

Particulars	Rs.	Rs.
Salaries		
Gross salary received	3,00,000	
Add: Shares allotted at concessional price – fair market value less the amount recovered from the employee [Section 17(2)(vi)] (i.e. Rs. 1,00,000 minus Rs. 20,000)	80,000	
	3,80,000	
Less: Conveyance allowance exempt under section 10(14)	30,000	3,50,000
Capital gains		
Sale consideration of equity shares sold on 28.02.2014	1,80,000	
Less: Fair Market Value of shares on the date of exercise of option (i.e., 30.5.2013)	1,00,000	80,000
Gross Total Income		4,30,000
Less: **Deduction under Chapter VIA**		
Under section 80C		
For investment in notified bonds of NABARD	40,000	
Under section 80CCD		
For deposit in pension scheme notified by Central Government [Rs. 30,000 but restricted to 10% of salary i.e. 10% of Rs. 2,70,000]	27,000	
Under section 80D		
For payment of health insurance premium by credit card	9,000	
Under section 80E		
For payment of interest on loan taken from bank for higher studies of daughter	60,000	1,36,000
Total Income		2,94,000

Notes:

(i) Conveyance allowance received for official duties is fully exempt under section 10(14). It is assumed that such amount is actually incurred by the employee for official purpose.

(ii) Section 80CCD provides for deduction of employee's and employer's contribution to pension scheme notified by the Central Government. This deduction has been extended also to individuals employed by any other employer on or after 1.1.2004. However, if the amount contributed exceeds 10% of salary, then, the deduction would be restricted to 10% of salary. [As per *Explanation* to section 80CCD, salary for this purpose would include dearness allowance if the terms of employment so provide, but excludes all other allowances and perquisites]. Therefore, "salary" for the purpose of section 80CCD would be Rs. 2,70,000 (Rs. 3,00,000 – Rs. 30,000).

(iii) The deduction under section 80E available to an individual in respect of interest on loan taken for his higher education has been extended to include interest on such loan taken for higher education of his relative i.e. his or her spouse and children. Hence, interest on loan taken by Mr. Piyush from bank for the higher studies of his daughter is eligible for deduction under section 80E.

(iv) For claiming deduction under section 80D, the payment of medical insurance premium has to be made by any mode other than cash. Hence, payment of Rs. 8,500 made in cash will not qualify for deduction under section 80D.

(v) Subscription to notified bonds issued by NABARD will qualify for deduction under section 80C(2)(xxii).

(vi) The value of any specified security or sweat equity shares allotted or transferred by the employer, free of cost or at a concessional rate to the employee would be treated as a perquisite in the hands of the employee. The value would be the fair market value of the specified security or sweat equity shares on the date on which the option is exercised by the employee as reduced by the amount actually paid by, or recovered from the employee in respect of such security or shares.

Consequently, section 49(2AA) provides that for the purpose of computing capital gains in the hands of the employee at the time of sale of such securities/shares by the employee, the cost of acquisition shall be the fair market value which has been taken into account for the purpose of computing the perquisite value in the hands of the employee.

(b) Computation of Net Wealth of M/s Shradha Constructions Ltd. as on valuation date 31.03.2014

Particulars	Rs. (in lacs)	Rs. (in lacs)
Assets [as per the definition of assets under section 2(ea)]		
(i) Land in urban area (held as stock in trade since 2000) – taxable since it is held as stock-in-trade for more than 10 years		81
(ii) Motor cars (excluding imported car not being an asset since it is used for hiring) [Rs. 38 Lacs – Rs. 18 Lacs]		20
(iii) Agricultural land acquired for construction of residential and commercial complex (is a stock-in-trade in the hands of a construction company – hence, not an asset)		Nil
(iv) (a) Residential flats provided to 2 employees drawing salary less than Rs. 10 lacs per annum – not an asset		Nil
(b) Residential flat provided to one employee drawing salary exceeding Rs. 10 lacs per annum is an asset [36 × 1/3]		12
(v) Farm house - not an asset		Nil
(vi) Cash in hand as per cash book is not an asset since it represents cash recorded in the books		Nil
		113
Less: Liabilities		
(i) Loan for purchase of land in urban area – deductible, since it is incurred in relation to land in urban area, which is an asset chargeable to wealth-tax.	30	
(ii) Loan for purchase of agricultural land - not deductible, since land is not an asset	Nil	
(iii) Wealth tax liability for Assessment year 2013-14 – wealth tax liability is not deductible	Nil	
(iv) Loan for construction of residential flats - the portion relating to taxable asset (1/3) is deductible i.e. $\frac{1}{3} \times 9 \text{ lacs}$	3	33
Net Wealth		80

2. Computation of total income of Sunshine Private Ltd. for the A.Y.2014-15

Particulars		Rs.
Profits and gains of business or profession		
Net profit for the year as per profit and loss account		75,00,000
Add: Expenses debited to profit and loss account but not allowable		
(i)	Contribution to Employees Welfare Trust disallowed under section 40A(9)	2,00,000
(ii)	Expenses on course fee and hostel expenses for MBA course of a close relative of a director, who is not in employment of Sunshine Private Ltd., is not deductible under section 37 *[Enkay (India) Rubber Co. Pvt. Ltd v. CIT (2003) 263 ITR 521 (Del)].* Such expenditure is not incurred wholly and exclusively for the purposes of business. Hence, it should be added back to compute business income.	12,00,000
(iii)	Expenses on installation of traffic signal, to facilitate its employees to overcome traffic jam and be on time, is in the interest of the business so that the work gets completed on time, and is hence, an allowable expense under section 37(1).	--
(iv)	Expenses on distribution of gift items to dealers under sales incentive scheme would promote goodwill and is made in the interest of business. Such gifts are prompted by commercial expediency and hence, the expenditure is allowable under section 37(1) [*CIT v. Avery Cycle Industries Ltd. (2008) 298 ITR 239 / 296 ITR 393 (Punjab & Haryana)].*	--
(v)	Expenses on travelling to Singapore of the wife of Managing Director on the invitation of Trade and Commerce Chamber, Singapore, is an allowable expense on the grounds of commercial expediency and business considerations.	--
(vi)	Increase in liability due to change in currency rate and paid to the suppliers of machinery is to be added to cost of the asset irrespective of the method of accounting as per section 43A. Hence, it should be added back to compute business income.	3,00,000
(vii)	Payments to a contractor for repair work in a day by two separate vouchers in cash, is not an allowable expense as per section 40A(3), since the aggregate payment in a day exceeds the limit of Rs. 20,000.	27,000
(viii)	Interest of Rs. 2 lakhs paid in March, 2014, on which tax	-

deducted at source was remitted to the Government before the due date of filing of return (i.e., before 30th September, 2014), is allowable as per section 40(a)(ia).		
		92,27,000
Less: Expenditure allowable as deduction but not debited to profit and loss account		
Provision for audit fees for the year ended 31.3.2013 for which tax was not deducted in the F.Y. 2012-13 but was deducted and paid in F.Y. 2013-14 is allowable as deduction in the A.Y.2014-15, as per the proviso to section 40(a)(ia).	6,00,000	
Depreciation on the amount of Rs. 3 lakhs added in cost of machinery @ 15% for the year, since the machinery was put to use for more than 180 days *(See Note below)*	45,000	6,45,000
		85,82,000
Income from other sources		
Difference between the aggregate fair market value of shares of a closely held company and the consideration paid for purchase of such shares is deemed as income in the hands of the purchasing company under section 56(2)(viia). Since the difference exceeds Rs. 50,000, the entire sum is taxable.		2,00,000
Total income		87,82,000

Computation of tax liability of Sunshine Private Ltd. for A.Y.2014-15

Particulars	Rs.
Tax on Rs. 87,82,000 @ 30%	26,34,600
Add: Education cess @ 2%	52,692
Secondary and higher education cess @ 1%	26,346
Total Tax Payable	27,13,638

3. (a) (i) As per section 50B, any profits or gains arising from the slump sale effected in the previous year shall be chargeable to income-tax as capital gains arising from the transfer of capital assets and shall be deemed to be the income of the previous year in which the transfer took place.

If the assessee owned and held the undertaking transferred under slump sale for more than 36 months before slump sale, the capital gain shall be deemed to be long-term capital gain. Indexation benefit is not available in case of slump sale as per section 50B(2).

Ascertainment of tax liability of Brown Ltd. from slump sale of Unit II

Particulars	Rs.
Slump sale consideration	2,60,00,000
Less : Cost of acquisition (net worth) [*See Working Note below*]	1,05,00,000
Long-term capital gain (as Unit II is held for more than 36 months)	1,55,00,000
Calculation of tax liability	
Income tax @ 20% (Being long term capital gain under section 112)	31,00,000
Surcharge @ 5%	1,55,000
	32,55,000
Education cess @ 2% and Secondary and higher education cess@1%	97,650
Total tax liability	33,52,650

Working Note: Net worth of Unit II

Particulars	Rs.
WDV of block of assets	60,00,000
Debtors	67,00,000
Inventories	23,00,000
	1,50,00,000
Less : Liabilities	45,00,000
Net worth	1,05,00,000

(ii) Tax Advice

(i) Transfer of any capital asset by a holding company to its 100% Indian subsidiary company is exempted from tax under section 47(iv). Therefore, if it is possible for Brown Ltd. should try to acquire the entire shareholding of Heat Ltd. and thereafter make a slump sale, then the resultant capital gain shall not attract tax liability. However, in such case also, Brown Ltd. should not transfer any shares in Heat Ltd. for 8 years from the date of slump sale.

(ii) Alternatively, if acquisition of 15% share is not feasible, Brown Ltd. may think about demerger plan of Unit-II to get benefit of section 47(vib) of the Income-tax Act, 1961.

(b) Ashok, Vikash, Chetan and Dhruv are the four shareholders of a private limited company. The shareholding pattern of the company in the last three financial years are given below:

As on 31st day of March	Ashok	Vikas	Chetan	Dhruv	Suraj	Raj
	%	%	%	%	%	%
2012	25	25	25	25	-	-
2013	-	25	25	25	25	-
2014	-	-	25	25	25	25

Section 79 provides that, in case of a closely held company, no loss incurred in the previous year shall be carried forward and set off against the income of the subsequent previous year unless the shares carrying at least 51% of the voting power of the company are beneficially held on the last day of the previous year in which the loss is sought to be set off, by the same shareholders, who beneficially held the shares carrying at least 51% of the voting power on the last day of the previous year in which the loss was incurred.

Since shareholders holding at least 51% of the voting power are the same in the first and second year, the restriction imposed by section 79 is not applicable for the second year. Thus, the taxable income for the assessment year 2013-14 would be:

Particulars	Rs.
Business profit	18,00,000
Less: Current year's depreciation	9,00,000
	9,00,000
Less: Brought forward business loss [as per section 72(2)]	9,00,000
Taxable income	Nil

Unabsorbed depreciation relating to the earlier assessment years can be carried forward to the next assessment year i.e. 2014-15. There is no brought forward business loss and section 79 is not applicable in case of carry forward of unabsorbed depreciation. Section 32 governs the carry forward and set off of depreciation for which the shareholding pattern is not relevant at all. Consequently, the income for A.Y.2014-15 will be determined as under -

Particulars	Rs.	Rs.
Business income		45,00,000
Less: Current year's depreciation		7,50,000
		37,50,000
Less: Unabsorbed depreciation:-		
Assessment year 2010-11	15,00,000	
Assessment year 2011-12	12,00,000	

Assessment year 2012-13	9,00,000	36,00,000
Taxable Income for A.Y.2014-15		1,50,000

4. (a) (i) Computation of total income of Govind Public Charitable Trust for A.Y. 2014-15

	Particulars	Rs.(in Lacs)
(i)	Income from Engineering College – exempt under section 10(23C) (iiiad) as gross receipts do not exceed Rs. 1 crore.	Nil
(ii)	Income from properties held under trust	26.00
(iii)	Income from business undertaking held under trust (assumed that the business is incidental to the attainment of objectives of the trust and separate books are maintained satisfying section 11(4A))	2.00
		28.00
	85% of the income required to be spent (85% of Rs. 28 Lacs)	23.80
	Less : Amount spent on free scholarship, free meals and free medical centre	(-)9.00
	Repayment of loans for construction of health centre (this is utilized for the fulfillment of the objects of the trust) (See *CIT v.Janmbhoomi Press Trust (2000) 242 ITR 703)*	(-)3.00
		11.80
	Less: Option exercised under *Explanation 2* to section 11 of the Act	
	(i) Amount not received during the previous year	2.00
	(ii) income received on the last day to be spent in the next year	2.00
	Income of the trust liable to tax	7.80

(ii) In order to minimize and /or reduce the tax liability, the trustees may give a notice in writing to the Assessing Officer in the prescribed manner about their intention to accumulate the unspent amount of Rs. 7.80 Lacs specifying the period and the purpose for which, the accumulation is proposed to be made and invest the sum of Rs. 7.80 Lacs in specified assets as per section 11(5). This accumulation would be in compliance with section 11(2) and in such case no tax will be payable on the sum of Rs. 7.80 Lacs.

(b) Computation of taxable income of Mr. Kalra for A.Y.2014-15

Particulars	Rs.
Capital Gains	
(A) Long-term capital gain derived from transfer of land on Jaipur-Delhi highway acquired by NHAI in F.Y. 2008-09 for which award was paid in F.Y. 2013-14 is chargeable to tax in A.Y.2014-15 **[See Note (i) below]**	
Sale consideration i.e. compensation paid	15,00,000
Less: Indexed cost of acquisition **[See Note (ii) below]**	
$\frac{10000 \times 582}{100}$	58,200
Long Term Capital Gains (A)	14,41,800
(B) Sale of land at Chennai in February 2014 **[See Note (iii) below]**	
Full value of consideration as per section 50C **[See Note (iv) below]**	40,00,000
Less: Indexed cost of acquisition	
(Rs. 25,00,000 × 939/480)	48,90,625
Long Term Capital Loss (B)	(8,90,625)
Long Term Capital Gains (A - B)	5,51,175

Total income chargeable to tax arising as a result of these transactions in the A.Y.2014-15 is equal to Rs. 5,51,175 (i.e. Rs. 14,41,800 - Rs. 8,90,625). Long term capital loss can be set-off from the long term capital gain.

Notes:

(i) The capital gains arising on compulsory acquisition shall be charged to tax in the year in which the compensation is first received as per section 45(5)(a).

(ii) The option of fair market value as on 1.4.1981 is not exercised by the assessee since the fair market value is lower than the cost.

582 is the cost inflation index of F.Y.2008-09 i.e. the year in which the property was compulsorily acquired.

(iii) The execution of sale deed is not compulsory for the purpose of charge of capital gain because the transfer of right enabling enjoyment of immovable property gives rise to charge of capital gains as held by the Kerala High Court in the case of *CIT v. C.F. Thomas (2006) 284 ITR 557.*

(iv) As per section 50C, the value applied by the stamp valuation authority is deemed to be the full value of consideration received or accruing as a result of such transfer, since such value is higher than the sale consideration of Rs. 35

lacs. 939 is the cost inflation index of F.Y.2013-14 i.e. the year in which the property at Chennai was sold.

5. (a) Interest paid in respect of capital borrowed for the purposes of business or profession is admissible under section 36(1)(iii). However, the proviso to section 36(1)(iii) says that interest paid in respect of capital borrowed for acquiring an asset for extension of existing business or profession (whether capitalized in the books of account or not) for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use will not be allowed as deduction.

In this case, the asset (plant & machinery) was not put to use till the end of the previous year. Therefore, interest of Rs. 6,00,000 will not be allowed as a deduction. However, the cost of the asset shall be increased by the amount of interest and depreciation shall be admissible on the enhanced cost of Rs. 66,00,000, once the asset is put to use.

As regards the brokerage of Rs. 60,000 paid to a broker for arranging the loan there are two possible views –

The first view is that since the definition of the term “interest” under section 2(28A) includes service fee or other charges in respect of moneys borrowed, “brokerage” can be considered to fall under the scope of the term “other charges” and is therefore covered by the definition “interest”. Hence, brokerage of Rs. 60,000 for arranging the loan will be treated in the same way as interest and capitalized with the cost of the asset.

The alternate view is based on the High Court decision in *C. Moolchand v. CIT (1956) 29 ITR 449 (Hyd.),* where it was held that brokerage or commission paid to an agent for arranging a loan for the purpose of business is not allowable as deduction under section 36(1)(iii), but allowable under section 37(1). As per this view, Rs. 60,000 paid to broker for arranging the loan is allowable under section 37(1).

(b) In order to assess income under the head "Income from house property" the assessee must be the owner of the house property. The need for registration of document in favour of a person to enable him to be treated as the owner of the house property for the purpose of section 22, was considered by the Supreme Court in the case of CIT vs. Poddar Cement Pvt. Ltd. (1997) 226 ITR 625.

It was held that so long as a person is entitled to receive income from the house property in his own right and not on behalf of someone else, it is not necessary that the sale deed must be registered in favour of the person to treat him as the owner of the property for the purpose of section 22. In such a case, the income derived from the property is chargeable to tax under the head "Income from house property". The fact that registration is not yet complete does not affect the chargeability of such income under the head "Income from house property".

Therefore, the claim of Girdhar that rent should be assessed under the head "Income from other sources" and deduction of various expenses and depreciation should be allowed therefrom is not tenable.

(c) In the instant case, the trust was created by Mr. Chawla himself out of his professional income. The client did not create the trust. The client did not impose any obligation in the nature of a trust binding on Mr. Chawla. Thus, there is no diversion of the money to the trust before it became professional income in the hands of Mr. Chawla. This case is one of application of professional income and not of diversion of income by overriding title. Therefore, the amount received by Mr. Chawla is chargeable to tax under the head “Profits and gains of business or profession”.

(d) This question is based on the principles laid down by Madras High Court in the case of *CIT v. Smt. R. Bharati (1999) 240 ITR 697* where the interpretation of the terms “professional qualifications” and “knowledge” came up for consideration as per proviso to section 64(1).

These words do not necessarily connote a qualification conferred by a recognized university after examining the candidate who has undergone a course of study in a technical subject or course of study preparing him for a profession of law, accountancy etc. Accordingly, the term “qualification” must be given a wide meaning as referring to the qualities which are required to be possessed by a person performing the work that he does, so long as that work is capable of being regarded as technical or professional.

The word “professional” is a term capable of very broad meaning and would encompass a variety of occupations. A large number of occupations are being practiced which form a source of livelihood and are capable of being regarded, as professions as long as they require certain degree of skill. A person having skill, experience and competence in a line of work can be regarded as professionally qualified for the purpose of section 64(1)(ii).

A model in the light of above is having skill, competence and experience in her line and is thus professionally qualified. Hence, the action of the Assessing Officer is not correct.

(e) Section 78(2) provides that where a person carrying on any business or profession has been succeeded in such capacity by another person, otherwise than by inheritance, then, the successor is not entitled to carry forward and set-off the loss of the predecessor against his income. This implies that generally, set-off of business losses should be claimed by the same person who suffered the loss and the only exception to this provision is when the business passes on to another person by inheritance.

The facts of case given in the question are similar to the case *CIT v. Madhukant M. Mehta (2001) 247 ITR 805*, where the Supreme Court has held that if the business is succeeded by inheritance, the legal heirs are entitled to the benefit of carry forward of the loss of the predecessor. Even if the legal heirs constitute themselves as a partnership firm, the benefit of carry forward and set off of the loss of the predecessor would be available to the firm.

In this case, the business of Rajan was continued by his legal heirs after his death by constituting a firm. Hence, the exception contained in section 78(2) along with the decision of the Apex Court discussed above, would apply in this case. Therefore, the firm is entitled to carry forward the business loss of Rs. 5 lacs of Rajan.

6. (a) The selection of the form of organisation to carry on any business activity is essential in view of the differential tax rates prescribed under the Income-tax Act, 1961 and specific concessions and deductions available under the Act in respect of different entities. For the purpose of formulating advice as to the tax efficient structure of the business, it is necessary for the tax consultant to consider the following issues:

1 In the case of sole proprietary concern, interest on capital and remuneration paid to the proprietor is not allowable as deduction under section 37(1) as the expenditure is of personal nature. On the other hand, in the case of partnership firm, both interest on capital and remuneration payable to partners are allowable under section 37(1) subject to the conditions and limits laid down in section 40(b). Remuneration and interest should however, be authorised by the instrument of partnership and paid in accordance with such instrument. Such interest and salary shall be taxable in the hands of partners to the extent the same is allowed to the firm under section 40(b). Interest to partners can be allowed up to 12% on simple interest basis, while the limit for allowability for partners' remuneration is based on book profit under section 40(b). As per section 40(b)(v) the partners' remuneration shall be allowed to the extent of aggregate of -

(a) On the first Rs. 3,00,000 of book profits or in case of loss – Rs. 1,50,000 or at the rate of 90% of book profits, whichever is more

(b) on the balance of book profits – at the rate of 60%

2. Partner's share in the profits of firm is not taxed in the hands of the partners by virtue of section 10(2A).

3. If a proprietary concern is formed, the salary of Mrs. Goswami shall be allowed as deduction under section 37(1).

4. The possibility of invoking section 40A(2) cannot be ruled out as salary is payable to a relative, who is an interested person within the meaning of section 40A(2). However, it can be argued successfully that salary of Rs. 5 Lacs is justified in view of her long experience as marketing manager of a multinational company and the fair market value of services to be rendered by her to the concern.

5. An issue arises as to whether remuneration of Mrs. Goswami would be includible in the total income of Mr. Goswami. Under section 64(1)(ii), remuneration of the spouse of an individual working in a concern in which the individual is having a substantial interest shall be included in the total income of the individual. **However, the clubbing provision does not apply if the spouse possesses technical or professional qualification and the income is solely attributable to the application of his or her technical or professional knowledge and experience.** Further, technical or professional qualification would not necessarily mean the qualifications obtained by degree or diploma of any recognized body *[Batta Kalyani vs. CIT (1985) 154 ITR 0059 (AP)]* The experience of Mrs. Goswami as a marketing manager in a multinational company for 15 years may reasonably be considered as a professional qualification for this purpose.

6. If Mrs. Goswami joins the proprietary concern or partnership concern of her husband as employee, remuneration of Rs. 5 lacs shall be taxed in her hands under the head "salary".

7. If she joins as partner in the business, remuneration shall be taxed in her hand as business income under section 28 to the extent such remuneration is allowed in the hands of the firm under section 40(b).

8. The tax rate applicable to an individual depends on the level of his/her income, whereas for partnership firms it is flat rate at 30%. For individuals, the rate of tax is at 10% on income exceeding Rs. 2,00,000 but not exceeding Rs. 5 lacs and @ 20% for income exceeding Rs. 5 lacs but not exceeding Rs. 10 lacs and @ 30% in respect of income exceeding Rs. 10 lacs for the assessment year 2014-15. Education cess @ 2% and Secondary and higher education cess@1% is attracted in both the cases.

Note : Considering the comparatives given above, Mr. Goswami is advised to commence a proprietary concern and pay salary to Mrs. Goswami. In the event of the business expanding and necessitating inclusion of Mrs. Goswami, it can always be resorted to with zero tax consequence by converting into a partnership firm or limited liability partnership, as the case may be, to avail all the advantages.

(b) **Mr. Bajaj is entitled to relief under section 91, since: -**

(i) He is a resident in India during the relevant previous year.

(ii) Income, by way of commission and dividend, accrues or arises to him outside India (in Hong Kong) during the previous year.

(iii) Such income is not deemed to accrue or arise in India during the previous year.

(iv) The income in question, namely, commission and dividend, has been subjected to income-tax in Hong Kong in the hands of Mr. Bajaj and he has paid tax on such income in Hong Kong.

(v) There is no agreement under section 90 for the relief or avoidance of double taxation between India and Hong Kong.

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

Computation of total income and tax liability of Mr. Bajaj for A.Y.2014-15

Particulars		Rs.
Income from business in India		2,50,000
Commission received from a company in Hong Kong		3,00,000
Dividend received from a company in Hong Kong		90,000
Interest on fixed deposits with banks in India		2,00,000
Total Income		8,40,000
Tax on the above:		
Upto Rs. 2,50,000	Nil	
Over Rs. 2,50,000 & upto Rs. 5,00,000 @ 10%	25,000	
Over Rs. 5,00,000 & upto Rs. 8,40,000 @ 20%	68,000	93,000
Education cess @ 2% and secondary and higher education cess @ 1%		2,790
Total tax liability		95,790
Average rate of income-tax in India: (Rs. 95,790/ Rs. 8,40,000 x 100)	11.40%	
Average rate of income-tax in Hong Kong (Rs. 78,000/ Rs. 3,90,000 x 100)	20%	
Double tax relief under section 91 shall be @11.40% or 20% of foreign income, whichever is less [i.e., Rs. 3,90,000 x 11.40%]		44,460
Net tax liability (Rs. 95,790 – Rs. 44,460)		51,330

(c) Mr. Sujit, is required to maintain books of account as per section 44AA and get them audited under section 44AB, since his gross sales exceeded Rs. 1 crore. He is liable to pay penalty under section 271A for not maintaining his books of account as per section 44AA. Accordingly, the action of the Assessing Officer in levying penalty under section 271A is correct. However, where books of account have not been maintained, there cannot be a question of getting them audited. Audit of books of account presupposes maintenance of books of account. When admittedly Mr. Sujit has not maintained books, he cannot obviously get the audit done.

In *Surajmal Parsuram Todi v. CIT (1996) 222 ITR 691*, the Gauhati High Court has held that when a person commits an offence by not maintaining books of accounts as contemplated by section 44AA, the offence is complete and after that there can be no possibility of any offence as contemplated by section 44AB and, therefore, the imposition of penalty under section 271B is erroneous.

Therefore, in this case, the Assessing Officer is not justified in levying penalty under section 271B.

7. (a) Any income arising from an international transaction, where two or more "associated enterprises" enter into a mutual agreement or arrangement, shall be computed having regard to arm's length price as per the provisions of Chapter X of the Act.

Section 92A defines an "associated enterprise" and sub-section (2) of this section speaks of the situations when the two enterprises shall be deemed to associated enterprises. Applying the provisions of section 92A(2)(a) to (m) to the given facts, it is clear that "Surya Motors Ltd." is associated with :-

(i) Thin Ltd. as per section 92A(2)(a), because this company holds shares carrying more than 26% of the voting power in Surya Motors Ltd.;

(ii) Kyoto Ltd. as per section 92A(2)(g), since this company is the sole owner of the technology used by Surya Motors Ltd. in its manufacturing process;

(iii) Dorf Ltd. as per section 92A(2)(c), since this company has financed an amount which is more than 51% of the book value of total assets of Surya Motors Ltd.

The transactions entered into by Surya Motors Ltd. with different companies are, therefore, to be adjusted accordingly to work out the income chargeable to tax for the A.Y. 2014-15.

	Particulars	Rs. (in crores)
Income of Surya Motors Ltd. as computed under Chapter IV-D, prior to adjustments as per Chapter – X		300.00
Add:	Difference on account of adjustment in the value of international transactions:	
(i)	Difference in price of car @ $ 200 each for 10,000 cars ($ 200 x 10,000 x 63)	12.60

(ii)	Difference for excess payment of royalty of \$ 30,00,000 (\$ 30,00,000 x 63) [See Note below]	18.90
(iii)	Difference for excess interest paid on loan of EURO 1000 crores (84*1000*1/100)	840.00
Total Income		1,171.50

The difference for excess payment of royalty has been added back presuming that the manufacture of cars by Surya Motors Ltd is wholly dependent on the use of know-how owned by Kyoto Ltd.

Note: It is presumed that Surya Motors Ltd. has not entered into an Advance Pricing Agreement or opted to be subject to Safe Harbour Rules.

(b) (i) The definition of "work" under section 194C includes manufacturing or supplying a product according to the requirement or specification of a customer by using material purchased from such customer. In the instant case, Short Limited manufactures the product as per the specification given by Tall Limited by using the raw materials purchased from Tall Limited. Therefore, it falls within the definition of "work" under section 194C. Consequently, tax is to be deducted on the invoice value excluding the value of material purchased from such customer if such value is mentioned separately in the invoice. If the material component is not mentioned separately in the invoice, tax is to be deducted on the whole of the invoice value.

(ii) Provisions for deduction of tax at source under section 194J are attracted in respect of payment of fees for professional services, if the amount of such fees exceeds Rs. 30,000 in the relevant financial year. The service rendered by a commentator in relation to sports activities has been notified by the CBDT as professional service for the purpose of section 194J vide its *Notification No. 88 dated 21st August, 2008.* Therefore, tax is required to be deducted@10% from the fee of Rs. 5 lacs payable to the former cricketer.

(iii) Section 195 requires deduction of tax at source by any person responsible for making payment to a non-resident, any interest or any other sum chargeable under the provisions of the Income-tax Act, 1961 (other than income chargeable under the head "Salaries").

Section 192(1) requires "any person" responsible for paying income under the head "Salaries" to deduct tax at source. Therefore, even if the payer is a foreign company, section 192 would be applicable.

TDS provisions under section 192 are attracted, if the salary payable to a non-resident is chargeable to tax in India. Under section 9(1)(ii), income which falls under the head "Salaries" shall be deemed to accrue or arise in India, if it is earned in India. Salary payable for service rendered in India shall be regarded as income earned in India. Therefore, salary paid to Mr. David, a non-resident, attracts tax liability in India, as he has rendered services in India and the salary is attributable to such services.

Therefore, the foreign company, SN Limited, is liable to deduct tax at source under section 192 from the salary of Mr. David.

(iv) Section 192 requires deduction of tax from salary at the time of payment. Thus, the employer is not required to deduct tax at source when salary has not been paid but is merely credited to the account of the employee in its books of account. TPO Ltd. therefore, is not required to deduct tax at source in respect of the salary merely credited to the account of employee Dinesh which is not paid.

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – II

PAPER – 8: INDIRECT TAX LAWS

Question No. 1 is compulsory.

Attempt any **five** *questions from the remaining* **six** *Questions.*

(Wherever appropriate, suitable assumption should be made and indicated in the answer by the candidate)

Time Allowed – 3 Hours | Maximum Marks – 100

1. (a) ABC & Co. is the small scale unit located in a rural area which is eligible for exemption under *Notification No. 8/2003-CE* during the year 2012-13. You are required to determine the value of the first clearance of the unit and duty liability of ABC & Co. for the year 2012-13 on the basis of particulars given below:

		Rs.
(i)	Total value of clearances of goods with own brand name	50,00,000
(ii)	Total value of clearances of goods with brand name of other parties	1,00,00,000
(iii)	Clearances of goods which are totally exempt under another notification (other than an exemption based on quantity or value of clearances)	45,00,000
(iv)	Rate of excise duty – 12% plus education cesses as applicable	

(Make suitable assumptions where required and show the calculations with appropriate notes) *(5 Marks)*

(b) Secure Bank Ltd. furnishes the following information relating to services provided and the gross amount received during the month of January, 2014. Compute the value of taxable service and service tax payable:

		Rs.(Lakhs)
(i)	Amount of commission received for debt collection service	10
(ii)	Discount earned on bills discounted	4.5
(iii)	Value of sale and purchase of forward contract	5.7
(iv)	Charges received on credit card and debit card facilities	3.8

	extended	
(v)	Penal interest recovered from the customers for the delay in repayment of loan	2.6
(vi)	Commission received for service rendered to Government for tax collection	6.0
(vii)	Interest earned on reverse repo transaction	25.0

Note: Secure Bank Ltd. is not eligible for small service providers' exemption under *Notification No. 33/2012 – ST dated 20.06.2012.* (10 Marks)

(c) Compute the assessable value for the purpose of determination of customs duty from the following data:

	US $
Machinery imported from USA by air (FOB price)	4,000
Accessories compulsorily supplied alongwith the machinery	1,000
Air freight	1,200
Insurance charges	Actuals not available
Local agent's commission to be paid in Indian currency	Rs. 9,300
Transportation from Indian airport to factory	Rs. 4,000

Exchange rate US $ 1 = Rs. 60

Provide explanations where necessary. *(5 Marks)*

2. (a) Compute the assessable value and amount of excise duty payable under the Central Excise Act, 1944 and rules made thereunder from the following information:

Particulars	No. of units	Price at factory per unit*	Price at depot per unit*	Rate of duty ad valorem
Goods transferred from factory to depot on 8th February	1,000	Rs. 200	Rs. 220	12%
Goods actually sold at depot on 18th February	750	Rs. 225	Rs. 250	10%

*Note: Assume it to be the price at which the greatest aggregate quantity of goods are sold. *(4 Marks)*

(b) Discuss whether service tax is leviable in respect of transporation services provided by Raja Ram Goods Transport Agency in each of the following independent cases:

Customer	Nature of services provided	Amount charged
A	Transportation of milk	Rs. 20,000
B	Transportation of books on a consignment transported in a single goods carriage	Rs. 3,000
C	Transportation of chairs for a single consignee in the goods carriage	Rs. 600

(8 Marks)

(c) Assessable value of certain goods imported from USA is Rs. 10,00,000. The packet contains 10,000 pieces with maximum retail price of Rs. 200 each. The goods are assessable under section 4A of the Central Excise Act, 1944, after allowing an abatement of 40%. The excise duty rate is 12% ad valorem. Calculate the amount of additional duty of customs under section 3(1) of the Customs Tariff Act, 1975 assuming basic customs duty @ 10% ad valorem. *(4 Marks)*

3. (a) Sundar Ltd. manufactured cigarettes. It used duty paid paperback aluminum foil in the roll form for the purpose of packing cigarettes. In the process, the roll of aluminum foil was cut horizontally to make separate pieces of the foil and word 'PULL' was embossed on it. Thereafter, fixed number cigarettes were wrapped in it. An aluminium foil being resistant to moisture was used as a protector for the cigarettes and to keep them dry.

Revenue issued a show cause notice to Sundar Ltd. alleging that the process of cutting and embossing aluminum foil amounted to manufacture. Since the aluminum foil was used as a shell for cigarettes to protect from them moisture; the nature, form and purpose of foil were changed.

Briefly discuss, with reference to case law, whether the show cause notice is sustainable in law. *(4 Marks)*

(b) The assessee, Devkinandan, Mathura, was running guest houses for the pilgrims. The Department issued show cause notice stating that the assessees were liable to get service tax registration under "short term accommodation service" and liable to pay service tax. The assessee, on the other hand, submitted that it was a religious and charitable institution and was running guest houses without any profit motive.

You are required to examine whether the show cause notice issued by the Department is valid or not, referring to a decided case law, if any.(8 Marks)

(c) Mr. William was the managing director of a company, which had set up a unit in the Cochin Export Processing Zone for manufacture of certain equipments for cent percent export. On the basis of the relevant notifications, the company was entitled to import capital goods and claim benefit of duty exemption on proof of total export.

With the passage of time, the business of the company fell and it went into liquidation. In the mean while, the customs authorities confiscated the capital goods in terms of Section 111(o) of the Customs Act, 1962, and imposed penalty on the company. Penalty under section 112(a)(ii) was also imposed on Mr. William without stating any reasons as he was in control of the affairs of the company. This was done as the Assistant Commissioner of Customs found that neither the capital goods nor the raw materials and other goods were used in the production of goods for export in terms of the relevant notification.

Briefly discuss, with reference to case law, whether the show cause notice imposing penalty on Mr. William under section 112(a)(ii) is sustainable in law. (4 Marks)

4. (a) Discuss the circumstances when an advance ruling will be void under the Central Excise Act, 1944.(4 Marks)

(b) Hanuman Ltd. is the owner of a coal-mine in Bihar. It obtained a patent from the concerned competent authorities in relation of the coal-mine in February, 2011. Further, Hanuman Ltd. has entered into an agreement with Laxman Ltd. in April, 2011 for allowing the latter to extract coals from such mines for next three years. The consideration payable by Laxman Ltd. for using the coal-mine has been fixed @ Rs. 1000 per tonne. The quantum of coal extracted by Laxman Ltd. and other relevant details are given in the following table:

Financial Year	Output [in tonnes]	Date of issuance of invoice	Date of receipt of payment
2011-12	2,000	05.07.2012	26.08.2012
2012-13	3,000	13.04.2013	03.04.2013
2013-14	4,000	11.04.2014	20.05.2014

You are required to determine the point of taxation in the above case. *(8 Marks)*

(c) What are the provisions made under the Customs Act, 1962 regarding control of customs over the warehoused goods? *(4 Marks)*

5. (a) PQR Ltd, a output service provider, has misused the service tax credit. Discuss the actions that can be taken by the department against PQR Ltd. *(4 Marks)*

(b) Mrs. Sukriti Arora, an interior designer based in Delhi provides her service to an Indian Hotel Chain (which has business establishment in Mumbai) for its newly acquired property in London. State whether the service would be taxable in India on the basis of Place of Provision of Service Rules, 2012. *(8 Marks)*

(c) Briefly explain the power of CBEC to issue instructions regarding non-filing of appeal in certain cases under the Customs Act, 1962 *(4 Marks)*

Or

An importer filed bill of entry after 60 days of filing Import General Manifest. The Deputy Commissioner of Customs imposed a penalty of Rs. 10,000 by endorsement on the bill of entry. Since importer wanted to clear the goods he paid the penalty. Can penalty be imposed for late filing of bill of entry? Examine the issue in the light of relevant statutory provisions. *(4 Marks)*

6. (a) Mr. Manoj Jain manufactures electronic items for selling them within India as well as exports to Germany. He has stored his goods in the warehouse for the purpose of export. However, on account of certain unforeseen circumstances, goods cannot be exported to Germany. Now, he wishes to divert the goods kept in the warehouse for the purpose of export for home consumption. Explain briefly the procedure under Central Excise Act, 1944 to be adopted by Mr. Manoj Jain for diverting the said goods kept in the warehouse for the purpose of export to Germany for home consumption. *(4 Marks)*

   (b) Rohan fails to pay service tax of ₹ 15 lakh payable on 5th January, 2014 He pays it on 16th January, 2014 Determine the penalty under section 76 payable by Rohan in this case. *(8 Marks)*

   (c) Mr. X wants to import a laptop from the USA which has been used by the seller for some time there. Mr. X contends that he can freely import such laptop without any restriction/ authorization. Examine the correctness of Mr. X's claim in the light of the provisions of FTP 2009-14. (4 Marks)

7. (a) Under Excise Audit, 2000, the selection of unit for audit is based on 'risk factors'. Explain in brief the term 'risk factors' giving any five examples. *(4 Marks)*

   (b) LMN Ltd. did not pay its service tax dues of Rs. 40 lakh for the period ending 30.09.2013.

   Can the Department create first charge on the property of LMN Ltd.? If your answer is affirmative, whether there are any limitations in respect of creation of such first charge? *(8 Marks)*

   (c) Are supplies made by the sub-contractors eligible for deemed export benefits under FTP? Discuss. *(4 Marks)*

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – II

PAPER – 8: INDIRECT TAX LAWS

SUGGESTED ANSWERS / HINTS

1. (a) Computation of the value of first clearances and duty liability of ABC & Co.

Sl. No.	Particulars	Amount (Rs.)
(i)	Clearances of goods with own brand name	50,00,000
(ii)	Clearances of goods with brand name of other parties [Note 1]	1,00,00,000
(iii)	Clearances of goods which are exempt under a notification other than exemption based on quantity or value of clearances [Note 2]	_
	Total value of clearances eligible for SSI exemption available under *Notification No. 8/2003 CE dated 01.03.2003*	1,50,00,000
	Less: SSI exemption [Note 3]	1,50,00,000
	Dutiable clearances	Nil
	Excise duty payable	Nil

Notes: As per *Notification No. 8/2003 CE dated 01.03.2003 -*

1. Since, ABC & Co. is situated in rural area, clearances of goods with brand name of other parties would also be eligible for SSI exemption.
2. Clearances of goods which are exempt (other than an exemption based on quantity or value of clearances) under a notification are not included in the first clearances of Rs.150 lakh.
3. First clearances of Rs.150 lakh are exempt from payment of excise duty under SSI exemption.

(b) Computation of value of taxable service and service tax payable by Secure Bank Ltd.

Sl. No.	Particulars	Amount (Rs. in lakh)
(i)	Commission received for debt collection service [Note 1]	10,00,000
(ii)	Discount earned on bills discounted [Note 2]	-
(iii)	Value of sale and purchase of forward contract [Note 3]	-
(iv)	Charges received on credit and debit card facilities extended [Note 4]	3,80,000
(v)	Penal interest recovered from the customers for the delay in repayment of loan [Note 5]	-
(vi)	Commission received for service rendered to Government for tax collection [Note 1]	6,00,000
(vii)	Interest earned on reverse repo transaction [Note 6]	-
	Total	19,80,000
	Value of taxable service $\left[19,80,000 \times \frac{100}{112.36}\right]$ rounded off [since all the amounts are total amounts **received**]	17,62,193
	Service tax payable [Rs. 17,62,193 × 12%]	2,11,463
	Education cess [Rs. 2,11,463 × 2%]	4,229
	Secondary and higher education cess [Rs. 2,11,463 × 1%]	2,115
	Total service tax payable	2,17,807

Notes:

1. Commission received for debt collection service and commission received for service rendered to Government for tax collection are neither transactions in money which are excluded from the definition of service nor covered in negative list or under any exemption notification and are thus liable to service tax.

2. Services of bills discounting, to the extent the consideration is represented by way of discount, is covered in the negative list of services as such discounting is also a manner of extending credit facility or a loan.

3. Sale or purchase of forward contracts, being transaction in money, is outside the scope of the definition of service.

4. Credit extended through credit and debit cards is not in the nature of loan or advance for interest and thus, the charges received on account of such extended credit is in fact, the consideration for the services rendered by way of credit card.

5. Penal interest recovered from the customers for the delay in repayment of loan is not a consideration for an activity. Further, since services of extending loans in so far as the consideration is represented by way of interest is covered in the negative list, penal interest charged for delay in repayment of loan will also not be liable to service tax.

6. Reverse repo being a security, which is goods is excluded from the definition of service.

(c) Computation of Assessable Value of Machinery and Accessories

	Accessories US $	Machinery US $
FOB price	1,000.00	4,000.00
Add : Air Freight [Note 2]	200.00	800.00
Add : Insurance charges [Note 3]	11.25	45.00
Total CIF price excluding agent's commission	1,211.25	4,845.00
Exchange rate 1US $ = Rs. 60		
	Rs.	Rs.
Total in Indian currency	72,675.00	2,90,700.00
Add : Local agent's commission (allocated on *pro-rata* basis)	1,860.00	7,440.00
CIF value	74,535.00	2,98,140.00
Add : Landing charges @1% of CIF value (Note 4)	745.35	2,981.40
Assessable value	75,280.35	3,01,121.40

Notes :

(1) Since the price of the accessories is not included in the price of the machinery and is charged separately, the accessories will not be charged at the same rate as applicable to the machinery. Hence, separate assessable values for the machinery and accessories have been computed [Proviso (a) to section 19 of the Customs Act, read with Accessories (Condition) Rules, 1963]

(2) If the goods are imported by air, the freight cannot exceed 20% of FOB price [Second proviso to rule 10(2) of the Customs (Determination of Value of Imported Goods) Rules, 2007].

(3) Insurance charges are taken as 1.125% of FOB price if actual charges are not known [Clause (iii) of first proviso to rule 10(2) of the Customs (Determination of Value of Imported Goods) Rules, 2007].

(4) Even if there is no information regarding landing charges, still they are charged @ 1% of CIF value [Clause (ii) of first proviso to rule 10(2) of the Customs (Determination of Value of Imported Goods) Rules, 2007].

(5) Transportation charges from Indian airport to factory of importer are not includible in the assessable value.

2. (a) According to rule 7 of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000, in case where the goods are not sold at factory gate, but they are transferred by the assessee to his depot, the assessable value for the goods cleared from factory and sold from depot shall be normal transaction value of such goods at the depot at or about the same time at which the goods being valued are removed from the factory.

Assessable Value = 1,000 units × Rs. 220 = Rs. 2,20,000

Calculation of central excise duty:-

Basic excise duty @ 12% (Rs. 2,20,000 × 12%) [Refer note below]	26,400
Education cess @ 2%	528
Secondary and higher education cess @ 1%	264
Total duty payable	27,192

Note: The applicable rate of duty will be the rate of duty in force on the date on which such goods are removed from the factory.

(b)

Customer	Nature of services provided	Amount charged	Taxability
A	Transportation of milk	Rs.20,000	Exempt. Transportation of milk by goods transport agency is exempt vide *Notification No. 25/2012-S.T. dated 20.06.2012*.
B	Transportation of books on a consignment transported in a single goods carriage	Rs.3,000	Service tax is leviable. Exemption vide *Notification No. 25/2012-S.T. dated 20.06.2012* is available for transportation of goods only where the gross amount charged for transportation of goods on a

			consignment transported in a single goods carriage does not exceed Rs.1,500
C	Transportation of chairs for a single consignee in the goods carriage	Rs.600	Exempt. Transportation of goods where gross amount charged for transportation of all goods for a single consignee does not exceed Rs.750/- is exempt vide *Notification No. 25/2012-S.T. dated 20.06.2012*

(c) As the goods are assessable under section 4A of the Central Excise Act, 1944, additional duty of customs will be payable on the basis of maximum retail price printed on the packing; less abatement as permissible [proviso to section 3(2) of the Customs Tariff Act.]

	Rs.
Maximum retail price [10,000 pieces x Rs. 200]	20,00,000
Less : Abatement 40%	8,00,000
Assessable value under section 3(2)	12,00,000
Additional duty of customs @ 12%	1,44,000
Additional customs duty payable	1,44,000

3. (a) No, the show cause notice is not sustainable in law. The facts of the given case are similar to case of *CCE v. GTC Industries Ltd. 2011 (266) E.L.T. 160 (Bom.)*. The High Court pronounced that cutting and embossing did not transform aluminum foil into distinct and identifiable commodity. It did not change the nature and substance of foil. The said process did not render any marketable value to the foil and only made it usable for packing. There were no records to suggest that cut to shape/embossed aluminum foils used for packing cigarettes were distinct marketable commodity. Hence, process did not amount to manufacture as per section 2(f) of the Central Excise Act, 1944. Only the process which produces distinct and identifiable commodity and renders marketable value can be called manufacture.

(b) Yes, the show cause notice issued by the Department is valid in law.

The facts of the given case are similar to the case of *Tirumala Tirupati Devasthanams, Tirupati v. Superintendent of Customs, Central Excise, Service Tax 2013 (30) S.T.R. 27 (A.P.)* wherein the High Court stated that there is no absolute exemption granted to the petitioner.

The contention, in the present case, by Devkinandan that, it is a religious and charitable institution and is running guest houses without any profit motive, is irrelevant.

Running guest houses by whatever name they are called - whether as a shelter for pilgrims or any other name with or without profit is no answer and the Devkinandan is thus, liable to get itself registered under 'short term accommodation service' and pay service tax on the services provided by it.

(c) No, the show cause notice imposing penalty on Mr. William under section 112 of the Customs Act, 1962 is not sustainable in law. The facts of the given case are similar to case of *O.T. Enasu v. UOI 2011 (272) E.L.T. 51 (Ker.)*

The High Court stated that the non-observance of the conditions of import of the goods in question gives the jurisdiction to impose an order of confiscation in terms of Section 111(o) of the Act. However, while considering the question as to whether penalty has to be imposed on any person for any commission or omission, which has rendered the goods liable for confiscation under Section 111(o), it has to be decided as to whether the goods became liable for confiscation on account of any act of omission or commission attributable to the person in question. Merely because a person is the Managing Director of a company, he would not be fastened with penalty, unless it is shown that he had, by his commissions or omissions, led the goods to be liable for confiscation.

The High Court noted that under sub-clause (ii) of clause (a) of section 112, the liability to penalty is determined on the basis of duty sought to be evaded. Therefore, the jurisdictional fact to impose a penalty in terms of section 112(a)(ii) includes the essential ingredient that **"duty was sought to be evaded"**. The concept of evading involves a conscious exercise by the person who evades. Therefore, the process of "seeking to evade" essentially involves a mental element and the concept of the status "sought to be evaded" is arrived at only by a conscious attempt to evade. The High Court, therefore, inferred that unless it is established that a person has, by his omissions or commissions, led to a situation where duty is sought to be evaded, there cannot be an imposition of penalty in terms of section 112(a)(ii) of the Act.

The High Court, therefore held that since penalty had been imposed on the managing director without stating any reasons and without any finding that he was guilty of omissions or commission and had "sought to evade duty", the same could not be upheld.

4. (a) Where on a representation from the Commissioner of Central Excise or otherwise, it is proved that an advance ruling was obtained by the concerned applicant by fraud or misrepresentation of facts, the authority for advance ruling can declare the advance ruling as void ab initio. Consequently, all the provisions of the Central Excise Act shall apply to the applicant as if such ruling had never been made. Copy of such order is sent to the applicant and the Commissioner of Central Excise [Section 23F of the Central Excise Act, 1944].

(b) Rule 8 of the Point of Taxation Rules, inter alia, applies in respect of payments pertaining to patents, where the ***whole amount of the consideration*** for the provision of service is not ascertainable at the time when service was performed, and subsequently the use or the benefit of these services by a person other than the provider gives rise to any payment of consideration. The service shall be treated as provided each time when a payment in respect of such use or the benefit is received by the provider in respect thereof, or an invoice is issued by the provider, whichever is earlier.

Since in the given case, whole amount of the consideration for the provision of patent is not ascertainable at the time when service was performed and subsequently the use of these services by Laxman Ltd. gives right to any payment of consideration, both the conditions specified in rule 8 get satisfied. Therefore, the point of taxation of Hanuman Ltd. for various financial years, determined as per rule 8, is as under:

Financial Year	Point of Taxation	Reason
2011-12	05.07.2012	Date of issuance of invoice [05.07.2012] falls before date of payment [26.08.2012]
2012-13	03.04.2013	Date of payment [03.04.2013] precedes date of issuance of invoice [13.04.2013]
2013-14	11.04.2014	Date of issuance of invoice [11.04.2014] falls before date of payment [20.05.2014]

(c) Section 62 of the Customs Act, 1962 provides for the control of customs over the warehoused goods. The provisions are discussed as follows:

(i) All warehoused goods shall be subject to the control of the proper officer.

(ii) No person shall enter a warehouse or remove any goods therefrom without the permission of the proper officer.

(iii) The proper officer may cause any warehouse to be locked with the lock of the customs department and no person shall remove or break such lock.

(iv) The proper officer shall have access to every part of a warehouse and power to examine the goods therein.

5. (a) The following actions can be taken by the Department in case of misuse of service tax credit:

(i) Penalty not exceeding service tax on such services OR Rs. 2,000, whichever is greater can be levied if a person has taken CENVAT credit in respect of input services wrongly [Rule 15(1) of the CENVAT Credit Rules, 2004];

(ii) Penalty prescribed under section 78 of the Finance Act, 1994 can also be levied on the output service provider if the CENVAT credit in respect of input services has been taken or utilized wrongly by reason of fraud, collusion or any wilful mis-statement or suppression of facts or contravention of any of the provisions of CCR, 2004 or Finance Act, 1994 or the rules made thereunder with an intent to evade payment of service tax [Rule 15(3) of the CENVAT Credit Rules, 2004];

(iii) Special audit prescribed under section 72 of the Finance Act, 1994 can be ordered where credit of service tax availed and utilized is not within the normal limits etc.

(b) As per rule 5 of the Place of Provision of Service Rules, in case of a service that is 'directly in relation to immovable property', the place of provision is where the immovable property is located, irrespective of where the provider or receiver is located. Thus, on application of rule 5 in the instant case, place of provision of service is London and consequently, the service would not be taxable in India.

However, as per rule 8 of the Place of Provision of Service Rules, where the location of the provider of service as well as that of the recipient of service is in the taxable territory, the place of provision of service would be the location of the recipient of service. Since in the given case, both the provider and the receiver are located in taxable territory, on application of rule 8 in the instant case, the place of provision would be the location of the service receiver i.e. Mumbai and consequently, the service would be taxable in India.

As per rule 14 of the Place of Provision of Service Rules, if the place of provision of service is determinable in terms of more than one rule, the same is determined as per the rule that occurs later. Therefore, the place of provision in this case will be Mumbai and the service will be taxable in India (as per rule 8).

(c) Section 131BA provides as follows:-

The Board may issue instructions fixing such monetary limits for the purposes of regulating the filing of appeal/application/revision/reference by the Commissioner of Customs.

Where the Commissioner of Customs has not filed an appeal/application/revision/reference against any decision or order passed under the provisions of this Act in pursuance of such an instruction, he shall not be precluded from filing any appeal etc. in any other case involving the same or similar issues or questions of law.

Non-filing of appeal, application etc. by Commissioner of Customs cannot be considered to be his acquiescence in the decision on disputed issue. Further, Appellate Tribunal or court must have regard to the circumstances for non-filing of appeal etc.

Or

Section 46 of the Customs Act, 1962 does not prescribe any statutory time limit for filing Bill of Entry. However, under section 48 of the Customs Act, 1962, if imported goods are not cleared within 30 days from the date of unloading, goods can be disposed off by the custodian. Therefore, since no offence is committed by late filing of bill of entry, penalty cannot be imposed for the same. However, the custodian after giving notice to the importer and with the approval of the proper officer can sell the goods.

In the instant case, the importer can file an appeal before Commissioner (Appeals) against imposition of penalty since endorsement of penalty on the bill of entry can be considered as part of assessment.

6. (a) The goods kept in a warehouse for being exported can be diverted by Mr. Manoj Jain for home consumption in the following manner:

(i) With the permission of the Deputy or Assistant Commissioner of Central Excise, the goods can be cleared for home consumption on invoice prepared under rule 8 on payment of duty, interest and any other charges on TR-6 challans. Necessary entries are to be made in the export warehouse register maintained by the exporter in the warehouse.

(ii) Credit will be permitted in the Running Bond Account equivalent to the duty involved in the goods so diverted, which shall not exceed amount of duty debited on the basis of ARE-3 on which such goods were received in the warehouse.

(iii) Goods can also be diverted for home consumption even after clearance of goods from warehouse under ARE- 1. The documents will be cancelled as per *Notification No. 46/2001 CE (NT) dated 26.6.2001* as amended. The intimation of such cancellation is to be given to Deputy/Assistant Commissioner having jurisdiction over the warehouse. Credit in Running Bond Account will be permitted in the same manner as mentioned above.

(iv) The exporter has to pay an **interest @ 24% p.a.** on the amount of duty payable on such goods from the day of clearance from the factory of production or any other premises approved till the date of payment of duty and clearance.

(b) Amount of service tax which Rohan failed to deposit = Rs.15,00,000

Due date of depositing service tax is 05.01.2014

Date on which service tax actually deposited is 16.01.2014

No. of days by which service tax was deposited late = 11 days [16th Jan. – 5th Jan.]

(Penalty under section 76 is computed for a period beginning with the first day after the due date and ending with the date of actual payment.)

<u>Computation of quantum of penalty</u>

Rohan is liable to pay penalty for delayed payment of service tax under section 76 as follows:-

(A) Rs.100/- per day for every day during which such default continues

= Rs.100/- per day for 11 days = Rs.100× 11 days= Rs.1,100

or

(B) 1% per cent of amount of default, per month

$$= \text{Rs.}15{,}00{,}000 \times 1\% \times \frac{11}{31} = \text{Rs. } 5{,}323$$

whichever is higher.

However, total amount of penalty payable under this section shall not exceed 50% of the service tax that the assessee has failed to pay i.e.:-

Rs. 5,323 or Rs.7,50,000 [50% of Rs. 15,00,000], whichever is lower.

The amount of penalty payable by Rohan is Rs. 5,323/-.

(c) As per FTP 2009-14, second hand (used) goods, except second hand capital goods, are restricted for imports and can be imported only in accordance with the provisions of FTP, ITC(HS), prescribed procedures, public notice or an Authorization in this regard.

Import of second hand capital goods, including refurbished/ re-conditioned spares is allowed freely. However, second hand personal computers/ laptops, photocopier machines, air conditioners, diesel generating sets will only be allowed against an authorization. Import of re-manufactured goods will also be allowed only against an authorization.

In view of the afore-mentioned provisions, Mr. X's claim is not correct as second hand laptops can be imported only against an authorization.

7. (a) Risk factors under Excise Audit, 2000 means that the assessees who have a bad track record are taken up for audit on priority as opposed to those who enjoy a clean track record.

For example:

(i) assessee having past duty evasion cases

(ii) late payment of duty/late filling returns

(iii) major audit objections against them

(iv) no cash payment of duty (all CENVAT adjustment)

(v) past duty dues, etc

(b) According to provisions of section 88 of the Finance Act, 1994, any amount of tax, penalty, interest or any other sum payable by an assessee or any other person shall be the first charge on the property of the assessee or the person, as the case may be. Thus, the Department can create first charge on the property of LMN Ltd for recovery of service tax dues of Rs. 40 lakh.

However, the aforementioned first charge can be created subject to the provisions of following specified Acts:-

- Companies Act, 1956 (Section 529A);
- Recovery of Debt due to Band and Financial Institution Act, 1993; and
- Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest, 2002.

(c) Yes, the supplies made by the sub-contractor are eligible for deemed export benefit.

Normally, in order to be eligible for deemed export benefits, supplies are to be made directly to designated Projects/Agencies/Units/Advance Authorization/EPCG Authorization holders. However, FTP allows a sub-contractor to make supplies to main contractor, instead of supplying directly to designated Projects/Agencies. Such supplies are eligible for deemed export benefits if the main contractor makes payment to sub-contractor and issues payment certificate.

Supplies made by an Indian sub-contractor of an Indian or foreign main contractor directly to the designated Projects/Agencies are also eligible for deemed export benefits provided the name of the sub-contractor is indicated either originally or subsequently in the main contract (but before the date of supply of such goods) and payment certificate is issued by Project Authority in the name of sub-contractor.

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – II

PAPER – 8: INDIRECT TAX LAWS

Question No. 1 is compulsory.

Attempt any five questions from the remaining six Questions.

(Wherever appropriate, suitable assumption should be made and indicated in the answer by the candidate)

Time Allowed – 3 Hours Maximum Marks – 100

1. (a) Determine the amount of CENVAT credit available with Hindan Manufacturing Ltd. in respect of the following items procured by them in the month of October, 2014:-

Items	Excise duty paid (including EC and SHEC) (Rs.)
Raw materials	52,000
Capital goods used for generation of electricity for captive use within the factory	1,00,000
Motor spirit	40,000
Inputs used for construction of a building	1,00,000
Dairy and bakery products consumed by the employees	5,000

(Note: The aggregate value of clearances of Hindan Manufacturing Ltd. for the financial year 2013-14 is Rs. 450 lakh) *(5 Marks)*

(b) Hanuman Ltd. has a real estate business. It furnishes the following information pertaining to services provided:

Particulars	Amount (Rs.)
Construction services provided to International Labour Organisation	10,00,000
Construction of private clinic of a doctor	50,00,000
Repair service provided to State Government relating to plant for sewerage treatment	25,00,000
Construction of roads in a factory	20,00,000
Construction of residential complex meant for use of Member of Parliament	80,00,000

Renting of residential dwelling for use as residence	2,00,000
Repair and maintenance of a Railway Station	15,00,000

Compute the value of taxable service and the service tax liability of Hanuman Ltd. assuming that it is not eligible for small service providers' exemption under Notification No. 33/2012 – ST dated 20.06.2012. *(10 Marks)*

(c) A material was imported by air at CIF price of 5,000 US$. Freight paid was 1,500 US$ and insurance cost was 500 US$. The banker realized the payment from importer at the exchange rate of Rs. 61 per dollar. Central Board of Excise and Customs notified the exchange rate as Rs. 60 per US$. Find the value of the material for the purpose of levying duty. *(5 Marks)*

2. (a) What are the circumstances under which the certificate of registration can be revoked or suspended under Central Excise? *(4 Marks)*

(b) Shiv Ltd. enters into a contract with XYZ Ltd. for construction of a new building to be used primarily for commercial purposes for a total consideration of Rs.150 lakh on 02.07.2013. The relevant details are given as under:

Stage	Date	Date of issuance of invoice	Date of payment	Amount paid (Rs.)
Initial booking	02.07.2013	02.07.2013	02.07.2013	15 lakh
50% completion of building	15.03.2014	22.03.2014	29.03.2014	60 lakh
75% completion of building	20.06.2014	24.07.2014	25.07.2014	35 lakh
100% completion of building	30.09.2014	21.10.2014	20.10.2014	40 lakh

Note: A certificate from a Chartered Engineer registered with the Institution of Engineers (India) has been obtained with respect to each stage of completion of building. *(8 Marks)*

(c) After visiting USA, Mrs. & Mr. Aman brought to India a lap-top computer valued at Rs. 80,000, personal effects valued at Rs. 90,000 and a personal computer for Rs. 52,000. What is the customs duty payable? *(4 Marks)*

3. (a) The assessee M/s Z & Co. Ltd. were engaged in the manufacture of 'tarpaulin made ups'. This was nothing but tarpaulin cloth prepared by making a solution of wax, aluminum stearate and pigments that were mixed. The solution was heated in a vessel and was transferred to a tank. Grey cotton canvas fabric was then dipped into the solution and passed through two rollers, whereafter the canvas was dried by exposure to sun. The tarpaulin made ups were prepared by cutting the cloth into

various sizes and stitched and eyelets were fitted.

The central excise department has issued a show cause notice to M/s Z & Co. Ltd. that the process of preparing tarpaulin made ups by means of cutting, stitching and fixing eyelets amounts to manufacture under the Central Excise Act, 1944. Write a brief note with reference to decided case law, if any, whether the department's view in the matter is legally sustainable. *(4 Marks)*

(b) Pawan Ltd. is engaged in providing the taxable services and has been filing its service tax returns regularly. However, its jurisdictional Commissioner has the reasons to believe that Pawan Ltd. has understated the value of its taxable services for the previous year. Can the jurisdictional Commissioner of Central Excise direct such person to get his accounts audited by a Chartered Accountant to the extent and for the period as may be specified by him? Discuss briefly.

Will your answer be different if Pawan Ltd. contends that its accounts for the previous year have been audited under the Income-tax Act, 1961? *(8 Marks)*

(c) LMN Company Ltd. had imported brine shrimp eggs. This was classified as "prawn feed' for customs duty purposes under chapter heading No. 2309 of the Customs Tariff schedule which includes use as animal feed. The department's view was that this should be classified under chapter heading No. 051199 as non-edible animal products unfit for human consumption. M/s. LMN Company Ltd. provided literature to support their contention that the imported material contained little organisms/embryos which later became larva that were fed to the prawns. Therefore, according to the importers, the nature and character of the product was not changed or altered by nurturing or incubation. Hence, the classification should be as prawn feed under chapter heading No. 2309.

Decide with the help of case law, if any, whether the contention of the assessee, M/s. LMN Co. is correct in law. *(4 Marks)*

4. (a) Write a note on duty payment 'under protest' with reference to the Central Excise Act, 1944 and the rules made thereunder. *(4 Marks)*

(b) Compute service tax liability from the following particulars for the financial year 2013-14:

Gross amount (excluding all taxes) charged by the service provider for providing works contract service	Rs. 1,00,000
Actual value of material transferred in the above works contract (VAT under the relevant State VAT Law has been paid on this value)	Rs. 70,000
Excise duty paid on inputs	Rs. 8,750
Service tax paid on input services	Rs. 1,000
Excise duty paid on the capital goods, purchased during the year, used in the provision of works contract service	Rs. 1,000
Rate of service tax	12.36%

(8 Marks)

(c) Briefly write a note on whether an exporter who has been held guilty of exporting 'prohibited goods' is entitled to an option to pay fine in lieu of confiscation under section 125 of the Customs Act, 1962. *(4 Marks)*

5. (a) Under what circumstances it may be beneficial to pay duty and claim rebate under Rule 18 of Central Excise Rules, 2002. *(4 Marks)*

(b) Determine the place of provision of services as well as their taxability in each of the following cases:

(i) Mr. X, the owner of an immovable property located in New Delhi gives the said property to Mr. Y of London on rent, for commercial purposes.

(ii) Mr. Ram, a Delhi based interior decorator, provides his professional services in respect of property which is intended to be located in San Diego, U.S.A.

(iii) A U.S.A. based company possessing specialization in mineral exploration has been awarded a contract for mineral exploration in respect of specific sites in Canada by Mumbai based Mr. Krishna Kapoor.

(iv) PQR Ltd. agrees to provide services connected with oil exploration [by virtue of single agreement for consolidated consideration] to MNO Ltd. in respect of specific sites located in Assam, Gujarat and Maharashtra. The proportion of services provided by PQR Ltd. in relation of above States worked out to be 25%, 60% and 15%. PQR Ltd. does not have a centralized registration.

(8 Marks)

(c) Briefly state the rights of the owner of warehoused goods under the Customs Act, 1962. *(4 Marks)*

Or

Briefly explain the term 'export' for the purpose of duty drawback under section 75 of the Customs Act, 1962. Is duty drawback available if the goods do not reach the destination? *(4 Marks)*

6. (a) If a manufacturer manufactures various products, can he avail CENVAT credit on some products and exemption under Notification No. 8/2003-CE dated 01.03.03 on some other products ? *(4 Marks)*

(b) XYZ Constructions Ltd. is engaged in providing the services by way of construction of roads. The said services are exempt from service tax vide mega exemption notification- Notification No. 25/2012 ST dated 20.06.2012. Examine whether the sub-contractors who provide architects services and consulting engineer's services, which are used by XYZ Constructions Ltd. in relation to such construction service, are also exempt from service tax. *(8 Marks)*

(c) AB Corporation, a manufacturer-exporter, has approached CD Corporation, a merchant exporter, to export one of its consignments as owing to some technical difficulties, AB Corporation could not export the consignment itself. The shipping bills relating to the consignment bear the name of CD Corporation. Bank Realization Certificate, GR declaration, export order and invoice are also in the name of CD Corporation. Comment whether AB Corporation would be deemed as the exporter under FTP. *(4 Marks)*

7. (a) An assessee sold certain goods to MNO Ltd. for Rs. 20,000 (excluding excise duty and other taxes) on 09.09.2014. The buyer, MNO Ltd., is a related person as defined under section 4(3)(b) of the Central Excise Act, 1944. It did not sell the goods, but used it as intermediary product. The cost of production of the said goods determined as per CAS-4 was Rs. 16,000. Determine the assessable value in the given case.

   What will be the assessable value, if in the aforesaid case, MNO Ltd. is not related to the assessee? *(4 Marks)*

   (b) Discuss the prosecution, arrest and bail implications, if any, in respect of the following cases:

   (i) Mr. Govind provides consulting engineer's services of Rs. 60 lakh during the month of July, 2014 and knowingly evades the payment of service tax.

   (ii) Mr. Vijay avails and utilizes credit of service tax of Rs. 45 lakh during the quarter ending September, 2014 without actual receipt of taxable service.

   (iii) Mr. Vivek fails to supply any information [with service tax implications of Rs. 52 lakh] which he was required to supply under the Service Tax Rules, 1994.

   (iv) Miss Radha collected service tax of Rs. 70 lakh in the month of June, 2014 but did not deposit the said amount until 31st March, 2015. She has committed such offence for the second time. *(8 Marks)*

   (c) Mention the reward scheme provided under FTP which aims to compensate high transport costs and offset other disadvantages in the export of specified agricultural and village industry products. What is the general rate of entitlement under the Scheme? How can the duty scrips issued under the Scheme be utilized? *(4 Marks)*

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – II

PAPER – 8: INDIRECT TAX LAWS

SUGGESTED ANSWERS / HINTS

1. (a) Computation of the amount of CENVAT credit available with Hindan Manufacturing Ltd.:-

Items	Excise duty paid (including EC and SHEC) (Rs.)
Raw materials	52,000
Capital goods used for generation of electricity for captive use (50% of Rs. 1,00,000) (Note-1 & 2)	50,000
Motor spirit (Note-3)	Nil
Inputs used for construction of a building (Note-3)	Nil
Dairy and bakery products consumed by the employees (Note-3)	Nil
Total CENVAT credit available	1,02,000

Notes:-

1. Capital goods used for generation of electricity for captive use within the factory are eligible capital goods under rule 2(a) of the CENVAT Credit Rules, 2004.

2. Since, aggregate value of clearances of Hindan Manufacturing Ltd. for the financial year 2013-14 is Rs. 450 lakh i.e. more than Rs. 400 lakh, it is not eligible for SSI exemption. Therefore, CENVAT credit of only upto 50% of the duty paid is available in respect of the eligible capital goods in the year of purchase [Rule 4(2)(a)].

3. As per the definition of inputs under rule 2(k), there is specific exclusion with regard to the following:-

   (i) motor spirit

   (ii) goods used for construction of a building or a civil structure or a part thereof

(iii) any goods, such as food items used primarily for personal use or consumption of any employee

(b) Computation of value of taxable service and service tax liability of Hanuman Ltd:-

Particulars	Amount (Rs.)
Construction services provided to International Labour Organisation (Note-1)	Nil
Construction of private clinic of a doctor (Note-1)	50,00,000
Repair service provided to State Government relating to plant for sewerage treatment (Note-1)	Nil
Construction of roads in a factory (Note-1)	20,00,000
Construction of residential complex meant for use of a Member of Parliament (Note-1)	Nil
Renting of residential dwelling for use as residence (Note-2)	Nil
Repair and maintenance of a Railway Station (Note-1)	15,00,000
Value of taxable service	85,00,000
Service tax @ 12% [Rs. 85,00,000×12%]	10,20,000
Education cess @ 2% [Rs. 10,20,000×2%]	20,400
Secondary and higher education cess @ 1% [Rs. 10,20,000×1%]	10,200
Service tax liability	10,50,600

Notes:

1. Following service are exempt from service tax vide mega exemption notification - *Notification No. 25/2012-ST dated 20.06.2012*:-

   (a) Any services provided to the specified international organisations.

   (b) Construction of hospitals for the Government, a local authority or a Governmental authority. However, such services provided to any other person are taxable.

   (c) Repair service provided to State Government relating to plant for sewerage treatment.

   (d) Services provided by way of construction of roads for use by general public. However, construction of roads which is not for use by general public is taxable.

   (e) Construction of residential complex meant for use of a Member of Parliament.

(f) Services by way of construction, erection, or installation of original works pertaining to railway. Therefore, repair and maintenance of railways is liable to service tax.

2. Services by way of renting of residential dwelling for use as residence are included in the negative list and hence, are not taxable.

(c) Computation of assessable value

Particulars	Amount
CIF value	5000 US $
Less: Freight	1500 US $
Less: Insurance	500 US $
Therefore, FOB value	3000 US $
Assessable value for Customs purpose	
FOB value	3000 US $
Add: Freight (20% of FOB value) [Note 1]	600 US $
Add: Insurance (actual)	500 US $
CIF for customs purpose	4100 US $
Add: 1% for landing charges [Note 2]	41 US$
Value for customs purpose	4141 US $
Exchange rate as per CBEC [Note 3]	Rs. 60 per US $
Assessable value	Rs. 60 x 4141 US $ Rs. 2,48,460

Notes:

1. If the goods are imported by air, the freight cannot exceed 20% of FOB price [Second proviso to rule 10(2) of the Customs (Determination of Value of Imported Goods) Rules, 2007].

2. Even if there is no information regarding **landing charges**, still they are charged @ 1% of CIF value [Clause (ii) of first proviso to rule 10(2) of the Customs (Determination of Value of Imported Goods) Rules, 2007].

3. Rate of exchange determined by CBEC is considered [clause (a) of the explanation to section 14 of the Customs Act, 1962].

2. (a) The certificate of registration under the Central Excise Act, 1944, can be suspended or revoked by the Deputy Commissioner or the Assistant Commissioner of Central Excise under the following circumstances.

(i) when the assessee or any person under his employment has committed any breach of any condition of the Central Excise Act or any rules made there under.

(ii) the assessee or a person under his employment has been convicted of an offence under Section 161 read with section 109 or section 116 of the Indian Penal Code.

(b) Since in the present case, the construction services are provided by Shiv Ltd. to XYZ Ltd. under a contract for a period exceeding three months with the obligation for payment periodically, such services would fall within the ambit of term "continuous supply of service" as per rule 2(c) of the Point of Taxation Rules. The point of taxation in case of continuous supply of services is determined in accordance with provisions of rule 3 of Point of Taxation Rules.

Further, it is important to note that in case of continuous supply of service where the provision of the whole or part of the service is determined periodically on the completion of an event in terms of a contract, which requires service receiver to make any payment to service provider, the date of completion of each such event as specified in the contract shall be deemed to be the date of completion of provision of service.

Accordingly, the point of taxation with respect to each of the stages of completion is as follows:

Stage of Completion	Point of taxation
Initial booking	02.07.2013 as the date of completion of service, date of issuance of invoice and date of payment are the same.
50%	Since invoice has been issued within 30 days of completion of service, point of taxation is date of invoice (22.03.2014) or date of payment (29.03.2014) whichever is earlier, i.e. 22.03.2014.
75%	Since invoice has not been issued within 30 days of completion of service, point of taxation is date of completion of service (20.06.2014) or date of payment (25.07.2014) whichever is earlier, i.e. 20.06.2014.
100%	Since invoice has been issued within 30 days of completion of service, point of taxation is date of invoice (21.10.2014) or date of payment (20.10.2014) whichever is earlier, i.e. 20.10.2014.

(c) (1) As per Baggage Rules, 1998 in respect of a passenger of and above 10 years of age returning from a Country other than Nepal, Bhutan, Myanmar or China after a stay of more than three days.

(i) Personal effects are allowed duty free clearance without any value limit.

(ii) Besides (i) above, articles upto a value of Rs. 35,000 carried as accompanied baggage are allowed duty free clearance [General free allowance].

Hence, duty shall be payable on Rs. 52,000 – Rs. 35,000 = Rs. 17,000.

(2) One Laptop computer brought as baggage by a passenger of or above 18 years of age (other than member of crew) is fully exempt from customs duty *[Notification No. 11/2004 Cus dated 08.01.2004]*

(3) Effective rate of duty for baggage =36.05%[35% + 2% primary education cess & 1% secondary & higher education cess]

Therefore, duty payable = Rs. 5,950 + Rs. 179

Total customs duty = Rs. 6,129

3. (a) The facts of the given case are similar to the one decided by the Apex Court in the case of CCE v. *Tarpaulin International 2010 (256) E.L.T. 481 (S.C.)* In this case, the Apex Court has observed that stitching of tarpaulin sheets and making eyelets does not change the basic characteristic of the raw material as the process does not bring into existence a new and distinct product different from the original commodity. The original material used i.e., the tarpaulin, is still called tarpaulin made-ups even after undergoing the said process. Hence, the Supreme Court has held that process of making tarpaulin made ups by cutting, stitching the tarpaulin fabric and fixing eyelets therein cannot be said to be a manufacturing process liable to excise duty.

Therefore, in view of the above-mentioned judgement, the Department's view in the matter is not legally sustainable.

(b) Section 72A(1) of Finance Act, 1994, *inter alia*, provides that if the Commissioner of Central Excise has reasons to believe that any person liable to pay service tax has failed to declare or determine the value of a taxable service correctly, he may direct such person to get his accounts audited by a Chartered Accountant nominated by him, to the extent and for the period as may be specified by the Commissioner.

Therefore, in the present case, jurisdictional Commissioner of Central Excise can direct Pawan Ltd. to get its accounts audited by a Chartered Accountant nominated by him, to the extent and for the period as may be specified by him.

Further, section 72A(3) provides that the Commissioner of Central Excise is empowered to direct a special audit even if the accounts of such person have been audited under any other law for the time being in force.

Therefore, the contention of Pawan Ltd. that its accounts for the previous year have been audited under the Income-tax Act, 1961 cannot be accepted and it will have to comply with the order, if any, of the jurisdictional Commissioner to get its accounts audited.

(c) Yes, the contention of the assessee is justified in law. The facts of the given case are similar to the case of *Atherton Engineering Co. Pvt. Ltd. v. UOI 2010 (256) ELT 358 (Cal.)*. In the instant case, the Court noted that it was the use of the product that had to be considered in the instant case. If a product undergoes some change after importation till the time it is actually used, it is immaterial, provided it remains the same product and it is used for the purpose specified in the classification. Therefore, in the instant case, it examined whether the nature and character of the product remained the same.

The Court opined that if the embryo within the egg was incubated in controlled temperature and under hydration, a larva was born. The larva did not assume the character of any different product. Its nature and characteristics were same as the product or organism which was within the egg.

Hence, the Court held that the said product should be classified as feeding materials for prawns under the heading 2309. These embryos might not be proper prawn feed at the time of importation but could become so, after incubation.

4. (a) Duty payment "under protest":-Section 11B of the Central Excise Act, 1944 provides that the time limit of one year for claiming refund of central excise duty shall not apply where the duty has been paid under protest.

As per the **Supplementary Instructions** issued by Central Board of Excise and Customs, any assessee who desires to pay duty under protest, may do so by following the procedure mentioned below:

(i) The assessee shall inform the Superintendent or Inspector of Central Excise in writing giving reasons for paying duty under protest and a dated acknowledgement shall be given to him.

(ii) The assessee shall mark invoices or monthly/quarterly returns indicating the goods on which duty is paid "under protest" If it is a lump-sum duty payment in respect of past demand, he may record the fact of duty payment under protest in the Personal Ledger Account, CENVAT Account and the Daily Stock Account.

(iii) If a case is appealed against by the assessee or where the appeal period for further appeal is available, he may continue to pay duty under protest. However, if decision is not in his favour and he exhausts the appellate remedy or does not appeal within stipulated period, he shall not have any right to pay duty under protest.

(b) **Computation of service tax liability as per rule 2A(i) of the Service Tax (Determination of Value) Rules, 2006:**

Particulars	Amount (Rs.)
Gross amount charged	1,00,000

Less: Actual value of goods transferred (Note-1)		70,000
Value of service portion in the execution of works contract		30,000
Service tax on Rs. 30,000 @12.36%		3,708
Less:	CENVAT credit on inputs (Note-2)	-
	CENVAT credit on input services	1,000
	CENVAT credit on capital goods (50%) (Note-3)	500
Service tax payable		2,208

Notes:

1. Since VAT has been paid on the actual value of property in goods transferred in the execution of the works contract, such value adopted for the purposes of payment of VAT has been taken as the value of property in goods transferred in the execution of the said works contract [Clause (c) of Explanation to rule 2A(i) of the Valuation Rules].

2. CENVAT credit of duties or cess paid on any inputs, used in or in relation to the said works contract, is not available [Explanation 2 to rule 2A of the Valuation Rules].

3. Only 50% of the duty paid on the capital goods is available as CENVAT credit, in the current year [Rule 4(2)(a) of the CENVAT Credit Rules, 2004].

(c) As per section 125 of the Customs Act, 1962, whenever confiscation is ordered, the adjudicating officer *may* provide an option to the owner of the goods to pay redemption fine in lieu of confiscation if the importation or exportation of goods is prohibited. However, if importation or exportation of goods is not prohibited, the option to pay redemption fine *shall* be given to the owner of goods.

Therefore, an exporter guilty of exporting prohibited goods is not *entitled as such* to an option to pay fine in lieu of confiscation under section 125 of the Customs Act, 1962. It is at the discretion of the adjudicating officer to give or not to give such an option to the exporter guilty of exporting prohibited goods. However, the owner of the goods importing or exporting non-prohibited goods shall be entitled to such an option.

5. (a) It is usually preferable not to pay duty rather than to pay it and wait for refund from the government. However, in the following situations, it is beneficial to pay duty and claim rebate under Rule 18 of Central Excise Rules, 2002:

(A) If assessee has balance of duty in Capital Goods CENVAT Credit Account, it is advisable to pay duty and claim refund, as balance in Capital Goods CENVAT Credit Account is never refundable. The said situation may take place if duty paid on capital goods is heavy and assessee may not be able to utilize the credit.

(B) An SSI Unit may pay excise duty and claim rebate, as getting refund of CENVAT Credit of inputs is not an easy preposition. Further, he is not entitled to get refund of duty paid on capital goods.

(C) When duty paid goods are proposed to be exported.

(D) Claiming rebate is comparatively easy procedure than claiming refund of duty paid on inputs under CENVAT Credit Rules, 2004.

(b) (i) As per rule 5 of the Place of Provision of Service Rules, in case of a service that is 'directly in relation to immovable property', the place of provision is where the immovable property is located, irrespective of where the provider or receiver is located.

Since in the given case, the immovable property in question is located in New Delhi, the place of provision of service is New Delhi and resultantly, the service would be taxable in India.

(ii) Since in the given case, the immovable property in question is located in San Diego, the place of provision of service is San Diego, U.S.A. and resultantly, the service would not be taxable in India [Rule 5 of the Place of Provision of Service Rules].

(iii) In this case, since specific sites in respect of which mineral exploration is to be carried out are located in Canada, the place of provision of services as per rule 5 of the Place of Provision of Service Rules will be Canada which does not fall within the ambit of 'taxable territory' and resultantly, these services will not be taxable in India. The fact that service providing company is located in USA and service recipient is located in Mumbai (India) is not significant.

(iv) Although all the locations given in this case fall within the taxable territory, Place of Provision of Service Rules are still applicable as these rules are also useful for those service providers who operate from multiple locations within India without having centralised registration for the purpose of determining the precise taxable jurisdiction applicable to their operations.

Where any immovable property related service referred to in rule 5 is provided at more than one location, including a location in the taxable territory, its place of provision shall be the location in the taxable territory where the greatest proportion of the service is provided [Rule 7 of the Place of Provision of Service Rules].

Therefore, in the present case, PQR Ltd. is liable to pay service tax and the place of provision of services would be Gujarat because greatest proportion of taxable service [i.e. 60%] is provided there.

(c) Section 64 of Customs Act 1962, provides that with the sanction of the proper officer, and on payment of the prescribed fees, the owner of any goods either before or after warehousing the same -

(i) inspect the goods;

(ii) separate damaged or deteriorated goods from the rest;

(iii) sort the goods or change the containers for the preservation, sale, export or disposal of the goods;

(iv) deal with the goods & their containers in such manner as may be necessary to prevent loss, deterioration or damage to the goods;

(v) show the goods for sale;

(vi) take samples of the goods without entry for home consumption, if the proper officer so permits, without payment of duty on such samples.

Or

As per rule 2(c) of the Customs, Central Excise Duties and Service Tax Drawback Rules, 1995, 'export' with its grammatical variations and cognate expressions, means-

(i) taking out of India to a place outside India, or

(ii) taking out from a place in Domestic Tariff Area (DTA) to a special economic zone (SEZ), and

(iii) loading of provisions or store or equipment for use on board a vessel or aircraft proceeding to a foreign port.

Export is defined as taking out of India to a place out of India and India includes Indian Territorial Waters. Hence, export is complete when goods leave territorial waters of India. Drawback is available once 'export' is complete i.e., the goods cross the territorial waters even if they do not reach the destination or they are destroyed. However, if goods are destroyed in territorial waters of India, drawback will not be available as the export is not complete *[UOI v. Rajindra Dyeing and Printing Mills (2005) 180 ELT 433(SC)].*

6. (a) Simultaneous availment of CENVAT and SSI exemption is permissible when a SSI unit manufactures branded (with other's brand name) and unbranded/self branded goods. In other words, where a SSI unit manufactures branded (with other's brand name) and unbranded/self branded goods, it can-

- avail CENVAT on inputs used in the manufacture of branded goods (with other's brand name) and pay duty on the final product; and

- avail SSI exemption on unbranded/self branded goods (in this case, CENVAT on inputs used in the manufacture of such exempted goods will not be allowed).

However, it may be noted that such simultaneous availment of CENVAT and SSI exemption is permissible only in case of simultaneous manufacture of branded (with other's brand name) and unbranded/self branded goods. In other cases, this is not permissible.

(b) No, the sub-contractors who provide architect service and consulting engineer service, which are used by XYZ Constructions Ltd. in relation to such construction service, are not exempt from service tax. According to section 66F(1), reference to a service by nature or description in the Act shall not include reference to a service which is used for providing main service. Therefore, if any person is providing services by way of construction of roads such as architect's service and consulting engineer's service, which are used by the contractor in relation to such construction, the benefit of the mega-exemption would not be available to such persons unless the activities carried out by the sub-contractor independently and by itself falls in the ambit of the exemption.

Further, exemption is available to 'services by way of construction of roads' and not to 'services in relation to construction of roads'. It is thus apparent that just because the main contractor is providing the service by way of construction of roads, it would not automatically lead to the conclusion that services provided by the sub-contractor to the main contractor shall also be an exempt service.

(c) The above scenario is a case of third-party exports.

Third-party exports means exports made by an exporter or manufacturer on behalf of another exporter(s). The conditions for being allowed as third-party exports under FTP are:

(i) Export documents such as shipping bills shall indicate name of both manufacturing exporter/manufacturer and third party exporter(s).

(ii) Bank Realization Certificate, GR declaration, export order and invoice should be in the name of third party exporter.

In the above case, though Bank Realization Certificate, GR declaration, export order and invoice are in the name of CD Corporation (third party exporter), the shipping bill does not have the name of AB Corporation (manufacturing exporter). Therefore, AB Corporation will not be treated as the exporter in this case.

7. (a) The proviso to rule 9 of the Central Excise Valuation (Determination of Excisable Goods) Rules, 2000 lays down that in a case where the related person does not sell the goods but uses or consumes such goods in the production or manufacture of articles, the value thereof shall be determined in the manner specified in rule 8 of the Valuation Rules which provides that the value will be 110% of the cost of

production or manufacture of such goods.

Therefore, when the goods are sold to MNO Ltd., the assessable value shall be 110% of Rs. 16,000 (Rs. 16,000 × 110%) i.e., Rs. 17,600.

However, in the instant case, if MNO Ltd. is an unrelated buyer, the assessable value will be the transaction value of the goods i.e. Rs. 20,000.

(b)

Person	Offence	Prosecution	Arrest	Bail
Mr Govind	Non-cognizable offence	6 months to 3 years	Arrest can be ordered by Commissioner of Central Excise	Bailable Offence
Mr. Vijay	Non-cognizable offence	Upto 1 year	No arrest	Bailable Offence
Mr. Vivek	Non-cognizable offence	6 months to 3 years	Arrest can be ordered by Commissioner of Central Excise	Bailable Offence
Miss Radha	Cognizable offence	Upto 7 years	Arrest can be ordered by Commissioner of Central Excise without arrest warrant	Non-Bailable/Bailable Offence

(c) Vishesh Krishi and Gram Udyog Yojana (VKGUY) has been provided under FTP to compensate high transport costs and offset other disadvantages in the exports of specified agricultural products. Eligible exporters are entitled for duty credit scrip equivalent to 5% of FOB value of exports realized in free foreign exchange. The scrip can be utilized for payment of customs duties of all freely importable items as well as for procurement of domestic items without payment of central excise duty as well as service tax. Further, it can also be utilized for payment of application fee to DGFT for obtaining any Authorisation.