SUGGESTED ANSWERS

FINAL COURSE

May - 2006

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

PAPER – 1 : ADVANCED ACCOUNTING

Answer all questions.

Working notes should form part of the answer.

Question 1

The following are the Balance Sheets of Arun Ltd., Brown Ltd. and Crown Ltd. as at 31.12.2005:

Liabilities:	*Arun Ltd.*	*Brown Ltd.*	*Crown Ltd.*
	Rs.	*Rs.*	*Rs.*
Share Capital (Shares of Rs.100 each)	*6,00,000*	*4,00,000*	*2,40,000*
Reserves	*80,000*	*40,000*	*30,000*
Profit and Loss Account	*2,00,000*	*1,20,000*	*1,00,000*
Sundry Creditors	*80,000*	*1,00,000*	*60,000*
Arun Ltd.	*--*	*40,000*	*32,000*
Total	*9,60,000*	*7,00,000*	*4,62,000*

Assets:

	Arun Ltd.	*Brown Ltd.*	*Crown Ltd.*
	Rs.	*Rs.*	*Rs.*
Goodwill	*80,000*	*60,000*	*40,000*
Fixed Assets	*2,80,000*	*2,00,000*	*2,40,000*
Shares in:			
Brown Ltd. (3,000 Shares)	*3,60,000*	*--*	*--*
Crown Ltd. (400 Shares)	*60,000*	*--*	*--*
Crown Ltd. (1,400 Shares)	*--*	*2,08,000*	*--*
Due from: Brown Ltd.	*48,000*	*--*	*--*
Crown Ltd.	*32,000*	*--*	*--*
Current Assets	*1,00,000*	*2,32,000*	*1,82,000*
Total	*9,60,000*	*7,00,000*	*4,62,000*

(i) *All shares were acquired on 1.7.2005.*

(ii) *On 1.1.2005 the balances to the various accounts were as under:*

Particulars	*Arun Ltd.*	*Brown Ltd.*	*Crown Ltd.*
	Rs.	*Rs.*	*Rs.*
Reserves	*40,000*	*40,000*	*20,000*
Profit and Loss account	*20,000*	*(Dr.) 20,000*	*12,000*

(iii) *During 2005, Profits accrued evenly.*

(iv) In August, 2005, each company paid interim dividend of 10%. Arun Ltd. and Brown Ltd. have credited their profit and loss account with the dividends received.

(v) During 2005, Crown Ltd. sold an equipment costing Rs.40,000 to Brown Ltd. for Rs.48,000 and Brown Ltd. in turn sold the same to Arun Ltd. for Rs.52,000.

Prepare the consolidated Balance Sheet as at 31.12.2005 of Arun Ltd. and its subsidiaries.

(20 Marks)

Answer

Consolidated Balance Sheet of Arun Ltd. and its subsidiaries

as on 31.12.2005

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital (Shares of Rs. 100 each)	6,00,000	Goodwill (W. N. 5)	1,81,000
Minority Interest (W. N. 4)	2,33,729	Fixed Assets	7,08,000
Reserves (W. N. 8)	83,021	Current Assets	5,14,000
Profit & Loss A/c (W. N. 8)	2,54,250	Cash in Transit (W. N. 7)	8,000
Sundry Creditors	2,40,000		
	14,11,000		14,11,000

Working Notes

1. Shareholding Pattern

	Number of Shares	*%age of Holding*
In Brown Ltd.:		
Arun Ltd.	3,000	75%
Minority Interest	1,000	25%
In Crown Ltd.:		
Arun Ltd.	400	16.667%
Brown Ltd.	1,400	58.333%
Minority Interest	600	25%

2. Analysis of apportionment of profit in Crown Ltd.

(a) *Calculation of Unrealized Profit in Equipment*

Crown Ltd sold equipment to Brown Ltd. at a profit of Rs. 8,000 and this would be apportioned to

	Rs.
Arun Ltd.	1,333
Brown Ltd.	4,667
Minority Interest	2,000
	8,000

Brown Ltd sold the equipment to Arun Ltd. at a profit of Rs. 4,000. This would be apportioned to:

	Rs.
Arun Ltd.	3,000
Minority Interest	1,000
	4,000

The above amounts are to be deducted from the respective share of profits.

(b) *Reserves*

	Rs.	
Closing balance	30,000	
Opening balance	20,000	Capital Profit
Current year Appropriation	10,000	
Apportionment of Profit from 1.1.2005 to 30.6.2005	5,000	Capital Profit
Apportionment of Profit from 1.7.2005 to 31.12.2005	5,000	Revenue Reserve

(c) *Profit and Loss Account*

Closing balance	1,00,000	
Opening balance	12,000	Capital Profit
Current year profits before interim dividend	1,12,000	
Apportionment of Profit from 1.1.2005 to 30.6.2005	56,000	
Less: Interim Dividend	24,000	
	32,000	Capital Profit
From 1.7.2005 to 31.12.2005	56,000	Revenue Profit

(d) *Apportionment of profits of Crown Ltd.*

	Pre-Acquisition	Post Acquisition	
	Capital Profit	*Revenue Reserve*	*Revenue Profit*
	Rs.	*Rs.*	*Rs.*
Reserves	25,000	5,000	--
Profit & Loss Account	44,000	--	56,000
	69,000	5,000	56,000
Arun Ltd [16.667%]	11,500	833	9,333
Brown Ltd. [58.333%]	40,250	2,917	32,667
Minority Interest [25%]	17,250	1,250	14,000

3. Analysis of Profit of Brown Ltd

(a) *Reserves*

	Rs.	
Closing balance	40,000	
Opening balance	40,000	(Capital Profit)
Current year Appropriation	Nil	

(b) *Profit and Loss Account*

	Rs.
Closing balance	1,20,000
Opening balance (Dr.)	20,000
Current year Appropriation after interim dividend	1,40,000
Interim Dividend	40,000
Profit before Interim Dividend	1,80,000
Less: Dividend from Crown Ltd.	14,000
	1,66,000
Apportionment of Profit from 1.1.2005 to 30.6.2005	83,000
Less: Interim Dividend	40,000
Capital profit	43,000
Apportionment of Profit from 1.7.2005 to 31.12.2005 (Revenue profit)	83,000

(c) *Apportionment of Profit of Brown Ltd.*

	Pre-Acquisition	Post-Acquisition	
	Capital Profit	*Revenue Reserve*	*Revenue Profit*
	Rs.	*Rs.*	*Rs.*
Reserves	40,000	--	--
Profit & Loss Account			
(Opening balance (-) 20,000+43,000)	23,000		83,000
Less: Unrealised Profit of Equipment from Crown Ltd.			(4,667)
Share of Post-Acquisition Profit of Crown Ltd.	--	2,917	32,667
	63,000	2,917	1,11,000
Arun Ltd. 75%	47,250	2,188	83,250
Minority Interest 25%	15,750	729	27,750

4. Minority Interest

	Brown Ltd.	*Crown Ltd.*
	Rs.	*Rs.*
Share Capital	1,00,000	60,000
Capital Profit	15,750	17,250
Revenue: Reserves	729	1,250
Profit & Loss Account	27,750	14,000
Unrealised Profit on Equipment	(1,000)	(2,000)
	1,43,229	90,500

Total Minority Interest: Rs.1,43,229+ Rs.90,500 = Rs.2,33,729

5. Cost of Control

	Arun Ltd. in Brown Ltd.	*Arun Ltd. in Crown Ltd.*	*Brown Ltd in Crown Ltd.*
	Rs.	*Rs.*	*Rs.*
Amount Invested	3,60,000	60,000	2,08,000
Less: Pre-acquisition dividend*	30,000	4,000	14,000
Adjusted Cost of Investment (A)	3,30,000	56,000	1,94,000
Share capital	3,00,000	40,000	1,40,000
Capital Profit	47,250	11,500	40,250
(B)	3,47,250	51,500	1,80,250
Capital Reserve/Goodwill (A)-(B)	(17,250)	4,500	13,750
Net Goodwill	Rs.1,000		

Goodwill on Consolidation Rs. (80,000+ 60,000+40,000+1,000) = Rs.1,81,000

6. Dividend declared

	Brown Ltd.	*Crown Ltd.*
	Rs.	*Rs.*
Dividend declared	40,000	24,000
Share of: Arun Ltd.	30,000	4,000
Brown Ltd.		14,000
Minority	10,000	6,000

* The entire amount of interim dividend of 10 % has been treated as pre-acquisition dividend.

7. Inter-Company Transactions

(a) Owings

	Dr.	*Cr.*	*Cr.*
	Arun Ltd.	*Brown Ltd.*	*Crown Ltd.*
	Rs.	*Rs.*	*Rs.*
Balance in books	80,000	40,000	32,000
Less: Inter- co. owings	72,000	40,000	32,000
Cash-in-transit	8,000	NIL	NIL

(b) Fixed Assets

	Rs.
Total Fixed Assets	7,20,000
Less: Unrealised Profit on sale of equipment	12,000
Amount to be taken to consolidated Balance Sheet	7,08,000

8. Reserves and Profit and Loss Account balances in the Consolidated Balance Sheet

	Reserves	*Profit and Loss A/c*
	Rs.	*Rs.*
Balance in Books	80,000	2,00,000
Add: Shares of Post Acquisition Profits:		
From Brown Ltd.	2,188	83,250
From Crown Ltd	833	9,333
Less: Pre-Acquisition dividend:		
From Brown Ltd.		(30,000)
From Crown Ltd		(4,000)
Less: Unrealised Profit on Equipment:		
From Brown Ltd.		(3,000)
From Crown Ltd.		(1,333)
	83,021	2,54,250

Question 2

The following are the Balance Sheets of Big Ltd. and Small Ltd. as at 31.3.06:

(Rs. In lakhs)

	Big Ltd.	Small Ltd.		Big Ltd.	Small Ltd.
	Rs.	Rs.		Rs.	Rs.
Share Capital	40	15	Sundry Assets (including cost of shares)	56	20
Profit & Loss A/c	7.5	--	Goodwill	4	5
Sundry Creditors	12.5	12.5	Profit and Loss A/c	--	2.5
	60.0	27.5		60.0	27.5

Additional Information:

(i) *The two companies agree to amalgamate and form a new company, Medium Ltd.*

(ii) *Big Ltd. holds 10,000 shares in Small Ltd. acquired at a cost of Rs.2,50,000 and Small Ltd. holds 5,000 shares in Big Ltd. acquired at a cost of Rs.7,00,000.*

(iii) *The shares of Big Ltd. are of Rs.100 and are fully paid and the shares of Small Ltd. are of Rs.50 each on which Rs.30 has been paid-up.*

(iv) *It is agreed that the goodwill of Big Ltd. would be valued at Rs.1,50,000 and that of Small Ltd. at Rs.2,50,000.*

(v) *The shares which each company holds in the other are to be valued at book value having regard to the goodwill valuation decided as given in (iv).*

(vi) *The* new shares are to be of a nominal value of Rs.50 each credited as Rs.25 paid.

You are required to:

(i) *Prepare the Balance Sheet of Medium Ltd., as at 31st March, 2006 after giving effect to the above transactions; and*

(ii) *Prepare a statement showing the shareholdings in the new company attributable to the shareholders of the merged companies.* *(16 Marks)*

Answer

(i) Balance Sheet of Medium Ltd. as on 31st March, 2006

Liabilities	*Rs.*	*Assets*	*Rs.*
1,82,000 shares of Rs.50/- each, Rs.25 paid up [Issued for consideration other than cash]	45,50,000	Goodwill (Rs.1,50,000+Rs.2,50,000)	4,00,000
		Sundry Assets	
Sundry Creditors	25,00,000	(Rs. 53,50,000+ Rs.13,00,000)	66,50,000
	70,50,000		70,50,000

(ii) Statement of Shareholding in Medium Ltd.

	Big Ltd.	*Small Ltd.*
	Rs.	*Rs.*
Total value of Assets	44,20,513	8,52,564
Less: Pertaining to shares held by the other company	5,52,564	1,70,513
	38,67,949	6,82,051
Rounded off to	38,67,950	6,82,050
Shares of new company (at Rs. 25 per share)	1,54,718	27,282

Total purchase consideration to be paid to Big Ltd and Small Ltd. (Rs.38,67,950 + Rs.6,82,050)	Rs. 45,50,000
Number of shares in Big Ltd. (40,00,000/100)	40,000 shares
Number of shares in Small Ltd. (15,00,000/30)	50,000 shares
Holding of Small Ltd. in Big Ltd. (5,000/40,000)	1/8
Holding of Big Ltd. in Small Ltd. (10,000/50,000)	1/5
Number of shares held by outsiders in Big Ltd. (40,000 – 5,000) =	35,000
Number of shares held by outsiders in Small Ltd. (50,000 – 10,000)	40,000

Workings Note:

Calculation of Book Value of Shares

	Big Ltd	Small Ltd.
	Rs.	Rs.
Goodwill	1,50,000	2,50,000
Sundry Assets other than shares in other company		
(56,00,000 – 2,50,000)	53,50,000	
(20,00,000 – 7,00,000)		13,00,000
	55,00,000	15,50,000
Less: Sundry Creditors	12,50,000	12,50,000
	42,50,000	3,00,000

If "x" is the Book Value of Assets of Big Ltd and "y" of Small Ltd.

$$x = 42,50,000 + \frac{1}{5}y$$

$$y = 3,00,000 + \frac{1}{8}x$$

$$x = 42,50,000 + \frac{1}{5}(3,00,000 + \frac{1}{8}x)$$

$$= 42,50,000 + 60,000 + \frac{1}{40}x$$

$$\frac{39}{40}x = 43,10,000$$

$$x = 43,10,000 \times \frac{40}{39}$$

$$x = 44,20,513 \text{ (approx.)}$$

$$y = 3,00,000 + \frac{1}{8}(44,20,513)$$

$$= 3,00,000 + 5,52,564$$

$$= \text{Rs. } 8,52,564 \text{ (approx.)}$$

Book Value of one share of Big Ltd. = $\frac{44,20,513}{40,000} = \text{Rs.}110.513$ (approx.)

Book Value of one share of Small Ltd. = $\frac{8,52,564}{50,000} = \text{Rs.}17.05$ (approx.)

Question 3

The directors of a public limited company are considering the acquisition of the entire share capital of an existing company X Ltd engaged in a line of business suited to them. The directors feel that acquisition of X will not create any further risk to their business interest.

The following is the Balance Sheet of X Ltd., as at 31st December, 2005:

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital:		*Fixed assets*	*6,00,000*
4,000 equity shares of Rs.100 each fully paid-up	*4,00,000*	*Current assets:* *Stock*	*2,00,000*
General reserve	*3,00,000*	*Sundry debtors*	*3,40,000*
Bank overdraft	*2,40,000*	*Cash and bank balances*	*1,00,000*
Sundry creditors	*3,00,000*		
	12,40,000		*12,40,000*

X's financial records for the past five years were as under:

	2005	2004	2003	2002	2001
	Rs.	Rs.	Rs.	Rs.	Rs.
Profits	80,000	74,000	70,000	60,000	62,000
Extra ordinary item(s)	3,500	4,000	(6,000)	(8,000)	1,000
	83,500	78,000	64,000	52,000	61,000
Dividends	48,000	40,000	40,000	32,000	32,000
	35,500	38,000	24,000	20,000	29,000

Additional information:

(i) *There were no changes in the issued capital of X during this period.*

(ii) *The estimated values of X Ltd.'s assets on 31.12.2005 are:*

	Replacement cost	Realisable value
	Rs.	Rs.
Fixed assets	8,00,000	5,40,000
Stock	3,00,000	3,20,000

(iii) *It is anticipated that 1% of the debtors may prove to be difficult to be realized.*

(iv) *The cost of capital to the acquiring company is 10%.*

(v) *The current return of an investment of the acquiring company is 10%. Quoted companies with similar businesses and activities as X have a P/E ratio approximating to 8, although these companies tend to be larger than X.*

Required:

Estimate the value of the total equity capital of X Ltd., on 31.12.2005 using each of the following bases:

(a) *Balance sheet value*

(b) *Replacement cost*

(c) *Realisable value*

(d) *Gordon's dividend growth model*

(e) *P/E ratio model.* *(16 Marks)*

Answer

		Rs.	Rs.
(a)	Balance Sheet Value		
	Capital	4,00,000	
	Reserve	3,00,000	7,00,000

(b) Replacement cost value

Capital		4,00,000	
Reserve		3,00,000	
Appreciation:			
Fixed assets	2,00,000		
Stock	1,00,000	3,00,000	10,00,000

(c) Realizable value

Capital	4,00,000	
Reserve	3,00,000	
Appreciation in stock	1,20,000	
Depreciation in fixed assets	(60,000)	
Book debts (Bad)*	(3,400)	7,56,600

(d) Gordon's dividend growth model

The formula to be used is P= $\frac{E(1-b)}{k-br}$

Where

P Price of share

E Earning per share

b retention ratio

k cost of capital

br growth rate

r rate of return on investment.

Profits retained: Rs.35,500 + 38,000 + 24,000+ 20,000 + 29,000 = Rs. 1,46,500

Profits earned: Rs.83,500 + 78,000 + 64,000+ 52,000+61,000 = Rs. 3,38,500

Retention ratio: $\frac{\text{Rs.}1{,}46{,}500}{\text{Rs.}3{,}38{,}500} = 0.43$

Return on investment for the year 2005 = $\frac{\text{Rs.}80{,}000}{4{,}00{,}000 + 3{,}00{,}000 + \frac{1}{2}\text{ of } 35{,}500}$ x 100

* It has been assumed that estimated bad debts would not be relevant for estimating values under bases (a) and (b).

$$= \frac{80{,}000}{7{,}17{,}750} \times 100 = 11.14$$

Growth rate = Return on investment x retention ratio

= 11.14 x 0.43 = 4.79 %

Average profits = $\frac{\text{Rs.}3{,}38{,}500}{5} = \text{Rs.}67{,}700$

Market value = $\frac{\text{Rs.}67{,}700(1-.43)}{0.10-0.0479} = \frac{\text{Rs.}67{,}700 \times 0.57}{.0521} = \text{Rs.}7{,}40{,}672 \text{(approx.)}$

(e) P/E ratio model

Comparable quoted companies have a P/E ratio of 8. X Ltd. is prima facie small company.
If a P/E ratio of 6 is adopted, the valuation will be 80,000 x 6 = Rs.4,80,000
If a P/E ratio of 7 were to be adopted, the valuation will be 80,000 x 7 = Rs.5,60,000

Question 4

(a) Global Ltd. has initiated a lease for three years in respect of an equipment costing Rs.1,50,000 with expected useful life of 4 years. The asset would revert to Global Limited under the lease agreement. The other information available in respect of lease agreement is:

(i) The unguaranteed residual value of the equipment after the expiry of the lease term is estimated at Rs.20,000.

(ii) The implicit rate of interest is 10%.

(iii) The annual payments have been determined in such a way that the present value of the lease payment plus the residual value is equal to the cost of asset.

Ascertain in the hands of Global Ltd.

(i) The annual lease payment.

(ii) The unearned finance income.

(iii) The segregation of finance income, and also,

(iv) Show how necessary items will appear in its profit and loss account and balance sheet for the various years.

(b) Briefly describe the method of valuation of human resources as suggested by Jaggi and Lau. Also point out the special merit and demerit of this method. (8+8= 16 Marks)

Answer

(a) (i) Calculation of Annual Lease Payment*

	Rs.
Cost of the equipment	1,50,000
Unguaranteed Residual Value	20,000
PV of residual value for 3 years @ 10% (Rs.20,000 x 0.751)	15,020
Fair value to be recovered from Lease Payment (Rs.1,50,000 – Rs.15,020)	1,34,980
PV Factor for 3 years @ 10%	2.487
Annual Lease Payment (Rs. 1,34,980 / PV Factor for 3 years @ 10% i.e. 2.487)	54,275

(ii) Unearned Financial Income

Total lease payments [Rs. 54,275 x 3]	1,62,825
Add: Residual value	20,000
Gross Investments	1,82,825
Less: Present value of Investments (Rs.1,34,980 + Rs.15,020)	1,50,000
Unearned Financial Income	32,825

(iii) Segregation of Finance Income

Year	*Lease Rentals*	*Finance Charges @ 10% on outstanding amount of the year*	*Repayment*	*Outstanding Amount*
	Rs.	*Rs.*	*Rs.*	*Rs.*
0	-	-	-	1,50,000
I	54,275	15,000	39,275	1,10,725
II	54,275	11,073	43,202	67,523
III	74,275**	6,752	67,523	--
	1,82,825	32,825	1,50,000	

* Annual lease payments are considered to be made at the end of each accounting year.

** Rs. 74,275 includes unguaranteed residual value of equipment amounting Rs. 20,000.

(iv) Profit and Loss Account (Relevant Extracts)

	Credit side	Rs.
I Year	By Finance Income	15,000
II year	By Finance Income	11,073
III year	By Finance Income	6,752

Balance Sheet (Relevant Extracts)

Assets side	*Rs.*	*Rs.*
I year Lease Receivable	1,50,000	
Less: Amount Received	39,275	1,10,725
II year Lease Receivable	1,10,725	
Less: Received	43,202	67,523
III year :Lease Amount Receivable	67,523	
Less: Amount received	47,523	
Residual value	20,000	NIL

Notes to Balance Sheet

	Rs.
Year 1	
Minimum Lease Payments (54,275 + 54,275)	1,08,550
Residual Value	20,000
	1,28,550
Unearned Finance Income(11,073+ 6,752)	17,825
Lease Receivables	1,10,725
Classification:	
Not later than 1 year	43,202
Later than 1 year but not more than 5 years	67,523
Total	1,10,725
Year II:	
Minimum Lease Payments	54,275
Residual Value (Estimated)	20,000
	74,275
Unearned Finance Income	6,752
Lease Receivables (not later than 1year)	67,523
III Year:	
Lease Receivables (including residual value)	67,523
Amount Received	67,523
	NIL

(b) Jaggi and Lau suggested a model for valuation of human resources. According to them, proper valuation of human resources is not possible unless the contributions of individuals as a group are taken into consideration. A group refers to homogeneous employees whether working in the same department or division of the organization or not. An individual's expected service tenure in an organization is difficult to predict, but on a group basis, it is relatively easy to estimate the percentage of people in a group likely to leave the organization in future. This model attempts to calculate the present value of all existing employees in each rank. Such present value is measured with the help of the following steps:

(i) Ascertain the number of employees in each rank.

(ii) Estimate the probability that an employee will be in his rank within the organization on terminated/promoted in the next period. This probability will be estimated for a specified time-period.

(iii) Ascertain the economic value of an employee in a specified rank during each time period.

(iv) The present value of existing employees in each rank is obtained by multiplying the above three factors and applying an appropriate discount rate.

Jaggi and Lau tried to simplify the process of measuring the value of human resources by considering a group of employees as basis of valuation. But in the process they ignored the exceptional qualities of certain skilled employees. The performance of a group may be seriously affected in the event of exit of a single individual.

Merit

Jaggi and Lau model approached the valuation of human resources on the basis of grouping of employees. Under this method, calculations get simplified and the chances of errors get reduced.

Demerit

This model ignores individual skills of the employees. The varied skills of the employees is not recognized in the valuation process under Jaggi and Lau model.

Question 5

(a) Swift Ltd. acquired a patent at a cost of Rs.80,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalized the cost and started amortizing the asset at Rs.10,00,000 per annum. After two years it was found that the product life-cycle may continue for another 5 years from then. The net cash flows from the product during these 5 years were expected to be Rs.36,00,000,Rs.46,00,000, Rs.44,00,000, Rs.40,00,000 and Rs.34,00,000. Find out the amortization cost of the patent for each of the years.

(b) *The Chief Accountant of Sports Ltd. gives the following data regarding its six segments:*

Rs. In lakhs

Particulars	*M*	*N*	*O*	*P*	*Q*	*R*	*Total*
Segment Assets	*40*	*80*	*30*	*20*	*20*	*10*	*200*
Segment Results	*50*	*-190*	*10*	*10*	*-10*	*30*	*-100*
Segment Revenue	*300*	*620*	*80*	*60*	*80*	*60*	*1,200*

The Chief accountant is of the opinion that segments "M" and "N" alone should be reported. Is he justified in his view? Discuss.

(c) *On 24th January, 2006 Chinnaswamy of Chennai sold goods to Watson of Washington, U.S.A. for an invoice price of $40,000 when the spot market rate was Rs.44.20 per US $. Payment was to be received after three months on 24th April, 2006. To mitigate the risk of loss from decline in the exchange-rate on the date of receipt of payment, Chinnnaswamy immediately acquired a forward contract to sell on 24th April, 2006 US $ 40,000 @ Rs.43.70. Chinnaswamy closed his books of account on 31st March, 2006 when the spot rate was Rs.43.20 per US $. On 24th April, 2006, the date of receipt of money by Chinnaswamy, the spot rate was Rs.42.70 per US $.*

Pass journal entries in the books of Chinnaswamy to record the effect of all the above mentioned effects. *(4+4+8= 16 Marks)*

Answer

(a) Swift Limited amortised Rs.10,00,000 per annum for the first two years i.e. Rs.20,00,000. The remaining carrying cost can be amortized during next 5 years on the basis of net cash flows arising from the sale of the product. The amortisation may be found as follows:

Year	Net cash flows	Amortization Ratio	Amortization Amount
	Rs		*Rs.*
I	-	0.125	10,00,000[1]
II	-	0.125	10,00,000
III	36,00,000	0.180	10,80,000
IV	46,00,000	0.230	13,80,000
V	44,00,000	0.220	13,20,000
VI	40,00,000	0.200	12,00,000
VII	34,00,000	0.170	10,20,000
Total	2,00,00,000	1.000	80,00,000

[1] It has been assumed that the company had amortized the patent at Rs. 10,00,000 per annum in the first two years on the basis of economic benefits derived from the product manufactured under the patent.

It may be seen from above that from third year onwards, the balance of carrying amount i.e., Rs.60,00,000 has been amortized in the ratio of net cash flows arising from the product of Swift Ltd.

Note*:* The answer has been given on the basis that the patent is renewable and Swift Ltd. got it renewed after expiry of five years.

(b) As per para 27 of AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

(i) Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or

(ii) Its segment result whether profit or loss is 10% or more of:

(1) The combined result of all segments in profit; or

(2) The combined result of all segments in loss,

whichever is greater in absolute amount; or

(iii) Its segment assets are 10% or more of the total assets of all segments.

If the total external revenue attributable to reportable segments constitutes less than 75% of total enterprise revenue, additional segments should be identified as reportable segments even if they do not meet the 10% thresholds until atleast 75% of total enterprise revenue is included in reportable segments.

(a) On the basis of turnover criteria segments M and N are reportable segments.

(b) On the basis of the result criteria, segments M, N and R are reportable segments (since their results in absolute amount is 10% or more of Rs.200 lakhs).

(c) On the basis of asset criteria, all segments except R are reportable segments.

Since all the segments are covered in atleast one of the above criteria all segments have to be reported upon in accordance with Accounting Standard (AS) 17. Hence, the opinion of chief accountant is wrong.

(c) Journal Entries in the books of Chinnaswamy

2006			*Rs.*	*Rs.*
Jan. 24	Watson	Dr.	17,68,000	
	To Sales Account			17,68,000
	(Credit sales made to Watson of Washington, USA for $40,000 recorded at spot market rate of Rs.44.20 per US $)			
" "	Forward (Rs.) Contract Receivable Account	Dr.	17,48,000	
	Deferred Discount Account	Dr.	20,000	
	To Forward ($) Contract Payable			17,68,000
	(Forward contract acquired to sell on 24th April, 2006 US $40,000 @ Rs.43.70)			

March 31	Exchange Loss Account	Dr.	40,000	
	To Watson			40,000
	(Record of exchange loss @ Re.1 per $ due to market rate becoming Rs.43.20 per US $ rather than Rs.44.20 per US $)			
” ”	Forward ($) Contract Payable	Dr.	40,000	
	To Exchange Gain Account			40,000
	(Decrease in liability on forward contract due to fall in exchange rate)			
” ”	Discount Account	Dr.	14,667	
	To Deferred Discount Account			14,667
	(Record of proportionate discount expense for 66 days out of 90 days)			
April 24	Bank Account	Dr.	17,08,000	
	Exchange Loss Account	Dr.	20,000	
	To Watson			17,28,000
	(Receipt of $40,000 from Watson, USA customer @ Rs.42.70 per US $; exchange loss being Rs.20,000)			
” “	Forward ($) Contract Payable Account	Dr.	17,28,000	
	To Exchange Gain Account			20,000
	To Bank Account			17,08,000
	(Settlement of forward contract by payment of $40,000)			
” ”	BankAccount	Dr.	17,48,000	
” ”	To Forward (Rs.) Contract Receivable			17,48,000
	(Receipt of cash in settlement of forward contract receivable)			
” ”	Discount Account	Dr.	5,333	
	To Deferred Discount Account			5,333
	(Recording of discount expense for 24 days: $\text{Rs.}20{,}000 \times \frac{24 \text{ days}}{90 \text{ days}} = \text{Rs.}5{,}333$)			

Question 6

(*a*) *Narmada Ltd. sold goods for Rs.90 lakhs to Ganga Ltd. during financial year ended 31-3-2006. The Managing Director of Narmada Ltd. own 100% of Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices followed by Narmada Ltd. The Chief accountant of Narmada Ltd contends that these sales need not require a different* *treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant correct?*

(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) Victory Ltd. purchased goods on credit from Lucky Ltd. for Rs.250 crores for export. The export order was cancelled. Victory Ltd. decided to sell the same goods in the local market with a price discount. Lucky Ltd. was requested to offer a price discount of 15%. The Chief Accountant of Lucky Ltd. wants to adjust the sales figure to the extent of the discount requested by Victory Ltd. Discuss whether this treatment is justified.

(d) Accountants of Poornima Ltd. show a net profit of Rs.7,20,000 for the third quarter of 2005 after incorporating the following:

(i) Bad debts of Rs.40,000 incurred during the quarter. 50% of the bad debts have been deferred to the next quarter.

(ii) Extra ordinary loss of Rs.35,000 incurred during the quarter has been fully recognized in this quarter.

(iii) Additional depreciation of Rs.45,000 resulting from the change in the method of charge of depreciation.

Ascertain the correct quarterly income. (4x4=16 Marks)

Answer

(a) As per paragraph 13 of AS 18 'Related Party Disclosures', Enterprises over which a key management personnel is able to exercise significant influence are related parties. This includes enterprises owned by directors or major shareholders of the reporting enterprise that have a member of key management in common with the reporting enterprise.

In the given case, Narmada Ltd. and Ganga Ltd are related parties and hence disclosure of transaction between them is required irrespective of whether the transaction was done at normal selling price.

Hence the contention of Chief Accountant of Narmada Ltd is wrong.

(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% = 140 lakhs and deferred tax liability in the Balance Sheet will be (42+140) = Rs.182 lakhs.

(c) Lucky Ltd. had sold goods to Victory Ltd on credit worth for Rs.250 crores and the sale was completed in all respects. Victory Ltd's decision to sell the same in the domestic market at a discount does not affect the amount recorded as sales by Lucky Ltd. The price discount of 15% offered by Lucky Ltd. after request of Victory Ltd. was not in the nature of a discount given during the ordinary course of trade because otherwise the same would have been given at the time of sale itself. Now, as far Lucky Ltd is concerned, there appears to be an uncertainty relating to the collectability of the debt, which has arisen subsequent to the time of sale therefore, it would be appropriate to make a separate provision to reflect the uncertainty relating to collectability rather than to adjust the amount of revenue originally recorded. Therefore, such discount should be written off to the profit and loss account and not shown as deduction from the sales figure.

(d) In the above case, the quarterly income has not been correctly stated. As per AS 25 "Interim Financial Reporting", the quarterly income should be adjusted and restated as follows:

Bad debts of Rs. 40,000 have been incurred during current quarter. Out of this, the company has deferred 50% (i.e.) Rs. 20,000 to the next quarter. Therefore, Rs. 20,000 should be deducted from Rs. 7,20,000. The treatment of extra-ordinary loss of Rs. 35,000/- being recognized in the same quarter is correct.

Recognising additional depreciation of Rs. 45,000 in the same quarter is in tune with AS 25 .Hence, no adjustments are required for these two items.

Poornima Ltd should report quarterly income as Rs.7,00,000 (Rs. 7,20,000–Rs. 20,000).

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

Question No. 1 is compulsory. Answer any four questions from the rest.
Figures in the margin indicate marks allotted to each question.
Working notes should form part of the answer.

Question 1

(a) ABC Company has decided to acquire a Rs.5,00,000 pulp control device that has a useful life of ten years. A subsidy of Rs.50,000 is available at the time the device is acquired and placed into service. The device would be depreciated on straight-line basis and no salvage value is expected. The company is in the 50% tax bracket. If the acquisition is financed with a lease, lease payments of Rs.55,000 would be required at the beginning of each year. The company can also borrow at 10% repayable in equal instalments. Debt payments would be due at the beginning of each year:

(i) What is the present value of cash outflow for each of these financing alternatives, using the after-tax cost of debt?

(ii) Which of the two alternatives is preferable?

(b) A company is considering to engage a factor, the following information is available:

(i) The current average collection period for the Company's debtors is 80 days and ½% of debtors default. The factor has agreed o pay money due after 60 days and will take the responsibility of any loss on account of bad debts.

(ii) The annual charge for the factoring is 2% of turnover payable annually in arrears. Administration cost saving is likely to be Rs.1,00,000 per annum.

(iii) Annual sales, all on credit, are Rs.1,00,00,000. Variable cost is 80% of sales price. The Company's cost of borrowing is 15% per annum. Assume the year is consisting of 365 days.

Should the Company enter into a factoring agreement. *(15+5 = 20 Marks)*

Answer

(a) Initial amount borrowed = Rs.5,00,000 – Rs.50,000 = Rs.4,50,000

This amount of Rs.4,50,000 is the amount which together with interest at the rate of 10% on outstanding amount is repayable in equal installments i.e., annuities in the beginning of each of 10 years. The PVAF at the rate of 10% for 9 years is 5.759 and for the year 0 it is 1.000. So, the annuity amount may be ascertained by dividing Rs.4,50,000 by (5.759 + 1.000).

So Annual payment = Rs.4,50,000/6.759 = Rs.66,578

Amount owed at time 0 = Rs.4,50,000 – Rs. 66,578 = Rs.3,83,422.

SCHEDULE OF DEBT PAYMENT

End of Year	*Total Payment*	*Interest*	*Principal Amount Outstanding*
	Rs.	*Rs.*	*Rs.*
0	66,578	0	3,83,422
1	66,578	38,342	3,55,186
2	66,578	35,519	3,24,127
3	66,578	32,413	2,89,962
4	66,578	28,996	2,52,380
5	66,578	25,238	2,11,040
6	66,578	21,104	1,65,566
7	66,578	16,557	1,15,545
8	66,578	11,555	55,023
9	66,578	5,502	NIL

SCHEDULE OF CASH OUTFLOWS : DEBT ALTERNATIVE

(Amount in Rs.)

(1) End of year	*(2) Debt Payment*	*(3) Interest*	*(4) Dep*	*(5) Tax Shield [(3)+(4)]0.5*	*(6) Cash outflows (2) – (5)*	*(7) PV factors @ 5%*	*(8) PV*
0	66,578	0	0	0	66,578	1.000	66,578
1	66,578	38,342	50,000	44,171	22,407	0.952	21,331
2	66,578	35,519	50,000	42,759	23,819	0.907	21,604
3.	66,578	32,413	50,000	41,206	25,372	0.864	21,921
4	66,578	28,996	50,000	39,498	27,080	0.823	22,287
5	66,578	25,238	50,000	37,619	28,959	0.784	22,704
6	66,578	21,104	50,000	35,552	31,026	0.746	23,145
7	66,578	16,557	50,000	33,279	33,299	0.711	23,676
8	66,578	11,555	50,000	30,777	35,801	0.677	24,237
9	66,578	5,502	50,000	27,751	38,827	0.645	25,043
10	-	0	50,000	25,000	(-25,000)	0.614	(-15,350)

Total present value of Outflows = Rs.2,57,176

SCHEDULE OF CASH OUTFLOWS: LEASING ALERNATIVE

(Amount in Rs.)

End of year	*Lease Payment*	*Tax Shield*	*Cash Outflow*	*PVIFA @ 5%*	*PV*
0	55,000	0	55,000	1.000	55,000
1-9	55,000	27,500	27,500	7.109	1,95,498
10	0	27,500	-27,500	0.614	(-16,885)

Total Present value of Outflows =2,33,613

The present values of cash outflows are Rs.2,57,176 and Rs.2,33,613 respectively under debt and lease alternatives. As under debt alternatives the cash outflow would be more, the lease is preferred.

Note: (i) The repayment of loan as well as payment of lease rental is made in the beginning of the years. So, at the end of year 10, there will not be any payment in either option, but the tax benefit of depreciation for the year 10 as well as of lease rentals paid in the beginning of year 10, will be available only a the end of year 10.

(ii) Students may also calculate depreciation after subtracting the amount of subsidy from original cost, however, even in this situation, lease alternative is preferable.

(b) The annual change in cash flows through entering into a factoring agreement is:

(Amount in Rs.)

Savings		
Administration cost saved		1,00,000
Existing average debtors	21,91,781	
[Rs.1,00,00,000/365) x 80 days]		
Average New Debtors	16,43,836	
[(Rs.100,00,000/365) x 60 days]		
Reduction in debtors	5,47,945	
Cost there of @80%	4,38,356	
Add: Interest saving @15% P.A on Rs.4,38,356		65,753
Add: Bad Debts saved @.½% of Rs.1,00,00,000		50,000
	Total	2,15,753
Less: Annual charges @2% of Rs.1,00,00,000		2,00,000
Net annual benefits of factoring		15,753

Therefore, the factoring agreement is worthwhile and should be undertaken.

Question 2

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

Issue Price of CP → Rs.97,350

Face Value → Rs.1,00,000

Maturity period → 3 months.

Issue Expenses:

Brokerage : 0.125% for 3 months.

Rating Charges : 0.5% p.a.

Stamp duty : 0.125% for 3 months.

(b) *Distinguish between:*

(i) *Forward and Futures contracts.*

(ii) *Interinsic value and Time value of an option.*

(c) *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+8+6= 20 Marks)*

Answer

(a) Effective Interest = $\left[\frac{F-P}{P}\right]\times\frac{12}{m}\times 100$

$$= \left[\frac{100.000-97,350}{97,350}\right]\times\frac{12}{3}\times 100$$

= 0.02722 x 4 x 100

= 10.888

= 10.89

Effective Interest = 10.89% p.a

Cost of Funds to the Company:

Effective Interest	10.89%
Brokerage (0.125 x 4)	0.50%

Rating Charge	.0.50%
Stamp Duty (0.125 x 4)	0.50%
Cost of funds	12.39%

(b) (i) Forward and Future Contracts:

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

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

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

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

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

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

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

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

Example: Let us assume Wipro Stock is priced at Rs.105/-. In this case, a Wipro 100 call option would have an intrinsic value of (Rs.105 – Rs.100 = Rs.5). However, a Wipro 100 put option would have an intrinsic value of zero (Rs.100 – Rs.105 = -Rs.5). Since this figure is less than zero, the intrinsic value is zero. Also, intrinsic value can never be negative. On the other hand, if we are to look at a Wipro put option with a strike price of Rs.120. Then this particular option would have an intrinsic value of Rs.15 (Rs.120 – Rs.105 = Rs.15).

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

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

(c) (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 : $\frac{\text{Rs.}2.05}{\text{Rs.}8.75} = 23.43\%$

(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

%age of Holding Period Reward

$$\frac{\text{Rs.652.45}}{\text{Rs.2625.00}} \times 100 = 24.85\%$$

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.

Question 3

(a) (i) What is Capital rationing?

(ii) What is take over by reverse bid?

(b) The distribution of return of security 'F' and the market portfolio 'P' is given below:

Probability	*Return % F*	*Return % P*
0.30	*30*	*-10*
0.40	*20*	*20*
0.30	*0*	*30*

You are required to calculate the expected return of security 'F' and the market portfolio 'P', the covariance between the market portfolio and security and beta for the security.

(c) What is the procedure for the book building process? Explain the recent changes made in the allotment process. *(6+8+6= 20 Marks)*

Answer

(a) (i) Capital Rationing: When there is a scarcity of funds, capital rationing is resorted to. Capital rationing means the utilization of existing funds in most profitable manner by selecting the acceptable projects in the descending order or ranking with limited available funds. The firm must be able to maximize the profits by combining the most profitable proposals. Capital rationing may arise due to (i) external factors such as high borrowing rate or non-availability of loan funds due to constraints of Debt-Equity Ratio; and (ii) Internal Constraints Imposed by management. Project should be accepted as a whole or rejected. It cannot be accepted and executed in piecemeal.

IRR or NPV are the best basis of evaluation even under Capital Rationing situations. The objective is to select those projects which have maximum and positive NPV. Preference should be given to interdependent projects. Projects are to be ranked in the order of NPV. Where there is multi-period Capital Rationing, Linear Programming Technique should be used to maximize NPV. In times of

Capital Rationing, the investment policy of the company may not be the optimal one.

In nutshell Capital Rationing leads to:

(i) Allocation of limited resources among ranked acceptable investments.

(ii) This function enables management to select the most profitable investment first.

(iii) It helps a company use limited resources to the best advantage by investing only in the projects that offer the highest return.

(iv) Either the internal rate of return method or the net preset value method may be used in ranking investments.

(ii) Take Over by Reverse Bid: When the smaller company gains control of a larger one. Then it is called "Take-over by reverse bid". This concept has been successfully followed for revival of sick industries. 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. Under the Sick Industrial Companies (Special Provision) Act, 1985, a company becomes a sick industrial company when there is erosion of its net worth. This alternative is also known as taking over by reverse bid.

The three tests in a takeover by reverse bid that are required to be satisfied are, namely, (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.

In reverse takeover control goes to the shareholders (and usually management) of the company that is formally the target of the bid.

The term reverse takeover is also be applied to the purchase of a listed company by an unlisted company with control passing to the shareholders and management of the unlisted company. This is sometimes known as a 'back door listing'.

A reverse takeover will almost always take place by way of a pure equity acquisition, also called a share swap.

A reverse takeover for the purpose of obtaining a back door listing is accomplished by the shareholders of the unlisted company selling all of their shares to the listed company in exchange for shares of the listed company.

This is a cost effective method of obtaining a public listing because it avoids the expenses associated with a floatation. Sometimes, the unlisted company usually takesover a listed company, a company i.e., listed but not actively traded on the stock exchange.

(b) Security F

Prob(P)	R_f	PxR_f	*Deviations of F* $(R_f – ER_f)$	*(Deviation)²* *of F*	*(Deviations)²* $\times p$
0.3	30	9	13	169	50.7
0.4	20	8	3	9	3.6
0.3	0	0	-17	289	86.7
		ER_f=17			Var_f =141

STDEV σ f = $\sqrt{141}$ = 11.87

Market Portfolio, P

R_M %	P_M	*Exp. Return* R_M x P_M	*Deviation of P* $(R_M - ER_M)$	*(Deviation of P)²*	*(Deviation)²* P_M	*Deviation of F) x (Deviation of P)*	*Deviation of F x Deviation of P) x P*
-10	0.3	-3	-24	576	172.8	-312	-93.6
20	0.4	8	6	36	14.4	18	7.2
30	0.3	9	16	256	76.8	-272	-81.6
		ER_M=14			Var $_M$=264		=Co Var P_M
					σ_M=16.25		= −168

$$\text{Beta } \frac{\text{Co Var } P_M}{\sigma_M^2} = \frac{-168}{264} = -.636$$

(c) The modern and more popular method of share pricing these days is the BOOK BUILDING route. After appointing a merchant banker as a book runner, the company planning the IPO, specifies the number of shares it wishes to sell and also mentions a price band. Investors place their orders in Book Building process that is similar to bidding at an auction. The willing investors submit their bids above the floor price indicated by the company in the price band to the book runner. Once the book building period ends, the book runner evaluates the bids on the basis of the prices received, investor quality and timing of bids. Then the book runner and the company conclude the final price at which the issuing company is willing to issue the stock and allocate securities. Traditionally, the number of shares are fixed and the issue size gets determined on the basis of price per share discovered through the book building process.

Public issues these days are targeted at various segments of the investing fraternity. Companies now allot certain portions of the offering to different segments so that everyone gets a chance to participate. The segments are traditionally three-qualified institutional bidders (Q1Bs), high net worth individuals (HNIs) and retail investors (the general public). Indian companies now have to offer about 50% of the offer to Q1Bs, about 15% to high net worth individuals and the remaining 35% to retail investors. Earlier retail and high net worth individuals had 25% each. Also the Q1Bs are allotted shares on a pro-rata basis as compared to the earlier norm when it was at the discretion of the company management and the investment bankers. These investors (Q1B) also have to pay 10% margin on application. This is also a new requirement. Once the offer is completed, the company gets listed and investors and shareholders can trade the shares of the company in the stock exchange.

Question 4

(a) The following information pertains to M/s XY Ltd.

Earnings of the Company	*Rs.5,00,000*
Dividend Payout ratio	*60%*
No. of shares outstanding	*1,00,000*
Equity capitalization rate	*12%*
Rate of return on investment	*15%*

(i) What would be the market value per share as per Walter's model?

(ii) What is the optimum dividend payout ratio according to Walter's model and the market value of Company's share at that payout ratio?

(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?

(c) What is Credit rating? *(8+8+4= 20 Marks)*

Answer

(a) M/s X Y Ltd.

(i) Walter's model is given by

$$P = \frac{D + (E - D)(r / k_e)}{K_e}$$

Where P = Market price per share.

E = Earnings per share = Rs.5

D = Dividend per share = Rs.3

r = Return earned on investment = 15%

K_e = Cost of equity capital = 12%

$$P = \frac{3+(5-3)\times\frac{0.15}{0.12}}{0.12} = \frac{3+2.0\times\frac{.15}{.12}}{0.12}$$

= Rs.45.83

(ii) According to Walter's model when the return on investment is more than the cost of equity capital, the price per share increases as the dividend pay-out ratio decreases. Hence, the optimum dividend pay-out ratio in this case is nil.

So, at a pay-out ratio of zero, the market value of the company's share will be:

$$\frac{0+(5-0)\frac{0.15}{0.12}}{0.12} = \text{Rs.}52.08$$

(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) = 1503.7

(iii) Place DM 1503.7 in the money market for 3 months to obtain a sum of DM

Principal:	1503.70
Add: Interest @ 7% for 3 months =	26.30
Total	1530.00

(iv) Sell DM at 3-months forward to obtain Can$= (1530x0.67) = 1025.1

(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 = 1025.1 – 1022.5 = Can$ 2.6

(c) Credit rating: Credit rating is a symbolic indication of the current opinion regarding the relative capability of a corporate entity to service its debt obligations in time with reference to the instrument being rated. It enables the investor to differentiate between instruments on the basis of their underlying credit quality. To facilitate simple and easy understanding, credit rating is expressed in alphabetical or alphanumerical symbols.

Credit rating aims to (i) provide superior information to the investors at a low cost; (ii) provide a sound basis for proper risk-return structure; (iii) subject borrowers to a healthy discipline and (iv) assist in the framing of public policy guidelines on institutional investment. Thus, credit rating financial services represent an exercise in faith building for the development of a healthy financial system. In India the rating coverage is of fairly recent origin, beginning 1988 when the first rating agency CRISIL was established. At present there are few rating agencies like:

(i) Credit Rating Information Services of India Ltd. (CRISIL).

(ii) Investment Information and Credit Rating Agency of India (ICRA).

(iii) Credit Analysis and Research Limited (CARE).

(iv) Duff & Phelps Credit Rating India Pvt. Ltd. (DCR I)

(v) ONICRA Credit Rating Agency of India Ltd.

Question 5

(a) ABC Leasing Ltd. has been approached by a client to write a five years lease on an asset costing Rs.10,00,000 and having estimated salvage value of Rs.1,00,000 thereafter. The company has a after tax required rate of return of 10% and its tax rate is 50%. It provides depreciation @33 $\frac{1}{3}$ % on written down value of the asset. What lease rental will provide the company its after tax required rate of return?

(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.

(c) Briefly explain the objectives of "Portfolio Management". (7+7+6 = 20 Marks)

Answer

(a) In order to find out the annual lease rent, the cash flows from the asset must be evaluated as follows:

Year	*Depreciation (Rs.)*	*Tax Shield (Rs.)*	*Cash flow (Rs.)*	*PVF(10%)*	*PV (Rs.)*
1.	3,33,333	1,66,667	1,66,666	.909	1,51,500
2.	2,22,222	1,11,111	1,11,111	.826	91,778
3.	1,48,148	74,074	74,074	.751	55,630
4.	98,766	49,383	49,383	.683	33,728
5.	65,844	32,922	32,922	.621	20,444
6.	Salvage Value		1,00,000	.621	62,100
			Present Value of Inflows		4,15,180
			Outflow		…………..10,00,000
			Net Present value		.5,84,820

The firm therefore, should have total recovery of Rs.5,84,820 through the lease rentals. The annual lease rental after tax may be calculated as follows:

Lease rental (after tax) = Total recovery required ÷ PVAF $_{(10\%n)}$

= Rs.5,84,820 ÷ 3.791 = Rs.1,54,265

Now, the lease rental before tax = Rs.1,54,265 ÷ 0.5

= Rs.3,08,530

Therefore, the firm should charge a lease rental of Rs.3,08,530 in order to earn a required rate of return of 10% after tax.

(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 put, the investor will exercise it.

Ending position=(—Rs.300 cost of option)+(Re.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 option)+(Rs.4 per stock gain on put)x100	
	= — Rs.300 + 400	
Gain	= Rs.100	

(c) Objectives of Portfolio Management:

Portfolio management is concerned with efficient management of portfolio investment in financial assets, including shares and debentures of companies. The management may be by professionals or others or by individuals themselves. A portfolio of an individual or a corporate unit is the holding of securities and investment in financial assets. These holdings are the result of individual preferences and decisions regarding risk and return.

The investors would like to have the following objectives of portfolio management:

(a) Capital appreciation.

(b) Safety or security of an investment.

(c) Income by way of dividends and interest.

(d) Marketability.

(e) Liquidity.

(f) Tax Planning - Capital Gains Tax, Income tax and Wealth Tax.

(g) Risk avoidance or minimization of risk.

(h) Diversification, i.e. combining securities in a way which will reduce risk.

It is necessary that all investment proposals should be assessed in terms of income, capital appreciation, liquidity, safety, tax implication, maturity and marketability i.e., saleability (i.e., saleability of securities in the market). The investment strategy should be based on the above objectives after a thorough study of goals of the investor, market situation, credit policy and economic environment affecting the financial market.

The portfolio management is a complex task. Investment matrix is one of the many approaches which may be used in this connection. The various considerations involved in investment decisions are liquidity, safety and yield of the investment. Image of the organization is also to be taken into account. These considerations may be taken into account and an overall view obtained through a matrix approach by allotting marks for each consideration and totaling them.

Question 6

(a) Reliable Industries Ltd. (RIL) is considering a takeover of Sunflower Industries Ltd. (SIL). The particulars of 2 companies are given below:

Particulars	*Reliable Industries Ltd*	*Sunflower Industries Ltd.*
Earnings After Tax (EAT)	*Rs.20,00,000*	*Rs.10,00,000*
Equity shares O/s	*10,00,000*	*10,00,000*

Earnings per share (EPS)	*2*	*1*
PE Ratio (Times)	*10*	*5*

Required:

(i) *What is the market value of each Company before merger?*

(ii) *Assume that the management of RIL estimates that the shareholders of SIL will accept an offer of one share of RIL for four shares of SIL. If there are no synergic effects, what is the market value of the Post-merger RIL? What is the new price per share? Are the shareholders of RIL better or worse off than they were before the merger?*

(iii) *Due to synergic effects, the management of RIL estimates that the earnings will increase by 20%. What is the new post-merger EPS and Price per share? Will the shareholders be better off or worse off than before the merger?*

(b) *Write short notes on:*

(i) *Assumptions of CAPM.*

(ii) *Determinants of Dividend Policy.*

(c) *Abhishek Ltd. has a surplus cash of Rs.90 lakhs and wants to distribute 30% of it to the shareholders. The Company decides to buyback shares. The Finance Manager of the Company estimates that its share price after re-purchase is likely to be 10% above the buyback price; if the buyback route is taken. The number of shares outstanding at present is 10 lakhs and the current EPS is Rs.3.*

You are required to determine:

(a) *The price at which the shares can be repurchased, if the market capitalization of the company should be Rs.200 lakhs after buyback.*

(b) *The number of shares that can be re-purchased.*

(c) *The impact* of share re-purchase on the EPS, assuming the net income is same.

(8+6+6= 20 Marks)

Answer

(a) (i) Market value of Companies before Merger

Particulars	*RIL*	*SIL*
EPS	Rs.2	Re.1
P/E Ratio	10	5
Market Price Per Share	Rs.20	Rs.5
Equity Shares	10,00,000	10,00,000
Total Market Value	2,00,00,000	50,00,000

(ii) *Post Merger Effects on RIL*

	Rs.
Post merger earnings	30,00,000
Exchange Ratio (1:4)	
No. of equity shares o/s (10,00,000 + 2,50,000)	12,50,000
EPS: 30,00,000/12,50,000	2.4
Market Price per share	10.00
Market Value 10 x 2.4	24
Total Value (12,50,000 x 24)	3,00,00,000
Gains From Merger:	Rs.
Post-Merger Market Value of the Firm	3,00,00,000
Less: Pre-Merger Market Value	
RIL 2,00,00,000	
SIL 50,00,000	2,50,00,000
Total gains from Merger	50,00,000

Apportionment of Gains between the Shareholders:

Particulars	*RIL*	*SIL*
Post Merger Market Value:	*Rs.*	*Rs.*
10,00,000 x 24	2,40,00,000	--
2,50,000 x 24	-	60,00,000
Less:Pre-Merger Market Value	2,00,00,000	50,00,000
Gains from Merger:	40,00,000	10,00,000

Thus, the shareholders of both the companies (RIL + SIL) are better off than before

(iii) *Post-Merger Earnings:*

Increase in Earnings by 20%

New Earnings: Rs.30,00,000 x 20% = Rs.36,00,000

No. of equity shares outstanding: 12,50,000

EPS: Rs. 36,00,000/12,50,000 = Rs.2.88

PE Ratio = 10

Market Price Per Share:

= Rs.2.88 x 10 = Rs.28.80

∴ Shareholders will be better-off than before the merger situation.

(b) (i) Assumptions of Capital Assets Pricing Model (CAPM)

The Capital Assets Pricing Model is based on the following eight assumptions.

(a) The Investor's objective is to maximize the utility of terminal wealth.

(b) Investor's make choices on the basis of risk and return.

(c) Investors have homogenous expectations of Risk and Return.

(d) Investors have identical time horizon.

(e) Information is freely and simultaneously available to investors.

(f) There is a risk-free asset and investors can borrow and lend unlimited amount at the risk-free rate.

(g) There are no taxes, transaction costs, restrictions on short term rates or other market imperfections.

(h) Total asset quantity is fixed and all assets are marketable and divisible.

(ii) Determinants of Dividend Policy: Many factors determine the dividend policy of a company. The factors determining the dividend policy are as follows:

(a) Dividend payout Ratio: A certain share of earnings to be distributed as dividend has to be worked out. This involves the decision to pay out or to retain. The payment of dividends results in the reduction of cash and therefore depletion of assets. In order to maintain the desired level of assets as well as to enhance the investment opportunities, the company has to decide upon the pay-out ratio. Dividend Payout Ratio should be determined with the basic objectives of maximising the wealth of the firm's owners and providing sufficient funds to finance growth.

(b) Stability of Dividend: Generally investors favour a stable dividend policy. The policy should be consistent and there should be a certain minimum dividend that should be paid regularly. The policy can take any form, namely, constant dividend per share, stable D/P Ratio and constant dividend per share plus something extra.

(c) Legal, Contractual and Internal Constraints and Restriction: Legal and Contractual requirements have to be followed. All requirements of Companies Act, SEBI Guidelines, Capital Impairment Guidelines, net profit and insolvency etc., have to be kept in mind while declaring dividends. Also, there may be some contractual requirements which are to be honoured. Maintenance of certain debt-equity ratio may be one of such requirements. In addition, there may be certain internal constraints which are unique to the firm concerned. There may be growth prospects, financial requirements, availability of funds, earning stability and control etc.

(d) Owner's Considerations: This includes the tax status of shareholders, their opportunities for investment, dilution of ownership etc.

(e) Capital Market Conditions and Inflation: Capital Market conditions and rate of inflation also play a dominant role in determining the dividend payout. The extent to which a firm has access to capital market, also affects the dividend policy. A firm having easy access to capital market will follow a unique dividend policy. During inflation, rising prices eat into the value of money of investors which they receive as dividends. Good companies will try to compensate for rate of inflation by paying higher dividend. Replacement decisions of the companies also affects the dividend policy.

(c) (a) Let P be the buyback price decided by Abhishek Ltd.

Market Capitalisation After Buyback:

1.1 P (Original Shares – Shares Bought back)

$$= \left[1.1P\,(10\,\text{Lakhs} - \frac{30\%\text{ of }90\,\text{lakhs}}{P}\right]$$

= 11 Lakhs x P – 27 lakhs x 1.1

= 11 lakhs x P – 29.7 lakhs

Market capitalization rate after buyback is 200 lakhs.

Thus, we have:

11 Lakhs x P – 29.7 lakhs = Rs.200 lakhs

OR 11P = 200 + 29.7

$$\text{OR } P = \frac{229.7}{11} = \text{Rs.}20.88$$

(b) Number of shares to be bought back:

$$= \frac{27\,\text{Lakhs}}{20.88} = 1.29 \text{ lakhs (Approximaely)}$$

(c) New Equity Shares

= (10 – 1.29) lakhs = 8.71 lakhs

$$\text{EPS} = \frac{3 \times 10\,\text{lakhs}}{8.71\text{lakhs}} = \frac{30\,L}{8.71L} = \text{Rs.}3.44$$

Thus EPS of Abhishek Ltd., increases to Rs.3.44

PAPER – 3 : ADVANCED AUDITING

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

Question 1

As a statutory auditor, how would you deal with the following:

(a) A Pvt. Ltd., started stock broking activities in 2005. For this purpose it acquired membership of a stock exchange for Rs.110 lacs. While finalizing the accounts, the company disclosed the above amount under the Fixed Assets schedule as "Stock Exchange Membership Rights". The company also did not write off any amount since the rights would enable the company to perpetually carry on its business. (5 Marks)

(b) ABC Ltd. having a paid up capital of Rs. 1 crore earned as total net profit of Rs. 1 crore for the years 2001-02 to 2003-04. The Company did not declare any dividend nor transferred any amount to Reserves for these years. The entire profit was retained in the Profit & Loss Account.

In 2004-05, the company made a profit of Rs. 20 lacs. The company also proposed in 2004-05 to declare dividend @25% out of accumulated profits. (4 Marks)

(c) XYZ Ltd. had received a grant of Rs. 50 lacs in 1997 from a State Government towards installation of pollution control machinery on fulfillment of certain conditions. The company, however, failed to comply with the said conditions and consequently was required to refund the said amount in 2005.

The company debited the said amount to its machinery in 2005 on payment of the same. It also reworked the depreciation for the said machinery from the date of its purchase and passed necessary adjusting entries in the year 2005 to incorporate the retrospective impact of the same. (5 Marks)

(d) C Ltd. holds shares of D Ltd. which also entitles it to 51% voting power. These shares are held as "Stock-in-Trade" since C Ltd.'s intention is to dispose them in the near future. Due to this, C Ltd. Is of the view that the financial statements of D Ltd. need not be consolidated. (4 Marks)

Answer

(a) Stock Exchange Membership Rights: A Pvt. Ltd. has paid Rs.110 lacs for acquiring membership of stock exchange. Such membership rights provide exclusive right to A Pvt. Ltd. for carrying out stockbroking activities. Thus, Stock Exchange Membership Rights are controlled by A Pvt. Ltd. and provide the basis for generating economic benefits to it. All these criteria appear to meet the definition of intangible assets as laid down in AS 26, "Intangible Assets". The Standard requires an entity to recognize an intangible asset if it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise and the cost of the asset can be measured reliably. In the instant case, membership rights of stock exchange acquired by A Pvt. Ltd. meet the criteria of identifiability, control and arising of future benefits as well as reliability of the amount of cost. Thus recognizing the membership rights as Fixed Assets is proper.

However, the fact that the company did not write-off any amount since it would enable the company to perpetually carry on its business is not proper since AS 26 requires that all Intangible Assets to be amortised. For this purpose, a rebuttable presumption of 10 years is to be considered. Hence in the instant case, the company should have amortised such rights over 10 years. Since the company has not amortised any amount, the auditor will have to qualify his report and state the fact of non-compliance with AS 26.

(b) Declaration of Dividends: ABC Ltd. earned a total net profit of Rs.1 crore for three years 2001-02 to 2003-04 but it did not declare any dividend nor transferred any amount to Reserves for these three years. Since it did not declare any dividend, there was no compulsion to transfer any amount to Reserves. It appears that the company has retained the profit of previous years as "surplus" under the heading of "Reserves & Surplus". ABC Ltd. wants to declare dividend of Rs. 25 lacs for the financial year 2004-05, which works out to 25% of its paid up capital. However, since this rate of dividend exceeds 20% of the paid up share capital, as per the requirements of Companies (Transfer of Profit to Reserves) Rules, 1975, the company should transfer at least 10% of its current profit that is Rs.2 lacs to reserves resulting into deficiency of Rs. 7 lacs in the amount of current profit which could be available for the purpose of distribution of dividend.

The company, however, is well within its power to cover the said deficiency of profit out of its accumulated profit inspite of restrictions laid down in the rules prescribed under section 205A (3) of the Act, viz., Companies (Declaration of Dividend out of Reserves) Rules, 1975, since the company had not transferred any of its profit for the years 2001-2002 to 2002-04 to reserves. Thus, the company is well within its powers and right to declare the dividend of Rs.25 lacs for the year 2004-05.

(c) Refund of Government Grant: As per facts of the case, XYZ Ltd. had received a grant of Rs. 50 lacs in 1997 from a State Government towards installation of pollution control machinery on fulfillment of certain conditions. However, the amount of grant has to be refunded since it failed to comply with the prescribed conditions. In such circumstances, AS 12, "Accounting for Government Grants", requires that the amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. The Standard further makes it clear that in the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Accordingly the accounting treatment given by XYZ Ltd. of increasing the value of the plant and machinery is quite proper. However, the accounting treatment in respect of depreciation given by the company of adjustment of depreciation with retrospective effect is improper and constitutes violation of both the AS 6, "Depreciation Accounting" and AS 12, "Accounting for Government Grants".

The auditor, therefore, should discuss with the management to make necessary changes in respect of same and if not agreed to, qualify the report quantifying the impact of the same on profit as well as assets of the company.

(d) Consolidation of Accounts: AS 21, "Consolidated Financial Statements", requires that a subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future. In this case it needs consideration as to whether C Ltd.'s intention is to dispose off shares or hold the same. Since shares are being held as 'stock-in-trade' and the intention is to dispose off in near future, it is quite clear that control is temporary. Accounting Standards Interpretation issued by the Institute of Chartered Accountants of India specifies that where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise 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. Hence in a such a case the concerned subsidiary should be excluded from consolidation. Therefore, the contention of the C Ltd. that D Ltd. can be excluded from consolidation is correct.

Question 2

Comment on the following with reference to the Chartered Accountants Act, 1949, Code of Ethics and Schedules to the Act:

(a) P, a Chartered Accountant in practice provides management consultancy and other services to his clients. During 2005, looking to the growing needs of his clients to invest in the stock markets, he also advised them on Portfolio Management Services whereby he managed portfolios of some of his clients. *(5 Marks)*

(b) B, a Chartered Accountant in practice is a partner in 3 firms. While printing his personal letter heads, B gave the names of all the firms in which he is a partner. *(4 Marks)*

(c) XYZ & Associates, a firm with 5 partners developed a website www.xyzassociates.com. The website also contained a link to "All India Chartered Accountants Association", a voluntary association where X, a partner of the firm is currently the Vice-president.

(4 Marks)

(d) M/s LMN, a firm of Chartered Accountants responded to a tender from a State Government for computerization of land revenue records. For this purpose, the firm also paid Rs.50,000 as earnest deposit as part of the terms of the tender. *(5 Marks)*

Answer

(a) Advising on Portfolio Management Services: The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting "Management Consultancy and other Services" by a Chartered Accountant in practice. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, etc. It is, however, specifically stated that CAs in practice are not permitted to undertake the activities of broking, underwriting and portfolio management Services. Thus, a chartered accountant in practice is not permitted to manage portfolios of his clients.

In view of this, P would be guilty of misconduct under the Chartered Accountants Act, 1949.

(b) Advertisement of Professional Attainments: Clause 7 of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public. Even a member is not permitted to specify the date of setting up of practice or establishment of firm. However, there is no prohibition for printing names of all the three firms on the personal letterheads in which a member holding Certificate of Practice is a partner. Thus B is not guilty of any misconduct under the Chartered Accountants Act, 1949.

(c) Developing Website: As per the guidelines laid down under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 in respect of websites by chartered accountants in practice, it is permitted that website may provide a link to the website of ICAI, its Regional Councils, Branches and Government Departments and other professional Bodies like AICPA, ICAEW, CICA. In this case, M/s XYZ Associates provided a link to "All India Chartered Accountants Association" which is not permitted. Hence the firm would be liable for misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(d) Responding to Tenders: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down guidelines for responding to tenders, etc. As per the guidelines if a matter relates to any services other than audit, members can respond to any tender. Further, in respect of a non-exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposits.

In the instance case, since computerization of land revenue records does not fall within exclusive areas for chartered accountants, M/s LMN can respond to tender as well as deposit Rs.50,000 as earnest deposit and shall not have committed any professional misconduct.

Question 3

Answer the following:

(a) Designing an Audit Strategy is the backbone of the "Audit Planning" process. Discuss. *(10 Marks)*

(b) As a Statutory Auditor, of a bank, how would you verify the "Sacrifice" on Non-Performing Assets for which Corporate Debt Restructuring has been undertaken? *(6 Marks)*

Answer

(a) Audit strategy is concerned with designing optimised audit approaches, that seeks to achieve the necessary audit assurance at the lowest cost within the constraints of the information available. The formulation of audit strategy as shall be evident from the process as explained in the following paragraphs in fact shall form the basis of audit planning to achieve the audit objectives in the most efficient and effective manner. Audit strategy generally involves the following steps:

(i) Obtaining Knowledge of Business: AAS 20, "Knowledge of Business", states that in performing an audit of financial statements, the auditor should have or obtain knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgement, may have a significant effect on the financial statements or on the examination or audit report. Knowledge of the business is a frame of reference within which the auditor exercises professional judgement. Understanding the business and using this information appropriately assists the auditor in assessing risks and identifying problems, planning and performing the audit effectively and efficiently. It also ensures that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to enable them to carry out the audit work delegated to them. This would also ensure that the audit staff understands the need to be alert for additional information and the need to share that information with the auditor and the other audit staff.

(ii) Performing Analytical Procedures: The purpose of analytical procedures at the planning stage is attention-directing; corroboration is not normally necessary at this stage. The use of the analytical procedures during the planning stage requires the extensive use of accounting and business knowledge and experience to assess the potential for material misstatement in the financial statements as a whole, because the key aspect of the task is to identify the relevant risk indicators and to interpret them properly. Furthermore, analytical techniques applied during the planning stage are not generally as precise as the analytical techniques at the substantive stage.

(iii) Evaluating Inherent Risk: To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors such as quality of accounting system, unusual pressure on management, etc. having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which, might have taken place since his last assessment.

(iv) *Evaluating Internal Control*: The auditor's assessment of the control environment is crucial to the decision on whether to make an extended assessment of controls. This is because a good control environment is conducive to the maintenance of a reliable system of accounting and control procedures. For strategy purposes, the auditor should obtain a sufficient understanding of the control environment. The auditor needs an understanding of the accounting systems, regardless of whether the audit strategy will involve an extended assessment of internal accounting controls. This is done by:

(a) considering the results of gathering or updating information about the client; and

(b) making preliminary judgements about materiality, inherent risk and control effectiveness. These will include identification of the system(s) the auditor proposes to subject to an extended assessment of controls.

Thus, the audit strategy is evolved after considering the engagement objectives, the results of the business review, preliminary judgements as to materiality and identified inherent risks. Audit strategy also considers main points relating to planning and controlling the audit or comments on adequacy of the existing arrangements. Thus, the overall audit plan involving determination of timing, manpower, coordination and the directions in which the audit work has to proceed is dependent upon the audit strategy formulated by the audit firm.

(b) Corporate Debt Restructuring and Sacrifice Element: The Revised Guidelines on Corporate Debt Restructuring (CDR) Mechanism specified that in case of rescheduling of accounts, the element of interest to be computed in present value terms. The guidelines state that the sacrifice should be computed as the difference between the present value of future interest income reckoned based on the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring and the interest charged as per the restructuring package discounted by the current BPLR as on the date of restructuring plus appropriate term premium and credit risk premium as on the date of restructuring. Accordingly, the following steps may be taken in this regard:

(i) Check that the appropriate credit risk premium for the specific borrower category for all restructured accounts.

(ii) Ascertain appropriate rate of discount.

(iii) Check the computation of present value interest and the sacrifice amount.

(iv) See that the entire amount should be written off or provided for in case sacrifice is positive.

(v) Verify provision of adequate security coverage of the loan in case restructuring of principal amounts.

Question 4

Answer the following:

(a) A Company gets its accounting data processed by a third party to achieve cost reduction. As a Statutory Auditor of such a company, what are the additional precautions/checks that you would consider for conduct of the audit? (8 Marks)

(b) *What are the special points in the audit of a Non-Banking Equipment Leasing Finance Company? (8 Marks)*

Answer

(a) Precaution to be taken by auditor in case Accounting Data Processed by Third Party: Processing of accounting data may be given to a third party on account of various considerations such as economy, own computer working to full capacity, an interim measures restricting accessibility to sensitive information, etc. A client may use a service organisation such as one that executes transactions and maintains related accountability or records transactions and processes related data (e.g., a computer systems service organisation). If a client uses a service organisation, certain policies, procedures and records maintained by the service organisation might be relevant to the audit of the financial statements of the client. Consequently, the auditor would consider the nature and extent of activities undertaken by service organisations so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk. AAS 24, "Audit Considerations Relating to Entities Using Service Organisations", while planning the audit, the auditor of the client should determine the significance of the activities of the service organisation to the client and their relevance to the audit. In doing so, the auditor of the client would need to consider the following, as appropriate:

- Ø Nature of the services provided by the service organisation.
- Ø Terms of contract and relationship between the client and the service organisation.
- Ø The material financial statement assertions that are affected by the use of the service organisation.
- Ø Inherent risk associated with those assertions.
- Ø Extent to which the client's accounting and internal control systems interact with the systems at the service organisation.
- Ø Client's internal controls that are applied to the transactions processed by the service organisation.
- Ø Service organisation's capability and financial strength, including the possible effect of the failure of the service organisation on the client.
- Ø Information about the service organisation such as that reflected in user and technical manuals, if any.
- Ø Information available on general controls and computer systems controls relevant to the client's applications.

The auditor of the client would also consider the availability of third-party reports from service organisation's auditors, internal auditors, or regulatory agencies as a means of providing information about the accounting and internal control systems of the service organisation and about its operation and effectiveness.

(b) Special Points in the Audit of Non Banking Equipment Leasing Finance (NBELF) Company:

(i) Ascertain whether the NBFC has an adequate appraisal system for extending equipment leasing finance.

(ii) Verify whether there is an adequate system in place for ensuring installation of assets and their periodic physical verification. In respect of some major transactions, an auditor should arrange for physical verification of the leased assets so as to dispel any doubts that equipment leasing finance was not extended without the corresponding assets being created.

(iii) Ascertain whether the NBFC has an adequate system for monitoring whether the assets have been adequately insured against and regular maintenance of the leased assets is being carried out by a the lessee.

(iv) Verify the lease agreement entered into with the lessee in respect of the equipment given on lease.

(v) Verify whether the AS 13 issued by the Institute of Chartered Accountants of India in respect of "Accounting for Investments" has been complied with.

Question 5

Answer the following:

(a) As an internal auditor of a Cement Manufacturing Company, draft an audit programme for verification of transportation charges for despatches from the factory. (8 marks)

(b) As a tax auditor, how would you report on the following:

(i) Labour charges paid on which tax is deducted at source at an inappropriate rate.

(4 Marks)

(ii) Capital expenditure incurred for Scientific Research Assets. (4 Marks)

Answer

(a) Procedure for Audit of Transportation Charges

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

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

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

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

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

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

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

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

(ix) Check whether the transport booking orders are prenumberred.

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

(xi) In case there is an additional charge by the transporter due to extra carriage, check for the relevant supportings (like material Inward Note/Customer Rejection Note) and necessary authorization by the sanctioning authority.

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

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

(b) (i) Section 40(a) of the Income-tax Act, 1961 specifies that amounts payable to a contractor or sub-contractor, being resident, for carrying out any work (including supply or labour for carrying out any work) on which tax is deductible under Chapter XVII-B and such tax has not been deducted or after deduction has not been paid during the previous year or in the subsequent year before the expiry of the time prescribed under sub-section (1) of section 200, shall not be deducted in computing the income. Therefore, if tax is deducted at an unappropriate rate, the amount is disallowable u/s 40(a)(ia) of the Income-tax Act. This fact needs to be reported in Clause 17(f) of Form 3CD where all amounts unadmissible u/s 40(a) are to be reported. In case, the assessee submits that the rate is proper, though in the auditor's view it is improper, the tax auditor should exercise his judgement and accordingly report in Clause 17(f) of Form 3CD.

(ii) Clause 15(a) and (b) of Form 3CD requires that expenditure on Scientific Research (capital as well as revenue) covered u/s 35 of the Income-tax Act, 1961 reported of the amount debited to the profit and loss account (showing the amount debited and deduction allowable and not debited to the profit and loss account. Accordingly, the auditor should exercise his judgement and accordingly report in Clause 15(b) the amount of capital expenditure not debited to the Profit and Loss Account which is eligible for deduction u/s 25 as Scientific Research Expenditure.

Question 6

Answer the following:

(a) Discuss the various aspects to be considered by the Statutory Auditor before qualifying his report. *(8 Marks)*

(b) As a Statutory Auditor, how would you report on the following under CARO:

(i) O Pvt. Ltd. Is a dealer in Shares and Securities. *(4 Marks)*

(ii) ABC Pvt. Ltd. Is an Manufacturer of jewellery. A senior employee of the Company informed you that the Company does not properly disclose the purity of gold used on the jewellery. *(4 Marks)*

Answer

(a) Aspects to be Considered Before Qualifying the Audit Report: AAS 28, "The Auditor's Report on Financial Statements", specifies that auditor's report may need modification on account of certain matters which may or may not affect the auditor's opinion. There may be certain circumstances when an auditor may not be able to express an unqualified opinion because the effort of such circumstances in the auditor's judgment, is or may be material to the financial statements:

(i) there is a limitation on the scope of the auditor's work; or

(ii) there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

Further, while qualifying a report, it is important to appreciate as to which of the various items of statement of fact or statement of opinion require a qualification in respect of audits under the Companies Act, 1956, the auditor may also see whether the matters constituting the qualification involve a material contravention of any requirements of the Companies Act, 1956 which have a bearing on the accounts.

Finally, whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report. A quantified opinion should be expressed as being "subject to" or "except for" the effects of the matter to which qualification related.

(b) Reporting under CARO, 2003

(i) O Pvt. Ltd. is a dealer in shares and securities. Clause (xiv) of CARO, 2003 is applicable to a company in case it is dealing or trading in shares, securities, debentures and other investments. The requirements applicable to O Pvt. Ltd. would be as under:

- whether proper records are maintained for transactions and contracts;
- whether timely entries are made in such records; and
- whether shares, securities, debentures and other investments have been held by the company in its own name except to the extent of exemption, if any granted under section 49 of the Companies Act, 1956.

In case auditor is satisfied in respect of aforesaid matters, after making examination, the auditor may report as under:

> "In our opinion, and according to information and explanation given to us, the company has been maintained proper records in respect of transactions and contracts in securities during the year and timely entries have been made therein. Further, all shares and certificates are held by the company in its own name."

(ii) In the case of ABC Pvt. Ltd. If purity of gold is not properly disclosed on the jewellery it amounts to defrauding the customers. That means the management is deceiving customers to obtain an illegal advantage. However, the auditor is concerned with fraudulent acts that cause a material misstatement in financial statements. As long as books of account are not falsified arising out of difference in the purity of gold, i.e., actual cost of the gold and the sale price of gold, it has no implication for the auditor. Further, under CARO, 2003, the auditor may examine this from the view point of maintaining proper records of inventory. But even the requirement of maintaining proper records does not necessitate that purity as such should be mentioned on the gold itself. However, the purity of gold would have implication on the valuation of inventory. But this aspect is not required to be reported under CARO, 2003.

Thus, from the view point of reporting on frauds under CARO, 2003, there is no implication for misstatement in the financial statements. Hence, no reporting is necessary for non-proper disclosure of purity of gold on the jewelry.

Question 7

Answer the following:

(a) Elaborate how the Statutory Auditor can verify the existence of related parties for the purpose of reporting under Accounting Standard 18. (8 Marks)

(b) A company engaged in manufacturing of chemicals is consistently recording higher sales turnover, but declining net profits since the last 5 years. As an investigator appointed to find out the reasons for the same, what are the points you would verify? (8 Marks)

Answer

(a) Verification of Existence of Related Parties: Related Parties (for AS 18), the auditor should adopt audit procedures laid down in AAS 23, "Related Parties", to identify the existence of such parties. The auditor should review information provided by the management of the entity, identifying the names of all known related parties and should perform the following procedures in respect of the completeness of this information:

(a) review his working papers for the prior years for names of known related parties;

(b) review the entity's procedures for identification of related parties;

(c) inquire as to the affiliation of directors and key management personnels, officers with other entities;

(d) review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a list of principal shareholders from the share register;

(e) review memorandum and articles of association, minutes of the meetings of shareholders and the board of directors and its committees and other relevant statutory records such as the register of directors' interests;

(f) inquire of other auditors of the entity as to their knowledge of additional related parties and review the report of the predecessor auditors;

(g) review the entity's income tax returns and other information supplied to regulatory agencies; and

(h) review the joint venture and other relevant agreements entered into by the entity.

If, in the auditor's judgement, the risk of significant related parties remaining undetected is low, these procedures may be reduced or modified as appropriate.

(b) Decline in Net Profits Despite Increasing Sales: As per the facts that there has been consistently high turnover but declining net profits is an anomalous situation. It may be attributed to one or more following reasons requiring further investigation:

(i) *Unfavourable Salesmix*: Where the company sells different chemical products with different product margins, the product with the maximum PV ratio/margin should have a higher share in the total sales. If due to revision of salesmix, more quantities of unprofitable products are sold, profits will be reduced inspite of an increase in sales.

(ii) *Negative Impact of Financial Leverage*: Where the company does not have sufficient own funds (equity) but has a higher debt-equity ratio, the interest commitments will be higher. As the volume of its operation increases, higher debt and interest charges would result in lower profits.

(iii) *Other Items Included in Sales*: The figure of sales as per Profit and Loss Account may include incidental revenues, e.g., freight, excise duty, sales-tax, etc. where the amount of excise duty goes up considerably the total sales may show an increase which is not represented by a real increase in sales quantity/value.

(iv) *High Administrative and Selling Expenses*: Administrative and selling costs are generally period costs which are fixed in nature. Their increase is generally not proportional to sale increase. However, a reduction in profit could also be due to increase in administrative overheads and sales overheads at a rate higher than the rate of increase in sales.

(v) *Cost-Price Relationship*: If the increases in cost of raw materials and labour has not been compensated by a corresponding increase in the sales price this would also result in higher sales and declining profits. Inspite of same sales quantity, for the increasing cost of raw materials and other services, per unit values of the product has been increased which is however unmatched by the increase in cost.

(vi) *Competitive Price*: Where sales have been made at cut-throat prices in order to eliminate competition from the market, the profits would be in the declining trend in the short-run.

(vii) *Additions to Fixed Assets*: Where there are heavy additions to fixed assets and consequent depreciation charges in the initial years of additions, there may be reduction in profits in spite of increased sales.

Question 8

Write short notes on (any four):

(a) Remuneration to Statutory Auditors under the Companies Act, 1956.

(b) Disclosure under "Basis of Issue Price" in prospectus.

(c) Deferred Taxation

(d) Sampling Risk

(e) Test Packs *(4 × 4 = 16 Marks)*

Answer

(a) Remuneration to Statutory Auditors under the Companies Act, 1956: The company auditor's remuneration is fixed by:

(i) directors when the first auditors are appointed or to fill a casual vacancy (other than the one caused by resignation of the auditor);

(ii) Central Government when the appointment is made by it; and

(iii) company in general meeting or in such other manner as the company in General meeting may determine (including those wherein the auditor is appointed by the C&AG of India u/s 619 of the Act.)

It is further provided that any sums paid by the company in respect of the auditor's expenses shall be deemed to be included in the expression 'remuneration'. This implies that where a fixed sum is approved as remuneration of the auditor, it includes his expenses. However, it is not necessary that the amount of remuneration is specified by the company in its general meeting. It would be enough if the manner in which the remuneration is to be fixed is laid down in the general meeting. It is also not essential that the remuneration is fixed in the same general meeting in which the auditor is appointed.

Disclosure Requirements Under Companies Act, 1956: As per the Profit and Loss Account under Schedule VI to the Companies Act, 1956, the remuneration may be disclosed to the auditors in the following manner:

(a) As auditor

(b) As adviser or in any other capacity in respect of:

(i) taxation matters

   (ii) Company Law Matters, and
   (iii) Management Services

(c) The amounts paid in any other manner.

(b) Disclosures under 'Basis of Issue Price': Under this heading, the following information is to be disclosed:

(i) (a) Earnings per share, i.e., EPS pre-issue for the last three years (as adjusted for changes in capital);

   (b) P/E pre-issue and comparison thereof with industry P/E where available (giving the source from which industry P/E has been taken);

   (c) Average return on net worth in the last three years;

   (d) Minimum return on the increased net worth required to maintain pre-issue EPS;

   (e) Net Asset Value per share based on last balance sheet;

   (f) Net Asset Value per share after issue and comparison thereof with the issue price.

   Provided that projective earnings shall not be used as a justification for the issue price in the offer document.

(ii) The accounting ratios disclosed in the offer document in support of basis of the issue price shall be calculated after giving effect to the consequent increase of capital on account of compulsory conversions outstanding, as well as on the assumption that the options outstanding, if any, to subscribe for additional capital will be exercised.

(c) Deferred Taxation: AS 22, Accounting for Taxes on Income, prescribes the accounting treatment for taxes on income. The amount of taxable income for a period and the amount of profit (or loss) as shown by the profit and loss account for that period are seldom the same. The difference between accounting income and taxable income arise due to the fact that taxable income is calculated in accordance with tax laws whose requirements regarding computation of taxable income differ from the accounting policies applied to determine accounting income. The difference between taxable income and accounting income can be classified into 'permanent differences' and 'timing differences'. 'Permanent differences' are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. Timing differences, on the other hand, are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. The standard requires that deferred tax should be recognized for all timing differences, subject to the consideration of prudence in respect of deferred tax assets. Deferred tax represents the future tax effects of timing differences. Some timing differences are such that their reversal in future year(s) would result in the taxable income for the year(s) of reversal being higher than the accounting income for that year (or those years).

(d) Sampling Risk: Sampling Risk arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. The auditor is faced with sampling risk in both tests of control and substantive procedures as follows:

(a) Tests of Control:

(i) *Risk of Under Reliance*: The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.

(ii) *Risk of Over Reliance*: The risk that, although the sample result supports the auditor's assessment to control risk, the actual compliance rate would not support such an assessment.

(b) Substantive Procedures:

(i) *Risk of Incorrect Rejection*: The risk that, although the sample result supports the conclusion that a recorded amount balance or class of transactions is materially mis-stated, in fact it is not material mis-stated.

(ii) Risk of Incorrect Acceptance: The risk that, although the sample result supports the conclusion that a recorded amount balance or class of transactions is no materially mis-stated, in fact it is materially mis-stated.

The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements then either the risk of under reliance or the risk of incorrect rejection.

Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

(e) Test Packs: Test pack is a technique to determine the correctness of the computer programming used to record transactions through the computer. Preparation of test pack requires a great deal of expertise. It may be prepared by the auditor himself with the help of the entity's staff or by the Internal Control department of the entity. Normally test packs are used where:

(i) a significant part of the control system is embodied in the programme;

(ii) there are gaps in audit trail making it difficult to trace output from input and to verify intermediate calculation; and

(iii) the volume of records is large, so that it may be more economical and more effective to use test packs rather than to trace the transactions manually.

The operations of a test pack involve following steps:

(i) The auditor or the Internal Audit Department prepares a set of special data covering different types of transactions containing valid and unvalid conditions.

(ii) Data will include both that falling outside the control parameters (and printed out as an error or conception) and that falling within the parameters (and hence should be processed normally).

(iii) The test data are seen on the clients' computer with the client's programme but under audit supervision.

(iv) The results of the test data are also prepared separately, independent of the computer/programme, and are compared with the results obtained by running the programme through the computer.

(v) If the results are identical, reliability of the computer programme is proved.

(vi) If the results are identical, reliability of the computer programme is proved.

PAPER – 4 : CORPORATE LAWS AND SECRETARIAL PRACTICE

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

Question 1

Answer any two of the following:

(a) A is Managing Director of APAR Ltd. He gave his resignation letter to the Chairman of the Board of Directors on 31st December, 2005 and requested that he should be relieved immediately. When does the resignation of Mr. A take effect? (5 Marks)

(b) On 31st March, 2006 D holds certain securities issued under 'Collective Investment Scheme.' His name appears in the books of the scheme. He has transferred these securities to another person for a consideration. The transferee lodged the instrument of transfer with the authorities one month after the date on which the income on these securities became due. Examining the provisions of the Securities Contracts (Regulation) Act, 1956 state:

(i) Whether D is entitled to receive and retain the income on these securities for the financial year ended 31st March, 2006 in the given case?

(ii) Would your answer be still the same in case the transferee lodged the instrument of transfer with the authorities 14 days after the date on which the income on these securities became due? (5 Marks)

(c) The Executive Committee of a recognized Stock Exchange desires to transfer certain duties and functions of a clearing house to a recently set up Clearing Corporation, incorporated as a company under the Companies Act, 1956. Examining the provisions of the Securities Contracts (Regulation) Act, 1956:

(i) State the purpose for which such transfer of duties and functions can be made to Clearing Corporation.

(ii) What is the procedure to be adopted for such transfer of duties and functions? (5 Marks)

Answer

(a) A director can resign from his office by serving a notice of his resignation upon the Company or the Board. There is no need for its acceptance by the Board or the Company.

However, if a Managing Director resigns, he cannot give up his office at his pleasure simply by serving the notice. This is because he occupies two positions i.e., of a director and an employee. In case of Managing Director, the notice or letter of resignation is required to be approved or accepted by the company and he has to be relieved of his duties and responsibilities attaching to his office from which he has resigned. Similar views were accepted in the case of *Achutha Pal vs. Registrar of Companies (1956) 36 Comp. Cases 598.*

Accordingly, in the given case, the resignation of A, the Managing Director shall be effective when approved or accepted by the company and he is relieved of his duties and responsibilities attaching to his office from which he has resigned.

(b) Transfer of securities under Collective Investment Scheme under the Securities Contracts (Regulation) Act, 1956 (Section 27A)

Problem as asked in the question is based on the provisions of Section 27A of the Securities Contracts (Regulation) Act, 1956, wherein it shall be lawful for the holder of any securities, being units or the other instruments issued by collective investment scheme, whose name appears on the books of the scheme, issuing the said security to receive and retain any income in respect of units issued by the scheme in respect thereof for any year, notwithstanding that the said security, being units issued by the scheme, has already been transferred by him for consideration, unless the transferee who claims the income in respect of units issued by the scheme from the transferor has lodged the security and all other documents relating to the transfer which may be required by the scheme with the scheme for being registered in his name within 15 days of the date on which the income in respect of units or other instruments issued under the scheme became due. The period of 15 days can be extended in certain contingencies as stated in Explanation to Section 27A (1).

Applying the above provisions in the given case:

(i) the holder of securities (i.e. D, the transferor) has right to receive or retain the income on these securities for the financial year ended 31st March, 2006, since the instrument for transfer was lodged one month after the date on which the income became due.

(ii) The answer in the second case would differ. The holder (i.e. D, the transferor) cannot receive and retain the income since the instruments for transfer was lodged with the company within the statutory period of 15 days by the transferee.

(c) Transfer of certain duties and functions of a clearing house by a stock exchange to clearing corporation under the Securities Contracts (Regulation) Act, 1956 (Section 8A)

Purposes:

A recognized stock exchange may, with the prior approval of the Securities and Exchange Board of India, transfer the duties and functions of a clearing house to a clearing corporation, being a company incorporated under the Companies Act, 1956 for the purpose of:

(i) the periodical settlement of contracts and differences thereunder,

(ii) the delivery of, and payments for, securities;

(iii) any other matter incidental to, or connected with, such transfer.

Procedure:

1. Every clearing corporation shall for the purpose of transfer of the duties and functions of a clearing house to clearing corporation make bye-laws and submit the

same to the SEBI for approval.

2. The SEBI may, on being satisfied that it is in the interest of the trade and also in the public interest to transfer the duties and functions of a clearing house to a clearing corporation, grant approval to the bye-laws submitted to it under sub-section (2) and approve transfer of the duties and functions of a clearing house to a clearing corporation.

3. The provisions of Sections 4 to 12 shall, as far as may be, apply to a clearing corporation as they apply in relation to a recognized stock exchange.

Question 2

Answer any two of the following:

(a) State which kind of approval is required for the following transactions under the Foreign Exchange Management Act, 1999:

(i) X, a Film Star, wants to perform alongwith associates in New York on the occasion of Diwali for Indians residing at New York. Foreign Exchange drawal to the extent of US dollars 20,000 is required for this purpose.

(ii) F International Ltd. has purchased the trade mark from a Foreign Company to establish retail business chain in India as a joint venture at a consolidated price of US dollars 500,000 which is to be paid in Foreign currency of that country.

(iii) R wants to get his heart surgery done at UK. Up to what limit Foreign Exchange can be drawn by him and what are the approvals required ?

(iv) L wants to pursue a course in Fashion design in Paris. The Foreign Exchange drawal is US dollars 20,000 towards tuition fees and US dollars 30,000 for incidental and stay expenses for studying abroad. (7 Marks)

(b) A French Manufacturing Company desirous of setting up its branch office at Pune, seeks your advice on the objects for which the company may be allowed to set up the desired branch office. Advise the company about the procedure as required under the Foreign Exchange Management Act, 1999 to be followed in this regard. (7 Marks)

(c) Examine with reference to the relevant provisions of the Competition Act, 2002 the following:

(i) Whether a Government Department supplying water for irrigation to the Agriculturists after levying charges for water supplied (and not a water tax) can be considered as an 'Enterprise'.

(ii) Whether a person purchasing goods not for personal use, but for resale can be considered as a 'consumer.' (7 Marks)

Answer

(a) Approval to the following transactions under FEMA, 1999 :

(i) Foreign Exchange drawals for cultural tours require prior permission/approval of the

Government of India irrespective of the amount of foreign exchange required. Therefore, in the given case X, the Film Star is required to seek permission of the Government of India.

(ii) In this case prior permission/approval of RBI is required for purchasing trade mark from a foreign company where purchase consideration is to be paid in foreign currency. Therefore, F International Ltd. needs prior permission of RBI.

(iii) Remittance in foreign exchange for medical treatment abroad requires prior permission/approval of RBI when the expenditure in foreign currency exceeds the estimate of hospital/doctor abroad or estimate from doctor in India in that field of treatment. Therefore, R can draw foreign exchange up to the estimate of hospital/doctor abroad or estimate from doctor in India in that field of treatment and prior permission/approval of RBI is required.

(iv) Release of foreign exchange for education abroad is permitted up to US$ 1,00,000 on self declaration basis. Therefore, L can draw foreign exchange on self declaration basis for pursuing a course in fashion design in Paris.

(b) Setting up a branch office at Pune by a French company – Objects and the procedure under the FEMA, 1999 :

Since setting up a branch office by a foreign company in India involves foreign exchange, permission of RBI is required. Following are the objects for which RBI permits companies engaged in manufacturing and trading activities abroad to set up Branch Office in India:

1. To represent the parent company/other foreign companies in various matters in India e.g. acting as buying/selling agents in India.
2. To conduct research work in the area in which the parent company is engaged.
3. To undertake export and import trading activities.
4. To promote possible technical and financial collaborations between the Indian companies and overseas companies.
5. Rendering professional or consultancy services.
6. Rendering services in information technology and development of software in India.
7. Rendering technical support to the products supplied by the partner/group companies.

Steps / procedure:

1. Foreign company can set up Branch Offices in India after obtaining approval from RBI.
2. The office can act as a channel of communication between Head Office abroad and parties in India. It is not allowed to undertake any business activity in India and cannot earn any income in India. Expenses of such offices are to be met entirely through inward remittances of foreign exchange from the Head Office abroad.

3. Permission to set up such office is initially granted for a period of 3 years and this may be extended from time to time by the Regional Office in whose jurisdiction the office is set up.
4. The representative office will have to file an annual activity certificate etc. from a Chartered Accountant to the concerned Regional Office of the RBI.
5. Application is required to be made in Form FNC-1.

(c) Competition Act, 2002:

Enterprise: The term 'enterprise' is defined in Section 2(h) of Competition Act, 2002. Accordingly 'enterprise' means a person or a department of the Government, who or which is engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or the provision of services of any kind. But the term does not include any activity of the Government relatable to sovereign functions of the Government including all activities carried on by the departments of the Central Government dealing with atomic energy, currency, defence and space.

Certain specific activities of Government departments like dealing with atomic energy, etc,. and sovereign functions of the Government (like police, defence, etc.) are excluded from the purview of the said terms. Hence, a Government department engaged in the activity of providing service in the form of supply of water for irrigation to the agriculturists after levying charges can be considered as an 'enterprise' within the meaning of Section 2(h) of Competition Act, 2002.

Consumer: The term 'consumer' is defined in Section 2(f) of Competition Act, 2002. Accordingly 'consumer' means any person who buys any goods for a consideration, which has been paid or promised or partly paid and partly promised, whether such purchase of goods is for resale or for any commercial purpose or for personal use.

Hence, it is not necessary that a person must purchase the goods for personal use in order to be considered as a 'consumer' under Competition Act, 2002. Even a person purchasing goods for resale or for any commercial purpose will also be considered as a 'Consumer' within the meaning of Section 2(f) of Competition Act, 2002.

Question 3

Answer any two of the following:

(a) SEBI received complaints from some investors alleging that ABC Ltd. And some brokers are indulging in price manipulation in the shares of ABC Ltd. Explain the powers that can be exercised by SEBI under the Securities and Exchange Board of India Act, 1992 in case the allegations are found to be correct. *(8 Marks)*

(b) A designated Financial Institution under the Companies Act, 1956 proposes to go for issue of shares. Referring to the SEBI guidelines the institution seeks your advice on the following:

(i) What minimum reservation to promoters is to be made by the Financial Institution ?

(ii) To what conditions shall the Financial Institution be subject to, for reservation for

employees out of the proposed issue? Advise. *(8 Marks)*

(c) *What are the Internal and External aids to interpretation of statutes ? Give five examples each of Internal and External aids.* *(8 Marks)*

Answer

(a) SEBI Act, 1992: Price manipulation in the shares of ABC Ltd. can be considered as fraudulent and unfair trade practices relating to securities market. In this case SEBI may exercise the following powers under Section 11(4) of securities and Exchange Board of India Act, 1992.

(i) Suspend the trading of any security (in this case the securities of ABC Ltd.) in a recognized stock exchange.

(ii) Restrain persons (in this case ABC Ltd.) from accessing the securities market. It can also prohibit any person associated with securities market (i.e. brokers who have indulged in price manipulation) to buy, sale or deal in securities market.

SEBI may issue the above orders for reasons to be recorded in writing. SEBI shall, either before or after passing such orders give an opportunity of hearing to company and brokers concerned (proviso 2 to Section 11(4))

SEBI may also appoint an adjudicating officer who may levy penalty under Section 15 HA after holding an enquiry in the prescribed manner. According to Section 15HA if any person indulges in fraudulent and unfair trade practices relating to securities, he shall be leviable to a penalty of Rs. 25 crores or 3 times the amount of profits made out of such practices, whichever is higher.

Prohibition on manipulation and deceptive practices: Further according to Section 12A, no person shall directly or indirectly indulge in following (i.e.) (a) using in manipulative or deceptive device in connection with purchase, sale or securities listed (b) Employ any scheme or device to defraud in connection with dealing in securities which are listed (c) engage in an act which would operate as fraud on deceit upon any person in connection with dealing in securities which are listed. SEBI may impose penalty upto Rs. 1 crore on any person who fails to comply with any provisions of SEBI Act (Section 15 HB).

(b) Issue of shares by designated financial institution: SEBI Guidelines

The designated financial institutions viz. Public Financial Institution as defined under Section 4A of the Companies Act, 1956 approaching the capital market for funds through an offer document, shall be subject to the following guidelines:

(i) Promoters' Contribution: There is no requirement of minimum promoters' contribution in respect of any issue made by DFIs. In case any DFI proposes to make a reservation for promoters, such contributions from the promoters shall come only from actual promoters and not from directors, friends, relatives, associates, etc.

(ii) Reservation for Employees:

1. The DFIs may make a reservation out of the proposed issue for allotment only

to their permanent employees including their Managing Director(s) or any whole time Director.

2. Such reservation shall be restricted to the number of permanent employees on the pay rolls of the DFIs as on the date of the offer document multiplied by 200 shares of Rs. 10 each or 20 shares of Rs. 100 each as the case may be per employee, subject to a maximum of 5% of the issue size.

3. The shares allotted under the reserved category shall be subject to a lock in period of 3 years.

4. In case of public issue, unsubscribed portion, if any, in the reserved category shall be added back to the public offer.

5. In case of right issue, unsubscribed portion if any, shall lapse.

6. Where the Managing Director or the Whole Time Director represents the promoters, he may acquire securities as part of the promoters' contribution but not under the reservation made for the employees in the proposed issue.

Thus the answer to the given question shall be as under:

1. There is no requirement of minimum reservation for promoters in the public issue by the designated financial institution.

2. Reservation to employees can be made subject to the conditions as stated above.

(c) Internal aids to interpretation / construction are those which are found within the text of the statutes. On the other hand external aids of interpretation are those factors which are external to the text of the statute but are of great help.

Examples of internal aids to interpretation:

1. Definitional sections and clauses
2. Illustrations
3. Provisos
4. Long title and short title
5. Preambles
6. Heading and title of chapter
7. Marginal notes
8. Explanations
9. Schedules
10. Reading the statute as a whole

Examples of external aids to interpretation:

1. Historical setting (Background)

2. Consolidating statute & Previous law
3. Usage
4. Earlier & later analogous acts
5. Earlier acts explained by the later act
6. Reference to repealed acts
7. Dictionary definition
8. Use of foreign decisions

Question 4

(a) Clever, a Director of ABC Ltd. Made default in filing of Annual Accounts and Annual Returns with the Registrar of Companies for a continuous period of three financial years ending 31st March, 2005. Referring to the provisions of the Companies Act, 1956 examine the validity of the following:

(i) Whether X can continue to be a Director of ABC Ltd. And also EF Ltd., where he is a Director. Also state whether he can be reappointed as a Director in ABC Ltd. as well as EF Ltd.

(ii) Would your answer be still the same in case X is a nominee Director of a Public Financial Institution ?

(iii) What would be your answer in case the defaulting company (i.e. ABC Ltd.) is a Private Company ? (8 Marks)

(b) A meeting of members of a Company was convened under the orders of the court to consider a scheme of compromise and arrangement. The meeting was attended by 200 members holding 5,00,000 shares in aggregate. 70 members holding 4,00,000 shares voted for the scheme. The remaining members voted against the scheme. Examine with reference to the relevant provisions of the Companies Act, 1956 whether the scheme is approved by the required majority. (7 Marks)

Answer

(a) In accordance with the provisions of Section 274(1)(g) a person shall not be capable of being appointed as director of a company if such person is already a director of a public company, which –

(A) has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after the first day of April, 1999;

Provided that such person shall not be eligible to be appointed as a director of any other public company for a period of 5 years from the date on which such public company, in which he is a director failed to file annual accounts and annual returns under this clause.

Applying the above provisions as contained in Section 274(1)(g), answers to the given questions are:

1. In the given case, Mr. Clever, the Director of ABC Ltd. is disqualified to be appointed as Director of other public companies for a period of 5 years from the date on which default has been committed.
2. In the second case, Mr. Clever, as a nominee of the Public Financial Institution, shall not be disqualified to be appointed as Director for the reason that the Public Financial Institutions and are exempted from the provisions of Section 274(1)(g) of the Companies Act, 1956.
3. A director of a private company is not disqualified even if that company is a defaulter in filing return.

   Mr. Clever does not cease to be a director in ABC Ltd. and EF Ltd. immediately because Section 283 which provides for 'vacation of office' has not been amended. He can continue as a director till his term ends. But he can be reappointed in the defaulting company ABC Ltd., but not in EF Ltd. as the disqualification applies only to 'any other public company'.

(b) Scheme of compromise and arrangement / amalgamation

The majority required to consider a scheme of compromise or arrangement under Section 391(2) of the Companies Act, 1956 is a majority in number representing 3/4th in value of the members present and voting either in person or, where proxies are allowed by proxy at the meeting, agree to the scheme of compromise or arrangement. The majority required two separate compliances to constitute the passage of the resolution approving the scheme placed before the meeting -

(1) majority in number must vote for the scheme (2) they must compulsorily held three-fourths of the total value of the shares of all the members present and voting at the meeting.

Here the scheme is approved by members holding more than three fourths in value of the total value of shares. But as only 70 members voted for the scheme as against 130 members voting against the scheme, the second requirement of majority in number approving the scheme is not complied with. Hence the scheme is not approved by the required majority under Section 391(2) of the Companies Act, 1956.

Question 5

(a) From the following information extracted from the Balance Sheet of VCD Ltd. as at 31st March, 2006, Board of Directors of the Company decide to grant a loan of Rs. 80 crores to another company JN Ltd.

	Rs. (in crores)
Paid-up Share Capital:	
Equity Share Capital	*50*
Preference Share Capital	*10*
General Reserves	*100*
Debentures	*5*
Debenture Redemption Reserve	*5*

The company has already given loans to the following companies:

(i)	*Peters Ltd.*	*Rs. 5 crores*
(ii)	*Steel India Ltd.*	*Rs. 10 crores*

The Company has also given a corporate guarantee of Rs. 10 crores to NR & Co. Ltd.

Advise whether the Board can go ahead with the above proposal. *(8 Marks)*

(b) *The subscribed share capital of AJR Company Ltd. at the end of the financial year ending 31st March, 2005 was Rs. 20 crores, out of which two public Financial Institutions were holding share capital amounting to Rs. 3 crores. During the financial year 2005-2006 the company through public issue of shares raised its subscribed capital by additional Rs. 60 crores. Out of Rs. 60 crores, the two public financial institutions were further allotted shares amounting to Rs. 20 crores, raising the total contribution of these two institutions to Rs. 23 crores before the date of the company's closure of books for annual general meeting scheduled for 15th September, 2005, where auditors were to be appointed. The company as usual, by getting an ordinary resolution passed appointed the auditors. A group of shareholders of the company allege that the appointment of auditors is violative of certain provisions of the Companies Act, 1956. They however, did not raise any objection to the appointment of auditors at the previous annual general meeting held on 10th September, 2004. Examining the provisions of the Companies Act, 1956 decide:*

(i) *Whether contention of the shareholders shall be tenable?*

(ii) *Should the contention of shareholders be tenable, what action is the company required to take for the appointment of auditors in the above situation at the annual general meeting scheduled for 15th September, 2005 ?*

(iii) *Would your answer be still the same in case the total subscribed capital contributed by the two public financial institutions in only Rs. 10 crores, including the previous contribution of Rs. 3 crores ?* *(7 Marks)*

Answer

(a) Problem on Inter-Corporate Investment

In accordance with the provisions of the Companies Act, 1956, as contained in Section 372A, Companies Act, 1956 a company cannot grant any loans or inter corporate investment exceeding 60% of its paid up capital and free reserves or 100% of its free reserves, whichever is more.

In case of VCD Ltd. the position as at 31st March, 2006 is as under:

Paid-up share Capital:	Equity Share Capital :	Rs. 50 crores
	Preference Share Capital:	Rs. 10 crores
General Reserves		Rs. 100 crores

Total Rs. 160 crores. (60% of Rs. 160 crores = Rs. 96 crores)

100% of Reserves & Surplus (i.e. General Reserve) Rs. 100 crores.

As 100% of free reserves, i.e. Rs. 100 crores is more than 60% of paid up share capital (both Equity and Preference share Capital) and free reserves, i.e. Rs. 96 crores, therefore, the overall limit for release of loan is Rs. 100 crores.

The company has already granted loan / given guarantee as under:

(i)	Peters Ltd.	Rs. 5 crores
(ii)	Steel India Ltd.	Rs. 10 crores
(iii)	Corporate Guarantee	Rs. 10 crores
	Total	Rs. 25 crores

Balance of limit upto which further loans/guarantee can be given = Rs. 100 crores – 25 crores = Rs. 75 crores

Therefore, the company can grant loan upto Rs. 75 crores to JN Ltd. Loan upto Rs. 80 crores as proposed can be given provided a special resolution in company's general meeting has been passed as required under Section 372A of the Companies Act, 1956. It may however, be noted that the special resolution as required must be passed through postal ballot in accordance with the rule 4 of the Companies (Passing of the Resolution by Postal Ballot) Rules, 2001.

(b) Appointment of Auditors by Special Resolution (Section 224 A, Companies Act, 1956)

The problem as asked in the question is based on the provisions of Section 224A of the Companies Act, 1956. The section provides for the appointment of auditors in certain cases only by a special resolution. Normally the auditors are appointed by passing ordinary resolution. In terms of Section 224A, a company in which not less than 25% of the subscribed capital is held by:

(i) a Public Financial Institution or a Government company or the Central Government or any State government, or

(ii) any financial or other institution established by any Provincial or State Act in which a State Govt. holds not less than 51% of the subscribed share capital, or

(iii) a nationalized bank or an insurance company carrying on general insurance business, or

(iv) any combination of the above categories shall appoint or re-appoint an auditor in the annual general meeting only by passing a special resolution.

In case the aforesaid company omits or fails to pass a special resolution in the annual general meeting to appoint an auditor or auditors it shall be deemed that no auditor or auditors have been appointed, and thereupon the Central Government's power to appoint the auditors pursuant to Section 224(3) will become exercisable. In determining whether the appointment calls for a special resolution or not the measuring yardstick is the proportion of the subscribed capital held by the various categories mentioned above. If any of them singly or several of them jointly held 25% of the subscribed capital of the company as on the day of the closing of the register of members before the AGM of the company, it will be covered by the provisions of Section 224A. and consequently, the appointment of the auditor can only be made by passing a special resolution.

The Department of Company Affairs has clarified that the material date is the date for considering the 25% holding is the date of the AGM at which the resolution is required to be passed. Moreover, since generally articles of association of the companies provide for closure of the register of members before the general meeting during a period not exceeding in 30 days at any one time, it is unlikely that the position regarding shareholding in the company will be different between the date of issue of notice and date of the general meeting.

Therefore, applying the above provisions in the given case answers to the question shall be as under:

1. Since in the first case the public financial institutions holds the total subscribed share capital to an extent of Rs. 23 crores (i.e. in excess of 25% of the subscribed share capital on the date of AGM i.e. 15 September, 2005) the appointment of auditor shall be made by special resolution as required under Section 224A. The company, therefore, has violated the provisions of Section 224A, since the company has passed only ordinary resolution instead of passing special resolution. Therefore, it shall be presumed as if no auditors have been appointed and the Central Government shall exercise its power for appointing the auditors. The contention of the shareholders is tenable.

2. Since the contention of the shareholders in the first case is tenable, in the second case the company shall, within 7 days of the Central Govt.'s power under sub-section (3), becoming exercisable, gave notice of that fact to that Govt. and if a company fails to give such notice, the company and every officer of the company who is in default, shall be punishable with fine which may extend to Rs. 5,000 (Section 224(3))

3. Answer in the third part will differ, i.e. the shareholders contention shall not be tenable as the subscribed capital of the financial institution is less than 25% of the total subscribed capital of the company.

Question 6

(a) *The Executive Committee of an Inter-state Co-operative society decides to convert the society into a 'Producer Company' under the provisions of the Companies Act, 1956. You being a practicing Chartered Accountant are approached by the society for advice. Advise the society on the following matters:*

   (i) *The steps to be taken for conversion of the society into a 'Producer Company'.*

   (ii) *Manner in which voting rights of members of Producer company after conversion may be exercised.* *(8 Marks)* *(b) Referring to the provisions of the Companies Act, 1956, as contained in Section 397 of the Act, Examine whether the following Acts of the company amount to oppression:*

(i) Allotment of shares by the Directors of the Company by which the existing majority is reduced to minority.

(ii) Allotment of shares by the Directors by which the existing minority shareholders are made to majority.

(iii) A share sale agreement was executed by VC, an NRI. The shares and transfer deed were handed over to an escrow agent. The sale was subject to RBI permission. The shares were not transferred for 6 years since RBI permission was not received. VC, after waiting for a long period of time raises the issue and complains of oppression in the capacity of a member. As per the agreement the sale was unconditional. During the above period VC did not exercise any right as shareholder nor the company treated him as a member. (7 Marks)

Answer

(a) Conversion of inter state cooperative society into producer company steps to be taken and manner in which voting rights of members after conversion to be exercised. [Section 581J and 581D The Companies (Amendment) Act, 2002.]

As a practicing Chartered Accountant the following advise can be given to the inter-state society which wants to get converted into a 'Producer company' under the provisions of Companies (Amendment) Act, 2002.

1. Steps to be taken for conversion (Section 58IJ):

   Any inter-state cooperative society having objects for multiplicity for states may make an application to the Registrar for registration as producer company. Such application should be accompanied by –

   (a) A copy of the special resolution, of not less than $2/3^{rd}$ of total member of Inter-State Cooperative Society, for its incorporation as a producer company.

   (b) A Statement showing : (i) names and address or the occupation of the directors and Chief Executive, if any, by whatever name called, of such inter-state cooperative society; and (ii) list of members of such inter-state cooperative society.

   (c) A statement indicating that the inter-state cooperative society is engaged in any one or more of the objects specified in Section 581B.

   (d) A declaration by two or more directors of the inter-state cooperative society certifying that particulars given in clauses (a) to (c) given above are correct.

   The word "Producer Company Ltd." should form part of its name to show its identity. On compliance with the requirements of the Act, the Registrar shall, within a period of 30 days of the receipt of application, certify under his hand that the society applying for registration is registered and thereby incorporated as a producer company.

Upon registration as a producer company, the Registrar of Companies who registers the company is required to intimate the Registrar with whom the erstwhile inter-State cooperative society was earlier registered for appropriate deletion of the society from its register.

2. Manner in which voting rights of members can be exercised (Section 581Z):

   Section 581Z of the Companies Act, 1956 states that subject to the provisions of sub-sections (1) and (3) of Section 581D, every member shall have one vote and in the case of equality of votes, the chairman or the person presiding shall have a casting vote except in the case of election of the chairman. As regards the voting rights it may be noted that:

   1. Where individual is a member of the producer company, he has one vote irrespective of the size of his holding.
   2. Where both individuals and producer institutions are members – single vote for every member.
   3. Where membership is confined to producer institutions only, in the first year of registration of the company, the voting rights shall be based on the size of the shareholding of the member institution and in the following years it will be based on participation by the respective institutions in the business of the producer company in the previous year (as may be specified in the Articles),
   4. A producer company, may, if authorized by the Articles, restrict the voting rights to active members of the producer company, and
   5. Casting vote can be cast by the presiding member (Chairman) in case of equality of votes on any resolution (except for election of the Chairman).

(b) Acts of oppression (and the action to be taken against the company): Section 397 of the Companies Act, 1956 provides that any members of a company who complain that the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner oppressive to any member or members (including any one or more of themselves) may apply to the National Company Law Tribunal (NCLT) for an order under this section, provided such members have a right so to apply by virtue of Section 399 [Sub section (1)]. Further, if on any application as stated, the NCLT is of opinion -

   (a) that the company's affairs are being conducted in a manner prejudicial to public interest or in a manner oppressive to any member or members;

   (b) that to wind up the company would unfairly prejudice such member or members, but that otherwise the facts would justify the making of a winding up order on the ground that it was just and equitable that the company should be wound up;

   the NCLT may, with a view to bringing to an end the matters complained of, make such order as it thinks fit.

   Applying the above provisions answers to the given questions are:

   1. In the first question allotment of shares by the directors of a company by which

the existing majority is reduced to minority amounts to oppression and appropriate action can be taken against the company. *(Gluco Series (P) Ltd., in Re. (1987) 61 Comp. Cas. 227 (Cal.). Anand Kumar Saigal v. Manu Properties (P) Ltd. (2001) 32SCL 367 (CLB).*

2. In the second case also allotment of shares to turn minority to majority amounts to an act of oppression. And appropriate action as stated above can be taken against the company.

3. The act as given in the question does not amount to oppression and no action can be taken against the company under section 397. (*Mrs. Jameela Beevi v. Narmada Bldg. Enterprises (P) Ltd. (2004) a50 SCL 610 (CLB). Rajiv Mehta v. Group 4 Securities Hindustan (P) Ltd., CLB. Principal Bench, New Delhi (1998) 18 SCL89)*

Question 7

(a) (i) Mr. John has been appointed as Additional Director on the Board of MCX Ltd. on 12th January, 2006. Mr. John has filed his consent to Act as a Director, if appointed, only with the company. Examine with reference to the provisions of the Companies Act, 1956 whether he is also required to file his consent with the Registrar of Companies.

(ii) One of the members of ADB Ltd. has proposed the name of Mr. Fame for appointment as a Director of the Company in the Annual General Meeting and given a notice under Section 257 of the Companies Act, 1956. Mr. Fame is one of the partners of the Fame & Fame, Chartered Accountants, who are the retiring auditors of the company. But the audit of the company is being looked after by another partner of the firm. Examine whether Fame & Fame can be reappointed as auditors, if Mr. Fame is appointed as Director. (8 Marks)

(b) Examine the validity of the following:

(i) The Board of Directors of a company decides to revise the accounts which have been submitted to the Auditors, but the auditors have not yet given their report.

(ii) The Board of Directors of a company decides to revise the Audited accounts before adoption by the shareholders in the Annual General Meeting.

(iii) The Board of Directors of a company decides to revise the accounts which have already been adopted by the shareholder in the Annual General Meeting. (7 Marks)

Answer

(a) (i) Filing of consent under section 264: Problem as asked in the question is based on the provisions of Section 264(1) and (2) of The Companies Act, 1956 and also the case ruling in Lalitbhai C. Kapadia Vs. Laljibhai B. Desai. Section 264(1) of the Companies Act, 1956 requires that a person proposed as a candidate for the office of director should file with the company his consent to act as a director, if appointed. Section 264(2) stipulates that a person shall not act as a director unless he has filed with the Registrar of Companies his consent in writing (Form No. 29) to act as such. Additional and alternate directors are not required to file consent under section 264(2) *(Lalitbhai C. Kapadia v. Laljibhai B. Desai (1973) 43 Comp. Cases 17).* Accordingly, applying the above provisions and the ruling of the case, John is not required to file his consent for accepting Additional Directorship.

(ii) Appointment of a partner of the company's auditors as a director: Problem as asked in the question is based on the provisions of Companies Act, 1956 as contained in Section 2(30) read with Section 226(3)(b) and (c). Accordingly, Mr. Fame is appointed as a director of the company 'Fame and Fame' cannot be reappointed as company's auditors. It is so because a director is an officer of the company within the meaning of section 2(30) of the Companies Act, 1956 and the audit firm becomes disqualified under section 226(3) (b) and (c) even if any of its partner is also an officer of the company. It is immaterial that the audit of the company is being looked after by another partner of the firm and not by Mr. Fame. Therefore, if Mr. Fame is appointed as a director of the company, 'Fame and Fame' cannot be reappointed as company's auditors.

(b) Revision / rectification of accounts

(i) Revision of Accounts Before the auditors have given their report: The Board of directors of the company is competent to revise the accounts. The revised accounts are required to be approved at a Board meeting and properly authenticated as required under Section 215 of the Companies Act, 1956 before they are sent to the auditors for their report thereon.

(ii) Board of Directors of a company decides to revise the audited accounts before adoption by the shareholders in AGM: The Board of Directors of the company can revise the accounts and re-submit the same to the auditors for their report thereon provided the original accounts have not been placed before the shareholders at the AGM. The Auditor's Report on the revised accounts will be in substitution of their earlier report on the original accounts. However, adequate disclosure as regards revision of accounts and auditor's report should be made in the revised accounts and auditor's report respectively. (Guidance Notes on Auditor's Report on Revised Accounts of Companies before circulation to shareholders).

(iii) Board of directors decide to revise the accounts which have already been adopted by the shareholders in the AGM: The Institute of Chartered Accountants of India have opined that the accounts once adopted by the members of a company cannot be reopened under any circumstances.

However, Department of Company Affairs clarified in 1987 that a company could reopen and revise its accounts even after their adoption in the Annual General Meeting in order to comply with technical requirements of taxation laws.

In the absence of any provision in the Companies Act, 1956 in this regard, reopening/revision of accounts in appropriate cases is not completely prohibited. In such event, the revised annual accounts would be required to be adopted in the subsequent Annual General Meeting / Extraordinary General Meeting and filed with the Registrar of Companies after such adoption.

Question 8

(a) *PQR Machines Ltd. Entered into a contract with MN forgings, in which wife of P, a director of the company is a partner. The contract is for supply of certain components by the firm for a period of three years with effect from 1st September, 2005 on credit basis. The paid-up Share Capital was increased from Rs. 70 lakhs to Rs. 140 lakhs on 1st March, 2006. Explain the requirements under the Companies Act, 1956, which should have been complied with by PQR Machines Ltd. before entering into contract with MN Forgings. Whether there is any additional requirement which is required to be complied with by PQR Machines Ltd. in view of the increased paid-up Share Capital on 1st March, 2006.*

What would be your answer in case MN forgings is a Private Company in which P's wife is holding substantial shares ? *(8 Marks)*

(b) *Imprudent Company Ltd. approached Safe Finance Company Ltd. for a loan of Rs. 20 lakhs to finance purchase of some essential machinery. The company created a floating charge on some of its assets on 1st December, 2004 for Rs. 25 lakhs to secure Rs. 5 lakhs already due to Safe Finance Company Ltd. and additional amount to be advanced by the said Finance Company. Safe Finance Company Ltd. advanced Rs. 15 lakhs on 15th December, 2004 towards purchase of certain machinery. Some of the creditors filed winding up petition in the court on 1st January, 2005 on the ground that the company was unable to pay its debts and the company was ordered to be wound up on 15th December, 2005. Examine with reference to the provisions of the Companies Act, 1956 whether the floating charge is valid.* *(7 Marks)*

Answer

(a) Contracts in which directors are interested: The contract for supply of components entered into between PQR Ltd. and MN Forgings, a partnership firm (on which wife of P, a director of the company is a partner) attracts Sections 297, 299, 300 and 301 of the Companies Act, 1956.

The contract cannot be entered into unless it is approved in the meeting of the Board of Directors of PQR Ltd. Specific Board resolution is required (Section 297). However, in case of urgent necessity such consent of the Board may be obtained within 3 months of the date on which the contract was entered into (Section 297(3))

P, the interested director must disclose his interest at the Board meeting at which the question of entering into the contract has been taken up for consideration (Section 299(1) & (2). P, the interested director should not have taken part in the discussion at the said board meeting and he should not have noted on the resolution in respect of that contract (Section 300)

Prescribed particulars of the contract must be entered into the Registrar of Contract maintained under Section 301 within 7 working days of the Board meeting (Section 301).

In the given case the contract was entered into on 1.9.2005 for supply of components for a period of 3 years. As the paid-up share capital was only Rs. 70 lakhs (i.e. less than Rs. 1 crore) on 1.9.2005 proviso to Section 297(1) requiring prior approval of the Central Government is not attracted. Subsequent increase in the paid up share capital beyond Rs. 1 crore will not make it necessary to get the approval of the Central Government for continuation of the contract for the remaining period. Hence, there is no additional requirement.

If MN Forgings is a private company the provisions of Section 297 are not attracted as the director of PQR Ltd. is a director or member of MN Forgings Private Ltd.

Section 299 is also not attracted for the reasons given below:

If the contract or arrangement is between companies, a director is deemed to be interested only if he singly or along with other directors hold 2% or more shares in other company (Section 299(6)). While calculating the 2% shares in other company, only investment of directors is considered. Here P, a director of PQR Ltd. is not holding any shares in MN forgings Pvt. Ltd. Shares held by P's wife are not to be considered. Hence the provisions of Section 299 are not attracted. Sections 300 and 301 are also not applicable.

(b) Effect of floating charge: The effect of floating charge in case of winding up of the company is dealt with in section 534 of the Companies Act, 1956. Accordingly, any floating charge made within 12 months preceding the commencement of winding up is void, unless it is proved that the company was solvent immediately after the creation of the charge. However, charge is valid in respect of any sum advanced at the time of creation of charge or subsequent to the charge together with interest at 5% or such other rate as may be notified by the Central Government.

In the given case though the winding up order was passed by the court on 15.12.05. The winding up shall be deemed to have commenced at the time of presentation of the petition for winding up i.e. 01.01.2005 (Section 441(2)). As regards floating charge was created on 1.12.04, it was within 12 months preceding the commencement of winding up. The company also could not be considered as solvent, as it was ordered to be wound up on the ground that it was unable to pay its debt.

The finance company advanced a total sum of Rs. 20 lakhs, out of which Rs. 15 lakhs was advanced after the creation of floating charge. Hence, the floating charge is valid only for Rs. 15 lakhs together with interest at 5% p.a. (and not 12%).

Question 9

(a) EF Chemicals Ltd. proposes to appoint one whole-time technical Director on a consolidated monthly remuneration of Rs. 30,000 and one whole-time Marketing Director on a consolidated salary of Rs. 25,000 per month for a period for three years with effect from 1st September, 2005. The company has got a Managing Director and he is getting Rs. 40,000 per month. Explain the requirements under the companies Act to be complied with by the company in connection with the proposed appointment of whole-time Directors taking into account the following data collected from the Balance Sheet of

the company as on 31st March, 2005:

		Rs.
1.	*Paid-up Share Capital*	*80,00,000*
2.	*Debentures redeemable after three years*	*90,00,000*
3.	*Investments*	*20,00,000*
4.	*Accumulated Loss*	*70,00,000*
5.	*Preliminary Expenses not written off*	*15,00,000*

(8 Marks)

(b) *A Public Company proposes to appoint an alternate Director for one of its Directors, who is likely to be outside India for most of the year. There is no specific provision in the Articles of Association in this regard. State the steps to be taken by the Company to give effect to the proposal.*

Draft a specimen resolution for appointment of alternate Director and also state the kind of meeting at which such resolution is to be passed. *(7 Marks)*

Answer

(a) Appointment of whole time directors: In the given case two whole time directors are proposed to be appointed with effect from 1st September, 2005. The remuneration payable to these directors depends on the effective capital of the company on the last day of the preceding financial year i.e. 31.3.2005. The effective capital is Rs. 65 lakhs (Rs. 80 lakhs + 90 lakhs – Rs. 20 lakhs –Rs. 70 lakhs –Rs. 15 lakhs) on 31.3.2005.

The ceiling on minimum remuneration has been prescribed in Part II of Schedule XIII of the Companies Act, 1956. Here the Managing Director is already getting a minimum monthly remuneration of Rs. 40,000. The proposed minimum remuneration to the whole-time technical director is Rs. 30,000 p.m. and to the whole time marketing director is Rs. 25,000 p.m. If a company has more than one managing director and / or whole-time director, the company may pay to each of them minimum remuneration within the prescribed ceiling. As the effective capital is less than Rs.1crore, the company may pay to each of the Managing Director/whole time director minimum remuneration upto Rs. 75,000 p.m. Hence the proposed minimum remuneration is within the prescribed limits.

The remuneration payable to the whole-time directors must be approved by Remuneration Committee of the Board of Directors, and thereafter the appointments of the Technical Director and Marketing Director shall be approved at a Board meeting.

Abstract of terms of appointment of whole-time directors must be sent to every member within 21 days as required under section 302(2). Nature of concern or interest of each director must be disclosed.

Copy of Board resolution, Form No. 32, Directors consent in Form No. 29 must be filed with the Registrar of Companies.

Return in Form No. 25C must also be filed within 90 days from appointment as required under section 269(2). The return must contain a certificate from the auditor or the Secretary of the company or a Secretary in Whole-Time Practice that the requirements under Schedule XIII have been complied with Part III of Schedule XIII – Para 2)

The appointment and remuneration of the whole-time marketing and technical directors must be approved in next annual general meeting by ordinary resolution (Section 305(1) and part III of Schedule XIII).

The company has to comply with the above requirements under the Companies Act, 1956 with regard to the proposed appointment of two whole-time directors.

(b) Alternate Director: In accordance with the provisions of the Companies Act, 1956 as contained in Section 313 Board of Directors of any company (public or private) may appoint an alternate director, if so authorized by its Articles. In the absence of an enabling provisions in the Articles, the Board may be empowered with this power by an ordinary resolution passed in a general meeting. The company in general meeting cannot itself exercise such power of appointment. It can only empower the Board to make the appointment at the Board's discretion. The company must convene an extra - ordinary general meeting and pass an ordinary resolution as stated above (it is not necessary to alter the Articles of Association) and thereafter pass a Board Resolution for appointment of alternate director.

Specimen Board Resolution: Resolved that pursuant to Section 313 of the Companies Act, 1956 and the ordinary resolution passed at the EGM held on ……....Mr. …………..be and is hereby appointed as an alternate director for Mr. ……………, Director to hold office during his absence for a period of not less than three months from the State of ………….. in which meetings of the Board are ordinarily held [alternatively to hold office of the alternate director for a period of ………… Provided, however, that he shall, during the stated period, vacate the office as and when the original director returns to the state and shall assume the signature on behalf of Board of Directors office as and when the original director goes out of the State.

Signature on behalf of Board of Directors

PAPER – 5 : COST MANAGEMENT

Question No. 1 is compulsory.

Answer any four questions from the rest.

Working notes should form part of the answer wherever appropriate, suitable assumptions should be made.

Question 1

(a) *What are the elements of a Balanced Score card? Also explain how it can be used as a Financial Planning model.*

(b) *What is the concept of 'Value-chain' and why is it important for Cost Management?*

(c) *Computo Ltd. manufactures two parts 'P' and 'Q' for Computer Industry.*

P : annual production and sales of 1, 00,000 units at a selling price of Rs. 100.05per unit.

Q : annual production and sales of 50,000 units at a selling price of Rs. 150 per unit.

Direct and Indirect costs incurred on these two parts are as follows:

	(Rs. in thousand)		
	P	*Q*	*Total*
Direct Material cost (variable)	*4,200*	*3,000*	*7,200*
Labour cost (variable)	*1,500*	*1,000*	*2,500*
*Direct Machining cost (See Note)**	*700*	*550*	*1,250*
Indirect Costs:			
Machine set up cost			*462*
Testing cost			*2,375*
Engineering cost			*2,250*
			16,037

Note: Direct machining costs represent the cost of machine capacity dedicated to the production of each product. These costs are fixed and are not expected to vary over the long-run horizon.

Additional information is as follows:

	P	*Q*
Production Batch Size	*1,000 units*	*500 units*
Set up time per batch	*30 hours*	*36 hours*
Testing time per unit	*5 hours*	*9 hours*
Engineering cost incurred on each product	*8.40 lacs*	*14.10 lacs*

A foreign competitor has introduced product very similar to 'P'. To maintain the company's share and profit, Computo Ltd. has to reduce the price to Rs. 86.25. The company calls for a meeting and comes up with a proposal to change design of product 'P'. The expected effect of new design is as follows:

- *Direct Material cost is expected to decrease by Rs. 5 per unit.*
- *Labour cost is expected to decrease by Rs. 2 per unit.*
- *Machine time is expected to decrease by 15 minutes; previously it took 3 hours to produce 1 unit of 'P'. The machine will be dedicated to the production of new design.*
- *Set up time will be 28 hours for each set up.*
- *Time required for testing each unit will be reduced by 1 hour.*
- *Engineering cost and batch size will be unchanged.*

Required:

(a) Company management identifies that cost driver for Machine set-up costs is 'set up hours used in batch setting' and for testing costs is 'testing time'. Engineering costs are assigned to products by special study. Calculate the full cost per unit for 'P' and 'Q' using Activity-based costing.

(b) What is the Mark-up on full cost per unit of P?

(c) What is the Target cost per unit for new design to maintain the same mark up percentage on full cost per unit as it had earlier? Assume cost per unit of cost drivers for the new design remains unchanged.

(d) Will the new design achieve the cost reduction target?

(e) List four possible management actions that the Computo Ltd. should take regarding new design. (4 + 4 + 16 = 24 Marks)

Answer

(a) The elements of a balanced score card are:

(i) Financial perspective

(ii) Customer perspective

(iii) Internal business process perspective

(iv) Learning and growth perspective.

The objective of the balanced score card is to provide a comprehensive framework for translating the company's strategic objectives into a coherent set of performance measures. It emphasizes the use of financial and non-financial measures as part of the programme to achieve future financial performance. It helps in planning, setting targets and aligning strategic initiatives.

To evaluate the success of the implementation of the strategy, the company can assess the change in the operating income by comparing the targeted operating income with the actual operating income. The change in the operating income may arise due to growth factor, change in the price of inputs and outputs and productivity factor. The company is said to be successful in implementation of strategy only if the change in the operating income closely aligns with that strategy.

(b) Value chain is the linked set of value creating activities from the basic raw materials and components sources to the ultimate end use of the product or service delivered to the customer.

The six business functions contained in the value chain are (i) Research and Development, (ii) Design (iii) Production (iv) Marketing (v) Distribution and (vi) Customer service.

The objective of value chain is to serve as means of increasing the customer satisfaction and managing costs effectively. Coordination of the individual parts of the value chain activities creates conditions to improve customer satisfaction in terms of cost efficiency, quality and delivery. A firm which performs value chain activities more efficiently and at a lower cost than its competitors will be able to gain competitive advantage. The following methodology should be adopted.

1. The firm should identify the industry value chain and then assign costs, revenues and assets to value activities.
2. Diagnose the cost drivers regulating each value activity.
3. Develop sustainable cost advantage either by controlling cost drivers better than competitors or by reconfiguring the chain value.

By analyzing costs, revenues and assets in each activity systematically a company can achieve low cost. Thus value chain helps managers in deciding how to apply the organization's valuable physical and human resources to each linked process so as to achieve cost effectiveness.

(c) Working Notes:

	Particulars	*P*	*Q*
(a)	Production/Sales Quantity (units)	1,00,000	50,000
(b)	Batch Size (units)	1000	500
(c)	No of batches $\left(\frac{a}{b}\right)$	100	100
(d)	Set up time per batch (hours)	30	36
(e)	Total set up hours ($c \times d$) (hours)	3,000	3,600
(f)	Machine set up cost (Rs.)		4,62,000

(g) Cost driver per machine set up hour

$$\frac{4,62,000}{6,600} = \text{Rs. } 70$$

(h)	Testing time per unit	5 hours	9 hours
(i)	Total testing time (a×h) (hours)	5,00,000	4,50,000

(j) Testing cost

Rs. 23,75,000

(k) Cost driver per testing hour

$$\frac{23,75,000}{9,50,000} = \text{Rs. } 2.50$$

(a) Computation of full cost per unit using Activity Based Costing:

Particulars	*Basis*	*P*	*Q*
Direct material	Direct	42,00,000	30,00,000
Direct labour	Direct	15,00,000	10,00,000
Direct machine cost	Direct	7,00,000	5,50,000
Machine set up cost	3,000 hours @ Rs. 70	2,10,000	
	3,600 hours @ Rs. 70		2,52,000
Testing cost	5,00,000 hours @ Rs. 2.50	12,50,000	
	4,50,000 hours @ Rs. 2.50		11,25,000
Engineering cost	Allocated	8,40,000	14,10,000
Total cost (Rs.)		87,00,000	73,37,000
Cost per unit (Rs.)		87.00	146.74

(b) Mark up on full cost basis for Product P:

Particulars	*Per unit*
Selling price	100.05
Less: Full cost	87.00
Mark up	13.05
Percentage of mark up on full cost	$\frac{13.05}{87.00} \times 100 = 15\%$

(c) Target cost of Product P after new design is implemented

	Rs.
Target price (given)	86.25
Mark-up $\frac{86.25 \times 15}{115}$	11.25
Target cost per unit (Rs.)	75.00

(d) Statement of cost for new design of P

Particulars	*Basis*	*Cost P.U.*	*Total Cost*
Direct Material	Decreased by Rs. 5 p.u.	37.00	37,00,000
Direct Labour	Decreased by Rs. 2 p.u.	13.00	13,00,000
Direct Machining cost	No change as machine is dedicated	7.00	7,00,000
Machine set up cost	100 set up × 28 hours × Rs. 70	1.96	1,96,000
Testing cost	1,00,000 units ×Rs. 2.5 × 4 hours	10.00	10,00,000
Engineering cost	No change	8.40	8,40,000
Total cost		77.36	77,36,000

The target cost is Rs. 75 p.u. and estimated cost of new design is Rs. 77.36 p.u. The new design does not achieve the target cost set by Computo Ltd. Hence the target mark up shall not be achieved.

(e) Possible Management Action:

- Value engineering and value analysis to reduce the direct material costs.
- Time and motion study in order to redefine the direct labour time and related costs.
- Exploring possibility of cost reduction in direct machining cost by using appropriate techniques.
- Identification of non-value added activities and eliminating them in order to reduce overheads.
- The expected selling price based on estimated cost of Rs. 77.36 per unit is (Rs.77.36 + 15%) Rs. 88.96. Introduce sensitivity analysis after implementation of new design to study the sales quantity changes in the price range of Rs. 86.25 to Rs. 88.96.

Question 2

(a) *Zilmil Ltd. makes two products 'Brightly; and 'Lightly'. Both the products use the same labour force, the size of which is restricted to 78,000 hours per month. Brightly needs 2 hours per unit to make whereas lightly needs one hour. The estimated production and sales, manufacturing and selling expenses per month are as follows:*

	Brightly		*Lightly*	
Production and Sales (in Nos.)	*12,000*	*16,000*	*40,000*	*48,000*
Cost per month (Rs.)	*34,00,000*	*38,00,000*	*62,00,000*	*66,80,000*

The Company is considering pricing option in a highly competitive market. It has estimated sales demand at various selling prices:

Brightly:

Selling Price per unit (Rs.)	*276*	*272*	*268*	*264*	*260*	*254*
Sales demand per month	*12,000*	*14,000*	*16,000*	*18,000*	*20,000*	*22,000*

Lightly:

Selling Price per unit (Rs.)	*163*	*162*	*161*	*160*	*156*	*152*
Sales demand per month	*40,000*	*42,000*	*44,000*	*46,000*	*48,000*	*50,000*

You are required to compute profit maximizing price and quantity for each product.

(b) *What are some goals of a 'transfer-pricing' system in an organization?*

(c) *"Overhead variances should be viewed as interdependent rather than independent". Explain.* *(11 + 4 + 4 = 19 Marks)*

Answer

(a) Brightly

Unit price Rs.	*Contribution per unit Rs.*	*Volume Units*	*Total contribution (Rs. in 000)*	*Incremental contribution (Rs. 000)*	*Labour hours*	*Incremental labour hours*	*Incremental contribution per labour hour Rs.*	*Rank*
276	176	12000	2112	2112	24000	24000	88	2
272	172	14000	2408	296	28000	4000	74	6
268	168	16000	2688	280	32000	4000	70	7
264	164	18000	2952	264	36000	4000	66	8
260	160	20000	3200	248	40000	4000	62	9
254	154	22000	3388	188	44000	4000	47	10

Lightly

Unit price	*Contribution per unit*	*Volume*	*Total contribution (Rs. in 000)*	*Incremental contribution (Rs. 000)*	*Labour hours*	*Increment al labour hours*	*Incremental contribution per labour hour*	*Rank*
163	103	40,000	4120	4,120	40,000	40,000	103	1
162	102	42,000	4284	164	42,000	2,000	82	3
161	101	44,000	4444	160	44,000	2,000	80	4
160	100	46,000	4600	156	46,000	2,000	78	5
156	96	48,000	4608	8	48,000	2,000	4	11
152	92	50,000	4600	(8)	50,000	2,000	(4)	Loss

As the labour time is scarce source (time available 78,000 hours), the decision has to be taken on the basis of ranks based upon incremental contribution per labour hour.

Product	*Price*	*Incremental volume*	*Incremental labour hours*	*Balance hours*	*Incremental Contribution (in 000 Rs.)*
Lightly	163	40,000	40,000	38,000	4120
Brightly	276	12,000	24,000	14,000	2112
Lightly	162	2,000	2,000	12,000	164
Lightly	161	2,000	2,000	10,000	160
Lightly	160	2,000	2,000	8,000	156
Brightly	272	2,000	4,000	4,000	296
Brightly	268	2,000	4,000		280
Total					7,288

Hence product mix is Brightly – 16,000 units and Lightly 46,000 units

Optimal contribution per month	Rs. 72,88,000
Fixed costs per month	Rs. 60,00,000
Optimal profit per month	Rs. 12,88,000

Working Notes:

	Brightly	*Lightly*
Variable cost (p.u.)	$\frac{(38{,}00{,}000-34{,}00{,}000)}{(16{,}000-12{,}000)}=\text{Rs.}100$	$\frac{(66{,}80{,}000-62{,}00{,}000)}{(48{,}000-40{,}000)}=\text{Rs.}60$
Fixed cost (Rs.)	22,00,000	38,00,000

Contribution = Unit selling price less variable cost per unit.

(b) The goals of transfer pricing are that it should:

1. provide information that motivates divisional managers to take good economic decisions which will improve the divisional profits and ultimately the profits of the company as a whole.
2. provide information which will be useful for evaluating the divisional performance.
3. seek to achieve goal congruence.
4. ensure that divisional autonomy is not undermined.

(c) The operations of a firm are so inter linked that the level of performance in one area of operation will affect the performance in other areas. Improvements in one area may lead to improvements in other areas. A sub-standard performance in one area may be compensated by a favourable performance in another area. Because of such interdependency among activities in the firm, the managers should not jump to conclusions merely based on the label of variances namely favourable or unfavourable. They should remember that there is a room for trade off amongst variances. Hence, variances need to be viewed as 'attention directors' rather than problem solvers. Thus, a better picture will be captured when overhead variance are not viewed in isolation but in an integrated manner.

Question 3

(a) Jay Kay Limited is a single product manufacturing company. The following information relates to the months of May and June, 2003:

		May	June
		Rs.	*Rs.*
(i)	*Budgeted Costs and Selling prices:*		
	Variable manufacturing cost per unit	*2.00*	*2.20*
	Total fixed manufacturing cost		
	(based on budgeted output of 25,000 units per month)	*40,000*	*44,000*
	Total fixed marketing cost	*14,000*	*15,400*
	Selling price per unit	*5.00*	*5.50*
(ii)	*Actual production and sales:*		
		Units	*Units*
	Production	*24,000*	*24,000*
	Sales	*21,000*	*26,500*

(iii) There was no stock of finished goods at the beginning of May, 2003. There was no wastage or loss of finished goods during May or June, 2003.

(iv) Actual costs incurred corresponded to those budgeted for each month.

You are required to calculate the relative effects on the monthly operating profits of applying: (a) Absorption costing and (b) Marginal costing.

(b) *What is total-life-cycle costing approach? What is it important?*

(c) *Why are conventional product costing systems more likely to distort product costs in highly automated plants? How do activity-based costing systems deal with such a situation?* *(11 + 4 + 4 = 19 Marks)*

Answer

(a) *Quantity tally:*

		May 2003	*June 2003*
Opening Stock	units	–	3,000
Production	units	24,000	24,000
Total	units	24,000	27,000
Sales	units	21,000	26,500
Closing Stock	units	3,000	500
Fixed manufacturing overheads	Rs.	40,000	44,000
Budgeted output	units	25,000	25,000
Fixed overheads absorption rate per unit	Rs.	1.60	1.76

(i) Profitability based on absorption costing:

		May 2003	*June 2003*
		Rs.	*Rs.*
Sales:			
May: 21,000 units @ Rs. 5.00		1,05,000	
June: 26,500 units @ Rs. 5.50			1,45,750
Production Costs:			
Variable:	May 24,000 units @ Rs. 2.00	48,000	
	June 24,000 units @ Rs. 2.20		52,800
Fixed:	May 24,000 units @ Rs. 1.60	38,400	
	June 24,000 units @ Rs. 1.76		42,240
Total production costs		86,400	95,040
Add: Opening stock			
May	Nil		
June	3,000 units @ Res. 3.60*		10,800
Total		86,400	1,05,840

Less: Closing stock			
May 3,000 units @ Rs. 3.60*		10,800	
June 500 units @ Rs. 3.96*			1,980
Production cost of goods sold		75,600	1,03,860
Marketing fixed costs		14,000	15,400
Total cost of goods sold		89,600	1,19,260
Profit (Sales – COGS)		15,400	26,490
Budgeted output	25,000 units		
Actual output	24,000 units		
Shortfall	1,000 units		
Under recovery of fixed overheads			
May	1,000 units @ Rs. 1.60	1,600	
June	1,000 units @ Rs. 1.76		1,760
Net profit		13,800	24,730

*Total cost = VC + FC

May 2.00 + 1.60 = 3.60

June 2.20 + 1.76 = 3.96

(ii) Profitability based on marginal costing:

		May 2003	*June 2003*
		Rs.	*Rs.*
Sales		1,05,000	1,45,750
Production cost – variable		48,000	52,800
Add: Opening stock			
May	Nil		
June	3,000 units @ Rs. 2.00		6,000
Total		48,000	58,800
Less: Closing stock			
May 3,000 units @ Rs. 2.00		6,000	
June 500 units @ Rs. 2.20			1,100
Variable cost of goods sold		42,000	57,700
Contribution		63,000	88,050

Fixed costs:	May	June		
Production	40,000	44,000		
Marketing	14,000	15,400	54,000	59,400
Net profit			9,000	28,650

(b) *Total life cycle costing approach:*

Life cycle costing estimates, tracks and accumulates the costs over a product's entire life cycle from its inception to abandonment or from the initial R & D stage till the final customer servicing and support of the product. It aims at tracing of costs and revenues on product by product basis over several calendar periods throughout their life cycle. Costs are incurred along the product's life cycle starting from product's design, development, manufacture, marketing, servicing and final disposal. The objective is to accumulate all the costs over a product life cycle to determine whether the profits earned during the manufacturing phase will cover the costs incurred during the pre and post manufacturing stages of product life cycle.

Importance:

Product life cycle costing is important for the following reasons:

(i) When non-production costs like costs associated with R & D, design, marketing, distribution and customer service are significant, it is essential to identify them for target pricing, value engineering and cost management. For example, a poorly designed software package may involve higher costs on marketing, distribution and after sales service.

(ii) There may be instances where the pre-manufacturing costs like R & D and design are expected to constitute a sizeable portion of life cycle costs. When a high percentage of total life cycle costs are likely to be so incurred before the commencement of production, the firm needs an accurate prediction of costs and revenues during the manufacturing stage to decide whether the costly R & D and design activities should be undertaken.

(iii) Many costs are locked in at R & D and design stages. Locked in or Committed costs are those costs that have not been incurred at the initial stages of R & D and design but that will be incurred in the future on the basis of the decisions that have already been taken. For example, the adoption of a certain design will determine the product's material and labour inputs to be incurred during the manufacturing stage. A complicated design may lead to greater expenditure on material and labour costs every time the product is produced. Life cycle budgeting highlights costs throughout the product life cycle and facilitates value engineering at the design stage before costs are locked in.

Total life-cycle costing approach accumulates product costs over the value chain. It is a process of managing all costs along the value chain starting from product's design, development, manufacturing, marketing, service and finally disposal.

(c) The conventional product cost system was in vogue when companies manufactured narrow range of products, overhead costs were relatively small and distortions arising from inappropriate overhead allocations were not significant. It used volume measures like direct labour hours or machine hours for charging overhead costs to products. In the case of a company using highly automated plant, direct labour is a small fraction of cost when compared with overheads (because of higher amount of depreciation). In case where such a company is multi product, overheads which are large in proportion to direct labour are influenced by number of set up, inspection, number of purchases etc. In these circumstances, the volume based method of recovery of overheads is no longer appropriate and such a measure will report inaccurate product costs. Hence, the traditional system of costing was found to over cost high volume products and under cost low volume products.

Activity Based Costing (ABC) system aims at refining the costing system used in automated plants in the following manner:

1. ABC systems trace more costs as direct costs.
2. ABC systems create homogeneous cost pools linked to different activities.
3. For each activity cost pool, ABC systems seek a cost allocation base that has a cause-and-effect relationship with costs in the cost pool.

Question 4

(a) *An organisation manufactures a product, particulars of which are detailed below:*

Annual Production (Units)	*20,000*
Cost per annum (Rs.)	
Material	*50,000*
Other variable cost	*60,000*
Fixed cost	*40,000*
Apportioned Investment (Rs.)	*1,50,000*

Determine the unit selling price under two strategies mentioned below. Assume that the organisation's Tax rate is 40%—

(a) 20% return on investment.

(b) 6% profit on list sales, when trade discount is 40%.

(b) *"Sunk cost is irrelevant in decision-making, but irrelevant costs are not sunk costs". Explain with example.*

(c) *How will you apply customer costing in service sector? Explain with the help of a suitable example.* *(11 + 4 + 4 = 19 Marks)*

Answer

(a) (i) Selling price to yield 20% return on investment:

		Rs.
Investment		1,50,000
After tax required ROI 20%		30,000
Tax	40%	
After tax profit	100 – 40 = 60%	
Pre tax profit (return) (30,000 ÷ 60) × 100		50,000
Sales = cost + return or 1,50,000 + 50,000		2,00,000
Number of units produced		20,000
Selling price Rs. 2,00,000 ÷ 20,000 = Rs. 10 per unit		

Alternative solution

(Sales – cost) (1 – Tax) = ROI

(Sales – 1, 50,000) (1 – 0.40) = 1, 50,000 × 20%

(0.60 Sales – 90,000) = 30,000

0.60 Sales = 1, 20,000

Sales = 1, 20,000 ÷ 0.60 = Rs. 2, 00,000

Number of units 20,000

Selling price Rs. 2, 00,000 ÷ 20,000 = Rs. 10.

(ii) Selling price to yield 6% profit on list price.

	Rs.	Rs.
Investment		1,50,000
Let the list price be	100	
Desired after tax profit of 6%	6	
Pre-tax profit (1– 0.40) = 0.60 = (6÷0.60) =	10	
List price		100
Discount		40
Net price		60
Profit desired		10
Cost		50

Cost of 50% = Rs. 1,50,000

Sales = (Rs.1,50,000 ÷ 50) × 100 = Rs. 3,00,000

Number of units		20,000
List selling price	(3,00,000 ÷ 20,000) = Rs. 15	
Discount	40%	
Net price	(15 × 60%)	Rs. 9 per unit

Alternative solution

Let s be the list sales

[List Sales (1 – tax discount) – cost] (1 – Tax rate) = 0.60s

[s (1– .40) – 1, 50,000] (1– 0.40) = .06s

s = Rs. 3, 00,000

List sales price per unit is Rs. 15 $\left(\frac{3,00,000}{20,000}\right)$

Net selling price per unit is Rs. 9 (Rs. 15 – 40% of 15%).

(b) Sunk costs are costs that have been created by a decision made in the past and that cannot be changed by any decision that will be made in the future. For example, the written down value of assets previously purchased are sunk costs. Sunk costs are not relevant for decision making because they are past costs.

But not all irrelevant costs are sunk costs. For example, a comparison of two alternative production methods may result in identical direct material costs for both the alternatives. In this case, the direct material cost will remain the same whichever alternative is chosen. In this situation, though direct material cost is the future cost to be incurred in accordance with the production, it is irrelevant, but, it is not a sunk cost.

(c) Customer costing analyses the costs incurred to earn the revenues from customers. A customer cost hierarchy, categorising the costs relating to the customers into different cost pools on the basis of different types of cost drivers or different degrees of difficulty in determining cause and effect relationship, is used. The details of activities involved in customer costing, for example, are sales order processing, sales visits, normal delivery costs, special orders, and credit collection charges. The central theme of this approach is customer satisfaction. The profitability of different customers or groups of customers will differ.

Customer costing can be introduced in a company engaged in courier service where the costs to serve the customers vary with the type of service selected by customers (how fast the package is to be delivered), the destination, weight, size of package and whether the package is to be collected from customers' location or will be dropped at the office of the courier firm. The firm could use an efficient system of internet strategy to accomplish the tasks like preparing labels at the customers' site, arranging for pick up, dropping at the destination and tracking and tracing packages. The system calculates the freight charges, invoices customers daily and produces customized reports. These parameters can be used with the objective of determining customer profitability and based on the costs involved in handling each customer, the firm can even offer volume discounts to customers who use the services heavily.

Question 5

(a) *A Company is engaged in manufacturing two products 'X' and 'Y'. Product X uses one unit of component 'P' and two units of component 'Q'. Product 'Y' uses two units of component 'P', one unit of component 'Q' and two units of component 'R'. Component 'R' which is assembled in the factory uses one unit of component 'Q'.*

Component 'P' and 'Q' are purchased from the market. The company has prepared the following forecast of sales and inventory for the next year:

	Product 'X'	*Product 'Y'*
Sales (in units)	*80,000*	*1,50,000*
At the end of the year	*10,000*	*20,000*
At the beginning of the year	*30,000*	*50,000*

The production of both the products and the assembling of the component 'R' will be spread out uniformly throughout the year. The company at present orders its inventory of 'P' and 'Q' in quantities equivalent to 3 months production. The company has compiled the following data related to two components:

	P	*Q*
Price per unit (Rs.)	*20*	*8*
Order placing cost per order (Rs.)	*1,500*	*1,500*
Carrying cost per annum	*20%*	*20%*

Required:

(a) Prepare a Budget of production and requirements of components during next year.

(b) Suggest the optimal order quantity of components 'P' and 'Q'.

(b) *Differentiate between 'Value-added' and 'Non-value-added' activities in the context of Activity-based costing.*

Give examples of Value-added and Non-value-added activities.

(c) *"The use of Absorption costing method in decision-making process leads to anomalies." Discuss.* *(11 + 4 + 4 = 19 Marks)*

Answer

(a) Production Budget for product X and Y

	X units	Y units
Inventory at the end of the year	10,000	20,000
Sales forecast	80,000	1,50,000
Total requirements	90,000	1,70,000
Less: Beginning inventory	30,000	50,000
Production	60,000	1,20,000

Budgeted requirements of components P, Q and R

Components	P	Q	R
For Product X: Production 60,000 units			
P: 60,000 × 1 per unit	60,000		
Q: 60,000 × 2 per unit		1,20,000	
For Product Y: Production 1,20,000 units			
P: 1,20,000 × 2 per unit	2,40,000		
Q: 1,20,000 × 1 per unit		1,20,000	
R: 1,20,000 × 2 per unit			2,40,000
For comp R: Production 2,40,000 comp			
Q: 2,40,000 × 1 per component R		2,40,000	
Total requirements	3,00,000	4,80,000	2,40,000

(a) The company is advised to adopt EOQ system.

P Q

$$\text{EOQ} \sqrt{\frac{2\times 3{,}00{,}000\times 1{,}500}{20\times 20\%}} \qquad \sqrt{\frac{2\times 4{,}80{,}000\times 1{,}500}{8\times 20\%}}$$

= 15,000 components = 30,000 components

(b) A value added activity is an activity that customers perceive as adding usefulness to the product or service they purchase. In other words, it is an activity that, if eliminated, will reduce the actual utility or usefulness which customers obtain from using the product or service. For example, painting a car in a company manufacturing cars or a computer manufacturing company making computers with preloaded software.

A non-value added activity is an activity where there is an opportunity of cost reduction without reducing the product's service potential to the customer. In other words, it is an activity that, if eliminated, will not reduce the actual or perceived value that customers obtain by using the product or service. For example, storage and moving of raw materials, reworking or repairing of products, etc.

Value-added activities enhance the value of products and services in the eyes of the organisation's customers while meeting its own goals. Non-value added activities on the other hand do not contribute to customer-perceived value.

(c) In absorption costing, fixed overheads are assigned to products by establishing overhead absorption rates based on budgeted or normal output. By using absorption costing principles, it is possible for profit to decline when sales volume increases. If the stock levels fluctuate significantly, profits may be distorted because stock changes will significantly affect the amount of fixed overheads allocated to a period. If profits are measured on monthly or quarterly or on periodical basis, seasonal variations in sales may cause significant fluctuations in profits.

Internal profit statements on monthly or quarterly basis are used for measuring the managerial performance. In the circumstances, managers may deliberately alter inventory levels to influence profit, if absorption costing is used. When sales are less and the closing inventory increases, a part of the fixed overheads contained in the value of the closing stock is reduced from the fixed costs allocated to production for the period. Thus, if sales are reduced, inventories will increase and absorption cost will post higher profits. Similarly, if sales are increased as compared to production, inventories will be reduced and absorption costing will return lower profits.

Question 6

(a) A Company manufactures two products 'X' and 'Y'. Company's fixed cost per annum is Rs. 5 lacs. These products are sold for Rs. 288 per unit of 'X' and Rs. 432 per unit of 'Y'. Standard cost data are:

	Product 'X'	*Product 'Y'*
	Rs.	*Rs.*
Direct Raw Material	*40*	*80*
Direct wages Rs. 8 per hour in Departments:		
1	*48*	*72*
2	*24*	*48*
3	*72*	–
4	–	*96*
Variable overhead	*32*	*28*

The Company operates 8 hours shift for 300 days in a year. Number of workers engaged by each department is given below:

Department	*1*	*2*	*3*	*4*
No. of Workers	*45*	*24*	*27*	*36*

Required:

(a) How many units of each product should be manufactured and what is the resultant maximum profit, if numbers of employees cannot be increased or transferred?

(b) If only one product is to be manufactured by the Company, which of the products would give the maximum profit and what is the amount of such profit?

(b) How has the composition of manufacturing costs changed during recent years? How has this change affected the design of cost accounting systems?

(c) Explain the concept 'Learning curve'. How can it be applied for Cost management?

(11 + 4 + 4 = 19 Marks)

Answer

(a) Contribution analysis:

	Product X	*Product Y*
	Rs.	*Rs.*
Selling price	288	432
Variable costs:		
Direct materials	40	80
Direct Labour: Dep't. 1	48	72
Dep't. 2	24	48
Dep't. 3	72	–
Dep't. 4	–	96
Variable overheads	32	28
Total variable costs	216	324
Contribution per unit	72	108

The direct labour hours required to manufacture the two products in each of the four departments at the wage rate of Rs. 8 per hour are as under:

Department	Product X		Product Y	
	Wage cost	*Hours/unit*	*Wage cost*	*Hours/unit*
1	48	6	72	9
2	24	3	48	6
3	72	9	–	–
4	–	–	96	12

Department 3 is used only for product X and department 4 is used only for product Y. Hence, these two departments will determine the maximum production of these two products as under:

Department 3 : Maximum available hours:

Workers	×	Hours/day	×	days/year		
27	×	8	×	300	=	64,800 hours

Maximum possible production of product X: $\frac{64,800}{9 \text{ hrs per unit}}$ = 7,200 units

Department 4 : Maximum available hours:

Workers	×	Hours/day	×	days/year		
36	×	8	×	300	=	86,400 hours

Maximum possible production of product Y: $\frac{86,400}{12 \text{ hrs per unit}}$ = 7,200 units

The company can produce 7,200 units each of products X and Y provided departments 1 and 2 have capacity to process this quantity of output.

We can check the capacity of departments 1and 2 as under:

Department 1: Maximum available hours:

Workers	×	Hours/day	×	days/year		
45	×	8	×	300	=	1,08,000 hours

Hours required to produce 7,200 units each of X and Y:

Product X	7,200 × 6 hours	=	43,200 hours
Product Y	7,200 × 9 hours	=	64,800 hours
Total		=	1,08,000 hours

Department 1 has capacity to produce 7,200 units each of products X and Y.

Department 2 : Maximum available hours:

Workers	×	Hours/day	×	days/year		
24	×	8	×	300	=	57,600 hours

Hours required to produce 7,200 units each of X and Y:

Product X	7,200 $\times$3 hours	=	21,600 hours
Product Y	7,200 $\times$ 6 hours	=	43,200 hours
Total		=	64,800 hours

Department 2 has scarce capacity.

Since department 2 capacity is scarce, link the contribution to the key factor of department 2 hours as under:

		Product X	Product Y
Contribution per unit	Rs.	72	108
Department 2 hours per unit	Hours	3	6
Contribution per hour of Department 2	Rs.	24	18
Rank		1	2

Optimal product mix:

Product	Max. units	Lab. Hours/unit	Prod. units	Hours used	Balance hours	Cont./unit	Total cont.
						Rs.	*Rs.*
X	7,200	3	7,200	21,600	36,000	72	5,18,400
Y	7,200	6	6,000	36,000	–	108	6,48,000
Total optimal contribution							11,66,400
Fixed costs							5,00,000
Optimal profit							6,66,400

Alternative Solution:

The maximum possible production of product X is 7,200 units and that of product Y is 7,200 units. The following two methods shall be used to determine the optimal profit:

(a) Produce 7,200 units of product X and use the balance capacity to produce product Y.

(b) Produce 7,200 units of product Y and use the balance capacity to produce product X.

Profitability based on (a):

Direct labour hours are scarce in Department 2.

Maximum available hours in Department 2	57,600
Product X requires 7,200 × 3 =	21,600 hours
Balance hours on Y	36,000
Production of Y 36,000 ÷ 6 =	6,000 units

Contribution:	X 7,200 units @ Rs. 72	Rs. 5,18,400
	Y 6,000 units @ Rs. 108	Rs. 6,48,000
	Total	Rs. 11,66,400
	Fixed costs	Rs. 5,00,000
	Profit	Rs. 6,66,400

Profitability based on (b):

Maximum available hours in Department 2	57,600
Product Y requires 7,200 × 6 =	43,200 hours
Balance hours on X	14,400
Production of X 14,400 ÷ 3 =	4,800 units

Contribution:	X 4,800 × 72	Rs. 3,45,600
	Y 7,200 × 108	Rs. 7,77,600
	Total	Rs. 11,23,200
	Fixed costs	Rs. 5,00,000
	Profit	Rs. 6,23,200

Profitability of (a) is better.

(b) Traditionally, manufacturing companies classified the manufacturing costs to be allocated to the products into (a) direct materials. (b) direct labour and (c) indirect manufacturing costs. In the present day context, characterised by intensive global competition, large scale automation of manufacturing process , computerization and product diversification to cater to the changing consumer tastes and preferences has forced companies to refine their costing systems to provide better measurement of the overhead costs used by different cost objects. Accordingly, manufacturing costs are classified in to three broad categories as under:

1. *Direct cost*: As many total costs relating to cost objects as feasible are classified into direct cost. The objective is to trace as many costs as possible in to direct and to reduce the amount of costs classified into indirect because the greater the proportion of direct costs the greater the accuracy of the cost system.

2. *Indirect cost pools*: Increase the number of indirect cost pools so that each of these pools is more homogeneous. In a homogeneous cost pool, all the costs will have the same cause-and-effect relationship with the cost allocation base.

3. Use cost-and-effect criterion for identifying the cost allocation base for each indirect cost pool.

The change in the classification of manufacturing costs as above has lead to the development of Activity Based Costing (ABC). Activity Based Costing refines a costing system by focusing on individual activities as the fundamental cost objects. An activity is an event, task or unit of work with a specified purpose as for example, designing, set up, etc. ABC system calculates the costs of individual activities and assigns costs to cost objects such as products or services on the basis of the activities consumed to produce the product or provide the service.

(c) The first time when a new operation is performed, both the workers and the operating procedures are untried. As the operation is repeated and the workers become more familiar with work, labour efficiency increases and the labour cost per unit declines. This process continues for some time and a regular rate of decline in cost per unit can be established. This rate can be used to predict future labour costs. The learning process starts from the point when the first unit comes out of the production line. In other words 'Learning curve' is a function that measures how labour hours per unit decline as units of production increase because workers are learning and becoming better at their jobs.

Cost Management Application:

1. Learning curve is useful in analysing cost volume profit relationship. The company can set low price of its product to generate high demand. As the production increases, cost per unit drops.
2. It helps in budgeting and profit planning.
3. It enables the company in price fixation. In particular, the company can fix a lower price for repeat orders.
4. It helps the design engineers to take suitable decisions based on expected rates of improvement.
5. It helps in price negotiations.
6. It is useful in setting standards and in performance evaluation.

PAPER – 6 : MANAGEMENT INFORMATION AND CONTROL SYSTEMS

Question no. 1 is compulsory.

Answer any four questions from the remaining six questions.

Question 1

(a) *A XYZ Company receives orders from customers either by telephone, facsimile or electronic data interchange. A clerk then transcribes the order into one of the company's order form to be keyed into the order entry system.*

You being the information system auditor of the company, suggest various internal control procedures to be adopted to prevent inaccurate or unauthorized source data entry?

(b) *Describe the composition and powers of Cyber regulatory appellate tribunal.*

(c) *Discuss the limitations of the Management Information system.*

(d) *Define the following computer Fraud and Abuse technique:*

(i) *Hacking*

(ii) *Logic time bomb*

(iii) *Piggy backing*

(iv) *Spamming*

(v) *Data diddling.* *(5 + 5 + 5 + 5 = 20 Marks)*

Answer

(a) The auditor should ensure that the source data controls such as proper authorization and editing data input are integrated with the processing controls and are independent of other functions. If source data controls are inadequate, user department control over data preparation, batch control totals, and edit programs etc. should be stronger.

The following control procedures may be adopted:

- Effective handling of source data input by data control personnel.
- User authorization of source data input.
- Preparation and reconciliation of batch control totals.
- Logging of the receipt, movement and disposition of source data input.
- Check digit verification.
- Key verification.
- Use of turnaround documents.
- Computer data editing routines.
- File change listings and summaries prepared for user department review.

Although source data controls may not change often, the auditor should test them on regular basis by evaluating samples of source data.

(b) Cyber Regulatory Appellate Tribunal : The cyber regulation appellate tribunal shall consist of one person only called the Presiding Officer of the Tribunal who shall be appointed by the Central Government. The person must be qualified to be a Judge of a High Court or is or has been a member of Indian Legal Services in the post in Grade I of that service for at least three years. The Presiding Officer shall hold the office for a term of five years or upto a maximum age limit of 65 years, whichever is earlier.

Some of the powers specified are following:

(i) Summoning and enforcing the attendance of any person and examining him on oath.

(ii) Requiring production of documents and other electronic records.

(iii) Receiving evidence on affidavits

(iv) Reviewing its decisions.

(v) Issuing commissions for examination of witness etc.

(c) Limitations of the Management Information System :

(i) MIS is not a substitute for effective management. It cannot replace managerial judgement in making decisions in different functional areas.

(ii) MIS may not have requisite flexibility to quickly update itself with changing needs of time.

(iii) MIS cannot provide tailor-made information packages suitable for the purpose of every type of decision made by executives.

(iv) MIS takes into account mainly quantitative factors, thus it ignores the non-quantitative factors like morale and attitude of members of the organization.

(v) MIS is less useful for making non-programmed decisions.

(vi) The effectiveness of MIS decreases due to frequent changes in top managements, organisational structure and operational team.

(vii) MIS effectiveness is reduced where culture of hoarding information and not sharing with others exists.

(viii) The quality of the outputs of MIS is basically governed by the quality of input and processes.

(d) (i) Hacking: It refers to unauthorised access to and use of computer system usually by means of a personal computer and telecommunication network.

(ii) Logic time Bomb: It refers to the program that lies idle until some specified circumstance or a particular time triggers it. Once triggered, the bomb sabotages the system by destroying programs, data or both.

(iii) Piggy Backing: It refers to tapping into a telecommunications line and latching on to a legitimate user before he logs into the system; legitimate user unknowingly carries perpetrator into the system.

(iv) Spamming: It refers to a situation where the same message is e-mailed to everyone on one or more Usenet news groups or LISTSERV lists.

(v) 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 known as data diddling.

Question 2

(a) What do you mean by Information? Describe the important characteristics of information, which makes it useful to the organization.

(b) "Information is necessary to executive for performing the function of planning". Substantiate the above statement with regard to information requirements of a marketing system.

(c) Describe various decisions which can be made with the help of Financial Information system. (10 + 5 + 5 = 20 Marks)

Answer

(a) Information: Information is data that has been processed into a form that is meaningful to the recipient and is of real or perceived value in current or progressive decision. The term data and information are often used interchangeably. However, the relation of data to information is that of raw material to finished product.

Characteristics of Information: The important characteristics of useful and effective information are as follows:

(i) Timeliness: Timeliness refers to when user needs information. Some information is required on regular, periodic basis – perhaps daily, weekly, monthly or quarterly, while much other information is generated on the request of the manager. Usually as we proceeds from lower level to higher level of management, the time interval necessary for providing decisions impelling information on a routine or on exception basis increases at strategic level.

(ii) Purpose: Information must have purposes at the time it is transmitted to a person or machine, otherwise it is simple data. Information communicated to people has a variety of purposes because of the variety of activities performed by them in business organisations. The basic purpose of information is to inform, evaluate, persuade and organize. It helps in creating new concepts, identifying problems, solving problems, decision making, planning and controlling.

(iii) Mode and Format: The mode of communicating information in business are either visual, verbal or in written form. Format of information should be so designed that it assists in decision-making, solving problems, planning, controlling and searching. Therefore, all the statistical rules of compiling statistical tables and presenting information by means of diagram, graph, curves etc. should be considered. The reports should be preferably supplied on an exception basis to save the manager from an overload of information. Also the data should be classified into categories, which have relevance to the problem at hand.

(iv) Redundancy: It means the excess of information carried per unit of data. However, in business situation redundancy may some time be necessary to safeguard against error in the communication process.

(v) Rate: The rate of transmission/reception of information may be represented by the time required to understand a particular situation. Quantitatively, the rate for humans may be measured by the number of numeric characters transmitted per minute. For machines, the rate may be based on the number of bits of information per character per unit of time.

(vi) Frequency: The frequency with which information is transmitted or received affects its value. Frequency has some relationship with the level of management and it should also be related to operational needs. For example, at the level of foreman it should be on weekly basis but at the management level, it should be usually on monthly basis.

(vii) Completeness: The information should be as complete as possible. For example, net present value models provide a point estimate and do not give any indication of the range within which these estimates may vary. Thus, complete information helps the manager to arrive at better decisions.

(viii) Reliability: In statistical surveys, for example, the information that is arrived at should have an indication of the confidence level. Even otherwise also, information should be reliable.

(ix) Cost benefit analysis: The benefits that are derived from the information must justify the cost incurred in procuring information. The information may be categorised into three categories: (i) necessary (ii) normal and (iii) extra. The information of necessary category cannot be discontinued whatever be the cost of preparing them. The second category statements may have a high cost but may be discontinued only in very stringent circumstances. Some of the normal statements can be discontinued or replaced if their costs are too high.

(x) Validity: It measures the closeness of the information to the purpose, which it purports to serve. The measures suiting the organisation may have to be carefully selected or evolved.

(xi) Quality: It refers to the correctness of information, which is likely to be spoiled by personal bias. Hence, proper internal controls and procedures should be developed.

(b) Information requirements of a Marketing System

The information required for the purpose of planning in the case of a marketing system can be classified into three types:

(i) Environmental Information: It includes the following:

(a) Political and Governmental considerations: To forecast market plan, political stability etc., information plays an important role as it enables executives to guess quite accurately the financial policies, taxation and their effect on the organization.

(b) Demographic and social trends: Information about demography, its compositions and location is also useful to business organisation for planning its products, services or outputs.

(c) Economic trends: This includes information related to the GNP level and trend, disposable income of consumers, employment, productivity, capital investments, prices, wage level and numerous other economic indicators which provide valuable planning information for those firms whose output is function of these variables.

(ii) Competitive information: Data related to business operations of competing firms is quite useful for forecasting individual firm's product demand, making decisions and plans to achieve the forecast.

(iii) Internal information: Information available from internal sources affects the planning decisions at different levels in the organizations. The main sources of internal information are: (a) Sale forecast, (b) Financial plans , (c) Supply factors and (d) Policies .

(c) Financial decisions: Various financial decisions made with the help of Financial Information System are as follows:

(i) Estimation of requirement of funds: A careful estimation of funds and the timing when they will be required is to be made. This can be done by forecasting all physical activities of the firm and translating them into monetary units.

(ii) Capital structure: Decisions are to be taken to select an optimal mix of different sources of capital structure so that the company is able to procure funds at optimum cost.

(iii) Capital Budgeting: Decision makers can determine feasibility of investment in long-term assets. This will help in attainment of financial objectives.

(iv) Profit planning: Financial decisions concerning profits and dividend are to be taken to ensure that adequate surplus for future growth is available.

(v) Tax management: The purpose of tax planning is to take full advantages of exemptions, deductions, concessions, rebates so that outflow of cash resources by way of tax is minimized.

(vi) Working Capital Management: Working capital is concerned with investment of long-term funds into current assets. Decisions are to be taken for effective financing of current assests required for day-to-day running of the organisation.

(vii) Current Asset Management : Policy decisions are taken regarding various items of current assets. Credit policy determines the amount of sundry debtors at any point of time. Inventory policy is to be determined jointly between finance and production department.

Question 3

(a) A Company is offering a wide range of products and services to its customers. It relies heavily on its existing information system to provide up to date information. The company wishes to enhance its existing system. You being an information system auditor, suggest how the investigation of the present information system should be conducted so that it can be further improved upon.

(b) Describe various software tools used in Decision support system.

(c) Describe various components of Client server architecture. (10 + 5 + 5 = 20 Marks)

Answer

(a) Investigation of present system: It involves collecting, organizing and evaluating facts about the system and the environment in which it operates.

The following areas should be studied in-depth so that the enhanced system can be improved upon :

1. Review of historical aspects: A brief history of the organization is a logical starting point for an analysis of the present system. The historical facts should identify the major turning points and milestones that have influenced its growth. A review of annual reports can provide an excellent historical perspective. A historical review of the organization chart can identify the growth of management level as well as the development of various functional areas.
2. Analyse Input: The auditor should be aware of the various sources from where the data are initially captured, keeping in view the fact that outputs for one area may serve as an input for other area. He must understand the nature of form, what is contained in it, who prepared it, from where the form is initiated, where it is completed etc.
3. Review data files: Auditor should investigate the data files maintained by each department noting their number and size, where they are located, who uses them and the number of times per given time interval these are used. The related cost of retrieving and processing the data is another important factor that should be considered.
4. Review methods, procedures and data communications: Methods and procedures transform input data into useful output. A method is defined as a way of doing; a procedure is a series of logical steps by which job is completed. Its basic objective is to eliminate unnecessary tasks or to perceive improvement opportunities in the present system. Auditor should also investigate existing communication network including components like data interface, data links, modems, dial-up and leased lines and multiplexers to identify the need to revamp the network when new system is installed.

5. Analyse Output: The output or reports should be scrutinized carefully to determine how well they would meet the organisation's needs. The auditor must understand what information is needed, and why, who needs it and when. Additional questions concerning the sequence of the data, how often the form reporting it is used, how long it is kept on file etc. must be investigated.

6. Review Internal Controls: Locating the internal control points helps the auditor to visualize the essential parts and framework of a system. It also indicates weaknesses of the existing system.

7. Model the existing system: As the logic of inputs, methods, procedures, data files, data communications, reports, internal controls and other important items are reviewed and analysed in a top down manner, the process must be properly documented. The logical flow of the present information system may be depicted with the help of system flow charts. The physical flow of the existing system may be shown by employing data flow diagrams. The data flow diagrams are drawn after reviewing or developing system flow charts. Each major operation in the system flow charts is broken down into its lowest-level modules and the data flow diagram is drawn for each one of them. During the process of developing the data flow diagram, work on data dictionary for the new information system should be begun. The data elements needed in the new system will be found in the present system only. Hence, it is wise to start the development of the data dictionary as early as possible.

   The flow charting and diagramming of present information not only organizes the facts, but also helps disclose gaps and duplication in the data gathered. It allows a thorough comprehension of the numerous details and related problems in the present operation.

8. Undertake overall analysis: Auditor should also undertake overall analysis of the following:

   (i) Present work volume.

   (ii) Personnel requirements.

   (iii) Present benefits and cost.

   Each of these must be investigated thoroughly.

(b) Software tools of DSS: Decision support system includes a variety of software supporting database query, modelling, data analysis and display. These tools fall under following four categories:

   (i) Database languages: Tools supporting database query and report generation use mainframe, mini computer and microcomputer based databases. FOCUS, RAMIS and NOMAD II are mainframe based languages supporting data base query, report generation and analysis. FOCUS, RAMIS are also available in PC version. MS Access is one of the most popular database query package used in Window based PC.

(ii) Model based Software: Model based analysis tools such as spreadsheet software enable manager to design models that incorporate business rules and assumptions. Lotussuits and MS-Excel supports model building and "what if" type analysis. Modelling tools like IFPS are designed to support financial modelling and analysis.

(iii) Statistics and Data Manipulation tools: Statistical analysis software such as SAS, SPSSS supports market researchers, operation research analysts and other professionals using statistical analysis functions and are generally used on mainframe computers. Microcomputer-based statistical packages are available as well.

(iv) Display based DSS: Graphic displays of output generated from MS-Excel are very effective in management presentation. Graphics tools running in a mainframe environment include DISSPLA, TELLAGRAF and SASGRAPH. Microcomputer based tools such as Harward Graphics, and Power Point display output in the form of pie charts, bar charts and graphs.

An integrated module of MS-Excel and Power-Point that provides the ability to generate, manipulate and statistically analyse data is best example of query, modelling and display software.

(c) Components of Client Server Architecture: It includes following five components :

(i) Client: Clients, which are typically PC's, are the user of the services offered by the servers. There are basically three types of clients:

(a) *Non-GUI clients:* These require a minimum amount of human interaction. These include ATM, Cell Phones, Fax machine and robots.

(b) *GUI Clients* : These are human interaction models usually involving objects/action models like pull down menu in Windows 3-x.

(c) *Object oriented GUI:* This client takes GUI-client even further with expanded visual formats, multiple work places and object interaction rather than application interaction. Windows 95 is a common OOGUI-client.

(ii) Server: Server awaits requests from the client and regulates access to shared resources. There are servers, which fulfil different functions as stated below:

(a) *File server* makes it possible to share files across a network by maintaining a shared library of documents, data and images.

(b) *Database server* allows processing power to execute SQL requests from clients.

(c) *Web server* allows clients and servers to communicate with a universal language called HTTP.

(iii) Middleware: The network system implemented within the client/server technology is commonly called as middleware. It is all the distributed software needed to allow clients and server to interact. It is typically composed of four layers, which are (i) service, (ii) back end processing, (iii) network operating system and (iv) transport stacks.

(iv) Fat client/Fat server: In a Fat client system, more of the processing takes place on the client like with a file server or database server. In Fat server, more emphasis is on the server and it tries to minimize the processing done by the clients. Example of Fat server is web server.

(v) Network: The network hardware includes cabling, the communication cords and the device that links the server and the clients. The communication and data flow over the network is managed and maintained by network software.

Question 4

(a) What do you mean by Production scheduling? Draw the information flow diagram for design of computerized production scheduling system. Also explain:

(i) System interface

(ii) File inputs and

(iii) Reports required for the above system.

(b) Briefly discuss about various factors which should be considered for evaluating the vendor proposal for supply of computer system.

(c) Describe various strategies for change over from manual system to computerised system. *(10 + 5 + 5 = 20 Marks)*

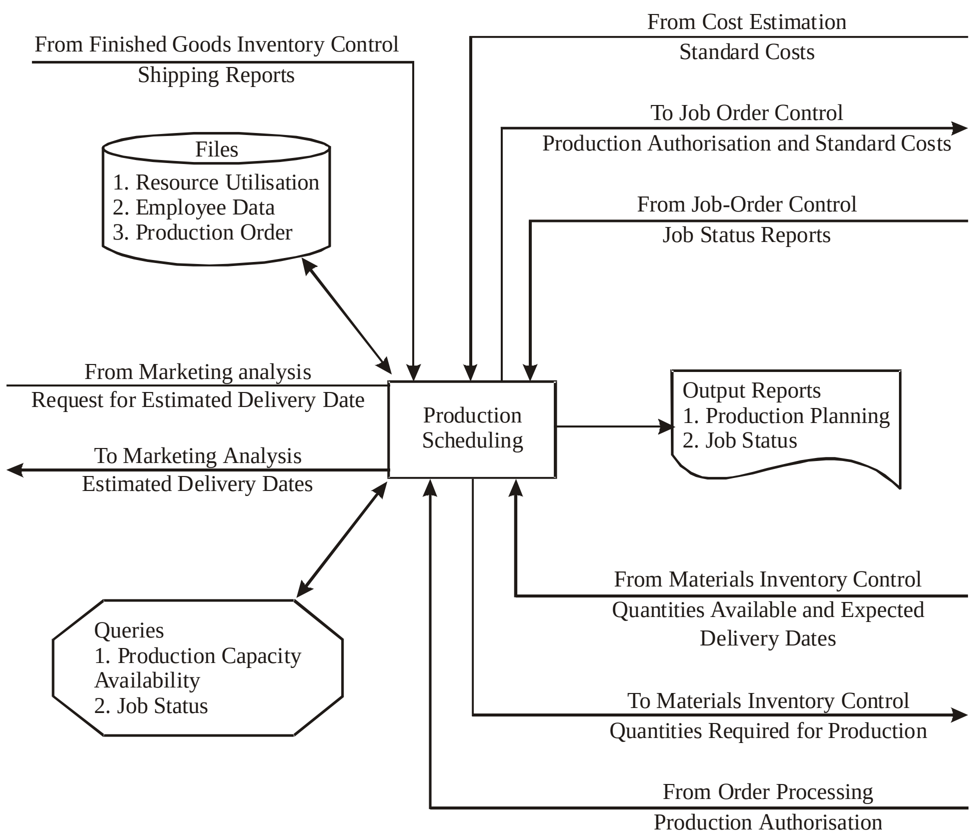
Answer

(a) Production scheduling: It schedules production of components and monitors their progress throughout. It is the nerve centre of the production management system. The information flow involving the production scheduling is given on the next page.

System Interfaces: The production scheduling system interacts with various other systems of the organisation. The sales order processing system authorizes production scheduling to start work on a job. Production scheduling then provides with estimated delivery dates and receives shipping reports from the finished goods inventory control system. Production scheduling informs material inventory control of the items and quantity required to schedule production and inventory control indicates the quantities available. Work in progress (WIP) control receives production authorization from the scheduling system. This authorization creates a new record for a job and production costs can be charged on the job. At the same time, the work-in-process control system receives the standard cost for the job and provides status reports to the scheduling system. Cost estimation provides production scheduling with budgeted standard costs for all jobs production.

Files and Inputs: Three files are required in the production scheduling system. The resource utilization file contains a record for each machine and production process in the factory and maintains work schedules for them. The employee data file contains data concerning employee skills and scheduled work assignments. The production order file maintains completion date and schedule information for each job.

Reports: The scheduling system produces periodic production planning reports. They include the available capacity and scheduled future utilisation of labour and machinery. Job status reports concern the status of jobs in the production process. They compare scheduled and actual completion time in the production process.



(b) Factors for evaluation of vendor's Proposal : The following factors have to be considered towards rigorous evaluation of the vendor proposal for supply of computer system:

1. The Performance Capability of Each Proposed System in Relation to its Costs: It is imperative that a vendor system be capable of processing the organisation's data within the time frames desired by management. Otherwise, delays in providing needed outputs will occur once the computer system is operational. There are many measures of performance, including speed, response time, number of users supported, and system testing. One way to examine the operating efficiency of a particular system is to use a benchmark test. With this approach, the vendor's

system performs a data processing task that the new system must perform (e.g., payroll processing), and representatives of the organisation then examine the outputs for accuracy, consistency, and efficiency.

2. The Costs and Benefits of Each Proposed System: The accountants on the design team will analyze the costs of every vendor's proposed system in relation to the system's anticipated performance benefits – i.e., will perform a cost-benefit analysis for each proposed system. In this effort, the accountants should also investigate the differences between purchasing and leasing each vendor's system. If the steering committee elects to purchase its computer system, the accountants should then advise the committee on a realistic depreciation schedule for the new system.

3. The Maintainability of Each Proposed system : Maintainability refers to the case with which a proposed computer system can be modified. For example, this flexibility enables a firm to alter a portion of a payroll system to reflect new tax laws.

4. The Compatibility of Each Proposed system with Existing Systems: Compatibility refers to the ability to implement and interface the new system with existing computer resources and software. In some instances, this comes down to hardware issues. For example, it may not be possible to run specific software modules of the new system on some of the company's older local area network servers, which will consequently have to be upgraded. But compatibility issues can also involve the operating system, existing application software, or procedural concerns as well .

5. Vendor Support : Vendor support includes such things as (1) training classes that familiarize employees with the operating characteristics of the new system, (2) help in implementing and testing the new system, (3) assistance in maintaining the new system through a maintenance contract, and (4) backup systems for temporarily processing company data if required. The availability of "business-hours-only" versus "round-the-clock" support is another consideration. Most vendors charge extra for enhanced services.

(c) Strategies for change over from manual system to computerized system : The following strategies are adopted:

(i) *Direct change over:* Conversion by direct changeover means that on a specified date the old system is dropped and the new system is put into use. This can be successful only if extensive testing is done before hand.

It is risky approach and may cause long delays if error occurs. Users may resent being forced into using an unfamiliar system.

(ii) *Parallel conversion:* This refers to running the old system and the new system at the same time, in parallel. Both systems are run simultaneously for a specified period of time and the reliability of results is examined. When the same results are gained over time, the new system is put into use and the old one is stopped.

The advantage includes the possibility of checking new data against old data. It also offers a feeling of security to users who are not forced to make abrupt changes. However, cost of running two systems is high and at the same time workload also increases. With a given choice between two systems, employees will continue to use old system because of their familiarity with it.

(iii) *Gradual conversion:* In this plan, the volume of transactions is gradually increased as the system is phased in. It combines the best features of the earlier two plans. However, it takes too long time to get new system in place.

(iv) *Modular conversion:* This approach uses the building of modular, operational prototypes to change from old system to new in a gradual manner. As each module is modified and accepted, it is put into use. In this manner, each module is tested thoroughly and users also get familiarised. However, special attention is required to be paid to interfaces so that the modules being built actually work as a system.

(v) Distributed system: In this method, one entire conversion is done at one site. When that conversion is successfully completed, other conversions are done for other sites. It is most popular in banking industry or in franchises etc. This approach requires that peculiarities of each site should be handled properly.

Question 5

(a) What is the significance of input validation control? Describe briefly three different levels of input validation controls used in computerized information system.

(b) Explain the various criteria used for evaluation of the ERP packages.

(c) Describe briefly five components of a CASE work bench. (10 + 5 + 5 = 20 Marks)

Answer

(a) Input Validation Controls: These controls are intended to detect errors in transaction data before the data are processed. Validation procedures are most effective when they are performed as close to the source of the transactions as possible. However, depending on the type of Computer Based Information Systems (CBISs) in use, input validation may occur at various points in the system. For example, some validation procedures require making references against the current master file. Computer Based Information Systems (CBISs) using real-time processing or batch processing with direct access master files can validate data at the input stage. Some validation procedures are performed by each processing module prior to updating the master file record.

There are three levels of input validation controls:

(i) Field Interrogation: It involves programmed procedures that examine the characters of the data in the field.

The following are some common types of field interrogation:

(1) Limit Check: It may be applied to both the input data and the output data. The field is checked by the program to ensure that its value lies within certain

predefined limits. For example, no pay where there is sick leave, physical balance can never go below zero etc.

(2) Picture checks: These check against entry into processing of incorrect characters. For example, all rooms are numbered by numeric. An incorrect room number 4D3 would be filtered.

(3) Valid Code checks: These checks are made against predetermined transactions codes, tables or order data to ensure that input data are valid. The predetermined codes or tables may either be embedded in the programs or stored in direct access files.

(4) Check digits: A customers' account number or any other numeric digits are checked for transcription and transposition errors.

(5) Arithmetic check: Arithmetic check is performed in different ways to validate the results of other computations of the values of selected data fields.

(6) Cross checks: These may be employed to verify fields appearing in different files to see that the results tally. For example, the quantity received, quantity invoiced by the supplier and quantity ordered may be compared. It may also be necessary to put check on the units of quantity.

(ii) Record Interrogation:

(1) Sequence checks are exercised to detect any missing transactions, off serially numbered vouchers or erroneous sorting.

(2) Format completeness checks are used to check the presence and position of all the fields in a transaction. This check is particularly useful for variable data field records.

(3) Redundant data checks are used in sequential processing. Matching keys of the transaction record and its master record may not be deemed enough. One may want to compare, say first five characters of the customer's name.

(4) Password: It is used to authorize users to access, read and write information.

(iii) File Interrogation: The purpose of file interrogation is to ensure that the correct file is being processed by the system. These controls are particularly important for master files, which contain permanent records of the firm and which, if destroyed or corrupted are difficult to replace. Various types of checks employed are:

(1) Internal label checks: These checks verify that the file processed is the one the program is actually calling for. To ensure that the correct file is processed, the system matches the file name and serial number in the header label with the programme's file requirements. If the wrong file has been loaded, the system will send a message and suspend operation.

(2) Version checks are used to verify that the version of the file being processed is correct as per the programme's requirement.

(3) Expiration date check prevents a file from being deleted before it expires. To protect against destroying an active file by mistake, the system first checks the retention period contained in the header label. If the retention period has not yet expired, the system will generate error message.

(b) Evaluation of ERP Packages: The following criteria are considered:

(1) Flexibility: The ERP package should enable organisations to respond quickly by leveraging changes to their advantage, letting them concentrate on strategic expansion to address new products and markets.

(2) Comprehensive: It should be applicable across all sizes, functions and industries. It should have in-depth features in accounting and controlling, production and materials management, quality management, plant maintenance etc. It should be open and modular. It should embrace an architecture that supports component or modules that can be used individually expandable in stages to meet the specific requirements of the business.

(3) Integrated: It should overcome the limitations of traditional hierarchical and function oriented structure. It should be able to integrate workflow of business events and processes across departments enabling workers to receive right information and right documents at right time.

(4) Beyond the company: It should support and enable inter-enterprise business processes with customers, suppliers, bank etc. to create complete logistical chains.

(5) Best business practice: The software should enable integration of all business operations in an overall system for planning, controlling and monitoring and offer a choice of multiple readymade business processes including best business practices that reflect the experiences, suggestions and requirements of leading companies across industries.

(c) Components of A CASE Workbench:

(1) *A diagram editing system* that is used to create data flow diagrams, structure charts, entity relationship diagrams etc. It captures information about these entities and saves this information in a central responsibility.

(2) *Design analysis and checking facilities* that process the design and correct errors. These are integrated with the editing system so that the users may be informed of errors during diagram creation.

(3) *Query language facilities* that allow the user to browse the stored information and examine completed designs.

(4) *Data dictionary* that maintains information about named entities in a system design.

(5) *Report generation facilities* that take information from the central store and automatically generate system documentation.

(6) *Forms generation tools* that allow screen and document formats to be specified.

(7) *Import/export facilities* that allow interchange of information from the central repository with other development tools.

(8) *Some systems support skeleton code generation* which generates codes or code segments automatically from the design captured in the central store.

Question 6

(a) *What do you mean by Information Security policy? Explain the salient features of the Information Security Policy.*

(b) *Describe the various security components available in a Secure Operating system.*

(c) *Suggest suitable guidelines to be followed for efficient form design.*

(10 + 5 + 5 = 20 Marks)

Answer

(a) Information Security Policy : Security policy defines acceptable behaviours and the reaction of the organisation when such behaviours are violated. The electronic trading, viruses affecting organisation's security documents and the misuse of credit cards have increased and this has augmented the need for security management. Also, legislation relating to information technology is becoming more prolific, with many countries enacting laws on issues such as copyright and software privacy, intellectual property and personal data. These commercial, competitive and legislative pressures require the implementation of proper security policies.

A good security policy should suggest procedures and policies that can prevent loses and also help in saving money and increasing productivity. The security policy defines ways in which resources in a computer system may be accessed and used. Security policies might differ depending upon the system under consideration.

Features of Information Security Policy: The security objectives and core principles provide a framework for the first critical step for any organization-developing a security policy. The security policy should support and complement existing organizational policies. The thrust of the policy statement must be to recognize the underlying value of, and dependence on, the information within an organization. The information security policy should describe:

- Importance of information security to the organisation
- A statement from the chief executive officer in support of goals and principles of effective information security.
- Specific statements indicating minimum standards and compliance requirements for specific areas.
- Asset classifications.
- Data security
- Personnel security

- Physical, logical and environment security
- Communications security
- Legal, regulatory and contractual security
- System development and maintenance life cycle requirements
- Business continuity planning
- Security awareness, training and education
- Security breach detection and reporting requirements
- Violation enforcement provision
- Definitions of responsibility, accountability for information security and proper separation of duties
- Reporting responsibilities and procedures.

(b) Operating System Security: Operating system security involves policy, procedures and controls that determine who can access the operating system, which resources they can access, and what actions they can take. The following security components are found in secure operating system:

(i) Log-on Procedure: A log-on procedure is the first line of defence against unauthorised access. When the user initiates the log-on process by entering user id and password, the system compares the ID and password to a database of valid users. If the system finds a match, then log-on attempt is authorised. If password or ID is entered incorrectly, then after a specified number of attempts, the system should lock out the user from the system.

(ii) Access token: If the log on attempt is successful, the OS creates an access token that contains key information about the user including user ID, password, user group and privileges granted to the user. The information in the access token is used to approve all actions attempted by the user during the session.

(iii) Access control list: This list contains information that defines the access privileges for all valid users of the resource. When a user attempts to access a resource, the system compasses his or her ID and privileges contained in the access token with those contained in the access control list. If there is a match, the user is granted access.

(iv) Discretionary Access Control: The system administrator usually determines who is granted access to specific resources and maintains the access control list. However, in distributes system, resources may be controlled by the end-use. Resource owners in this setting may be granted discretionary access control, which allows them to grant access privileges to other users. For example, the controller who is owner of the general ledger grants read only privilege to the budgeting department while accounts payable manager is granted both read and write permission to the ledger.

(c) Guidelines for form Design: Forms are pre-printed papers, which elicit and capture information required and often serve as source documents for the data entry personnel.

The following guidelines should be observed in order to design useful form.

(i) Making forms easy to fill: To reduce errors, speed up completion and facilitate entry of data, it is essential that forms should be easy to fill out.

- Proper flow can minimise time and effort.
- It should be from left to right and top to bottom.
- Divide forms in logical sections consisting of heading, identifications and access instructions, body, signature and verification and comments.
- Clear captioning is another technique to make work easy.

(ii) Meeting the intended purpose: Forms are created to serve one or more purposes such as recording, processing, storing and retrieving of information for various departments. It should be able to provide the information required by different departments while avoiding duplication of information.

(iii) Ensure accurate completion: Error rates associated with collecting data can drop sharply when forms are designed to assure accurate completion. Various controls such as internal double cheek with column and row totals, summing to same number can be embedded to ensure that forms are filled accurately.

(iv) Keeping forms attractive: An aesthetic form draws people to encourage proper completion. Forms should look uncluttered, organised and logical even after they are filled in. To be attractive, forms should elicit information in the expected order. Using different fonts makes it attractive and forces people to fill in correctly. Type fonts and lines weights are useful

Question 7

Write short notes on any four of the following:

(i) Firewalls.

(ii) Top down approach of system development.

(iii) Material requirement planning.

(iv) Source program library control.

(v) Sources of packaged software. *(5 ×4 = 20 Marks)*

Answer

(i) Firewalls: Organisations connected to the Internet or other public networks often implement an electronic "firewall" to insulate their Intranet from outside intruders. A firewall is a system that enforces access control between two networks. Firewalls can be used to authenticate an outside user of the network, verify his or her level of access authority, and then direct the user to the program, data, or service requested. In addition to insulating the organisation's network from external networks, firewalls can also be used to insulate portions of the organisation's Intranet from internal access. There are a number of firewall products on the market. Generally two types of firewalls are used:

(a) Network level firewalls: These provide low cost and low security access control. These consist of screening router that examines the source and destination addresses that are attached to incoming message packets. The firewall accepts or denies access request based on filtering rules that have been programmed. These firewalls are insecure because they are designed to facilitate the free flow of information rather than restrict it. Using IP spoofing, hacker can disguise their message packets to look as if they came from an authorised user and thus gain access to the host's network.

(b) Application level firewalls: These provide high level of customizable network security but is extremely expensive. These systems are configured to run security applications called proxies that permit routine services such as e-mail to pass through but can perform sophisticate functions such as logging or user authentication for specific tasks. If an outside user attempts to connect, the network administrator can be notified immediately.

(ii) Top Down Approach of system development: The top down approach assumes a high degree of top management involvement in the planning process and focuses on organisational goals, objectives and strategies. The logic here is that, above all, an information system needs to be responsive to and supportive of an organisation's basic reasons for being. Hence the organisation's goals should be the driving force behind development of all the computer systems. Thus, using top down approach, we begin analysing objectives and goals of the organisation and end by specifying application programs and modules that are needed to be developed.

Various steps in top-down approach are as follows:

(a) Analyse the objectives and goals of the organisation in terms of profit, growth, diversification etc.

(b) Identify the functions of the organisation and explain how they support the entire organisation.

(c) Ascertain major activities, decisions and functions at various levels of hierarchy. It should be analysed what decisions are made and what need to be made.

(d) Identify models that guide managerial decision process and find the information requirements for activities and decisions.

(e) Prepare specific information processing programs in detail and modules within these programs. Also identify files and database for applications.

(iii) Material Requirements Planning: A major cause of production inefficiency in organisations is a lack of integrated production planning, production scheduling, and production control information systems. One approach to improve production efficiency is materials requirements planning (MRP.) which integrates several production related information systems so that MRP system can access and extract data from these systems to accomplish production scheduling. MRP's purpose is to greatly improve both inventory management and production scheduling.

To achieve the efficiencies of which they are capable, MRP systems require high levels of discipline-such as not requisitioning materials long before they are needed, proper scrap reporting, and using well-defined procedures for implementing and recording changes promptly. Accurate input data also is absolutely necessary; for example inventory quantity data must be accurate, and interplant transfers must be recorded accurately and promptly.

The benefits of a successful MRP system include:

1. Significantly decreased inventory levels and corresponding decreases in inventory carrying costs.
2. Fewer stock shortage, which cause production interruptions and time-consuming schedule juggling by managers,
3. Increased effectiveness of production supervisors and less production chaos.
4. Better customer service-an increased ability to meet delivery schedules and to set delivery dates earlier and more reliably.
5. Greater responsiveness to change. MRP gives manufacturing a better feel for the effects of economic swings and changes in product demand can be translated into schedule changes quickly.
6. Closer coordination of the marketing, engineering, and finance activities with the manufacturing activities.

(iv) Source Program library controls : In large computer systems, application program modules are stored in source code form on magnetic disks called the source program library (SPL).

To control the SPL, protective features and procedures must be explicitly addressed. This requires the implementation of SPL management system. This software is used to control four critical functions.

- Storing programs on the SPL.
- Retrieving program for maintenance purposes.
- Deleting obsolete programs from the library.
- Documenting program changes to provide an audit trail of the changes.

SPLMs may be supplied by the computer manufacturer as part of operating system or may be purchased through software vendors. An SPL requires specific planning and control techniques to ensure program integrity. The following control techniques may be used:

- Password control : One form of access control over the SPL is provided by assigning passwords. Every financially significant program stored in the SPL can be assigned a separate password. However, passwords have drawbacks. When more than one person is authorized to access a program, preserving the secrecy of a shared password is a problem.

- Separation of Test Libraries : Under this concept, a strict separation is maintained between the production programs that are subject to maintenance in the SPL and those being developed. Production programs are copied into the programmer's library for maintenance and testing purposes only. Direct access to the production SPL is limited to a specific librarian group that must approve all requests to modify, delete, and copy programs. Passwords for production programs can be changed regularly and disclosed only on a need-to-know basis.

(v) Sources of packaged software : Today, packaged softwares are available in the market from various sources. Computer manufacturers, large and small software houses and computer retail stores are some of the sources from where these packages can be purchased. Another source of packaged software is user groups or associations of users of a particular computer system. User groups often recognise the need for a specific program, which may be developed by one member organisation and made available to other members. For example, utility program and extensions of existing operating systems are typically developed by a member organisation and distributed through the user group. Buying packaged software is risky. Some are difficult to install. There may be undetected bugs in the software, which may create problem at a later stage for the purchaser. Many packages may not be adequately developed and tested. The best method is to deal only with those suppliers who are known for their reputation and who provide after sales support such as training, answering queries and correcting program defects.

The Suggested Answers for Paper 7: - Direct Taxes are based on the provisions applicable for A.Y. 2006-07, which is the assessment year relevant for May, 2006 examinations.

PAPER – 7 : DIRECT TAXES

Answer all questions

Question 1

ABC Ltd. is engaged in the manufacture and sale of textiles. Its net profit for the year ending 31.3.2006 after debit/credit of the following items to the Profit and Loss Account was Rs.75,00,000:

(i) Payment to two employees of Rs.2,50,000 each in connection with their voluntary retirement.

(ii) Fringe benefit tax paid Rs.1,00,000.

(iii) Charges of Rs.2,00,000 paid for the advertisement in souvenir published by a Political Party registered with the Election Commission of India.

(iv) Retrenchment compensation paid to employees of one of the units closed down during the year Rs.10,00,000.

(v) Capital expenditure incurred for the purpose of promoting family planning amongst its employees Rs.3,00,000.

(vi) Banking cash transaction tax paid Rs.10,000.

(vii) Interest paid under section 234B for short payment of advance tax pertaining to the assessment year 2005-06 Rs.1,10,000.

(viii) Loss incurred in transactions of purchase and sale of shares of various companies Rs.3,00,000.

(ix) Compensation received from supplier for delay in supply of raw materials Rs.1,00,000.

(x) Dividend received from a foreign company Rs.2,00,000.

The total sales of ABC Ltd. for the year was Rs.30 crores out of which export sales amounted to Rs.10 crores.

Compute the total income of ABC Ltd. for the assessment year 2006-07.

Furnish explanations for the treatment of the various items given above. *(16 Marks)*

Answer

Computation of total income of ABC Ltd. for the Assessment Year 2006-07

Particulars	Rs.
Net profit as per Profit and Loss Account	75,00,000
Add: Inadmissible expenditure	

4/5th of Rs.5,00,000 paid to employees on voluntary retirement [1/5th is allowable as deduction u/s 35DDA]	4,00,000
Fringe benefit tax u/s 40(a)(ic)	1,00,000
Advertisement charges of souvenir of political party u/s 37(2B)	2,00,000
4/5th of Rs.3,00,000, being capital expenditure incurred for promoting family planning amongst employees [1/5th is allowable as deduction u/s 36(1)(ix)]	2,40,000
Interest paid u/s 234B	1,10,000
Loss incurred in transactions of purchase and sale of shares considered as speculation loss	3,00,000
	88,50,000
Less: Dividend received from a foreign company considered under 'Income from other sources'	2,00,000
Business income	86,50,000
Income from other sources	
Dividend received from a foreign company	2,00,000
Gross total income	88,50,000
Less: Deduction u/s 80GGB	2,00,000
Total income	86,50,000

Explanations for the treatment of the various items in computing the total income of the company are furnished below -

(i) Section 35DDA provides for amortisation of expenditure incurred under voluntary retirement scheme over a period of five years in equal instalments. The company is, therefore, entitled to deduction of Rs.1,00,000, being one-fifth of the total sum of Rs.5,00,000 paid to the two employees in connection with their voluntary retirement for the relevant assessment year.

(ii) Fringe benefit tax paid is not allowable as deduction from business profits as per section 40(a)(ic). Hence, fringe benefit tax paid by the company is not deductible.

(iii) Section 37(2B) prohibits allowance of any expenditure incurred by an assessee on advertisement in any souvenir, brochure, pamphlet or the like published by a political party. As such, advertisement charges paid in respect of souvenir published by a political party is not allowable as deduction from business profits of the company.

However, under section 80GGB, expenditure incurred by an Indian company on advertisement in any publication, including a souvenir, by a political party is deemed to be a contribution of such amount to the political party and is, therefore, allowable as deduction in the hands of the company. It is logical to presume that ABC Ltd. is an Indian company.

(iv) Retrenchment compensation paid to employees at the time of closure of one of the units of the business is allowable as per the decision of the Allahabad High Court in *CIT (Central) Kanpur vs. JK Cotton Spinning & Weaving Co. Ltd. (2005) 145 Taxman 591.*

(v) Capital expenditure incurred for the purpose of promoting family planning amongst employees is deductible over a period of 5 years as per the first proviso to section 36(1)(ix). Hence, only Rs.60,000 is deductible in the current year in respect of such expenditure incurred by the company.

(vi) Banking cash transaction tax paid by the company is eligible for deduction in view of section 36(1)(xiii).

(vii) Interest paid for delayed payment of tax by the assessee is part and parcel of the liability to pay income-tax. When income-tax paid is itself not allowable as a deduction under section 40(a)(ii), the interest paid under section 234B cannot qualify for deduction. Thus, interest paid under section 234B is not deductible.

(viii) Loss of Rs.3 lakhs incurred by the company in dealing of shares constitutes speculation loss in view of the Explanation to section 73. In the absence of any speculative profit for the year, speculation loss is to be carried forward under section 73(2) for set off against speculation profits of subsequent assessment years. It can be carried forward for a maximum of 4 assessment years

(ix) Compensation received from supplier for delay in supplying the raw materials is a trading receipt.

(x) Dividend received from a foreign company in assessable under the head "Income from other sources".

(xi) Deduction under section 80HHC in respect of profits from export business is not allowable for and from the assessment year 2005-06.

Question 2

(*a*) *A charitable trust registered under section 12AA of the Income-tax Act, 1961 has, out of its income of Rs.3,90,000 for the year ending 31.3.2006 and sale proceeds of a capital asset, held by it for less than 36 months, amounting of Rs.9,60,000, purchased a building during the year ending 31.3.2006 for Rs.13,50,000. The capital asset was sold during the year ending 31.3.2006. The building is held only for charitable purposes. The trust claims that the purchase of the building amounts to application of its income for charitable purposes and that the capital gain arising on the sale of the capital asset is deemed to have been applied to charitable purposes. Are the claims made by the charitable trust valid in law? (5 Marks)* *(b) R, an individual resident in India, bought 1,000 equity shares of Rs.10 each of A Ltd. at Rs.50 per share on 30.5.2005. He sold 700 equity shares at Rs.35 per share on 30.9.2005 and the remaining 300 shares at Rs.25 per share on 20.12.2005. A Ltd. declared a dividend of 50%, the record date being 10.8.2005. R sold on 1.2.2006, a house from which he derived a long-term capital gain of Rs.75,000.*

Compute the amount of capital gain arising to R for the assessment year 2006-07.

(5 Marks)

Answer

(a) Section 11(1)(a) stipulates that in order to avail exemption of income derived from property held under trust wholly for charitable or religious purposes, the trust is required to apply for charitable or religious purposes, 85% of its income from such property for the year. In this case, the trust has earned income of Rs.3,90,000 for the year ending 31.3.2006. It has also earned short term capital gain from sale of capital asset for Rs.9,60,000. The trust had utilized the entire amount of Rs.13,50,000 for the purchase of a building held for charitable purposes.

The Supreme Court in *S.RM. M. CT. M. Tiruppani Trust v. CIT (1998) 230 ITR 636* ruled that the assessee-trust, which applied its income for charitable purposes by purchasing a building for use as a hospital, was entitled to exemption under section 11(1) in respect of such income. The ratio of the decision squarely applies to the case of the charitable trust in question. Therefore, the charitable trust is justified in claiming that the purchase of the building amounted to application of its income for charitable purposes.

Under section 11(1A), where the whole of the sale proceeds of a capital asset held by a charitable trust is utilised by it for acquiring another capital asset, the capital gain arising therefrom is deemed to have been applied to charitable purposes and would be exempt. Section 11(1A) does not make any distinction between a long-term capital asset and a short-term capital asset. The claim of the charitable trust to the effect that the capital gain is deemed to have been applied to charitable purposes is, therefore, in accordance with law.

(b) The amount of capital gains arising to R has to be computed applying the provisions of sub-section (7) of section 94, which provides that “where:

(a) any person buys or acquires any securities or unit within a period of three months prior to the record date; and

(b) such person sells or transfers -

(i) such securities within a period of three months after such date; or

(ii) such unit within a period of nine months after such date; and

(c) the dividend or income on such securities or unit received or receivable by such person is exempted,

then the loss, if any, arising to him on account of such purchase and sale of securities or unit, to the extent such loss does not exceed the amount of dividend or income received or receivable on such securities or unit, shall be ignored for the purpose of computing his income chargeable to tax".

For this purpose, "record date" means such date as may be fixed by a company for the purpose of entitlement of the holder of the securities to receive dividend and "securities" includes stocks and shares.

Computation of capital gains of Mr. R for the assessment year 2006-07

Particulars	Rs.	Rs.
Long-term capital gain on sale of building		75,000
Less: Short-term capital loss on sale of shares		
700 shares	7,000	
300 shares	7,500	14,500
Taxable long-term capital gains		60,500

Computation of capital gain on sale of shares of A Ltd. by Mr.R

Date of purchase of shares		30.5.2005
Record date		10.8.2005
Date of sale of shares	30.9.2005	20.12.2005
Number of shares sold	700	300
Sale price per share	Rs.35	Rs.25

Particulars	Rs.	Rs.
Sale consideration	24,500	7,500
Less: Cost of acquisition	35,000	15,000
	10,500	7,500
Less: Dividend income as per section 94(7) [700×10×50%] [See Note below]	3,500	-
Short-term capital loss on sale of shares	7,000	7,500

Note:

1. 700 shares are sold within 3 months of record date, hence related dividend income should be deducted from the loss as per section 94(7).
2. 300 shares having been sold after 3 months of record date, section 94(7) is not applicable. So, the dividend income of Rs.1,500/- should not be deducted. Such dividend is exempt under section 10(34).

3. Short-term capital loss can be set-off against long-term capital gains as per the provisions of section 74(1)(a). Therefore, short-term capital loss on sale of shares can be set-off against long-term capital gains on sale of building.

Question 3

(a) *Examine the obligation of the person responsible for paying the income to deduct tax at source and indicate the due date for payment of such tax, wherever applicable, in respect of the following items:*

   (i) *MNO Ltd., the employer, credited salary due for the financial year 2005-06 amounting to Rs.2,40,000 to the account of Q, an employee, in its books of account on 31.3.2006. Q has not furnished any information about his income/loss from any other head or proof of investments/payments qualifying for deduction under section 80C.*

   (ii) *T, an individual whose total sales in business during the year ending 31.3.2005 was Rs.1.20 crores, paid Rs.9 lakhs by cheque on 1.1.2006 to a contractor, for construction of his business premises, in full and final settlement. No amount was credited earlier to the account of the contractor in the books of T.*

   (iii) *BCD Ltd. credited Rs.18,000 towards fees for professional services and Rs.12,000 towards fees for technical services to the account of HG in its books of account on 6.10.2005. The total sum of Rs.30,000 was paid by cheque to HG on 18.12.2005*

(6 Marks)

(b) *H, a mentally retarded minor, has a total income of Rs.1,20,000 for the assessment year 2006-07. The total income of his father L and of his mother R for the relevant assessment year is Rs.2,40,000 and Rs.1,80,000 respectively. Discuss the treatment to be accorded to the total income of H for the relevant assessment year.* *(3 Marks)*

(c) *M/s. PR and M/s. ST are firms with common partners carrying on different businesses. M/s. PR had taken a loan from M/s. ST for the purpose of its business. Interest on the loan for the year ending 31.3.2006 worked out to Rs.20,000. M/s. PR deducted tax of Rs.2,244 on interest and paid the balance sum of Rs.17,756 in cash to M/s. ST on 31.3.2006. Tax deducted was remitted to the credit of the Central Government on 30.4.2006. How will you treat the interest paid while computing the total income of M/s. PR for the assessment year 2006-07?* *(3 Marks)*

Answer

(a) (i) 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. MNO Ltd, therefore, is not required to deduct tax at source in respect of the salary merely credited to the account of Q and not paid.

   (ii) Section 194C(1) which governs tax deduction on payments to contractor is not applicable where the contract is between an individual and a contractor. Therefore, T, who is an individual, need not deduct tax on payment of Rs.9 lakhs made to the contractor for construction of his business premises.

(iii) The limit of Rs.20,000 for non-deduction of tax under section 194J has been separately fixed for fees for professional services and fees for technical services. This means that if a person has rendered services falling under both the categories, tax need not be deducted if the fees for each category does not exceed Rs.20,000 even though the aggregate of the amounts credited to the account of such person or paid to him for both the categories of services exceed Rs.20,000. Therefore, BCD Ltd., is not required to deduct tax at source in respect of the fees either at the time of credit or at the time of payment.

(b) Section 64(1A) provides that all income accruing or arising to a minor child has to be included in the income of that parent, whose total income is greater. However, the income of a minor child suffering from any disability of the nature specified in section 80U shall not be included in the income of the parents but shall be assessed in the hands of the child. Thus, the total income of H has to be assessed in his hands and cannot be included in the total income of either his father or his mother.

(c) Section 40(a)(ia) provides that interest paid shall not be allowed as deduction in computing business income, if tax deductible at source has not been deducted thereon or if deducted, has not been paid during the previous year or in the subsequent year before the time prescribed in section 200(1). M/s PR had to remit the tax deducted (on interest paid to M/s ST) on or before 7.4.2006 as per section 200(1) read with Rule 30. Since it remitted the tax deducted on 30.4.2006, which was beyond the due date prescribed in section 200(1), it will not be entitled to claim deduction of the interest paid of Rs.20,000 for the assessment year 2006-07.

Question 4

(a) M/s. JKLM, a firm, consists of four partners namely, J, K, L and M. They shared profits and losses equally during the year ending 31.3.2005. The assessed business loss of the firm for the assessment year 2005-06 which it is entitled to carry forward amounts to Rs.3,60,000. A new deed of partnership was executed among J, K, L and M on 1.4.2005 in terms of which they agreed to share profits and losses in the ratio of 15:15:20:50 respectively.

Compute the amount of business loss relating to the assessment year 2005-06, which the firm is entitled to set off against its business income for the assessment year 2006-07. The business income of the firm for the assessment year 2006-07 is Rs.3,30,000. Your answer should be supported by reasons. *(3 Marks)*

(b) The Income-tax Act, 1961 provides for taxation of a certain income earned by X. The Double Taxation Avoidance Agreement, which applies to X, excludes the income earned by X from the purview of tax. Is X liable to pay tax on the income earned by him? Discuss. *(4 Marks)*

(c) *A co-operative society engaged in the business of banking seeks your opinion in the matter of eligibility of deduction u/s 80P on the following items of income earned by it during the year ending 31.3.2006:*

   (i) Interest on investment in Government securities made out of statutory reserves

   (ii) Hire charges of safe deposit lockers. *(3 Marks)*

(d) *The Assessing Officer found, during the course of assessment of a firm, that it had paid rent in respect of its business premises amounting to Rs.60,000, which was not debited in the books of account for the year ending 31.3.2005. The firm did not explain the source for payment of rent. The Assessing Officer proposes to make an addition of Rs.60,000 in the hands of the firm for the assessment year 2005-06. The firm claims that even if the addition is made, the sum of Rs.60,000 should be allowed as deduction while computing its business income since it has been expended for purposes of its business. Examine the claim of the firm.* *(2 Marks)*

Answer

(a) The firm is entitled to set off its brought forward business loss amounting to Rs.3,60,000 relating to the assessment year 2005-06 to the extent of Rs.3,30,000 against its business income of Rs.3,30,000 for the assessment year 2006-07 as per the provisions of section 72(1). Section 78(1), which deals with carry forward and set-off of losses in case of change of constitution of firm, is applicable to cases where a partner has retired or died. The section is not applicable to a case where there is a change in the ratio of sharing profits and losses amongst the existing partners. Therefore, section 78(1) is not applicable to the case of M/s. JKLM. The unabsorbed business loss of Rs.30,000 relating to the assessment year 2005-06 will be carried forward for set-off against the business income for the assessment year 2007-08.

(b) Section 90(2) makes it clear that where the Central Government has entered into a Double Taxation Avoidance Agreement, then in respect of an assessee to whom such agreement applies, the provisions of the Act shall apply to the extent they are more beneficial to the assessee. This means that where tax liability is imposed by the Act, the Double Taxation Avoidance Agreement may be resorted to for reducing or avoiding the tax liability.

   The Supreme Court has held, in *CIT v. P.V.A.L. Kulandagan Chettiar (2004) 267 ITR 654,* that in case of any conflict between the provisions of the Double Taxation Avoidance Agreement and the Income-tax Act, 1961, the provisions of the Double Taxation Avoidance Agreement would prevail over those of the Income-tax Act. X is, therefore, not liable to pay tax on the income earned by him.

(c) (i) Interest earned on investment in Government securities made out of statutory reserves by a co-operative society engaged in banking business is eligible for deduction under section 80P as per the decision of the Supreme Court in *CIT v. Karnataka State Co-operative Apex Bank (2001) 251 ITR 194.* In this case, it was held that the placement of such funds being imperative for the purpose of carrying on banking business, the income therefrom would be income from the assessee's business and there is nothing in section 80P which restricts the exemption to only income derived from working or circulating capital.

(ii) Provision of safe deposit lockers is part of the ordinary banking business. Income from hiring of such lockers is income from banking business and, therefore, eligible for deduction under section 80P. Therefore, the society is entitled to deduction under section 80P in respect of hire charges of safe deposit lockers.

(d) The claim of the firm for deduction of the sum of Rs.60,000 in computing its business income is not tenable. The action of the Assessing Officer in making the addition of Rs.60,000, being the payment of rent not debited in the books of account (for which the firm failed to explain the source of payment) is correct in law since the same is an unexplained expenditure under section 69C. The proviso to section 69C states that such unexplained expenditure, which is deemed to be the income of the assessee, shall not be allowed as a deduction under any head of income. Therefore, the claim of the firm is not tenable.

Question 5

(a) S, an individual, filed his return of income for the assessment year 2005-06 erroneously offering for taxation, interest received from notified Relief Bonds exempt under section 10(15)(iic), in the said return. The Assessing Officer completed the assessment under section 143(3) on 20.4.2006 accepting the income returned by S. S had furnished complete particulars relating to the interest income in the return of income. S approaches you for advice regarding the steps to be taken to secure exemption of the income. Advise S about the various remedies available under the Income-tax Act, 1961 for the redressal of his grievance. (6 Marks)

(b) D, a lady, received *the following gifts during the year ending 31.3.2006:*

(i) Rs.30,000 from her elder sister.

(ii) Rs.50,000 from the daughter of her elder sister.

(iii) Rs.1,25,000 from various friends on the occasion of her marriage.

Discuss the taxability or otherwise of these gifts in the hands of D. (4 Marks)

(c) What is the circumstance in which it is not necessary for a non-resident Indian, whose total income is above the taxable limit, to file his return of income under section 139(1)? (2 Marks)

Answer

(a) S can file an appeal under section 246A, against the order of assessment, to the Commissioner (Appeals). The law is well settled that an appeal can be filed by an assessee even against inclusion in assessment, of such income erroneously included by him in the return of income. Reliance is place upon the decision of the Delhi High Court in *CIT v. Bharat General Reinsurance Co. Ltd. (1971) 81 ITR 303.*

If an assessee makes a mistake in submitting a return of income and submits to be assessed on a particular income before the assessing authority, he is not estopped or precluded by law from preferring an appeal and showing to the appellate authority that the income is, in fact, either wholly or partly, not exigible to tax. If such a contention is taken, it is the duty of the appellate authority to examine the matter and determine the proper tax leviable. There is no question of invoking the doctrine of estoppel in such a case *[Narsepalli Oil Mills v. State of Mysore (1973) 32 STC 599 (Mys.)]*

In the alternative, S can file a revision petition under section 264 with the Commissioner of Income-tax seeking exemption of interest from Relief Bonds, not claimed in the return of income and not allowed in the order of assessment.

The other course of action S could take is to file an application under section 154 with the Assessing Officer, seeking rectification of the order of assessment made. The consistent judicial view is that exemption not claimed by the assessee and not allowed by the Assessing Officer, though the material relating thereto was in the return of income, constitutes a mistake apparent from the record within the meaning of section 154 of the Act.

(b) (i) Section 56(2)(v) provides for taxation of gifts exceeding Rs.25,000, received by an individual from any person, under the head "Income from other sources". The proviso thereto states that gifts of money received from any relative would not be so taxed. *Explanation* to section 56(2)(v) defines the term "relative". Sister of the individual is included in the said definition. Therefore, gift of Rs.30,000 received by D from her elder sister is not taxable.

(ii) Daughter of the elder sister of an individual is not a "relative" within the definition of the term as contained in Explanation to section 56(2)(v). Since the amount received from the daughter of her elder sister exceeds Rs.25,000, the whole of the amount gifted shall be included in D's total income. Therefore, the entire sum of Rs.50,000 gifted is taxable in the hands of D.

(iii) The proviso to section 56(2)(v) stipulates that gifts of money received by an individual on the occasion of the marriage of the individual is not taxable. Therefore, gifts amounting to Rs.1,25,000 received by D from her friends on the occasion of her marriage are not taxable.

(c) Section 115G of the Income-tax Act, 1961 provides that it is not necessary for a non-resident Indian to furnish a return of income under section 139(1) if his total income consisted only of investment income or long-term capital gains or both and tax deductible at source under Chapter XVII-B has been deducted from such income.

Question 6

(a) State whether the following persons are liable to pay fringe benefit tax in respect of the fringe benefits provided to their employees:

(i) Hindu undivided family having 30 employees on its rolls in its textile business.

(ii) Charitable trust running a hospital registered under section 12AA. *(3 Marks)*

(b) Examine the liability to fringe benefit tax in respect of the following items of expenditure incurred by a private limited company:

(i) Transport allowance paid to employees exempt under section 10(14) read with rule 2BB.

(ii) Expenditure on conference of dealers.

(iii) Free medical samples distributed to doctors by its pharmaceutical manufacturing unit. (3 Marks)

(c) X, an individual whose total sales in the business of food grains for the year ending 31.3.2005 was Rs.66 lakhs, did not maintain books of account. The Assessing Officer levied penalties 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? (3 Marks)

(d) An assessee sustained a loss under the head "Income from house property" in the previous year relevant to the assessment year 2005-06, which could not be set off against income from any other head in that assessment year. The assessee did not furnish the return of loss within the time allowed under section 139(1) in respect of the relevant assessment year. However, the assessee filed the return within the time allowed under section 139(4). Can the assessee carry forward such loss for set off against income from house property of the assessment year 2006-07? (3 Marks)

Answer

(a) (i) Section 115W(a) defines the term "employer" to mean a company, firm, association of persons, body of individuals, local authority and artificial juridical person. Thus, individual and Hindu Undivided Family have not been included in the definition. Therefore, in the instant case, the Hindu Undivided Family having 30 employees on its rolls in its textile business is not liable to pay fringe benefit tax in respect of fringe benefits provided to its employees.

(ii) Charitable trusts registered under section 12AA do not fall within the meaning of the term "employer" as defined in section 115W(a), since the proviso to section 115W(a) specifically provides that any person registered under section 12AA shall not be deemed to be an employer for the purposes of Chapter XIIH. Therefore, the charitable trust running a hospital registered under section 12AA is not liable to pay fringe benefit tax in respect of fringe benefits provided to its employees.

(b) (i) Transport allowance falls within the meaning of "salary" as defined in section 17(1). Any expenditure incurred for the purposes of salary does not fall within the purview of fringe benefits. Therefore, transport allowance paid to the employees is not liable to fringe benefit tax.

(ii) As per section 115WB(2)(C), expenditure incurred for the purpose of conference is liable to fringe benefit tax. It is immaterial whether the conference is of agents or dealers or any other persons. Therefore, expenditure incurred for the purpose of conference of dealers is liable to fringe benefit tax.

(iii) The Supreme Court, in *Eskayef Ltd. v. CIT 245 ITR 116,* has held that expenditure on free medical samples distributed to doctors is in the nature of sales promotion. As such, expenditure on free medical samples distributed to doctors by the pharmaceutical manufacturing unit of the company would be liable to fringe benefit tax under section 115WB(2)(D).

Note – These clarifications on the above issues have been given by the CBDT in Circular No.8 dated 29.8.2005.

(c) X has not maintained books of account though he was required under the Income-tax Act to do so since his gross sales exceeded Rs.40 lakhs. He is liable to pay penalty under section 271A for such default. 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 X 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.

(d) Section 139(3) stipulates that an assessee claiming carry forward of loss under the heads "Profits and gains of business or profession" or "Capital gains" should furnish the return of loss within the time stipulated under section 139(1). There is no reference to loss under the head "Income from house property" in section 139(3). The assessee, in the instant case, has filed the return showing loss from property within the time prescribed under section 139(4). The assessee is, therefore, entitled to carry forward such loss for set off against the income from house property of the assessment year 2006-07.

Question 7

(a) A foreign company entered into contracts with several Indian companies for installation of mobile telephone system and made an application to the Authority for Advance Rulings for advance ruling on the rate of withholding tax on receipts from Indian companies. One of the Indian companies made an application to its Assessing Officer for determination of the rate at which tax is deductible on payment to the said foreign company. The Authority for Advance Rulings rejected the application of the foreign company on the ground that the question raised in the application is already pending before an income tax authority. Is the rejection of the application of the foreign company justified in law? (8 Marks)

(b) Can an employee of a State Government claim exemption under section 10(10C) in respect of compensation received on voluntary retirement to the extent of Rs.5 lakhs and

relief under section 89(1) in respect of the amount of compensation in excess of Rs.5 lakhs? *(4 Marks)*

(c) *(i)* *J inherits a house property from his father, who had mortgaged it. J discharges the mortgage debt. J later sells the property. Can he claim the amount paid to the mortgagee as cost of improvement in computing the capital gain?*

(ii) *L mortgaged his house property and utilized the mortgage amount to perform the marriage of his son. He paid the amount to the mortgagee later. Upon sale of the said property thereafter, he claims the mortgage debt discharged as forming part of the cost of acquisition. Can capital gain be computed accepting his claim?*

(4 Marks)

Answer

(a) The matter relates to the admission or rejection of the application filed before the Advance Ruling Authority on the grounds specified in clause (i) of the first proviso to sub-section (2) of section 245R of the Income-tax Act, 1961.

Clause (i) of the first proviso of section 245R(2) provides that the Authority shall not allow the application where the question raised in the application is already pending before any income-tax authority or Appellate Tribunal or any court.

In the above case, no application had been filed or contention urged by the applicant (foreign company) before any income-tax authority/Appellate Tribunal/court, raising the question raised in the application filed with AAR. One of the Indian companies, however, had raised the question before the Assessing Officer, not on the applicant's behalf or with a view to benefit the applicant, but only to safeguard its own interest, as it had a statutory duty to deduct the proper amount of tax from payments made to a non-resident. Although the question raised pertains to one of the payments made or to be made to the non-resident applicant, it was not one pending determination before any income-tax authority in the applicant's case.

Therefore, as held by the AAR in *Ericsson Telephone Corporation of India AB v. CIT (1997) 224 ITR 203,* the application filed by the Indian company before the Assessing Officer cannot be treated to have been filed by the non-resident. Hence, it would not be proper to reject the application of the foreign company relying on clause (i) of the proviso to sub-section (2) of section 245R of the Income-tax Act. The application is, therefore, maintainable.

(b) The Income-tax Act, 1961 does not contain any provision which prohibits an assessee from claiming both exemption under section 10(10C) and relief under section 89(1) in respect of compensation which has been offered for taxation in the same assessment year. Sections 10(10C) and 89(1) are independent provisions. There is no element of exemption being sought while claiming relief under section 89(1). Compensation constitutes profits in lieu of salary, which is included in the definition of salary under section 17(1). Voluntary retirement compensation upto Rs.5 lakhs is exempt under section 10(10C). The amount in excess of Rs.5 lakhs is taxable as salary, in respect of which relief has to be granted under section 89(1). The Madras High Court in *CIT v. G.V.*

Venugopal (2005) 273 ITR 0307 (Mad.) and Karnataka High Court in *CIT v. P. Surendra Prabhu (2005) 279 ITR 0402* have taken this view.

The employee of the State Government can, therefore, claim exemption under section 10(10C) in respect of compensation received on voluntary retirement to the extent of Rs.5 lakhs and relief under section 89(1) in respect of the amount of compensation in excess of Rs.5 lakhs.

(c) (i) J inherited the house property with the liability to discharge the mortgage debt. He can, therefore, claim the amount paid to the mortgagee as cost of improvement while computing the capital gain on sale of the said property. The decision of the Supreme Court in *RM. Arunchalam v. CIT (1997) 227 ITR 222* supports this view.

(ii) L has himself created the mortgage in respect of his house property. It is a self-created mortgage. Therefore, the debt discharged by L on the property under mortgage created by him does not form part of cost of acquisition. The decision of the Supreme Court in *V.S.M.R. Jagadish Chandran v. CIT (1997) 227 ITR 240* supports this view. Therefore, capital gain on sale of the property cannot be computed on the basis of the claim made by him.

Note – This question can also be answered with reference to the recent Bombay High Court ruling in *CIT v. Roshanbabu Mohammed Hussein Merchant (2005) 144 Taxman 720 / 275 ITR 0231*. This case highlights the difference in tax treatment in respect of allowability of the expenditure incurred on removing an encumbrance in two different cases, namely –

(i) In a case where the mortgage is created by the previous owner and

(ii) In a case where the mortgage is created by the assessee himself.

The Bombay High Court pointed out that there is a distinction between the obligation to discharge the mortgage debt created by the previous owner and the obligation to discharge the mortgage debt created by the assessee himself. Where the property acquired by the assessee is subject to the mortgage created by the previous owner, the assessee acquires absolute interest in that property only after the discharge of mortgage debt. In such a case, the expenditure incurred by the assessee to discharge the mortgage debt created by the previous owner to acquire absolute interest in the property is treated as 'cost of acquisition' and is deductible from the full value of consideration received by the assessee on transfer of that property. However, where the assessee acquires property which is unencumbered, the assessee gets absolute interest in that property on acquisition. When the assessee transfers that property, he is liable for capital gains tax on the full value realized, even if he has himself created an encumbrance on that property. The assessee is under an obligation to remove that encumbrance for effectively transferring the property. In other words, the expenditure incurred by the assessee to remove the encumbrance created by the assessee himself on the property (which was acquired by him without any encumbrance) is not an allowable deduction under section 48.

Question 8

G, an individual, furnishes the following particulars of his assets and liabilities as on 31.3.2006:

Assets:	*Rs. in lakhs*
Residential house at New Delhi	*25*
Residential house at Agra	*15*
Plot of land comprising an area of 450 square meters at Mumbai	*60*
House at New Delhi exclusively used for carrying on his business	*15*
Commercial complex at Agra	*20*
Residential house at Chennai let out for 335 days during the relevant previous year	*10*
Motor cars used in business of running them on hire	*20*
Shares in private limited companies	*25*
Cash in hand	*3*
Gold jewellery	*12*
Liabilities:	
Loan borrowed for purchase of land at Mumbai	*20*
Loan borrowed for purchase of shares in private limited companies	*10*
Loan borrowed for purchase of gold jewellery	*6*

Amounts stated against assets, except cash in hand, are the values determined as per section 7 of the Wealth-tax Act, 1957 read with Schedule III thereto.

Compute the net wealth of G for the assessment year 2006-07.

State the reasons for inclusion or exclusion of the various items. *(10 Marks)*

Answer

Computation of net wealth of G for the A.Y. 2006-07

	Particulars	Amount in Rs.
(a)	Residential house at New Delhi is an asset	25,00,000
(b)	Residential house at Agra is an asset	15,00,000
(c)	Plot of land comprising an area of 450 square meters at Mumbai is an asset but exempt under section 5(vi)	Nil
(d)	House at New Delhi exclusively used for carrying on his business is not an asset	Nil
(e)	Commercial complex at Agra is not an asset	Nil
(f)	Residential house at Chennai let out for 335 days during the relevant	Nil

	previous year is not an asset	
(g)	Motor cars used in the business of running them on hire is not an asset	Nil
(h)	Shares in private limited companies is not an asset	Nil
(i)	Cash in hand in excess of Rs.50,000 is not includible in net wealth	2,50,000
(j)	Gold jewellery is an asset	12,00,000
		54,50,000
	Less: Debts incurred in relation to assets	
(k)	Loan borrowed for purchase of land at Mumbai (not deductible since exemption under section 5(vi) has been claimed in respect of the said land)	Nil
(l)	Loan borrowed for purchase of shares in private limited companies (not deductible since shares are not included in net wealth)	Nil
(m)	Loan borrowed for purchase of gold jewellery	6,00,000
	Net Wealth	48,50,000

Reasons for inclusion or exclusion of the various items are furnished below:

(a) Residential house at New Delhi is included, as residential house is an "asset" within the meaning of section 2(ea) of the Wealth Tax Act, 1957. Exemption under section 5(vi) is not claimed in respect of this house as it is more beneficial for the assessee to claim exemption in respect of plot of land at Mumbai whose value is higher.

(b) Residential house at Agra is an asset u/s 2(ea) and, therefore, included in the net wealth.

(c) Plot of land measuring 450 square metres at Mumbai is exempt under section 5(vi) and, therefore, does not form part of net wealth. One house or part thereof or a plot of land, not exceeding 500 square metres, belonging to an individual or a Hindu Undivided Family is exempt u/s 5(vi) without any monetary ceiling.

(d) House at New Delhi, occupied for own business purposes, is excluded from net wealth as it is not an asset.

(e) Commercial complex at Agra is excluded as it is not an asset.

(f) Any residential property let out for a minimum period of 300 days in the previous year is not considered as an asset. Residential house at Chennai let out for more than 300 days is, therefore, excluded from net wealth.

(g) Motor cars used in business of running them on hire are not assets as per section 2(ea)(ii) and, therefore, excluded from net wealth.

(h) Shares in private limited companies are not assets and, therefore, excluded from net wealth.

(i) Cash in hand, in excess of Rs.50,000, of individuals constitutes an asset. Therefore, Rs.2,50,000, being cash in hand in excess of Rs.50,000, is included in net wealth.

(j) Gold jewellery constitutes an asset as per section 2(ea) and is includible in net wealth.

(k) Debts incurred in relation to an exempted asset are not deductible in computing net wealth. Loan borrowed for purchase of land at Mumbai is not deductible as exemption under section 5(vi) has been claimed in respect of the said land.

(l) Loan borrowed for purchase of shares in private limited companies is not deductible while computing net wealth as shares are not included in net wealth.

(m) Gold jewellery, being an asset, has been included in the net wealth. Therefore, loan borrowed for purchase thereof is deductible in computing the net wealth.

The suggested answers for Indirect Taxes (Paper 8) are based on the provisions as amended by Finance Act, 2005 and Notifications/Circulars issued up to 31.10.2005 which are relevant for May 2006 examinations.

PAPER – 8 : INDIRECT TAXES

Question Nos. 1, 6 and 9 are compulsory. In addition thereto, answer any two questions from Part "A" and one question from Part "B".

PART – A

Question 1

(a) Briefly explain any two of the following with reference to the provisions of Central Excise Act, 1944:

(i) Wholesale dealer

(ii) Factory

(iii) Dutiability of waste and scrap (2 x 2 = 4 Marks)

(b) With reference to CENVAT Credit Rules, 2004, discuss giving reason whether the following statements are true or false:

(i) Credit of duties of excise on inputs will not be available if inputs are used in intermediate product, which is exempt from duty, even though the final product is dutiable.

(ii) A manufacturer can sell the inputs on which CENVAT credit has already been availed of, as they are, provided he pays the amount equal to the credit availed.

(iii) A manufacturer is eligible for CENVAT credit in the cases stated below:

(1) Inputs used in trial runs;

(2) Materials used for maintaining factory building. (3 x 2 = 6 Marks)

(c) With reference to the Central Excise Act, 1944 and the rules thereunder, explain briefly whether the following persons require registration or not?

(i) Persons, who manufacture excisable goods chargeable to 'nil' rate of duty;

(ii) Central Government undertakings manufacturing excisable goods;

(iii) 100% EOU. (3 x 2 = 6 Marks)

(d) ABC Company imported medicines in pallets with one big box containing assorted medicines in smaller units which were, then, repacked in thermocole boxes of different sizes which again were put into cardboard boxes. The cardboard boxes were in turn labelled containing, interalia, the name of the medicine, the name of the manufacturer, the quantity, batch no., manufacturing date, expiry date and name of the marketing agency. The department relying upon note 5 to chapter 30, claimed that the activities as aforesaid amount to manufacture i.e., bulk pack to retail pack.

Decide whether the above activities tantamount to manufacture. (4 Marks)

Answer

(a) (i) As per section 2(k) of the Central Excise Act, 1944, wholesale dealer means a person who buys or sells excisable goods wholesale for the purpose of trade or manufacture and includes a broker or commission agent who, in addition to making contracts for the sale or purchase of excisable goods for others, stocks such goods belonging to others as an agent for the purpose of sale.

(ii) As per section 2(e) of the Central Excise Act, 1944, factory means any premises, including the precincts thereof, wherein or in any part of which excisable goods other than salt are manufactured, or wherein or in any part of which any manufacturing process connected with the production of these goods is being carried on or is ordinarily carried on.

(iii) The issue relating to dutiability of waste and scrap was settled by the Supreme Court by its decision in *Khandelwal Metal & Engineering Works Vs Union of India 1985 20 ELT 222* by holding that notwithstanding that process waste and scrap arose as intermediate products or by-products out of final products, such process waste and scrap, if marketable, would be chargeable to duty in view of the incorporation of the specific sub-headings in various chapters of the tariff. The Apex court has held that process waste and scrap is a commercially distinct and identifiable product and has commercial value. Hence, such waste and scrap is chargeable to duty if covered in the Tariff.

Therefore, the position as it currently stands is that all process waste and scrap if incorporated in the Tariff and if marketable would be chargeable to duty. It is important to note here that as the excise duty is on manufacture, the waste and scrap actually generated in the course of manufacture alone is chargeable to duty and the waste and scrap generated without any process is not liable to excise duty.

(b) (i) False. It was held in *CCEx. v. Hindustan Sanitaryware 2002 (145) ELT 3 (SC)* that CENVAT credit would be available in respect of duty paid on inputs even if intermediate product is exempt from duty but the final product is dutiable. Further, the Central Board of Excise and Customs has clarified vide *Clarification No. B-4/7/2000-TRU, dated 03.04.2000* that the CENVAT credit shall not be denied if the inputs are used in any intermediate product of the final product even if such intermediate product is exempt from payment of duty so long as the final product is dutiable. The basic idea is that CENVAT credit should be admissible so long as the inputs are used in or in relation to the manufacture of dutiable final products, whether directly or indirectly.

(ii) True. Rule 3(5) of CENVAT Credit Rules, 2004 *inter alia* provides that a manufacturer of the final products can remove inputs on which CENVAT credit has been taken, as such, from the factory if he pays an amount equal to the credit availed in respect of such inputs and such removal is made under the cover of an invoice referred to in rule 9 of CENVAT Credit Rules, 2004.

(iii) 1. True. Inputs used in trial runs during the production or commissioning of plant are eligible for CENVAT credit as they are considered to have been used in or in relation to the manufacture of final product *[Fertiliser Corporation of India v. CCE 1990 (50) ELT 494 CEGAT].*

2. False. Materials used for maintaining factory building only facilitate manufacture and are not integrally used in or in relation to manufacture of final products and hence are not eligible for CENVAT Credit.

(c) (i) No, because manufacturers of goods which are chargeable to 'NIL' rate of duty are exempt from registration provided a declaration is filed.

(ii) Yes, as the provisions of section 6 of the Central Excise Act, 1944 read with rule 9 of Central Excise Rules, 2002 apply in respect of every person who manufactures or produces excisable goods (including Central/State Government Undertakings or undertakings owned or controlled by autonomous corporations) in India.

(iii) No, as 100% EOU is deemed to be registered under Rule 9. However, such unit shall be required to get itself registered if it removes excisable goods to domestic tariff area (DTA) or procure excisable goods from DTA.

(d) The facts of the case are similar to the case of *CCEx., Mumbai v. Johnson & Johnson Ltd., 2005 (188) ELT 467 (SC)*. While dismissing the case, the Supreme Court observed that merely packing for being marketed does not amount to manufacture for the purpose of Note 5 to Chapter 30 of Central Excise Tariff. The products have to be repacked from *bulk packs to retail packs* so as to make them marketable to the consumer for the activity to be termed as 'manufacture'. In that case there was no evidence relied upon by the department to the effect that the cardboard boxes or the thermocole containers in which the units were placed were 'retail packs'.

In view of the abovementioned decision, the activity of repacking described in the question would not amount to manufacture.

Question 2

(a) The assessee was a manufacturer of I.C. engine parts like piston and gudgeon pins. He used to procure from the market piston rings and circlips and supply them along with the items that he had manufactured, to the buyers. He was also selling these procured items separately. The department contended that those bought-out items, supplied along with the manufactured items, were part of piston assembly and therefore, their value should be included in the value of the piston assemblies cleared by the manufacturer. But the assessee contended that the piston rings and circlips were all different parts of I.C. engine and therefore they were not to be considered as parts of another item.

Decide whether the contention of the department is correct or not. (6 Marks)

(b) Explain whether an application from an NRI for advance ruling under section 23C, regarding determination of whether a certain process would amount to manufacture, is maintainable? (4 Marks)

(c) *State the procedure for valuing excisable goods that are to be sold from depot/branch or premises of a consignment agent under the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000.* *(5 Marks)*

Answer

(a) This problem is based on the case of *Goetze (India) Ltd. v. CCEx, Chandigarh 2004 (169) ELT 274 (Tri.-Del.).* The case was decided in favour of the assessee. The Tribunal observed that the trading practice made it clear that each of the item was bought and sold separately and not as parts of one item. The fact that they were assembled together in an I.C. engine or that each part had an integral function in an assembly was not sufficient to hold that one item formed part of another item.

The Tribunal reiterated the well settled law that excise duty was a levy on manufacture and a manufacturer would be liable to pay duty on the goods manufactured by him and not on all the goods supplied by him. Therefore, it was decided by the Tribunal that value of such items would not be included in the assessable value of the manufactured goods.

In view of the abovementioned decision, the contention of the department is not correct.

(b) As per section 23C of the Central Excise Act, 1944, advance ruling can be sought only in respect of the following matters:

(i) classification of any goods under the Central Excise Tariff Act, 1985.

(ii) notifications issued in respect of excise duty under the Central Excise Act, the Central Excise Tariff Act and duty chargeable under any other law for the time being in force.

(iii) applicability of exemption notification issued under section 5A having effect on rate of duty.

(iv) principles to be adopted for determination of value of goods.

(v) admissibility of credit of excise duty paid or deemed to have been paid on the goods used in or in relation to the manufacture of the excisable goods.

Thus, a person cannot obtain an advance ruling to decide whether a process would amount to manufacture or not as such a matter is not covered by section 23C. Further, it was held in *Shonkh Technologies International Ltd. (AAR)* that an application for advance ruling cannot be maintained in respect of determination of a question as to whether a process amounts to manufacture or not.

(c) As per rule 7 of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 where the excisable goods are not sold by the assessee at the time and place of removal but are transferred to a depot, premises of a consignment agent or any other place or premises (hereinafter referred to as 'such other place') from where the excisable goods are to be sold after their clearance from the place of removal and where the assessee and the buyer of the said goods are not related and the price is the sole consideration for the sale, the value shall be the normal transaction value of such goods sold from such other place at or about the same time and, where such goods are not sold at or about the same time, at the time nearest to the time of removal of goods under assessment.

Question 3

(a) Explain the provisions regarding maintenance of daily stock account of stored goods under rule 10(1) of Central Excise Rules, 2002. (4 Marks)

(b) Write a short note on the procedure in respect of exported goods subsequently re-imported and returned to factory. (5 Marks)

(c) Comment on the following:

(i) Excise department cannot challenge the reasonability of MRP printed on the package.

(ii) If any excisable goods are exempted from duty of excise absolutely, the manufacturer of such goods will be bound to avail of the exemption.

(iii) SSI units whose turnover exceeds Rupees 90 lakhs per annum have to give a declaration in the prescribed form.

(iv) Annual Financial Information Statement (ER-4) is required to be submitted by the assesses paying duty of Rs. 4 crores or above per annum through PLA.

(4 x 1 = 4 Marks)

(d) What is CT-1 certificate? (2 Marks)

Answer

(a) As per Rule 10(1) of the Central Excise Rules, 2002 a daily stock account has to be maintained by every assessee. The records should be maintained on daily basis in a legible manner, indicating particulars regarding:

(a) description of goods produced or manufactured

(b) opening balance

(c) quantity produced or manufactured

(d) inventory (i.e. stock) of goods

(e) quantity removed

(f) assessable value

(g) amount of duty payable and

(h) particulars regarding amount of duty actually paid

The first and last page of such account book shall be duly authenticated by the producer or manufacturer or his authorized agent. All such records shall be preserved for 5 years. Separate records for different grades/qualities are to be kept.

(b) Exported excisable goods, which are re-imported for carrying out repairs, reconditioning, refining, remaking or subject to any similar process, may be returned to the factory of manufacturer for carrying out the said processes and subsequent re-export.

Notification No. 42/2001-CE (NT) as amended prescribes the procedure in respect of exported goods subsequently re-imported and returned to the factory as under:

(i) The manufacturer shall maintain separate account for return of such goods in the daily stock account and shall make suitable entry in the said account after the goods are processed, repaired, reconditioned, refined or remade.

(ii) Such re-import and re-export shall be governed by the provisions of the Customs Act, 1962.

(iii) Any waste or refuse arising as a result of the said processes shall be removed from the factory after the payment of appropriate duty or destroyed after informing the proper officer in writing at least 7 days in advance and after observing such conditions and procedure as may be specified by the Commissioner of Central Excise.

(iv) Thereafter, the duty payable on such waste or refuse may be remitted by the said Commissioner of Central Excise.

(c) (i) True. The central excise department cannot challenge the reasonability of MRP printed on the package. It can only satisfy itself that there is a declaration of MRP in prescribed form *[ITC Ltd. v. CCEx., New Delhi 2004 (171) ELT 433 (SC)].*

(ii) True. As per section 5A(1A) of the Central Excise Act, 1944, if any excisable goods is exempt from duty of excise absolutely, the manufacturer of such goods will be bound to avail the exemption.

(iii) False. SSI units whose turnover exceeds Rs.40 lakhs per annum have to give a declaration in the prescribed form.

(iv) False. Annual Financial Information Statement (ER- 4) is required to be submitted by the assessees paying duty of Rs.1 crore or above per annum through PLA.

(d) CT-1 certificate is the document on the basis of which a merchant-exporter can procure excisable goods for export without payment of duty. Such a certificate has to be obtained from the Superintendent of Central Excise. CT-1 forms are issued to the merchant-exporter in lots of 25 covering a period of 1 to 3 months depending on his track record. The merchant-exporter has to send the CT-1 form to the manufacturer from whom the goods are to be procured for exports and should specify the estimated amount of duty liability in the said certificate. CT- 1 is valid for one year from the date of issue.

CT-1 contains the details of bond amount, quantity of goods to be received, value and duty involved.

Question 4

(a) *A SSI unit has effected clearances of goods of the value of Rs. 475 lacs during the financial year 2005-06. The said clearances include the following:*

(i)	*Clearance of excisable goods without payment of excise duty to a 100% EOU*	*Rs.120 lacs*
(ii)	*Job work in terms of Notification No. 214/86 CE, which is exempt from duty*	*Rs.75 lacs*
(iii)	*Export to Nepal and Bhutan*	*Rs.50 lacs*
(iv)	*Goods manufactured in rural area with the brand name of the others*	*Rs.90 lacs*

Examine with reference to the notification governing SSI under the Central Excise Act whether the benefit of exemption would be available to the unit for the financial year 2006-07. *(5 Marks)*

(b) *(i) Whether provisional assessment can be initiated by the department of excise?*

(ii) What is the remedy available with the department in case assessing officer does not find the self assessment filed by the assessee in order? *(2 + 3 = 5 Marks)*

(c) *State the provisions relating to confiscation and penalty under CENVAT Credit Rules, 2004.* *(5 Marks)*

Answer

(a) A SSI unit shall be eligible for benefit of exemption notification only if value of clearances during preceding financial year does not exceed Rs.400 lakhs.

The item wise treatment shall be as under -

1. Clearance to 100% EOU shall be excluded for calculating the limit of 400 lakhs.
2. Clearance under *Notification No. 214/86* shall be excluded for calculating the limit of 400 lakhs.
3. Export to Nepal & Bhutan is considered as home consumption and thus, it shall be included for computing limit of 400 lakhs.
4. The turnover of goods manufactured in rural area with the brand name of the others shall be included for computing limit of Rs.400 lakhs.

Calculation of clearances during financial year 2005-06:

Total value of clearances		475 lakhs
Less: Clearance to 100% EOU	120 lakhs	
Clearance under *Notification No. 214/86*	75 lakhs	195 lakhs
		280 lakhs

As the value of clearances for home consumption in financial year 2005-06 does not exceed Rs. 400 lakhs, the benefit of exemption shall be available to the SSI unit during financial year 2006-07.

(b) (i) Rule 7 of the Central Excise Rules, 2002 gives an option to the assessee to make a request to the Assistant Commissioner/Deputy Commissioner of Central Excise for provisional assessment in case he is unable to determine the value of excisable goods or the rate of duty applicable thereto. Rule 7 does not give power to the department to order provisional assessment on its own. Thus, the excise department cannot *suo motu* issue directions for resorting to provisional assessment.

(ii) Where the central excise officers during scrutiny or otherwise find that self-assessment is not in order, they may ask the assessee for all necessary documents, records or other information for issue of duty demand for differential duty, if any, after conducting inquiry.

If the assessee fails to provide such records or information, the department may raise the demand based on collateral evidences. In such a case, the burden will be on the assessee to provide information for appropriate re-determination of duty.

(c) (1) If any person, takes CENVAT credit in respect of input or capital goods, wrongly or without taking reasonable steps to ensure that appropriate duty on the said input or capital goods has been paid as indicated in the document accompanying the input or capital goods specified in rule 9, or contravenes any of the provisions of these rules in respect of any input or capital goods, then, all such goods shall be liable to confiscation and such person, shall be liable to a penalty not exceeding the duty on the excisable goods in respect of which any contravention has been committed, or ten thousand rupees, whichever is greater.

(2) In a case, where the CENVAT credit in respect of input or capital goods has been taken or contravention of any of the provisions of the Excise Act or the rules made thereunder with intention to evade payment of duty, then, the manufacturer shall also be liable to pay penalty in terms of the provisions of section 11AC of the Excise Act.

(3) If any person, takes CENVAT credit in respect of input services, wrongly or without taking reasonable steps to ensure that appropriate service tax on the said input services has been paid as indicated in the document accompanying the input services specified in rule 9, or contravenes any of the provisions of these rules in respect of any input service, then, such person, shall be liable to a penalty which may extend to an amount not exceeding ten thousand rupees.

(4) In a case, where the CENVAT credit in respect of input services has been taken or utilized wrongly by reason of fraud, collusion, willful mis-statement, suppression of facts, or contravention of any of the provisions of the Finance Act or of the rules made thereunder with intention to evade payment of service tax, then the provider

of output service shall also be liable to pay penalty in terms of the provisions of the section 78 of the Finance Act.

(5) Any order under points (1), (2), (3) or (4) shall be issued by the Central Excise Officer following the principles of natural justice.

Question 5

(a) Write a note on duty payment 'Under protest' with reference to the Central Excise Act, 1944 and the rules made thereunder. (3 Marks)

(b) What are the orders that are appealable to Supreme Court under the Central Excise Act 1944? (3 Marks)

(c) Explain briefly the provisions relating to 'Special Audit' in certain cases under section 14A of the Central Excise Act, 1944. (5 Marks)

(d) What is Consumer Welfare Fund? How is this fund utilized? (4 Marks)

Answer

(a) 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) As per section 35L of the Central Excise Act, 1944, an appeal shall lie to the Supreme Court from

(a) any judgment of the High Court delivered -

(i) in an appeal made under section 35G or

(ii) on a reference made under section 35G by the Appellate Tribunal before the 1st day of July, 2003 or

(iii) on a reference made under section 35H if the High Court certifies the case to be fit for appeal to the Supreme Court. The High Court can certify any case on its own motion or on an oral application made by or on behalf of the aggrieved party, immediately after passing of the judgement.

(b) any order of the Appellate Tribunal having relation to the determination of rate of duty or value of goods, among other things.

(c) If at any stage of enquiry, investigation or any other proceedings before him, any Central Excise Officer not below the rank of an Assistant/Deputy Commissioner of Central Excise having regard to the nature and complexity of the case and the interest of revenue, is of the opinion that the value has not been correctly declared or determined by a manufacturer or any person, he may, with the previous approval of the Chief Commissioner of Central Excise, direct such manufacturer of such person to get the accounts of his factory, offices, depots, distributors or any other place, as may be specified by the said Central Excise officer, audited by a Cost Accountant, nominated by the Chief Commissioner of Central Excise in this behalf.

The Cost Accountant shall submit the audit report duly signed and certified to the said Central Excise Officer within the period specified by him or the period further extended on an application made to him. However, in any case the aggregate of the original and extended period cannot exceed 180 days.

The manufacturer shall be given an opportunity of being heard in respect of any material gathered on the basis of audit and proposed to be utilized in any proceedings under the Central Excise Act or Rules. This special audit can be conducted notwithstanding that the accounts of the manufacturer or the person have been audited under any other law for the time being in force or otherwise.

(d) The Consumer Welfare Fund is established by the Central Government under section 12C of the Central Excise Act, 1944 wherein the following amounts are credited:-

(i) the refund of duty of excise/customs, which is not to be granted to the applicant.

(ii) any income from investment of the amount credited to the Fund and any other monies received by the Central Government for the purposes of this Fund.

As per section 12D, any money credited to the fund shall be utilized by the Central Government for the welfare of the consumers in accordance with such rules framed in this behalf. The Central Government shall maintain or, if it thinks fit, specify the authority, which shall maintain, proper and separate account and other relevant records in relation to the Fund in such form as may be prescribed in consultation with the Comptroller and Auditor General of India.

PART - B

Question 6

(a) Briefly explain with reference to the provisions of the Customs Act, any two of the following:

(i) Indian customs waters

(ii) Person-in-charge

(iii) Foreign going vessel or aircraft *(2 x 2 = 4 Marks)*

(b) M/s. AJ imported some inputs and paid basic customs duty Rs.5 lakhs, surcharge on customs duty Rs.50,000 and CVD Rs.1 lakh. Calculate the amount that he can claim as CENVAT credit. Would it make any difference, if the assessee is not a manufacturer but a service provider? *(3 Marks)*

(c) Explain the meaning of:

(i) Similar goods

(ii) Identical goods *(6 Marks)*

(d) Briefly elucidate the meaning of "Importer" under the Customs Act. *(2 Marks)*

(e) (i) If the applicant does not co-operate or obtains order by fraud, whether the Settlement Commission is empowered to send the case back to the officer for further action as per law ? Answer in the light of amended provisions of section 127MA of the Customs Act, 1962.

(ii) What is meant by 'boat notes'? *(3 + 2 = 5 Marks)*

Answer

(a) (i) As defined by section 2(28) of the Customs Act,1962 'Indian customs waters' means the waters extending into the sea up to the limit of contiguous zone of India under section 5 of the Territorial waters, Continental Shelf, Exclusive Economic Zone and other Maritime Zones Act, 1976, and includes any bay, gulf, harbour, creek or tidal river.

(ii) As per section 2(31) of the Customs Act, 1962 person-in-charge means-

(a) in relation to a vessel, the master of the vessel;

(b) in relation to an aircraft, the commander or the pilot-in-charge of the aircraft;

(c) in relation to a railway train, the conductor, guard or other person having the chief direction of the train;

(d) in relation to any other conveyance, the driver or other person-in-charge of the conveyance.

(iii) As per section 2(21) of the Customs Act, 1962, foreign going vessel or aircraft means any vessel or aircraft for the time being engaged in the carriage of goods or passengers between any port or airport in India and any port or airport outside India, whether touching any intermediate port or airport in India or not, and includes-

(a) any naval vessel of any foreign Government taking part in any naval exercises;

(b) any vessel engaged in fishing or any other operations outside the territorial waters of India;

(c) any vessel or aircraft proceeding to a place outside India for any purpose whatsoever.

(b) M/s. AJ can take credit of Rs.1,00,000 i.e. of additional duty of customs (CVD). Rule 3(1) of CENVAT Credit Rules, 2004 allows the credit of additional duty of customs imposed under section 3 of the Customs Tariff Act, 1975. The credit of other two duties i.e. basic custom duty and the surcharge on customs duty is not allowed.

It will not make any difference if the assessee is a service provider as credit of additional duty of customs (CVD) can be availed both by the manufacturers and the service providers alike.

Note: It has been assumed that the additional duty of customs (CVD) referred to in the question is not the additional duty of customs (CVD) leviable under section 3(5) of the Customs Tariff Act, 1975 as in that case the service provider will not be entitled to avail the CENVAT credit.

(c) (i) As per rule 2(e) of Customs Valuation (Determination of Price of Imported Goods) Rules, 1988, similar goods means imported goods

(a) which although not alike in all respects, have like characteristics and like component materials which enable them to perform the same functions and to be commercially interchangeable with the goods being valued having regard to the quality, reputation and the existence of trade mark;

(b) produced in the country in which the goods being valued were produced; and

(c) produced by the same person who produced the goods being valued, or where no such goods are available, goods produced by a different person,

but shall not include imported goods where engineering, development work, art work, design work, plan or sketch undertaken in India were completed directly or indirectly by the buyer on these imported goods free of charge or at a reduced cost for use in connection with the production and sale for export of these imported goods.

(ii) As per rule 2(c) of Customs Valuation (Determination of Price of Imported Goods) Rules, 1988, identical goods means imported goods-

(i) which are same in all respects, including physical characteristics, quality and reputation as the goods being valued except for minor differences in appearance that do not effect the value of the goods;

(ii) produced in the country in which the goods being valued were produced; and

(iii) produced by the same person who produced the goods, or where no such goods are available, goods produced by a different person,

but shall not include imported goods where engineering, development work, art work, design work, plan or sketch undertaken in India were completed directly or indirectly by the buyer on these imported goods free of charge or at a reduced cost for use in connection with the production and sale for export of these imported goods.

(d) As per section 2(26) of the Customs Act, 1962 importer in relation to any goods at any time between their importation and the time when they are cleared for home consumption, includes any owner or any person holding himself out to be the importer.

(e) (i) As per the provisions of section 127-I, if the applicant does not cooperate, the Settlement Commission can send the case back to the proper officer for further action as per law. Similarly, as per section 127C(11) read with section 127C(9), if the order is obtained by misrepresentation of facts or fraud, the order stands void and the proceedings with respect to the matters covered by the settlement shall be deemed to have been revived from the stage at which the application was allowed to be proceeded with by the Settlement Commission and proper officer may, notwithstanding anything contained in any other provision of the Customs Act, complete such proceedings at any time before the expiry of two years from the date of the receipt of communication that the settlement became void.

Section 127MA of the Customs Act, 1962 has been amended by the Finance Act, 2005 with effect from 13.05.2005 to provide for sending back of a case to the Appellate Tribunal by the Settlement Commission in the event of non-cooperation by the assessee. Section 127MA does not provide for sending back of a case to the proper officer. It must be noted that section 127MA is only of academic importance in view of the fact that it applies only in respect of the applications filed on or before 29.02.2000.

(ii) In case the vessel arriving at the port does not get a birth, then, the import cargo is taken from the ship to the shore and the export cargo is taken from the shore to the ship in boats. Section 35 of the Customs Act, 1962 stipulates that no imported goods shall be water borne for being loaded in any vessel, and no export goods which are not accompanied by a shipping bill, shall be water borne for being shipped unless the goods are accompanied by a 'boat note' in the prescribed form.

Question 7

(a) What is the purpose of interpretation rules regarding Customs Tariff? Do they form part of the tariff schedule? Explain the 'Akin Rule' of interpretation. (4 Marks)

(b) What do you understand by first appraisement and second appraisement systems under the Customs Act, 1962? (4 Marks)

(c) State the procedure for clearance of goods imported by post. (5 Marks)

(d) Can the rate of drawback be determined provisionally by the exporter? Briefly explain. (2 Marks)

Answer

(a) The Customs Tariff has a set of six rules for interpretation of the tariff schedule and two general explanatory notes. The six rules of interpretation and two general explanatory notes are integral part of the schedule. The purpose of their inclusion is:

(i) to give clear direction as to how the nomenclature in the schedule is to be interpreted and

(ii) to give statutory force to the interpretation rules and the general explanatory notes.

Rule 4 of the rules of interpretation is called as akin rule. This rule lays down that goods which cannot be classified in accordance with rules 1, 2 and 3 of the rules of interpretation shall be classified under the heading appropriate to the goods to which they are most akin.

(b) Section 17 of the Customs Act, 1962 stipulates that after bill of entry or shipping bill has been presented, the proper officer may examine and test the goods. After such examination and testing, the proper officer assesses the duty leviable on such goods.

Under the first appraisement system, the goods are examined first and then they are assessed. The appraiser normally resorts to this method if he is not able to make assessment on the basis of declaration made in the bill of entry or shipping bill and the documents submitted along with them and deems that inspection is necessary. The importer himself may also request 'first check procedure', if he cannot give all required details regarding description/value of goods. He has to make request for first check examination at the time of filing of bill of entry.

Under the second appraisement system, the information and documents furnished by the importer are adequate to determine the correct tariff nomenclature, tariff classification and valuation of the goods for purposes of assessment. In such a situation, physical examination of the goods or their weighment or testing is only a confirmatory check. Under this system, such an examination is carried out after assessment and collection of duty.

(c) Clearance of goods imported by post is governed by sections 82 to 84 of the Customs Act, 1962. Any label or declaration accompanying the goods showing the description, quantity and value thereof, shall be treated as "an entry for import" under the Customs Act. The rate of duty and tariff value applicable to goods imported by post shall be the rate and valuation in force on the date on which the postal authorities present to the proper officer a list containing the particulars of such goods for the purpose of assessment of duty. In case the goods are imported by a vessel and the list of the goods containing the particulars is presented before the date of the arrival of the vessel, the crucial date shall be the date of arrival of the vessel.

The procedure for clearance of imported goods by post is as under:

(i) Post parcels are allowed to pass from port/airport to Foreign Parcel Department of Government Post Offices without payment of customs duty. The Postmaster hands over to Principal Appraiser of Customs the memo showing total number of parcels from each country of origin, parcel bills or senders' declaration, customs declaration and despatch notes, and other information that may be required.

(ii) The mail bags are opened and scrutinised by Postmaster under supervision of Principal Postal Appraiser of Customs. Packets suspected of containing dutiable goods are separated and presented to Customs Appraiser with letter mail bill and assessment memos.

(iii) The Customs Appraiser marks the parcels which are required to be detained as (a) necessary particulars are not available or (b) mis-declaration or under-valuation is suspected or (c) goods are prohibited for import. Other parcels are assessed without opening, on the basis of details given in parcel bill or dispatch notes. The duty is assessed and is entered on parcel bill. These are then audited and returned to Postmaster. Postmaster will hand over parcel to addressee only after collecting the customs duty.

(iv) Parcels selected by Appraiser for examination are opened and examined. If required, details are called from addressee. After inspection, the parcels are sealed with a distinctive seal. If mis-declaration or under-valuation is noted or goods are prohibited goods for imports these will be detained and reported to Customs Commissioner. After assessment, these will be handed over to Post Master, who will hand over to addressee on receipt of payment of customs duty.

(d) The exporter may be granted provisional duty drawback when he executes a bond binding himself to repay the entire or excess amount of drawback. Where an exporter desires that he may be granted drawback provisionally, he may make an application in writing to the Commissioner of Central Excise or Commissioner of Customs and Central Excise that a provisional amount be granted to him towards drawback on the export of such goods pending determination of the final amount or drawback. The manufacturer may be allowed provisional duty drawback of an amount not exceeding the amount claimed by him in respect of such export.

Question 8

(a) M/s. XYZ Ltd. were liable for the duty assessed and payable on certain import which, it paid under protest and filed a claim for refund of duty on the ground that duty had been wrongly levied. On rejection of claim for refunds, the assessee filed an appeal before Tribunal which was also dismissed on the ground that as no appeal had been filed against the assessment order, the refund claim was not maintainable. Assessee seeks your advice for remedy. Discuss whether the stand taken by the Tribunal is correct.

(5 Marks)

(b) Write a note on warehousing period under section 61 of the Customs Act, 1962.

(4 Marks)

(c) What is residual method of valuation? Bring out your answer with reference to the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988. (6 Marks)

Answer

(a) The facts of the case are similar to the case of *Priya Blue Industries Ltd. v. CCus., 2004 (172) ELT 145 (SC).* The Supreme Court has held in this case that refund claim under section 27 of the Customs Act, 1962 can be made by any person who has paid duty in pursuance of an assessment order. However, such a claim for refund cannot be made without challenging the order of assessment in appeal. It cannot be inferred that if the assessment is not correct, a party can file a claim for refund and the correctness of the assessment order can be examined while considering the claim for refund.

So long as the order of assessment stands the duty would be payable as per that order. Unless that order is modified in appeal or has been reviewed, the order of assessment stands and thus, a claim for refund contrary to such an order cannot be maintained.

A refund claim is not an appeal proceeding. The officer considering refund claim cannot sit in appeal over an assessment made by a competent officer.

Thus, in view of the abovementioned decision the stand taken by the Tribunal is correct.

(b) Section 61(1) of the Customs Act, 1962 provides that any warehoused goods may be left in the warehouse in which they were deposited or in any warehouse to which they may be removed-

(a) in the case of capital goods intended for use in any hundred percent export oriented undertaking, till the expiry of five years;

(b) in the case of goods other than capital goods, intended for use in any hundred per cent export-oriented undertaking, till the expiry of three years; and

(c) in the case of any other goods, till the expiry of one year,

after the date on which the proper officer has made an order under section 60 permitting the deposit of the goods in a warehouse.

However,

(i) in the case of any goods which are not likely to deteriorate, the period specified in clause (a) or clause (b) or clause (c) may, on sufficient cause being shown, be extended-

(A) in the case of such goods intended for use in any hundred percent export oriented undertaking, by the Commissioner of Customs, for such period as he may deem fit, and

(B) in any other case, by the Commissioner of Customs, for a period not exceeding six months and by the Chief Commissioner of Customs for such further period as he may deem fit;

(ii) in the case of any goods referred to in clause (c) if they are likely to deteriorate, the Commissioner of Customs may reduce the aforesaid period of one year to such shorter period as he may deem fit.

(c) Rule 8 of the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988 provides the residual method of valuation. According to this rule, where the value of imported goods cannot be determined under the provisions of any of the preceding rules, the value should be determined using reasonable means consistent with the principles and general provisions of these rules and sub-section (1) of Section 14 of the Customs Act, 1962 and on the basis of data available in India.

No value should be determined under the provisions of this rule on the basis of —

(i) the selling price in India of the goods produced in India;

(ii) a system which provides for the acceptance for customs purposes of the highest of the two alternative values;

(iii) the price of the goods on the domestic market of the country of exportation;

(iv) the cost of production other than computed values which have been determined for identical or similar goods in accordance with the provisions of rule 7A;

(v) the price of the goods for export to a country other than India;

(vi) minimum customs values; or

(vii) arbitrary or fictitious values.

PART -C

Question 9

(a) Explain whether the following activities come under the service tax liability:

(i) Reimbursement of expenses like cess, customs duty, port dues claimed by custom house agents;

(ii) Surveillance fee collected by a credit rating agency;

(iii) Transporters who are rendering "Express Cargo Service" for delivery.

(3 x 2 = 6 Marks)

(b) (i) M/s. Renu Consultants are a labour contractor of manpower to M/s. Sanu Creations. They charge to the principal employer for the wages of their labour which amounts to Rs.1,20,000 plus their service charge of 12,000 for arranging the labour. The issue is whether service tax is payable on the gross amount charged by them or only their charges for labour. Examine the case and advise suitably.

(ii) For providing beauty treatment services, a parlour uses materials such as cosmetics and toilet preparations. Whether the cost of such materials will be included in the value of taxable service? Whether any abatement is admissible on account of the value of materials consumed in providing the service? (4 + 3 = 7 Marks)

(c) (i) What is the time limit under Rule 4A for raising/issuing an invoice for services?

(ii) What is the due date for monthly/quarterly payment of service Tax?

(1+ 1 = 2 Marks)

Answer

(a) (i) Service tax is not leviable on the reimbursement of expenses incurred by the custom house agents in respect of the statutory levies like cess, custom duty etc. *[CCEx., New Delhi, Trade Notice No. 39/97-C.E., S.T.39/97, dated 11.06.1997].*

(ii) Service tax is to be paid on the surveillance fee collected by a credit rating agency *[M.F. (D.R.) Letter No.11/3/98-TRU, dated 07.10.1998].*

(iii) Transporters rendering "Express Cargo Service" for door to door delivery of goods and articles are liable to service tax as the nature of service provided by them is not different from the service provided by the conventional courier agencies *[Circular F. No. 341/43/96-ST (TRU) dated 31.10.1996].*

(b) (i) Section 67 states that value of any taxable service is the gross amount charged by the service provider for the taxable services rendered by him. The labour contractor charges to the principal employer for the wages of his labour plus his service charges for arranging the labour.

Further, the department has clarified vide *M.F. (D.R.) Letter F.No.B1/6/2005-TRU dated 27.07.2005* that service tax is to be charged on the full amount of consideration for the supply of manpower, whether full-time or part-time. The value includes recovery of staff costs from the recipient e.g. salary and other contributions. Even if the arrangement does not involve the recipient paying these staff costs to the supplier (because the salary is paid directly to the individual or the contributions are paid to the respective authority) these amounts are still part of the consideration and hence form part of the gross amount.

Hence the taxable amount is the entire amount i.e. Rs1,32,000.

(ii) It has been clarified vide *M.F. (D.R.) F. No.B11/1/2002 TRU dt. 01.08.2002* that the cost of cosmetics and toilet preparations used for providing the service shall be included in the value of taxable service as they are not sold as such but are integral to the service provided. No abetment will be admissible on account of the value of material consumed in providing the service.

(c) (i) As per Rule 4A(1) of Service Tax Rules, 1994, an invoice is to be issued within 14 days from the date of completion of the taxable service or receipt of payment towards the value of taxable service, whichever is earlier.

(ii) The due date for monthly/quarterly payment of service tax is 5^{th} of the following month or quarter as the case may be, except that the payment for the month/quarter ending in March will have to be made by 31st March.