



Suggested Answers

FINAL (New) Examination

Group I

June, 2009



SUGGESTED ANSWERS TO QUESTIONS SET AT THE
FINAL (NEW) EXAMINATION – GROUP I
JUNE, 2009



BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
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Question No. 1 is compulsory. Answer any **five** out of the remaining questions.

Working notes should form part of the answer.

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

Question 1

Answer any four out of the following:

(a) From the following details of an asset

- (i) Find out impairment loss
- (ii) Treatment of impairment loss
- (iii) Current year depreciation

Particulars of asset:

Cost of asset	Rs.56 lakhs
Useful life period	10 years
Salvage value	Nil
Current carrying value	Rs. 27.30 lakhs
Useful life remaining	3 years
Recoverable amount	Rs.12 lakhs
Upward revaluation done in last year	Rs.14 lakhs

- (b) Rainbow Limited borrowed an amount of Rs.150 crores on 1.4.2008 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. Since the weighted average cost of capital is 13% p.a., the accountant of Rainbow Ltd. capitalized Rs.19.50 crores for the accounting period ending on 31.3.2009. Due to surplus fund, out of Rs.150 crores, an income of Rs.3.50 crores was earned and credited to profit and loss account. Comment on the above treatment of accountant with reference to relevant accounting standard.
- (c) Suraj Limited wishes to obtain a machine costing Rs.30 lakhs by way of lease. The effective life of the machine is 14 years, but the company requires it only for the first 5 years. It enters into an agreement with Ashok Ltd., for a lease rental for Rs.3 lakhs p.a. payable in arrears and the implicit rate of interest is 15%. The chief accountant of Suraj Limited is not sure about the treatment of these lease rentals and seeks your advise.
- (d) Omega Limited is working on different projects which are likely to be completed within 3 years period. It recognizes revenue from these contracts on percentage of completion method for financial statements during 2006, 2007 and 2008 for Rs.11,00,000, Rs.16,00,000 and Rs.21,00,000 respectively. However, for income-tax purpose, it has adopted the completed contract method under which it has recognized revenue of

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Rs.7,00,000, Rs.18,00,000 and Rs.23,00,000 for the years 2006, 2007 and 2008 respectively. Income-tax rate is 35%. Compute the amount of deferred tax asset/liability for the years 2006, 2007 and 2008.

- (e) *While preparing its final accounts for the year ended 31st March, 2009, a company made a provision for bad debts @ 5% of its total debtors. In the last week of February 2009, a debtor for 2 lakhs had suffered heavy loss due to earthquake. The loss was not covered by any insurance policy. In April, 2009, the debtor became bankrupt. Can the company provide for full loss arising out of insolvency of debtor in the final accounts for year ended 31st March, 2009? (4x5 = 20 Marks)*

Answer

- (a) According to para 59 of AS 28 "Impairment of Assets", an impairment loss on a revalued asset is recognised as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset.

Impairment Loss and its treatment	Rs.
Current carrying amount (including revaluation amount of Rs.14 lakhs)	27,30,000
Less: Current recoverable amount	12,00,000
Impairment Loss	15,30,000
Impairment loss charged to revaluation reserve	14,00,000
Impairment loss charged to profit and loss account	1,30,000

As per para 61 of AS 28, "after the recognition of an impairment loss, the depreciation (amortization) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life."

In the given case, the carrying amount of the asset will be reduced to Rs.12,00,000 after impairment. This amount is required to be depreciated over remaining useful life of 3 years (including current year). Therefore, the depreciation for the current year will be Rs.4,00,000.

- (b) Para 10 of AS 16 'Borrowing Costs' states, "to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings." The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. Hence, in the above case, treatment of accountant of Rainbow Ltd. is

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incorrect. The amount of borrowing costs capitalized for the financial year 2008-2009 should be calculated as follows:

Actual interest for 2008-2009 (11% of Rs.150 crores)	Rs.16.50 crores
Less: Income on temporary investment from specific borrowings	Rs. 3.50 crores
Borrowing costs to be capitalized during year 2008-2009	Rs. 13.00 crores

- (c) As per AS 19 'Leases', a lease will be classified as finance lease if at the inception of the lease, the present value of minimum lease payment* amounts to at least substantially all of the fair value of leased asset. In the given case, the implicit rate of interest is given at 15%. The present value of minimum lease payments at 15% using PV- Annuity Factor can be computed as follows:

Annuity Factor (Year 1 to Year 5)	3.36** (approx.)
Present value of minimum lease payments (for Rs.3 lakhs each year)	Rs.10.08 lakhs (approx.)

Thus, present value of minimum lease payments is Rs.10.08 lakhs and the fair value of the machine is Rs.30 lakhs. In a finance lease, lease term should be for the major part of the economic life of the asset even if title is not transferred. However, in the given case, the effective useful life of the machine is 14 years while the lease is only for five years. Therefore, lease agreement is an operating lease. Lease payments under an operating lease should be recognized as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

- (d) **Omega Limited**

Calculation of Deferred Tax Asset/Liability

Year	Accounting Income	Taxable Income	Timing Difference (balance)	Deferred Tax Liability (balance)
2006	11,00,000	7,00,000	4,00,000	1,40,000
2007	16,00,000	18,00,000	2,00,000	70,000
2008	<u>21,00,000</u>	<u>23,00,000</u>	NIL	NIL
	<u>48,00,000</u>	<u>48,00,000</u>		

* In calculating the present value of minimum lease payments, the discount rate is the interest rate implicit in the lease.

** This is calculated using the following formula:

$$\frac{1}{(1+.15)^1} + \frac{1}{(1+.15)^2} + \frac{1}{(1+.15)^3} + \frac{1}{(1+.15)^4} + \frac{1}{(1+.15)^5}$$

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- (e) As per para 8.2 and 13 of Accounting Standard 4 'Contingencies and Events occurring after the Balance Sheet Date', assets and liabilities should be adjusted for events occurring after the date of balance sheet, that provide additional evidence to assist estimation of amounts relating to conditions existing at the Balance Sheet Date. Therefore, in the given case, full provision for bad debt amounting Rs.2 lakhs should be made to cover the loss arising due to insolvency in the final accounts for the year ended 31st March, 2009 as earthquake took place before the balance sheet date.

Question 2

The Balance Sheet of Munna Ltd as on 31st March, 2009 is as follows:

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
<i>Authorised and issued Share capital</i>		<i>Goodwill</i>	<i>2,00,000</i>
<i>20,000 Equity shares of Rs.100 each, fully paid</i>	<i>20,00,000</i>	<i>Plant & Machinery</i>	<i>18,00,000</i>
<i>10,000, 7% Preference shares of Rs.100 each</i>	<i>10,00,000</i>	<i>Stock</i>	<i>3,00,000</i>
<i>Sundry creditors</i>	<i>7,00,000</i>	<i>Debtors</i>	<i>7,50,000</i>
<i>Bank overdraft</i>	<i>3,00,000</i>	<i>Cash</i>	<i>1,50,000</i>
		<i>Preliminary expenses</i>	<i>1,00,000</i>
		<i>Profit and Loss A/c</i>	<i>7,00,000</i>
	<u><i>40,00,000</i></u>		<u><i>40,00,000</i></u>

Additional Information:

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

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

- (i) Creditors agreed to forego 50% of their claim.*
- (ii) Preference shareholders withdrew arrear dividend claim. They also agreed to lower down their capital claim by 20% by reducing nominal value in consideration of 9% dividend effective after reconstruction, in case equity shareholder's loss exceeded 50% on the application of the scheme.*
- (iii) Bank has agreed to convert overdraft into term loan to the extent required for making current ratio to 2:1.*
- (iv) Revalued amount for plant and machinery was accepted as Rs.15,00,000.*
- (v) Debtors to the extent of Rs.4,00,000 were considered as good.*
- (vi) Equity shares shall be exchanged for the same number of equity shares at a revised denomination as required after the reconstruction.*

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You are required to show the following:

- (a) Total loss to be borne by the equity and preference shareholders for the reconstruction.
- (b) Share of loss to the individual class of shareholders.
- (c) New structure of share capital after reconstruction.
- (d) Working capital of the reconstructed company, and
- (e) A Performa Balance Sheet after reconstruction. (16 Marks)

Answer

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

	Rs.
Profit and loss account (debit balance)	7,00,000
Preliminary expenses	1,00,000
Goodwill	2,00,000
Plant and machinery (Rs. 18,00,000 – Rs. 15,00,000)	3,00,000
Debtors (Rs. 7,50,000 – Rs. 4,00,000)	<u>3,50,000</u>
Amount to be written off	16,50,000
Less: 50% of Sundry Creditors	<u>3,50,000</u>
Total loss to be borne by the equity and preference shareholders*	<u>13,00,000</u>

(b) Share of loss to preference shareholders and equity shareholders

Total loss of Rs. 13,00,000 being more than 50% of equity share capital i.e. Rs.10,00,000	
Preference shareholders' share of loss = 20% of Rs. 10,00,000 =	Rs. 2,00,000
Equity shareholders' share of loss (Rs. 13,00,000 – Rs. 2,00,000)=	<u>Rs. 11,00,000</u>
Total loss	<u>Rs. 13,00,000</u>

(c) New structure of share capital after reorganisation

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

* Two years' preference dividend (arrears) has been ignored in the computation of loss to be borne by equity and preference shareholders.

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(d) Working capital of the reorganized company

Current Assets:	Rs.	Rs.
Stock		3,00,000
Debtors		4,00,000
Cash		<u>1,50,000</u>
		8,50,000
Less: Current liabilities:		
Creditors	3,50,000	
Bank overdraft **	<u>75,000</u>	<u>4,25,000</u>
Working capital		<u>4,25,000</u>

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

as on 31st March, 2009

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
<i>Share Capital Authorised (issued and paid up)</i>		<i>Fixed Assets</i>	
20,000 equity shares of Rs. 45 each	9,00,000	Plant and Machinery	15,00,000
10,000, 9% preference shares of Rs. 80 each	8,00,000	<i>Current Assets</i>	
<i>Unsecured loan</i>		Stock	3,00,000
Term loan with Bank	2,25,000	Debtors	4,00,000
<i>Current liabilities</i>		Cash	1,50,000
Bank overdraft	75,000		
Creditors	<u>3,50,000</u>		
	<u>23,50,000</u>		<u>23,50,000</u>

Question 3

From the following details, prepare a consolidated Balance Sheet of Sun Limited and its subsidiaries as on 31st March, 2009:

	<i>(Rs. in Lakhs)</i>		
<i>Assets</i>	<i>Sun Ltd.</i>	<i>Moon Ltd.</i>	<i>Star Ltd.</i>
<i>Fixed assets (net)</i>	816	312	126
<i>Investment (at cost)</i>			

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

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7,50,000, equity shares of Moon Ltd.	75	-	-
2,40,000 equity shares of Star Ltd.	24	-	-
4,80,000, equity shares of Star Ltd.	-	60	-
30,000 cumulative preference shares of Sun Ltd.	-	-	30
4,500 mortgage debentures of Sun Ltd.	-	-	42
Current assets	1,059	369	336
Profit and loss account	288	108	63
	<u>2,262</u>	<u>849</u>	<u>597</u>
<i>Liabilities</i>			
Equity share capital (Rs.10 each fully paid up)	180	144	120
7.5% Cumulative preference share capital (Rs.100 each fully paid)	45	36	30
Capital reserve (revaluation of fixed assets)	360	-	-
General reserve	75	45	30
7,500, 8% mortgage debenture bonds of Rs.1,000 each	75	-	-
<i>Secured loans and advances:</i>			
From banks	513	249	165
<i>Unsecured loans:</i>			
From Moon Ltd.	-	-	36
From Star Ltd.	45	-	-
<i>Current liabilities and provisions:</i>			
Inter-company balances	27	-	-
Other liabilities	942	375	216
	<u>2,262</u>	<u>849</u>	<u>597</u>

Other information are as follows:

- Moon Ltd. subscribed for 2,40,000 shares of Star Ltd. at par at the time of first issue and further acquired 2,40,000 shares from the market at Rs.15 each, when the Reserve and Surplus account of Star Ltd. stood at Rs.15 lakhs.
- Sun Ltd. subscribed for shares of Moon Ltd. and Star Ltd. at par at the time of first issue of shares by both the companies.
- Current assets of Moon Ltd. and Star Ltd. includes Rs.12 lakhs and Rs.18 lakhs respectively being current account balance against Sun Ltd. (16 Marks)

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Answer

Consolidated Balance Sheet of Sun Limited and its subsidiaries as on 31st March, 2009

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>	<i>Rs.</i>
<i>Share capital</i>		<i>Goodwill</i>		3,00,000
(18,00,000 Equity Shares of Rs.10 each)	180,00,000	<i>Fixed assets</i>		12,54,00,000
15,000, 7½% Cumulative Preference shares of Rs. 100 each	15,00,000	<i>Current assets</i>	17,64,00,000	
<i>Minority interest</i>	132,18,750	Less: Inter-company owing	<u>81,00,000</u>	
<i>Reserves and surplus</i>			16,83,00,000	
Capital reserve	360,00,000	Less: Inter-company balances	<u>27,00,000</u>	16,56,00,000
<i>Secured loan</i>				
8% Mortgage debentures	30,00,000	Profit and loss account		264,18,750
<i>Loans and advances</i>				
Secured loan from bank	927,00,000			
Current liabilities and provisions	<u>15,33,00,000</u>			
	<u>31,77,18,750</u>			<u>31,77,18,750</u>

Working Notes:

(1) Shareholding Pattern		In Moon Ltd.	In Star Ltd.
(i)	Sun Limited	$\frac{25}{48}$	$\frac{2}{10}$
(ii)	Moon Limited		$\frac{4}{10}$
(iii)	Minority Interest	$\frac{23}{48}$	$\frac{4}{10}$
(2) Analysis of Profits		<i>Capital</i>	<i>Revenue</i>
(a)	Star Limited	<i>Rs.</i>	<i>Rs.</i>
	Balance at acquisition	15,00,000	
	Balance as per P&L A/c	(63,00,000)	
	General reserve	30,00,000	
	Profit on debentures	<u>3,00,000</u>	
	Net loss as on 31.3.09	(30,00,000)	
	Less: Capital profit	<u>(-15,00,000)</u>	
		<u>(45,00,000)</u>	<u>(45,00,000)</u>

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	Minority interest (4/10)	6,00,000	(18,00,000)
	Share of Moon Limited (4/10)	6,00,000	(18,00,000)
	Share of Sun Limited (2/10)	3,00,000	(9,00,000)
(b)	Moon Limited		
	P&L A/c as on 31.3.09		(1,08,00,000)
	General Reserve		45,00,000
			(63,00,000)
	Share of revenue loss in Star Ltd.		(18,00,000)
			(81,00,000)
	Minority Interest (23/48)		(38,81,250)
	Sun Limited (25/48)		(42,18,750)
(3)	Goodwill/Capital Reserve	<i>Moon Ltd.</i>	<i>Star Ltd.</i>
	Cost of investment	75,00,000	84,00,000
	Less: Share capital	75,00,000	72,00,000
	Capital profit	<u>3,00,000</u>	<u>6,00,000</u>
	Capital reserve/Goodwill	(3,00,000)	6,00,000
	Goodwill Rs.6,00,000 less Rs.3,00,000	3,00,000	
(4)	Minority Interest		
	Share capital	69,00,000	48,00,000
	Capital profit	-	6,00,000
	Revenue profit	(38,81,250)	(18,00,000)
	Preference shares (36,00,000+30,00,000)	-	66,00,000
		<u>30,18,750</u>	<u>1,02,00,000</u>
	Total		<u>1,32,18,750</u>
(5)	Profit and Loss Account – Sun Ltd.		
	Balance as on 31.03.2009	(2,88,00,000)	
	General reserve	75,00,000	
	Share of Star Limited	(9,00,000)	
	Share of Moon Limited	<u>(42,18,750)</u>	
		<u>(2,64,18,750)</u>	

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Question 4

- (a) On 1.4.2008, a mutual fund scheme had 18 lakh units of face value of Rs.10 each was outstanding. The scheme earned Rs.162 lakhs in 2008-09, out of which Rs.90 lakhs was earned in the first half of the year. On 30.9.2008, 2 lakh units were sold at a "NAV" of Rs.70.

Pass Journal entries for sale of units and distribution of dividend at the end of 2008-09.

- (b) Following is the Balance Sheet of Rampal Limited as on 31st March, 2009:

Liabilities	Rs.	Assets	Rs.
1,00,000 equity shares of Rs.10 each	10,00,000	Goodwill	5,00,000
10,000, 12% preference shares of Rs.100 each	10,00,000	Buildings	15,00,000
General reserve	6,00,000	Plant	10,00,000
Profit and Loss account	4,00,000	Investment in 10% stock	4,80,000
15% debentures	10,00,000	Stock-in-trade	6,00,000
Creditors	8,00,000	Debtors	4,00,000
		Cash	1,00,000
		Preliminary expenses	2,20,000
	<u>48,00,000</u>		<u>48,00,000</u>

Additional information are given below:

- (a) Nominal value of investment is Rs.5,00,000 and its market value is Rs.5,20,000.
- (b) Following assets are revalued:
- | | |
|----------------------|--------------|
| (i) Building | Rs.32,00,000 |
| (ii) Plant | Rs.18,00,000 |
| (iii) Stock-in-trade | Rs.4,50,000 |
| (iv) Debtors | Rs.3,60,000 |
- (c) Average profit before tax of the company is Rs.12,00,000 and 12.50% of the profit is transferred to general reserve, rate of taxation being 50%.
- (d) Normal dividend expected on equity shares is 8% while fair return on closing capital employed is 10%.
- (e) Goodwill may be valued at three year's purchase of super profits.

Ascertain the value of each equity share under fair value method. (6+10= 16 Marks)

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Answer

(a)

Allocation of Earnings	<i>Old Unit Holders</i>	<i>New Unit Holders</i>	<i>Total</i>
	<i>[18 Lakh Units]</i>	<i>[2 Lakh Units]</i>	
	<i>Rs. in Lakhs</i>	<i>Rs. in Lakhs</i>	<i>Rs. in Lakhs</i>
First half year (Rs.5 per unit)	90.00	Nil	90.00
Second half year (Rs.3.60 per unit)	64.80	7.20	72.00
	154.80	7.20	162.00
Add: Equalization payment recovered	-	-	10.00
Available for distribution			172.00
Equalization Payment:- Rs.90 lakhs ÷ 18 Lakhs = Rs.5 per unit.			
	<i>Old Unit Holders</i>	<i>New Unit Holders</i>	
	<i>Rs.</i>	<i>Rs.</i>	
Dividend distributed	8.60	8.60	
Less: Equilisation payment	-	5.00	
	8.60	3.60	

Journal Entries		<i>(Rs. in lakhs)</i>	
30.9.2008	Bank A/c	Dr.	150.00
	To Unit Capital A/c		20.00
	To Reserves A/c		120.00
	To Dividend Equilisation A/c		10.00
	(Being the amount received on sale of 2 lakhs unit at a NAV of Rs.70/- per Unit)		
31.3.2009	Dividend Equalization A/c	Dr.	10.00
	To Revenue A/c		10.00
	(Being the amount transferred to Revenue Account)		
	Revenue A/c	Dr.	172.00
	To Bank A/c		172.00
	(Being the amount distributed among 20 lakhs unit holders @ Rs.8.60 per unit)		

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(b)

1.	Capital Employed	Rs.	Rs.
	Assets:		
	Buildings		32,00,000
	Plant		18,00,000
	Stock		4,50,000
	Debtors		3,60,000
	Cash		1,00,000
			<u>59,10,000</u>
	Less: Liabilities:		
	Creditors	8,00,000	
	Debentures	<u>10,00,000</u>	18,00,000
	Capital Employed		<u>41,10,000</u>
2.	Actual Profit		
	Average Profit		12,00,000
	Less: Income from investment		<u>50,000</u>
			11,50,000
	Less: Income Tax @ 50%		<u>5,75,000</u>
	So, Actual Profit		<u>5,75,000</u>
3.	Profit for Equity Shareholders		
	Actual Profit		5,75,000
	Less: Transfer to reserves @ 12.50%		71,875
	Less: Preference Dividend		<u>1,20,000</u>
	Profit available to Equity Shareholders		<u>3,83,125</u>
4.	Normal Profit	= 10% of Capital Employed = 10% of Rs.41,10,000 = Rs.4,11,000	
5.	Super Profit	= Actual profit – Normal profit	
		= Rs.5,75,000 – 4,11,000 = Rs.1,64,000	
6.	Goodwill	= Rs.1,64,000 × 3 = Rs.4,92,000	
7.	Net Assets for equity shareholders	= Capital Employed + Goodwill + Investment – Preference Share Capital	
		= Rs.(41,10,000+4,92,000+4,80,000- 10,00,000)	
		= Rs.40,82,000	

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8. **Value per Share (Intrinsic Value Method)** = Rs.40,82,000 ÷ 1,00,000 = Rs.40.82

9. **Value per Share (Yield Method)**

$$\begin{aligned}\text{Yield on equity shares} &= \frac{\text{Pr ofit for Equity Shareholders}}{\text{Equity Capital}} \times 100 \\ &= \frac{\text{Rs.3,83,125}}{10,00,000} \times 100 = 38.31\%\end{aligned}$$

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

10. **Value of equity share under Fair Value Method**

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

Question 5

The Balance Sheet of R Ltd. for the year ended on 31st March, 2006, 2007 and 2008 are as follows:

	(Rs. in thousands)		
	31.3.2006	31.3.2007	31.3.2008
Liabilities			
3,20,000 equity shares of Rs.10 each, fully paid	3,200	3,200	3,200
General reserve	2,400	2,800	3,200
Profit and Loss account	280	320	480
Creditors	1,200	1,600	2,000
	7,080	7,920	8,880
Assets			
Goodwill	2,000	1,600	1,200
Building and Machinery less, depreciation	2,800	3,200	3,200
Stock	2,000	2,400	2,800
Debtors	40	320	880
Bank balance	240	400	800
	7,080	7,920	8,880

Additional information:

(a) Actual valuations were as under

Building and machinery less, depreciation	3,600	4,000	4,400
Stock	2,400	2,800	3,200
Net profit (including opening balance after			

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writing off depreciation, goodwill, tax provision
and transferred to general reserve) 840 1,240 1,640

- (b) Capital employed in the business at market value at the beginning of 2005-06 was Rs.73,20,000 which included the cost of goodwill. The normal annual return on average capital employed in the line of business engaged by R Ltd. is 12½%.
- (c) The balance in the general reserve on 1st April, 2005 was Rs.20 lakhs.
- (d) The goodwill shown on 31.3.2006 was purchased on 1.4.2005 for Rs.20 lakhs on which date the balance in the Profit and Loss account was Rs.2,40,000. Find out the average capital employed in each year.
- (e) Goodwill is to be valued at 5 year's purchase of Super profit (Simple average method). Find out the total value of the business as on 31.3.2008. (16 Marks)

Answer

1. Average Capital Employed at the end of each year

	31.3.2006	31.3.2007	31.3.2008
	Rs.	Rs.	Rs.
Goodwill	20,00,000	16,00,000	12,00,000
Building and Machinery (Revaluation)	36,00,000	40,00,000	44,00,000
Stock (Revalued)	24,00,000	28,00,000	32,00,000
Debtors	40,000	3,20,000	8,80,000
Bank Balance	<u>2,40,000</u>	<u>4,00,000</u>	<u>8,00,000</u>
Total Assets	82,80,000	91,20,000	104,80,000
Less: Creditors	<u>12,00,000</u>	<u>16,00,000</u>	<u>20,00,000</u>
Closing Capital	70,80,000	75,20,000	84,80,000
Add: Opening Capital	<u>73,20,000</u>	<u>70,80,000</u>	<u>75,20,000</u>
Total	<u>144,00,000</u>	<u>146,00,000</u>	<u>160,00,000</u>
Average Capital	<u>72,00,000</u>	<u>73,00,000</u>	<u>80,00,000</u>

Since the goodwill has been purchased, it is taken as a part of Capital employed.

2. Total value of business

	Rs.
Total Net Assets as on 31.3.2008	84,80,000
Less: Goodwill as per Balance Sheet	12,00,000
Add: Goodwill as calculated in Working Note	<u>41,12,500</u>
Value of Business	<u>113,92,500</u>

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Working Note:

Valuation of Goodwill

(i) Future Maintainable Profit	31.3.2006	31.3.2007	31.3.2008
	Rs.	Rs.	Rs.
Net Profit as given	8,40,000	12,40,000	16,40,000
Less: Opening Balance	2,40,000	2,80,000	3,20,000
Adjustment for Valuation of Opening Stock	-	4,00,000	4,00,000
Add: Adjustment for Valuation of closing stock	4,00,000	4,00,000	4,00,000
Goodwill written off	-	4,00,000	4,00,000
Transferred to General Reserve	<u>4,00,000</u>	<u>4,00,000</u>	<u>4,00,000</u>
Future Maintainable Profit	14,00,000	17,60,000	21,20,000
Less: 12.50% Normal Return on average capital	<u>9,00,000</u>	<u>9,12,500</u>	<u>10,00,000</u>
(ii) Super Profit	<u>5,00,000</u>	<u>8,47,500</u>	<u>11,20,000</u>
(iii) Average Super Profit = Rs.(5,00,000 + 8,47,500+11,20,000) ÷ 3 = Rs.8,22,500			
(iv) Value of Goodwill at five years' purchase= Rs.8,22,500 × 5 = Rs.41,12,500.			

Question 6

- (a) Rajkumar Ltd. is adopting historical cost system. From the following details furnished, prepare current cost Profit and Loss account for the year ended on 31.3.2009:

Statement of Profit and Loss:	(Rs.)
Sales	24,00,000
Cost of sales:	
Opening stock	1,80,000
Purchases	15,60,000
Less: Closing stock	<u>2,40,000</u>
Gross Profit	9,00,000
Operating expenses	3,60,000
Depreciation	1,20,000
Interest on loan	1,80,000
Provision for tax	90,000
Net profit	1,50,000
Dividend (proposed)	30,000
Retained profit	1,20,000

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The chief finance officer of Rajkumar Ltd. furnished the additional information as below:

(a)	Gearing adjustment for the year	Rs.20,232
(b)	Cost of sales adjustment for the year	Rs.37,998
(c)	Depreciation adjustment for the year	Rs.18,000
(d)	Monetary working capital adjustment for the year	Rs.13,500

(8 Marks)

(b) *From the following information of Vinod Ltd., compute the economic value added:*

(i)	Share capital	Rs.2,000 lakhs
(ii)	Reserve and surplus	Rs.4,000 lakhs
(iii)	Long-term debt	Rs.400 lakhs
(iv)	Tax rate	30%
(v)	Risk free rate	9%
(vi)	Market rate of return	16%
(vii)	Interest	Rs.40 lakhs
(viii)	Beta factor	1.05
(ix)	Profit before interest and tax	Rs.2,000 lakhs

(8 Marks)

Answer

(a) **Current Cost Profit and Loss Account of Raj Kumar Ltd.
for the year ended 31.3.2009**

	Rs.	Rs.
Trading profit before interest and tax under historical cost system		
Gross profit less (Operating expenditure + Depreciation)		
Rs. 9,00,000 – (Rs. 3,60,000 + Rs.1,20,000)		4,20,000
Less: Current cost adjustments		
Depreciation adjustment	18,000	
Cost of sales adjustment	37,998	
Monetary working capital adjustment	<u>13,500</u>	69,498
Current cost operating profit		3,50,502
Less: Interest on loan	1,80,000	
Gearing adjustment	<u>20,232</u>	<u>1,59,768</u>
Current cost profit before tax		1,90,734
Less: Provision for tax		<u>90,000</u>

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Current cost profit after tax	1,00,734
Less: Dividend	<u>30,000</u>
Retained current cost profit for the year	<u>70,734</u>

(b)

Vinod Limited

Computation of Economic Value Added

<u>Economic Value Added</u>	<i>Rs. in Lakhs</i>
Net Operating Profit after Tax (Refer Working Note 5)	1,372.00
Add: Interest on Long-term Fund (Refer Working Note 2)	<u>28.00</u>
	1,400.00
Less: Cost of Capital Rs. 6,400 lakhs × 15.77% (Refer working notes 3 and 4)	<u>1,009.28</u>
Economic Value Added	<u>390.72</u>

Working Notes:

- (1) **Cost of Equity** = Risk free Rate + Beta Factor (Market Rate – Risk Free Rate)

$$9\% + 1.05 (16 - 9) = 9\% + 7.35\% = 16.35\%$$

- (2) **Cost of Debt**

Interest Rs.40 lakhs

Less: Tax (30%) Rs.12 lakhs

Interest after Tax Rs.28 lakhs

$$\text{Cost of Debt} = \frac{28}{400} \times 100 = 7\%$$

- (3) **Weighted Average Cost of Capital**

Cost of Equity Rs. 6,000 lakhs × 16.35% (W.N.1) Rs. 981 lakhs

Cost of Debt Rs. 400 lakhs × 7% (W.N.2) Rs. 28 lakhs

Rs. 1,009 lakhs

$$\text{WACC} = \frac{1,009}{6,400} \times 100 = 15.77\% \text{ (approx.)}$$

4. Capital Employed

	<i>Rs. in Lakhs</i>
Share Capital	2,000
Reserves and Surplus	4,000
Long term debts	<u>400</u>
	<u>6,400</u>

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5. Net Operating Profit after Tax

Profit before Interest and Tax	2,000
Less: Interest	<u>40</u>
	<u>1,960</u>
Tax 30% on 1,960 Lakhs	588
Net Operating Profit after Tax	1,372

Question 7

Write short notes on any **four** from the following:

- (a) What are the objectives of financial reporting?
- (b) What do you mean by "Net asset value" (NAV) in case of mutual fund units?
- (c) State the treatment of the following items with reference to Indian Accounting Standards and IFRS:
 - (i) Discontinued operations – definition and measurement
 - (ii) Acquired intangible assets.
- (d) Non-performing asset in the context of NBFC.
- (e) Forward contract. (4x4 = 16 Marks)

Answer

- (a) The following are the objectives of financial reporting:
- (i) To provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.
 - (ii) To provide information to help investors, creditors, and others to assess the amount, timing and uncertainty of prospective net cash inflows to the related enterprise.
 - (iii) To provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events and circumstances that change resources and claims to those resources.
 - (iv) To provide information about an enterprise's financial performance during a period.
 - (v) To give information about an enterprise's performance provided by measures of earnings and its components.
 - (vi) To provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise's resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.

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- (vii) To provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it.
 - (viii) To provide information that is useful to managers and directors in making decisions in the interest of owners.
- (b) Mutual funds sell their shares to public and redeem them at current net assets value (NAV) which is calculated as under:–

Total market value of all Mutual Fund holdings - All Mutual Fund liabilities

Unit size

The net asset value of a mutual fund scheme is basically the per unit market value of all the assets of the scheme. Simply stated, NAV is the value of the assets of each unit of the scheme. Thus, if the NAV is more than the face value (Rs. 10), it means your money has appreciated and vice versa. NAV also includes dividends, interest accruals and reduction of liabilities and expenses, besides market value of investments. NAV is the value of net assets under a mutual fund scheme. The NAV per unit is NAV of the scheme divided by number of units outstanding. NAV of a scheme keeps on changing with change in market value of portfolio under the scheme.

(c) Treatment under Indian Accounting Standard and IFRS

		Indian Accounting Standards	IFRS
(i)	Discontinuing operation - definition and measurement	Operations and cash flows that can be clearly distinguished for financial reporting and represent major line of business or geographical area of operations are discontinued operations. Measurement of discontinued operations is based on AS 24.	Definition of discontinued operations under IFRS is similar to Indian Accounting Standards. However, it also includes a subsidiary acquired exclusively with a view to resale. Discontinued operations are measured at lower of carrying amount and fair value less cost to sell.
(ii)	Acquired intangible assets	If recognition criteria are satisfied then it can be capitalized. All intangibles are amortized over useful life with rebuttable presumption of not exceeding 10 years. Revaluations are not permitted.	If recognition criteria are satisfied then it can be capitalized. It is amortized over useful life. Intangibles assigned an indefinite useful life are not amortized but reviewed at least annually for impairment. Revaluations are permitted in rare circumstances.

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(d) “Non–Performing Asset” as per NBFC Prudential Norms (RBI) directions means:

- (i) An asset, in respect of which, interest has remained past due for six months;
- (ii) A term loan inclusive of unpaid interest, when the instalment is overdue for more than six months of which interest amount remained past due for six months;
- (iii) A bill which remained overdue for six months;
- (iv) The interest in respect of a debt or the income on receivables under the head ‘other current assets’ in the nature of short term loans/advances that remained overdue for a period of six months;
- (v) Any dues on account of sales of assets or services rendered or reimbursement expenses made, which remained overdue for a period of six months;
- (vi) The lease rental and hire purchase instalment, which has become overdue for a period of more than twelve months;
- (vii) In respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities made available to borrower /beneficiary when anyone of the credit facilities becomes NPA.

However, an NBFC may classify each such account on the basis of record of recovery as regards hire purchase and lease transactions.

- (e)** A forward contract is an agreement between two parties whereby one party agrees to buy from, or sell to, the other party an asset at a future time for an agreed price (usually referred to as the ‘contract price’). The parties to forward contracts may be individuals, corporates or financial institutions. At maturity, a forward contract is settled by delivery of the asset by the seller to the buyer in return for payment of the contract price. For example, a person (X) may enter into a forward contract with another person (Y) on June 15, 20x3 to buy 10 kgs. of silver at the end of 90 days at a price of Rs. 8,200 per kg. At the end of the 90 days, Y will deliver 10 kgs. of silver to X against payment of Rs. 82,000. If the price of silver, at the end of the 90 days, is Rs. 8,300 per kg., X would make a profit of Rs. 1,000 and Y would lose Rs. 1,000, as X could sell silver bought at Rs. 82,000 for Rs. 83,000, whereas Y would have to buy silver for Rs. 83,000 and sell for Rs. 82,000. On the other hand, if the price of silver at the end of the 90 days is Rs. 7,800 per kg., X would lose Rs. 4,000, whereas Y would make a profit of Rs. 4,000, as X would have to sell silver bought at Rs. 82,000 for Rs. 78,000, whereas Y would buy silver for Rs. 78,000, which he would sell to X at Rs. 82,000.

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

Question No. 1 is compulsory. Answer any **four** questions from the rest. Working notes should form part of the answer.

Question 1

- (a) Consider a two year American call option with a strike price of Rs. 50 on a stock the current price of which is also Rs. 50. Assume that there are two time periods of one year and in each year the stock price can move up or down by equal percentage of 20%. The risk free interest rate is 6%. Using binominal option model, calculate the probability of price moving up and down. Also draw a two step binomial tree showing prices and payoffs at each node. (8 Marks)
- (b) Mr. X owns a portfolio with the following characteristics:

	Security A	Security B	Risk Free security
Factor 1 sensitivity	0.80	1.50	0
Factor 2 sensitivity	0.60	1.20	0
Expected Return	15%	20%	10%

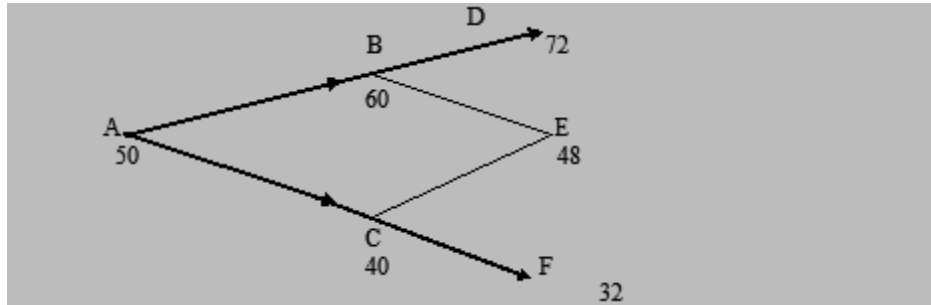
It is assumed that security returns are generated by a two factor model.

- (i) If Mr. X has Rs. 1,00,000 to invest and sells short Rs. 50,000 of security B and purchases Rs. 1,50,000 of security A what is the sensitivity of Mr. X's portfolio to the two factors?
- (ii) If Mr. X borrows Rs. 1,00,000 at the risk free rate and invests the amount he borrows along with the original amount of Rs. 1,00,000 in security A and B in the same proportion as described in part (i), what is the sensitivity of the portfolio to the two factors?
- (iii) What is the expected return premium of factor 2? (8 Marks)
- (c) The share of X Ltd. is currently selling for Rs. 300. Risk free interest rate is 0.8% per month. A three months futures contract is selling for Rs. 312. Develop an arbitrage strategy and show what your riskless profit will be 3 month hence assuming that X Ltd. will not pay any dividend in the next three months. (4 Marks)

FINAL (NEW) EXAMINATION : JUNE, 2009

Answer

(a) Stock prices in the two step Binominal tree

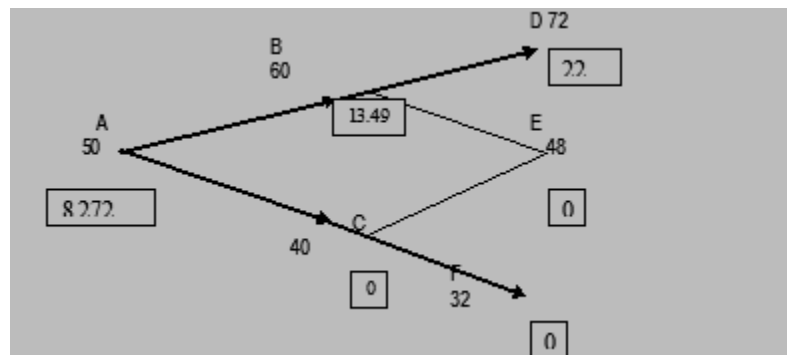


Using the single period model, the probability of price increase is

$$p = \frac{R - d}{u - d} = \frac{1.06 - 0.80}{1.20 - 0.80} = \frac{0.26}{0.40} = 0.65$$

therefore the p of price decrease = $1 - 0.65 = 0.35$

The two step Binominal tree showing price and pay off



The value of an American call option at nodes D, E and F will be equal to the value of European option at these nodes and accordingly the call values at nodes D, E and F will be 22, 0 and 0 using the single period binomial model the value of call option at node B is

$$C = \frac{C_u p + C_d (1 - p)}{R} = \frac{22 \times 0.65 + 0 \times 0.35}{1.06} = 13.49$$

At node B the payoff from early exercise will pay Rs. 10, which is less than the value calculated using the single period binomial model. Hence at node B, early exercise is not preferable and the value of American option at this node will be Rs. 13.49. If the value of

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

an early exercise had been higher it would have been taken as the value of option. The value of option at node 'A' is

$$\frac{13.49 \times 0.65 + 0 \times 0.35}{1.06} = 8.272$$

- (b) (i) Mr. X's position in the two securities are +1.50 in security A and -0.5 in security B. Hence the portfolio sensitivities to the two factors:-

$$\text{b prop. 1} = 1.50 \times 0.80 + (-0.50 \times 1.50) = 0.45$$

$$\text{b prop. 2} = 1.50 \times 0.60 + (-0.50 \times 1.20) = 0.30$$

- (ii) Mr. X's current position:-

$$\text{Security A} \quad \text{Rs. 300000 / Rs. 100000} = 3$$

$$\text{Security B} \quad -\text{Rs. 100000 / Rs. 100000} = -1$$

$$\text{Risk free asset} -\text{Rs. 100000 / Rs. 100000} = -1$$

$$\text{b prop. 1} = 3.0 \times 0.80 + (-1 \times 1.50) + (-1 \times 0) = 0.90$$

$$\text{b prop. 2} = 3.0 \times 0.60 + (-1 \times 1.20) + (-1 \times 0) = 0.60$$

- (iii) The portfolio created in part (ii) is a pure factor 2 portfolio.

Expected return on the portfolio in part (b) is:

$$R_p = 3 \times 0.15 + (-1) \times 0.20 + (-1) \times 0.10$$

$$= 0.15 \text{ i.e. } 15\%$$

$$\therefore \text{Expected return premium} = 15\% - 10\%$$

$$= 5\%$$

- (c) The appropriate value of the 3 months futures contract is –

$$F_0 = \text{Rs. } 300 (1.008)^3 = \text{Rs. } 307.26$$

Since the futures price exceeds its appropriate value it pays to do the following:-

Action	Initial Cash flow	Cash flow at time T (3 months)
Borrow Rs. 300 now and repay with interest after 3 months	+ Rs. 300	- Rs. 300 (1.008) ³ = - Rs. 307.26
Buy a share	- Rs. 300	ST
Sell a futures contract (F ₀ = 312/-)	0	Rs. 312 – ST
Total	Rs. 0	Rs. 4.74

Such an action would produce a risk less profit of Rs. 4.74.

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Question 2

- (a) An investor has two portfolios known to be on minimum variance set for a population of three securities A, B and C having below mentioned weights:

	WA	WB	WC
Portfolio X	0.30	0.40	0.30
Portfolio Y	0.20	0.50	0.30

It is supposed that there are no restrictions on short sales.

- (i) What would be the weight for each stock for a portfolio constructed by investing Rs. 5,000 in portfolio X and Rs. 3,000 in portfolio Y?
- (ii) Suppose the investor invests Rs. 4,000 out of Rs. 8,000 in security A. How he will allocate the balance between security B and C to ensure that his portfolio is on minimum variance set? (6 Marks)

- (b) Calculate the value of share from the following information:

Profit of the company	Rs. 290 crores
Equity capital of company	Rs. 1,300 crores
Par value of share	Rs. 40 each
Debt ratio of company	27
Long run growth rate of the company	8%
Beta 0.1; risk free interest rate	8.7%
Market returns	10.3%
Capital expenditure per share	Rs. 47
Depreciation per share	Rs. 39
Change in Working capital	Rs. 3.45 per share

(6 Marks)

- (c) The returns on stock A and market portfolio for a period of 6 years are as follows:

Year	Return on A (%)	Return on market portfolio (%)
1	12	8
2	15	12
3	11	11
4	2	-4
5	10	9.5
6	-12	-2

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

You are required to determine:

- (i) Characteristic line for stock A
- (ii) The systematic and unsystematic risk of stock A. (8 Marks)

Answer

- (a) (i) Investment committed to each security would be:-

	<u>A</u>	<u>B</u>	<u>C</u>	<u>Total</u>
Portfolio X	Rs. 1,500	Rs. 2,000	Rs. 1,500	Rs. 5,000
Portfolio Y	Rs. 600	Rs. 1,500	Rs. 900	Rs. 3,000
Combined Portfolio	Rs. 2,100	Rs. 3,500	Rs. 2,400	Rs. 8,000
∴ Stock weights	0.26	0.44	0.30	

- (ii) The equation of critical line takes the following form:-

$$WB = a + bWA$$

Substituting the values of WA & WB from portfolio X and Y in above equation, we get

$$0.40 = a + 0.30b, \text{ and}$$

$$0.50 = a + 0.20b$$

Solving above equation we obtain the slope and intercept, $a = 0.70$ and $b = -1$ and thus, the critical line is

$$WB = 0.70 - WA$$

If half of the funds is invested in security A then,

$$WB = 0.70 - 0.50 = 0.20$$

$$\text{Since } WA + WB + WC = 1$$

$$WC = 1 - 0.50 - 0.20 = 0.30$$

$$\begin{aligned} \therefore \text{Allocation of funds to security B} &= 0.20 \times 8,000 \\ &= \text{Rs. 1,600, and} \\ \text{Security C} &= 0.30 \times 8,000 \\ &= \text{Rs. 2,400} \end{aligned}$$

(b) No. of Shares = $\frac{1300}{40} = 32.5$ Crores

$$\text{EPS} = \frac{\text{PAT}}{\text{No. of shares}}$$

FINAL (NEW) EXAMINATION : JUNE, 2009

$$EPS = \frac{290}{32.5} = \text{Rs. } 8.923$$

$$FCFE = \text{Net income} - [(1-b) (\text{capex} - \text{dep}) + (1-b) (\Delta WC)]$$

$$FCFE = 8.923 - [(1-0.27) (47-39) + (1-0.27) (3.45)]$$

$$= 8.923 - [5.84 + 2.5185]$$

$$= 0.5645$$

$$\text{Cost of Equity} = R_f + \beta (R_m - R_f)$$

$$= 8.7 + 0.1 (10.3 - 8.7)$$

$$= 8.86\%$$

$$P_0 = \frac{FCFE(1+g)}{K_e - g} = \frac{0.5645(1.08)}{0.0886 - .08} = \frac{0.60966}{0.0086} = \text{Rs. } 70.89$$

(c) Characteristic line is given by

$$\alpha_i + \beta_i R_m$$

$$\beta_i = \frac{\sum xy - n \bar{x} \bar{y}}{\sum x^2 - n(\bar{x})^2}$$

$$\alpha_i = \bar{y} - \beta \bar{x}$$

Return on A (Y)	Return on market (X)	xy	x ²	(x- $\bar{x}$)	(x- $\bar{x}$) ²	(y- $\bar{y}$)	(y- $\bar{y}$) ²
12	8	96	64	2.25	5.06	5.67	32.15
15	12	180	144	6.25	39.06	8.67	75.17
11	11	121	121	5.25	27.56	4.67	21.81
2	-4	-8	16	-9.75	95.06	-4.33	18.75
10	9.5	95	90.25	3.75	14.06	3.67	13.47
-12	-2	24	4	-7.75	60.06	-18.33	335.99
38	34.5	508	439.25		240.86		497.34

$$\bar{y} = 38/6 = 6.33$$

$$\bar{x} = 34.5/6 = 5.75$$

$$\beta_i = \frac{\sum xy - n \bar{x} \bar{y}}{\sum x^2 - n(\bar{x})^2} = \frac{508 - 6(5.75)(6.33)}{439.25 - 6(5.75)^2} = \frac{508 - 218.385}{439.25 - 198.375}$$

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

$$= \frac{289.615}{240.875} = 1.202$$

$$\alpha = \bar{y} - \beta \bar{x} = 6.33 - 1.202 (5.75) = -0.58$$

Hence the characteristic line is $-0.58 + 1.202 (R_m)$

$$\text{Total Risk of Market} = \sigma_{m^2} = \frac{\sum(x - \bar{x})^2}{x - 1} = \frac{240.86}{5} = 48.17(\%)$$

$$\text{Total Risk of Stock} = \frac{497.34}{5} = 99.47 (\%)$$

$$\text{Systematic Risk} = \beta^2 \sigma_{m^2} = (1.202)^2 \times 48.17 = 69.59(\%)$$

$$\begin{aligned} \text{Unsystematic Risk is} &= \text{Total Risk} - \text{Systematic Risk} \\ &= 99.47 - 69.59 = 29.88(\%) \end{aligned}$$

Question 3

- (a) *M/s Gama & Co. is planning of installing a power saving machine and are considering buying or leasing alternative. The machine is subject to straight-line method of depreciation. Gama & Co. can raise debt at 14% payable in five equal annual instalments of Rs. 1,78,858 each, at the beginning of the year. In case of leasing, the company would be required to pay an annual end of year rent of 25% of the cost of machine for 5 years.*

The Company is in 40% tax bracket. The salvage value is estimated at Rs. 24,998 at the end of 5 years.

Evaluate the two alternatives and advise the company by considering after tax cost of debt concept under both alternatives.

P.V. factors 0.9225, 0.8510, 0.7851, 0.7242, 0.6681 respectively for 1 to 5 years.

(12 Marks)

- (b) *ABC Ltd. has Rs. 300 million, 12 per cent bonds outstanding with six years remaining to maturity. Since interest rates are falling, ABC Ltd. is contemplating of refunding these bonds with a Rs. 300 million issue of 6 year bonds carrying a coupon rate of 10 per cent. Issue cost of the new bond will be Rs. 6 million and the call premium is 4 per cent. Rs. 9 million being the unamortized portion of issue cost of old bonds can be written off no sooner the old bonds are called off. Marginal tax rate of ABC Ltd. is 30 per cent. You are required to analyse the bond refunding decision.*

(6 Marks)

- (c) *Mr. X earns 10% on his investments in equity shares. He is considering a recently floated scheme of a Mutual Fund where the initial expenses are 6% and annual recurring*

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expensed are expected to be 2%. How much the Mutual Fund scheme should earn to provide a return of 10% to Mr. X? (2 Marks)

Answer

(a)

CALCULATION OF COST OF THE MACHINE

Year	Cl. Balance at the beginning	Installment	Interest	Principal component
5	0	1,78,858	21,965	1,56,893
4	1,56,893	1,78,858	41,233	1,37,625
3	2,94,518	1,78,858	58,134	1,20,724
2	4,15,242	1,78,858	72,960	1,05,898
1	5,21,140	1,78,858	0	<u>1,78,858</u>
		Total		<u>6,99,998</u>

Cost of the machine is Rs. 6,99,998

Buying Option

Depreciation p.a. = Rs. 6,99,998- Rs. 24,998

5

Depreciation p.a. = Rs. 1,35,000

Tax Saving on interest & Depreciation

Year	Interest (Rs.)	Dep. (Rs.)	Total (Rs.)	Tax Saving (Rs.)
1	72,960	1,35,000	2,07,960	83,184
2	58,134	1,35,000	1,93,134	77,254
3	41,233	1,35,000	1,76,233	70,493
4	21,965	1,35,000	1,56,965	62,786
5	0	1,35,000	1,35,000	54,000

P.V. Out flow

Year	Installment (Rs.)	Tax Saving (Rs.)	Net outflow (Rs.)	PV @8.4%	P.V. (Rs.)
0	1,78,858	0	1,78,858	1.000	1,78,858.00
1	1,78,858	83,184	95,674	0.9225	88,259.00
2	1,78,858	77,254	1,01,604	0.851	86,465.00
3	1,78,858	70,493	1,08,365	0.7851	85,077.00
4	1,78,858	62,786	1,16,072	0.7242	84,059.00

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5	54,000	-54,000	0.6681	<u>-36,077.00</u>
				4,86,641.00
	Salvage Value	24,998	0.6681	<u>16,701.00</u>
	P.V. of Outflow			<u>4,69,940.00</u>

Leasing Option

Lease Rent 25% of Rs. 6,99,998 i.e. Rs. 1,74,999.50 app. Rs. 1,75,000

Lease Rent payable at the end of the year

Year	Lease Rental (Rs.)	Tax Saving (Rs.)	Net outflow (Rs.)	PV @8.4%	P.V. (Rs.)
1-5	1,75,000	70,000	1,05,000	3.9509	4,14,844.50

Decision – The company is advised to opt for leasing as the total PV of cash outflow is lower by Rs. 55,095.50

(b)

1. Calculation of initial outlay:-

	Rs. (million)
a. Face value	300
Add:-Call premium	<u>12</u>
Cost of calling old bonds	312
b. Gross proceed of new issue	300
Less: Issue costs	<u>6</u>
Net proceeds of new issue	294
c. Tax savings on call premium and unamortized cost 0.30 (12 + 9)	6.3
∴ Initial outlay = Rs. 312 million – Rs 294 million – Rs. 6.3 million	
= Rs. 11.7 million	

2. Calculation of net present value of refunding the bond:-

Saving in annual interest expenses	Rs. (million)
[300 x (0.12 – 0.10)]	6.00
Less:- Tax saving on interest and amortization	
0.30 x [6 + (9-6)/6]	<u>1.95</u>

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Annual net cash saving	<u>4.05</u>
PVIFA (7%, 6 years)	4.766
∴ Present value of net annual cash saving	= Rs. 19.30 million
Less:- Initial outlay	= <u>Rs. 11.70 million</u>
Net present value of refunding the bond	<u>Rs. 7.60 million</u>

Decision: The bonds should be refunded

(c) $r_2 = \frac{1}{1 - \text{initial exp}} \times r_1 + \text{recurring exp.}$

The rate of return the mutual fund should earn;

$$= \frac{1}{1 - 0.06} \times 0.1 + 0.02$$

$$= 0.1264 \text{ or } 12.64\%$$

Question 4

- (a) Your forex dealer had entered into a cross currency deal and had sold US \$ 10,00,000 against EURO at US \$ 1 = EUR 1.4400 for spot delivery.

However, later during the day, the market became volatile and the dealer in compliance with his management's guidelines had to square – up the position when the quotations were:

Spot US \$ 1	INR 31.4300/4500
1 month margin	25/20
2 months margin	45/35
Spot US \$ 1	EURO 1.4400/4450
1 month forward	1.4425/4490
2 months forward	1.4460/4530

What will be the gain or loss in the transaction?

(6 Marks)

- (b) On 19th April following are the spot rates

Spot EUR/USD 1.20000 USD/INR 44.8000

Following are the quotes of European Options:

Currency Pair	Call/Put	Strike Price	Premium	Expiry date
EUR/USD	Call	1.2000	\$ 0.035	July 19
EUR/USD	Put	1.2000	\$ 0.04	July 19

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USD/INR	Call	44.8000	Rs. 0.12	Sep. 19
USD/INR	Put	44.8000	Rs. 0.04	Sep. 19

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

(8 Marks)

- (c) You have following quotes from Bank A and Bank B:

	Bank A	Bank B
SPOT	USD/CHF 1.4650/55	USD/CHF 1.4653/60
3 months	5/10	
6 months	10/15	
SPOT	GBP/USD 1.7645/60	GBP/USD 1.7640/50
3 months	25/20	
6 months	35/25	

Calculate :

- (i) How much minimum CHF amount you have to pay for 1 Million GBP spot?
- (ii) Considering the quotes from Bank A only, for GBP/CHF what are the Implied Swap points for Spot over 3 months?

(6 Marks)

Answer

- (a) 1 The amount of EUR bought by selling USD
 $10,00,000 \times 1.4400 = \text{EUR } 14,40,000$
- 2 The amount of EUR sold for buying USD
 $10,00,000 \times 1.4450 = \underline{\text{EUR } 14,45,000}$
- 3 Net Loss in the Transaction = EUR 5,000

To acquire EUR 5,000 from the market @

(a) USD 1 = EUR 1.4400 &

(b) USD1 = INR 31.4500

Cross Currency buying rate of EUR/INR is

Rs. 31.4500 / 1.440 i.e. Rs. 21.8403

Loss in the Transaction Rs. 21.8403 * 5000 = Rs. 1,09,201.50

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

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

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

Profit or Loss to a trader is

Premium received	\$0.075
Loss on call option exercised $1.2900 - 1.2000$	\$0.090
Net Loss of	\$ 0.015 per EUR

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

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

On 19th April to pay Premium 15,00,000 @ Rs. 0.12 i.e. INR 1,80,000

On 19th September exercise call option to gain 15,00,000 @ Rs. 0.20 INR 3,00,000

Net Gain or Profit INR 1,20,000

(c) (i) To BUY 1 Million GBP Spot against CHF

1. First to BUY USD against CHF at the cheaper rate i.e. from Bank A.

1 USD = CHF 1.4655

2. Then to BUY GBP against USD at a cheaper rate i.e. from Bank B

1 GBP = USD 1.7650

By applying chain rule Buying rate would be

1 GBP = 1.7650×1.4655 CHF

1 GBP = CHF 2.5866

Amount payable CHF 2.5866 Million or CHF 25,86,600

(ii) Spot rate Bid rate GBP 1 = CHF 1.4650×1.7645 = CHF 2.5850

Offer rate GBP 1 = CHF 1.4655×1.7660 = CHF 2.5881

GBP / USD 3 months swap points are at discount

Outright 3 Months forward rate GBP 1 = USD $1.7620 / 1.7640$

USD / CHF 3 months swap points are at premium

Outright 3 Months forward rate USD 1 = CHF $1.4655 / 1.4665$

Hence

Outright 3 Months forward rate GBP 1 = CHF $2.5822 / 2.5869$

Spot rate GBP 1 = CHF $2.5850 / 2.5881$

Therefore 3 month swap points are at discount of 28/12.

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Question 5

The following information relating to the acquiring Company Abhiman Ltd. and the target Company Abhishek Ltd. are available. Both the Companies are promoted by Multinational Company, Trident Ltd. The promoter's holding is 50% and 60% respectively in Abhiman Ltd. and Abhishek Ltd. :

	Abhiman Ltd	Abhishek Ltd.
Share Capital (Rs.)	200 lakh	100 lakh
Free Reserve and Surplus (Rs.)	800 lakh	500 lakh
Paid up Value per share (Rs.)	100	10
Free float Market Capitalisation (Rs.)	400 lakh	128 lakh
P/E Ratio (times)	10	4

Trident Ltd. is interested to do justice to the shareholders of both the Companies. For the swap ratio weights are assigned to different parameters by the Board of Directors as follows:

Book Value	25%
EPS (Earning per share)	50%
Market Price	25%

- (a) What is the swap ratio based on above weights?
- (b) What is the Book Value, EPS and expected Market price of Abhiman Ltd. after acquisition of Abhishek Ltd. (assuming P.E. ratio of Abhiman Ltd. remains unchanged and all assets and liabilities of Abhishek Ltd. are taken over at book value).
- (c) Calculate:
 - (i) Promoter's revised holding in the Abhiman Ltd.
 - (ii) Free float market capitalization.
 - (iii) Also calculate No. of Shares, Earning per Share (EPS) and Book Value (B.V.), if after acquisition of Abhishek Ltd., Abhiman Ltd. decided to :
 - (a) Issue Bonus shares in the ratio of 1 : 2; and
 - (b) Split the stock (share) as Rs. 5 each fully paid. (20 Marks)

Answer

(a) Swap Ratio	Abhiman Ltd.	Abhishek Ltd.
Share Capital	200 Lakh	100 Lakh
Free Reserves	<u>800 Lakh</u>	<u>500 Lakh</u>
Total	<u>1000 Lakh</u>	<u>600 Lakh</u>
No. of Shares	2 Lakh	10 Lakh
Book Value per share	Rs. 500	Rs. 60

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Promoter's holding	50%	60%
Non promoter's holding	50%	40%
Free Float Market Cap. i.e. relating to Public's holding	400 Lakh	128 Lakh
Hence Total market Cap.	800 Lakh	320 Lakh
No. of Shares	2 Lakh	10 Lakh
Market Price	Rs. 400	Rs. 32
P/E Ratio	10	4
EPS	40	8

Calculation of Swap Ratio

Book Value	1 : 0.12 i.e.	0.12 x 25%	0.03
EPS	1 : 0.2	0.20 x 50%	0.10
Market Price	1 : 0.08	0.08 x 25%	<u>0.02</u>
		Total	<u>0.15</u>

Swap ratio is for every one share of Abhishek Ltd., to issue 0.15 shares of Abhiman Ltd.
Hence total no. of shares to be issued

$$10 \text{ Lakh} \times 0.15 = 1.50 \text{ lakh shares}$$

(b) Book Value , EPS & Market Price

Total No of Shares	2 Lakh + 1.5 Lakh = 3.5 Lakh
Total Capital	Rs. 200 Lakh + Rs. 150 Lakh = Rs. 350 Lakh
Reserves	Rs. 800 Lakh + Rs. 450 Lakh = Rs. 1,250 Lakh
Book Value	<u>Rs. 350 Lakh + Rs. 1,250 Lakh</u> = Rs. 457.14 per share 3.5 Lakh

$$\text{EPS} = \frac{\text{Total Profit}}{\text{No. of Share}} = \frac{\text{Rs. 80 Lakh} + \text{Rs. 80 Lakh}}{3.5 \text{ Lakh}} = \frac{\text{Rs. 160 Lakh}}{3.5} = \text{Rs. 45.71}$$

$$\text{Expected Market Price} = \text{EPS (Rs. 45.71)} \times \text{P/E Ratio (10)} = \text{Rs. 457.10}$$

(c) (1) Promoter's holding

Promoter's Revised Holding	Abhiman 50% i.e.	1.00 Lakh shares
	Abhishek 60% i.e.	<u>0.90 Lakh shares</u>
	Total	<u>1.90 Lakh shares</u>

$$\text{Promoter's \%} = 1.90/3.5 \times 100 = 54.29\%$$

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(2) Free Float Market Capitalisation

Free Float Market = $(3.5 \text{ Lakh} - 1.9 \text{ Lakh}) \times \text{Rs. } 457.10$

Capitalisation = Rs. 731.36 Lakh

(3) (i) & (ii)

Revised Capital Rs. 350 Lakh + Rs. 175 Lakh = Rs. 525 Lakh

No. of shares before Split (F.V Rs. 100) 5.25 Lakh

No. of Shares after Split (F.V. Rs 5) $5.25 \times 20 = 105 \text{ Lakh}$

EPS $160 \text{ Lakh} / 105 \text{ Lakh} = 1.523$

Book Value Cap. Rs. 525 Lakh + Rs. 1075 Lakh

No. of Shares = 105 Lakh

= Rs.15.238 per share

Question 6

- (a) Consider two bonds, one with 5 years to maturity and the other with 20 years to maturity. Both the bonds have a face value of Rs. 1,000 and coupon rate of 8% (with annual interest payments) and both are selling at par. Assume that the yields of both the bonds fall to 6%, whether the price of bond will increase or decrease? What percentage of this increase/decrease comes from a change in the present value of bond's principal amount and what percentage of this increase/decrease comes from a change in the present value of bond's interest payments? (8 Marks)
- (b) Consider a bond selling at its par value of Rs. 1,000, with 6 years to maturity and a 7% coupon rate (with annual interest payment), what is bond's duration? (6 Marks)
- (c) If the YTM of the bond in (b) above increases to 10%, how it affects the bond's duration? And why? (3 Marks)
- (d) Why should the duration of a coupon carrying bond always be less than the time to its maturity? (3 Marks)

Answer

- (a) If the yield of the bond falls the price will always increase. This can be shown by following calculation.

IF YIELD FALLS TO 6%

Price of 5yr. bond

Rs. 80 (PVIFA 6%, 5yrs.) + Rs. 1000 (PVIF 6%, 5yrs.)

Rs. 80 (4.212) + Rs. 1000 (0.747)

Rs. 336.96 + Rs. 747 = Rs. 1,083.96

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Increase in 5 year's bond price = Rs. 83.96

Current price of 20 year bond

Rs. 80 (PVIFA 6%, 20) + Rs. 1,000 (PVIF 6%, 20)

Rs. 80 (11.47) + Rs. 1,000 (0.312)

Rs. 917.60 + Rs. 312.00 = Rs. 1229.60

So increase in bond price is Rs. 229.60

PRICE INCREASE DUE TO CHANGE IN PV OF PRINCIPAL

5 yrs. Bond

Rs. 1,000 (PVIF 6%, 5) – Rs. 1,000 (PVIF 8%, 5)

Rs. 1,000 (0.747) – Rs. 1,000 (0.681)

Rs. 747.00 – Rs. 681.00 = Rs. 66.00

& change in price due to change in PV of Principal

(Rs. 66/ Rs. 83.96) x 100 = 78.6%

20 yrs. Bond

Rs. 1,000 (PVIF 6%, 20) – Rs. 1,000 (PVIF 8%, 20)

Rs. 1,000 (0.312) – Rs. 1,000 (0.214)

Rs. 312.00 – Rs. 214.00 = Rs. 98.00

& change in price due to change in PV of Principal

(Rs. 98/ Rs. 229.60) x 100 = 42.68%

PRICE CHANGE DUE TO CHANGE IN PV OF INTEREST

5 yrs. Bond

Rs. 80 (PVIFA 6%, 5) – Rs. 80 (PVIFA 8%, 5)

Rs. 80 (4.212) – Rs. 80 (3.993)

Rs. 336.96 – Rs. 319.44 = Rs. 17.52

% change in price $\frac{\text{Rs.17.52}}{\text{Rs.83.96}} \times 100 = 20.86\%$

20 yrs. Bond

Rs. 80 (PVIFA 6%, 20) – Rs. 80 (PVIFA 8%,20)

Rs. 80 (11.47) – Rs. 80 (9.82)

Rs. 917.60 – Rs. 785.60 = Rs. 132

& change in price = $\frac{\text{Rs.132}}{\text{Rs.229.60}} \times 100 = 57.49\%$

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

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

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

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

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

(c) If YTM goes up to 10% , current price of the bond will decrease to

$$\text{Rs. } 70 \times \text{PVIFA} (10\%,6) + \text{Rs. } 1000 \text{ PVIF} (10\%,6)$$

$$\text{Rs. } 304.85 + \text{Rs. } 564.00 = \text{Rs. } 868.85$$

Year (A)	Inflow (Rs.) (B)	PVIF @ 10% (C)	(A)x(B)x (C) (Rs.)
1	70	0.909	63.63
2	70	0.826	115.64
3	70	0.751	157.71
4	70	0.683	191.24
5	70	0.621	217.35
6	1070	0.564	<u>3,620.88</u>
		Σ ABC	<u>4,366.45</u>

$$\text{New Duration Rs. } 4,366.45 / \text{Rs. } 868.85 = 5.025 \text{ years}$$

The duration of bond decreases, reason being the receipt of slightly higher portion of one's investment on the same intervals.

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

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

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

Question 1

Comment on the following:

- (a) *You are appointed to compile financial statements of Y & Co. for tax purposes. During the course of work, you learn that the inventory is grossly understated. On pointing the same, the partners of Y & Co. tell you that since you are not conducting an audit, the said figures duly certified by the firm should be accepted.* (5 Marks)
- (b) *While conducting statutory Audit of ABC Ltd., you come across IOUs amounting to Rs. 2 crores as against a cash balance shown in books of Rs. 2.10 crores. You also observe that despite similar high balances throughout the year, small amounts of Rs. 50,000 are withdrawn from the bank to meet day-to-day expenses.* (5 Marks)
- (c) *Z Ltd. had appointed an outside expert to assess accrued gratuity liability of the company. Based on the said report, the company provides Rs. 80 lakhs as gratuity in the financial statements.* (4 Marks)
- (d) *A Company's net worth is eroded and creditors are unpaid due to liquidity constraints. The management represents to the statutory auditor that the promoter's wife is expected to give an unsecured loan to meet the liquidity constraints and that negotiations are underway to secure large export orders.* (4 Marks)

Answer

- (a) According to AAS 31 (SRS 4410) "Engagement to Compile Financial Information" if an accountant becomes aware of material misstatements, the accountant should persuade the management to carry out necessary amendments in the financial statements or other compiled financial information. If such amendments are not made and the financial statements are still considered to be misleading the accountant should withdraw from the engagement. Hence, in this case, there is a clear violation of AAS 31(SRS 4410).
- (b) According to AAS 4 (SA 240) "Auditors responsibility to consider fraud and error in an audit of financial statements", when the auditor comes across such circumstances indicating the possible misstatements resulting from procedure to consider the effect of fraud and error on auditors report. In this case, the circumstances indicate that the possible misstatements in financial statements is due to fraud and error and the auditor must investigate further to consider effect on financial statements.

The Guidance Note on Audit of Cash and Bank balances also mentions that if the entity is maintaining an unduly large balance of cash, he should carry out surprise verification of cash more frequently to ascertain whether it agrees. If cash in hand is not in agreement with the book balance, he should seek explanations and if the same are not satisfactory should state the said fact appropriately in his Audit Report.

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

- (c) AAS 9 (SA 620) states that while using the work of an expert, auditor should consider the materiality of the item, nature and complexity of the item, the other audit evidence available and professional qualifications, experience and reputation in the field of the concerned expert.

The auditor should ensure that the expert has used appropriate source data, has made consistent assumptions, has applied correct methods and that results of expert's work are in line with auditor's overall knowledge of the business and match with results of his audit procedures. The auditor should also ensure that substance of expert's findings is properly reflected in the financial information.

- (d) In this case, it is subjective, but prima-facie a mere expectation of future cash flows from the promoter's wife without any firm commitment and the possibility of an export order being negotiated, may not that be sufficient appropriate audit evidence of mitigating factors for resolving the going concerns question under AAS 16 (SA 570) "Going Concern".

Question 2

Comment with reference to the Chartered Accountants Act, 1949 and Schedules thereto:

- (a) *H, a Chartered Accountant in practice is a partner in 3 firms. On the personal Letter Heads of H, names/address of all the 3 firms are mentioned.* (4 Marks)
- (b) *D, who conducts the tax audit u/s 44AB of the Income Tax Act, 1961 of M/s ABC, a partnership firm, has received the entire audit fees of Rs. 25,000 in April, 2009 in respect of the tax audit for the year ended 31.3.2009. The audit report was, however, signed on 25.5.2009.* (4 Marks)
- (c) *M/s LMN, a firm of Chartered Accountants having 5 partners accepts an audit assignment of a newly formed private limited company for audit fees of Rs. 5,000.* (5 Marks)
- (d) *P, a Chartered Accountant in practice, accepts appointment as statutory auditor for LMN Pvt. Ltd. Q, brother of P has substantial interest in LMN Pvt. Ltd.* (5 Marks)

Answer

- (a) Under clause (7) of part -1 of First Schedule, a CA in practice is deemed to be guilty of professional misconduct if he (i) advertises his professional attainments or services or (ii) uses any designation or expressions other than 'Chartered Accountant' on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a university established by law in India or recognized by the Central Government or a title indicating membership of the ICAI or of any other institution that has been recognized by the Central Government or may be recognized by the council.

Here there is no prohibition for printing names of all 3 firms on the personal letter heads in which a member holding certificate of practice is a partner. Thus, H is not guilty of any professional misconduct in the above case.

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- (b) Under section 226(3)(d) of Companies Act, 1956 a person is disqualified from being an auditor if he is indebted to the company for more than Rs. 1,000/-. This provision applies only to an auditor appointed under the Companies Act, 1956.

In the instant Case, D is appointed to conduct a tax audit u/s 44AB of the Income Tax Act, 1961. There is no such similar provisions in the Income Tax Act. Thus, D will still be able to do the audit and would not be disqualified. He also does not violate any provision of the CA Act, 1949 and schedules thereto.

- (c) As per the council general guidelines 2008, the minimum audit fees are prescribed depending on the number of partners in a firm and the city in which the audit is to be carried out. A proviso to the said guidelines states that the restriction does not apply for audit of newly formed concerns for 2 accounting years from the date of commencement of operations.

In the instant case, since the audit assignment is of a newly formed private limited company the proviso shall apply and M/s LMN can conduct the audit without violation of any code of conduct.

- (d) As per clause (4) of part I of II schedule, a CA is deemed to be guilty of professional misconduct if he expresses his opinion on financial statements in which his firm or a partner has substantial interest. As per Council General Guidelines, 2008, the above restriction is also made applicable for relatives of the members.

In the instant Case, since Q, a relative has a substantial interest in LMN Pvt. Ltd, P cannot conduct the audit and will be guilty of misconduct.

Question 3

Answer the following:

- (a) *You are appointed statutory auditor of X Ltd. X Ltd. has an internal audit system and reports for the same are given to you. Mention the factors you will consider to ensure that the said system of internal audit of X Ltd. is commensurate with the size of the company and nature of its business.* (8 Marks)
- (b) *The audit report of P Ltd. for the year 2007-08 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2008-09, how would you report, if:*
- (i) *The company does not make provision for doubtful debts in 2008-09?*
- (ii) *The company makes adequate provision for doubtful debts in 2008-09?* (8 Marks)

Answer

- (a) As per AAS 7 (SA 610) "Relying on Work of an Internal Auditor" the statutory auditor has to consider the following before placing reliance on the same".
- (i) Organizational status – whether the same is done internally or by an external agency.
- (ii) Scope of work – What is the nature and depth of the coverage of the assignment.

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

- (iii) Technical competence – Whether the internal auditor is technically competent to do the work i.e. having adequate technical training and proficiency.
- (iv) Due professional care – Whether his work and reports appear to be properly planned, supervised reviewed and documented.

If the above factors are not satisfactory, the statutory auditor will have to modify his audit program and increase the verification to be carried out.

- (b) Auditor's responsibilities in cases where audit report for an earlier year is qualified is given in AAS 25 (SA 710) "Comparative". As per AAS 25 (SA 710), when the Audit Report on the prior period intended a qualified opinion and the said matter is:
- (i) Unresolved and results in an modification of the auditors report regarding current year's figures, his report should be modified regarding corresponding figures.
 - (ii) Resolved and properly dealt with in the financial statements, the current report should ordinarily not refer to such modification. If however, the matter is material, he may include an "emphasis of matter" paragraph.

In the instant Case, if P Ltd. does not make provision for doubtful debts the auditor will have to modify his report for both current and previous year's figures. If however, the provision is made, the auditor need not refer to the earlier years modification.

Question 4

Answer the following:

- (a) What are the duties of a statutory auditor regarding disqualification of a director u/s 274(1)(g) of the Companies Act, 1956 ? (8 Marks)
- (b) While doing the audit of consolidated Financial Statements, which current period consolidation adjustments are to be taken into account? (8 Marks)

Answer

- (a) As per section 274(1)(g) of the Companies Act, a director is disqualified if :
- the concerned public company has not filed the annual returns/accounts for any 3 continuous financial years on or after 1-4-1999.
 - the director in such a case becomes disqualified on the last date for filing the above documents. The Auditor should therefore obtain representation for :
 - (i) names of directors for the period.
 - (ii) particulars of appointment/reappointment for above.
 - (iii) whether directors have submitted for DD-A as required by the Rules.
 - (iv) that the information contained in Register of Directors is updated .
 - (v) whether company has committed any default as envisaged above.
 - (vi) if default is committed, whether Form DD-B has been submitted.

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After ascertaining the above, auditor has to report under section 227(3)(f) whether any director has been disqualified and if so, mention the said fact.

- (b) Following are the current period consolidation adjustments while making consolidation of financial statements.
- Elimination of intra-group transactions relating to interest or management fees etc.
 - Elimination of unrealized intra-group profits on assets acquired from other subsidiaries.
 - Elimination of intra-group indebtedness.
 - Adjustments for harmonizing different accounting policies of parent unit and its subsidiaries.
 - Adjustments for impairment loss that might exist for goodwill.
 - Adjustment for significant events that occur between date of financial statements of the parent and of its components when the date/s of financial statements of components are different from the reporting date.
 - Determination of movement in equity attributable to the minorities since the date of acquisition of the subsidiary.
 - Treatment of minority interests' share of the losses, if such losses exceed the minority interests' share in the equity.

Question 5

Answer the following:

- (a) *Loans were given out of the funds of an Employees Provident Fund to the employer company in contravention of the applicable rules. As the auditor of the said Provident Fund, M discloses the contraventions to the Trustees of the fund, but failed to do so to the members of the fund. Comment.* (5 Marks)
- (b) *X Ltd. did not follow the applicable Accounting Standard for disclosing Earnings Per Share (EPS) in the financial statements. The fact of such non-disclosure was however, mentioned in the notes forming part of accounts. As the statutory auditor of X Ltd., how would you report in the above case?* (5 Marks)
- (c) *What are the considerations to be kept in mind while performing analytical procedures on data prepared by the client.* (6 Marks)

Answer

- (a) In the given Case, CA M has contravened clause (5) of part I of Second Schedule to the CA, Act. It is the duty of a CA in practice to disclose material facts known to him so that the financial statement does not become misleading. Further the auditor CA should disclose such facts to beneficiaries of a fund in applicable cases. Technically, appointment of an auditor could be done by a company through its directors, but in substance the auditor in such cases addresses to the beneficiaries just like he gives his

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report to the shareholders of a company. Mr. M is found guilty of professional misconduct.

- (b) Disclosure of EPS is required for all companies as per AS 20 "Earnings per Share". AS 20 is also one of the AS notified by the Companies (Accounting Standards) Rules, 2006. If the disclosures required by AS 20 are not made, it is the duty of the auditor to qualify in his report "Whether Accounting Standards under the clause as notified u/s 211(3C) have been followed?". Mere disclosure by company in notes does not absolve him of his duty.

The same is however not a qualification to affect the "True & Fair" position of financial results of the company.

- (c) When the auditor intends to perform analytical procedures on data prepared by the client, he should consider the following:
- Objective of such procedures and the extent to which he may be able to rely on their results.
 - Nature of the entity and the degree to which information can be disaggregated, for example, analytical procedures may be effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
 - Availability of information, both financial, such as budgets or forecasts, and non-financial such as the number of units produced or sold.
 - Reliability of the information available
 - Relevance of the information available
 - Sources of information available
 - Comparability of the information available
 - Knowledge gained by the auditor during previous examinations.
 - Testing the controls over the preparation of non financial information, if any, used in applying analytical procedures.

Question 6

Answer the following:

- (a) List the special features involved in the audit of a Cooperative Society. (8 Marks)
- (b) Draft an Audit programme for conducting the audit of a Public Trust registered under section 12A of the Income Tax Act, 1961. (8 Marks)

Answer

- (a) Following are the special features in the audit of a cooperative society:
- Examination of overdue debts.

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- Special treatment of over due interest in the determination of profit.
 - Certification of bad debts before write off.
 - Valuation of assets and liabilities
 - Adherence to co-operative Principles.
 - Observations of the Provisions of the Act and Rules
 - Verification of members' Register and examination of their pass books
 - Special report to the registrar on fraud, mismanagement and personal profiteering.
 - Audit classification of society based on the audit findings
 - Discussion of draft audit report with the managing committee.
- (b) An auditor should conduct routine checking during the course of audit of a public trust, in the following manner:
- (i) Check the books of account and other records having regard to the system of accounting and internal control
 - (ii) Vouch the transactions of the trust to satisfy that:
 - (a) the transaction falls within the ambit of the trust
 - (b) the transaction is properly authorized by the trustees or other delegated authority as may be permissible in law;
 - (c) all incomes due to the trust have been properly accounted for on the basis of the system of accounting followed by the trust;
 - (d) all expenses and outgoings appertaining to the trust have been recorded on the basis of the system of accounting followed by the trust;
 - (e) amounts shown as applied towards the object of the trust are covered by the objects of trust as specified in the document governing the trust.
 - (iii) Obtain trial balance on the closing date certified by the trustees' duty certified by the trustee;
 - (iv) Obtain Balance Sheet and Profit & Loss Account of the trust authenticated by the trustees and check the same with the trial balance with which they should agree.

Question 7

Answer the following:

- (a) *Enumerate the verification procedures in relation to audit of a Hire-Purchase Finance Company.* (8 Marks)
- (b) *As the tax auditor of a non-corporate entity u/s 44AB of the Income Tax Act, 1961, how would you ensure compliance of section 145 of the Income Tax Act, 1961?* (8 Marks)

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Answer

- (a) Verification Procedures in relation to audit of a Hire Purchase Finance company (HPFC):

Hire Purchase Finance Company

- (i) Ascertain whether the NBFC has an adequate appraisal system for extending hire purchase finance. The system of appraisal is basically concerned with obtaining information regarding the credit worthiness of the hirer, his experience in the field, assets owned, his past track record and future projections of his income.
 - (ii) Verify that the payment for acquiring an asset should be made directly to the supplier/dealer and that the original invoice has been drawn out in the name of the NBFC.
 - (iii) In the case of high value hire purchase items relating to machinery/equipment, an auditor should ascertain whether the valuation reports and installation reports are called for. In case of some high value items, he should also physically verify the asset in possession of the hirers, particularly in a situation where he has any doubts as regards the genuineness of the transaction.
 - (iv) If the hire purchase finance is against vehicles, check whether the registration certificate contains an endorsement in favour of the hire purchase company.
 - (v) The auditor should verify whether the NBFC has a system in place for verifying the hire purchase assets periodically to ensure that the hirers have not sold the assets or otherwise encumbered them.
 - (vi) Check whether hire purchase instalments are being received regularly as and when they fall due. Check whether adequate provision has been made for overdue hire purchase instalments as required by the NBFC Prudential Norms directions.
 - (vii) Examine the method of accounting followed by the hire purchase finance company for appropriation of finance charges over the period of the hire purchase contract. Ascertain that there is no change in the method of accounting as compared to the immediately preceding previous year.
 - (viii) Verify that the assets given on hire purchase have been adequately insured against.
 - (ix) In case the goods are repossessed by the hire purchase finance company on account of non-repayment of hire purchase instalments, verify that the repossessed goods have been valued on a realistic basis by the hire purchase finance company.
- (b) Income under the head Profit & Gains of business or profession or income from other sources has to be computed under mercantile or cash system of accounting as regularly maintained by the assessee.

The Central Government may notify in the official Gazette from time to time the accounting standards to be followed by any class or assesses or in respect of any class of income. The following Accounting Standards have been notified.

- (i) AS (IT)-1: Disclosure of accounting policies.

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- (ii) AS (IT)-2: Disclosure of prior period and extra ordinary items and disclosure of accounting policies.

The above AS are corresponding to AS-1 and AS-5 respectively if the ICAI u/s 145(3) the Assessing Officer may make a best judgement assessment under section 144 in the following assessment under section 144 in the following situation:

- (i) Where the Assessing Officer is not satisfied about the correctness or complete ness of the accounts of the assessee
- (ii) Where the method of accounting has not been regularly followed by the assessee.
- (iii) Where the AS notified u/s 145(2) have not been regularly followed by the assessee.

The auditor has to therefore ensure that:

- (a) the entity follows either the cash or accrual method of accounting
- (b) Accounting policies are required by AS (IT) -1 has been disclosed separately.
- (c) Other provisions of AS 1 (IT) and AS (IT) -2 have been complied with.

Question 8

Answer the following:

- (a) *What are the points to be considered while evaluating the "Knowledge of the Business" in the conduct of an audit?* (8 Marks)
- (b) *Write short notes on:*
- (i) *Probable format of Environmental Statement.* (4 Marks)
- (ii) *"Reporting" stage in Peer Review.* (4 Marks)

Answer

- (a) Points to be considered while evaluating "Knowledge of the Business" (as per erstwhile AAS 20 which has now been withdrawn):
- (i) Changes in management, organization structure and activities of the client;
- (ii) Legislation charges affecting the business of the client
- (iii) Business developments affecting the client.
- (iv) Existence of related parties with whom business is being conducted by the client
- (v) Changes in technology, production facilities and its effect on profitability
- (vi) Significant matters from earlier years audit reports etc.
- (vii) Changes in internal control systems
- (viii) New facilities and other charges made during the year
- (ix) Relevance of work carried out by internal auditors.

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- (b) (i) Probable format of “Environmental Statement”
- (a) Name/address of owner/occupier of the industry, operation or process.
 - (b) Date of last environmental audit report submitted
 - (c) Consumption of water and other raw materials as input during current and previous year.
 - (d) Pollution generated in air and water with output and types of pollutants and deviation from standard.
 - (e) Generation of hazardous waste in current year and previous year from processes or from pollution control facility.
 - (f) Quantity of solid waste generated during current year and previous year from process/es from pollution control facility and from recycling or reutilization of waste, etc.
 - (g) The disposal practice for different type waste.
 - (h) The practice of conservation of natural resources.
- (ii) The additional investment proposal for environmental protection including abatement of pollution.
- (iii) Reporting stage in Peer Review: This includes the following steps:
1. Preliminary Report of Reviewer - At the end of the on-site review, the reviewer is required to send a preliminary report to the practice unit before making any report to the Board on the areas in case systems and procedures of the practice unit reviewed have been found to be deficient or where non-compliance with reference to any other matter has been noticed by the reviewer during the course of review. The reviewer has to take care that the report does not contain name of any individual of the practice unit. However, no preliminary report is required in case no deficiencies or non-compliance are noticed by the reviewer.
- The reviewer while preparing the preliminary report should review and assess the conclusions drawn from the review that indicates the deficiencies to be reported upon. The preliminary report is addressed to the practice unit. The report, apart from mentioning the areas where systems and procedures of the practice unit have been found to be deficient, should also contain a paragraph that discusses the scope of the review performed by the reviewer. If the reviewer draws a conclusion that there existed a limitation on scope of review, the fact, along with such limitation on the scope of the review, should also be communicated to the practice unit through the preliminary report. The reviewer should prepare the report on his letterhead. The report should be dated and also contain the reviewer's signature and membership number and reviewer's code number allotted by the Board.

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2. Reply to Preliminary Report - The practice unit has to send its submissions or representations, in writing, to the reviewer, on the areas mentioned in the preliminary report. The reply to the preliminary report should be sent by the practice unit within a period of 21 days from the receipt of the preliminary report from the reviewer.
3. Interim Report of the Reviewer - If the reviewer is not satisfied with the reply of the practice unit, the reviewer has to submit an interim report to the Board. The report so submitted should clearly indicate that it is an "interim report". It may be noted that the Board may then give recommendations to the practice unit and instruct the reviewer to carry out a further review after minimum six months in case of any weakness in the compliance of technical standards is reported by the reviewer or follow up review after twelve months in case of any weakness in the internal control system of the concern is reported by the reviewer and to verify whether the systems and procedures of the practice unit have been modified appropriately. The reviewer is then required to submit a report to the Board.
4. Final Report of the Reviewer - If the reviewer is satisfied with the reply of the practice unit, the reviewer shall submit his final report to the Board. The final report should incorporate the findings as discussed with the practice unit.

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SECTION – A

*Question No.1 is compulsory. Answer any **six** from the rest.*

Question 1

*Answer any **two** of the following:*

- (a) *Examine the validity of the following with reference to the provisions of the Companies Act, 1956:*
- (i) *The Balance Sheet and Profit and Loss Account of TXN Ltd. for the year ended 31st March, 2009 was signed by one of its Directors and the Secretary.*
 - (ii) *Mr. Prakash, a Chartered Accountant in full time practice was appointed as the auditor of ABC Ltd., a company which is a subsidiary of DGH Ltd. and DGH Ltd. has another subsidiary called PKM Ltd. Mr. Prakash had taken a loan of Rs.25,000 from PKM Ltd. and the loan is outstanding as on the date of his appointment as auditor of ABC Ltd. (5 Marks)*
- (b) *Board of Directors of M/s. RPP Ltd. in its meeting held on 29th May, 2009 declared an interim dividend payable on paid up Equity Share Capital of the Company. In the Board Meeting scheduled for 10th June, 2009, the Board wants to revoke the said declaration. You are required to state with reference to the provisions of the Companies Act, 1956 whether the Board of Directors can do so. (5 Marks)*
- (c) *Chairman of Board of Directors of ABC Ltd. came across a matter, which required the approval by way of a board resolution. In the prevailing circumstances, it is not possible to convene and hold a Board Meeting. The Chairman approaches you to advise him of the way and the relevant procedure to obtain such approval without holding the Board Meeting. You are required to advise him on the matter as per the provisions of the Companies Act, 1956. (5 Marks)*

Answer

- (a) (i) Applicable provisions of section 215 of the Companies Act, 1956 provides that every Balance Sheet and every Profit & Loss account of a company (other than a banking company) shall be signed by its manager or secretary, if any, and by not less than two Directors of the Company one of whom shall be the Managing Director where there is a Managing Director in the Company.

In view of the above provisions of the Companies Act, 1956, the signing of the Balance Sheet and Profit & Loss Account by only a Director and Secretary does not fulfill the requirements of the law.

In the given case, if the company has a managing director, then the managing director and at least one other director together with the secretary of the company shall sign the Balance Sheet and Profit & Loss A/c. If there is no managing director then two directors authorized by the Board and the Secretary shall sign the same.

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- (ii) Section 226(3) of the Companies Act, 1956 provides for the disqualifications of an auditor. Clause (d) of the said Section states that if a person is indebted to a company for a sum exceeding Rs.1,000/- then such person is not qualified for being appointed as the auditor of that company. Section 226(4) of the said Act states that a person shall also not be qualified for appointment as auditor of a company if he is, by virtue of said Section, disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company.

In view of the above provisions of law, since ABC Ltd is a subsidiary of DGH Ltd; which is the holding company of PKM Ltd. to whom Mr. Prakash is indebted for a sum exceeding Rs.1,000/- his appointment as the auditor of ABC Ltd. is not in order as it is violative of provisions of Section 226(3) read with Section 226(4) of the said Act.

- (b) Prior to the passing of Companies (Amendment) Act, 2000 only Regulation 86 of Table "A" to the Companies Act, 1956 dealt with the question of interim dividend. The said Regulation empowered the directors to declare interim dividend. i.e., dividend in between two annual general meetings. The said amending Act introduced sub-Section 14A in Section 2 of the Companies Act, 1956 whereby interim dividend is now part of dividend. Accordingly, all provisions of the Companies Act, 1956 relating to dividend have become applicable to interim dividend also.

Section 205 of the Companies Act, 1956 has also been amended by the said amending Act to provide as follows:

- (i) The Board of Directors may declare interim dividend and the amount of dividend including interim dividend shall have to be deposited in a separate bank account within five days from the date of declaration of such dividend. [Section 205(1A)]
- (ii) The amount of interim dividend so deposited as stated above shall be used for payment of interim dividend. [Section 205(1B)]
- (iii) The provisions of Sections 205, 205A, 205C, 206, 206A, and 207 of the Companies Act, 1956 have also become applicable to interim dividend to the extent possible. [Section 205(1C)]

In view of the above legal position, the Board of Directors of RPP Ltd. must have deposited the amount of interim dividend declared on 29th May, 2009 into a separate bank account on or before 3rd June, 2009 i.e. within five days from 29th May, 2009 when the interim dividend was declared. As stated above, the amount once deposited into a separate bank account, can be used only for payment of interim dividend.

As per provisions of the Companies Act, 1956, the Board of RPP Ltd. has no power to revoke the interim dividend declared on 29th May, 2009 and shall not have any power to use the interim dividend amount transferred to a separate bank account for any other purpose.

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In case the amount of interim dividend has not been transferred to a separate bank account and is not paid within the time, the company and its directors have exposed themselves to the applicable penal provisions of the said Act.

- (c) As per the provisions of the Companies Act, 1956 several Board Resolutions are required in course of carrying on the affairs of a limited company. But, it may sometimes so happen that a Board Meeting can not be held. To meet such eventualities, the Companies Act, 1956 contains the solution in Section 289. According to this section, the board resolution can be passed by way of circulation. It may, however, be noted that the matters listed in the provisions of Section 292 requiring passing of resolution at the board meetings only can not be passed by way of circulation.

The chairman of ABC Ltd. is advised that the approval in the form of a Board Resolution may be obtained by way of passing the relevant resolution by circulation if the matter is not covered by Section 292 of the said Act.

Assuming that the present resolution required to be passed is not falling within the items listed in Section 292 of the said Act, the resolution can be passed by circulation.

The procedure to be adopted for the purpose of passing a resolution by circulation is as follows:-

- (i) Send the draft of the resolution in duplicate together with the necessary papers, if any, to all the directors then in India. It is to be ensured that the number of such directors is not less than the directors required to form the quorum for a Board Meeting.
- (ii) Send that draft of the resolution in duplicate together with the necessary papers, if any, to all other directors at their usual address in India.
- (iii) Obtain one copy of the draft resolution duly signed by the directors, whether approving the resolution or disapproving the same. It may be noted that the resolution shall be deemed to be passed by the Board if all the directors then in India or majority of all directors as are entitled to vote on the matter approve the resolution by signing one copy and returning the same to the company.
- (iv) The resolution passed by circulation shall be placed before the next Board Meeting for confirmation.
- (v) The resolution shall be recorded in the minutes of the next Board Meeting.

Question 2

- (a) ABC Ltd. has 12 directors on its Board and has the following clause in its Articles of Association:

“The questions arising at any meeting of the Board of Directors or any Committee thereof shall be decided by a majority of votes, except in cases where the Companies Act, 1956 expressly provides otherwise.”

In one of the meetings of the Board of Directors of ABC Ltd., 8 directors were present. After completion of discussion on a matter, voting was done. 3 directors voted in favour

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of the motion, 2 directors voted against the motion while 3 directors abstained from voting.

You are required to state with reference to the provisions of the Companies Act, 1956 whether the motion was carried or not. It is clarified that the motion being voted upon was not concerning a matter which requires consent of all the directors present in the meeting.
(5 Marks)

- (b) *The Articles of Association of MKP Limited incorporated with an Authorised Share Capital of Rs.50 crores divided into 5 crores Equity Shares of Rs.10 each contained the following clause:*

"The qualification of a director shall be the holding of at least 1,000 Equity shares in the Company and such a director if not already so qualified shall have to obtain his qualification within a period of 30 days from the date of his appointment as director."

Examine the validity of the above clause in the light of the provisions of the Companies Act, 1956.
(5 Marks)

Answer

- (a) Regulation 74(1) of Table A of Schedule 1 to the Companies Act, 1956 provides that save as otherwise expressly provided in the Companies Act, 1956, questions arising at any meeting of the Board shall be decided by a majority of votes.

In the problem given in the question, the similar article exists in the Articles of Association of ABC Ltd. In the given case, only 8 directors out of a total strength of 12 directors are present and out of those 8 directors present only 5 directors have exercised their votes. In such a case, only those directors who are present and vote on a motion are considered for determining whether the motion is carried or not. That means out of the 5 directors who voted on the motion are to be considered. Accordingly, since number of directors who voted in favour of the motion being 3, is higher than the number of directors who voted against the motion being 2, the motion is carried or is considered to be passed by majority.

- (b) The subject matter of the question is covered by the provisions of Section 270 of the Companies Act, 1956. The Companies Act, 1956 does not provide for any qualification for becoming a director of any company. According to the said Section, any person appointed as a director is required to obtain the qualification if it is so provided by the Articles of Association of the Company.

The said Section states that in case the Articles of Association of a company provides for the qualification of a director, then such a director is required to obtain the requisite qualification within a period of two months from the date of his appointment as a director. The Section further states that any clause in the Articles of association requiring the director to obtain the qualification shares within a shorter time than two months shall be void.

The said Section also puts a maximum limit on the qualification that can be prescribed by the Articles of Association. Such maximum limit being shares with nominal value not

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exceeding Rs. 5,000 or in a case where the nominal value of one share exceeds Rs. 5,000 then the qualification share shall be maximum one share.

Based on the provisions of Section 270 of the Companies Act, 1956 as explained above, the clause in the Articles of Association as given in the question is void since it stipulates the obtaining of the qualification shares within a period of 30 days which is shorter than two months. Moreover the clause also violates the maximum limit of share qualification by prescribing the same to be 1,000 shares of Rs.10 each totaling Rs.10,000 which is more than the limit of Rs. 5,000 as prescribed in the said Section.

It is pertinent to note that as per Section 9 of the Companies Act, 1956, any clause in the Articles of Association of any company which is ultra virus the Act is void.

Question 3

- (a) (i) *Examine the validity of the following with reference to the relevant provisions of the Companies Act, 1956 and/or decided case laws:*

The Articles of Association of Big Limited provide that a meeting of the Board of Directors of the company shall be held at 11.00 A.M. on the last day of every quarter ending 31st March, 30th June, 30th September and 31st December. Relying on such a clause in the Articles, the company did not send notices to the directors in respect of the board meeting held on 30th September, 2008. Some of the directors have questioned the validity of the board meeting on the ground that individual notices have not been sent to the directors.

- (ii) *A Producer Company wants to issue bonus shares. You are required to state the relevant provisions of the Companies Act, 1956 in this regard. (5 Marks)*

- (b) *What do you understand by the term "Director Identification Number" (DIN)? Describe the procedure to obtain the same as enumerated under the Companies Act, 1956 read with the relevant Rules. (5 Marks)*

Answer

- (a) (i) If the articles of association of Big Limited provides that a meeting of the board of directors shall be held on the last day of each quarter, it is not necessary that separate notices are required to be served on the directors. It was held in the case of *Arunachalam Chettlar vs. kaleswarar Mills Ltd. [(1956) 26 COMP. CAS. 431]* that where articles of the company provide that there will be a meeting of the board of directors on the first Saturday of every month, there will be no necessity of service of notice to individual director and such clause in the articles of association is sufficient compliance of Section 286(1) of the Companies Act, 1956. In view of the said judgement the clause in the article is sufficient compliance of the requirement of sending the notice for a board meeting and the contention of some of the directors is not legally valid. However, as a good secretarial practice, notice for every board meeting should be sent to all the directors eligible to receive the notice.

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- (ii) As per provisions of Section 581ZJ of the Companies Act, 1956, any Producer Company may, upon recommendation of the Board and passing of resolution in the general meeting, issue bonus shares by capitalization of amounts from general reserves referred to in Section 581ZI in proportion to the shares held by the Members on the date of the issue of such shares.
- (b) Director Identification Number (DIN) is a unique identification Number given by the Ministry of Corporate Affairs. It is required to be obtained by every person who is or intends to become a director of any company. DIN is a pre-requisite for filling various forms with the Registrar of Companies. The electronic system of the Ministry of Corporate Affairs will not allow to file/submit the forms if DIN of the signatory director is not mentioned in the form being filed/submitted.

In order to obtain DIN from the Ministry of Corporate Affairs, following procedure is to be adopted.

- (i) To check whether the computer system through which the DIN Application is being made has the requisite hardware and the software as well as the Internet facility.
- (ii) Using the internet facility, DIN Application Form has to be downloaded from the website of Ministry of Corporate Affairs.
- (iii) The DIN application Form is to be filled up and submitted electronically.
- (iv) On electronic submission of the DIN application Form, a provisional DIN will be generated and displayed on the said Application Form.
- (v) Thereafter, the form is to be printed, signed and submitted to the Ministry of Corporate Affairs – DIN Cell along with following papers/documents:
 - (a) Passport size photograph of the Applicant duly attested by a Magistrate or a Notary Public or a practising Chartered accountant or a practising Company Secretary or a practising Cost Accountant or a Gazetted Officer.
 - (b) Attested copy of any one of the following as a proof of identity:
 - a. Passport
 - b. Election/Voter Identity Card
 - c. Driving Licence
 - d. Income Tax Pan Card
 - e. Any other document which will prove the identity of the Applicant
 - (c) Attested copy of any one of the following as a proof of residence:
 - a. Passport
 - b. Election / Voter Identity Card
 - c. Ration card
 - d. Driving Licence

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- e. Electricity Bill
- f. Telephone Bill
- g. Bank account Statement
- h. Any other document which will prove the residential address of the Applicant

On Submission of the above, the DIN Cell of the Ministry of Corporate Affairs shall allot final DIN and send an intimation letter to the Applicant. The intimation is also sent via e-mail.

The status of DIN application can also be checked online.

Question 4

- (a) (i) *Mr. KMP is director of XLS Ltd. He intends to construct a residential building for his own use. The cost of construction is estimated at Rs.1.50 Crores, which Mr. KMP proposes to finance partly from his own sources to the tune of Rs.60 lacs and the balance Rs.90 lacs from housing loan to be obtained from a housing finance company. For the purpose of obtaining the loan, he has approached the housing finance company which has in principle agreed to grant the loan, but has put a condition. The condition put by the housing finance company is that the Company XLS Ltd. of which Mr. KMP is a director should provide the guarantee for repayment of the loan and interest as per the terms of the proposed agreement for granting the loan to Mr. KMP. You are required to advise Mr. KMP on the matter with reference to the provisions of the Companies Act, 1956.*
- (ii) *Draft a Board Resolution of XLS Ltd. For providing guarantee for Rs. 90.00 lacs in respect of a Loan to be obtained by Mr. KMP, a director thereof from a Housing Finance Company for construction of a residential house for his own use. (5 Marks)*
- (b) *Big Ben Ltd., a reputed public company, had advanced certain sum of money to one of its Directors, namely, Mr. Tanmay on certain terms and conditions and fixing the time limit for repayment thereof. Now, Mr. Tanmay has approached the Company with a request to extend the time limit for repayment of balance of loan amounting to Rs.12.00 lacs by another six months.*

You are required to state with reference to the provisions of the Companies Act, 1956, the answer to the following:

- (i) *Who is authorized to grant the extension as requested by Mr. Tanmay?*
- (ii) *Draft an appropriate notice for the meeting where such extension may be granted.*

(5 Marks)

Answer

- (a) (i) According to the provisions of Section 295 of the Companies Act, 1956, no company shall make any loan or give any guarantee or any security in connection with a loan made by any other person to any director of the lending company unless the

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previous approval of the Central Government is obtained in this respect.

In view of the above provisions of the law, Mr. KMP is required to approach XLS Ltd. intimating the company the full details of the loan transaction and the condition imposed by the housing finance company. The company XLS Ltd. is required to pass a Board Resolution as required by Section 292 of the Companies Act, 1956 and also a special resolution in terms of Section 372A if the facts of the case so require. Thereafter, the company is required to make an application to the Central Government for obtaining the approval under Section 295 of the Companies Act, 1956. On receipt of the approval of the Central Government, XLS Ltd. can provide the guarantee to housing finance company in respect of the loan proposed to be granted to Mr. KMP

(ii) RESOLUTION PASSED IN THE MEETING OF THE BOARD OF DIRECTORS OF XLS LTD. HELD ON _____

“RESOLVED that, subject to the approval of the Central Government, sanction be and is hereby accorded to the proposal of furnishing the guarantee in respect of a loan of Rs.90.00 lacs to be obtained by Mr. KMP, a director of the Company, from M/s _____, a housing finance company as per terms and conditions contained in the draft loan agreement to be entered into between the said housing finance company and Mr. KMP, a copy of which is placed before this meeting and initialed by the Chairman for the purpose of identification.

RESOLVED FURTHER that Mr. _____, Secretary of the Company by and is hereby authorized to digitally sign the e-form 24AB, submit the application to the Ministry of Corporate Affairs and comply with all other formalities in this regard.”

- (b) (i)** As per provisions of Section 293(1)(b) of the Companies Act, 1956, the Board of Directors of Big Ben Ltd., a public company can not give time for the repayment of any debt due by Mr. Tanmay, a director of the company except with the consent of the Company by way of an ordinary resolution passed in a General Meeting. In view of this provision of the law, the Company in a General Meeting is authorized to grant the extension as requested by Mr. Tanmay.

- (ii)** Notice for calling the General Meeting of the company:

BIG BEN LIMITED

Registered Office: _____

NOTICE FOR EXTRA ORDINARY GENERAL MEETING

NOTICE is hereby given that an Extra Ordinary General Meeting of the members of the company will be held at the Registered office of the Company on _____, the _____ day of _____, 2009 at 11.00 A.M. to transact the following business:

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- (1) To Pass, with or without modification, the following resolution as an Ordinary Resolution:

“RESOLVED THAT pursuant to the provision of Section 293(1)(b) of the Companies Act, 1956, consent be and is hereby accorded to the company for extending the time for the repayment of the balance amount of Rs. 12.00 Lacs advanced to Mr. Tanmay, a Director of the company, by a further period of six months ending on _____, 2009.”

FOR & ON BEHALF OF THE BOARD

Dated. _____, 2009

Company Secretary

Notes:

- (1) A member entitled to attend and vote at the Meeting is entitled to appoint a proxy to attend and vote instead of himself and such proxy need not be a member of the Company. Proxies in order to be valid must be deposited at least 48 hours prior to commencement of the Meeting.
- (2) Explanatory Statement pursuant to Section 173(2) of the companies Act, 1956 is annexed hereto.

Question 5

- (a) *A group of share holders has approached you for advice regarding the affairs of LPM Paper Mills Ltd. According to them, the management of the company is not carrying out its functions in accordance with the prudent commercial practice and if the affairs of the company are allowed to run in future in the same manner, the company's solvency would be in danger. They want that a Special Audit under the Companies Act, 1956 be conducted to find out the actual nature of the transactions. You are required to draft an application to be submitted to the appropriate authority in this respect. (5 Marks)*
- (b) *A company incorporated in Singapore has established its place of business at Chennai. State the documents which are required to be furnished on such establishment of business in India under the Companies Act, 1956 and the authorities to whom such documents are to be furnished. (5 Marks)*

Answer

- (a) Section 233A of Companies Act, 1956 deals with the matter relating to Special Audit. The special audit can be ordered by Central Government under certain circumstances, as enumerated in the said Section.

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Draft application to Central Government requesting Special Audit:

Dated _____

To,

The secretary,

Ministry of Corporate Affairs,

Government of India,

(Address)

New Delhi

Sir,

We, the undersigned, the shareholders of LPM Paper Mills Ltd. would like to bring to your kind notice that for a long time the affairs of the said company are not being managed in accordance with sound business principles and prudent commercial practices.

We are of the view that certain expenditure which are being incurred by the company are not related to the business of the company and the company is not getting any benefit out of such expenses. Moreover, we have the apprehension that there are certain business transactions which are being entered into by the directors with the concerns which are owned by the relatives of the Directors and the prices charged for such transaction are not comparable with the prices charged by other parties for similar transactions.

If such state of affairs is allowed to be carried on for long, the financial position of the company will reach a stage where it will endanger its solvency.

We feel that the modus operandi of the transaction is such that it may be difficult for the regular statutory auditor to detect them in course of normal audit.

It is, therefore prayed that the Central Government be pleased to appoint, pursuant to Section 233A of the Companies Act, 1956, a Special Auditor to properly audit the accounts of the Company and find the real nature of the transactions and determine the losses so far sustained and being sustained by the company on this account.

Yours faithfully

1.

2.

3.

4.

5.....

Shareholders

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(b) Foreign Company

A foreign company has to furnish to the Registrar of Companies the following documents within 30 days of the establishment of the place of business in India (Section 592 of the Companies Act, 1956).

- (i) Certified copy of charter, statute or memorandum and articles of the company or other instruments deferring the constitution of the company. If it is not in English Language its certified translation should be submitted.
- (ii) Full address of the registered or principal office of the company.
- (iii) List of directors and Secretary giving details like present and former name and surname, his usual residential address, nationality, business occupation etc.
- (iv) The names and address of one or more persons resident in India authorized to accept on behalf of the company, service of process and any notices or other documents required to be served on the company.
- (v) The full address of the office of the company in India which is deemed to be its principal place of business in India.

The aforesaid documents shall be required to be filed at two places first with the Registrar of the state where principal place of business (Chennai) is situated i.e. Registrar of Tamil Nadu in this case and second with the Registrar of New Delhi (Section 597).

Question 6

- (a) A company wants to include the following clause in its Articles of Association:

“Each director shall be entitled to be paid out of the funds of the company for attending meetings of the Board or a Committee thereof including adjourned meeting such sum as sitting fees as shall be determined from time to time by the Directors but not exceeding a sum of Rs.30,000 for each such meeting to be attended by the Director.”

You are required to advise the company as to the validity of such a clause and the correct legal position under the provisions of the Companies Act, 1956. (5 Marks)

- (b) *State the conditions which must be satisfied before filing a petition under Section 397 of the Companies Act, 1956 for prevention of oppression.* (5 Marks)

Answer

- (a) The payment of sitting fee to a Director is governed by the provisions of Section 310 of the Companies Act, 1956 read with Rule 10B of the companies (Central Government's) General Rules and Forms, 1956. According to the said provisions, a Company with a paid up share capital and free reserves of Rs.10 crores and above or a turnover of Rs.50 Crores and above can pay to its director by way of sitting fee for each meeting of the board of directors or a committee thereof an amount not exceeding Rs.20,000/- and in case of other companies, the limit has been set at Rs.10,000/-.

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In view of the above legal provisions, the company cannot have a clause in its Articles of Association which exceeds the limit prescribed by law. The company is advised to check whether the aggregate of its paid up capital and free reserves exceeds Rs. 10 Crore or whether its turnover exceeds Rs. 50 crore and accordingly it can have a clause in its Articles of Association. In case the company keeps the clause as given in the question, it shall be ultra vires the Companies Act, 1956 as Section 9 states that any provision contained in Memorandum of Association, Articles of Association, Agreements or Resolutions to the extent it is repugnant to the provisions of the Companies Act, 1956 shall be void.

- (b) The conditions which are required to be satisfied before filing a petition under Section 397 of the Companies Act, 1956 can be enumerated as follows:
- (i) An application under the said Section 397 can be made only by the members. In the case of a company having share capital minimum one hundred members or one-tenth of total number of member of the company, whichever is less; or a member or members holding not less than 10% of the paid up capital of the company can file such petition. In case of a company not having share capital, minimum one-fifth of the total number of members of the company are required for the purpose. However, Central Government may authorise any lesser number of members to file such petition.
 - (ii) It must be established that the affairs of the company are being conducted in a manner (a) oppressive to any member/members of the company or (b) prejudicial to public interest.
 - (iii) The oppression complained of must affect a person in his capacity as a member of the company. Rights and interests as a member of a company can only be agitated and not in relation to any commercial relation that a member has with the company as was decided by the Company Law Board in the case of *Anil Gupta vs. Mirai Auto Industries Ltd.* [(2003)113 COMP. CAS.63].
 - (iv) The acts complained of must be continuing acts of oppression. The acts constituting oppression must continue till the date of making the application.
 - (v) The applicant must make out a prima facie case that the degree of oppression is so severe that there is just and equitable ground for winding up of the company. But at the same time, it must also be established that the winding up of the company would not unfairly prejudice the applicant.
 - (vi) It may be noted that expression "issued share capital" in section 399(1) includes both the preference and equity share capital.

Question 7

- (a) Draft a board resolution for appointment of Mr. Paul as the Managing Director for 5 years with effect from 1st July, 2009 of DBM Limited passed in the board meeting of the said company held on 6th June, 2009. (5 Marks)

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- (b) *Amar Textiles Ltd. is a company engaged in manufacture of fabrics. The Company has investments in shares of other bodies corporate including 70% shares in Amar Cotton Co. Ltd. and it has also advanced loans to other bodies corporate. The aggregate of all the investments made and loans granted by Amar Textiles Ltd. exceeds 60% of its paid up share capital and fee reserves and also exceeds 100% of its free reserves. In course of its business requirements, Amar Textiles Ltd. has obtained a term loan from Industrial Development Bank of India and the said loan is still subsisting. Now the company to increase its holding from 70% to 80% of the equity share capital in Amar Cotton Co. Ltd. by purchase of additional 10% shares from other existing shareholders.*

State the legal requirements to be complied with by Amar Textiles Ltd. under the provisions of the Companies Act, 1956 to give effect to the above proposal. (5 Marks)

Answer

- (a) Resolution passed at the meeting of Board of Directors of DBM Limited held at its registered office at on 6th June, 2009 at A.M.

“RESOLVED that subject to the approval by the shareholders in a general meeting and pursuant to provisions of Sections 198, 309, 310, schedule XIII and other applicable provisions of the Companies Act, 1956, Mr. Paul be and is hereby appointed as the Managing Director of the Company with effect from 1st July, 2009 for a period of five years on a remuneration approved by the Remuneration committee as enumerated below:

1. Salary: Rs_____per month.
2. Perquisites, Benefits & Facilities:

RESOLVED FURTHER that Mr. Paul, so long as he functions as the Managing Director of the Company, shall not be entitled to any sitting free for attending any meeting of the Board of Directors or any Committee thereof and that he shall not be liable to retire by rotation.

RESOLVED FURTHER that Mr. Paul, till he holds the office of Managing Director of the Company, shall not become interested or concerned in any selling agency directly or through his wife or minor children in future without prior approval of the Central Government.

RESOLVED FURTHER that Mr. Paul, the Chairman, as well as the company shall have right to terminate the appointment by giving 3 (three) months' notice in writing.

RESOLVED FURTHER that the Secretary of the company be and is hereby directed and authorized to electronically file necessary returns with the Registrar of Companies by putting his digital signature and to do all other necessary things required under the provisions of the Companies Act, 1956.”

- (b) Amar Cotton Co. Ltd is not a wholly – owned subsidiary of Amar Textiles Ltd. and hence investments in such a subsidiary company is not covered by exemption under Section 372(A)(8)(e) of the Companies Act. 1956. As the aggregate of the investments in shares

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and loans granted to other bodies corporate exceeds 60% of the paid-up share capital and free reserves and also 100% of the free reserves, it is necessary for Amar Textiles Ltd. to pass a special resolution in the General Meeting before increasing its holding from 70% to 80%. [First Proviso to section 372A(1)].

The notice of Special Resolution must indicate clearly the specific limits, the particulars of the body corporate in which the investment is proposed to be made, the purpose of the investment, specific source of funding and such other details. [Third Proviso to Section 372A(1)]

In the present case, Amar Textiles Ltd. obtained a term loan from Industrial Development Bank of India (IDBI) which is a public financial institution within the meaning of Section 4A of the said Act and therefore the provisions of Section 372A(2) are attached as such loan is still subsisting. The company is required to obtain prior approval of IDBI for making any further investment.

As required by provisions of Section 372A(2), the investment proposal must be passed at the Board Meeting by unanimous decision of all the directors present at the meeting.

The company must enter the prescribed particulars of investment in a register of investment within 7 days of making the investment. [Section 372A(5)]

The company must also take into consideration the guidelines, if any prescribed by the Central Government under Section 372A(7) of the said Act.

Question 8

- (a) *LMB Ltd., Kolkata is a multiproduct manufacturing company having paid up capital of Rs. 5.00 crores. In order to increase the product portfolio, the said company intends to procure certain machines and equipments worth Rs.1.00 crore from a partnership firm, namely, M/s. MLPK, in which the son of managing director of LMB Ltd. is a partner. The contract for purchase of said machines and equipments is to be placed the Board of Directors of the company for its consideration.*

In view of above facts, you are required to explain briefly the procedure under the provisions of the Companies Act, 1956 to be followed by LMB Ltd. to enter into the said contract. (5 Marks)

- (b) *Explain, how the provisions of the Companies Act, 1956 relating to Audit Committee will help in achieving some of the objectives of Corporate Governance.* (5 Marks)

Answer

- (a) As per provisions of Section 297 of the Companies Act, 1956, when a company enters into a contract in which some of the directors are interested, then consent of the Board of Directors of the company is required to be obtained. In the present case since the Managing Director of LMB Ltd is interested in the contract for the purchase of machines and equipments because of his son's partnership in the supplier firm, the same should be approved by the Board of Directors of the company.

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Proviso to Section 297(1) of the said Act states that in the case of a company having a paid-up share capital of not less than rupees one crore, no such contract shall be entered into except with the previous approval of the Central Government. Since the paid up capital of LMB Ltd. is Rs.5.00 Crores the company is required to take prior approval of the Central Government.

For this purpose, following steps are required to be taken:

- (i) Hold a board meeting and place the terms of the contract for consideration. The Managing Director should disclose the nature of his interest as required under section 299 of the Companies Act, 1956.
- (ii) The managing director should not participate in discussion when in the board meeting, the matter in respect of the above mentioned contract is being discussed. He must not also vote on the relevant resolution. Moreover, his presence shall also not be counted for determining the quorum of the board meeting. [Section 300 of the Companies Act, 1956]
- (iii) The consent of the Board of Directors must be accorded by way of resolution and not otherwise.
- (iv) An application to the Central Government (by delegation to Regional Director) should be made in prescribed form (Form No. 24A). Following enclosures should be made with the said form:
 - (a) A certified true copy of the board resolution approving the contract.
 - (b) A copy of the proposed agreement
 - (c) A copy of the Memorandum and Articles of Association of the company.
 - (d) A copy of latest audited annual accounts with directors' and auditors' reports thereon
 - (e) Bank draft or treasury challan evidencing the payment of prescribed fees.
- (v) Necessary entries are to be made in Register of Contracts (Section 301).

On receiving the approval from the Central Government (Regional Director), the company can proceed to enter into the contract for supply of machines and equipments with the firm M/s MLPK in which the son of Managing Director is a partner.

(b) AUDIT COMMITTEE:

For better corporate governance the concept of Audit committee for companies was introduced by section 292A of the Companies Act, 1956. Every public company having paid up capital of not less than Rs.5.00 Crores must have an audit Committee.

The auditors, the internal auditor, if any and the Director-In-Charge of finance shall attend and participate at meetings of the Audit Committee [Section 292A(5)]

As per Section 292A(6) of the said Act, the functions of the Audit Committee includes the following:

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- (a) The Audit Committee should discuss with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors.
- (b) The Audit Committee should review half yearly and annual financial statements before submission to the Board.
- (c) The Audit Committee should ensure compliance of internal control systems.

The Audit committee shall have authority to investigate into any matter in relation to the items specified in this Section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary. [Section 292A (7)].

The recommendations of the Audit Committee on any matter relating to financial management including the audit report shall be binding on the Board and if the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefore and communicate such reasons to the shareholders. (Section 292A(8) & (9)).

The above provisions of law relating to powers and functions of the Audit committee relating to financial statements will help in achieving one of the objective of corporate governance i.e. accountability and avoidance of poor financial reporting.

SECTION – B

*Question No. 9 is compulsory. Answer any **four** from the rest.*

Question 9

Answer any **one** of the following

- (a) *Following information is available from the Records of Star Chemicals & Engineering Ltd.:*
 - (i) *The company is a closely held unlisted company.*
 - (ii) *The paid up share capital of the company since 1st April, 1999 is Rs.3.00 crores and its net worth as at 31st March, 2008 was Rs.5.00 crores as per audited Balance Sheet.*
 - (iii) *The Net Tangible Assets of the company as per last 3(three) audited Balance Sheets as at 31st March, 2005, 2006 and 2007 were Rs.4.00 crores, 4.50 crores and 5.00 crores respectively, out of which monetary assets were less than Rs. 50 lacs in each of the three years.*
 - (iv) *The company was incorporated in 1996 and commenced its business on 1st April, 1996 and since then it has earned good profits and it has not incurred any loss in any year in past.*
 - (v) *The company has not declared any dividend so far, but according to the profits earned so far, the management could have declared the dividend in each of the last five years.*

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- (vi) *The name of the company was changed from Star Engineering Ltd. to its present name with effect from 1st January, 2007*
- (vii) *The company's turnover in the years ended 31st March, 2006, 2007 and 2008 was Rs.20 crores, 30 crores and 35 crores respectively.*

The company wants to make a public issue of shares to raise Rs. 20.00 crores by issuing equity shares at premium. For the purpose of including the information in the prospectus, the Company has prepared its accounts for 12 months ended 31st December, 2007 showing segmentwise revenue which reveals that revenue from chemical segment is more than the revenue from Engineering segment.

You are required to state the relevant guidelines issued by SEBI and your conclusion whether the Company can make the desired issue of equity shares based on the facts stated above. (6 Marks)

- (b) *Excel Ltd., a public limited company listed with the The Stock Exchange, Mumbai wants to issue equity shares on preferential basis pursuant to a scheme approved under Corporate Debt Restructuring framework specified by Reserve Bank of India, to various persons as may be selected by the Board of Directors of the Company. Following information relevant to the preferential issue is available:*

Total No. of equity shares to be issued : 50 lac equity shares of Rs.10 each out of which 30 lac equity shares will be allotted shares will be allotted on 31st December, 2008 as fully paid up and balance 20 lac equity shares shall be allotted on the same date but paid up to Rs.5 each and balance Rs.5 shall be called upon at a later date and shall be paid up on 31st May, 2009.

- (i) *Out of the proposed allottees some persons are holding their shares in Excel Ltd. in physical form and not in dematerialized form and some persons had sold their entire shareholding in Excel Ltd. in July, 2008.*
- (ii) *The meeting of general body of shareholders for approving the preferential issue was held on 15th October, 2008.*

Based on the above information you are required to answer the following queries with reference to the SEBI (Disclosure and Investor Protection) Guidelines, 2000:

- (i) *What would be that lock-in period for the shares allotted on preferential basis?*
- (ii) *Who are the persons not entitled for allotment of shares on preferential basis?*

(6 Marks)

Answer

- (a) *The relevant guidelines issued by SEBI in respect of issue of shares by an unlisted company are laid down in Chapter II of the SEBI (Disclosure and investor Protection) Guidelines, 2000 as amended vide SEBI/CFD/DIL/DIP/ circular No.11 dated August 14, 2003.*

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According to Para 2.2.1 of the said Guidelines, an unlisted company can make an initial public offer of equity shares if the following conditions are fulfilled.

- (i) The company has net tangible assets of at least Rs. 3 crores in each of the preceding 3 full years (of 12 months each), of which not more than 50% is held in monetary assets.

Provided that if more than 50% of the net tangible assets are held in monetary assets, the company has made firm commitments to deploy such excess monetary assets in its business/project;

- (ii) The company has a track record of distributable profits in terms of Section 205 of the Companies Act, 1956 for at least three (3) out of immediately preceding five (5) years;
- (iii) The company has a net worth of at least Rs.1 crore in each of the preceding 3 full years (of 12 months each);
- (iv) In case the company has changed its name within the last one year at least 50% of the revenue for the preceding 1 full year is earned by the company from the activity suggested by the new name; and
- (v) The aggregate of the proposed issue and all previous issues made in the same financial year in terms of size (i.e.; offer through offer document+ firm allotment + promoters' contribution through the offer document), does not exceed five (5) times its pre-issue networth as per the audited balance sheet of the last financial year.

In the case given in the question, all the conditions are fulfilled. The company has net Tangible Assets exceeding Rs. 3.00 crores in each of the preceding three years and it has monetary assets which are less than 50% thereof. The company has a track record of having distributable profit in last three out of last five years. The declaration of dividend is not essential. The company has a net worth of more than Rs.1 crore in each of the preceding three full years. The company has changed its name by including the word "Chemicals" therein and as per the information provided, the revenue earned by the company from this activity is more than 50% of the total revenue earned by it during the preceding one full year of 12 months. Finally, the issue size is Rs.20.00 crores, which is less than five times its pre-issue net worth of Rs.5.00 Cores. The company is free to price their equity shares. Hence the company can raise Rs.20.00 crores through public issue of equity shares at a premium. The turnover information is not relevant for deciding the desired public issue of shares.

(b) (i) Lock – in – Period:

As per Guidelines issued by SEBI [Para 13.3.1(e)], the lock- in period in respect of the shares issued on preferential basis pursuant to a scheme approved under Corporate Debt Restructuring framework specified by Reserve Bank of India, shall commence from the date of allotment and shall continue for a period of one year in case of fully paid up shares. In the case of allotment of partly paid shares, the lock-

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in period shall commence from the date of allotment and continue for a period of one year from the date when shares become fully paid up.

In view of the above guidelines of SEBI, the lock-in period for 30 shares to be allotted as fully paid up shall commence from 31st December, 2008 and shall continue for one year from the date. In case of 20 lac shares allotted as partly paid up on 31st December, 2008 and to be made fully paid up on 31 May, 2009, the lock-in-period shall commence from 31st December, 2008 and shall continue till one year from 31st May, 2009, the date on which the same were made fully paid up.

(ii) Non- eligibility for preference shares:

As per Guidelines issued by SEBI [Para 13.3.1 (f)], where any shares are issued on preferential basis any person who does not hold his entire shareholding in the issuing company in dematerialized form shall not be entitled for the preferential allotment of shares. Para 13.3.1(h) of the said guidelines disentitles any persons from receiving shares in a preferential issue, if such person has sold his shares in the issuing company during the six months period prior to the relevant date.

In view of the above guidelines, the persons who are holding the shares in Excel Ltd. in physical form and not in dematerialized form and the persons who have sold their shares in the said company in July, 2008 being falling within the period of six months prior to the relevant date, are not entitled to receive the shares in the preferential issue.

Relevant date for this purpose means the date thirty days prior to the date on which the meeting of general body of shareholders is held under Section 81(1A) of the Companies Act, 1956 to consider the proposed issue.

Question 10

Industrial Finance Corporation of India, established under the Industrial Finance Corporation Act, 1948 having its registered office at Mumbai issued 8% Redeemable Bonds redeemable after 7 years. These bonds were issued directly to the members of the public and not through mechanism of Stock exchanges.

You are required to state with reference to the provisions of Securities Contracts (Regulation) Act, 1956, whether such direct issue of bonds by the Industrial Finance Corporation of India is not violating the provisions of the said Act. (6 Marks)

Answer

In order to prevent undesirable transactions in securities and to promote healthy stock market, the Securities Contracts (Regulation) Act, 1956 was enacted and all the Stock Exchanges in the country are registered under this Act. Section 73 of the Companies Act, 1956 states that offer of shares or debentures to public for subscription shall be made only after the permission of a Stock exchange.

Section 28(1) of the Securities Contracts (Regulation) Act, 1956 states that the provisions of this Act shall not apply to the Government, the Reserve Bank of India, any local authority, or

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corporation set up by a special law or any person who has effected any transaction with or through the agency of any such authority as stated earlier.

As stated in the question Industrial Finance Corporation of India is a corporation set up under the Industrial Finance Corporation Act, 1948. i.e. under a special statute enacted by the Parliament Therefore, this Corporation does not need any permission from a Stock Exchange to issue any Bond or other securities. Accordingly, it has not violated the provisions of the Securities Contracts (Regulation) Act, 1956. The nature and tenure of the Bonds are immaterial.

Question 11

- (i) *Mr. Sekhar resided in India for a period of 150 days during the financial year 2007-2008 and thereafter went abroad. He came back to India on 1st April, 2008 as an employee of a business organization. What would be his residential status under Foreign Exchange Management Act, 1999 during the financial year 2008-2009?*
- (ii) *Mr. Atul, an Indian National desires to obtain Foreign Exchange for the Following purpose:*
 - (a) *Remittance of US Dollars 10,000 for payment for goods purchased from a party situated in Nepal.*
 - (b) *US Dollars 10,000 for remitting as commission to his agent in U.S.A for sale of Commercial plot situated near Bangalore, consideration in respect of which was received by Mr. Atul by way of foreign currency inward remittance amounting to US Dollars 1,00,000.*

Advise him, if he can get the Foreign Exchange and under what conditions for making the above remittances. (6 Marks)

Answer

- (i) According to the provisions of Section 2(v) of the Foreign Exchange Management Act, 1999, a person in order to qualify for the purpose of being treated as a "Person Resident in India" in any financial year, must reside in India for a period of more than 182 days during the preceding financial year. In the given case, Mr. Sekhar has resided in India for a period of only 150 days, i.e. less than 182 days, during the financial year 2007-2008. Hence he cannot be considered as a "Person Resident in India" during the financial year 2008-2009 irrespective of the purpose or duration of his stay.
- (ii) Under provisions of Section 5 of the Foreign Exchange Management Act, 1999 certain Rules have been made for drawal of Foreign Exchange for Current Account transactions. As per these Rules, drawal of Foreign Exchange for some of the Current Account transactions is prohibited. As regards some other Current Account Transactions, Foreign Exchange can be drawn with prior permission of the Central Government while in case of some Current Account transactions, prior permission of Reserve Bank of India is required.

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- (a) In respect of item (a), i.e. remittance to Nepal, such remittance is prohibited and the same is included in First Schedule to the Foreign Exchange Management (Current Account Transactions) Rules, 2000. Hence Mr. Atul can not withdraw foreign Exchange for this purpose.
- (b) The type of payment as envisaged in item (b) is covered under Third Schedule to the Foreign Exchange Management (Current Account Transactions) Rules, 2000 and for withdrawing foreign Exchange exceeding 5% (five percent) of the inward remittance as commission to agent abroad for sale of commercial plot in India Mr. Atul will require the prior permission of the Reserve Bank of India.

Question 12

- (i) *The promoters of a company to be registered under the Companies Act, 1956 having its main object of carrying on the business as manufacturers and stockists of Iron and Steel proposes that the name of the company is to be "ABC Steel Bank Limited". You are required to state with reference to the provisions of the Banking Regulation Act, 1949 whether the said company with the proposed name can be registered.*
- (ii) *Union Bank of India, a National Bank acquired on 1st January, 2002 a building, fully occupied by various tenants, from Mr. Rahul, the owner of the building, in discharge of a term loan advanced to Mr. Rahul, who had mortgaged the said building as security with the said Bank and failed to repay the loan. The said bank wants to keep the building permanently with it and earn the rent from tenants. You are required to state with reference to the provisions of the Banking Regulation Act, 1949 whether the said bank can do so.* (6 Marks)

Answer

- (i) As per provisions of Section 7 of the Banking Regulation Act, 1949 no company other than a banking company can use, as part of its name, the word "Bank" unless it is a banking company as defined in Section 5(c) of the said Act. In view of such a legal provision, the promoters of the company having the main object of carrying on the business as manufacturers and stockists of iron & steel can not keep the name of the company as "ABC Steel Bank Limited".
- (ii) Union Bank of India being a nationalized bank is a banking company within the meaning of the Banking Regulation Act, 1949. As per provisions of Section 9 thereof, no banking company shall hold any immovable property, howsoever acquired, for a period exceeding seven years except:
 - (i) If such property is required for banking company's own use.
 - (ii) If the Reserve Bank of India extends the said period of seven years by up to another five years on the ground that such extension would be in the interest of the depositors of the banking company.

Accordingly, Union Bank of India in this case would normally be required to dispose off the building acquired from Mr. Rahul before 1st January, 2009. However, if the Reserve Bank of India on above stated ground grants the extension, then also the said Bank will

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have to dispose off the same before 1st January, 2014. But in no case, Union Bank of India can hold it permanently because the building is not for bank's own use.

Question 13

- (i) *With reference the provisions of Insurance Act, 1938, what do you mean by "Life Insurance Business"?*
- (ii) *What are the provisions in the Insurance Act, 1938 regarding nomination by of Life Insurance Policy holder? Whether a minor can be a nominee in a Life Insurance Policy?*

(6 Marks)

Answer

- (i) As per Section 2(11) of the Insurance Act, 1938, Life Insurance Business means the business of effecting contracts of insurance upon human life, including any contract whereby the payment of money is assured on death (except death by accident only) or the happening of any contingency dependent on human life, and any contract which is subject to payment of premiums for a term dependent on human life and shall be deemed to include:
 - (a) The granting of disability and double or triple indemnity accident benefits, if so provided in the contract of insurance.
 - (b) The granting of annuities upon human life; and
 - (c) The granting of superannuation allowances and annuities payable out of any fund applicable solely to the relief and maintenance of persons engaged or who have been engaged in any particular profession, trade or employment or of the dependents of such persons.
- (ii) As per Section 39 of the Insurance Act, 1938, the holder of a policy of life insurance on his own life may nominate a person or persons to whom the money secured by the life insurance policy shall be paid in the event of his death. Such nomination can be made either at the time of taking the policy or at any time before the maturity of the policy. Such nomination is either incorporated in the text of the policy or is stated as an endorsement on the policy document. The nomination can be cancelled or altered by the policyholder at anytime before the maturity of the policy. The insurer is required to communicate to the policyholder that it has recorded the nomination, its cancellation or alteration as the case may be. In case the policyholder survives the full term of policy, the insurer shall pay the maturity amount to him only and the nomination becomes redundant. In a case where the nominee dies before the maturity of the policy and if no new nomination is made, the maturity proceeds of the policy shall be paid to the policy holder and if dies before the maturity, to the legal heirs of the policy holders.

Minor as a nominee:

A minor can be nominated as a nominee in life insurance policy by its holder. The only other requirement as per proviso to Section 39(1) of the said Act is that the policyholder is to appoint, in the prescribed manner, an adult person to receive the money secured by

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the policy on behalf of the minor in the event of death of the policyholder during the minority of the nominee.

Question. 14

Explain the principles of “Rule of Beneficial Interpretation”.

(6 Marks)

Answer

While framing the language of a statute, generally, the care is taken to make it in such a manner that there does not remain any confusion in its interpretation. But sometimes, the language of the statute may be capable of more than one interpretation. In such cases the most firmly established rule of construction is the principle laid down in the Heydon's case. This rule is also called the “mischief rule”. This rule enables construction of four matters in construing an Act as stated below:

- (i) What was the law before the making of the Act.
- (ii) What was the mischief or defect for which the law did not provide;
- (iii) What is the remedy that the Act has provided; and
- (iv) What is the reason for the remedy.

The rule then directs that the courts must adopt that construction which ‘shall suppress the mischief and advance the remedy’. Therefore, even in a case where the usual meaning of the language used falls short of the whole object of the legislature, a more extended meaning may be attributed to the words, provided they are fairly susceptible of it. If however, the circumstances show that the phraseology in the Act is used in a larger sense than its ordinary meaning then that sense may be given to it. If the object of a statute is public safety then its working must be interpreted widely to give effect to that object. Thus the legislature having intended, while passing the Workmen's Compensation Act, the main object being provision of compensation to workman, it was decided that the act ought to be so construed, as far as possible, so as to give effect to its primary provisions.

It has been emphasized by the Supreme Court that the rule in Heydon's case is applicable only when the words used are reasonably capable of more than one meaning.

This rule does not normally apply to a fiscal statute like Income tax Act,. While construing a fiscal statute the words of the statute are given three plain meanings. If a tax payer is within the plain meaning of the terms of an exemption, he cannot be denied the benefit by resorting to any supposed intention of the exempting authority. This was held by the Supreme Court in the case of *Hemraj Gordhandas vs. H.H. Dave*.



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