



Suggested Answers

FINAL (New) Examination

Group II

June, 2009



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



BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
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Question Nos. 1 is compulsory.

Answer any **five** questions from the rest.

Working notes should form part of the answer.

Question 1

- (a) XYZ Ltd. has two divisions, A and B. Division A makes and sells product A, which can be sold outside as well as be used by B. A has a limitation on production capacity, that only 1,200 units can pass through its machining operations in one month. On an average, about 10% of the units that A produces are defective. It may be assumed that out of each lot that A supplies, 10% are defectives. (12 Marks)

When A sells in the outside market, the defectives are not returned, since the transportation costs make it uneconomical for the customer. Instead, A's customers sell the defectives in the outside market at a discount.

But, when B buys product A, it has to fix it into its product, which is reputed for its quality. Therefore, B returns all the defective units to A. A can manually rework the defectives, incurring only variable labour cost and sell them outside at Rs.150 and not having to incur any selling costs on reworked units. If A chooses not to rework, it can only scrap the material at Rs.30 per unit. B can buy product A from outside at Rs.200 per unit, but has to incur Rs.10 per unit as variable transport cost. B can insist to its outside suppliers also that it will accept only good units.

A incurs a variable selling overhead only on units (other than reworked units) sold outside. The following figures are given for the month:

Variable cost of production – Dept. A (Rs./unit)	120
Variable selling overhead (Rs./u)	20
Selling price per unit in the outside market (Rs./u)	200
Current selling price to B (Rs./u)	190
Additional variable labour cost of reworking defectives (Rs./u)	100
Selling price of reworked defectives (Rs./u)	150
Fixed costs for the month (Rs.)	36,000
Maximum demand from B at present (no. of units)	630

The outside demand can be freely had upto 900units.

Given the demand and supply conditions, you are required to present appropriate calculations for the following:

- Evaluation of the best strategy for A in the present condition.
- If B can buy only upto 540 units and the outside demand is only 600 units, how much should A charge B to maintain the same level of profit as in (i) above?

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- (b) PQ Ltd. makes and sells a labour-intensive product. Its labour force has a learning rate of 80%, applicable only to direct labour and not to variable overhead. (8 Marks)

The cost per unit of the first product is as follows:

Direct materials	10,000
Direct labour	8,000 (@Rs.4 per hour)
Variable overhead	<u>2,000</u>
Total variable cost	<u>20,000</u>

PQ Ltd. has received an order from X Ltd. for 4 units of the product. Another customer, Y Ltd. is also interested in purchasing 4 units of the product. PQ Ltd. has the capacity to fulfill both the orders. Y Ltd. presently purchases this product in the market for Rs.17,200 and is willing to pay this price per unit of PQ's product. But X Ltd. lets PQ choose one of the following options:

- (i) A price of Rs.16,500 per unit for the 4 units it proposes to take from PQ.

Or

- (ii) Supply X Ltd.'s idle labour force to PQ, for only 4 units of production, with PQ having to pay only Re. 1 per labour hour to X Ltd.'s workers. X Ltd.'s workers will be withdrawn after the first 4 units are produced. In this case, PQ need not use its labour for producing X Ltd.'s requirement. X Ltd. assures PQ that its labour force also has a learning rate of 80%. In this option, X Ltd. offers to buy the product from PQ at only Rs.14,000 per unit.

X and Y shall not know of each other's offer.

If both orders came before any work started, what is the best option that PQ may choose?

Present suitable calculations in favour of your argument.

Answer

1. (a) (i) Contribution per unit against sale to outside = Rs (200-120-20) = Rs 60
In case of transfer, good units and rejected units are in proportion of 9:1
In case of transfer, contribution per good unit = Rs (190 – 120) = Rs 70
In case of transfer, contribution per rejected unit = Rs (150 – 120-100) = Rs -70
Thus, effective contribution per unit of transfer = Rs (70 x 0.9 – 70x 0.1) = Rs 56
As contribution per unit against outside sale is higher, the best strategy should be to sell maximum number of unit to outside market.
Contribution from outside market from sale of 900 units = Rs 54,000
Rs.(900 x 60)

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Contribution from transfer of 300 units to B	= Rs 16,800
Rs (300 x 56)	
Total Contribution from best strategy	= Rs 70,800
(ii) If B's demand is 540 unit, total production required	= 600 units.
(540 /0.9)	
Taking outside market demand of 600, it is within production capacity of 1200 units.	
Now contribution from 600 units of outside sale	= Rs 36,000
Rs (600 x 60)	
Contribution from rejected 60 units	= Rs (4,200)
Rs (60 x – 70)	
	<u>= Rs 31,800</u>
To keep same level of contribution as in (i), the contribution required from transfer of 540 unit to B	
	= Rs 39,000
(Rs 70,800 – 31,800)	
Thus, contribution required per unit	= Rs 72.22
Rs 39,000 /540	
Hence price to be charged per unit against transfer to B = Rs 192.2	
Rs (120 + 72.22)	

Alternative Solution:

Let x be the number of units sold outside and y be the number of units sold to B, before B returns 10% as defectives.

Then, $x + y = 1,200$, is the limitation on production capacity of A.

	Department A	
	Outside	to B
	Rs.	Rs.
Selling Prices	200	190
Variable Cost – Production	120	120
Variable Cost – Sale	<u>20</u>	<u>--</u>
Total Variable Cost	<u>140</u>	<u>120</u>
Contribution	60	70
Contribution on x units sold outside = 60x		

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Out of y units to B, $10\% = \frac{1}{10}y = .1y$ is returned to A. If A scraps, amount got = 30 per unit.

If A reworks and sells, it gets $150 - 100 = 50$ / unit.

∴ Decision to reworks all defectives. i.e. $(.1)(y)$

Contribution on good units of B = $0.9y \times 70 = 63y$

Contribution on reworked units of B = $(.1)(y) \times 50 = 5y$

Amount of material lost on manufacture of defectives to B = $12y$

$(.1)(y) \times 120$

∴ Contribution on y gross units transferred to B = $56y$

$63y + 5y - 12y$

Total contribution earned by A = $60x + 56y$

where $x + y = 1200$

To maximize contribution, maximize units sold outside.

∴ 900 units – sell outside.

Balance $\frac{300}{1200}$ units (gross transfer to B, of which B gives back 30 defectives)

Contribution : Rs.60 (900) + Rs.56 (300)
= Rs.54,000 + Rs.16,800

Contribution = Rs.70,800

Fixed Cost = Rs.36,000

(i) Profit = Rs.34,800

(ii) Outside demand = 600 units

Contribution = $600 \times \text{Rs.}60 = \text{Rs.}36,000$

Balance to be got = Rs.34,800

= Rs.70,800

Out of Rs.34,800, defectives of B will give

Rs. 3,000 60×50

Rs. 31,800 charge to B for 540 units

Contribution to be obtained from 540 units of B = Rs. 31,800

Add: Production cost of 600 units @ 120/- = Rs. 72,000

Amount charged for 540 units = Rs. 1,03,800

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$$\therefore \text{Price to be charged to B} = \frac{1,03,800}{540} = 192.22$$

Per good unit transferred, to maintain the same level of profit as in (a).

(b)	Units	Average/ hrs/u.
	1	2,000
	2	1,600
	4	1,280
	8	1,024
	Material Cost / u	= 10,000
	Variable cost	= <u>2,000</u>
	Variable Cost	= <u>12,000</u>

Option I

If both the orders came together, learning rate 80% applies and 8 units can be made, with average time of 1,024 hours per unit.

Cost to PQ:

Variable cost excl. labour	= Rs.12,000
Labour cost 1,024 hrs × 4 Rs./hr	= Rs. <u>4,096</u>
	= Rs. <u>16,096</u>

In this case,

	Y	X	
Selling Price p. u.	Rs.17,200	Rs.16,500	→ (under option I)
Variable Cost p. u.	<u>Rs.16,096</u>	<u>Rs.16,096</u>	
Contribution p. u.	Rs.1,104	Rs.404	
No. of units	4	4	
Contribution (Rs.)	4416	1616	6032

Option II

If X Ltd supplies its labour. 80% learning curve will apply to 4 units each of PQ & X.

Hence: hrs/ u = 1280

	Y	X
Selling Price	Rs.17,200	Rs.14,000
Variable Cost (excl. labour)	Rs.12,000	Rs.12,000
Labour cost:		
1280 × 4	Rs.5,120	

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1280 × 1		Rs.1280	
Total Variable Cost	<u>Rs.17,120</u>	<u>Rs.13,280</u>	
Contribution	Rs.80	Rs.720	
Units	4	4	
Contribution (Rs.)	320	2,880	3,200
PQ should not take labour from X Ltd. It should choose option I.			

Question 2

- (a) Ret Ltd., a retail store buys computers from Comp Ltd. and sells them in retail. Comp Ltd. pays Ret Ltd. a commission of 10% on the selling price at which Ret sells to the outside market. This commission is paid at the end of the month in which Ret Ltd. submits a bill for the commission. Ret Ltd. sells the computers to its customers at its store at Rs.30,000 per piece. Comp Ltd. has a policy of not taking back computers once dispatched from its factory. Comp Ltd. sells a minimum of 100 computers to its customers. (13 Marks)

Comp Ltd. charges prices to Ret Ltd. as follows:

Rs.29,000 per unit, for order quantity 100 units to 140 units.

Rs.26,000 per unit, for the entire order, if the quantity is 141 to 200 units. Ret Ltd. cannot order less than 100 or more than 200 units from Comp Ltd.

Due to the economic recession, Ret Ltd. will be forced to offer as a free gift, a digital camera costing it Rs.4,500 per piece, which is compatible with the computer. These cameras are sold by another Co., Photo Ltd. only in boxes, where each box contains 50 units. Ret Ltd. can order the cameras only in boxes and these cameras cannot be sold without the computer.

In its own store, Ret Ltd. can sell 110 units of the computer. At another far of location, Ret Ltd. can sell upto 80 units of the computer (along with its free camera), provided it is willing to spend Rs.5,000 per unit on shipping costs. In this market also, the selling price that each unit will fetch is Rs.30,000 per unit.

You are required to:

- State what is Ret's best strategy along with supporting calculations.
 - Compute the break-even point in units, considering only the above costs.
- (b) What are the various formulae used in calculating budget ratios? (3 Marks)

Answer

2. (a)

	Order Qty 100-140 (Rs.)	Order Qty 141-200 (Rs.)
Selling Price Rs./u	30,000	30,000

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Commission @ 10%	3,000	3,000
Sales revenue p. u.	33,000	33,000
Less: Variable purchase cost	29,000	26,000
Contribution / unit (before shipping)	4,000	7,000
Less: Shipping cost > 110 units		5,000
Contribution/ units after Shipping		2,000

- (i) Upto 110 units, Reference will earn a contribution of Rs.4,000/u.
- (ii) Between 110 & 140 units, contribution of 4,000 will be wiped out by 5,000 on shipping costs. Hence we should not consider 110 – 140 range.
- (iii) 101 – 110 not to be considered since additional fixed costs 2,25,000 will not be covered by 10 units.
- (iv) Valid consideration, 100 units or 141 to 190 units.

Fixed cost of box of 50 cameras is Rs. 2,25,000

Units		100	141	150	190
No. of Camera Boxes	A	2	3	3	4
Cost of Cameras (Rs.)	B	4,50,000	6,75,000	6,75,000	9,00,000
Contribution (Rs/u) Rs. 4,000	C	400,000			
Contribution (Rs.) first 110 units @ 7,000/u	D		7,70,000	7,70,000	7,70,000
Contribution (Rs.) Balance units @ 2,000/u	E		62,000	80,000	1,60,000
Total Contribution (F = C + D + E) (Rs.)	F	4,00,000	8,32,000	8,50,000	9,30,000
Profit (F) – (B) (Rs.)	G	- 50,000	1,57,000	1,75,000	30,000

Best strategy buy 150 units from Comp. sell 110 at store and 40 outside.

BEP should be between 151 – 191 units

Extra Camera box cost beyond 150 units	= 2,25,000
Less: Profit for 150 units	= <u>1,75,000</u>
Extra profit acquired	= <u>50,000</u>

$$\text{No. of units to cover this additional costs at contribution 2000 Rs./u} = \frac{50,000}{2,000} = 25$$

$$\therefore \text{BEP} = 150 + 25 = 175 \text{ units}$$

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Alternative Solution to Q2(a)

The problem involves fixed cost of 50 Computers i.e Rs 2,25,000 for incremental sale of 50.

	Units sold			
	110	140	150	190
Margin per unit = Sales price – buying price + commission (Rs)	4000	4000	7000	7000
Margin (Excluding shipping cost)	4,40,000	5,60,000	10,50,000	13,30,000
Shipping cost (Rs)		30 x 5000	40 x 5000	80 x 5000
For sale beyond 110 units		= 1,50,00	= 2,00,000	= 4,00,000
Contribution (Rs)	4,40,000	4,10,000	8,50,000	9,30,000
Fixed cost (Cost of Computers)	6,75,000	6,75,000	6,75,000	9,00,000
Profit	-2,75,000	-2,65,000	1,75,000	30,000

Best strategy is sales level at 150 units.

The variations of profit is due to incremental fixed cost.

From the profits at different levels, it is seen that the BEP lies between 151 and 190.

Let BEP = X Units

Margin = 7000 X

Shipping Cost = (X - 110) x 5000

Cost of Computers = Rs 9,00,000

We have, 7000 X = (X - 110) x 5000 + 900000

Or 7X = 5X – 550 + 900

Or 2X = 350 or X = 175

Thus, BEP = 175 units.

(b) Type of budgeted ratio used are:

1. Efficiency Ratio = (Standard hours + Actual hours) × 100
2. Activity Ratio = (Standard hours + Budgeted hours) × 100
3. Calendar Ratio = (Available working days ÷ budgeted working days) × 100
4. Standard Capacity Usage Ratio (Budgeted hours ÷ Max. possible hours in the budgeted period) × 100
5. Actual Capacity Usage Ratio = (Actual hours worked + Maximum possible working hours in a period) × 100
6. Actual usage of Budgeted Capacity Ratio = (Actual working hours ÷ Budgeted hours) × 100

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Question 3

- (a) The CEO of your company has been given the following statement showing the results for a recent month:

Particulars	Master Budget	Actual
Units produced & sold	10,000	9,000
	Rs.	Rs.
Sales	8,00,000	7,00,000
Direct material	2,00,000	1,84,000
Direct Wages	3,00,000	2,62,000
Variable overhead	1,00,000	94,000
Fixed overhead	1,00,000	98,000
Total Cost	7,00,000	6,38,000
Net Surplus	1,00,000	62,000

The standard cost of the product is as follows:

Direct material (1 kg @ Rs. 20/kg) Rs. 20.00 per unit

Direct Wages (1 hour @ Rs. 30/hour) Rs. 30.00 per unit

Variable overhead (1 hour @ Rs. 10/hour) Rs. 10.00 per unit

Actual results for the month revealed that 9,800 kg. of material was used and 8,800 labour hours were recorded.

- (i) Prepare a flexible budget for the month and compare with the actual results. (6 Marks)
- (ii) Calculate material volume and variable overhead efficiency variances. (2 Marks)
- (b) What is disinvestments strategy? Highlight the main reasons for disinvestments. (4 Marks)
- (c) What is uniform costing? Why is it recommended? (4 Marks)

Answer

3. (a) (i)

Particular	Master Budget		Flexible Budget	Actual	Variance
Units	10,000		9,000	9,000	
	(Rs.) Total	(Rs.) Per Unit	(Rs.)	(Rs.)	
Sales	8,00,000	80	7,20,000	7,00,000	20,000 (A)
Direct Material	2,00,000	20	1,80,000	1,84,000	4,000 (A)
Direct Wages	3,00,000	30	2,70,000	2,62,000	8,000 (F)

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Variable Overhead	1,00,000	10	90,000	94,000	4,000 (A)
Total Variable Cost	6,00,000	60	5,40,000	5,40,000	-
Contribution	2,00,000	20	1,80,000	1,60,000	20,000 (A)
Fixed Overhead	1,00,000	10	1,00,000	98,000	2,000 (F)
Net Profit	1,00,000	10	80,000	62,000	18,000 (A)

(ii) Calculation of Variances:

Material Volume Variance: $SP (SQ - AQ) = 20 (9,000 - 9,800) = 16,000 (A)$

Variable Overhead efficiency variance $SR (SH - AR) = 10 (9,000 - 8,800) = 2,000 (F)$

(b) Divestment Strategy:

Divestment involves a strategy of selling off or shedding business operations to divert the resources, so released, for other purposes. Selling off a business segment or product division is one of the frequent forms of divestment strategy. It may also include selling off or giving up the control over subsidiary where by the wholly owned subsidiaries may be floated as independently quoted companies.

Reason for Divestment Strategy

1. In case of a firm having an opportunity to get more profitable product or segment but have resource constraint, it may selling off it's unprofitable or less profitable division and utilized the recourse so released. Cost Benefit analysis & Capita Budgeting Method are the useful tool for analyzing this type of situation.
2. In case of purchase of new business, it may be found that some of the part of the acquired business is not upto the mark. In such type of situation disposal of the unwanted part of the business is more desirable than hold it.
3. In case where any business segment or product or subsidiary is pull down the profit of the whole organization, it is better to cut down of that operation of the product or business segment.

(c) Uniform Costing: It is not a distinct method of costing when several undertakings start using the same costing principles or practices, they are said to be following uniform costing. Different concerns in an industry should adopt a common method of costing and apply uniformly the same principles and techniques for better cost comparison and common good and helps in mutual cost control and cost reduction. Hence, it is recommended that a uniform method of costing should be adopted by the member units of an industry.

Question 4

- (a) *The cost per unit of transporting goods from the factories X, Y, Z to destinations. A, B and C, and the quantities demanded and supplied are tabulated below. As the company is working out the optimum logistics, the Govt.; has announced a fall in oil prices. The*

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revised unit costs are exactly half the costs given in the table. You are required to evaluate the minimum transportation cost. (6 Marks)

<i>Destinations</i> <i>Factories</i>	A	B	C	Supply
X	15	9	6	10
Y	21	12	6	10
Z	6	18	9	10
Demand	10	10	10	30

(b) Give an appropriate cost unit for each of the following service sectors: 4

- (i) Hotel
- (ii) School
- (iii) Hospital
- (iv) Accounting firm
- (v) Transport
- (vi) Staff Canteen
- (vii) Machine maintenance
- (viii) Computer Department

(c) A factory manager contends that the mean operating life of light bulbs of his factory is 4,200 hours. A customer disagrees and says it is less. (6 Marks)

The mean operating life for a random sample of 9 bulbs is 4,000 hours, with a sample standard deviation of 201 hours.

Test the hypothesis of the factory manager, given that the critical value of the test statistic as per the table is (-) 2.896.

Answer

(a) The problem may be treated as an assignment problem. The solution will be the same even if prices are halved. Only at the last stage, calculate the minimum cost and divide it by 2 to account for fall in oil prices.

	A	B	C
X	15	9	6
Y	21	12	6
Z	6	18	9

Subtracting Row minimum, we get

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	A	B	C
X	9	3	0
Y	15	6	0
Z	0	12	3

Subtracting Column minimum,

	A	B	C
X	9	0	0
Y	15	3	0
Z	0	9	3

No of lines required to cut Zeros = 3

		<i>Cost / u</i>	<i>Units</i>	<i>Cost</i>	<i>Revised Cost</i>
Allocation:	X → B	9	10	90	45
	Y → C	6	10	60	30
	Z → A	6	10	<u>60</u>	<u>30</u>
				<u>210</u>	<u>105</u>

Minimum cost = 105 Rs.

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Alternative Solution I

Least Cost Method

	A	B Step V	C		Step I Diff.	Step III	
X	15	9 10	6	10	3	3	
Y	21	12	6 10	10	6	6	← Step IV
Z	6 10	18	9	10	3		
	10	10	10	30			
Step I Diff.	9	3	10				
Step III Diff.	Step II	3	10				

Initial Feasible solution

X – B

Y – C

Z – A

Test for optimality

No. of allocation = 3

No. of rows $m = 3$, no. of column = 3

$$m + n - 1 = 3 + 3 - 1 = 5$$

2 very small allocation are done to 2 cells of minimum costs, so that , the following table is got :

	A	B	C
X	15	10 9	e 6
Y	21	12	10 6
Z	10 6	18	e 9

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$$m + n - 1 = 5$$

Now testing for optimality

				u_i
		9	e	0
			6	0
	6		e	0
v_j	6	9	6	

$u_i + v_j$ for unoccupied cells

	A	B	C
X	6	-	-
Y	6	9	-
Z	-	9	-

Diff = $C_{ij} - (u_i + v_j)$

	A	B	C
X	9	-	-
Y	15	3	-
Z	-	9	-

All $\Delta_{ij} > 0$, Hence this is the optimal solution.

	Original Costs	Reduced Costs due to Oil Price	Qty.	Cost
X – B	9	4.5	10	45
Y – C	6	3	10	30
Z – A	6	3	10	<u>30</u>
				<u>105</u>

Total cost of transportation is minimum at Rs.105

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Alternative Solution II

	A	B	C		Step I Diff.	Step III Diff.
X	7.5	4.5 10	3	10	1.5	1.5
Y	11.5	6	3 10	10	3	3
Z	3 10	9	1.5	10	1.5	
Qty.	10	10	10	30		
Step I Diff.	4.5	1.5	0			
Step III Diff.	Step II	1.5	0			

Step V

Step IV

Initial Solution :

	A	B	C
X	7.5	4.5 10	3
Y	11.5	6	3 10
Z	3 10	9	4.5

No. of rows + no. of column – 1

$$m + n - 1 = 5$$

No. of allocation = 3

Hence add 'e' to 2 least cost cells so that

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X	7.5	4.5	10	3	e
Y	11.5	6		3	10
Z		10	9	4.5	e

Now $m + n - 1 = 5$

Testing for optimality,

u_i, v_j table

	A	B	C	u_i
X		4.5	e	0
Y			3	0
Z	3		e	0
v_j	3	4.5	3	

$u_i + v_j$ for unoccupied cells

	3	-	-
	3	4.5	-
	-	4.5	-

C_{ij}

7.5	-	-	
11.5	6	-	
-	9	-	

$\Delta_{ij} = C_{ij} - (u_i + v_j)$

4.5	-	-	
11.5	1.5	-	
8.5	4.5	-	

$u_i + v_j$

3	-	-	
3	4.5	-	
-	4.5	-	

All $\Delta_{ij} > 0$. Hence the solution is optimal.

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	Qty.	Cost/u	Total Cost
X – B	10	4.5	45
Y – C	10	3	30
Z – A	10	3	30
Total minimum cost at revised oil prices			105

(b)

Service Sector		Cost Unit
(i)	Hotel	Bednights available or occupied
(ii)	School	Student hours or no. of full time students
(iii)	Hospital	Patient-day / Room-day
(iv)	Accounting firm	Client hours
(v)	Transport	Passenger-Kms, or Quintal km or tonne-km
(vi)	Staff Canteen	No. of meals provided or no. of staff
(vii)	Machine maintenance	Maintenance hours to user departments
(viii)	Computer Department	Computer time to user departments.

(c) Manager's Hypothesis	H_0	$\mu_0 = 4,200$
	H_1	$\mu < 4,200$ (Left Tail test)

$$t = \frac{\bar{x} - \mu_0}{\sigma}$$

$$\text{where } \sigma = \frac{s}{\sqrt{n}} = \frac{201}{\sqrt{9}} = \frac{201}{3} = 67$$

$$t = \frac{4,000 - 4,200}{67} = \frac{-200}{67} = -2.985$$

Calculated $t = 2.985$, < table value of $t .01$ (sdf) which is -2.896

Hence reject the null hypothesis H_0 . i.e. Accept H_1

The customer's claim is correct.

Question 5

(a) Bearings Ltd. makes three products, A, B and C in Divisions A, Band C respectively. The following information is given: (12 Marks)

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	A	B	C	
Direct Materials (excluding material A for Divisions B and C)	4	15	20	Rs./u
Direct Labour	2	3	4	Rs./u
Variable overhead	1	1	1	Rs./u
Selling price to outside customers	15	40	50	Rs./u
Existing Capacity	5,000	2,500	2,500	(No. of units)
Maximum External demand	3,750	5,000	4,000	(No. of units)
Additional fixed costs that would be incurred to install additional capacity	24,000	6,000	18,700	Rs.
Maximum Additional units that can be produced by additional capacity	5,000	1,250	2,250	(No. of units)

B and C need material A as their input. Material A is available outside at Rs.15 per unit. Division A supplies the material free from defects. Each unit of B and C requires one unit of A as the input material.

If B purchases from outside, it has to pay Rs.15 per unit. If B purchases from A, it has to incur in addition to the transfer price, Rs.2 per unit as variable cost to modify it.

B has sufficient idle capacity to inspect its inputs without additional costs.

If C gets material from A, it can use it directly, but if it gets material from outside, which is at Rs.15, it has to do one of the following:

(i) Inspect it at its own shop floor at Rs.3 per unit

Or

(ii) Get the supplier to supply inspected products and pay the supplier Rs.2 p. u. as inspection charges.

Or

(iii) A has enough idle labour, which it can lend to C to inspect at Re. 1 p.u. even though C purchases from outside.

A has to fix a uniform transfer price for both B and C. The transfer price will not be known to outsiders and is at the discretion of the Divisional Managers.

What is the best strategy for each division and the company as a whole?

(b) Explain the following in the context of a network: (4 Marks)

(i) Critical path

(ii) Dummy activity.

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Answer

- (a) B will not pay A anything more than 13, because at 13, it will incur additional cost of Rs.2/- to modify it, $13 + 2 = 15$, the outside cost.

	A		B	C
	Outside sale	Transfer to B & C		
Divisional variable cost of production	7	7	19	25
Transfer from A			13	13
Modification			2	
Total Variable Cost of production	7	7	34	38
Selling Price	15	13	40	50
Contribution	8	6	6	12

Option for C, Purchase all units from A @ 13: Any other option is costlier.

	A	B	C
Maximum external demand	3,750	5,000	4,000
Existing capacity	5,000	2,500	2,500
Maximum capacity that can be added	5,000	1,250	2,250
Total maximum that can be produced	10,000	3,750	4,750
Additional fixed cost on expansion	24,000	6,000	18,700
Units that must be sold/transfer to get this amount as contribution	$\frac{24,000}{6} = 4,000$	$\frac{6,000}{6} = 1,000$	$\frac{18,700}{6} = 1,558.33$
External demand not covered by existing capacity	-	2,500	1,500
Decision	Expand make 10,000 units $3,750 - \text{outside}$ $3,750 - B$ $2,500 - C$	Expand make 2,500 + 1,250 = 3,750 units	Do not expand make only 2,500 units.

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	A		B	C
	Outside sale	Transfer to B & C		
Units	3,750	$3,750 + 2,500 = 6,250$	3,750	2,500
Contribution / unit	8	6	6	12
Contribution (Rs.)	30,000	37,500	22,500	30,000
	67,500		22,500	30,000
Additional Fixed Cost	24,000		6,000	-
Net revenue addition	43,500		16,500	30,000

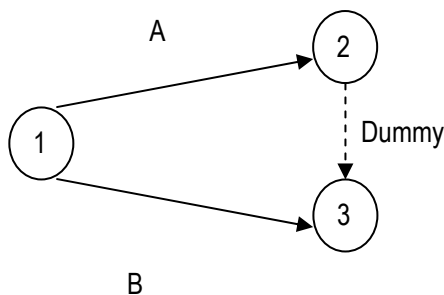
Individual strategy is the Company's best strategy.

(b) (i) Critical Path:

Critical Path is a chain of activities that begin with the starting event and ends with ending event of a particular project. It is that path that runs through a network with the maximum length of time or it indicates the maximum possible time required for completion of a project. Critical path indicates the minimum time that will be required to complete a project. It is determined after identifying critical events. Critical path goes through critical events.

(ii) Dummy Activities:

Dummy Activity is that activity which does not consume time or resources. It is used when two or more activities have same initial and terminal events. As a result of using dummy activities, other activities can be identified by unique end events. These are usually shown by arrows with dashed lines.



Question 6

(a) Formulate the dual for the following linear program:

(6 Marks)

Maximise : $100x_1 + 90x_2 + 40x_3 + 60x_4$

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Subject to

$$6x_1 + 4x_2 + 8x_3 + 4x_4 \leq 140$$

$$10x_1 + 10x_2 + 2x_3 + 6x_4 \leq 120$$

$$10x_1 + 12x_2 + 6x_3 + 2x_4 \leq 50$$

$$x_1, x_2, x_3, x_4 \geq 0$$

(Only formulation is required. Please do not solve.)

- (b) Name the various methods of fitting a straight line to a time series and briefly explain any two of them. (5 Marks)
- (c) Traditional Ltd. is a manufacturer of a range of goods. The cost structure of its different products is as follows: (5 Marks)

Particulars	Product A	Product B	Product C	
Direct materials	50	40	40	Rs./u
Direct labour @ 10 Rs./hour	30	40	50	Rs./u
Production overheads	30	40	50	Rs./u
Total Cost	110	120	140	Rs./u
Quantity produced	10,000	20,000	30,000	Units

Traditional Ltd. was absorbing overheads on the basis of direct labour hours. A newly appointed management accountant has suggested that the company should introduce ABC system and has identified cost drivers and cost pools as follows:

Activity Cost Pool	Cost Driver	Associated Cost
Stores Receiving	Purchase Requisitions	2,96,000
Inspection	Number of Production runs	8,94,000
Dispatch	Orders Executed	2,10,000
Machine Setup	Number of setups	12,00,000

The following information is also supplied:

Details	Product A	Product B	Product C
No. of Setups	360	390	450
No. of Orders Executed	180	270	300
No. of Production runs	750	1,050	1,200
No. of Purchase Requisitions	300	450	500

You are required to calculate activity based production cost of all the three products.

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Answer

(a) Dual:

$$\text{Minimise } 140u_1 + 120u_2 + 50u_3$$

$$\text{S.T. } 6u_1 + 10u_2 + 10u_3 \geq 100$$

$$4u_1 + 10u_2 + 12u_3 \geq 90$$

$$8u_1 + 2u_2 + 6u_3 \geq 40$$

$$4u_1 + 6u_2 + 2u_3 \geq 60$$

$$u_1, u_2, u_3, u_4 \geq 0$$

(b) The various methods of fitting a straight line are:

(i) Free hand method

(ii) Semi-average

(iii) Moving average

(iv) Least square

Freehand method:

First the time series figures are plotted on a graph. The points are joined by straight lines. We get fluctuating straight lines, through which an average straight line is drawn. This method is however, inaccurate, since different persons may fit different trend lines for the same set of data.

Method of Semi Averages:

The given time series is divided into two parts, preferably with the same number of years. The average of each part is calculated and then a trend line through these averages is fitted.

Moving Average Method:

A regular periodic cycle is identified in the time series. The moving average of n years is got by dividing the moving total by n . The method is also used for seasonal and cyclical variation.

Method of Least Squares:

The equation of a straight line is $Y = A + bX$, where X is the time period, say year and Y is the value of the item measured against time, a is the Y intercept and b , the co-efficient of X , indicating the slope of the line. To find a and b , the following 'normal' equations are solved.

$$\sum Y = an + b \sum X$$

$$\sum XY = a \sum X + b \sum X^2$$

Where n is the no. of observation in the series or n = no. of data items.

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(c) The total production overheads are Rs.26,00,000:

Product A: 10,000 × Rs. 30 = Rs. 3,00,000

Product B: 20,000 × Rs. 40 = Rs. 8,00,000

Product C: 30,000 × Rs. 50 = Rs. 15,00,000

On the basis of ABC analysis this amount will be apportioned as follows:

Statement of Activity Based Production Cost							
<i>Activity Pool</i>	<i>Cost</i>	<i>Cost Driver</i>	<i>Ratio</i>	<i>Total Amount (Rs.)</i>	<i>A (Rs.)</i>	<i>B (Rs.)</i>	<i>C</i>
Stores Receiving		Purchase requisition	6:9:10	2,96,000	71,040	1,06,560	1,18,400
Inspection		Production Runs	5:7:8	8,94,000	2,23,500	3,12,900	3,57,600
Dispatch		Orders Executed	6:9:10	2,10,000	50,400	75,600	84,000
Machine Setups		Set ups	12:13:15	12,00,000	3,60,000	3,90,000	4,50,000
Total Activity Cost					7,04,940	8,85,060	10,10,000
Quantity Sold					10,000	20,000	30,000
Unit Cost					70.49	44.25	33.67
Add: Conversion Cost					80	80	90
Total					150.49	124.25	123.67

Question 7

(a) Vikram Ltd. produces 4 products using 3 different machines. Machine capacity is limited to 3,000 hours for each machine. The following information is available for February, 2009: (7 Marks)

Products	A	B	C	D
Contribution (Sales-direct material) Rs.	1,500	1,200	1,000	600
<i>Machine Hours Required/Unit :</i>				
Machine 1	10	6	2	1
Machine 2	10	9	3	1.5
Machine 3	10	3	1	0.5
Estimated Demand (units)	200	200	200	200

From the above information you are required to identify the bottleneck activity and allocate the machine time.

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(b) Explain the essential features of Life-cycle costing. (5 Marks)

(c) Explain briefly the concepts of Opportunity costs and Relevant costs. (4 Marks)

Answer

(a)

Machine	Time required for products				Total Time	Time Available	Machine utilization
	A	B	C	D			
1	2000	1200	400	200	3800	3000	126.67%
2	2000	1800	600	300	4700	3000	156.67%
3	2000	600	200	100	2900	3000	96.67%

Since Machine 2 has the highest machine Utilization it represents the bottleneck activity hence product, ranking & resource allocation should be based on contribution/machine hour of Machine 2.

Allocation of Resources						
	A	B	C	D	Machine Utilization	Spare Capacity
Contribution per unit (Rs.)	1500	1200	1000	600		
Time required in Machine 2	10	9	3	1.5		
Contribution per Machine – hour (Rs.)	150	133.33	333.33	400		
Rank as per contribution / mach. Hour	3 rd	4 th	2 nd	1 st		
Allocation of Machine 2 time	200×10 = 2000	100 (balancing figure)	200×3 = 600	200×1.5 = 300	3000	
Production Quantity	200	100/9=11.11	200	200		
Allocation Machine 1 time	2000	11.11×6 = 66.66	400	200	2666.66	333.34
Allocation of Machine 3 time	2000	11.11×3 = 33.33	200	100	2333.33	666.67

(b) Essential features of Life Cycle Costing:

Product Life Cycle costing involves :

- Tracing of costs and revenue of product over several calendar period. Throughout their entire life cycle.
- Emphasis is on Cost and revenue accumulation over the entire life cycle of the product.
- Life cycle costing traces research and design.
- It focus on development costs, incurred to individual products over their entire life cycles.
- Total magnitude of research and development costs are reported and compared with product revenues generated in later periods.

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- (c) Opportunity cost is a measure of the benefit of opportunity forgone when various alternatives are considered.

Or

It is the cost of sacrifice made by alternative action chosen.

E.g. opportunity cost of funds invested in business is the interest that could have been earned by investing the funds in bank deposit.

Relevant Cost:

Expected future costs which differ for alternative course.

(Or)

It is not essential that all variable costs are relevant and all fixed costs are irrelevant. Fixed, or variable costs that differ for various alternatives are relevant costs. Relevant costs draw our attention to those elements of cost which are relevant for the decision.

E.g. Direct labour under alternative I – Rs.10/ hour

Direct labour under alternative II – Rs.20/hour

Then, direct labour is relevant cost.

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Question no. 1 is compulsory

Attempt any **four** question from the remaining **six** questions

Question 1.

XYZ Company, engaged in the manufacturing of several types of electronic goods is having its branches all over the World. The company wishes to centralize and consolidate the information flowing from its branches in a uniform manner across various levels of the Organization.

The factories are already working on legacy systems using an intranet and collating information. But each factory and branch is using different software and varied platforms, which do not communicate with each other. This not only results in huge inflow of data which could not be consolidated for analysis but also the duplication of data. Even one percent change in any data entry or analysis translates into millions of Rupees and can sometimes wipe out the profits of the organization. So the company needs a system that would help them to be responsive and act fast.

Read the above carefully and answer the following with justifications:

- (a) What are the problems that the company is facing now? (5 Marks)
- (b) Should the company go for ERP solution? If yes, will the company be able to share a common platform with its dealers to access servers and database to update the information of issues of mutual interest? (5 Marks)
- (c) For the selection of ERP package, state the issues to be considered. (5 Marks)
- (d) Suggest how to go about the implementation of ERP package. (5 Marks)

Answer

- (a) XYZ company, having its branches all over the world, is engaged in manufacturing of several types of electronic goods. It is confronted with the problem of centralizing and consolidating the information flowing in from its various branches in uniform manner across various levels of the organization.

No doubt, the factories are working on legacy systems using an intranet and collating information. As each factory is using different type of software on varied platforms, therefore, they are not able to communicate with each other. Because of this reason, there is a huge inflow of data which could not be consolidated for analysis. Lack of communication among factories has not only resulted into duplication of the data entry which is not only costly, slight change in data entry and analysis may translate into millions of rupees that can sometimes wipe out the profits of the organization. Hence, there is an urgent need of a system that would help the branches to be responsive and to act fast.

- (b) Yes, the company should go for ERP solutions. ERP implementation brings different business functions, personalities, procedures, ideologies and philosophies on one platform, with an aim to pool knowledge base to effectively integrate and bring worthwhile and beneficial changes throughout the organization. Some of the major features of ERP

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are that it provides the support to multi platform, multi facility, multi mode, manufacturing, multi currency, multi lingual facilities. It supports strategic and business planning activities, operational planning and execution activities, creation of material and resources. All these functions are effectively integrated for flow and updation of information immediately upon entry of any information, thereby providing a company-wide Integrated Information System.

In case, the company decides to include a module for dealers which provides limited/restricted access to company databases and server, dealers will be able to update the information of issues of mutual interest.

- (c) While selecting the ERP package, the performance of following issues should be taken into account:
- (i) Better inventory management and control.
 - (ii) Improved financial reporting and control.
 - (iii) Automation of certain tasks that were performed manually to increase productivity.
 - (iv) Improved production planning.
 - (v) Better information on stocks at various locations.
 - (vi) Using an integrated system as opposed to disparate systems at different locations, thereby eliminating errors of duplicate entries.
 - (vii) More accurate costing of products.
 - (viii) Better credit control.
 - (ix) Improved cash flow planning.
 - (x) Automatic quality control and tracking.
 - (xi) Better after sales services.
 - (xii) Better information and reporting to top management.
- (d) In the stated scenario, several steps involved in the implementation of a typical ERP package are enumerated below:
- (i) Identifying the needs for implementing an ERP package.
 - (ii) Evaluating the 'As Is' situation of the business i.e., to understand the strength and weakness prevailing under the existing circumstances.
 - (iii) Deciding the 'Would be' situation for the business i.e., the changes expected after the implementation of ERP.
 - (iv) Reengineering the Business Process to achieve the desired results in the existing processes.
 - (v) Evaluating the various available ERP packages to assess suitability.
 - (vi) Finalizing of the most suitable ERP package for implementation.
 - (vii) Installing the required hardware and networks for the selected ERP package.

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- (viii) Finalizing the Implementation consultants who will assist in implementation.
- (ix) Implementing the ERP package.

Question 2.

- (a) *The top management of company has decided to develop a computer information system for its operations. Is it essential to conduct the feasibility study of system before implementing it? If answer is yes, state the reasons. Also discuss three different angles through which the feasibility study of the system is to be conducted.*
(10 Marks)
- (b) "While reviewing a client's control system, an information system auditor will identify three components of internal control." State and briefly explain these three components.
(5 Marks)
- (c) While testing a software, how will you involve the people working in the system areas?
(5 Marks)

Answer

- (a) Yes, it is essential to carry out the feasibility study of the project before its implementation. After possible solution options are identified, project feasibility-the likelihood that these systems will be useful for the organization-is determined. A feasibility study is carried out by the system analysts for this purpose. Feasibility study refers to a process of evaluating alternative systems through cost/benefit analysis so that the most feasible and desirable system can be selected for development. It is carried out by the system analysts.

The feasibility study of the system is undertaken from three angles i.e. technical, economic and operational. The proposed system is evaluated from a technical view point first and if technically feasible, its impact on the organization and staff is assessed. If a compatible technical and social system can be devised, it is then tested for economic feasibility.

Technical feasibility: It is concerned with hardware and software. Essentially, the analyst ascertains whether the proposed system is feasible with existing or expected computer hardware and software technology. The technical issues usually raised during the feasibility stage of investigation include the following:

- (i) Does the necessary technology exist to do what is suggested (and can it be acquired)?
- (ii) Does the proposed equipment have the technical capacity to hold the data required to use the new system?
- (iii) Will the proposed system provide an adequate response to inquiries, regardless of the number or location of users?
- (iv) Can the system be expanded if developed?

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- (v) Are there technical guarantees of accuracy, reliability, ease of access, the data security?

Some of the technical issues to be considered are given in the Table-1 below.

Design Considerations	Design Alternatives
Communications channel configuration	Point to point, multidrop, or line sharing
Communications channels	Telephone lines, coaxial cable, fiber optics, microwave, or satellite
Communications network	Centralized, decentralized, distributed, or local area
Computer programs	Independent vendor or in-house
Data storage medium	Tape, floppy disk, hard disk, or hard copy
Data storage structure	Files or database
File organization and access	Direct access or sequential files
Input medium	Keying, OCR, MICR, POS, EDI, or voice recognition
Operations	In-house or outsourcing
Output frequency	Instantaneous, hourly, daily, weekly, or monthly
Output medium	CRT, hard copy, voice, or turnaround document
Output scheduling	Predetermined times or on demand
Printed output	Preprinted forms or system-generated forms
Processor	Micro, mini, or mainframe
Transaction processing	Batch or online
Update frequency	Instantaneous, hourly, daily, weekly, or monthly

Table-1: Technical Issues

Due to tremendous advancements in computer field these days, the technology is available for most business data processing systems but sometimes not within the constraints of the firm's resources or its implementation schedule. Therefore, trade offs are often necessary. A technically feasible system may not be economically feasible or may be so sophisticated that the firm's personnel cannot effectively operate it.

Economic feasibility: It includes an evaluation of all the incremental costs and benefits expected if the proposed system is implemented. This is the most difficult aspect of the study. The financial and economic questions raised by analysts during the preliminary investigation are for the purpose of estimating the following:

- (i) The cost of conducting a full system's investigation.
- (ii) The cost of hardware and software for the class of applications being considered.
- (iii) The benefits in the form of reduced costs or fewer costly errors.

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(iv) The cost if nothing changes (i.e. the proposed system is not developed).

The procedure employed is the traditional cost-benefit study.

Operational feasibility: It is concerned with ascertaining the views of workers, employees, customers and suppliers about the use of computer facility. The support or lack of support that the firm's employees are likely to give to the system is a critical aspect of feasibility. A system can be highly feasible in all respects except the operational and fails miserably because of human problems. Some of the questions which may help in conducting the operational feasibility of a project are stated below:

- (i) Is there sufficient support for the system from management? From users? If the current system is well liked and used to the extent that persons will not be able to see reasons for a change, there may be resistance.
 - (ii) Are current business methods acceptable to user? If they are not, users may welcome a change that will bring about a more operational and useful system.
 - (iii) Have the users been involved in planning and development of the project? Early involvement reduces the chances of resistance to the system and changes in general and increases the likelihood successful projects.
 - (iv) Will the proposed system cause harm? Will it produce poorer results in any respect or area? Will loss of control results in any areas? Will accessibility of information be lost? Will individual performance be poorer after implementation than before? Will performance be affected in an undesirable way? Will the system slow performance in any areas?
- (b) The basic purpose of information system controls in an organization is to ensure that the business objectives are achieved and undesired risk events are prevented or detected and corrected. This is achieved by designing an effective information control framework, which comprises of policies, procedures, practices, and organization structure to give reasonable assurances that the business objectives will be achieved.

While reviewing a client's control systems, the auditor will be able to identify three components of internal controls. Each component is aimed at achieving different objectives as stated below:

- (i) *Accounting Controls:* These controls are extended to safeguard the client's assets and ensure reliability of financial records.
 - (ii) *Operational Controls:* These deal with the day to day operations, functions and activities to ensure that the operational activities are contributing to business objectives.
 - (iii) *Administrative Control:* These are concerned with ensuring efficiency and compliance with management policies, including the operational controls.
- (c) Following are the main testing techniques which involve the people working in the system areas:
- (i) *White Box Testing:* White box testing is a test case design method that uses the control structure of the procedural design to derive test cases. Test cases can be derived to

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- guarantee that all independent paths within a module have been exercised at least once,
 - exercise all logical decisions on their true and false sides,
 - execute all loops at their boundaries and within their operational bounds, and
 - exercise internal data structures to ensure their validity
- (ii) *Unit Testing:* In computer programming, a unit test is a method of testing the correctness of a particular module of source code. The idea is to write test cases for every non-trivial function or method in the module so that each test case is separate from the others if possible. This type of testing is mostly done by the developers.
- (iii) *Requirements Testing:* These test conditions are generalized ones, which become test cases as the SDLC progresses until system is fully operational. The main usage of this testing technique is
- to ensure that system performs correctly
 - to ensure that correctness can be sustained for a considerable period of time.
 - system can be tested for correctness through all phases of SDLC but in case of reliability the programs should be in place to make system operational.
- (iv) *Regression Testing:* Under this testing technique, test cases, which were used previously for the already tested segment are, re-run to ensure that the results of the segment tested currently and the results of same segment being tested earlier, are same. Test automation is needed to carry out the test transactions (test condition execution) else the process is very time consuming and tedious. In this case of testing, cost/benefit should be carefully evaluated else the efforts spent on testing would be more and payback would be minimum. The major objectives are as follows:
- System documents remain current.
 - System test data and test conditions remain current.
 - Previously tested system functions properly without getting effected though changes are made in some other segment of application system.
- (v) *Manual Support Testing:* It involves testing of all the functions performed by the people while preparing the data and using these data from automated system. The major objectives of this testing technique are to
- verify that manual support documents and procedures are correct,
 - determine that manual support responsibility is correct,
 - determine that manual support people are adequately trained,
 - determine that manual support and automated segment are properly interfaced.

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- (vi) *Internal System Testing: This technique is used to ensure interconnection between application functions correctly. The major objectives of the testing are to ensure that*
- proper parameters and data are correctly passed between the applications,
 - documentation for involved system is correct and accurate,
 - proper timing and coordination of functions exists between the application systems.

Question 3.

- (a) *A company is engaged in the stores taking data activities. Whenever, input data error occurs, the entire stock data is to be reprocessed at a cost of Rs. 50,000. The management has decided to introduce a data validation step that would reduce errors from 12% to 0.5% at a cost of Rs. 2,000 per stock taking period. The time taken for validation causes an additional cost of Rs. 200. (i) Evaluate the percentage of cost-benefit effectiveness of the decision taken by the management and (ii) suggest preventive control measures to avoid errors for improvement. (10 Marks)*
- (b) *What are the issues that should be considered by a system auditor at post implementation review stage before preparing the audit report? (5 Marks)*
- (c) *"Always, there exist some threats due to Cyber Crimes." Explain these threats. (5 Marks)*

Answer

- (a) (i) The percentage of cost benefit effectiveness based on the information is calculated in the following table:

S. No.	Particulars	Without validation Procedure	With Validation Procedure
1.	Cost of reprocessing the stock data	Rs. 50,000	Rs. 50,000
2.	Risk of data errors	12%	0.5%
3.	Expected processing cost	Rs. 6,000	Rs. 250
4.	Cost of validation procedure	Nil	Rs. 2,000
5.	Cost of delay due to validation	Nil	Rs. 200
6.	Total cost involved	Rs. 56,000	Rs. 52,450
7.	Net expected benefit		Rs. 3,550
	in %		6.3%

Hence there is 6.3% cost benefit effectiveness of the decision taken by the management.

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(ii) Preventive Control Measures

Preventive controls are those inputs, which are designed to prevent an error, omission or malicious act occurring. An example of a preventive control is the use of passwords to gain access to a financial system. The broad characteristics of preventive controls are:

- (i) A clear-cut understanding about the vulnerabilities of the asset.
- (ii) Understanding probable threats.
- (iii) Provision of necessary controls for probable threats from materializing.

Any control can be implemented in both manual and computerized environment for the same purpose. Only the implementation methodology may differ from one environment to the other.

Some of the major preventive controls to avoid errors are as follows:

- Employ qualified personnel
- Segregation of duty
- Access controls
- Vaccination against disease
- Maintain proper documentation
- Prescribing appropriate books for a course
- Training and retraining of personnel
- Authorization of transactions
- Validation, edit checks in the application programmes
- Firewalls
- Anti-virus software
- Passwords

The above list in no way is exhaustive, but is a mix of manual and computerized preventive controls. The following table enumerates the kind of manual controls and computerized controls applied to a similar scenario.

Scenario	Manual Control	Computerized Control
Restrict unauthorized entry into the premises	Build a gate and post a security guard.	Use access control software, smart card, biometrics, etc.
Restricted unauthorized entry into the software applications	Keep the computer in a secured location and allow only authorized person to use the applications.	Use access control, viz. User ID, password, smart card, etc.

Table-2: Manual & Computerized Controls

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- (b)** An auditor will consider following issues at PIR (Post Implementation Review) stage before preparing the audit report:
- (i) Interview business users in each functional area covered by the system, and assess their satisfaction with, and overall use of, the system.
 - (ii) Interview security, operations and maintenance staff and, within the context of their particular responsibilities, assess their reactions to the system.
 - (iii) Based on the User Requirements Specification, determine whether the system's requirements have been met. Identify the reasons(s) why any requirements are not to be provided, are yet to be delivered, or which do not work properly.
 - (iv) Confirm that the previous system has been de-commissioned or establish the reasons(s) why it remains in use.
 - (v) Review system problem reports and change proposals to establish the number and nature (routine, significant, major) of problems, and changes being made to remedy them. The volume of system change activity can provide an indicator of the quality of systems development.
 - (vi) Confirm that adequate internal controls have been built into the system, that these are adequately documented, and that they are being operated correctly. Review the number and nature of internal control rejections to determine whether there are any underlying system design weaknesses.
 - (vii) Confirm that an adequate Service Level Agreement has been drawn up and implemented. Identify and report on any area where service delivery either falls below the level specified, or is inadequate in terms of what was specified.
 - (viii) Confirm that the system is being backed up in accordance with user requirements, and that it has been successfully restored from backup media.
 - (ix) Review the Business Case and determine whether:
 - anticipate benefits have / are been achieved;
 - any unplanned benefits have been identified;
 - costs are in line with those estimated;
 - benefits and costs are falling with the anticipated time-frame.
 - (x) Review trends in transaction throughput and growth in storage use to identify that the anticipated growth of the system is in line with the forecast.
- (c)** Any computerized environment is dependent on people. Though they play a critical role in success of an enterprise computing, it is a fact that threats always exist due to cyber crimes committed by people. The special skill sets of IT operational team, programmers; data administrator, etc. are key links in ensuring that the IT infrastructure delivers output as per user requirements. At the same time, social engineering risks target key persons to get sensitive information to exploit the information resources of the enterprise. Threats also arise on account of dependence on external agencies. IT computing

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services are significantly dependant on various vendors and service providers for equipment supply and support, consumables, systems and program maintenance, air-conditioning, hot-site providers, utilities, etc. Following are some of the serious threats due to cyber crimes:

- *Embezzlement*: It is unlawful misappropriation of money or other things of value, by the person to whom it was entrusted (typically an employee), for his/her own use or purpose.
- *Fraud*: It occurs on account of internal misrepresentation of information or identity to deceive others, the unlawful use of credit/debit card or ATM, or the use of electronic means to transmit deceptive information, to obtain money or other things of value. Fraud may be committed by someone inside or outside the company.
- *Theft of proprietary information*: It is illegal to obtain of designs, plans, blueprints, codes, computer programs, formulas, recipes, trade secrets, graphics, copyrighted material, data, forms, files, lists, and personal or financial information, usually by electronic copying.
- *Denial of service*: There can be disruption or degradation of service that is dependent on external infrastructure. Problems may erupt through internet connection or e-mail service that result in an interruption of the normal flow of information. Denial of service is usually caused by events such as ping attacks, port scanning probes, and excessive amounts of incoming data.
- *Vandalism or sabotage*: It is the deliberate or malicious, damage, defacement, destruction or other alteration of electronic files, data, web pages, and programs.
- *Computer virus*: Viruses are hidden fragments of computer codes which propagates by inserting themself into or modifying other programs.
- *Other*: Threat includes several other cases such as intrusion, breaches and compromises of the respondent's computer networks (such as hacking or sniffing) regardless of whether damage or loss were sustained as a result.

Question 4.

- (a) As a system auditor, what control measures will you check to minimize threats, risks and exposures in a computerized system? (10 Marks)
- (b) State and explain four commonly used techniques to assess and evaluate risks. (5 Marks)
- (c) What are the audit tools and techniques used by a system auditor to ensure that disaster recovery plan is in order? Briefly explain them. (5 Marks)

Answer

- (a) To minimize threats to the confidentiality, integrity, and availability, of data and computer systems and for successful business continuity, the system auditor should evaluate

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potential threats to computer systems. Discussed hereunder are various control measures that will be checked by him to minimize threats, risks and exposures in a computerized system:

- (i) *Lack of integrity* : Control measures to ensure integrity include implementation of security policies, procedures and standards, use of encryption techniques and digital signatures, inclusion of data validation, editing, and reconciliation techniques for inputs, processes and outputs, updated antivirus software, division of job and layered control to prevent impersonation, use of disk repair utility, implementation of user identification, authentication and access control techniques, backup of system and data, security awareness programs and training of employees, installation of audit trails, audit of adequacy of data integrity.
- (ii) *Lack of confidentiality*: Control measures to ensure confidentiality include use of encryption techniques and digital signatures, implementation of a system of accountability by logging and journaling system activity, development of a security policy procedure and standard, employee awareness and training, requiring employees to sign a non-disclosure undertaking, implementation of physical and logical access controls, use of passwords and other authentication techniques, establishment of a documentation and distribution schedule, secure storage of important media and data files, installation of audit trails, and audit of confidentiality of data.
- (iii) *Lack of system availability*: Control measures to ensure availability include implementation of software configuration controls, a fault tolerant hardware and software for continuous usage and an asset management software to control inventory of hardware and software, insurance coverage, system backup procedure to be implemented, implementation of physical and logical access controls, use of passwords and other authentication techniques, incident logging and report procedure, backup power supply, updated antivirus software, security awareness programmes and training of employees, installation of audit trails, audit of adequacy of availability safeguards.
- (iv) *Unauthorized users attempt to gain access to the system and system resources*: Control measures to stop unauthorized users to gain access to system and system resources include identification and authentication mechanism such as passwords, biometric recognition devices, tokens, logical and physical access controls, smart cards, disallowing the sharing of passwords, use of encryption and checksum, display of warning messages and regular audit programs.

Data transmitted over a public or shared network may be intercepted by an unauthorized user, security breaches may occur due to improper use or bypass of available security features, strong identification and authentication mechanisms such as biometric, tokens, layered system access controls, documentation procedures, quality assurance controls and auditing.

- (v) *Hostile software e.g. virus, worm, Trojan horses, etc.*: Establishment of policies regarding sharing and external software usage, updated anti-virus software with

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detection, identification and removal tools, use of diskless PCs and workstations, installation of intrusion detection tools and network filter tools such as firewalls, use of checksums, cryptographic checksums and error detection tools for sensitive data, installation of change detection tools, protection with permissions required for the 'write' function.

- (vi) *Disgruntled employees*: Control measures to include installation of physical and logical access controls, logging and notification of unsuccessful logins, use of disconnect feature on multiple unsuccessful logins, protection of modem and network devices, installation of one time use only passwords, security awareness programs and training of employees, application of motivation theories, job enrichment and job rotation.
 - (vii) *Hackers and computer crimes*: Control measures to include installation of firewall and intrusion detection systems, change of passwords frequently, installation of one time use passwords, discontinuance of use of installed and vendor installed passwords, use of encryption techniques while storage and transmission of data, use of digital signatures, security of modem lines with dial back modems, use of message authentication code mechanisms, installation of programs that control change procedures, and prevent unauthorized changes to programs, installation of logging feature and audit trails for sensitive information.
 - (viii) *Terrorism and industrial espionage*: Control measures to include usage of traffic padding and flooding techniques to confuse intruders, use of encryption during program and data storage, use of network configuration controls, implementation of security labels on sensitive files, usage of real-time user identification to detect masquerading, installation of intrusion detection programs.
- (b) Four most commonly used techniques to access and evaluate risks are:
- Judgment and intuition
 - The Delphi Approach
 - Scoring
 - Quantitative Techniques

A brief discussion on each of them is given as follows:

- (i) *Judgment and intuition*: In many situations, the auditors have to use their judgment and intuition for risk assessment. This mainly depends on the personal and professional experience of the auditors and their understanding of the system and its environment. Together with it, systematic education and ongoing professional updating is also required.
- (ii) *The Delphi Approach*: This technique is used for obtaining a consensus opinion. A panel of experts is engaged and each expert is asked to give his opinion in a written and independent method. They enlist the estimate of the cost benefits and the reasons why a particular system is to be chosen, the risks and exposures of the system. These estimates are then compiled together. The estimates falling within a

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pre-decided acceptable range are taken. The process may be repeated four times for revising estimates falling beyond the range. Then a curve is drawn taking all the estimates as points on the graphs. The median is drawn and this is the consensus opinion.

- (iii) *The Scoring Approach:* In this approach, the risks in the system and their respective exposures are listed. Weights are then assigned to the risks and to the exposures depending on the severity, impact of occurrence and costs involved. The product of the risk weight with the exposure weight of every characteristic gives the weighted score. The sum of these weighted score gives the risk and exposure score of the system. System risks and exposures are then ranked according to the scores.
 - (iv) *Quantitative Techniques:* Quantitative techniques involve the calculating of an annual loss exposure value based on the probability of the event and the exposure in terms of estimated costs. This helps the organization to select cost effective solutions. It is the assessment of potential damage in the event of occurrence of unfavorable events, keeping in mind how often such an event may occur.
- (c) Audit tools and techniques used by a system auditor to ensure that the disaster recovery plan is in order, are briefly discussed below:

The best audit tool and technique is a periodic simulation of a disaster. Other audit techniques would include observations, interviews, checklists, inquiries, meetings, questionnaires and documentation reviews. These are categorized as follows:

- (i) *Automated tools:* They make it possible to review large computer systems for a variety of flaws in a short time period. They can be used to find threats and vulnerabilities such as weak access controls, weak passwords, and lack of integrity of the system software.
- (ii) *Internal Control auditing:* This includes inquiry, observation and testing. The process can detect illegal acts, errors, irregularities or lack of compliance for laws and regulations.
- (iii) *Disaster and Security Checklists:* These checklists are used to audit the system. The checklists should be based upon disaster recovery policies and practices, which form the baseline. Checklists can also be used to verify changes to the system from contingency point of view.
- (iv) *Penetration Testing:* It is used to locate vulnerabilities to the system.

Question 5.

- (a) *When an organization is audited for the effective implementation of ISO 27001-(BS 7799: part II)-Information Security Management System, what are to be verified under.*

(10 Marks)

- (i) Establishing Management Framework
- (ii) Implementation
- (iii) Documentation.

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- (b) *The Information Security Policy of an organization has been defined and documented as given below:*

“Our organization is committed to ensure Information Security through established goals and principles. Responsibilities for implementing every aspect of specific applicable proprietary and general principles, standards and compliance requirements have been defined. This is reviewed at least once a year for continued suitability with regard to cost and technological changes.”

Identify the salient components that have not been covered in the above policy. (5 Marks)

- (c) *Briefly explain Asset Classification and Control under Information Security Management Systems. (5 Marks)*

Answer

- (a) **ISO 27001 –(BS7799: Part II) – Specification for Information Security Management Systems**

It deals with the Information Security Management Standard (ISMS). In general, organizations shall establish and maintain documented ISMS addressing assets to be protected, organization approach to risk management, control objectives and control, and degree of assurance required.

- (i) *Establishing Management Framework:* This would include the following activities:

- Define information security policy;
- Define scope of ISMS including functional, asset, technical, and locational boundaries;
- Make appropriate risk assessment ;
- Identify areas of risk to be managed and degree of assurance required;
- Select appropriate controls;
- Prepare Statement of Applicability.

- (ii) *Implementation:* Effectiveness of procedures to implement controls to be verified while reviewing security policy and technical compliance.

- (iii) *Documentation:* The documentation shall consist of evidence of action undertaken under establishment of the following:

- Management control
- Management framework summary, security policy, control objective, and implemented control given in prepare Statement of Applicability
- Procedure adopted to implement control under Implementation clause
- ISMS management procedure
- Document Control: The issues focused under this clause would be

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- Ready availability
- Periodic review
- Maintain version control;
- Withdrawal when obsolete
- Preservation for legal purpose
- Records: The issues involved in record maintenance are as follows:
 - Maintain to evidence compliance to Part 2 of BS7799.;
 - Procedure for identifying, maintaining, retaining, and disposing of such evidence;
 - Records to be legible, identifiable and traceable to activity involved.
 - Storage to augment retrieval, and protection against damage.
- (b) A Policy is a plan or course of action, designed to influence and determine decisions, actions and other matters. The security policy is a set of laws, rules, and practices that regulates how assets including sensitive information are managed, protected, and distributed within the user organization.

An information Security policy addresses many issues such as disclosure, integrity and availability concerns, who may access what information and in what manner, basis on which access decision is made, maximized sharing versus least privilege, separation of duties, who controls and who owns the information, and authority issues.

Issues to address: This policy does not need to be extremely extensive, but clearly state senior management's commitment to information security, be under change and version control and be signed by the appropriate senior manager. The policy should at least address the following issues:

- a definition of information security,
- reasons why information security is important to the organization, and its goals and principles,
- a brief explanation of the security policies, principles, standards and compliance requirements,
- definition of all relevant information security responsibilities, and
- reference to supporting documentation.

The auditor should ensure that the policy is readily accessible to all employees and that all employees are aware of its existence and understand its contents. The policy may be a stand-alone statement or part of more extensive documentation (e.g. a security policy manual) that defines how the information security policy is implemented in the organization. In general, most if not all employees covered by the ISMS scope will have some responsibilities for information security, and auditors should review any

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declarations to the contrary with care. The auditor should also ensure that the policy has an owner who is responsible for its maintenance and that it is updated responding to any changes affecting the basis of the original risk assessment.

In the stated scenario of the question, the ISMS Policy of the given organization does not address the following issues:

- (i) Definition of information security,
- (ii) Reasons why information security is important to the organization,
- (iii) A brief explanation of the security policies, principles, standards and compliance, and
- (iv) Reference to supporting documents.

(c) Asset Classification and Control

One of the most laborious but essential task is to manage inventory of all the IT assets, which could be information assets, software assets, physical assets or other similar services. These information assets need to be classified to indicate the degree of protection. The classification should result into appropriate information labeling to indicate whether it is sensitive or critical and what procedure, is appropriate to copy, store, transmit or destruction of the information asset.

An Information Asset Register (IAR) should be created detailing each of the following information asset within the organization:

- Databases
- Personnel records
- Scale models
- Prototypes
- Test samples
- Contracts
- Software licenses
- Publicity material

The Information Asset Register (IAR) should also describe who is responsible for each information asset and whether there is any special requirement for confidentiality, integrity or availability. For administrative convenience, separate register may be maintained under the subject head of IAR e.g. 'Media Register' will detail the stock of software and its licenses. One major advantage of following this practice is that, it provides a good back-up for example, in case the carton/label containing password is accidentally misplaced, media register will provide the necessary information. Similarly, 'Contracts Register' will contain the contracts signed and thus other details. The impact that is an addendum to mere maintenance of a register is control and thus protection of

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valuable assets of the corporation. The value of each asset can then be determined to ensure that appropriate security is in place.

The detailed **control and objectives** thereof are as follows:

- *Accountability for assets*: to maintain appropriate protection of organizational assets,
- *Information Classification*: to ensure that information assets receive an appropriate level of protection.

Question 6.

- (a) *What purpose the information system audit policy will serve? Briefly describe the scope of information system audit.* (10 Marks)
- (b) *State the duties of the subscriber of a digital signature as specified in Section 40 to 42 of Chapter VIII of Information Technology Act, 2000.* (5 Marks)
- (c) *What are the conditions subject to which electronic record may be authenticated by means of affixing digital signature?* (5 Marks)

Answer

(a) Purpose of the Audit Policy

Purpose of the audit policy is to provide the guidelines to the audit team to conduct an audit of IT based infrastructure system. The Audit is done to protect entire system from the most common security threats which includes the following:

- Access to confidential data
- Unauthorized access of the department computers
- Password disclosure compromise
- Virus infections
- Denial of service attacks
- Open ports, which may be accessed by outsiders
- Unrestricted modems, unnecessarily open ports

Audits may be conducted to ensure integrity, confidentiality and availability of information and resources. The IS Audit Policy should lay out the objective and the scope of the Policy.

An IS audit is conducted to:

- Safeguarding of Information System Assets/Resources
- Maintenances of Data Integrity
- Maintenance of System Effectiveness
- Ensuring System Efficiency

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- Compliance with Information System related policies, guidelines, circulars, and any other instructions requiring compliance in whatever name called.

Scope of IS Audit

The scope of information system auditing should encompass the examination and evaluation of the adequacy and effectiveness of the system of internal control and the quality of performance by the information system. Information System Audit will examine and evaluate the planning, organizing, and directing processes to determine whether reasonable assurance exists that objectives and goals will be achieved. Such evaluation, in the aggregate, provides information to appraise the overall system of internal control.

The scope of the audit will also include the internal control system (s) for the use and protection of information and the information system, as under:

- Data
- Application systems
- Technology
- Facilities
- People

The information System auditor will consider whether the information obtained from the above reviews indicates coverage of the appropriate areas. The information system auditor will examine, among other, the following:

- Information system mission statement and agreed goals and objectives for information system activities.
- Assessment of the risks associated with the use of the information systems and approach to managing those risks.
- Information system strategy plans to implement the strategy and monitoring of progress against those plans.
- Information system budget and monitoring of variances.
- High level policies for information system use and the protection and monitoring of compliance with these policies.
- Major contract approval and monitoring of performance of the supplier.
- Monitoring of performance against service level agreements
- Acquisition of major systems and decisions on implementation.
- Impact of external influences on information system such as internet, merger of suppliers or liquidation etc.
- Control of self-assessment reports, internal and external audit reports, quality assurance reports or other reports on Information System.

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- Business Continuity Planning, Testing thereof and Test results.
- Compliance with legal and regulatory requirements
- Appointment, performance monitoring and succession planning for senior information system staff including internal information system audit management and business process owners.

- (b) The duties of the subscriber of a Digital Signature as specified in Section 40 to 42 of Chapter VII of IT Act- 2000 are as follows:

On acceptance of the Digital Signature Certificate the subscriber shall generate a key pair using a secure system.

A subscriber shall be deemed to have accepted a Digital Signature Certificate if he publishes or authorizes the publication of a Digital Signature Certificate-

- (i) to one or more persons;
- (ii) in a repository, or otherwise demonstrates his approval of the Digital Signature
- (iii) certificate in any manner.

By accepting a Digital Signature Certificate, the subscriber certifies to all who reasonably rely on the information contained in the Digital Signature Certificate that –

- (i) the subscriber holds the private key corresponding to the public key listed in the Digital Signature Certificate and is entitled to hold the same;
- (ii) all representations made by the subscriber to the Certificate Authority and all material relevant to the information contained in the Digital Signature Certificate are true;
- (iii) all information in the Digital Signature Certificate that is within the knowledge of the subscriber is true.

The subscriber shall exercise all reasonable care to retain control of his private key corresponding to the public key. If such private key has been compromised (i.e., endangered or exposed), the subscriber must immediately communicate the fact to the Certifying Authority.

Otherwise, the subscriber shall be liable till he has informed the Certifying Authority that the private key has been compromised.

- (c) Chapter-II of IT Act, 2000 gives legal recognition to electronic records and digital signatures. It contains only **section 3**.

This Section deals with the conditions subject to which an electronic record may be authenticated by means of affixing digital signature which is created in two definite steps. First the electronic record is converted into a message digest by using a mathematical function known as “Hash function” which digitally freezes the electronic record thus ensuring the integrity of the content of the intended communication contained in the electronic record. Any tampering with the contents of the electronic record will

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immediately invalidate the digital signature. Secondly, the identity of the person affixing the digital signature is authenticated through the use of a private key which attaches itself to the message digest and which can be verified by any body who has the public key corresponding to such private key. This will enable anybody to verify whether the electronic record is retained intact or has been tampered with since it was so fixed with the digital signature. It will also enable a person who has a public key to identify the originator of the message.

For the purposes of this sub-section, “hash function” means an algorithm mapping or translation of one sequence of bits into another, generally smaller set known as “hash result” such that an electronic record yields the same hash result every time the algorithm is executed with the same electronic record as its input making it computationally infeasible-

- to derive or reconstruct the original electronic record from the hash result produced by the algorithm;
- that two electronic records can produce the same hash result using the algorithm.

Question 7.

Write short notes on the following:

(4x5=20 Marks)

- (a) *System Manual*
- (b) *Control Objectives for Information related Technology (COBIT)*
- (c) *Firewalls*
- (d) *White Box Testing.*

Answer

- (a) **System Manual:** The basic output of the system design is a description of the task to be performed, complete with layouts and flowcharts. This is called the job specifications manual or system manual. It contains:
- (i) General description of the existing system.
 - (ii) Flow of the existing system.
 - (iii) Outputs of the existing system - the documents produced by existing system are listed and briefly described, including distribution of copies.
 - (iv) General description of the new system - its purposes and functions and major differences from the existing system are stated together with a brief justification for the change.
 - (v) Flow of the new system - this shows the flow of the system from and to the computer operation and the flow within the computer department.
 - (vi) Output Layouts.

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- (vii) Output distribution - the distribution of the new output document is indicated and the number of copies, routing and purpose in each department shown. The output distribution is summarized to show what each department will receive as a part of the proposed system.
 - (viii) Input layouts - the inputs to the new system are described and complete layouts of the input documents and input disks or tapes provided.
 - (ix) Input responsibility - the source of each input document is indicated as also the user department responsible for each item on the input documents.
 - (x) Macro-logic- the overall logic of the internal flow will be briefly described by the systems analyst, wherever useful.
 - (xi) Files to be maintained - the specifications will contain a listing of the tape, disk or other permanent record files to be maintained, and the items of information to be included in each file. There must be complete layouts for intermediate or work file; these may be prepared later by the programmer.
 - (xii) List of programs - a list of the programs to be written shall be a part of the systems specifications.
 - (xiii) Timing estimates - a summary of approximate computer timing is provided by the system analyst.
 - (xiv) Controls - this shall include type of controls, and the method in which it will be operated.
 - (xv) Audit trail - a separate section of the systems specifications shows the audit trail for all financial information. It indicates the methods with which errors and defalcation will be prevented or eliminated.
 - (xvi) Glossary of terms used.
- (b) **Control Objectives for Information Related Technology (COBIT):** The Information Systems Audit and Control Foundation (ISACF) developed the Control Objectives for Information and Related Technology (COBIT). COBIT is a trademark of generally applicable information systems security and control practices for IT controls. The framework allows:
- (i) management to benchmark the security and control, practices of IT environments;
 - (ii) users of IT services to be assured that adequate security and control exist, and
 - (iii) auditors to substantiate their opinions on internal control and to advice on IT security and control matters.

The framework addresses the issue of control from three vantage points, or dimensions:

- (1) Business Objectives. To satisfy business objectives, information must conform to certain criteria the COBIT refers to as business requirements for information. The criteria are divided into seven distinct yet overlapping categories that map into the COSO objectives: effectiveness (relevant, pertinent, and timely), efficiency,

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confidentiality, integrity, availability, compliance with legal requirements and reliability.

- (2) IT resources, which include people, application systems, technology, facilities, and data.
- (3) IT processes, which are broken into four domains: planning and organization, acquisition and implementation, delivery and support, and monitoring.

COBIT, which consolidates standards from 36 different sources into a single framework, is having a big impact on the information systems profession. It is helping managers to learn how to balance risk and control investment in an information system environment. It provides users with greater assurance that the security and IT controls provided by internal and third parties are adequate. It guides auditors as they substantiate their opinions and as they provide advice to management on internal controls.

- (c) **Firewall:** A firewall is a collection of components (computers, routers, and software) that mediate access between different security domains. All traffic between the security domains must pass through the firewall, regardless of the direction of the flow. Since the firewall serves as an access control point for traffic between security domains, they are ideally situated to inspect and block traffic and coordinate activities with network intrusion detection system (IDSs).

There are four primary firewall types from which to choose: packet filtering, stateful inspection, proxy servers, and application-level firewalls. Any product may have characteristics of one or more firewall types. The selection of firewall type is dependent on many characteristics of the security zone, such as the amount of traffic, the sensitivity of the systems and data, and applications. Additionally, consideration should be given to the ease of firewall administration, degree of firewall monitoring support through automated logging and log analysis, and the capability to provide alerts for abnormal activity.

Typically, firewalls block or allow traffic based on rules configured by the administrator. Rule sets can be static or dynamic. A static rule set is an unchanging statement to be applied to packet header, such as blocking all incoming traffic with certain source addresses. A dynamic rule set often is the result of coordinating a firewall and an IDS. For example, an IDS that alerts on malicious activity may send a message to the firewall to block the incoming IP address. The firewall, after ensuring that the IP is not on a "white list", creates a rule to block the IP. After a specified period of time the rule expires and traffic is once again allowed from that IP.

Firewalls are subject to failure. When firewalls fail, they typically should fail closed, blocking all traffic, rather than failing open and allowing all traffic to pass. Firewalls provide some additional services such as network address translation, dynamic host configuration protocols and virtual private network gateways.

- (d) **White Box Testing**

White box testing is a test case design method that uses the control structure of the procedural design to derive test cases. Test cases can be derived that

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- guarantee that all independent paths within a module have been exercised at least once,
- exercise all logical decisions on their true and false sides,
- execute all loops at their boundaries and within their operational bounds, and
- exercise internal data structures to ensure their validity.

The Nature of Software Defects

Logic errors and incorrect assumptions are inversely proportional to the probability that a program path will be executed. General processing tends to be well understood while special case processing tends to be prone to errors.

We often believe that a logical path is not likely to be executed when it may be executed on a regular basis. Our unconscious assumptions about control flow and data lead to design errors that can only be detected by path testing. Typographical errors are random.

Basis Path Testing

This method enables the designer to derive a logical complexity measure of a procedural design and use it as a guide for defining a basis set of execution paths. Test cases that exercise the basis set are guaranteed to execute every statement in the program at least once during testing.

Flow Graphs

Flow graphs can be used to represent control flow in a program and can help in the derivation of the basis set. Each flow graph node represents one or more procedural statements. The edges between nodes represent flow of control. An edge must terminate at a node, even if the node does not represent any useful procedural statements. A region in a flow graph is an area bounded by edges and nodes. Each node that contains a condition is called a predicate node.

Loop Testing

This white box technique focuses exclusively on the validity of loop constructs. Four different classes of loops can be defined:

- Simple loops
- Nested loops
- Concatenated loops
- Unstructured loops

Other white box testing techniques include:

1. Condition testing which exercises the logical conditions in a program.
2. Data flow testing which selects test paths according to the locations of definitions and uses of variables in the program.

The Suggested Answers for Paper 7: - Direct Tax Laws are based on the provisions applicable for A.Y. 2009-10, which is the assessment year relevant for June, 2009 examination.

PAPER – 7 : DIRECT TAX LAWS

*Answer **all** questions*

Question 1

(a) The Net Profit of "Simran Ltd." for the year ended 31.3.2009 is Rs.50 lacs after debit of the following:

- (i) Amount of Rs.1,50,000 contributed to Employees Welfare Trust.*
- (ii) Amount of Rs.15,00,000 paid towards college fee and hostel expense for the MBA course of a close relative of a director.*
- (iii) Amount of Rs.3,00,000 incurred on installation of a traffic signal, so as to facilitate its employees coming to office to overcome traffic jam and save office time.*
- (iv) Amount of Rs.5,00,000 on the gift articles distributed to various dealers under sales incentive scheme.*
- (v) Expenses of Rs.5,00,000 incurred on the travelling of the wife of Managing Director, who accompanied him on a tour to U.K. on the invitation of Trade and Commerce Chamber, London.*
- (vi) Amount of Rs.3,00,000 paid on 11.5.08 consequent upon change in currency rate due to exchange fluctuation in excess of the amount due to the suppliers of machinery.*

Following further information are also provided by the company:

- (a) Both the employees and employers contribution towards PF amounting to Rs.2 lacs each for the month of March, 2009 were deposited on 1.7.2009.*
- (b) Provision for audit fees of Rs.5 lacs made in the books for the year ended 31.03.2008 was paid to the auditors in September, 2008 after deducting tax under section 194J and the tax so deducted was remitted by 7.10.2008.*
- (c) A contractor who carried out repairing work in the office was paid in cash on 25.9.2008 by two vouchers No. 175 of Rs.17,000 and No.180 of Rs. 8,000.*
- (d) TDS, out of payment of interest of Rs.1 lac in February, 2009 and of Rs.2 lacs in March, 2009, was remitted to the Government in July, 2009.*

Compute the income chargeable to tax in A.Y. 2009-10 and work out the amount of tax payable on such income. (13 Marks)

(b) The net profit as per the profit and loss account of XYZ Ltd., a resident company, for the year ended 31.3.2009 is Rs.190 lacs arrived at after making the following adjustments:

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(i)	Depreciation on assets	Rs. 100 lacs
(ii)	Reserve for currency exchange fluctuation	Rs. 50 lacs
(iii)	Provision for tax	Rs. 40 lacs
(iv)	Proposed dividend	Rs.120 lacs

Following further information are also provided by company:

- (a) Net profit includes Rs.10 lacs received from a subsidiary company.
- (b) Provision for tax includes Rs.16 lacs of tax payable on distribution of profit and of Rs.2 lacs of interest payable on income-tax.
- (c) Depreciation includes Rs.40 lacs towards revaluation of assets.
- (d) Amount of Rs.50 lacs credited to P & L account was drawn from revaluation reserve.
- (e) Balance of profit and loss account shown in balance sheet at the asset side as at 31.3.2008 was Rs.30 lacs representing unabsorbed depreciation.

Compute the income of the company for the year ended 31.3.2009 liable to tax under MAT. (7 Marks)

Answer

(a) Computation of total income of Simran Ltd. for the A.Y.2009-10

Particulars	Amount (Rs.)
Profits and gains of business or profession	
Net profit for the year as per P&L Account	50,00,000
Add: Expenses debited to Profit and Loss Account but not allowable	
(i) Contribution to Employees Welfare Trust can be regarded as labour welfare expenditure and hence, is allowable as deduction under section 37 as the payments were made on the ground of assessee's business exigencies [<i>CIT v. Cheran Transport Corp. Ltd. (1999) 238 ITR 892 (Mad.)</i>]	--
(ii) Expenses on the education of a relative of Director, who is not in employment of Simran Ltd., is not deductible under section 37 [<i>Enkay (India) Rubber Co. Pvt. Ltd v. CIT (2003) 263 ITR 521 (Del)</i>]. Hence, it should be added back to compute business income.	15,00,000
(iii) Expenses on installation of traffic signal, to facilitate its employees to overcome traffic jam and be on time, is an allowable expense under section 37(1) [<i>Infosys Technologies Ltd. v. CIT (2007) 109 TTJ 631 (Bangalore)</i>]	--

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(iv)	Expenses on distribution of gift articles to dealers under sales incentive scheme would promote goodwill and is made in the interest of business. Such gifts are prompted by commercial expediency and hence, the expenditure is allowable under section 37(1) [<i>CIT v. Avery Cycle Industries Ltd. (2006) 157 Taxman 381/ 298 ITR 0239 / 296 ITR 0393 (Punjab & Haryana)</i>]	--
(v)	Expenses on travelling to UK of the wife of Managing Director on the invitation of Trade and Commerce Chamber, London, is an allowable expense for the purposes of business [<i>Hero Honda Motors Ltd. v. CIT (2005) 3 SOT 572 (Delhi)</i>]	--
(vi)	Increase in liability due to change in currency rate and paid to the suppliers of machine is to be added to cost of the asset irrespective of the method of accounting as per section 43A. Hence, it should be added back to compute business income.	3,00,000
		68,00,000

Less: Expenditure allowable as deduction but not debited to profit and loss account (See Note below)

(a)	Employers contribution towards PF paid before due date for filing of return is allowable as per section 43B	2,00,000
	Employees contribution to PF is not remitted before the due date under the PF Act (i.e. by 31.5.2009). Therefore, it is not allowable as deduction under section 36(1)(va).	-
(b)	Provision for audit fees for the year ended 31-3-2008 for which tax was not deducted in the F.Y. 2007-08 but was deducted and paid in F.Y. 2008-09 is allowable in the year of payment as per the proviso to section 40(a)(ia).	5,00,000
(c)	Payment to a contractor for repairing work in a day by two vouchers in cash, the aggregate exceeding the limit of Rs.20,000 is not an allowable expense as per section 40A(3).	-
(d)	TDS on interest for the month of Feb 2009 is not paid before the end of the financial year. Accordingly, such interest is not allowable in the A.Y.2009-10 as per section 40(a)(ia).	-
	Interest for the month of March, 2009, on which TDS was remitted to the Government before the due date of filing of return, is allowable as per section 40(a)(ia).	2,00,000

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(e) Depreciation on the amount of Rs.3 lacs added in cost of machine @ 15% for the year	<u>45,000</u>	<u>9,45,000</u>
Total income		<u>58,55,000</u>

Computation of tax liability for A.Y.2009-10	Rs.	Rs.
Tax on Rs.58,55,000 @ 30%		17,56,500
Add: Education cess @ 2%	35,130	
Secondary and higher education cess @ 1%	<u>17,565</u>	
		<u>52,695</u>
Total Tax Payable		<u>18,09,195</u>

Note – The first sentence of the question states that the net profit of the company has been arrived at after debit of the following expenditure, which implies that the items of expenditure in serial nos. (i) to (vi) (given below the first sentence) have been debited to profit and loss account. Thereafter, the question states that following further information are also provided by the company, after which items in serial nos. (a) to (d) are given. From a plain reading of the question, it is apparent that items of expenditure in serial nos. (a) to (d) have not been debited to profit and loss account. Therefore, the deductibility or otherwise of these items of expenditure have to be considered while computing the business income and dealt with accordingly. Accordingly, the items of expenditure in (a) to (d), which are allowable as per the provisions of the Act, have to be deducted while computing business income and no adjustment is required of items of expenditure disallowed since they have not been debited to profit and loss account.

(b) Computation of income of XYZ Ltd. liable to tax under MAT for the year ended 31.3.2009

Particulars	Rs.	Rs.
Net Profit as per Profit & Loss Account		1,90,00,000
Add : Net profit to be increased by the following amounts as per Explanation 1 to section 115JB		
Depreciation	1,00,00,000	
Reserve for currency exchange fluctuation, since the amount carried to any reserve, by whatever name called, has to be added back	50,00,000	
Provision for tax (See Note 1 below)	40,00,000	
Proposed dividend	<u>1,20,00,000</u>	<u>3,10,00,000</u>
		5,00,00,000

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Less : Net profit to be decreased by the following amounts as per Explanation 1 to section 115JB

Depreciation other than depreciation on revaluation of assets (Rs.100 lacs - Rs.40 lacs)	60,00,000	
Withdrawal from revaluation reserve restricted to the extent of depreciation on account of revaluation of assets (Rs.50 lacs or Rs.40 lacs, whichever is less)	40,00,000	
Unabsorbed depreciation or brought forward business loss, whichever is less, as per the books of account (Rs.30 lacs or Nil)	NIL	
Dividend income [since the same is exempt under section 10(34)] (See Note 2 below)	10,00,000	1,10,00,000
Income liable to tax under MAT		3,90,00,000

Note – 1. For the purpose of section 115JB, book profit means the net profit as per the profit and loss account prepared in accordance with Parts II and III of Schedule VI to the Companies Act, as adjusted by certain additions/deductions as specified. One of the adjustments is to add back income-tax paid or payable, and the provision therefor. The Finance Act, 2008 has inserted *Explanation 2* after sub-section (2) of section 115JB to clarify that income-tax includes, inter alia, dividend distribution tax / tax on distributed income and interest. Therefore, the entire provision of Rs.40 lacs for income-tax has to be added back for computing book profit for levy of MAT.

2. It is presumed that the amount of Rs.10 lacs received from subsidiary company represents dividend income.

Question 2

- (a) Explain in the context of provisions of the Act, whether the income derived during the year ended on 31.03.2009 in each of the following cases shall be subject to tax in the A.Y. 2009-10 :
- (i) Income of Rs.75,000 derived by Anand Nursery from the sale of seedlings grown without carrying out all the basic operations on land.
 - (ii) Mr. Gaitonde, born and brought up in the State of Sikkim, had a net profit of Rs.2,25,000 from the business located in Sikkim and interest of Rs.55,000 on the securities/ bonds issued by the Government of Rajasthan.
 - (iii) Mr. Ravi, an IAS Officer, was posted to USA by the Government of India on 11.07.08 for a period of three years. He was paid salary of Rs.3 lacs for the period 01.04.08 to 10.07.08 and of Rs.12 lacs for the period upto 31.03.09. He left India for USA in the night of 10.07.08 and did not come even for a day up till 31.03.09.
 - (iv) Chitra received gifts of Rs.1,00,000 from her father-in-law and of Rs.11,000 each from her 10 friends at the time of her marriage on 11.03.09.

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- (v) A political party, duly registered under section 29A of the Representation of the People Act, 1951, received rent of Rs.1,25,000 per month of one of its building let out to a bank from 01.06.07. (2 × 5 = 10 Marks)
- (b) Work out, from the following particulars, the amount of capital gain which shall be deemed to have been applied for charitable or religious purpose arising out of sale of a capital asset utilized for the purposes of trust to the extent of 60% :

	Amount (Rs.)
Cost of transferred asset	2,40,000
Sale consideration	3,60,000
Cost of new asset purchased	3,00,000

(4 Marks)

Answer

- (a) (i) Explanation 3, added in section 2(1A) by the Finance Act, 2008 provides that the income derived from saplings or seedlings grown in a nursery shall be deemed to be agricultural income, whether or not the basic operations were carried out on land. Accordingly, the income of Rs.75,000 derived by Anand Nursery from the sale of seedlings grown without carrying out all the basic operations on land shall be treated as agricultural income and exempt from tax under section 10(1).
- (ii) Clause (26AAA), inserted in section 10 by the Finance Act, 2008, exempts the income which accrues or arises to a Sikkimese individual from any source in the State of Sikkim and the income by way of dividend or interest on securities. Therefore, the income of Mr. Gaitonde from a business located in Sikkim and interest income on the securities/bonds of Government of Rajasthan shall not be subject to tax.
- (iii) The salary drawn by an IAS Officer by virtue of his posting in USA, despite the fact that he was a non-resident in the previous year, shall be subject to tax in India as per section 9(1)(iii) which states that income chargeable under the head "Salaries" payable by the Government to a citizen of India for his services outside India shall be deemed to accrue or arise in India. Therefore, the total amount of salary of Rs.15 lakh received by the IAS Officer in and outside India shall be subject to tax in India in the A.Y 2009-10.
- (iv) The cash gifts received by Chitra at the time of her marriage shall not be subject to tax by virtue of clause (b) of the proviso to section 56(2)(vi). Therefore, gifts of Rs.1 lakh received from her father-in-law and Rs.1.10 lakh received @ Rs.11,000 each from her 10 friends shall not be taxable as all such gifts were received by her on the occasion of her marriage.
- (v) Rent received by the political party from the bank is an income chargeable under the head "Income from house property". According to the provisions of section 13A, this income shall not be subject to tax in the hands of a political party registered under section 29A of the Representation of the People Act, 1951, provided the political party fulfills the conditions as specified therein.

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- (b) In this case, since the asset which is transferred is utilized for the purposes of the trust only to the extent of 60%, only the proportionate amount (i.e. 60%) of the capital gain would be regarded as having been applied for charitable or religious purposes.

As per section 11(1A), where a capital asset held under trust is transferred, and only a part of the net consideration is utilized for acquiring a new capital asset, only so much of the capital gain as is equal to the amount, if any, by which the amount so utilized exceeds the cost of the transferred asset shall be considered to have been applied for the objects of the trust.

In this case, only a part of the net consideration of Rs.3,60,000 is utilized for acquiring the new capital asset costing Rs.3,00,000. The amount utilized in acquiring the new asset (i.e. Rs.3,00,000) exceeds the cost of the transferred asset (i.e. Rs.2,40,000) by Rs.60,000.

Therefore, only 60% of (Rs.3,00,000 – Rs.2,40,000) = 60% of Rs.60,000 = Rs.36,000 is deemed to be applied for the objects of the trust.

Question 3

- (a) *Work out the taxable income for A.Y. 2009-10 of a partnership firm engaged in retail trade from the following particulars:*
- (i) *Net profit of Rs.3,65,000 arrived at after debit of interest on capital of partners of Rs.1,80,000 and salaries to working partners of Rs.4,80,000.*
 - (ii) *Total capital of the partners on which interest paid is debited in the profit and loss account was Rs.10,00,000.* (5 Marks)
- (b) *An assessee, on fulfillment of certain conditions, can claim relief in respect of the income arising in those countries with which India does not have any double taxation agreement. Do you agree?* (5 Marks)
- (c) *"The profits and gains of an industrial undertaking established in specified areas and engaged in carrying out certain activities are enjoying tax holiday." Specify such areas and the activities.* (4 Marks)

Answer

- (a) **Computation of taxable income of the partnership firm for A.Y.2009-10**

Particulars	Amount (Rs.)	Amount (Rs.)
Net Profit as per profit and loss account		3,65,000
Add : Interest on Capital		1,80,000
Salaries to Partners		<u>4,80,000</u>
		10,25,000
Less : Interest on capital allowable @ 12% on Rs.10 lakh		<u>1,20,000</u>
Book Profits		9,05,000

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Less: Admissible amount of salary as a percentage of book profits or actual paid, whichever is less

90% of Rs.75,000	67,500	
60% of Rs.75,000	45,000	
40% of balance of Rs.7,55,000	<u>3,02,000</u>	
	<u>4,14,500</u>	<u>4,14,500</u>
Taxable Income		<u>4,90,500</u>

- (b) The assessee shall be allowed relief in respect of such income under section 91 provided all the following conditions are fulfilled :-
- (a) The assessee is a resident in India during the relevant previous year.
 - (b) The income accrues or arises to him outside India during that previous year.
 - (c) Such income is not deemed to accrue or arise in India during the previous year.
 - (d) The income in question has been subjected to income-tax in the foreign country in the hands of the assessee and the assessee has paid tax on such income in the foreign country.
 - (e) There is no agreement under section 90 for the relief or avoidance of double taxation between India and the other country where the income has accrued or arisen.
- (c) This question can be answered on the either on the basis of the provisions of section 10A or section 80-IB or section 80-IC.

Section 10A

This section provides tax holiday in respect of newly established industrial undertakings in free trade zones, electronic hardware technology parks and software technology parks set up in accordance with a scheme notified by the Central Government. The section exempts the profits and gains of such undertakings derived from the export of articles or things or computer software.

The benefit of exemption under this section is available to all categories of assesseees who derive any profits or gains from an undertaking engaged in export of articles or things or computer software. The profits and gains derived from on-site development of computer software (including services for development of software) outside India shall be deemed to be the profits and gains derived from the export of computer software outside India.

Section 80-IB

The tax holiday under section 80-IB is available in respect of the following industrial undertakings –

- (a) Small Scale Industrial undertakings

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- (b) Industrial undertakings set up in an industrially backward State specified in the Eighth Schedule. Industrial undertakings in the State of Jammu & Kashmir should not manufacture or produce cigarettes/cigar, distilled and brewed alcoholic drinks, aerated branded beverages and their concentrates.
- (c) Industrial undertakings, set up in notified backward districts, producing articles other than those given in the Eleventh Schedule.

Section 80-IC

The tax holiday under section 80-IC is available in respect of the industrial undertakings set up in Sikkim, Himachal Pradesh, Uttaranchal and North-Eastern States. If the undertaking is set up in the specified zone in the States of Sikkim, Himachal Pradesh and Uttaranchal, it should manufacture any article or thing other than those given in the Thirteenth Schedule. If the undertaking is set up in any other area in these States, it should manufacture any article given in the Fourteenth Schedule. Specified zones include export processing zone, integrated infrastructure development centre, industrial growth centre, industrial estate, industrial park, software technology park, industrial area or theme park.

Question 4

- (a) *Meghna Film Distributors have acquired the rights of exhibition of a feature film 'Nasha' in the territory of Rajasthan from the producers under an agreement executed on 11.06.08 against a consideration of Rs.300 lacs. It thereafter executed a sub-agreement with a distributor to whom the rights of exhibition of the film in some of the areas of Rajasthan were assigned against an amount of Rs.100 lacs. The film was released for exhibition on commercial basis on 25.12.08. Collection from the exhibition of film of "Meghna Film Distributors" for 25.12.2008 to 10.01.2009 was Rs.50 lacs and thereafter up to 31.03.2009 was Rs.190 lacs.*

It asks you to clarify as to how these transactions will be reflected in the Income-tax return for A.Y. 2009-10. Would your answer be different if the film was released for exhibition on 11.01.2009?

(6 Marks)

- (b) *State the circumstances, when notional income is charged to tax instead of real income under the head "Income from house property".*
- (c) *What meaning has been assigned to "Speculative transaction"? Narrate those transactions which shall not be treated as speculative transactions under the Income-tax Act, 1961.*

(3 Marks)

(5 Marks)

Answer

- (a) Meghna Film Distributors is engaged in the business of exhibition of feature films after taking the rights from the producers. The profits and gains of such business are to be computed as per the provisions given in Rule 9B of the Income-tax Rules.

Accordingly, the profits shall be worked out after deducting the amount paid towards cost of acquisition of film by the film distributor to the producer from the amount recovered by giving the rights of exhibition of film to sub-distributors and the receipts from exhibition of

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the feature films on commercial basis by the distributor himself where the film was released for exhibition on commercial basis before 90 days from the end of the financial year. If the film is not so released at least 90 days before the end of such previous year, the cost of acquisition shall be allowed to the extent of the amount realized by the film distributor and the balance shall be carried forwarded to the next following previous year and allowed as deduction in that year.

In the present problem, the agreement was executed on 11.06.2008 and the film also stands released for exhibition on commercial basis before 90 days from the end of the financial year i.e., on 25.12.08. Accordingly, the profit of the assessee will be computed as under: -

Particulars	Rs.
Collection from exhibition of film (Rs.50 lacs + Rs.190 lacs)	240 lacs
Collection from sub-distributor	<u>100 lacs</u>
	340 lacs
Less : Cost of acquisition	
Amount paid to producer for exhibition rights of the film	<u>300 lacs</u>
Net income of film "Nasha"	<u>40 lacs</u>

Release of film for exhibition on commercial basis in the second case on 11.1.09 i.e., less than 90 days before the end of the previous year. In this case, the profits of the assessee will be as under :-

Particulars	Rs.
Collection from exhibition of film	190 lacs
Collection from sub-distributor	<u>100 lacs</u>
	290 lacs
Less : Cost of acquisition	
Amount paid to producer for exhibition rights of the film (Rs.300 lakh, but restricted to Rs.290 lakh)	<u>290 lacs</u>
Net income of film "Nasha"	<u>Nil</u>

The balance of Rs.10 lakh (i.e. Rs.300 lakh – Rs.290 lakh) has to be carried forward to the next following previous year and allowed as a deduction in that year i.e., P.Y.2009-10.

- (b) The circumstances when notional income is charged to tax instead of real income under the head "Income from house property" are as under -
- (i) Where the assessee owns more than one house property for the purpose of self-occupation, the annual value of any one of those properties, at the option of the assessee, will be Nil and the other properties are deemed to be let-out properties for which income has to be computed on notional basis by taking the Annual Letting Value (ALV) as the Gross Annual Value (GAV).

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- (ii) In the case of let-out property, where the ALV exceeds the actual rent, the ALV is taken as the GAV.

Note – Annual Letting Value is the higher of municipal valuation and fair rent, but restricted to standard rent.

- (c) According to section 43(5), the expression "speculative transaction" means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips.

The following transactions shall not be deemed to be speculative transactions:

- (i) a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchanting business to guard against loss through future price fluctuations in respect of his contracts for the actual delivery of goods manufactured by him or merchandise sold by him; or
- (ii) a contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holdings of stocks and shares through price fluctuations; or
- (iii) a contract entered into by a member of a forward market or a stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss which may arise in the ordinary course of his business as such member; or
- (iv) an eligible transaction in respect of trading in derivatives carried out in a recognized stock exchange.

Question 5

Examine critically in the context of provisions contained in Income-tax Act, 1961 as to the correctness of the action or the treatment given in each of the following cases:

- (a) *An amount of Rs.12,50,000 paid by XYZ Ltd., after approval by the board, to a hospital in UK for the heart surgery of its managing director was charged under medical expenses. The Assessing Officer, while completing the assessment of the company, taxed the amount so paid by the company as a perquisite in the hands of its Managing Director. (3 Marks)*
- (b) *Singhal Sons Mines, for acquiring rights for extracting minerals, had taken a mine on lease basis w.e.f. 01.09.08 for a period of 15 years from Mr. Naresh against an amount of Rs.30 lacs payable in three equal instalments on 31.08.08, 31.08.09 and 31.08.10. Amount of Rs.10 lacs paid on 31.08.08 was charged as an expense in the mining account. (4 Marks)*
- (c) *XYZ is engaged in the business of sale of Zinc Concentrate in India and in U.K. markets. The company valued its closing stock on 31.03.09 on the basis of the price prevailing in London Metallic Exchange instead of price in the domestic market, as the price in London Metallic Exchange was lesser than the Indian rate. (4 Marks)*
- (d) *M/s Soft Drinks Limited entered into an agreement for the warehousing of its products with XYZ Warehousing and deducted tax at source as per provisions of section 194C out*

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of warehousing charges paid during the year ended on 31.03.2008. The Assessing Officer, while completing the assessment for A.Y. 2008-09 of Soft Drinks Limited, treated the warehousing charges as rent as defined in section 194-I and asked the company to make payment of difference amount of TDS with interest. It was submitted by the company that the recipient had already paid tax on the entire amount of warehousing charges and therefore, now the difference amount of TDS cannot be recovered. However, it will make the payment of due interest on the difference amount of TDS.

(3 Marks)

Answer

- (a) A Managing Director generally occupies the dual capacity of being a director as well as an employee of the company. In this case, assuming that the Managing Director is also an employee of XYZ Ltd., clause (vi) of the proviso to section 17(2) would get attracted. Clause (vi) of the proviso to section 17(2) provides that any expenditure incurred by the employer on medical treatment of the employee outside India shall be excluded from perquisite only to the extent permitted by RBI. Therefore, the expenditure on medical treatment of the Managing Director outside India shall be excluded from perquisite to the extent permitted by RBI as per clause (vi) of the proviso to section 17(2). If it is assumed that the entire amount is permitted by RBI, there would be no perquisite chargeable in the hands of the Managing Director. Therefore, in such a case, the action of the Assessing Officer in taxing the entire amount paid by the company as a perquisite in the hands of the Managing Director is incorrect.

This question can also be answered by applying the ratio of the Allahabad High Court ruling in *CIT v. D.P. Kanodia (2008) 296 ITR 0616*. In that case, the High Court observed that the reimbursement by the company of medical expenditure incurred outside India by the director cannot be considered as an amenity or benefit provided by the company to its director, and therefore the provisions of section 17(2)(iii)(a) would not be attracted. Therefore, such reimbursement was not a perquisite within the meaning of section 17(2)(iii)(a).

Hence, applying the ratio of the above case to the facts of this case, the action of the Assessing Officer in taxing the amount paid by the company as a perquisite in the hands of the Managing Director is incorrect.

- (b) The assessee had acquired the mining rights after entering into the lease agreement against the payment of lease money in 3 installments. The assessee firm had charged the payment of Rs.10 lacs made on 31.8.2008 in the previous year as revenue expenditure. The Apex Court, in the case of *Enterprising Enterprises v. DCIT (2007) 293 ITR 437*, on identical facts, had held that the payment of royalty or rent for the mining lease falls under revenue expenditure where it is paid on a year to year basis, but where the lease money is paid either one time or in installments then the same would be a capital expenditure. Accordingly, the amount of Rs.10 lacs charged by the assessee in the mining account will not be allowed as revenue expenditure but shall be treated as capital expenditure.

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- (c) The Supreme Court, in the case of *Hindustan Zinc Limited v. CIT* (2007) 295 ITR 453, observed that it was generally accepted as a rule of commercial practice and accountancy that the closing stock has to be valued on the basis of cost or market price, whichever is lower, and there should be no writing down in the value of goods except when there was an actual or anticipated loss. In that case, the assessee was engaged only in domestic business activities and no export had taken place during the relevant previous year. Accordingly, the Supreme Court held that writing down the value of Zinc Concentrate by adopting the price of London Metallic Exchange as its net realizable value is incorrect as the same does not correspond with the term “actual or anticipated loss” in any manner, because prices in the domestic market were higher.

Therefore, in the case on hand, the action of the assessee to value the closing stock on the basis of the prices prevailing in the London Metallic Exchange is not correct, assuming that in this case also, the assessee was engaged only in domestic business activities and no export had taken place during the relevant previous year. Hence, the assessee is required to adopt the net realizable value of the goods held in the closing stock, being the market price prevailing in the domestic market, when the same is less than the cost price, for valuation of its closing stock.

- (d) The facts given in the case are identical to the facts, which were before the Apex Court in the case of *Hindustan Coca Cola Beverage P. Ltd v. CIT* (2007) 293 ITR 226. The Court held that though the assessee was as an assessee-in-default, the difference of tax deducted cannot be recovered from him since the same had already been paid by the recipient of income. Therefore, the Supreme Court had, in view of the Circular No. 275/201/95-IT(B) dated 29.1.97 and considering the payment of interest under section 201(1A) by the assessee, held that the tax cannot once again be recovered from the assessee. Therefore, the action of Assessing Officer to recover the amount of difference along with interest from M/s Soft Drinks Ltd., when the tax has been paid by the recipient and the assessee is making the payment of interest, is incorrect in view of the decision of the Apex Court.

Question 6

- (a) *The net result of the business carried on by a branch of foreign company in India for the year ended 31.03.2009 was a loss of Rs.100 lacs after charge of head office expenses of Rs.200 lacs allocated to the branch. Explain with reasons the income to be declared by the branch in its return for the assessment year 2009-10.* (4 Marks)
- (b) *Axel Ltd. has two industrial undertakings. Unit-I is engaged in the production of television sets and Unit-II is engaged in the production of refrigerators. The company has, as part of its restructuring program, decided to sell Unit-II as a going concern by way of slump sale for Rs.260 lacs to a new company called Gamma Ltd., in which it holds 85% equity shares. The following is the extract of the balance sheet of Axel Ltd. as on 31st March, 2009:*

	Rs. in lacs	
	Unit – I	Unit – II
Fixed Assets	112	158

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Debtors	88	67
Inventories	60	23
Liabilities	33	45

Paid-up share capital	Rs.231 lacs
General Reserve	Rs.160 lacs
Share Premium	Rs.39 lacs
Revaluation Reserve	Rs.105 lacs

The company set up Unit-II on 1st April, 2005. The written down value of the block of assets for tax purpose as on 31st March, 2009 is Rs.150 lacs of which Rs.60 lacs are attributable to Unit-II.

- (i) Determine what would be the tax liability of Axel Ltd. on account of Slump sale;
- (ii) How can the restructuring plan of Axel Ltd. be modified, without changing the amount of consideration, in order to make it more tax efficient? (7 Marks)
- (c) Can an assessee, fulfilling all the prescribed conditions, having total income of Rs.1,84,000 and paying house-rent @ Rs.4,800 p.m. in respect of the residential accommodation occupied by him at Mumbai, claim the deduction for the house rent so paid while computing his taxable income? (3 Marks)

Answer

- (a) Section 44C restricts the allowability of the head office expenses to the extent of lower of an amount equal to 5% of the adjusted total income or the amount actually incurred as is attributable to the business of the assessee in India.

For the purpose of computing the adjusted total income, the head office expenses of Rs.200 lakh charged to the profit and loss account have to be added back.

The amount of income to be declared by the assessee for A.Y. 2009-10 will be as under:

Particulars	Rs.
Net loss for the year ended on 31.03.2009	(100 lacs)
Add: Amount of head office expenses to be considered separately as per section 44C	<u>200 lacs</u>
Adjusted total income	100 lacs
Less: Head Office expenses allowable under section 44C is the lower of	
(i) Rs.5 lacs, being 5% of Rs.100 lacs and	
(ii) Rs.200 lacs.	<u>5 lacs</u>
Income to be declared in return	<u>95 lacs</u>

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- (b) (i) As per section 50B, any profits or gains arising from the slump sale effected in the previous year shall be chargeable to income-tax as capital gains arising from the transfer of capital assets and shall be deemed to be the income of the previous year in which the transfer took place.

If the assessee owned and held the undertaking transferred under slump sale for more than 36 months before slump sale, the capital gain shall be deemed to be long-term capital gain. Indexation benefit is not available in case of slump sale as per section 50B(2).

Calculation of capital gains

Particulars	Rs.
Slump sale consideration	2,60,00,000
Less :Cost of acquisition (net worth) [see working note below]	<u>1,05,00,000</u>
Long-term capital gain	<u>1,55,00,000</u>

Calculation of tax liability

Income tax @ 20%	31,00,000
Surcharge @ 10%	<u>3,10,000</u>
	34,10,000
Education Cess @ 2% and Secondary and higher education cess@1%	<u>1,02,300</u>
Total tax liability	<u>35,12,300</u>

Working Note:

Net worth of Unit II

Particulars	Rs.
WDV of block of assets	60,00,000
Debtors	67,00,000
Inventories	<u>23,00,000</u>
	1,50,00,000
Less : Liabilities	<u>45,00,000</u>
Net worth	<u>1,05,00,000</u>

- (ii) Transfer of any capital asset by a holding company to its 100% Indian subsidiary company is exempted from tax under section 47(iv). Therefore, if it is possible for Axel Ltd. to acquire the entire shareholding of Gamma Ltd. and thereafter make a slump sale, then the resultant capital gain shall not attract tax liability. However, in such case also, Axel Ltd. should not transfer any shares in Gamma Ltd. for 8 years from the date of slump sale.

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- (c) An individual, who is not in receipt of house rent allowance and complying with all the conditions as specified in section 80GG, shall be entitled to claim deduction (in respect of rent paid by him for the residential accommodation) of an amount, equal to the least of the following limits, under section 80GG -

	Rs.	Rs.
(i) Actual rent less 10% of total income i.e., Rs.57,600 minus Rs.18,400, being 10% of Rs.1,84,000	39,200	
(ii) 25% of total income i.e., 25% of Rs.1,84,000	46,000	
(iii) Amount calculated at Rs.2,000 p.m.	24,000	
Deduction allowable (least of the above)		24,000

Note - It is assumed that Rs.1,84,000 is the total income before providing deduction under section 80GG.

Question 7

- (a) Mr. Neeraj provides the following particulars and asks you to work out the amount of net wealth to be declared by him in the wealth tax return for Assessment year 2009-10 :
- (i) Value of a Motor Car Rs.5,00,000
 - (ii) Value of a Motor Cycle Rs.50,000
 - (iii) A house of which ground floor is used by him for business purposes and first floor for self residence having value of Rs.50,00,000 on 31.3.09.
 - (iv) Jewellery worth Rs.12 lacs purchased on 30.3.09 by his wife out of funds given by him of Rs.5 lacs and by his son of Rs.5 lacs.
 - (v) Shares of various companies worth Rs.2,00,000 purchased by him in the name of his daughter-in-law. (4 Marks)
- (b) An assessee, being aggrieved by the order of Wealth-tax Officer, filed an appeal by taking for the first time a ground "that notice to complete the assessment was not served upon him but he had co-operated in completion of proceedings". Are you in agreement with the view taken by the assessee? (3 Marks)
- (c) Ram gifted a house property valued at Rs.100 lacs to his wife on 1.4.2009 in an agreement to live apart. In whose hands the said property will be assessed to wealth-tax in the A.Y. 2009-10? (3 Marks)

Answer

- (a) **Computation of Net Wealth of Neeraj on valuation date 31.3.2009**

Particulars	Amount (Rs.)
(i) Motor car is an asset as per section 2(ea)	5,00,000
(ii) Motor cycle is not an asset as per section 2(ea)	--

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(iii)	Exemption under section 5(vi) shall be allowed in respect of one house, irrespective of its use, that is to say, the building may be used either for self-residence or for business purposes or for both.	--
(iv)	Jewellery purchased by his wife out of funds given by him is a deemed asset to the extent of funds given by him. It is presumed that the value of jewellery given in the question also represents the fair market value as on the valuation date, determined as per Rule 18 of Schedule III.	5,00,000
(v)	Shares purchased by him in the name of his daughter-in-law is not a deemed asset because shares are not an asset under the Wealth-tax Act.	--
Net wealth		10,00,000

- (b) Section 42 provides that the assessee would be precluded from raising any objection in any proceeding or inquiry that the notice was not served upon him or was not served in time or was served in an improper manner, if he had appeared in any proceedings or co-operated in any inquiry relating to assessment or re-assessment. Therefore, if the assessee had appeared in any proceedings or co-operated in any enquiry, it shall be deemed that any notice required to be served on him has been duly served upon him in time in accordance with the provisions of the Act.

Such deeming provision would, however, not apply where the assessee has raised an objection (regarding non-service of notice or non-service of notice in time or improper service of notice) before the completion of such assessment or reassessment.

In this case, the assessee objected to the non-service of notice for the first time at the appellate level i.e., after completion of the wealth-tax assessment. Therefore, the claim of the assessee is not tenable.

- (c) The property, gifted by Ram to his wife in an agreement to live apart, is not an asset to be included as a deemed asset in his wealth and accordingly, should be taxed in the hands of his wife. However, the transfer had taken place by way of gift on 1.4.2009 and accordingly, on the valuation date 31.3.2009, the house property was owned by Ram and therefore, the same would be assessed to wealth-tax in the hands of Ram for A.Y.2009-10. Thereafter, the property would be assessable in the hands of his wife.

The suggested answers for Indirect Tax Laws (Paper 8) are based on the provisions as amended by the Finance Act, 2008 and Notifications/Circulars issued up to 31.10.2008 which are relevant for June 2009 examinations.

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Answer **all** questions.

SECTION-A

Question 1

- (a) Determine the total amount of excise duty payable on a machine using the details given below:

	Rs.
(i) Sale price of the machine excluding taxes and duties	2,00,000
(ii) Sales tax	20,000
(iii) Cost of durable and returnable packing included in the sale price given at (i) above	5,000
(iv) Design and development charges paid by buyer on behalf of seller to a third party	20,000
(v) Warranty charges charged separately by the seller	5,000
Rate of excise duty	16%
Education cess	3%

Calculations should be supported by notes, wherever required. (5 Marks)

- (b) X, a manufacturer purchased 500 kgs of inputs on 1.10.2007. Total assessable value of inputs was Rs. 10,000 and excise duty of 16% and 2% of excise duty as education cess was paid on the input. On the day of receipt itself, inputs were sent to the job worker. Job worker sent back 50% of the inputs on 1.4.2008 and balance 50% on 31.5.2008. X received back the processed the inputs on the same day. Calculate the CENVAT credit required to be reversed or that can be availed on relevant dates and net availment and reversal in the financial years 2007-08 and 2008-09. (5 Marks)
- (c) Y & Co. is a small scale unit located in a rural area and is availing the benefit of small scale exemption under Notification No. 8/2003-C.E. during the year 2007- 08. Determine the value of the first clearances of the unit and duty liability on the basis of data given below:-

	Rs.
(1) Total value of clearances of goods with own brand name	75,00,000
(2) Total value of clearances of goods with brand name of other parties	90,00,000
(3) Clearances of goods which are totally exempt under another notification (other than an exemption based on quantity or value of clearances)	35,00,000

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Normal rate of Excise duty - 16%

Education cess @ 3% of Excise duty.

Calculations should be supported with appropriate notes.

It may be assumed that the unit is eligible for exemption under Notification No. 8/2003.

(5 Marks)

Answer

(a) Computation of total amount of excise duty payable:-

<i>Particulars</i>	<i>Rs.</i>
Sale price of the machine excluding taxes and duties	2,00,000
Add : Design and development charges (Note-3)	20,000
Add: Warranty charges (Note-4)	5,000
Less : Cost of durable and returnable packing (Note-2)	<u>5,000</u>
Assessable value	<u>2,20,000</u>
Excise duty @ 16%	35,200
Education cess @ 3%	<u>1,056</u>
Total excise duty payable (Rs. 35,200 + Rs. 1,056)	<u>36,256</u>

Notes:

1. Sales tax is not included since the definition of transaction value as per section 4 specifically excludes sales tax paid or payable on the goods.
 2. Cost of durable and returnable packing shall not form a part of transaction value.
 3. Design and development charges are essential for the purpose of manufacture and to make the product marketable. Hence, they have to be included in the assessable value, since payment is 'in connection with sale'.
 4. If the warranty charges are charged separately and are not considered as "price" of the goods by the assessee, then warranty charges will be includible in the transaction value forming basis of the valuation [Circular No. 354/81/2000-TRU dated 30.06.2000].
- (b) As per rule 4(5) of CENVAT Credit Rules, 2004, a manufacturer or output service provider is entitled to claim CENVAT credit on the inputs that are cleared to a job worker for further processing, testing, repair, re-conditioning, or for the manufacture of intermediate goods necessary for the manufacture of final products or any other purpose provided the goods are returned back in the factory within 180 days of their being sent to the job worker. In case inputs are not returned within 180 days, the manufacturer or provider of output service shall pay an amount equivalent to the CENVAT credit

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attributable to the inputs or capital goods by debiting the CENVAT credit or otherwise, but the manufacturer or provider of output service can take the CENVAT credit again when the inputs or capital goods are received back in his factory or in the premises of the provider of output service.

	Rs.
CENVAT credit that can be taken on 1.10.2007 (Rs. 10,000×16.32%)	1,632
CENVAT credit that should be reversed on 30.3.2008	1,632
 CENVAT credit availed and reversed in financial year 2007-08	 1,632
 CENVAT credit that can be taken on 1.4.2008 (50% of Rs. 1,632)	 816
CENVAT credit that can be taken on 31.5.2008 (50% of Rs. 1,632)	816
 CENVAT credit availed in financial year 2008-09	 1,632

(c) Computation of the value of first clearances and the duty liability:-

Particulars	Rs.
1. Value of clearances of goods with own brand name	75,00,000
2. Value of clearance of goods with brand name of other parties (Note-1)	<u>90,00,000</u>
Total value of first clearances	<u>1,65,00,000</u>
Value on which duty is chargeable (Rs. 1,65,00,000 – 1,50,00,000) = Rs. 15,00,000	
Excise duty payable @ 16% (Rs. 15,00,000 × 16%)	2,40,000
Education cess payable @ 3% (Rs. 2,40,000 × 3%)	<u>7,200</u>
Total excise duty payable	<u>2,47,200</u>

Notes:

1. SSI units in rural area are eligible to clear goods with other's brand name availing the exemption as per Notification No. 8/2003.
2. Notification No. 8/2003 also provides that value of clearances of goods totally exempt under other notifications need not be taken into account for calculation of aggregate value of first clearances.

Question 2

- (a) *M/s ABC Ltd. was a cement manufacturer. The company used ropeway system for bringing crushed limestone from the mines located 4 - 5 kms away from the factory. A part of ropeway system was installed in the factory and the system was controlled from*

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the factory. M/s ABC Ltd. availed CENVAT credit on parts / spares for ropeway system treating the same as capital goods. The Central Excise Department denied CENVAT credit on the ground that ropeway is used for transporting raw materials from the mines to the factory and can not be considered as material handling system within the factory premises. Examine, with the help of a decided case law, whether the stand taken by the Department is correct in law. (5 Marks)

- (b) *A Port Trust used cement concrete armour units in the harbour for keeping water calm. Each unit weighed about 50 tons and is like a tripod and keeps water calm and tranquil. These units are essentially in prismoid form and were made to order. They are harbour or location specific. The Central Excise Department contended that the armour units are excisable goods and chargeable to duty. Examine the validity of the Department's contention in the light of decided case law. (5 Marks)*
- (c) *I Scream Ltd. is engaged in manufacture of ice-cream falling under sub-heading 2105 of the Central Excise Tariff Act, 1985. The company supplied the ice cream in four litres pack to catering industry or hotels, who sell the same in scoops. The pack contained a declaration that the pack was not meant for retail sale. The Department contended that packs have to be assessed on the basis of value arrived at as per the provision of section 4(A) of Central Excise Act, 1944, which provides for assessment based on M.R.P and not under section 4 of the Central Excise Act, 1944. Assessee contended that the ice-cream pack sold was a bulk pack of 4 litres which was not meant to be sold in retail and they were not required to print the Maximum Retail Price and hence the transaction was a wholesale transaction and assessment under section 4 of the Central Excise Act, 1944 was correct. (5 Marks)*

Further contention of the assessee was that they are entitled to exemption under rule 34 of the Standard of Weights and Measures (PC) Rules, which exempts packs meant for industrial use. Examine whether the stand taken by the Department is correct in the light of decided case law.

Answer

- (a) No, Department's stand is not correct in law. Rule 2(a) of CENVAT Credit Rules, 2004, *inter alia*, provides that capital goods means goods "used in the factory of the manufacturer of final products". The Department's contention is that ropeway is used for transporting raw material from mines located 4-5 kms away and hence it can not be said to have been used in the factory.

The facts of the given case are similar to the case of *M/s. Birla Corporation Ltd. v. CCE 2005 (186) ELT 266 (SC)*. In the instant case, the Apex Court followed the principle laid down in case of *J.K. Udaipur Udyog Ltd. v. CCE, Jaipur-II 2001 (130) E.L.T. 996* wherein the same question arose for consideration and the facts were almost identical. Therefore, the assessee was entitled to the CENVAT credit of the spares of the ropeway system because the ropeway system, used to bring the crushed lime stone from the mines to the factory, could be covered under the expression 'precincts of the premises' in the definition of the factory under section 2(e) of the Central Excise Act, 1944. Thus,

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ropeway system is used within the factory. Therefore, parts/spares for ropeway system are covered under the definition of capital goods. Hence CENVAT credit is admissible.

- (b) The facts of the given case are similar to the case of *Board of Trustees v. CCE 2007 (216) ELT 513 (SC)*. The Supreme Court held that in order to constitute “goods”, twin tests have to be satisfied, namely, process constituting manufacture and secondly marketability. In the present case, the second test of marketability was in issue.

In this case, armour blocks, in prisomoid form, were made to order and were of certain specifications. They were harbour or location specific. It would depend on the water level required to be maintained in the harbour. There was no evidence to show that these blocks could be used in any other harbour. Moreover, the Department failed to prove marketability of the impugned goods. Therefore, assessee's contention, that goods are not capable of being bought and sold in the market, has to be accepted. Therefore, Department's stand is not correct and no duty is payable on the goods.

- (c) The issue is covered by a decision of the Supreme Court in the case of *Jayanti Food Processing (P) Ltd. v. CCE 2007 (215) ELT 327*. It was held that the product was not covered by the provision of section 4A of the Central Excise Act, 1944.

The Supreme Court held that firstly, the assessee could not be said to be “retail dealer” because four litre pack of ice-cream was not being sold directly to the consumer, but to the intermediary i.e. hotels.

Secondly, four litre pack of ice-cream could have been covered under the definition of “retail package” only if such package had been intended for retail sale for consumption by an individual or a group of individuals. However, the package specifically displayed that “the pack was not meant for retail sale”. Moreover, hotel could not be covered in term of ‘individual or a group of individuals’. Hence, the ice-cream package could not be termed as “retail package”. Therefore, the assessee was not required under Standards of Weight and Measures Act and the rules there under to print the MRP on the package

Lastly, the Apex Court agreed with the contention of the assessee that they were entitled to exemption under rule 34 which exempts the product from requirement of affixing maximum retail price on the pack. Rule 34 of the Standard of Weights and Measures (Packaging Commodity) Rules, 1977 exempts the package specially packed for the purpose of servicing any industry. Supreme Court concluded that the sale of pack of ice-cream to the retail industry was squarely covered in the term “servicing any industry”.

Hence, it could be inferred that, since, the requirement of affixing maximum retail price is a pre-condition for application of section 4A of the Central Excise Act, 1944, assessment under section 4 is correct.

Question 3

- (a) Explain special procedure and facilities made available to large tax payer under rule 12BB of Central Excise Rules, 2002 in respect of intermediate goods. (6 Marks)
- (b) What are the provisions relating to the payment of excise duty on used capital goods cleared by an assessee on which CENVAT credit has been availed? (2 Marks)

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- (c) *What are the situations in which duty can be remitted under rule 21 of Central Excise Rules, 2002.* (2 Marks)

Answer

- (a) Rule 12BB of Central Excise Rules, 2002 provides that a large tax payer may remove excisable intermediate goods from any of his registered premises to his other registered premises for further use in the manufacture of other excisable goods (subject goods).

For this purpose, he should satisfy the following conditions:

1. Either of the following conditions must be satisfied:-
 - (i) Subject goods should be manufactured out of the intermediate goods and cleared on payment of excise duties within six months from the date of receipt of intermediate goods, or
 - (ii) The subject goods should be manufactured out of the intermediate goods and exported out of India, under a bond or letter of undertaking, within six months from the date of receipt of intermediate goods.
 2. Removal should be made under a transfer challan/invoice.
 3. Transfer challan should be serially numbered and should contain details of registration number, name, address, description, classification, time and date of removal, mode of transport, vehicle number and name of consignee unit and registration number.
 4. If goods manufactured out of intermediate goods are not cleared/exported out of India within six months, duties on intermediate goods are required to be paid with interest under section 11AB of the Central Excise Act, 1944.
 5. If intermediate goods are used in exempted subject goods, recipient unit has to pay duty on intermediate product along with interest under section 11AB.
- (b) Second proviso to rule 3(5) of the CENVAT Credit Rules, 2004, as amended with effect from 13.11.2007, provides the method to be adopted for payment of duty on used capital goods.
- If the capital goods, on which CENVAT credit has been taken, are removed after being used, the manufacturer/provider of output service shall pay an amount equal to the CENVAT credit taken on the said capital goods reduced by 2.5 percent for each quarter of a year or part thereof from the date of taking the CENVAT credit.
- (c) Rule 21 of the Central Excise Rules, 2002 provides that where it is shown to the satisfaction of Commissioner, empowered to remit the duty, that:-
- (i) goods have been lost or destroyed by natural causes or,
 - (ii) by unavoidable accident or
 - (iii) the goods have become unfit for consumption or for marketing.
- at any time before removal, he may remit the duty payable on such goods.

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SECTION-B

Question 4

(a) Purchases by S & Co. for the month of December are as follows:

- (1) Rs. 1,00,000 at 4% VAT
- (2) Rs. 5,00,000 at 12.5% VAT.

Sales of S & Co. for the month of December are as follows:

- (1) Sales of Rs. 3,00,000 at 4% VAT
- (2) Sales of Rs. 3,00,000 at 12.5% VAT.

Compute eligible input tax credit and VAT payable for the month. (3 Marks)

(b) Calculate the value of taxable service of 'X' Transport Company engaged in the business of transport of goods by road. Give reasons for taxability or exemption of each item. No freight is received from any of the specified category of consignor/consignee. Suitable assumptions may be made wherever required. X does not avail CENVAT credit:

	Rs.
1. Total freight charges received by 'X' during the year	13,50,000
2. Freight charges received for transporting fruits	1,25,000
3. Freight collected for transporting small consignment for persons who paid less than Rs. 750 for each consignment	75,000
4. Freight collected for transporting goods in small vehicles for persons who paid less than Rs. 1,500 per trip	1,50,000
	(7 Marks)

Answer

(a) **Computation of input tax credit and VAT payable:-**

	Rs.
Input tax paid by S & Co on Rs. 1,00,000 @ 4%	4,000
Input tax paid by S & Co on Rs. 5,00,000 @ 12.5%	<u>62,500</u>
Total input tax credit eligible	<u>66,500</u>
Output tax payable on Rs. 3,00,000 @ 4%	12,000
Output tax payable on Rs. 3,00,000 @ 12.5%	<u>37,500</u>
Total tax payable	<u>49,500</u>
Net input tax allowed to be carried over (Rs. 66,500-Rs. 49,500)	17,000
VAT payable by S & Co.	Nil

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(b) Computation of value of taxable service:

	Rs.
Total freight collected	13,50,000
Less : Freight charges received for transporting fruits (Note-1)	1,25,000
Less : Freight collected less than Rs. 750/- for each consignment (Note-2)	75,000
Less : Freight collected for transporting goods in small vehicles for persons who paid less than Rs. 1,500/- per trip (Note-2)	<u>1,50,000</u>
Balance freight charges	10,00,000
Less : Abatement of 75 % (Note-3)	<u>7,50,000</u>
Value of taxable service	<u>2,50,000</u>

Notes:

1. Taxable service provided by a goods transport agency in relation to transport of vegetables, eggs or milk by road is exempt from service tax (*Notification No. 33/2004 dated 03.12.2004*).
2. Service tax is exempt where:
 - (i) the gross amount charged on all consignments transported in a goods carriage does not exceed Rs. 1,500/- or
 - (ii) the gross amount charged on an individual consignment transported in a goods carriage does not exceed Rs. 750/-(*Notification No. 34/ 2004 dated 3.12.2004*).
3. As per *Notification No. 13/2008 dated 1.3.2008*, service tax is required to be paid on 25% of the gross amount charged i.e. 75% of the gross amount charged is allowed as abatement.

Question 5

- (a) *The assessee owned a collection centre, which was engaged in drawing of human blood, urine and stool samples on behalf of the principal laboratory in a metro city for conducting pathological tests. The assessee sent the samples through courier and received commission for such service. Department demanded service tax on the ground that the activity amounted to promotion or marketing of the service provided by the principal and hence covered under business auxiliary service. With reference to legal provisions and case law, examine the stand taken by the Department. (5 Marks)*
- (b) *The assessee used to finance the purchase of vehicles manufactured by a leading automobile company which used to sell the vehicles through its distributors. Assessee financed part of the vehicle cost to the purchaser of vehicle after getting, an agreement with the purchaser providing the right of repossession of the vehicle in case buyer of the vehicle defaulted in paying installment. Immediately on sale, purchaser of the vehicle became the owner and vehicle was registered in his name. The Department seeks to*

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levy service tax in the category of "Banking and other Financial Services." Examine whether Department's stand is correct in terms of legal provisions' and case law. (5 Marks)

Answer

- (a) Section 65 (106) of the Finance Act, 1994 defines technical testing and analysis services. However, any testing or analysis done for the purpose of determination of the nature of diseased condition, identification of a disease, prevention of any disease or disorder in human beings or animals has been excluded from the scope of this service. In this case, the Department's contention is that assessee is providing business auxiliary service to the laboratory and is not eligible for the exemption since assessee is not performing laboratory functions.

Similar issue came up before Punjab & Haryana High Court in the case of *CCE v. Dr. Lal Path Lab (P) Ltd.* 2007 (8) STR 337 (P&H). High Court held that merely because the assessee renders any incidental service like putting across or dropping of the name of the principal laboratory, it does not get covered by the definition of business auxiliary service. The activity of drawing of test sample is covered by the exception to technical testing and analysis service under section 65(106) of the Finance Act, 1994.

- (b) The issue was examined by the Customs Excise, Service Tax Appellate Tribunal (CESTAT), Mumbai in the case of *Bajaj Auto Finance Ltd. v. CCE, Pune* 2007 (7) STR 423. The Tribunal distinguished between hire purchase agreement and hire purchase finance agreement. In the case of former, the title to the goods remains with the hire purchase company. Payments are considered as hire charges and when all periodical payments are made, title to the goods is transferred to the customer provided he exercises such an option. In the case of latter, title to the goods vests with the purchaser right from the beginning and hire purchase company has only a right to take over possession for non payment of loan.

It was also quoted that since the appellants herein have the right and control over the goods, it cannot be concluded that they had entered into a hire purchase agreement with their customers for the reason that in all hire purchase finance agreements, terms and conditions giving the finance company control over the goods, exist. Since hire purchase finance is not covered by the definition of banking and other financial services under section 65(10) of the Finance Act, 1994, service tax is not attracted. This judgment has been affirmed later on by the Apex Court in *CCE v. Bajaj Auto Finance Ltd.* 2008 (10) STR 433 (SC).

Question 6

- (a) *What are the purchases not eligible for input tax credit of VAT paid?* (6 Marks)
- (b) *What are the provisions relating to best judgement assessment under Service Tax Law?* (2 Marks)
- (c) *State whether the following services are taxable under the provisions of the Finance Act, 1994 relating to service tax:*

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- (i) *A practising Chartered Accountant representing a client before Income Tax Officer in assessment proceeding.* (2 Marks)
- (ii) *Royalty received from the publisher by an author of a text-book for printing and publishing his book.* (2 Marks)
- (d) *Give four illustrations to explain the scope of service rendered by a consulting engineer.* (4 Marks)
- (e) *List out any four services brought under the service tax net by the Finance Act, 2008.* (4 Marks)

Answer

- (a) Input tax credit is not allowed on the following purchases.
 - (i) purchases from unregistered dealers;
 - (ii) purchases from registered dealer who opt for composition scheme under the provisions of the Act;
 - (iii) purchase of goods as may be notified by the State Government;
 - (iv) purchase of goods where the purchase invoice is not available with the claimant or there is evidence that the same has not been issued by the selling registered dealer from whom the goods are purported to have been purchased;
 - (v) purchase of goods where invoice does not show the amount of tax separately;
 - (vi) purchase of goods, which are being utilized in the manufacture of, exempted goods;
 - (vii) goods in stock, which have suffered tax under an earlier Act but under VAT Act they are covered under exempted items;
 - (viii) purchase of goods used for personal use/consumption or provided free of charge as gifts (partial credit is available in the State of Maharashtra);
 - (ix) goods imported from outside the territory of India (commonly known as high seas purchases);
 - (x) goods imported from other States viz. inter-State purchases.

Note: Any 4 points may be given.

- (b) The Finance Act, 2008 has inserted a new section 72 to empower the Central Excise Officer to make best judgment assessment. The provisions of new section are as follows:

If any person, liable to pay service tax,—

- (a) fails to furnish the return under section 70;
- (b) having made a return, fails to assess the tax in accordance with the provisions of this Chapter or rules made thereunder, the Central Excise Officer, may require the person to produce such accounts, documents or other evidence as he may deem

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necessary and after taking into account all the relevant material which is available or which he has gathered, shall by an order in writing, after giving the person an opportunity of being heard, make the assessment of the value of taxable service to the best of his judgment and determine the sum payable by the assessee or refundable to the assessee on the basis of such assessment.

- (c) (i) Services provided or to be provided by a practicing chartered accountant in his professional capacity, to a client, relating to representing the client before any statutory authority in the course of proceedings initiated under any law for the time being in force, by way of issue of notice, from the whole of service tax leviable thereon under section 66 of the Finance Act, 1994 as amended (*Notification No. 25/2006 ST dated 13.7.2006*).
- (ii) As per section 65(55a) of the Finance Act, 1994, "intellectual property right" means any right to intangible property, namely, trade marks, designs, patents or any other similar intangible property, under any law for the time being in force, but does not include copyright. Therefore, any royalty or other payment related to publishing involving copyright is not liable to tax.
- (d) Consulting engineer service would include
- (i) Design engineering
 - (ii) Pre design services/project report
 - (iii) Supervision or construction and project management
 - (iv) Feasibility study
 - (v) Supervision of commissioning and initial operation
 - (vi) Post operation and management
 - (vii) Trouble shooting and technical services including establishing system and procedures for an existing plant.
- (e) Following new services have been brought under tax net by the Finance Act, 2008:-
1. Services in relation to information technology software for use in the course, or in furtherance of business or commerce.
 2. Services provided in relation to management of investment under unit linked insurance business, commonly known as ULIP.
 3. Services provided by a recognized stock exchange in relation to securities.
 4. Services provided by a recognized or registered association (commodity exchange) in relation to sale or purchase of any goods or forward contracts.
 5. Services provided by a processing and clearing house in relation to processing, clearing and settlement of transactions in securities, goods or forward contracts.
 6. Services provided in relation to supply of tangible goods without transferring right of possession and effective control of the tangible goods.
 7. Services provided in relation to internet telecommunication.

Note: Any four services may be given.

PAPER – 8 : INDIRECT TAX LAWS

SECTION-C

Question 7

From the following particulars, determine the assessable value of the imported equipment giving explanation for each item:

	Rs.
1. FOB cost of equipment (Japanese Yen)	2,00,000 Yen
2. Freight charges in Japanese Yen	20,000 Yen
3. Charges for development connected to equipment paid in India	Rs. 60,000
4. Insurance charge paid in India for transportation from Japan	Rs. 15,000
5. Commission payable to agent in India	Rs. 15,000
<i>Exchange rate as per RBI is 1 Yen = Rs. 0.45</i>	
<i>Exchange rate as per CBEC is 1 Yen = Rs. 0.50</i>	
<i>Landing charges: one percent of CIF cost</i>	

(5 Marks)

Answer

Computation of assessable value:-

FOB value	2,00,000 Yen
Add: Freight from Japan (Note – 1)	<u>20,000 Yen</u>
Total (in yen)	2,20,000 Yen
Exchange rate applicable is 1 Yen = Rs. 0.50 (Note – 4)	
Total (in rupees)	Rs. 1,10,000
Add : Insurance charges	<u>Rs. 15,000</u>
Total	Rs. 1,25,000
Add : Commission (Note – 2)	<u>Rs. 15,000</u>
CIF value	Rs. 1,40,000
Add : Landing charges @ 1% of CIF value	<u>Rs. 1,400</u>
Assessable value	<u>Rs. 1,41,400</u>

Notes:

1. Freight from Japan is includible in the assessable value.
2. Agency commission paid in India is not a buying commission and hence will be added to CIF value.

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3. Charges for development paid in India do not form part of assessable value because as per rule 10(1)(b)(iv) of the Customs Valuation (Determination of Value of Imported Goods) Rules, 2007, only the development undertaken at a place other than India shall form a part of assessable value.
4. Currency conversion rate as notified by CBEC is to be taken into consideration.

Question 8

ABC imported a vessel 'Waterloo' for the purpose of breaking from XYZ Ltd. of U.K. A memorandum of understanding was signed between the buyer and seller on 2.6.97 and ABC took delivery of the vessel on 4.6.97. Vessel drifted and landed in the yard of B in a damaged condition on 9.6.97. On 24.6.97, ABC filed application to concerned Assistant Commissioner for extension of time to file bill of entry, which was granted on 12.8.97. ABC paid Rs. 24 crores to XYZ Ltd. towards the purchase price of the vessel. Thereafter, ABC sold the vessel to B for Rs. 12 crores and B filed bill of entry on 12.9.97. Assessing authority assessed the ship taking the value as Rs. 24 crores and ship was taken over by B after assessment order was passed. 'B' argues that assessable value should be taken as Rs. 12 crores since the vessel was damaged because of the storm which made the vessel drift during appellate proceedings. No application for abatement of duty was made before the assessing authority by ABC or B. Examine whether benefit of relief under section 22 of the Customs Act, 1962 to reduce the value and thereby duty can be extended to B under the above circumstances. The assessment order in respect of bill of entry was passed on 23.12.97. (5 Marks)

Answer

Supreme Court held that in order to claim the benefit of the abatement under section 22, the party claiming the abatement has to satisfy the Assessing Authority that a case has been made out under section 22 for abatement of duty on damaged or deteriorated goods. In the absence of any claim made under section 22 in writing to the Assessing Authority, the appellant (B) could not claim the abatement under section 22 and the Assessing Authority did not record rightly to its satisfaction that the appellant was entitled to the abatement of duty.

In this case, damage occurred in Indian shore. Importer sought extension of time to file bill of entry. But, thereafter remitted the purchase price and sold the vessel to B. B in turn filed the bill of entry and the vessel was assessed. No application was made by the buyers i.e. importer (ABC) to the Assistant Commissioner for any abatement of duty on damaged goods.

The transaction between the importer (ABC) and the respondent (B) cannot be described as the transaction of purchase and sale during the course of international trade. Any sale of goods carried out, after the act of 'import' within the meaning of the Act is over, can only be described as a sale in the course of domestic trade and not a sale in the course of international trade. Therefore, the appellant i.e. buyer (B) who had purchased the vessel in the course of domestic trade was not entitled to seek any abatement of duty under section 22 of the Customs Act, 1962 on the ground on which it claimed before the Appellate Authority.

PAPER – 8 : INDIRECT TAX LAWS

Hence, in the light of above discussion, it can be inferred that the assessable value of the ship shall be the transaction value at which the importer (ABC) has paid at the time of importation i.e. Rs. 24 crores.

Question 9

- (a) *Is a person entitled to inspect or obtain copies of report made by any Officer to the Settlement Commission? Can the Settlement Commission furnish copies of such report?*
(2 Marks)
- (b) *Under what circumstances, provisional assessment under section 18 of the Customs Act, 1962 can be made?*
(2 Marks)
- (c) *Explain briefly, legal provisions relating to pilfered goods under the Customs Act, 1962.*
(2 Marks)
- (d) *Explain briefly, legal provisions relating to power to summon persons under the Customs Act, 1962.*
(2 Marks)
- (e) *Define customs area.*
(2 Marks)

Answer

- (a) As per the provisions of section 127G of the Customs Act, 1962, no person shall be entitled to inspect or obtain copies of any report made by any officer of customs to the Settlement Commission, but the Commission may, in its discretion, furnish copies thereof to any such person on an application and on payment of specified fee.

However, for the purpose of enabling any person whose case is under consideration to rebut any evidence brought on record against him in any such report, the Commission shall furnish a certified copy of relevant part of such report on receipt of an application and payment of fee as specified in rules.
- (b) According to provisions of section 18 of the Customs Act, 1962, provisional assessment can be resorted to in the following cases:-
 - (i) Where the proper officer is satisfied that an importer or an exporter is not able to produce documents or information necessary for assessment.
 - (ii) Where proper officer deems it necessary to subject the imported or export goods to chemical or other test for the purpose of assessment of duty thereon.
 - (iii) Where proper officer deems it necessary to make further enquiry.
- (c) Pilferage does not mean loss of total package. Normally claim for pilferage would be under following circumstances:
 - a. there should be evidence of tampering with packages.
 - b. there would be blank space for missing article on package.
 - c. Missing article would be unit article.

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According to section 13 of the Customs Act, 1962, if any imported goods are pilfered after unloading and before proper officer has passed an order for clearance for home consumption or deposit in warehouse, the importer shall not be liable to pay duty leviable on such goods.

However, where such goods are restored to the importer, he becomes liable to pay duty.

- (d) Section 108 of the Customs Act, 1962 provides that any Gazetted Officers of Customs shall have the power to summon any person either to present himself for enquiry or produce a document or any other thing in any inquiry which the officer is making under the Act. All persons who are summoned shall be bound to attend either in person or by an authorized agent and state the truth, make statement, produce document and other things.
- (e) As per section 2(11) of the Customs Act, 1962, customs area means the area of a customs station and includes any area in which imported goods or export goods are ordinarily kept before clearance by Customs Authorities.



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