

Suggested Answers

Final (New) Examination

Group I

November, 2009



Board of Studies
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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



BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
(Set up by an Act of Parliament)

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Answer **all** questions.

Working notes should form part of the answer.

Wherever necessary, suitable assumption(s) should be made by the candidates.

Question 1

- (a) The following data apply to 'X' Ltd. defined benefit pension plan for the year ended 31.03.09, calculate the actual return on plan assets :

- Benefits paid	2,00,000
- Employer contribution	2,80,000
- Fair market value of plan assets on 31.03.09	11,40,000
- Fair market value of plan assets as on 31.03.08	8,00,000

- (b) U.S.A Ltd. purchased raw material @ Rs. 400 per kg. Company does not sell raw material but uses in production of finished goods. The finished goods in which raw material is used are expected to be sold at below cost. At the end of the accounting year, company is having 10,000 kg of raw material in stock. As the company never sells the raw material, it does not know the selling price of raw material and hence can not calculate the realizable value of the raw material for valuation of inventories at the end of the year. However replacement cost of raw material is Rs. 300 per kg. How will you value the inventory of raw material?
- (c) Moon Ltd. entered into agreement with Sun Ltd. for sale of goods of Rs.8 lakhs at a profit of 20 % on cost. The sale transaction took place on 1st February, 2009. On the same day Sun Ltd. entered into another agreement with Moon Ltd. to resell the same goods at Rs. 10.80 lakhs on 1st August, 2009. State the treatment of this transaction in the financial statements of Moon Ltd. as on 31.03.09. The pre-determined re-selling price covers the holding cost of Sun Ltd. Give the Journal Entries as on 31.03.09 in the books of Moon Ltd.
- (d) XY Ltd. was making provisions for non-moving stocks based on no issues for the last 12 months upto 31.03.08. Based on technical evaluation the company wants to make provisions during the year 31.03.09.

Total value of stock --- Rs. 150 lakhs.

Provisions required based on 12 months issue Rs. 4.0 lakhs.

Provisions required based on technical evaluation Rs. 3.20 lakhs.

Does this amount to change in accounting policy ? Can the company change the method of provision?

(5x4=20 Marks)

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Answer

- (a)
- | | Rs. |
|---|-----------------------|
| Fair value of plan assets on 31.3.08 | 8,00,000 |
| Add: Employer contribution | 2,80,000 |
| Less: Benefits paid | <u>2,00,000</u> |
| (A) | <u>8,80,000</u> |
| Fair market value of plan assets at 31.3.09 | (B) <u>11,40,000</u> |
| Actual return on plan assets | (B-A) <u>2,60,000</u> |
- (b) As per Para 24 of AS 2 (Revised) "Valuation of Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. Therefore, in this case, USA Ltd. will value the stock of raw material at Rs. 30,00,000 (10,000 Kg. @ Rs.300 per kg.).
- (c) In the given case, Moon Ltd. concurrently agreed to repurchase the same goods from Sun Ltd. on 1st Feb., 2009. Also the re-selling price is pre-determined and covers purchasing and holding costs of Sun Ltd. Hence, the transaction between Moon Ltd. and Sun Ltd. on 1st Feb., 2009 should be accounted for as financing rather than sale. The resulting cash flow of Rs.9.60 lakhs received by Moon Ltd., cannot be considered as revenue as per AS 9 "Revenue Recognition".

Journal Entries in the books of Moon Ltd.

		<i>Rs. in lakhs</i>	
1.02.09	Bank Account	Dr.	9.60
	To Advance from Sun Ltd*.		9.60
	(Being advance received from Sun Ltd amounting [Rs.8 lakhs + 20% of Rs. 8 lakhs= 9.60 lakhs] under sale and re-purchase agreement)		
31.03.09	Financing Charges Account	Dr.	0.40
	To Sun Ltd.		0.40
	(Financing charges for 2 months at Rs.1.20 lakhs [10.80 – 9.60] i.e. 1.2 lakhs x 2/6)		
31.03.09	Profit and Loss Account	Dr.	0.40
	To Financing Charges Account		0.40
	(Being amount of finance charges transferred to P& L Account)		

* The balance of Sun Ltd. account will be disclosed as an advance under the heading liabilities in the balance sheet of Moon Ltd. as on 31st March, 2009.

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- (d) The decision of making provision for non-moving stocks on the basis of technical evaluation does not amount to change in accounting policy as per AS 5 “Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies”. The method of estimating the amount of provision may be changed, in case, a more prudent estimate can be made by adopting the changed method.

In the given case, considering the total value of stocks, the change in the amount of required provision of non-moving stocks from Rs.4.0 lakhs to Rs.3.20 lakhs is also not material. The disclosure can be made for such change by way of notes to the accounts in the financial statements of XY Ltd. for the year ending on 31.03.09, in the following manner:

“The company has provided for non-moving stocks on the basis of technical evaluation unlike preceding years. Had the same method been followed as in the previous year, the profit for the year and the corresponding effect on the year end, the net assets would have been higher by Rs.0.80 lakhs”.

Question 2

The following are the Balance Sheets of H Ltd. and S Ltd. as at 31.03.09:

			Rs. in lakhs	
	H Ltd.	S Ltd.	H Ltd.	S Ltd.
	Rs.	Rs.	Rs.	Rs.
Share capital			60	18
Share of Rs.10 each	50	10	6	-
General reserve	50	20	35	5
Profit and Loss	20	15	30	25
Secured loan	20	3	39	2
Current liabilities	<u>30</u>	<u>2</u>	<u>—</u>	<u>—</u>
	<u>170</u>	<u>50</u>	<u>170</u>	<u>50</u>

H Ltd. holds 60% of the paid up capital of S Ltd. and balance is held by a foreign company. The foreign company agreed with H Ltd. as under:

- (i) The shares held by the foreign company will be sold to H Ltd. at Rs. 50 above than nominal value of per share.
- (ii) The actual cost per share to the Foreign Company was Rs. 11, gain accruing to Foreign Company is taxable @ 20 % . The tax payable will be deducted from the sale proceeds and paid to Government by H Ltd. 50% of the consideration (after payment of tax) will be remitted to Foreign Company by H Ltd. and also any cash for fractional shares allotted.
- (iii) For the Balance of consideration H Ltd. would issue its shares at their intrinsic value.

It was also decided that H Ltd. would also absorb S Ltd. simultaneously by writing down the fixed assets of S Ltd. by 10 %. The Balance Sheet figure included a sum of Rs. 1 lakh due by S Ltd. to H Ltd, included stock of Rs. 1.5 lakhs purchased from S Ltd. who sold them at cost plus 20 %.

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Pass Journal entries in the books of H Ltd. to record the above arrangement on 31.03.09 and prepare the Balance Sheet of H Ltd. after absorption of S Ltd. Workings should form part of your answer. (16 Marks)

Answer

Journal Entries in the books of H Ltd.

		Rs.	Rs.
1.	Business Purchase A/c To Foreign Company (Being business purchased)	Dr. 24,00,000	24,00,000
2.	Fixed Assets A/c Debtors A/c Inventories A/c Cash at Bank A/c To Current Liabilities A/c To Secured Loan A/c To Investment in S Ltd. A/c To Business Purchase A/c To Capital Reserve A/c (B.F.) (Being various assets and liabilities taken over)	Dr. 16,20,000 Dr. 5,00,000 Dr. 25,00,000 Dr. 2,00,000	2,00,000 3,00,000 6,00,000 24,00,000 13,20,000
3.	Profit and Loss A/c To Inventories A/c (Being elimination of unrealised profit)	25,000	25,000
4.	Current Liabilities A/c To Debtors A/c (Being elimination of mutual owings)	Dr. 1,00,000	1,00,000
5.	Foreign Company To Tax Payable A/c To Bank A/c (Rs.10,04,000 + Rs.20) To Equity Share Capital A/c To Securities Premium A/c (Being payment made to foreign company)	Dr. 24,00,000	3,92,000 10,04,020* 3,34,660 6,69,320

* It is assumed that payment of fractional shares has also been routed through Bank A/c along with 50% payment remitted to Foreign Company.

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6.	Tax Payable A/c	Dr.	3,92,000	
	To Bank A/c			3,92,000
	(Being tax paid to Government)			

Balance Sheet of H Ltd. (After Absorption)

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
5,34,466 Shares of Rs.10 each	53,34,660	Fixed Assets	76,20,000
(out of above, 33,466 shares issued for consideration other than cash)		(60,00,000+16,20,000)	
General Reserve	50,00,000	Sundry Debtors	39,00,000
Profit & Loss (20,00,000– 25,000)	19,75,000	(35,00,000 – 1,00,000)	
Capital Reserve	13,20,000	+5,00,000)	
Securities Premium	6,69,320		
Secured Loan (20,00,000+3,00,000)	23,00,000	Inventories (30,00,000- 25,00,000+25,00,000)	54,75,000
Current Liabilities			
(30,00,000+2,00,000-1,00,000)	31,00,000	Cash at Bank	27,03,980
		(39,00,000+2,00,000– 10,04,020-3,92,000)	
	<u>196,98,980</u>		<u>196,98,980</u>

Working Notes:

1. Amount payable to foreign company

Price per share of S Ltd.= Rs.50 + Rs.10 (Nominal value) = Rs.60

Value of 40% shares held by foreign company = $10,00,000 \times 40\% \times \frac{60}{10} = \text{Rs. } 24,00,000$

Capital gain = $\text{Rs. } 24,00,000 - (4,00,000 \times \frac{11}{10}) = \text{Rs. } 19,60,000$

Tax on capital gain = $\text{Rs. } 19,60,000 \times 20\% = \text{Rs. } 3,92,000$

Amount payable to Foreign Company after tax = $\text{Rs. } 24,00,000 - \text{Rs. } 3,92,000 = \text{Rs. } 20,08,000$

50% of Rs.20,08,000 = Rs.10,04,000 to be remitted to foreign company.

2. Intrinsic value of shares of H Ltd. and balance payment to foreign company

	<i>Rs.</i>	<i>Rs.</i>
Total assets (Excluding Investment in S Ltd.)		1,64,00,000
Add: Investment in S Ltd. (60,000 shares × Rs.60)		<u>36,00,000</u>
		2,00,00,000

Less: Liabilities:

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Secured Loan	20,00,000	
Current Liability	<u>30,00,000</u>	<u>50,00,000</u>
		<u>1,50,00,000</u>
No. of equity shares		5,00,000
Intrinsic value per share		Rs.30
Number of shares to be issued for payment of 50% balance amount		
$\frac{\text{Rs.10,04,000}}{30} = 33,466 \text{ shares}$		

Cash for fractional shares = Rs.10,04,000 – (33,466 x Rs.30) = Rs.20

Question 3

P Ltd. owns 80% of S and 40% of J and 40% of A. J is jointly controlled entity and A is an associate. Balance Sheet of four companies as on 31.03.09 are:

	<i>P Ltd.</i>	<i>S</i>	<i>J</i>	<i>A</i>
				(Rs. in lakhs)
<i>Investment in S</i>	800	-	-	-
<i>Investment in J</i>	600	-	-	-
<i>Investment in A</i>	600	-	-	-
<i>Fixed assets</i>	1000	800	1400	1000
<i>Current assets</i>	<u>2200</u>	<u>3300</u>	<u>3250</u>	<u>3650</u>
<i>Total</i>	<u>5200</u>	<u>4100</u>	<u>4650</u>	<u>4650</u>
<i>Liabilities:</i>				
<i>Share capital Re. 1</i>				
<i>Equity share</i>	1000	400	800	800
<i>Retained earnings</i>	4000	3400	3600	3600
<i>Creditors</i>	<u>200</u>	<u>300</u>	<u>250</u>	<u>250</u>
<i>Total</i>	<u>5200</u>	<u>4100</u>	<u>4650</u>	<u>4650</u>

P Ltd. acquired shares in 'S' many years ago when 'S' retained earnings were Rs. 520 lakhs. P Ltd. acquired its shares in 'J' at the beginning of the year when 'J' retained earnings were Rs. 400 lakhs. P Ltd. acquired its shares in 'A' on 01.04.08 when 'A' retained earnings were Rs. 400 lakhs.

The balance of goodwill relating to S had been written off three years ago. The value of goodwill in 'J' remains unchanged.

Prepare the Consolidated Balance Sheet of P Ltd. as on 31.03.09 as per AS 21, 23, and 27.

(16 Marks)

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Answer

Consolidated Balance Sheet of P Ltd.

<i>Liabilities</i>	<i>Rs. in lakhs</i>	<i>Assets</i>	<i>Rs. in lakhs</i>
Share Capital	1,000	Goodwill (W.N.1)	120
Retained Earnings(W.N.2)	8,800	Fixed Assets	2,360
		[1,000 + 800 + 560 (1400 x 40%)]	
Creditors (200+ 300 + 40% of 250)	600	Current Assets	6,800
		[2,200+3,300+1,300(3,250x 40%)]	
Minority Interest (W.N.3)	<u>760</u>	Investment in Associates (W.N.4)	<u>1,880</u>
	<u>11,160</u>		<u>11,160</u>

Working Notes:

1. Computation of Goodwill

S (subsidiary)

		<i>Rs. in lakhs</i>
Cost of investment		800
Less:Paid up value of shares acquired	320	
Share in pre- acquisition profits of S Ltd. (520 × 80%)	<u>416</u>	<u>736</u>
Goodwill		<u>64</u>

J (Jointly Controlled Entity)

		<i>Rs. in lakhs</i>
Cost of Investment		600
Less:Paid up value of shares acquired (40% of 800)	320	
Share in pre-acquisition profits (40% of 400)	<u>160</u>	<u>480</u>
Goodwill		<u>120</u>

Note:Jointly controlled entity 'J' to be consolidated on proportionate basis i.e. 40% as per AS 27

Associate A (AS 23)

		<i>Rs. in lakhs</i>
Cost of investment		600
Less:Paid up value of shares acquired (800 x 40%)	320	
Share in pre-acquisition profits (400 x 40%)	<u>160</u>	<u>480</u>
Goodwill		<u>120</u>

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Goodwill shown in the Consolidated Balance Sheet

	<i>Rs. in lakhs</i>
Goodwill of 'J'	120
Goodwill of 'S'	64
Less: Goodwill written off of 'S'	<u>64</u>
Goodwill	<u>120</u>

2. Consolidated Retained Earnings

	<i>Rs. in lakhs</i>
P Ltd.	4,000
Share in post acquisition profits of S - 80% (3,400 – 520)	2,304
Share in post acquisition profits of J - 40% (3,600 – 400)	1,280
Share in post acquisition profits of A - 40% (3,600 – 400)	1,280
Less: Goodwill written off	<u>(64)</u>
	<u>8,800</u>

3. Minority Interest 'S'

	<i>Rs. in lakhs</i>
Share Capital (20% of 400)	80
Share in Retained Earnings (20% of 3,400)	<u>680</u>
	<u>760</u>

4. Investment in Associates

	<i>Rs. in lakhs</i>
Cost of Investments (including goodwill Rs. 120 lakhs)	600
Share of post acquisition profits	<u>1,280</u>
Carrying amount of Investment (including goodwill Rs. 120 lakhs)	<u>1,880</u>

Question 4

- (a) On 1 April, 2008 Delta Ltd. issued Rs.30,00,000, 6 % convertible debentures of face value of Rs. 100 per debenture at par. The debentures are redeemable at a premium of 10% on 31.03.12 or these may be converted into ordinary shares at the option of the holder, the interest rate for equivalent debentures without conversion rights would have been 10%.

Being compound financial instrument, you are required to separate equity and debt portion as on 01.04.08.

The present value of Re. 1 receivable at the end of the end of each year based on discount rates of 6% and 10% can be taken as:

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	6%	10%
End of year 1	0.94	0.91
2	0.89	0.83
3	0.84	0.75
4	0.79	0.68

- (b) When general price index was 100, Standard Ltd. purchased fixed assets of Rs. 2 crore and it had also permanent working capital of Rs.80 lakhs. The entire amount required for purchase of fixed assets and permanent working capital was financed by way of 12 % redeemable share capital. Standard Ltd. wants to maintain its physical capital.

On 31.03.09, the company had reserves of Rs. 3.50 crores. The general price index on that was 200. The written down value of fixed assets was Rs. 20 lakhs and they were sold for 3 crores. The proceeds were utilized for redemption of shares. On the same day (31.03.09), the company purchased new factory for Rs. 20 crores. The ratio of permanent working capital to cost of assets to be maintained at 0.4 : 1.

The company raised the additional funds required for the purpose by issue of equity shares.

(A) Calculate the amount of equity capital raised.

(B) Show the Balance Sheet as on 01.04.09.

(8+8 = 16 Marks)

Answer

(a) Computation of Equity and Debt Component of Convertible Debentures as on 1.4.08

Rs.

Present value of the principal repayable after four years	
[30,00,000 × 1.10 × 0.68 (10% Discount factor)]	22,44,000
Present value of Interest [1,80,000 x 3.17 (4 years cumulative 10% discount factor)]	<u>5,70,600</u>
Value of debt component	28,14,600
Value of equity component	<u>1,85,400</u>
Proceeds of the issue	<u>30,00,000</u>

(b)

Amount of equity capital raised	<i>Rs. in crores</i>
Amount required for purchase of new factory	20.00
Permanent working capital requirement at 40%	<u>8.00</u>
	28.00
Less: Existing working capital (W.N. 3)	<u>6.30</u>
Fresh equity capital raised	<u>21.70</u>

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Balance Sheet of Standard Ltd. as on 1st April, 2009

	Rs.	Assets	Rs.
<i>Liabilities</i>			
Share Capital	21.70	Fixed Assets	20.00
Reserves and Surplus (Bal. figure)	<u>6.30</u>	Working Capital	<u>8.00</u>
	<u>28.00</u>		<u>28.00</u>

Working Notes:

(Rs. in crores)

1. Preference share capital on 31st March, 2009

Fixed assets	2.00
Working capital	<u>0.80</u>
Financed by 12% Redeemable preference share capital	<u>2.80</u>

To maintain physical capital, the company needs to evaluate the financial capital on 31st March, 2009 which is required to maintain the existing operating capability of the physical assets. On the basis of price index data available, it can be worked out as follows:

$$\text{Rs. 2.80 crore} \times \frac{200}{100} = \text{Rs. 5.60 crores}$$

2. Working capital on 31st March, 2009

(before sale of fixed assets and redemption of preference shares)

Preference share capital	2.80
Reserves	<u>3.50</u>
	6.30
Less: Written down value of fixed assets	<u>0.20</u>
Working capital	<u>6.10</u>

As the physical capital on the basis of price index is Rs. 5.6 crores which is less than the actual working capital on 31st March, 09, therefore, physical capital is maintained.

3. Working capital as on 31st March, 2009

(after sale of fixed assets and redemption of preference shares)

Working capital before sale of fixed assets and redemption	6.10
Add: Sale proceeds of fixed assets	<u>3.00</u>
	9.10
Less: Redemption of preference shares	<u>2.80</u>
Working capital available after sale of fixed assets and redemption of pref. shares	<u>6.30</u>

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Question 5

- (a) A Mutual Fund raised 100 lakh on April 1, 2009 by issue of 10 lakh units of Rs. 10 per unit. The fund invested in several capital market instruments to build a portfolio of Rs. 90 lakhs. The initial expenses amounted to Rs. 7 lakh. During April, 2009, the fund sold certain securities of cost Rs. 38 lakhs for Rs. 40 lakhs and purchased certain other securities for Rs. 28.20 lakhs. The fund management expenses for the month amounted to Rs. 4.50 lakhs of which Rs. 0.25 lakh was in arrears. The dividend earned was Rs. 1.20 lakhs. 75% of the realized earnings were distributed. The market value of the portfolio on 30.04.2009 was Rs. 101.90 lakh.

Determine NAV per unit.

- (b) From the following details, compute according to Lev and Schwartz (1971) model, the total value of human resources of the employee groups skilled and unskilled.

	Skilled	Unskilled
(i) Annual average earning of an employee till the retirement age	Rs.50,000	Rs.30,000
(ii) Age of retirement	65 years	62 years
(iii) Discount rate	15%	15%
(iv) No. of employees in the group	20	25
(v) Average age	62 years	60 years

(8+8 = 16 Marks)

Answer

(a)

	Rs. in lakhs	Rs. in lakhs
Opening bank balance [(100- 90-7)Rs. lakhs]	3.00	
Add: Proceeds from sale of securities	40.00	
Dividend received	<u>1.20</u>	44.20
Less:		
Cost of securities	28.20	
Fund management expenses [(4.50-0.25) Rs. lakhs]	4.25	
Capital gains distributed [75% of (40.00 – 38.00) Rs. lakhs]	1.50	
Dividends distributed (75% of Rs. 1.20 lakhs)	<u>0.90</u>	<u>(34.85)</u>
Closing bank balance		9.35
Closing market value of portfolio		<u>101.90</u>
		111.25

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Less: Arrears of expenses	<u>0.25</u>	
Closing net assets	<u>111.00</u>	
Number of units		10,00,000
Closing Net Assets Value (NAV)		Rs. 11.10

- (b) According to Lev and Schwartz, the value of human capital embodied in a person of age τ is the present value of his remaining future earnings from employment. Their valuation model for a discrete income stream is given by the following formula:

$$V_{\tau} = \sum_{t=\tau}^t \frac{I(t)}{(1+r)^{t-\tau}}$$

Where,

V_{τ} = the human capital value of a person τ years old.

$I(t)$ = the person's annual earnings up to retirement.

r = a discount rate specific to the person.

t = retirement age.

Value of skilled employees:

$$= \frac{50,000}{(1+0.15)^{(65-62)}} + \frac{50,000}{(1+0.15)^{(65-63)}} + \frac{50,000}{(1+0.15)^{(65-64)}}$$

$$\text{Rs. } 32,875.81 + \text{Rs. } 37,807.18 + \text{Rs. } 43,478.26 = \text{Rs. } 1,14,161.25$$

$$\text{Total value of skilled employees is Rs. } 1,14,161.25 \times 20 = \text{Rs. } 22,83,225.$$

Value of unskilled employees

$$= \frac{30,000}{(1+0.15)^{(62-60)}} + \frac{30,000}{(1+0.15)^{(62-61)}}$$

$$= \frac{30,000}{(1+0.15)^2} + \frac{30,000}{(1+0.15)}$$

$$= 22,684.31 + 26,086.96 = 48,771.27$$

$$\text{Total value of the unskilled employees} = \text{Rs. } 48,771.27 \times 25 = \text{Rs. } 12,19,282$$

$$\therefore \text{Total value of human resources (skilled and unskilled)} = \text{Rs. } 22,83,225 + \text{Rs. } 12,19,282 \\ = \text{Rs. } 35,02,507.$$

Question 6

- Capital adequacy ratio for Non-Banking Financial Companies (NBFC)
- Treatment of refund of Government grants.
- Give four examples of activities that do not necessarily satisfy criterion (a) of paragraph 3 of

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AS 24, but that might do so in combination with other circumstances.

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

Net profit for the year 2008	Rs.12,00,000
Weighted average number of equity shares outstanding during year 2008	5,00,000 shares
Average fair value of one equity share during the year 2008	Rs.20
Weighted average number of shares under option during the year 2008	1,00,000 shares
Exercise price per share under option during the year 2008	Rs.15
(4x4= 16 Marks)	

Answer

- (a) Non-Banking Financial Companies (NBFC) are required to maintain adequate capital. Every NBFC shall maintain a minimum capital ratio consisting of Tier I¹ and Tier II² capital which shall not be less than 12% of its aggregate risk-weighted assets. The total of Tier II capital, at any point of time, shall not exceed 100% of Tier I capital. Capital adequacy is calculated as under:

$$\frac{\text{Tier I + Tier II Capital}}{\text{Risk Adjusted Assets}} \times 100$$

- (b) As per Para 11 of AS 12 "Accounting for Government Grants", government grant that becomes refundable should be treated as an extraordinary item. The amount refundable in respect of a government grant related to revenue is applied first against any unamortized deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement. The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset. Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.
- (c) Para 3 of AS 24 "Discontinuing Operations" explains the criteria for determination of discontinuing operations. According to Paragraph 9 of AS 24, examples of activities that

¹ "Tier-I Capital" means owned fund as reduced by investment in shares of other NBFCs and in shares, debenture, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, 10% of the owned fund.

² "Tier-II capital" includes (i) Preference shares, (ii) Revaluation reserves at discounted rate of 55%, (iii) General provisions and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of one and one fourth percent of risk weighted assets, (iv) hybrid debt capital instruments, (v) subordinated debt.

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do not necessarily satisfy criterion (a) of paragraph 3, but that might do so in combination with other circumstances, include:

- (i) Gradual or evolutionary phasing out of a product line or class of service;
- (ii) Discontinuing, even if relatively abruptly, several products within an ongoing line of business;
- (iii) Shifting of some production or marketing activities for a particular line of business from one location to another; and
- (iv) Closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

(d) Computation of diluted earnings per share

	<i>Earnings</i>	<i>Shares</i>	<i>Earning per share</i>
	<i>(Rs.)</i>		<i>(Rs.)</i>
Net profit for the year 2008	12,00,000		
Weighted average number of equity shares outstanding during the year 2008		5,00,000	
Basic earnings per share (12,00,000/5,00,000)			2.40
Weighted average number of shares under option		1,00,000	
Number of shares that would have been issued at fair value (1,00,000 × 15.00)/20.00)	_____ *	<u>(75,000)</u>	_____
Diluted earnings per share (12,00,000/5,25,000)	<u>12,00,000</u>	<u>5,25,000</u>	<u>2.29</u>

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

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Answer **all** questions.

Wherever appropriate, suitable assumption should be made by the candidates.

Working notes should form part of the answer.

Question 1

- (a) M/s ABC Ltd. is to acquire a personal computer with modem and a printer. Its price is Rs. 60,000. ABC Ltd. can borrow Rs. 60,000 from a commercial bank at 12% interest per annum to finance the purchase. The principal sum is to be repaid in 5 equal year-end instalments.

ABC Ltd. can also have the computer on lease for 5 years.

The firm seeks your advise to know the maximum lease rent payable at each year end. Consider the following additional information:

- (i) Interest on bank loan is payable at each year end.
- (ii) The full cost of the computer will be written off over the effective life of computer on a straight-line basis. This is allowed for tax purposes.
- (iii) At the end of year 5, the computer may be sold for Rs. 1,500 through a second -hand dealer, who will charge 8% commission on the sale proceeds.
- (iv) The company's effective tax rate is 30%.
- (v) The cost of capital is 11%.

Suggest the maximum annual lease rental for ABC Ltd. :

PV Factor at **11%**

Year	PVF
1	0.901
2	0.812
3	0.731
4	0.659
5	0.593

(12 Marks)

- (b) A mutual fund made an issue of 10,00,000 units of Rs. 10 each on January 01, 2008. No entry load was charged. It made the following investments:

	Rs.
50,000 Equity shares of Rs. 100 each @ Rs. 160	80,00,000
7% Government Securities	8,00,000
9% Debentures (Unlisted)	5,00,000

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10% Debentures (Listed)	<u>5,00,000</u>
	<u>98,00,000</u>

During the year, dividends of Rs, 12,00,000 were received on equity shares. Interest on all types of debt securities was received as and when due. At the end of the year equity shares and 10% debentures are quoted at 175% and 90% respectively. Other investments are at par.

Find out the Net Asset Value (NAV) per unit given that operating expenses paid during the year amounted to Rs. 5,00,000. Also find out the NAV, if the Mutual fund had distributed a dividend of Re. 0.80 per unit during the year to the unit holders. (8 Marks)

Answer

(a) Workings:

(i) Annual loan repayment: Rs. $\frac{60,000}{5}$ Rs. 12,000

(ii) Residual sale value at year 5 Rs. 1,500
 (-) Commission at 8% 120
 Profit on sale 1380
 (-) Tax @ 30% 414

Net cash flow (Rs. 1,380 - Rs. 414) = Rs.966

(iii) Net cash outflow under loan option –

Year	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>Total</u>
	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)
Principal repayment	12,000	12,000	12,000	12,000	12,000	60,000
Payment of Interest	7,200	5,760	4,320	2,880	1,440	21,600
(-) Tax Savings @ 30% on depreciation	(3,600)	(3,600)	(3,600)	(3,600)	(3,600)	(18,000)
Tax savings on Interest	<u>(2,160)</u>	<u>(1,728)</u>	<u>(1,296)</u>	<u>(864)</u>	<u>(432)</u>	<u>(6,480)</u>
Net out flow	13,440	12,432	11,424	10,416	9,408	57,120
Discount factor at 11%	0.901	0.812	0.731	0.659	0.593	3.696
PV of cash outflow	12,109	10,095	8,351	6,864	5,579	42,998
Less: PV of Post tax inflow at the end of year 5 Rs. 966×0.593						(573)

PV of net Cash outflows in 5 years 42,425

Computation of Annual Lease Rentals:

PV of post tax Annual Lease Rentals in 5 years should not exceed Rs. 42,425.

Or say, PV of Post-tax Lease Rental for one year. Should not exceed

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$$\text{Rs. } \frac{42,425}{3.696} = \text{Rs. } 11,480$$

$$\begin{aligned} \text{Rs. } 11,480 \text{ post-tax} &= [\text{Rs. } 11,480 / (1-t)] \text{ pretax} \\ &= \text{Rs. } 11,480 / (1 - 0.30) = \text{Rs. } 16,400 \end{aligned}$$

Therefore, maximum pre-tax annual rental should be Rs.16,400

- (b) In order to find out the NAV, the cash balance at the end of the year is calculated as follows-

Cash balance in the beginning	Rs.
(Rs.100 lakhs – Rs. 98 lakhs)	2,00,000
Dividend Received	12,00,000
Interest on 7% Govt. Securities	56,000
Interest on 9% Debentures	45,000
Interest on 10% Debentures	50,000
	15,51,000
(-) Operating expenses	5,00,000
Net cash balance at the end	10,51,000

Calculation of NAV

	Rs.
Cash Balance	10,51,000
7% Govt. Securities (at par)	8,00,000
50,000 equity shares @ Rs. 175 each	87,50,000
9% Debentures (Unlisted) at cost	5,00,000
10% Debentures @90%	4,50,000
Total Assets	1,15,51,000
No. of Units	10,00,000
NAV per Unit	Rs.11.55
Calculation of NAV, if dividend of Re.0.80 is paid –	
Net Assets (Rs. 1,15,51,000 – Rs. 8,00,000)	Rs. 1,07,51,000
No. of Units	10,00,000
NAV per unit	Rs. 10.75

Question 2

- (a) An investor holds two stocks A and B. An analyst prepared ex-ante probability distribution for the possible economic scenarios and the conditional returns for two stocks and the market index as shown below:

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Economic scenario	Probability	Conditional Returns %		
		A	B	Market
Growth	0.40	25	20	18
Stagnation	0.30	10	15	13
Recession	0.30	-5	-8	-3

The risk free rate during the next year is expected to be around 11%. Determine whether the investor should liquidate his holdings in stocks A and B or on the contrary make fresh investments in them. CAPM assumptions are holding true. (10 Marks)

- (b) What are the limitations of Credit Rating? (4 Marks)
- (c) Following Financial data are available for PQR Ltd. for the year 2008 :

	(Rs. in lakh)
8% debentures	125
10% bonds (2007)	50
Equity shares (Rs. 10 each)	100
Reserves and Surplus	300
Total Assets	600
Assets Turnovers ratio	1.1
Effective interest rate	8%
Effective tax rate	40%
Operating margin	10%
Dividend payout ratio	16.67%
Current market Price of Share	14
Required rate of return of investors	15%

You are required to:

- Draw income statement for the year
- Calculate its sustainable growth rate
- Calculate the fair price of the Company's share using dividend discount model, and
- What is your opinion on investment in the company's share at current price?

(6 Marks)

Answer

(a) Expected Return on stock A = $E(A) = \sum_{i=G,S,R} P_i A_i$

(G,S & R, denotes Growth, Stagnation and Recession)

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$$(0.40)(25) + 0.30(10) + 0.30(-5) = 11.5\%$$

Expected Return on 'B'

$$(0.40 \times 20) + (0.30 \times 15) + 0.30 \times (-8) = 10.1\%$$

Expected Return on Market index

$$(0.40 \times 18) + (0.30 \times 13) + 0.30 \times (-3) = 10.2\%$$

Variance of Market index

$$(18 - 10.2)^2 (0.40) + (13 - 10.2)^2 (0.30) + (-3 - 10.2)^2 (0.30) \\ = 24.34 + 2.35 + 52.27 = 78.96\%$$

Covariance of stock A and Market Index M

$$\text{Cov. (AM)} = \sum_{i=G,S,R} ([A_i - E(A)][M_i - E(M)]P_i)$$

$$(25 - 11.5)(18 - 10.2)(0.40) + (10 - 11.5)(13 - 10.2)(0.30) + (-5 - 11.5)(-3 - 10.2)(0.30) \\ = 42.12 + (-1.26) + 65.34 = 106.2$$

Covariance of stock B and Market index M

$$(20 - 10.1)(18 - 10.2)(0.40) + (15 - 10.1)(13 - 10.2)(0.30) + (-8 - 10.1)(-3 - 10.2)(0.30) = 30.89 + 4.12 + 71.67 = 106.68$$

$$\text{Beta for stock A} = \frac{\text{CoV(AM)}}{\text{VAR(M)}} = \frac{106.20}{78.96} = 1.345$$

$$\text{Beta for Stock B} = \frac{\text{CoV(BM)}}{\text{VarM}} = \frac{106.68}{78.96} = 1.351$$

Required Return for A

$$R(A) = R_f + \beta (M - R_f)$$

$$11\% + 1.345(10.2 - 11)\% = 9.924\%$$

Required Return for B

$$11\% + 1.351(10.2 - 11)\% = 9.92\%$$

Alpha for Stock A

$$E(A) - R(A) \text{ i.e. } 11.5\% - 9.924\% = 1.576\%$$

Alpha for Stock B

$$E(B) - R(B) \text{ i.e. } 10.1\% - 9.92\% = 0.18\%$$

Since stock A and B both have positive Alpha, therefore, they are UNDERPRICED. The investor should make fresh investment in them.

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(b) Limitations of Credit Rating

Credit rating is a very important indicator for prudence but it suffers from certain limitations. Some of the limitations are:

- (i) **Conflict of Interest** – The rating agency collects fees from the entity it rates leading to a conflict of interest. Since the rating market is very competitive, there is a distant possibility of such conflict entering into the rating system.
- (ii) **Industry Specific rather than Company Specific** – Downgrades are linked to industry rather than company performance. Agencies give importance to macro aspects and not to micro ones; overreact to existing conditions which come from optimistic / pessimistic views arising out of up / down turns. At times, value judgments are not ruled out.
- (iii) **Rating Changes** – Ratings given to instruments can change over a period of time. They have to be kept under constant watch. Downgrading of an instrument may not be timely enough to keep investors educated over such matters.
- (iv) **Corporate Governance Issues** – Special attention is paid to:
 - (a) Rating agencies getting more of their revenues from a single service or group.
 - (b) Rating agencies enjoying a dominant market position. They may engage in aggressive competitive practices by refusing to rate a collateralized / securitized instrument or compel an issuer to pay for services rendered.
 - (c) Greater transparency in the rating process viz. in the disclosure of assumptions leading to a specific public rating.
- (v) **Basis of Rating** – Ratings are based on 'point of time' concept rather than on 'period of time' concept and thus do not provide a dynamic assessment.
- (vi) **Cost Benefit Analysis** – Since rating is mandatory, it becomes essential for entities to get themselves rated without carrying out cost benefit analysis.

(c) (i) Workings:

Asset turnover ratio	= 1.1
Total Assets	= Rs. 600
Turnover Rs. 600 lakhs × 11	= Rs. 660 lakhs
Effective market rate	= $\frac{\text{Interest}}{\text{Liabilities}} = 8\%$
Liabilities	= Rs. 125 lakhs + 50 lakhs = 175 lakh
Interest	= Rs. 175 lakhs × 0.08 = Rs. 14 lakh
Operating Margin	= 10%
Hence operating cost	= (1 - 0.10) Rs. 660 lakhs = Rs.594 lakh
Dividend Payout	= 16.67%
Tax rate	= 40%

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Income statement

	(Rs. Lakhs)
Sale	660
Operating Exp	<u>594</u>
EBIT	66
Interest	<u>14</u>
EBT	52
Tax @ 40%	<u>20.80</u>
EAT	31.20
Dividend @ 16.67%	<u>5.20</u>
Retained Earnings	<u>26.00</u>

(ii) $SGR = G = ROE (1-b)$

$$ROE = \frac{PAT}{NW} \text{ and } NW = \text{Rs.100 lakh} + \text{Rs. 300 lakh} = 400 \text{ lakh}$$

$$ROE = \frac{\text{Rs.31.2lakhs}}{\text{Rs.400lakhs}} \times 100 = 7.8\%$$

$$SGR = 0.078(1 - 0.1667) = 6.5\%$$

(iii) Calculation of fair price of share using dividend discount model

$$P_0 = \frac{D_0(1+g)}{k_e - g}$$

$$\text{Dividends} = \frac{\text{Rs.5.2lakhs}}{10\text{lakhs}} = \text{Rs. 0.52}$$

$$\text{Growth Rate} = 6.5\%$$

$$\text{Hence } P_0 = \frac{\text{Rs.0.52}(1+ 0.065)}{0.15 - 0.065} = \frac{\text{Rs.0.5538}}{0.085} = \text{Rs.6.51}$$

(iv) Since the current market price of share is Rs.14, the share is overvalued. Hence the investor should not invest in the company.

Question 3

(a) Closing values of BSE Sensex from 6th to 17th day of the month of January of the year 200X were as follows :

Days	Date	Day	Sensex
1	6	THU	14522

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2	7	FRI	14925
3	8	SAT	No Trading
4	9	SUN	No Trading
5	10	MON	15222
6	11	TUE	16000
7	12	WED	16400
8	13	THU	17000
9	14	FRI	No Trading
10	15	SAT	No Trading
11	16	SUN	No Trading
12	17	MON	18000

Calculate Exponential Moving Average (EMA) of Sensex during the above period. The 30 days simple moving average of Sensex can be assumed as 15,000. The value of exponent for 30 days EMA is 0.062.

Give detailed analysis on the basis of your calculations. (6 Marks)

- (b) XYZ company has current earnings of Rs. 3 per share with 5,00,000 shares outstanding. The company plans to issue 40,000, 7% convertible preference shares of Rs. 50 each at par. The preference shares are convertible into 2 shares for each preference shares held. The equity share has a current market price of Rs. 21 per share.

- What is preference share's conversion value?
- What is conversion premium?
- Assuming that total earnings remain the same, calculate the effect of the issue on the basic earning per share (a) before conversion (b) after conversion.
- If profits after tax increases by Rs. 1 million what will be the basic EPS (a) before conversion and (b) on a fully diluted basis? (8 Marks)

- (c) What is the impact of GDRs on Indian Capital Market? (6 Marks)

Answer

(a)

Date	1 Sensex	2 EMA for Previous day	3 1-2	4 3×0.062	5 EMA 2 ± 4
6	14522	15000	(478)	(29.636)	14970.364

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7	14925	14970.364	(45.364)	(2.812)	14967.55
10	15222	14967.55	254.45	15.776	14983.32
11	16000	14983.32	1016.68	63.034	15046.354
12	16400	15046.354	1353.646	83.926	15130.28
13	17000	15130.28	1869.72	115.922	15246.203
17	18000	15246.203	2753.797	170.735	15416.938

Conclusion – The market is bullish. The market is likely to remain bullish for short term to medium term if other factors remain the same. On the basis of this indicator (EMA) the investors/brokers can take long position.

(b) (i) Conversion value of preference share

$$2 \times \text{Rs. } 21 = \text{Rs. } 42$$

Conversion Ratio x Market Price

(ii) Conversion Premium

$$(\text{Rs. } 50 / \text{Rs. } 42) - 1 = 19.05\%$$

(iii) Effect of the issue on basic EPS

BEFORE CONVERSION

Total (after tax) earnings $3 \times \text{Rs. } 5,00,000$	Rs. 15,00,000
Dividend or Preference shares	<u>Rs. 1,40,000</u>
Earnings available to equity holders	<u>Rs. 13,60,000</u>
No. of shares	5,00,000
EPS	Rs. 2.72

ON DILUTED BASIS

Earnings	Rs. 15,00,000
No of shares (Rs. 5,00,000 + Rs. 80,000)	Rs. 5,80,000
EPS	Rs. 2.59

(iv) EPS with increase in Profit

Earnings	Rs. 25,00,000
Dividend on Pref. shares	<u>Rs. 1,40,000</u>
Earning for equity shareholders	<u>Rs. 23,60,000</u>
No. of equity shares	5,00,000
EPS	Rs. 4.72

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On DILUTED BASIS

Earnings	Rs. 25,00,000
No. of shows	5,80,000
EPS	Rs. 4.31

(c) Impact of Global Depository Receipts (GDRs) on Indian Capital Market

After the globalization of the Indian economy, accessibility to vast amount of resources was available to the domestic corporate sector. One such accessibility was in terms of raising financial resources abroad by internationally prudent companies. Among others, GDRs were the most important source of finance from abroad at competitive cost. Global depository receipts are basically negotiable certificates denominated in US dollars, that represent a non- US company's publicly traded local currency (Indian rupee) equity shares. Companies in India, through the issue of depository receipts, have been able to tap global equity market to raise foreign currency funds by way of equity.

Since the inception of GDRs, a remarkable change in Indian capital market has been observed. Some of the changes are as follows:

- (i) Indian capital market to some extent is shifting from Bombay to Luxemburg and other foreign financial centres.
- (ii) There is arbitrage possibility in GDR issues. Since many Indian companies are actively trading on the London and the New York Exchanges and due to the existence of time differences, market news, sentiments etc. at times the prices of the depository receipts are traded at discounts or premiums to the underlying stock. This presents an arbitrage opportunity wherein the receipts can be bought abroad and sold in India at a higher price.
- (iii) Indian capital market is no longer independent from the rest of the world. This puts additional strain on the investors as they now need to keep updated with worldwide economic events.
- (iv) Indian retail investors are completely sidelined. Due to the placements of GDRs with Foreign Institutional Investor's on the basis free pricing, the retail investors can now no longer expect to make easy money on heavily discounted right/public issues.
- (v) A considerable amount of foreign investment has found its way in the Indian market which has improved liquidity in the capital market.
- (vi) Indian capital market has started to reverberate by world economic changes, good or bad.
- (vii) Indian capital market has not only been widened but deepened as well.
- (viii) It has now become necessary for Indian capital market to adopt international practices in its working including financial innovations.

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Question 4

(a) You have been provided the following Financial data of two companies:

	Krishna Ltd.	Rama Ltd.
Earnings after taxes	Rs. 7,00,000	Rs. 10,00,000
Equity shares (outstanding)	Rs. 2,00,000	Rs. 4,00,000
EPS	3.5	2.5
P/E ratio	10 times	14 times
Market price per share	Rs. 35	Rs. 35

Company Rama Ltd. is acquiring the company Krishna Ltd., exchanging its shares on a one-to-one basis for company Krishna Ltd. The exchange ratio is based on the market prices of the shares of the two companies.

Required:

- (i) What will be the EPS subsequent to merger?
 - (ii) What is the change in EPS for the shareholders of companies Rama Ltd. and Krishna Ltd.?
 - (iii) Determine the market value of the post-merger firm. PE ratio is likely to remain the same.
 - (iv) Ascertain the profits accruing to shareholders of both the companies. (10 Marks)
- (b) An investors is considering the purchase of the following Bond:

Face value	Rs. 100
Coupon rate	11%
Maturity	3 years

- (i) If he wants a yield of 13% what is the maximum price he should be ready to pay for?
 - (ii) If the Bond is selling for Rs.97.60, what would be his yield? (4 Marks)
- (c) A firm had been paid dividend at Rs.2 per share last year. The estimated growth of the dividends from the company is estimated to be 5% p.a. Determine the estimated market price of the equity share if the estimated growth rate of dividends (i) rises to 8%, and (ii) falls to 3%. Also find out the present market price of the share, given that the required rate of return of the equity investors is 15.5%. (6 Marks)

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Answer

(a)

(i)	Exchange Ratio	1:1
	New Shares to be issued	2,00,000
	Total shares of Rama Ltd. (4,00,000+2,00,000)	6,00,000
	Total earnings (Rs. 10,00,000 + Rs. 7,00,000)	Rs. 17,00,000
	New EPS (Rs. 17,00,000/6,00,000)	Rs. 2.83
(ii)	Existing EPS of Rama Ltd.	Rs. 2.50
	Increase in EPS of Rama Ltd (Rs. 2.83 – Rs. 2.50)	Rs. 0.33
	Existing EPS of Krishna Ltd.	Rs. 3.50
	Decrease in EPS of Krishna Ltd. (Rs. 3.50 – Rs. 2.83)	Rs. 0.67
(iii)	P/E ratio of new firm (expected to remain same)	14 times
	New market price (14 × Rs. 2.83)	Rs. 39.62
	Total No. of Shares	6,00,000
	Total market Capitalization (6,00,000 × Rs. 39.62)	Rs. 2,37,72,000
	Existing market capitalization (Rs. 70,00,000 + Rs. 1,40,00,000)	<u>Rs. 2,10,00,000</u>
	Total gain	<u>Rs. 27,72,000</u>

(iv)

	Rama Ltd.	Krishna Ltd	Total
No. of shares after merger	4,00,000	2,00,000	6,00,000
Market price	Rs. 39.62	Rs. 39.62	Rs. 39.62
Total Mkt. Values	Rs. 1,58,48,000	Rs. 79,24,000	Rs. 2,37,72,000
Existing Mkt. values	<u>Rs. 1,40,00,000</u>	<u>Rs. 70,00,000</u>	<u>Rs. 2,10,00,000</u>
Gain to share holders	18,48,000	9,24,000	27,72,000
or Rs. 27,72,000 ÷ 3 = Rs. 9,24,000 to Krishna Ltd. and Rs. 18,48,000 to Rama Ltd. (in 2: 1 ratio)			

(b) (i) Calculation of Maximum price

$$\begin{aligned}
 B_0 &= \text{Rs.}11 \times \text{PVIFA} (13\%,3) + \text{Rs.}100 \times \text{PVIF} (13\%,3) \\
 &= \text{Rs.}11 \times 2.361 + \text{Rs.}100 \times 0.693 \\
 &= \text{Rs.} 25.97 + \text{Rs.} 69.30 = \text{Rs.} 95.27
 \end{aligned}$$

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(ii) Calculation of yield

$$\begin{aligned}\text{At 12\% the value} &= \text{Rs.11} \times \text{PVIFA (12\%,3)} + 100 \times \text{PVIF (12\%,3)} \\ &= \text{Rs. 11} \times 2.402 + \text{Rs. 100} \times 0.712 \\ &= \text{Rs. 26.42} + \text{Rs. 71.20} \\ &= \text{Rs. 97.62}\end{aligned}$$

It the bond is selling at Rs.97.60 which is more than the fair value, the YTM of the bond would be less than 13%. This value is almost equal to the amount price of Rs.97.60. Therefore, the YTM of the bond would be 12%.

Alternatively

$$\text{YTM} = \frac{\text{Rs.11} + \frac{(\text{Rs.100} - \text{Rs.97.60})}{3}}{\frac{(\text{Rs.100} + \text{Rs.97.60})}{2}} = 0.1194 \text{ or } 11.94\% \text{ say } 12\%$$

- (c) In this case the company has paid dividend of Rs.2 per share during the last year. The growth rate (g) is 5%. Then, the current year dividend (D_1) with the expected growth rate of 5% will be Rs.2.10

$$\begin{aligned}\text{The share price is } P_0 &= \frac{D_1}{K_e - g} \\ &= \frac{\text{Rs. 2.10}}{0.155 - 0.05} \\ &= \text{Rs.20}\end{aligned}$$

In case the growth rate rises to 8% then the dividend for the current year. (D_1) would be Rs. 2.16 and market price would be-

$$\begin{aligned}&= \frac{\text{Rs. 2.16}}{0.155 - 0.08} \\ &= \text{Rs. 28.80}\end{aligned}$$

In case growth rate falls to 3% then the dividend for the current year (D_1) would be Rs. 2.06 and market price would be-

$$\begin{aligned}&= \frac{\text{Rs. 2.06}}{0.155 - 0.03} \\ &= \text{Rs.16.48}\end{aligned}$$

So, the market price of the share is expected to vary in response to change in expected growth rate is dividends.

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Question 5

- (a) *M/s Omega Electronics Ltd. exports air conditioners to Germany by importing all the components from Singapore. The company is exporting 2,400 units at a price of Euro 500 per unit. The cost of imported components is S\$ 800 per unit. The fixed cost and other variables cost per unit are Rs. 1,000 and Rs. 1,500 respectively. The cash flows in Foreign currencies are due in six months. The current exchange rates are as follows:*

Rs/Euro	51.50/55
Rs/S\$	27.20/25

After six months the exchange rates turn out as follows:

Rs/Euro	52.00/05
Rs/S\$	27.70/75

- (1) *You are required to calculate loss/gain due to transaction exposure.*
- (2) *Based on the following additional information calculate the loss/gain due to transaction and operating exposure if the contracted price of air conditioners is Rs.25,000 :*

- (i) *the current exchange rate changes to*

Rs/Euro	51.75/80
Rs/S\$	27.10/15

- (ii) *Price elasticity of demand is estimated to be 1.5*

- (iii) *Payments and receipts are to be settled at the end of six months. (12 Marks)*

- (b) *A study by a Mutual fund has revealed the following data in respect of three securities:*

Security	σ (%)	Correlation with Index, P_m
A	20	0.60
B	18	0.95
C	12	0.75

The standard deviation of market portfolio (BSE Sensex) is observed to be 15%.

- (i) *What is the sensitivity of returns of each stock with respect to the market?*
- (ii) *What are the covariances among the various stocks?*
- (iii) *What would be the risk of portfolio consisting of all the three stocks equally?*
- (iv) *What is the beta of the portfolio consisting of equal investment in each stock?*
- (v) *What is the total, systematic and unsystematic risk of the portfolio in (iv) ? (8 Marks)*

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

Answer

(a) Profit at current exchange rates

$$2400 [\text{€ } 500 \times \text{S\$ } 51.50 - (\text{S\$ } 800 \times \text{Rs. } 27.25 + \text{Rs. } 1,000 + \text{Rs. } 1,500)]$$

$$2400 [\text{Rs. } 25,750 - \text{Rs. } 24,300] = \text{Rs. } 34,80,000$$

Profit after change in exchange rates

$$2400 [\text{€ } 500 \times \text{Rs. } 52 - (\text{S\$ } 800 \times \text{Rs. } 27.75 + \text{Rs. } 1000 + \text{Rs. } 1500)]$$

$$2400 [\text{Rs. } 26,000 - \text{Rs. } 24,700] = \text{Rs. } 31,20,000$$

LOSS DUE TO TRANSACTION EXPOSURE

$$\text{Rs. } 34,80,000 - \text{Rs. } 31,20,000 = \text{Rs. } 3,60,000$$

Profit based on new exchange rates

$$2400 [\text{Rs. } 25,000 - (800 \times \text{Rs. } 27.15 + \text{Rs. } 1,000 + \text{Rs. } 1,500)]$$

$$2400 [\text{Rs. } 25,000 - \text{Rs. } 24,220] = \text{Rs. } 18,72,000$$

Profit after change in exchange rates at the end of six months

$$2400 [\text{Rs. } 25,000 - (800 \times \text{Rs. } 27.75 + \text{Rs. } 1,000 + \text{Rs. } 1,500)]$$

$$2400 [\text{Rs. } 25,000 - \text{Rs. } 24,700] = \text{Rs. } 7,20,000$$

Decline in profit due to transaction exposure

$$\text{Rs. } 18,72,000 - \text{Rs. } 7,20,000 = \text{Rs. } 11,52,000$$

$$\text{Current price of each unit in S\$} = \frac{\text{Rs. } 25,000}{\text{Rs. } 51.50} = \text{S\$ } 485.44$$

$$\text{Price after change in Exch. Rate} = \frac{\text{Rs. } 25,000}{\text{Rs. } 51.75} = \text{S\$ } 483.09$$

Change in Price due to change in Exch. Rate

$$\text{S\$ } 485.44 - \text{S\$ } 483.09 = \text{S\$ } 2.35$$

$$\text{or } (-) 0.48\%$$

Price elasticity of demand = 1.5

$$\text{Increase in demand due to fall in price} \quad 0.48 \times 1.5 = 0.72\%$$

$$\text{Size of increased order} = 2400 \times 1.0072 = 2417 \text{ units}$$

$$\text{Profit} = 2417 [\text{Rs. } 25,000 - (800 \times \text{Rs. } 27.75 + \text{Rs. } 1,000 + \text{Rs. } 1,500)]$$

$$= 2417 [\text{Rs. } 25,000 - \text{Rs. } 24,700] = \text{Rs. } 7,25,100$$

$$\text{Therefore, decrease in profit due to operating exposure} \quad \text{Rs. } 18,72,000 - \text{Rs. } 7,25,100 = \text{Rs. } 11,46,900$$

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- (b) (i) Sensitivity of each stock with market is given by its beta.

Standard deviation of Index = 15%

Variance of market Index = 0.0225

Beta of stocks = $\sigma_i r / \sigma_m$

A = $20 \times 0.60 / 15 = 0.80$

B = $18 \times 0.95 / 15 = 1.14$

C = $12 \times 0.75 / 15 = 0.60$

- (ii) Covariance between any 2 stocks = $\beta_1 \beta_2 \sigma_m^2$

	<u>Covariance matrix</u>		
Stock/Beta	0.80	1.14	0.60
A	400.000	205.200	108.000
B	205.200	324.000	153.900
C	108.000	153.900	144.000

- (iii) Total risk of the equally weighted portfolio = Variance = 200.244

- (iv) β of equally weighted portfolio = $\beta_p = \sum \beta_i / N = \frac{0.80 + 1.14 + 0.60}{3}$
 = 0.8467

- (v) Systematic Risk $\beta_p^2 \sigma_m^2 = 161.290$

Unsystematic Risk = Total Risk – Systematic Risk
 = 200.244 – 161.290
 = 38.954

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

Answer **all** questions.

Question 1

Comment on the following:

- (a) 'A' Limited has paid minimum alternate tax under Section 115 JB of the Income Tax Act, 1961, for the year ended 31st March, 2009. The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same. (5 Marks)
- (b) XYZ Limited received a grant of Rs.25 lakhs under the Government's Subsidy Scheme, for acquiring an imported machinery for setting up new plant. The entire grant received is credited to Profit and Loss Account. (5 Marks)
- (c) Moon Limited replaced its statutory auditor for the Financial year 2008-09. During the course of audit, the new auditor found a credit item of Rs.5 lakhs. On enquiry, the company explained him that it is, a very old credit balance. The creditor had neither approached for the payment nor he is traceable. Under the circumstances, no confirmation of the credit balance is available. (5 Marks)
- (d) The statutory audit of Fortune Limited for the year ended on 31.03.2009 was completed and auditor also submitted his report with the audited Financial Statements to the management of the company. Thereafter, the management of the company approached the auditor to revise certain items in the Financial Statements. (5 Marks)

Answer

- (a) As per para 6 of the Guidance Note issued by ICAI on "Accounting for credit available in respect of MAT under the IT Act, 1961", although MAT credit is not a deferred tax asset under AS 22, yet it gives rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specific period.

The Framework for the preparation and presentation of financial statements, issued by the ICAI, defines the term 'asset' is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

MAT paid in a year in respect of which the credit is allowed during the specified period under the Income Tax Act is a resource controlled by the company as a result of past event, namely the payment of MAT. The MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period. Accordingly, such credit is an asset.

According to the Framework, once an item meets the definition of the term 'Asset', it has to meet the criteria for recognition of an asset, so that it may be recognised as such in the financial statements.

Para 88 of the Framework provides the following criteria for recognition of an asset:

An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value

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that can be measured reliably.

Thus, if the auditor is satisfied that the probability of the company to claim the said credit is high, it could recognise the same as an asset. In balance sheet it could be shown under the head "Loans and Advances" as MAT credit entitlement.

- (b) According to AS 12, "Accounting for Government Grants" where grant is received for the acquisition of a specific fixed asset, the same cannot be credited to Profit and Loss Account since it fails to match revenue with the cost.

As per AS 12, such grants should be presented in the balance sheet showing the grant as a deduction from the gross value of the asset concerned (in arriving at its book value). Alternately, the grants related to a depreciable fixed asset may be treated as deferred income which should be recognised in the profit and loss account on a systematic and rational basis over the useful life of the asset. By crediting the entire amount of grant to profit and loss account, the company has treated it as a revenue income which is not in accordance with the requirements of the accounting standard.

Therefore, the statutory auditor would have to qualify appropriately that the income has been overstated to the extent of the amount of grant net of proportionate credit that would have been worked out.

- (c) This is a case of external confirmation, covered by SA 505 "External Confirmation". The identities of creditors are not traceable to confirm the credit balance as appearing in the financial statement of the company. It is also not a case of pending litigation.

It might be a case that an income of Rs.4 lakhs had been hidden in previous year/s. The statutory auditor should examine the validity of the credit balance as appeared in the company's financial statements. He should obtain sufficient evidence in support of the balance. He should apply alternative audit procedures to get documentary proof for the transaction/s and should not rely entirely on the management representation. Finally, he should include the matter by way of a qualification in his audit report to the members.

- (d) As per the Guidance Note on Revised Accounts of Companies Before Circulation to Shareholders, management can revise its accounts after adoption on which report has been issued by the Auditors, but before circulation to the shareholders.

In the instant case, the statutory auditor should ascertain whether the original audit report along with audited accounts has been circulated to the share-holders. If not, he can issue a revised report on the amended financial statements as laid down by the said Guidance Note:

- (i) For the same, the revised accounts must be re-approved by the Board of Directors of the company.
- (ii) He should ask the company to return all the original copies of the earlier audit report along with the audited accounts.
- (iii) The fact of revision of financial statements with reasons should be incorporated in the Directors' Report. If it is neither included nor found adequately disclosed in the Director's Report, he should include the fact with figures and reasons in his revised

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audit report to the shareholders. He should specifically mention that it is a revised audit report.

Question 2

Give your comments with reference to the Chartered Accountants Act, and schedules thereto:

- (a) *Mrs. Fair is a Director of XYZ Private Limited, having 15% share-holdings in the company. During 2003, the company appointed C.A. Mr. Lovely, Mrs. Fair's spouse, as its statutory auditor. On Mr. Lovely's advice, the company issued fresh equity shares in 2003-04, in the ratio of one share for every two shares held by the shareholders of the company. Mr. Lovely used to deliver audit report for subsequent years without any comments or disclosures, thereupon.* (4 Marks)
- (b) *Mr. A, a Chartered Accountant was the auditor of 'A Limited'. During the financial year 2007-08, the investment appeared in the Balance Sheet of the company of Rs.10 lakhs and was the same amount as in the last year. Later on, it was found that the company's investments were only Rs.25,000, but the value of investments was inflated for the purpose of obtaining higher amount of Bank loan.* (4 Marks)
- (c) *An advertisement was published in a Newspaper containing the photograph of Mr. X, a member of the institute wherein he was congratulated on the occasion of the opening ceremony of his office.* (4 Marks)
- (d) *Mr. X, a Chartered Accountant and the proprietor of X & Co., wrote several letters to the Assistant Registrar of Co-operative Societies stating that though his firm was on the panel of auditors, no audit work was allotted to the firm and further requested him to look into the matter.* (4 Marks)

Answer

- (a) As per the Companies Act, 1956, the definition of 'Relative' includes husband and wife. In this case M and N are spouse of each other. Mr. Lovely should not accept the appointment as Statutory auditor of the company, where his wife M has vulnerable interest. Where the company issued fresh equity shares on N's advice, it is an apparent evidence of N's control and direction over the company. Because of fresh issue of equity shares, Mr. Lovely's shareholding became 22.5% (15% + 50% thereof) and thus his wife now has substantial interest (i.e. more than 20%) in the said company. Mr. Lovely did not declare such interest of his wife, as substantial shareholder in the company in his audit report/s of the subsequent years, as he never offered any comment.

The independence of the auditor would be compromised without a declaration of his substantial interest. So Mr. Lovely is therefore liable for misconduct.

- (b) The primary duty of physical verification and valuation of investments is of the management. However, the auditor's duty is also to verify the physical existence and valuation of investments placed, at least on the last day of the accounting year. The auditor should verify the documentary evidence for the cost/value and physical existence of the investments at the end of the year. He should not blindly rely upon the Management's representation. In the instant case, such non-verification happened for

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two years. It also appear that auditors failed to confirm the value of investments from any proper source. In case auditor has simply relied on the management's representation the auditor has failed to perform his duty. Accordingly, Mr. A, will be held liable for professional misconduct under clauses (2), (7) and (8) of Part -1 of the Second Schedule to the Chartered Accountants Act, 1949 in terms of Sections 21 and 22.

- (c) Mr. X published an advertisement in a Newspaper containing his photograph on the occasion of the opening ceremony of his office. On this context, it may be noted that the advertisement which had been put in by the member is quite prominent. If soliciting of work is allowed, the independence and forthrightness of a Chartered Accountant in the discharge of duties can not be maintained.

The above therefore amounts to soliciting professional work by advertisement directly or indirectly. Mr. X would be therefore held guilty under Clause 6 of Part-I of the First Schedule to the Chartered Accountants Act, 1949.

- (d) Mr. X, a Chartered Accountant and proprietor of M/s X and Co, wrote several letters to the Assistant Registrar of Co-operative Societies, requesting for allotment of audit work. In similar cases, it was held that the Chartered Accountant would be guilty of professional misconduct under clause 6 of Part I of the First schedule to the Chartered Accountants Act, 1949. The writing of continuous letter to ascertain the reasons for not getting the work is quite alright but in case such either amount to request for allowing the work than Mr. X will be liable for professional misconduct. In fact Mr. X would be therefore held guilty under clause 6 of Part I of the Act.

Question 3

Answer the following:

- (a) *Briefly explain:*
- (i) *Audit procedures on subsequent events*
 - (ii) *Collection of evidences by Peer reviewer.* (8 Marks)
- (b) *ABC Printing Press, a proprietary concern, made a turnover of above Rs.43 lacs for the year ended 31.03.2009. The Management explained its auditor Mr. Z, that it undertakes different job work orders from customers. The raw materials required for every job are dissimilar. It purchases the raw materials as per specification/requirements of each customer, and there is hardly any balance of raw materials remaining in the stock, except pending work-in-progress at the year end. Because of variety and complexity of materials, it is rather impossible to maintain a stock-register. Give your comments.* (5 Marks)
- (c) *A Co-operative Society having receipts above Rs.40 lakhs gets its accounts audited by a person eligible to do audit under Co-operative Societies Act, 1912, who is not a Chartered Accountant. State with reasons whether such audit report can be furnished as tax audit report under Section 44 AB of the Income Tax Act, 1961?* (3 Marks)

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Answer

(a) (i) Audit Procedures on Subsequent Events

As per SA 560 “Subsequent Events”, events occurring between the dates of balance sheet and audit report and the facts that become known to the auditor after the date of the auditor’s report.

The Auditor should perform the following procedure to obtain sufficient appropriate evidence to find out the adjustments or disclosures of those subsequent events:

- (i) Review the procedures adopted by the management to identify subsequent events.
- (ii) Examine the minutes of the Board of Directors, Executive Committees and the General Meetings of the shareholders.
- (iii) Collect information from the other sources like budgets/estimates, cash flows, forecasts, interim financial statements etc.
- (iv) Make enquiries and hold discussions with the top management.
- (v) Details from company’s lawyers for any litigation matter.

(ii) Collection of Evidence by Peer Reviewer

A Peer Reviewer collects evidence by applying the following methods:

- (a) *Inspection*: It includes scrutiny of documentation and other records of the practicing unit.
 - (b) *Observation*: He observes the procedures/processes followed in the production unit.
 - (c) *Enquiries*: He enquires and collects required information from the responsible person of practice unit, even by the use of questionnaire.
- (b) The explanation of the entity for the use of varieties of raw materials for different jobs undertaken may be valid. But the auditor needs to verify the specified job-orders received and the different raw materials purchased for each job separately. The use of different papers (quality, quantity and size) ink, colour etc. may be examined. If possible, the auditor may also enquire with the other similar printers in the locality to ensure the prevailing custom. At the same time, he has to report and certify under the Para 28(b) and Para 9(b) of Form 3CD read with the Rule 6G(2) of the Income Tax Act, 1961, about the details of stock and account books (including stock register) maintained. He (or his deputy) must verify the closing stock of raw materials, work-in-progress and finished goods of the concern, at least on the date of its balance sheet. In case the said details are not properly maintained, he has to specifically mention the same with reasons for non-maintenance of stock register by the entity.
- (c) Proviso to Section 44AB lays down that where the accounts of an assessee are required to be audited by or under any other law, it shall be sufficient compliance with the provisions of this section, if such person get the accounts of such organisation audited under such other law before the specified date and furnishes by that date the report of the audit as required

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under such other law and a further report by an accountant in the form prescribed under this section.

In the case of any assessee like co-operative society where the accounts under the relevant law are allowed to be audited by a person other than a Chartered Accountant, the statutory auditor need not be a Chartered Accountant.

Thus, it shall be sufficient compliance with the provisions of this section and can be considered under section 44AB.

Question 4

Answer the following:

- (a) *How will you evaluate the Internal Control system in the area of Credit Card operations of a Bank?* (5 Marks)
- (b) *Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward in case of a General Insurance Company.* (5 Marks)
- (c) *Explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from Management Fraud.* (6 Marks)

Answer

(a) Evaluation of Internal Control System in the area of Credit Card Operations in a bank:

- (i) There should be effective screening of applications with reasonably good credit assessments.
- (ii) There should be strict control over storage and issue of cards.
- (iii) There should be a system whereby a merchant confirms the status of unutilised limit of a credit-card holder from the bank before accepting the settlement in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.
- (iv) There should be system of prompt reporting by the merchants of all settlements accepted by them through credit cards.
- (v) Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards.
- (vi) All the reimbursements (gross of commission) should be immediately charged to the customer's account.
- (vii) There should be a system to ensure that statements are sent regularly and promptly to the customer.
- (viii) There should be a system of monitor and follow-up of customers' payments.
- (ix) Items overdue beyond a reasonable period should be identified and attended to carefully. Credit should be stopped by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses.
- (x) There should be a system of periodic review of credit card holders' accounts. On this basis, the limits of customers may be revised, if necessary. The review should

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also include determination of doubtful amounts and the provisioning in respect thereof.

(b) Steps under sub-regulation 4 of the IRDA (General Insurance – Re-insurance) Regulations, 2000

- (1) The auditor should verify that re-insurance underwriting returns received from the operating units regarding premium, claims paid, outstanding claims tally with the audited figures of premium, claims paid and outstanding claims.
- (2) The auditor should check whether the pattern of reinsurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.
- (3) The auditor should also check whether the cessions have been made as per the stipulation applicable to various categories of risk.
- (4) The auditor should verify whether the cessions have been made as per the agreements entered into with various companies.
- (5) It should also be seen whether the outward remittances to foreign re-insurers have been done as per the foreign exchange regulations.
- (6) It should also be seen whether the on cessions have been calculated as per the terms of the agreements with the re-insurers.
- (7) The auditor should verify the computation of profit commission for various automatic treaty arrangements in the light of the periodical accounts rendered and in relation to outstanding loss pertaining to the treaty.
- (8) The auditor should examine whether the cash loss recoveries have been claimed and accounted on a regular basis.
- (9) The auditor should also verify whether the claims paid item appears in outstanding claims list by error. This can be verified at least in respect of major claims.
- (10) He should see whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support should be insisted and verified.
- (11) Accounting aspects of the re-insurance cession premium, commission receivable, paid claims recovered, and outstanding losses recoverable on cessions have to be checked.
- (12) The auditor should check percentage pattern of gross to net premium, claims paid and outstanding claims to ensure comparative justification.
- (13) The auditor should also check that the re-insurers balance on cessions and whether the sub ledger balances tallies with the general ledger balance.
- (14) The auditor should review the individual accounts to find out whether any balance requires provisioning/write off or write back.
- (15) He should verify whether the balances with re-insurers are supported by necessary confirmation obtained from them.
- (16) He should verify whether opening outstanding claims not paid during the year find place in the closing outstanding claims vis-avis the reinsurance inwards outstanding

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losses recoverable on cessions appears in both opening and closing list. If not, the reason for the same should be analysed.

- (17) Any major event after the balance sheet date which might have wider impact with reference to subsequent changes regarding the claim recovery both paid and outstanding and also re-insurance balances will need to be brought out suitably.

(c) Duties & Responsibilities of an auditor in case of Material misstatement resulting from management fraud

Misstatement in the financial statements can arise from fraud or error. The term fraud refers to an 'Intentional Act' by one or more individuals among management, those charged with governance. The auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements.

Fraud involving one or more members of management or those charged with the governance is referred to as "management fraud". The primary responsibility for the prevention and detection of fraud rests with those charged with the governance and the management of the entity.

SA 200A (AAS 2) indicates that an audit conducted in accordance with the standards on auditing generally accepted in India, is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement whether caused by error or fraud. The fact that an audit is carried out may act as deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of financial statements will not be detected, even though the audit is properly planned and performed in accordance with the standards on auditing generally accepted in India. An audit does not guarantee that all material misstatement will be detected because of such factors, as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.

Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees. Auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, hence in an audit, the auditor does not guarantee that material misstatements, will be detected.

Question 5

Answer the following:

- (a) *State briefly eight provisions of the Sarbanes-Oxley Act of 2002, which shall, if strictly applied to Indian Corporates, get fruitful results.* (8 Marks)
- (b) *Discuss briefly Accounting standards to be followed by assessee under the Income-tax Law.* (4 Marks)
- (c) *Under what circumstances, an auditor is required to submit a special report to the registrar of Co-operative Societies?* (4 Marks)

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

Answer

(a) Following are some provisions of the Sarbanes-Oxley Act of 2002, which, if enacted in India may be further fruitful in respect of Indian corporate:

1. More independence be given to Audit Committee and auditor.
2. Ban on personal loan to Directors / Executive Officers of a Company
3. Strict reporting by an auditor on insider trading.
4. Additional disclosures imposed on financial reporting.
5. If there is any conflict between company and its auditor, the Audit Committee should be empowered to resolve the same.
6. Higher penalties and criminal prosecution on financial frauds.
7. To include effectiveness of Internal Control System in the financial reporting.
8. More responsibilities must be imposed on managerial personnel with higher penalties and prosecutions on the breach.
9. Strict action against white collar crime.
10. Disclosures of the % of shareholdings by Directors, Executive Officers and principal shareholders.

(b) **Accounting Standards under the Income Tax Law:** The Finance Act, 1995, substituted a new Section 145 w.e.f. 1997-98. The section deals with method of accounting as under:

- 145 (1) Income chargeable under the head '*Profit and gains of business and profession*' or '*Income from other sources*' shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.
- 145(2) The Central Government may notify in the Official Gazette from time to time accounting standards to be followed by any class of assessee or in respect of any class of income.
- 145 (3) Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee, or where method of accounting provided in the Sub-section 10 or accounting standards as notified under Section (2) above have not been regularly followed by the assessee. The Assessing Officer may make an assessment in a manner provided in Section 144 of the Income Tax Act.

The Central Government has by Notification No. S. O. 69 (E), dated 25.01.1996, prescribed. As (IT) as under:

- A. Accounting Standard I relating to Disclosure of accounting policies.
- B. Accounting Standard II relating to Disclosure of Prior Period and Extraordinary Items and Changes in Accounting Policies.

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The above Accounting Standards are to be followed by all assessee following mercantile system of accounting. Therefore, it is clear that those assessees who are following cash system of accounting need not follow the Accounting Standards notified above.

- (c) Under the following circumstances, an auditor has to issue special report to the Registrar of Co-operative Societies (This report should be in addition to the regular report) :
1. (a) Any member of the managing committee is involved in personal profit making by using the properties or assets of the society, resulting into the loss to the society.
(b) Frauds are detected from the society's transactions.
 2. There is mismanagement in the society and the principles of co-operative are not maintained by the management.
 3. In the respect of audit of Urban Co-operative Banks, disproportionate advances to vested interest groups. Such as relative of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

Question 6

Answer the following:

- (a) *The role of an auditor in collecting audit evidences under EDP system is more complex than under the manual system - Discuss.* (8 Marks)
- (b) *What do you understand about Reserved Capital as provided under Section 99 of the Companies Act, 1956? How is it different from Capital Reserve?* (4 Marks)
- (c) *Explain briefly the Flow Chart technique for evaluation of the Internal Control system.* (4 Marks)

Answer

- (a) Collecting evidence on the reliability of an EDP system is more complex than collecting evidence on the reliability of manual system. Auditors can be faced or confronted with a diverse and sometimes complex range of EDP systems depending upon technology that did not exist in manual systems. For example, accurate and complete operation of a disc drive required a set of hardware controls not used in a manual system. Similarly, system development controls include procedures for testing programs that would not be found in the development of manual systems. Auditors must understand these controls if they are to be able to collect evidence competently on the reliability of the controls.

Unfortunately, understanding the changing technology is not easy. Hardware and software continue to evolve rapidly and although there is some time lag, the associated controls evolve rapidly also. Auditors must keep upto-date with the developments if they are to be able to evaluate the reliability of accounting system.

The continuing evolution of computer technology also makes it more difficult for auditors to collect evidence on the reliability of controls. It may be impossible for auditors to obtain the

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evidence using manual means. Thus auditors need EDP systems themselves if they are to be able to collect the necessary evidence. The development of generalised audit software occurred, for example, because auditors needed access to data maintained on magnetic media. Similarly, new audit tools may be required, in due course, to evaluate the controls.

(b) Reserve Capital

As per Section 99 of the Companies Act, 1956, a limited company may, by a Special Resolution determine a portion of its share capital not being called-up, is to be kept reserved and shall be called-up, in the event and for the purpose of being wound-up.

Capital Reserve

Certain capital profit is transferred to Capital Reserve, which is not a free-reserve. It is not available to distribute as dividend to shareholders. It is generally utilised to write-off capital losses. For example, Profit on re-issue of forfeited shares.

(c) Flow-Chart Technique for evaluation of Internal Control

This technique can be resorted to for evaluation of the Internal Control System. It is a graphic presentation of internal controls in the organisation and is normally drawn up to show the controls in each section or sub-section.

As distinct from a narrative form, it provides the most concise and comprehensive way for reviewing the internal controls and the evaluator's findings. In a flow chart narratives, are reduced to the minimum and by that process, it can successfully bring the whole control structure, specially the essential parts thereof, in a condensed but wholly meaningful manner. Every details relevant from the control point of view and the details about how an operation is performed can be included in the flow-chart.

Essentially, a flow chart is a diagram full with lines and symbols and if judicious use of them can be made, it is probably an effective way of presenting the state of internal controls in the client's organisation. A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of documents and activities. More specifically it can show –

- (i) at what point a document is raised internally or received from external sources;
- (ii) the number of copies in which a document is raised or received;
- (iii) the intermediate stages set sequentially through which the document and the activity pass;
- (iv) distribution of the documents to various sections, department or operations;
- (v) checking authorisation and matching at relevant stages;
- (vi) filing of the documents; and
- (vii) final disposal by sending out or destruction.

A flow chart is normally a horizontal one in which documents and activities are shown to flow horizontally from section to section and concerned sections are shown as the vertical column needs. These can be sales, purchase, wages, production etc.

Purchases can be linked with sundry creditors and payments, sales with sundry debtors

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and collections. By this process, a flow chart will become self contained, complete and meaningful for evaluation of internal controls. Generally, a questionnaire is also enclosed with a flow chart, incorporating questions, the answers to which are to be looked into from the flow chart.

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SECTION – A

*Answer **all** questions.*

Question 1

- (a) *Parkash Carriers Limited appointed Mr. Raman as its auditor in the Annual General Meeting held on 30th September, 2009. Initially, he accepted the appointment. But he resigned from his office on 31st October, 2009 for personal reasons. The Board of Directors seeks your advice for filling up the vacancy by appointment of Mr. Albert as auditor. Advise.*

Also suggest the procedure to be adopted in case Mr. Albert is proposed to be removed from his office before the expiry of his term. (5 Marks)

- (b) *A Public Company has been declaring dividend at the rate of 20% on equity shares during the last 5 years. The Company has not made adequate profits during the year ended 31st March, 2009, but it has got adequate reserves which can be utilized for maintaining the rate of dividend at 20%. Advise the Company as to how it should go about if it wants to declare dividend at the rate of 20% for the year 2008-2009. Would your answer be different if the company utilized only the profits made in the previous years and retained in the profit and loss account for the purpose of payment of dividend at the rate of 20% for the year 2008-2009?* (5 Marks)

Answer

- (a) Under section 224(6) of the Companies Act, 1956, the Board may fill any casual vacancy in the office of an auditor. However, where such vacancy is caused by resignation of an auditor, the vacancy shall be filled by the company in general meeting. Thus, in the present case, the company may convene an Extra Ordinary General Meeting to appoint Mr. Albert as its auditor consequent upon the resignation by Mr. Raman.

In term of section 224(7) of the Act, 1956, Mr. Albert may be removed from office before the expiry of his term only by the Company in General Meeting after obtaining previous approval of the Central Government.

- (b) As per Rule 2 of the Companies (Declaration of Dividend out of Reserves) Rules, 1975 dividend may be declared by a company for any year out of the accumulated profits earned by it previous years and transferred by it to the reserves subject to certain conditions. One of the conditions is that the rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the 5 years immediately preceding that year or 10% of its paid-up capital which ever is less. As the proposed dividend exceeds 10%, it is necessary to seek the approval of the Central Government as required under section 205A(3) and only after obtaining the approval of the Central Government, the company may declare dividend at rate of 20% for year 2008-09, even if the other conditions relating to the amount that can be drawn from the reserves and

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minimum balance in the reserve are fulfilled. However, the credit balance, if any, carried in the profit and loss account will be available for declaration of dividend without any restriction. Hence in such a case dividend may be declared at the rate of 20% for 2008-09, without approval of the Central Government.

Question 2

- (a) *Explain the action that can be taken by the Central Government, when a complaint is received from some shareholders of a Public Company that a person has been appointed as the Managing Director of the Company without seeking the approval of the Central Government, when such approval is required. Also examine the validity of the acts of the Managing Director, if the complaint is found to be true.* (5 Marks)
- (b) *Mr. Kamlesh, son of Managing Director of a Public Company, is proposed to be appointed as Chief Executive of the Company on a monthly remuneration of Rs.75,000. State the provisions of the Companies Act, 1956 which are required to be complied with by the company in this regard?*

Will it make any difference if Mr. Kamlesh is appointed as Whole-Time Director on the same remuneration? (5 Marks)

Answer

(a) Improper appointment of Managing Director:

On receipt of the complaint, if the Central Government is prima facie, of the opinion that the Managing Director has been appointed without approval of the Central Government, when in fact such approval was necessary, the Central Government may refer the matter to the Company Law Board (Tribunal) for decision [Section 269(7)]. The Company Law Board will issue show-cause notice to the Company as well as the concerned Managing Director [Section 269(8)]. The Company Law Board will hear the case, and if it comes to a conclusion that the appointment is in contravention of requirements of Schedule XIII, it will make an order to that effect [Section 269(9)]. On such order, the appointment of the concerned Managing Director shall be deemed to have come to an end. The person so appointed shall in addition to being liable to pay a fine of Rs 1 lakh, refund to the company the entire remuneration received by him between the date of his appointment and the passing of such an order [Section 269(10)]. But all acts done by him prior to the declaration of invalidity will be valid, if they are otherwise valid [Section 269(12)].

(b) Holding office or place of profit by Director's relative:

Under Section 314(1B) of the Companies Act, 1956, in case relative of a Director holds office or place of profit under the Company on a monthly remuneration of Rs.50,000 or more, the Company is required to obtain prior consent of the company by special resolution and approval of Central Government. In the present case, the Company is accordingly required to pass a special resolution and obtain approval of the Central Government.

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In case Mr. Kamlesh is appointed as Whole Time Director in the Company, Section 314 will not be attracted in view of sub-section (3) thereof, as he will be drawing remuneration in his capacity as a Director. He will be governed by the provisions of Section 269 read with Schedule XIII of the Act, according to which approval of Central Government is not required as the proposed remuneration of Rs.75,000. per month is within the ceiling provide in Part II of Schedule XIII provided the conditions prescribed in Part I of the Schedule have been complied with by the Company and the appointee.

Question 3

(a) *Proximo Limited has 9 Directors out of whom 3 Directors have gone abroad. The Chairman had an urgent matter to be approved by the Board of Directors which could not be postponed till the next Board meeting. The Company, therefore, circulated the resolution for approval of the Directors. 4 out of 6 Directors in India approved the resolution. The Company claimed that the resolution was passed. Examine with reference to the provisions of Section 289 of the Companies Act, 1956 the validity of the resolution.* (5 Marks)

(b) *Premier Machineries Limited having a paid-up share capital of Rs.90 lakhs proposes to enter into a contract with the following parties for supply of components with effect from 1st January, 2008 for a period of 3 years:*

(a) *XYZ Metal Forging Private Limited in which Mr. John, a Director of Premier Machineries Limited, is a Director and member.*

(b) *ABC Casting Limited in which Mr. Philips, a Director of Premier Machineries Limited, holds 30% of the paid-up share capital.*

The capital of Premier Machineries Limited was increased to Rs.1.50 crores on 1st January, 2009 by issue of further shares.

Briefly discuss the legal requirements to be complied with under the Companies Act, 1956 to give effect to the above proposals taking into account the increase in the paid-up share capital as on 1st January, 2009. (5 Marks)

Answer

(a) Passing of Resolution by Circulation

According to Section 289 of the Companies Act, 1956, a resolution by circulation shall not be deemed to have been passed, unless the resolution has been circulated in a draft, together with the necessary papers, if any to all the directors then in India (not less in number than the quorum fixed for a meeting of the Board) as the case may be, and all other directors at their usual addresses in India, and has been approved by such of the directors as are then in India or by majority of such of them, as are entitled to vote on the resolution. In this case, the resolution has been approved by 4 directors out of 6 in India; the majority of total number of directors who were entitled to vote was 5 as against 4 directors who approved the resolution. Thus both the alternate conditions were not fulfilled. The resolution cannot be deemed to have been passed.

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- (b) Under section 297 of the Companies Act, 1956 as Mr. John, a director of Premier Machineries Ltd. is interested in XYZ metal Forging Private Ltd. as a director and a member of the Company, a resolution in the meeting of the Board of Directors is required to be passed before entering into a contract with XYZ Metal Forging Private Ltd. If due to urgency it is not possible to pass a Board resolution before entering into the contract, the requisite consent of the Board shall be obtained within three months of the date on which the contract was entered into under Section 299, Mr. John must disclose his interest to the Board and not participate in the said meeting/deliberations.

Since the paid up capital of the Company is Rs.90 lakhs, approval of the Central Government is not necessary. In this case, the paid up capital was increased to Rs.1.50 crore subsequent to the date of entering the contract. No approval of the Central Government will be required as on the material date of entering into the contract, the paid up capital was less than Rs 1 crore.

(ii) Section 297 does not cover cases of Public Limited Companies, hence aforesaid approvals will not be necessary. In both the cases the interested directors must make disclosure of interest as required under section 299 and also comply with section 300. Entries are also required to be made in the Register of Contract under section 301.

Question 4

- (a) *The report submitted by the inspector appointed under Section 235/237 of the Companies Act, 1956 to investigate the affairs of a Company revealed that substantial funds of the Company have been misappropriated by the Managing Director of the Company. The Central Government is of the opinion that effective action may not be taken the company for recovery of the funds misappropriated by the Managing Director. Examine with reference to the provisions of the Companies Act, 1956 the action that can be taken by the Central Government for recovery of damages or funds misappropriated by the Managing Director.* (5 Marks)
- (b) *Answer the following explaining the relevant provisions of the Companies Act, 1956:*
- (1) *Whether the Companies being amalgamated must be Companies registered under the Companies Act, 1956.*
 - (2) *Whether the Companies seeking sanction of the court for a scheme of amalgamation must have specific power to amalgamate in the object clause of their Memorandum of Association.* (5 Marks)

Answer

(a) Recovery of damages

Section 244 of the Companies Act, 1956 provides that where from the inspectors' report it appears that a fraud or misappropriation of property has been committed and the Company is therefore, entitled to bring an action for damages for misconduct or for the recovery of any property, which has been misapplied or wrongfully retained, the Central Government may itself in public interest bring proceedings for that purpose in the name

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of the Company. Thus, the Central Government is empowered to bring civil proceedings in the name of the Company in any case where it appears that such proceedings ought in the public interest to be brought, even if the company does not take such action. In such a proceeding, the inspector's report shall be admissible as evidence of the opinion of the inspection in relation to any matter contained in the report (Section 246). The Central Government should indemnify the company against any cost or expenses incurred by it or in connection with any proceedings brought by it. [Section 244(2)].

(b) Amalgamation

A scheme of compromise or arrangement may provide for amalgamation of companies under section 394 of the Companies Act, 1956. Section 394(4)(b) defines the 'transferor' and 'transferee' companies. While the 'transferee' company does not include any company other than a company within the meaning of the Companies Act, 1956, the transferor company includes any body corporate, whether a company within the meaning of the Companies Act or not. 'Body Corporate' includes a company incorporated outside India [(section 2(7))]. Hence transferor company may be a company incorporated outside India, but transferee company must be a company incorporated under the Companies Act, 1956.

Usually the Memorandum of Association of a company contains in its object clause the power to amalgamate. But, in a number of cases it has been held that it is not necessary to have in the memorandum of association a specific power to amalgamate with another company. The provisions of Section 391/394 of the Companies Act, 1956 indicate the scope of the statutory power for amalgamating a company with another company despite the absence of any specific enabling provision in their memoranda. (*Aimco Pesticides Ltd, Feedback Reach Consultancy Pvt Ltd., Sir Matturdas Vissaiji Foundation in re*). Hence even companies not having specific power to amalgamate in their Memoranda can seek sanction of the Court for a scheme of amalgamation.

Question 5

- (a) *A group of members of XYZ Limited has filed a petition before the Company Law Board alleging various acts of oppression and mismanagement by the majority shareholders of the Company. The Petitioner group holds 12% of the issued share capital of the Company. During the pendency of the petition, some of the petitioner group holding about 5% of the issued share capital of the Company wish to disassociate themselves from the petition and they along with the other majority shareholders have submitted before the Company Law Board that the petition may be dismissed on the ground of non-maintainability. Examine their contention having regard to the provisions of the Companies Act, 1956*

(5 Marks)

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- (b) *M/s Raman Ltd. was wound up by the Court. The official liquidator invited claims from its creditors which stood as under:*

<i>Income tax dues</i>	<i>Rs.11 lakhs</i>
<i>Sales tax dues</i>	<i>Rs. 5 lakhs</i>
<i>Dues of workers</i>	<i>Rs.25 lakhs</i>
<i>Unsecured loans payable to directors</i>	<i>Rs.25 lakhs</i>
<i>Trade creditors who supplied raw material</i>	<i>Rs.15 lakhs</i>
<i>Secured creditor being the bankers of the company</i>	<i>Rs.75 lakhs</i>
	<i>Rs. 156 lakhs</i>

Official Liquidator could realize only Rs.80 lakhs by sale of assets and realizations made from the company's debtors, which is not sufficient to pay to all the creditors. Please decide the order of priority for payment to creditors explaining the relevant provisions of the Companies Act, 1956. (5 Marks)

Answer

- (a) The argument of the majority share holders that the petition may be dismissed on the ground of non-maintability is not correct. The proceedings shall continue irrespective of withdrawal of consent by some petitioners. It has been held by the Supreme Court in *Rajmundry Electric Corporation vs. V. Nageswar Rao*, AIR (1956) SC 213 that if some of the consenting members have subsequent to the presentation of the petition withdraw their consent, it would not affect the right of the applicant to proceed with the petition. Thus, the validity of the petition must be judged on the facts as they were at the time of presentation. Neither the right of the applicants to proceed with the petition nor the jurisdiction of Company Law Board to dispose it of on its merits can be affected by events happening subsequent to the presentation of the petition.
- (b) Under section 529A of the Companies Act, 1956, (i) workmen's dues, and (ii) debts due to secured creditor shall be paid in priority of all debts, and shall be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions.

Income tax dues and sales tax dues are preferential creditors under section 530 of the Act, and subject to the provisions of section 529A, the same may be paid in priority to the claims of unsecured creditors.

In the present case, the available funds are only to the extent of Rs.80 lakhs which will be distributed amongst the secured creditor and workmen in proportion to their dues, as follows:

Workmen

(1/4th of Rs.80 lakhs)

: Rs.20 lakhs

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Secured creditor

(3/4th of Rs.80 lakhs)

: Rs. 60 lakhs

As such, the dues of preferential creditors (namely, Income tax and sales tax dues) and unsecured creditors (unsecured loan and trade debtors) cannot be paid any amount.

Question 6

- (a) *Examine whether the following Companies can be considered as 'Foreign Companies' under the Companies Act, 1956:*
- (i) *A company which is incorporated outside India employs agents in India but has no place of Business in India.*
 - (ii) *A company incorporated outside India having shareholders who are all Indian citizens.*
 - (iii) *A company incorporated in India but all the shares are held by foreigners. (5 Marks)*
- (b) *A Producer Company has received applications from Mr.Ramanathan, a Director of the Company, and Mr. Prem, a member of the Company, for grant of loan of Rs.2,00,000 and Rs.25,000 respectively. Discuss the relevant provision of the Companies Act, 1956 as to how the applications for grant of loan will be disposed of by the Company. (5 Marks)*

Answer

- (a) (i) As definition given Section 591(1) of the Companies Act,1956 a Company incorporated outside India and having not established a place of business in India, is not deemed to be a Foreign Company. Thus establishing a place of business is an essential ingredient in the definition. In the given case, the company has not established a place of business India. It will not be deemed to be a foreign company:
- (ii) A company incorporated outside India, will not be deemed to be a Foreign Company even though all the shareholders are Indian citizens, unless it has a place of business in India.
- (iii) A company incorporated in India but having all foreign shareholders will be deemed to be an India Company as it is not incorporated outside India though it has a place of business in India.
- (b) Under Section 581ZK of the Companies Act, 1956, the Board of the Producer Company may, subject to the provision in the Articles of Association, provide financial assistance by way of loan and advances against such security as may be specified in its Articles of Association to any member repayable within a period exceeding three months but not exceeding seven years from the date of disbursement of such loan or advances. In the instant case, member has applied for loan of Rs.25.000. The period is not specified in the question. The Company may grant the member a loan of Rs.25,000 against such security and at such rate of interest as may be specified in the Articles. However, in the case of a director, loan of Rs.2 lakh can be granted only after its approval by the members in general meeting.

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Question 7

- (a) *A company proposes to appoint a Sole Selling Agent for its products. State the cases in which such appointment requires approval of Central Government. Draft a Board Resolution to appoint a sole selling agent in a case where such appointment does not require approval of Central Government. (5 Marks)*
- (b) *The Board of Directors of LM Limited propose to donate Rs.3,00,000 to a school established exclusively for the benefit of children of employees and also donate Rs.50,000 to a political party during the Financial year ending 31st March, 2010. The average net profits determined in accordance with the provisions of Sections 349 and 350 of Companies Act, 1956 during the three immediately preceding financial years is Rs.40,00,000. Examine with reference to the provisions of the Companies Act, 1956 whether the proposed donations are within the power of the Board of Directors of company. (5 Marks)*

Answer

(a) Appointment of sole selling agents

Under Section 294AA of the companies Act, 1956, in following cases, appointment of sole selling agents will require approval of Central Government:

- (i) An individual, firm or body corporate who has a substantial interest in the company cannot be appointed as a sole selling agent without prior approval of Central Government [Section 294 AA(2)]. Substantial interest means shares of Rs.5 lakhs or 5% paid up capital of the company, whichever is less. The shareholding may be singly or together with relatives (in the case of a sole selling agent being an individual), partners and their relatives (in the case of a firm) directors and relatives of directors (in the case of a body corporate) (Explanation (b) to Section 294AA).
- (ii) Any company having paid up share capital of Rs.50 lakhs or more cannot appoint sole selling agent with approval in general meeting by a special resolution and also approval of Central Government [Section 294AA(3)]. These restrictions apply to all Companies is both Private and Public Companies.

Board Resolution

Resolved that pursuant to the provisions of section 294 of the Companies Act, 1956, and subject to the approval of the Company at a general meeting by ordinary resolution, the Board approves the appointment of 'X' as the company's sole selling agent for the sale of in the territory of for a period of five years with effect from on the terms and conditions set out in the draft agreement produced to this meeting and initiated by the chairman for purposes of identification or with such modifications (not being less advantageous to the company) as may be mutually agreed by the Board and 'X'

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(b) Donations

As per section 293(1) (e) of the Companies Act, 1956, the Board of Directors of a Company must obtain approval of the shareholder by way of resolution passed in their meeting for contributing in any year, to charitable and other funds not directly relating to the business of the company or the welfare of to employees any amount exceeding Rs.50,000 or 5% of its average net profits of the last 3 financial years, whichever is higher. In the given case, the school is established exclusively for the benefit of the children of the employees of the company and hence the restriction under section 293 (1) (e) is not applicable and the Board is empowered to make the proposed donation.

Donation to political parties: It is presumed that LM Ltd is not a Government Company. It has been in existence for more than 3 years. The proposed donation to a political party is only Rs.50,000 which is less than 5% of the average net profit for 3 immediately preceding financial years. Hence the Board of Directors is empowered to make a donation by passing a resolution at a Board meeting. The company is also required to make proper disclosure in the profit and loss account. (Section 293 A).

SECTION – B

Question 8

An Unlisted Public Company, having a paid-up equity share capital of Rs.5 Crores consisting of 50,00,000 equity shares of Rs.10 each fully paid-up, proposes to reduce the denomination of equity shares to less than Rs.10 Per share and make an initial public offer of equity shares at a premium. Examine whether it is possible for the Company to issue shares at a denomination of less than Rs.10 and, if so, state the minimum issue price and other conditions to be fulfilled under the SEBI (Disclosure and Investor Protection) Guidelines, 2000. (6 Marks)

Answer

Denomination of shares for public issue

An eligible company shall be free to make a public or right issue of equity shares in any denomination determined by it by complying with section 13(4) of the Companies Act, 1956 and also SEBI Guidelines.

According to SEBI guidelines, in case of initial public offer by an unlisted company.

- (a) if the issue price is Rs.500 or more, the issuer company shall have a discretion to fix the face value below Rs.10 per share subject shall in no case be less than Re.1 per share and also it shall not be a decimal of a rupee.
- (b) If issue price is less than Rs.500 per share the face value shall be Re.10 per share.

Here the issue price has not been given in the question. It is possible for the company to issue shares having a face value of less than Rs.10 per share only if the issue price is Rs.500 or more (para 3.7.1)

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However, at any one time, shares shall be only of one denomination. Hence the denomination of existing shares can be altered by changing memorandum and articles by passing special resolution. The company is also required to adhere to the disclosure and accounting norms specified by the SEBI from time to time (para 3.7.3). The face value shall be disclosed in the advertisement offer documents and is application forms, in the same font size as that of issue price or price band[Para 3.7.1(ii)] .

Question 9

A Company incorporated in United Kingdom established a branch at Chennai. What is the residential status of the Chennai branch? The Chennai branch proposes the purchase some immovable property at Chennai for the purpose of its business. Is it a 'Capital Account Transaction' within the meaning of Section 2(e) of the Foreign Exchange Management Act, 1999? Are there any restrictions under the Foreign Exchange Management Act, 1999 in respect of such acquisition? (6 Marks)

Answer

According to section 2(v)(iii) of FEMA, 1999, person resident in India inter alia means an office, branch, or agency in India owned or controlled by a person resident outside India. The company incorporated in U.K is a person resident outside India [Section 2(v)(ii) read with section 2(w) of the FEMA, 1999] as it is not a body corporate registered or incorporate in India. As the Chennai branch is branch in India is owned and controlled by the U.K Company is resident outside India, the Chennai branch is resident is India under section 2(v) (iii) stated above.

Capital account transaction.

In the case of a resident in India, capital account transaction means a transaction which alters the assets or liabilities outside India. The Chennai branch (is resident in India) acquires immovable property at Chennai (is in India). Hence this acquisition is not a "capital account transition" within the meaning of Section 2(e) of FEMA. Section 6(3) empowers RBI to restrict or regulate the acquisition of immovable property in India by a person resident outside India. Hence there is no restriction in acquisition of immovable property in India by Chennai branch.

Question 10

Mr. Raj Behari retired as a Member of Competition Commission of India (CCI) on 31st October, 2008. He was offered the post of Chief Executive in M/s. LSD Ltd. which was earlier a party in the proceedings before CCI. Can he join the Company with effect from 1st November, 2009?

What will be the position if Mr. Raj Behari joins Oil & Natural Gas Commission Ltd., a Government Company with effect from 1st April, 2009? ONGC was also earlier a party in the proceedings before CCI. (6 Marks)

Answer

Under Section 12 of the Competition Act, 2002, a Member of CCI shall not, for a period of two years from the date on which he ceased to hold office, accept any employment in any

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enterprise, which has been a party to a proceeding before the Commission. However, these provisions will not apply to any employment in a Government Company or Government or local authority or any Corporation established under any Central or state Act. In view of the aforesaid, Mr. Raj Behari cannot join M/s LSD Ltd on 1-11-2009 as only one year has expired from the date of his retirement. However, there is no bar for him to join ONGC on 1-4-2009 even earlier than two years of his retirement as it is a Government Company.

Note: The period of one year was increased to two years by the Competition (Amendment) Act, 2007 w.e.f 12.10.2007.

Question 11

XLR Bank Limited is not managing its affairs properly. Employees as well as depositors of the bank have complained to the Central Government from time to time about such mismanagement and requested the Central Government to acquire the undertaking of the Banking Company. Explain the powers of the Central Government in this regard under the Banking Regulation Act, 1949. (6 Marks)

Answer

Under Section 36AE of the Banking Regulation Act, 1949, if the Central Government is of the opinion that a Banking company has failed to comply with the direction given by RBI relating to policy matters under section 21 and 35A and or the affairs of the Bank are being managed in a manner detrimental to the interest of depositors or that of the banking policy or for better provision of credit generally or of credit to any particular section of the community or in any particular area; it is necessary to the Government may after consultation with RBI, by notified order, acquire the undertaking of a Banking Company. In such a case, on the date specified in the notification, the undertaking of the Banking Company and its assets and liabilities shall stand transferred to and vest in Central Government. Before acquiring the undertaking, the Central Government shall give a reasonable opportunity of hearing to the Banking Company.

Question 12

Briefly discuss the Rule of 'ejusdem generis' as applied in the interpretation of statute. (6 Marks)

Answer

When particular words pertaining to a class or genus are followed by general words, the general words are construed as limited to things of the same kind as those specified. This rule which is known as Rule of *ejusdem generis* reflects an attempt 'to reconcile incompatibility between the specie and general words in view of the other rules of interpretation that all words in the statute are given effect if possible, that a statute is to be construed as a whole and that no words are presumed to be superfluous. For instance, where an Act permits keeping of dogs, cats, cows, buffaloes and other animals the expression 'Other animals' would not include animals like lions and tigers, but would mean, only domesticated animals like horses etc.

The rule applied when (i) the statute contains an enumeration of specific words: (ii) the subjects of enumeration constitute a class or category: (iii) that class or category is no

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exhausted by the enumeration; (iv) the general terms follow the enumeration; and (v) there is no indication of a different legislative intent. If the subjects of enumeration belong to a broad based genus as also to narrower genus, there is no principle that the general words should be confined to the narrower genus.

The rule is applied extensively in interpreting the various statutes. The rule of ejusdem generis has to be applied with care and caution. It is not an inviolable rule of law, but only permissible reference in the absence of an indication, to the contrary, and where the context and the object and mischief of the enactment do not require restricted meaning to be attached to word of general import, it becomes the duty of the Courts to give words their plain and ordinary meaning. The rule of ejusdem generis has no inverse application. General words preceding the enumeration of specific instances are not governed by this rule and their import cannot be limited by such words.

SUMMARY OF EXAMINERS' COMMENTS ON THE PERFORMANCE OF CANDIDATES

PAPER – 1 : FINANCIAL REPORTING

General Comments

The overall performance of the candidates was average. Questions based on practical application of Accounting Standards have not been answered well. It is also observed that the candidates neglect the theoretical aspects of the subject; they should go through the study material carefully. A thorough practice and lots of reading of the subject is required to maintain the level of knowledge expected from the students of Final Level. The candidates must present their answers in organized manner and solutions to practical problems should be given in prescribed formats along with suitable working notes. It is advised that they should read the questions carefully before writing the answers.

Specific Comments:

Question 1. Few candidates could not apply the relevant provisions of the Accounting standards in the given situations. In part (c) of the question, most of the candidates considered the transactions as sale and purchase instead of taking it as financing transaction.

Question 2. Several mistakes have been observed in the answers of the candidates including intrinsic value of shares of H Ltd. and ascertainment of number of equity shares issued to the foreign company. Consequently, the candidates could not prepare the required balance sheet of H Ltd. after absorption.

Question 3. Most of the answers reflected lack of knowledge of provisions of AS 21, 23 and 27. Majority of the candidates erred in the calculation of amounts of consolidated retained earnings and goodwill to be shown in the consolidated balance sheet of P Ltd.

Question 4.(a) The answers of the candidates exhibited lack of conceptual clarity of the topic "Accounting and Reporting of Financial instruments". Most of the candidates could not separate equity and debt portions of compound financial instrument which was required in the question.

(b) Many candidates failed to arrive at the correct amount of equity capital raised and hence, could not prepare the balance sheet of Standard Ltd. as on 1st April, 2009.

Question 5.(a) Candidates' answers reflected lack of knowledge of mutual funds. Large number of candidates erred in calculating the earnings, management expenses, distribution of capital gains and dividends among the unit holders, closing value of net assets and consequent net assets value.

(b) Except few, no candidate could apply the Lev and Schwartz formula of human resource accounting in the correct manner. Most of the candidates could not compute the value of human resources.

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Question 6. Few candidates were not aware of the provisions relating to capital adequacy ratio of NBFCs. Many candidates could not score good marks in this question as the answers were not concise and to the point, duly supported by appropriate Accounting Standards.

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

General Comments

The performance in general is “not satisfactory” because following errors have been observed in answering the questions, which candidates are required to make note for the improvement.

- (a) Answers have exhibited lack of systematic and logical approach, clear presentation, proper and adequate conceptual and analytical explanation.
- (b) It has been found that in most of the cases candidates have been failed to understand the requirement of the questions.
- (c) Candidates have shown poor knowledge of the concepts and also lacked of adequate practice to solve diverse range of questions.
- (d) It has also observed that many candidates did not prepare the subject in depth and make selective study.
- (e) In many cases candidates not answered the questions serially/completely in one sequence. Different parts of the answers to a particular question were scattered over different pages, which should normally be avoided.
- (f) Candidates have shown lack of knowledge in answering the theoretical questions. Therefore candidates should answer theoretical questions correctly, lucidly and precisely. Further candidate should allocate sufficient time for the preparation of theoretical portion of the paper.
- (g) It is advised that candidates before proceeding to answer the question should read “Cover Page” of the answer book.

Specific Comments

Question 1.(a) In this question of calculation of lease rental the performance of candidates is not satisfactory as many candidates solved the question with equal installments (Principal + Interest) though the question clearly states for repayment of principal portion only in equal year end installments.

(b) In this question of Mutual Fund the performance of the students was average as some candidate were able to solve question.

Question 2.(a) In this question based on Portfolio Theory, the performance is not satisfactory as most of candidates could calculate only mean and covariance but could not calculate Beta correctly.

SUMMARY OF EXAMINERS' COMMENTS

(b) In this question of financial services the performance of candidate was not satisfactory as most of the candidates explained credit rating concept in detail rather than the limitations of credit rating as required in the question.

(c) In this question of Dividend Decision the performance of candidates is not satisfactory as most of the candidates failed to calculate Fair Price of the Share.

Question 3.(a) In this question based on Security Analysis the performance of candidates was poor as very few candidates could solve the question.

(b) In this question of Security Analysis the performance was satisfactory as most of the candidate solved this question in proper manner. However, in some cases only part working was available.

(c) In this theoretical question the performance of candidates is not satisfactory as most of students explained GDRs but not explained its impact on Indian Capital Market.

Question 4.(a) In this question of Merger, Acquisition and Restructuring the performance of candidates was satisfactory as most candidates properly solved it with adequate workings.

(b) In this question of Security Analysis the performance of candidates was also satisfactory.

(c) In this question of Dividend Decision performance of candidates was overall good.

Question 5.(a) In this question of Foreign Exchange Exposures and Risk Management the performance of candidates is not satisfactory as only a few could solve it properly.

(b) This question based on Portfolio Theory, the performance of candidates is not good as most of the candidates calculated Beta of stocks correctly but very few could able to bifurcate total risk into Systematic and Unsystematic risks.

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

General Comments

Many students had written their answers in general and failed to address the specific issues in the practical questions. Those examinees who completed their answers within main book only obtained better marks than students who attempted to fill up more additional answer books. It was observed that majority of the students presented relevant subject matter but could not apply the same for the practical issues posed questions.

Specific Comments

Question 1. Many candidates have performed this part of the question well.

Question 2. Majority of the students' answers were wrong.

Question 3.(a) A few students performed this part well while others have given just the meaning of the terms.

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(b) Many students have given irrelevant answers while some students have answered correctly by giving the appropriate provisions of G. Act/CARO/Cost records.

(c) Many students were very brief in giving their answers and they lack in depth knowledge in the subject.

Question 4.(a) Overall performance of the students was poor. However, a few students performed this question well.

(b) Though many students have attempted this part of the question only a few students could enumerate the steps to be taken by an auditor for the verification of re-insurance outward in case of a General Insurance Company.

(c) Most of the students could not write the duties and responsibilities of an auditor in case of material misstatement resulting from Management fraud correctly.

Question 5.(a) Many students have answered well by giving the provisions of the Sarbanes-Oxley Act, 2002 correctly.

(b) Many students have answered well this part of the question, while a few students' answers were wrong.

(c) Most of the students did not perform this question well.

Question 6.(a) Very few students have attempted this part of the question and their answers were irrelevant.

(b) Many students had confused with reserve capital and capital reserve. A few students only could give the answer to this question correctly.

(c) Many students have answered this part of the question in general.

PAPER – 4 : CORPORATE AND ALLIED LAWS

General Comments

The performance in general was "average". Candidates are required to make note of the following improvements:

- (a) Arriving at conclusions/interpretation of the answer to the question based specific section/Important case laws, if any.
- (b) Writing answers in a sequence and logical manner.
- (c) Drafting of resolution to be specific by mentioning relevant section of the concerned law.
- (d) Avoid writing answers in general.
- (e) Study of allied laws requires attention.

SUMMARY OF EXAMINERS' COMMENTS

Specific Comments

Question 1. In respect of second part of the question relating to declaration of dividend, most of the candidates have answered the question in general without referring to Rule 2 of the Companies Declaration of (Dividend out of Reserves) Rules, 1975.

Question 2. In respect of improper appointment of Managing Director and the validity of acts, many candidates have stated that such acts are invalid. In respect of second part of the question dealing with appointment of Whole-time Director, candidates have not linked their answers in accordance with Sections 269, 314 and Schedule XIII of the Companies Act, 1956.

Question 3. Based on the language used in the question and with reference to interpretation of question based on section 289 of the Companies Act, 1956 and certain case laws, there is a possibility of alternate answer to the question. Some of the candidates have stated that the resolution is not valid, while some others have mentioned it is valid. Candidates may refer to the answer (including alternate) given in the suggested answers.

In respect of second part of the question relating to interest of the directors in proposed contract or arrangement with the company, most of the candidates have not conceptually understood the application of sections 297, 299 and 300 of the Companies Act, 1956.

Question 4. Reference to section 244 of the Companies Act, 1956 on the action that can be taken by the Central Government for recovery of damages or funds mis-appropriated by the Managing Director was not given. In respect of question relating to amalgamation, many of the candidates have mentioned that companies must have specific power to amalgamate in the object clause of their Memorandum of Association, whereas it is not so.

Question 5. In respect of question relating to withdrawal of petition filed under section 397/398 of the Companies Act, 1956, candidates have mentioned that withdrawal by certain percentage of petitioners under section 399 of the Act will affect the validity of the petition file for seeking relief against operation and mismanagement, whereas it is not so. The problem relating to order of priority of payment to creditors at the time of winding-up of companies was not in accordance with Section 529A of the Companies Act, 1956.

Question 6. Ascertaining the status of foreign company was not based on Section 591 of the Companies Act, 1956. The answer to the question on Producer Company was not satisfactory. Most of the candidates were not aware of the relevant sections relating to such companies.

Question 7. Drafting of Board's resolution in respect of sole-selling agent was lacking in terms of language and relevant section ie. 294AA of the Companies Act, 1956. In respect of second part of the question relating to donation to charitable purpose and to political parties, answers were not in accordance with section 293 of the Companies Act, 1956.

Question 8. The answer to the question on determination of minimum price issue was not satisfactory and many candidates were not aware of the relevant SEBI (DIP) Guidelines, 2000.

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Question 9. The determination of residential status of company under the Foreign Exchange Management Act, 1999 was not understood by many of the candidates.

Question 10. Candidates in general were not aware changes in the Section 12 of the Competition Act, 2002 brought in by the Competition (Amendment) Act, 2007. The period of one year was increased to two years by Competition (Amendment) Act, 2007.

Question 11. The Rule of 'ejusdem generis' as applied in the interpretation of statute was mentioned in a general way without any illustrations.



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