PROFESSIONAL COMPETENCE COURSE

Model Test Paper – BOS/PCC/Advanced Accounting – 1/2007

GROUP – I

PAPER – 1 : ADVANCED ACCOUNTING

SUGGESTED ANSWERS/HINTS

1. Trading and Profit and Loss Account of Mr. Ashok
for the year ended 31st March, 2006

			Rs.			Rs.
To	Opening stock (balancing figure)		80,000	By	Sales	4,00,000
				By	Closing stock	40,000
To	Purchases		2,40,000			
To	Gross profit c/d @ 30% on sales		1,20,000			
			4,40,000			4,40,000
To	Miscellaneous expenses (Rs.80,000 – Rs.8,000 + Rs.10,000)		82,000	By	Gross profit b/d	1,20,000
				By	Miscellaneous receipts	20,000
				By	Net loss transferred to Capital A/c	25,840
To	Depreciation:					
	Building	36,000				
	Furniture (Rs.6,800 + Rs.1,000)	7,800				
	Motor Car	16,000	59,800			
To	Loss on sale of furniture		11,000			
To	Bad debts		8,000			
To	Provision for doubtful debts		5,040			
			1,65,840			1,65,840

Balance Sheet of Mr. Ashok
as on 31st March, 2006

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital as on 1st April, 2005		7,16,000	Building	3,20,000	
			Add: Addition during the year	40,000	
Profit and Loss A/c					
Opening balance	40,000		Less: Provision for	3,60,000	
Less: Loss for the year	25,840	14,160	depreciation	36,000	3,24,000
			Furniture	60,000	
Sundry creditors		1,12,000	Less: Sold during the year	20,000	
Bills payable		16,000		40,000	
Outstanding salary		10,000	Add: Addition during the year	28,000	
				68,000	
			Less: Depreciation	6,800	61,200
			Motor car (at cost)	80,000	
			Less: Depreciation	16,000	64,000
			Stock in trade		40,000
			Sundry debtors	2,52,000	
			Less: Provision for doubtful debts @ 2%	5,040	2,46,960
			Bills receivable		28,000
			Cash in hand and at bank		1,04,000
		8,68,160			8,68,160

Working Notes:

Sundry Debtors Account

		Rs.			Rs.
To	Balance b/d	1,60,000	By	Cash/Bank A/c	2,00,000
To	Sales A/c	3,20,000	By	Bills receivable A/c	20,000
			By	Bad debts A/c	8,000
			By	Balance c/d (balancing fig.)	2,52,000
		4,80,000			4,80,000

Sundry Creditors Account

		Rs.			Rs.
To	Cash/Bank A/c	1,84,000	By	Balance b/d	1,20,000
To	Bills payable A/c	16,000	By	Purchases A/c	1,92,000
To	Balance c/d				
	(balancing figure)	1,12,000			
		3,12,000			3,12,000

Bills Receivable Account

		Rs.			Rs.
To	Balance b/d	32,000	By	Cash/ Bank A/c	24,000
To	Sundry debtors A/c	20,000		(balancing figure)	
			By	Balance c/d	28,000
		52,000			52,000

Bills Payable Account

		Rs.			Rs.
To	Cash/Bank A/c	28,000	By	Balance b/d	28,000
	(balancing figure)		By	Sundry creditors A/c	16,000
To	Balance c/d	16,000			
		44,000			44,000

Furniture Account

		Rs.			Rs.
To	Balance b/d	60,000	By	Bank/Cash A/c	8,000
To	Bank A/c	28,000	By	Depreciation A/c	1,000
			By	Profit and loss A/c (loss on sale)	11,000
			By	Depreciation A/c	6,800
			By	Balance c/d	61,200
		88,000			88,000

Cash/Bank Account

		Rs.			Rs.
To	Balance b/d	1,80,000	By	Misc. trade expenses A/c	80,000
To	Miscellaneous receipts A/c	20,000	By	Purchases A/c	48,000
To	Sundry debtors A/c	2,00,000	By	Furniture A/c (balancing figure)	28,000
To	Sales A/c	80,000	By	Sundry creditors A/c	1,84,000
To	Furniture A/c (sale)	8,000	By	Bills payable A/c	28,000
To	Bills receivable A/c	24,000	By	Building A/c	40,000
			By	Balance c/d	1,04,000
		5,12,000			5,12,000

Opening Balance Sheet of Mr. Ashok

as on 31st March, 2005

Liabilities	Rs.	Assets	Rs.
Capital (balancing figure)	7,16,000	Building	3,20,000
Profit and loss A/c	40,000	Furniture	60,000
Sundry creditors	1,20,000	Motor car	80,000
Bills payable	28,000	Stock in trade	80,000
Outstanding salary	8,000	Sundry debtors	1,60,000
		Bills receivable	32,000
		Cash in hand and at bank	1,80,000
	9,12,000		9,12,000

2. (a)

In the books of Omega Corporation
Hire Purchase Trading Account
for the year ended on 31st Dec., 2006

Dr.	Rs.	Rs.		Cr Rs.
To Hire Purchase Stock (30×Rs. 5,000)		1,50,000	By Hire Purchase Sales (W.N. 2)	91,40,000
To Goods Sold on Hire Purchase (240×Rs. 50,000)		1,20,00,000	By Stock Reserve (Rs. 1,50,000×20%)	30,000

To Bad Debts		12,000	By Goods sold on Hire Purchase	
To Loss on Re-possession	16,000		(Rs. 1,20,00,000× 20%)	24,00,000
Less : Intalments not yet due	8,000	8,000	By Hire Purchase Stock [(8×50+6×30+1×20)× Rs. 5,000]	30,00,000
To Stock Reserve (30,00,000 ×20%)		6,00,000		
To Profit & Loss A/c (Transfer of Profit)		18,00,000		
		1,45,70,000		1,45,70,000

Alternatively, hire purchase trading account can be prepared in the following manner :

Hire Purchase Trading Account
for the year ended on 31st Dec., 2006

	Rs.		Rs.
To Hire Purchase Stock (30×Rs. 5,000)	1,50,000	By Cash (W.N.1)	90,30,000
To Goods Sold on Hire Purchase (240×Rs. 50,000)	1,20,00,000	By Stock Reserve (Rs. 1,50,000×20%)	30,000
To Stock Reserve (Rs. 30,00,000 × 20%)	6,00,000	By Goods Sold on Hire Purchase (Rs. 1,20,00,000×20%)	24,00,000
To Profit & Loss A/c (Transfer of Profit)	18,00,000	By Goods Repossessed (2×Rs. 40,000×50%)	40,000
		By Instalments Due [(2×2+1×6)×Rs. 5,000]	50,000
		By Hire Purchase Stock [8×50+6×30+1×20)× Rs. 5,000]	30,00,000
	1,45,50,000		1,45,50,000

Working Notes :

		Rs.
(1)	Cash collected:	
	Cash down payment (240 × Rs. 10,000)	24,00,000
	Add :Instalments collected :	

	Last instalments on 30 computers outstanding on 1.1.2006			1,50,000
	Instalments due and collected on 240 computers sold during the year :			
	Total instalments on 240 computers			
	(8 × 240 × Rs. 5,000)		96,00,000	
	Less : Instalments due but not collected			
	[(2 × 2 + 1 × 6 + 6 × 2) × Rs. 5,000]	1,10,000		
	Instalments not due on 31.12.2006			
	[(8 × 50 + 6 × 30 + 1 × 20 1 × 2) × Rs. 5,000]	30,10,000	31,20,000	64,80,000
				90,30,000
2	Hire purchase sales:			
	Cash collected			90,30,000
	Add : Instalments due but not collected			
	[(2 × 2 + 1 × 6 + 6 × 2) × Rs. 5,000]			1,10,000
				91,40,000
(3)	Loss on repossessed computers:			
	Cost of instalments due but not collected			
	(6 × 2 × Rs. 4,000)			48,000
	Cost of Instalments not yet due			
	(1 × 2 × Rs. 4,000)			8,000
				56,000
	Less : Estimated value of repossessed computers			
	(2 × Rs. 40,000 × 50%)			40,000
	Loss			16,000
	Bad debts (in respect of repossessed computers):			
	Instalments due but not collected			
	(6 × 2 × Rs. 5,000)			60,000
	Cost of installments not due on 31.12.2006			
	(1 × 2 × Rs. 5,000 × 80%)			8,000
				68,000
	Less : Cost of instalments due but not collected			
	(6 × 2 × Rs. 4,000)		48,000	
	Cost of instalments not yet due			
	(1 × 2 × Rs. 4,000)		8,000	56,000
	Bad debts			12,000

(b) The amount of rebate on bills discounted as on 31st March, 2006 for the period which has not been expired upto that day will be calculated as follows:

Discount on Rs.2,80,000 for 62 days @ 10%	4,756
Discount on Rs.8,72,000 for 69 days @ 10%	16,484
Discount on Rs.5,64,000 for 82 days @ 10%	12,671
Discount on Rs.8,12,000 for 92 days @ 10%	20,467
Discount on Rs.6,00,000 for 96 days @ 10%	15,781
Total	70,159

The amount of discount to be credited to the profit and loss account will be:

	Rs.
Transfer from rebate on bills discounted as on 31.03.2005	68,259
Add: Discount received during the year	1,70,156
	2,38,415
Less: Rebate on bills discounted as on 31.03.2006 (as above)	70,159
	1,68,256

Journal Entries

		Rs.	Rs.
Rebate on bills discounted A/c	Dr.	68,259	
To Discount on bills A/c			68,259
(Transfer of unexpired discount on 31.03.2005)			
Discount on bills A/c	Dr.	70,159	
To Rebate on bills discounted			70,159
(Unexpired discount on 31.03.2006 taken into account)			
Discount on Bills A/c	Dr.	1,68,256	
To P & L A/c			1,68,526
(Discount earned in the year, transferred to P&L A/c)			

3. (a)

Mr. A in Account Current with Mr. X

(Interest upto 15th March, 2004 @ 10% p.a.)

Dr. Cr.

Date		Particulars	Amount	Days	Product	Date		Particulars	Amount	Days	Product
2004						2004					
Jan. 01	To	Balance b/d	4,000	75	3,00,000	Jan. 29	By	Purchase account	1,200	46	55,200

Jan. 15	To	Sales account	2,230	60	1,33,800	Feb. 10	By	Cash account	1,000	34	34,000
Mar. 13	To	Red Ink product (Rs. 2,000 × 29)			58,000	Mar. 13	By	Bills Receivable account	2,000		
Mar. 15	To	Interest account $\left(\frac{\text{Rs.}4{,}02{,}600\times10\times1}{100\times366}\right)$	110			Mar. 15	By	Balance of product			4,02,600
							By	Balance c/d (amount to be paid)	2,140		
			6,340		4,91,800				6,340		4,91,800

(b) In the books of Mr. Krishna Investment Account
for the year ended 31st March, 2006
(Scrip: Equity Shares of TELCO Ltd.)

Dr. Date			Nominal Value (Rs.)	Cost (Rs.)	Date			Nominal Value (Rs.)	Cr. Cost (Rs.)
1.4.2005	To	Bank A/c	1,00,000	1,23,000	31.3.2006	By	Bank A/c	50,000	44,100
31.1.2006	To	Bonus shares	50,000	–	31.3.2006	By	Balance c/d	1,00,000	82,000
31.3.2006	To	Profit & loss A/c	–	3,100					
			1,50,000	1,26,100				1,50,000	1,26,100

Working Notes:

(i) Cost of equity shares purchased on 1.4.2005 = 1,000 × Rs. 120 + 2% of Rs. 1,20,000 + ½% of Rs. 1,20,000 = Rs. 1,23,000

(ii) Sale proceeds of equity shares sold on 31st March, 2006= 500 × Rs. 90 – 2% of Rs. 45,000 = Rs. 44,100.

(iii) Profit on sale of bonus shares on 31st March, 2006

= Sales proceeds – Average cost

Sales proceeds = Rs. 44,100

Average cost = Rs. (1,23,000 × 50,000)/1,50,000

= Rs. 41,000

Profit = Rs. 44,100 – Rs. 41,000 = Rs. 3,100.

(iv) Valuation of equity shares on 31st March, 2006

Cost = (Rs. 1,23,000 × 1,00,000)/1,50,000 = Rs. 82,000

Market Value = 1,000 shares × Rs. 90 = Rs. 90,000

Closing balance has been valued at Rs. 82,000 being lower than the market value.

4. (a) Profit & Loss Adjustment Account

Dr.			Rs.		Cr. Rs.
To Partner's capital accounts (profit on revaluation)				By Goodwill	4,000
				By Land & building	15,600
	A	7,800		By Furniture	3,800
	B	15,600	23,400		
			23,400		23,400

Partners' capital Account

Dr.	A Rs.	B Rs.	C Rs.	Cr.	A Rs.	B Rs.	C Rs.
To Balance c/d	53,200	53,200	53,200	By Balance b/d	26,400	33,600	-
				By Contingency reserve	2,000	4,000	-
				By Profit & loss adjustment A/c	7,800	15,600	-
				By Sundry assets	-	-	22,400
				By Bank A/c	17,000	-	30.800
	53,200	53,200	53,200		53,200	53,200	53,200

Balance Sheet of New Firm as on 1st April, 2006

Liabilities		Rs.	Rs.	Assets	Rs.
Capital accounts:				Goodwill (18,000+6,000)	24,000
	A	53,200		Land & building	30,000
	B	53,200		Furniture (6,000+ 2,800)	8,800
	C	53,200	1,59,600	Stock (26,000+13,600)	39,600
Sundry creditors			9,000	Sundry debtors	6,400
				Cash at bank	59,800
			1,68,600		1,68,600

Note : Capital accounts of partners are to be so adjusted as to be equal and therefore, additional cash is to be brought in by the partner or partners concerned. For this purpose, highest capital of the partners is to be taken as base. In this case B's capital becomes highest, accordingly A is required to bring in Rs. 17,000 (53,200-36,200) and C has to bring in Rs. 30,800 (53,200-22,400).

(b) Liquidators' Final Statement of Account

Receipts	Rs.	Payments	Rs.
Cash	4,13,000	Return to contributors:	
Realisation from:		Preference dividend	33,000
Calls in arrears	10,000	Preference shareholders	3,00,000
Final call of Rs. 5 per		Calls in advance	5,000
equity share of Rs. 50 each		Equity shareholders of	
(Rs. 5 × 1,000)	5,000	Rs. 100 each (3,000 × Rs. 30)	90,000
	4,28,000		4,28,000

Working Note:

			Rs.
Cash account balance			4,13,000
Less:	Payment for dividend	33,000	
	Preference shareholders	3,00,000	
	Calls in advance	5,000	3,38,000
			75,000
Add: Calls in arrears			10,000
			85,000
Add: Amount to be received from equity shareholders of Rs. 50 each (1,000 × 20)			20,000
Amount disposable			1,05,000

Number of equivalent equity shares:

3,000 shares of Rs. 100 each = 6,000 shares of Rs. 50 each

1,000 shares of Rs. 50 each = 1,000 shares of Rs. 50 each

= 7,000 shares of Rs. 50 each

$$\text{Final payment to equity shareholders} = \frac{\text{Amount left for distribution}}{\text{Total number of equivalent equity shares}}$$

= Rs. 1,05,000 / 7,000 shares = Rs. 15 per share to equity shareholders of Rs. 50 each.

Therefore for equity shareholders of Rs. 100 each $\left(\text{Rs.}15 \times \frac{100}{50}\right)$

= Rs. 30 per share to equity shareholders of Rs. 100 each.

Calls in advance must be paid first, so as to pay the shareholders on prorata basis. Equity shareholders of Rs. 50 each have to pay Rs. 20 and receive Rs. 15 each. As a result, they are required to pay net Rs. 5 per share.

(c) General Insurance Company

(Abstract showing the amount of claims)

	Rs. '000	Rs. '000
Claims less Re-insurance :		
Paid during the year	52,20	
Add : Outstanding claims at the end of the year	7,52	
	59,72	
Less : Outstanding claims at the beginning of the year	7,85	51,87

Working Notes :

	Rs. '000	Rs. '000
1. Claims paid during the year		
Direct business	46,70	
Reinsurance	7,00	53,70
Add : Surveyor's fee	35	
Legal expenses	45	80
		54,50
Less : Claims received from re-insurers		2,30
		52,20
2. Claims outstanding on 31st March, 2006		
Direct business	8,12	
Reinsurance	53	8,65
Less : Claims receivable from re-insurers		1,13
		7,52
3. Claims outstanding on 1st April, 2005		
Direct business	763	
Reinsurance	87	8,50
Less : Claims receivable from re-insurers		65
		7,85.

5. (i) True- The economic life of an enterprise is artificially split into periodic intervals in accordance with the accounting period assumption or the periodicity concept. The going concern assumption assumes that an enterprise will continue in operation for indefinite period of time.

(ii) False- Average due date is 'no loss no gain' date to either party. i.e. neither the debtor nor the creditor stands to lose or gain anything by way of interest.

(iii) Although the case under consideration does not relate to extraordinary item, but the nature and amount of such item may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Para 12 of AS 5 (Revised in

1997) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies states that :

"When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately."

Circumstances which may give to separate disclosure of items of income and expense in accordance with para 12 of AS 5 include the write-down of inventories to net realisable value as well as the reversal of such write-downs.

(iv) B : 2/3 less 3/10 = 11/30

C: 1/3 less 2/10 = 4/30

Gaining ratio = B : C

11 : 4

(v) False- If there exists a specific sports fund, the expenditure incurred in carrying out the purpose of the fund i.e. incurred on sports activities will be deducted from that fund only.

(vi) False- The objective of taking a joint life policy is to minimize the financial hardships in the event of payment of a large sum to the legal representatives of a deceased partner or to the retiring partner.

(vii) Paragraph 4 of Accounting Standard 5 on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, defines Prior Period items as "income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods".

Rectification of error in stock valuation is a prior period item vide Para 4 of AS 5. Rs.14.5 lakhs must be added to the opening stock of 1/4/2006. It is also necessary to show Rs. 14.5 lakhs as a prior period adjustment in the Profit and loss Account below the line. Separate disclosure of this item as a prior period item is required as per Para 15 of AS 5.

(viii) Interest on Performing Assets should be recognised on accrual basis, but interest on Non-performing Assets should be recognised on cash/realisation basis.

	Rs. in lakhs
Interest on cash credit and overdrafts (1,800+70) =	1,870
Interest on bills purchased and discounted (700 + 36) =	736
Total income to be recognised	2,606

(ix) ABC Co. Ltd.

Journal Entries

		Dr. Rs.	Cr. Rs.
Bank A/c	Dr.	95,000	
Discount on issue of debentures A/c	Dr.	5,000	
Loss on issue of debentures A/c	Dr.	2,000	
To 11% Debentures A/c			1,00,000
To Premium on Redemption of debentures A/c			2,000
(Issue of Rs. 1,00,000 11% debentures at a discount of 5% but redeemable at a premium of 2%)			

(x) False- Whenever a balance is transferred from one account in one ledger to that in another, the entry is recorded through the journal. Also an additional entry is made in the control accounts for recording the corresponding effect.

(xi) Adjusted net profit for the current year (1,00,00,000 + 12,00,000 – 3,60,000) = Rs. 1,08,40,000

No. of equity shares resulting from conversion of debentures: 10,00,000 Shares

No. of equity shares used to compute diluted EPS: (50,00,000 + 10,00,000) = 60,00,000 Shares

Diluted earnings per share: (1,08,40,000/60,00,000) = Rs. 1.81

6. (i) Computer information system environment exists when one or more computer(s) of any type or size is (are) involved in the processing of financial information, including quantitative data, of significance to the audit, whether those computers are operated by the entity or by a third party. A computerised accounting environment will therefore have the following salient features :

1. The processing of financial information will be by one or more computers.
2. The computer or computers may be operated by the entity or by a third party.
3. The processing of financial information by the computer is done with the help of one or more computer software.
4. A computer software includes any program or routine that performs a desired function or set of functions and the documentation required to describe and maintain that program or routine.
5. The computer software used for the accounting system may be an acquired software or may be developed for the business.
6. Acquired software may consist of a spread sheet package or may be prepackaged accounting software. Larger organisations may use an Enterprise Resource Planning (ERP) package for: .

1. Developing a customised accounting package is an option that some organisation prefers so as to suit the peculiarities of their business function.
2. Outsourcing of the accounting system is also becoming popular where an organisation is having the financial accounting processed from a third party.

(ii) According to Accounting Standard 10 on "Accounting for Fixed Assets"

(a) When fixed assets are revalued in financial statements, the basis of selection should be an entire class of assets or the selection should be done on a systematic basis. The basis of selection should be disclosed.

(b) The revaluation of any class of assets should not result in the net book value of that class being greater than the recoverable amount of that class of assets.

(c) The accumulated depreciation should not be credited to profit and loss account.

(d) The net increase in book value should be credited to a revaluation reserve account.

(e) On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value should be charged or credited to the profit and loss account except that to the extent to which such a loss is related to an increase and which has not been subsequently reversed or utilised may be charged directly to that account.

(iii) The company should disclose the change in method of depreciation adopted for the accounting year. The impact on depreciation charge due to change in method must be quantified and reported by the enterprise.

Following aspects may be noted in this regard as per AS 6 on Depreciation Accounting.

(a) The depreciation method selected should be applied consistently from period to period.

(b) A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise.

(iv) Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

(v) Preferential creditors get preference over other unsecured creditors. Hence, they are known as preferential creditors. By law, the following are the preferential creditors:

   (i) all debts due to Government or any local authority.

   (ii) Salary and wages to staff in respect of the services rendered to the insolvent during 4 months preceding the date of presentation of insolvency petition, subject to the following limits:

      (a) Under the Presidency Towns Insolvency Act – Rs.300 for such clerk and Rs.100 each for each such servant or labourer.

      (b) Under the Provincial Insolvency Act Rs.20 for each such clerk, servant or labourer.

   (iii) One month's rent due to the landlord is preferential under the Presidency Towns Insolvency Act. Rent is not at all preferential as per the provincial Insolvency Act

PROFESSIONAL COMPETENCE COURSE

Model Test Paper – BOS/PCC/Advanced Accounting-2/2007

GROUP-I

PAPTER – 1 : ADVANCED ACCOUNTING

SUGGESTED ANSWERS/HINTS

1. Journal Entries in the books of RS Ltd.

(Rs. '000)

		Dr. Rs.	Cr. Rs.
10% Debentures Account	Dr.	500	
Loan from Financial Institutions Account	Dr.	250	
Sundry Creditors Account	Dr.	300	
Proposed Dividend Account	Dr.	200	
Realisation Account	Dr.	2,800	
To Fixed Assets Account			2,700
To Investments Account			700
To Sundry Debtors Account			400
To Cash and Bank Account			250
(Transfer of assets and liabilities to realisation account)			
Share Capital Account	Dr.	2,000	
Reserve and Surplus Account	Dr.	800	
To Equity Shareholders Account			2,800
(Transfer of share capital, reserve and surplus to shareholders account)			
Equity Shareholders Account	Dr.	250	
To Realisation Account			250
(Cancellation of 20% holding of XY Ltd. held as investments)			
Shares in XYZ Ltd.	Dr.	2,000	
To Realisation Account			2,000
(Issue of shares by XYZ Ltd. in the ratio of 1 : 1)			

Equity Shareholders Account	Dr.	550	
To Realisation Account			550
(Transfer of loss on realisation)			
Equity Shareholders Account	Dr.	2,000	
To Shares in XYZ Ltd.			2,000
(Distribution of Shares of XYZ Ltd. among the shareholders)			

Journal Entries in the books of XY Ltd.

(Rs. '000)

		Dr. Rs.	Cr. Rs.
Equity Share Capital (Face value of Rs. 100) Account	Dr.	1,000	
To Equity Share Capital (Face value of Rs. 10) Account			100
To Reconstruction Account			900
(Face value of equity shares of Rs. 100 each reduced to Rs. 10 each)			
Equity Share Capital (Face value of Rs. 10 each) Account	Dr.	100	
To Equity Share Capital Account (Face value of Rs. 100 each)			100
(Consolidation of 10,000 equity shares of Rs. 10 each to 1,000 equity shares of Rs. 100 each)			
Loan from Financial Institutions Account	Dr.	60	
To Reconstruction Account			60
(Waiver of 15% of loan by financial institutions)			
Reconstruction Account Rs. (900 + 60)	Dr.	960	
To Profit and Loss Account			800
To Capital Reserve			160
(Utilisation of Reconstruction account balance to write off the Profit and Loss Account)			

Proposed Dividend Account	Dr.	200	
To Bank Account			200
(Payment of Proposed dividend to shareholders of RS Ltd.)			
Fixed Assets Account	Dr.	2,700	
Other Investments Account	Dr.	450	
Sundry Debtors Account	Dr.	400	
Cash and Bank Account	Dr.	250	
To Reserves Account			570
To 10% Debentures Account			500
To Loan from Financial Institutions Account			250
To Sundry Creditors Account			300
To Proposed Dividend Account			200
To Business Purchase Account			1,980
(Incorporation of various assets and liabilities acquired from RS Ltd. after cancellation of investment held by RS Ltd. in XY Ltd., profit on acquisition credited to Reserves Account)			
Business Purchase Account	Dr.	1,980	
To Liquidator of RS Ltd.			1,980
(Consideration Payable on business acquired from RS Ltd.)			
Liquidator of RS Ltd.	Dr.	1,980	
To Equity Share Capital of XYZ Ltd.			1,980
(Discharge of purchase consideration in the form of equity shares of XYZ Ltd.)			
Sundry Creditors Account	Dr.	100	
To Sundry Debtors Account			100
(Cancellation of intercompany owings)			

Balance Sheet of XYZ Ltd.

as on 31st March, 2006 (immediately after acquisition)

(Rs. in 000's)

Liabilities	Rs.	Assets	Rs.
Share Capital:		Fixed Assets net of depreciation	3,550

20,800 Equity Shares @ Rs. 100 each (1,980 + 20 + 80)	2,080	Investments	450
		Sundry Debtors	450
Capital Reserve	160		
General Reserve	570		
10% Debentures	500		
Loan from financial institutions	590		
Bank Overdraft (100 – 250 + 200)	50		
Sundry Creditors	500		
	4,450		4,450

Working Notes:

			Rs.
1.	Original Share Capital of XY Ltd.		
	10,000 Equity Shares of Rs. 100 each		10,00,000
	Share Capital of XY Ltd. after Reduction		
	10,000 Equity Shares of Rs. 10 each		1,00,000
2.	Share Capital of XY Ltd. after Reconsolidation		
	1,000 Equity Shares of Rs. 100 each		1,00,000
3.	Reduced value of holdings of RS Ltd. in XY Ltd.		
	RS Ltd. was holding 20% of XY Ltd., that is,		
	2,000 Equity Shares of Rs. 100 each		2,00,000
	which has now reduced to 200 Equity Shares of Rs. 100 each		20,000
4.	Calculation of Purchase Consideration		
	Equity Share Capital of RS Ltd. 20,000 Equity Shares of Rs. 100 each		20,00,000
	Exchange Ratio = 1 : 1		
	No. of Equity Shares to be given	20,000	
	Less: No. of Equity Shares already held by RS Ltd.	200	
		19,800	
	Purchase consideration		
	19,800 Equity Shares of Rs. 100 each		19,80,000
5.	Aggregate Reserves in the new company on acquisition		
	Reserves of RS Ltd. acquired		8,00,000
	Less: Loss on investments held by RS Ltd.		
	Value of investments cancelled	2,50,000	
	Less: Reduced value of shares of XY Ltd.	20,000	2,30,000
	Amount of Reserves to be carried to Balance Sheet		5,70,000

6. Share Capital in Combined Balance Sheet of XYZ Ltd.

Holding of RS Ltd. (200 Equity Shares @ Rs. 100 each)	20,000
Other Existing Shares (800 Equity Shares of Rs. 100 each)	80,000
Given as Purchase Consideration (19,800 equity shares @ Rs.100 each)	19,80,000
	20,80,000

7. It has been assumed that the bank overdraft and cash balance can be netted of.

Alternative Solution:

The candidates may pass a journal entry in the books of XY Ltd. for cancellation of shares held by RS Ltd.

In that case the first three entries in books of XY Ltd. will remain the same, further:-

		Dr.	Cr.
			(Rs. '000)
		Rs.	Rs.
Equity Share Capital Account	Dr.	20	
To Reconstruction Account			20
Equity Share Capital (Rs.10) Account	Dr.	80	
To Equity Share Capital Account (Rs.100)			80
Reconstruction Account	Dr.	980	
To Profit and Loss Account			800
To Capital Reserve			180
Fixed Assets Account	Dr.	2,700	
Other Investments Account	Dr.	450	
Sundry Debtors Account	Dr.	400	
Cash and Bank Account	Dr.	250	
To Reserves Account			550
To 10% Debentures Account			500
To Loan from Financial Institutions Account			250
To Sundry Creditors Account			300
To Proposed Dividend Account			200
To Business Purchase Account			2,000

Business Purchase Account	Dr.	2,000	
To Liquidator of RS Ltd.			2,000
Liquidator of RS Ltd.	Dr.	2,000	
To Equity Shares (Rs.10 each)			2,000

Note: In the Balance Sheet, capital reserve will go up by Rs.20,000 and general reserve will come down by Rs. 20,000.

2. (a) X Ltd.

Cash Flow Statement for the year ended 31st March, 2007

(Using the direct method)

	Rs. '000	Rs. '000
Cash flows from operating activities		
Cash receipts from customers	2,800	
Cash payment to suppliers	(2,000)	
Cash paid to employees	(100)	
Cash payments for overheads	(200)	
Cash generated from operations	500	
Income tax paid	(250)	
Net cash from operating activities		250
Cash flows from investing activities		
Payment for purchase of fixed assets	(200)	
Proceeds from sale of fixed assets	100	
Net cash used in investing activities		(100)
Cash flows from financing activities		
Proceeds from issuance of equity shares	300	
Bank loan repaid	(300)	
Dividend paid	(50)	
Net cash used in financing activities		(50)
Net increase in cash		100
Cash at beginning of the period		50
Cash at end of the period		150

(b) Calculation of correct Profit

	Department X Rs.	Department Y Rs.	Department Z Rs.
Profit after charging managers' commission	36,000	27,000	18,000
Add back : Managers' commission (1/9)	4,000	3,000	2,000
	40,000	30,000	20,000
Less :Unrealised profit on stock (Working Note)	4,000	4,500	2,000
Profit before Manager's commission	36,000	25,500	18,000
Less :Commission for Department Manager @10%	3,600	2,550	1,800
	32,400	22,950	16,200

Working Note :

Stock lying with

	Dept. X Rs.	Dept. Y Rs.	Dept. Z Rs.	Total Rs.
Unrealised Profit of :				
Department X		1/5×15,000 =3,000	1/11×11,000 =1,000	4,000
Department Y	0.15×14,000 =2,100		0.20×12,000 =2,400	4,500
Department Z	1/6×6,000 =1,000	1/5×5,000 =1,000		2,000

3. (a) Realization Account

Dr.	Rs.		Cr. Rs.
To Sundry Debtors	3,50,000	By Sundry Creditors	3,00,000
To Stock	2,00,000	By Provision for Doubtful Debts	50,000
To Other assets	3,10,000	By Ajay's Capital A/c (Debtors)	2,80,000
To Ram's Capital A/c: (Creditors)	3,00,000	By Shyam's Capital A/c (stock)	1,90,000
To Cash (Expenses on realization)	30,000	By Cash (Other assets)	3,00,000
		By Ajay's Capital A/c	28,000
		By Vijay's Capital A/c	7,000
		By Ram's Capital A/c	14,000
		By Shyam's Capital A/c (Loss on realisation)	21,000
	11,90,000		11,90,000

Capital Accounts

Dr.	Ajay Rs.	Vijay Rs.	Ram Rs.	Shyam Rs.		Ajay Rs.	Vijay Rs.	Ram Rs.	Cr. Shyam Rs.
To Balance b/f	–	2,00,000	1,50,000	–	By Balance b/f	7,00,000	–	–	3,00,000
To Realisation (Debtors)	2,80,000	–	–	–	By Realisation (Creditors)	–	–	3,00,000	–
To Realisation (Stock)	–	–	–	1,90,000	By Balance c/d	–	2,07,000	–	–
To Realisation (loss)	28,000	7,000	14,000	21,000					
To Balance c/d	3,92,000	–	1,36,000	89,000					
	7,00,000	2,07,000	3,00,000	3,00,000		7,00,000	2,07,000	3,00,000	3,00,000
To Balance b/d	–	2,07,000	–	–	By Balance b/d	3,92,000	–	1,36,000	89,000
To Vijay's A/c	1,29,570	–	–	55,530	By Cash	–	21,900		
To Cash	2,62,430	–	1,36,000	33,470	By Ajay	–	1,29,570		
					By Shyam	–	55,530	–	–
	3,92,000	2,07,000	1,36,000	89,000		3,92,000	2,07,000	1,36,000	89,000

Cash Account

Dr.	Rs.			Cr. Rs.
To Balance b/d	1,40,000	By Realisation A/c (expenses)		30,000
To Realisation A/c	3,00,000	By Capital A/c		
To Vijay's Capital A/c	21,900	Ajay	2,62,430	
		Ram	1,36,000	
		Shyam	33,470	
				4,31,900
	4,61,900			4,61,900

Note:

1. Since creditors are taken over by Ram as per Balance Sheet figures, a direct entry for the same in Ram's Capital A/c is also correct.
2. Ajay takes over Debtors at 80% of Rs. 3,50,000 i.e. Rs. 2,80,000.
3. Vijay's deficiency will be borne by Ajay and Shyam in the ratio of 7 : 3 i.e. on opening capitals of Rs. 7,00,000 and Rs. 3,00,000. Ram will not bear any portion of the loss since at the time of dissolution he had a debit balance in his capital account.

(b)

	Rs.
Cost incurred till 31st March, 2006	64,99,000

Prudent estimate of additional cost for completion	32,01,000
Total cost of construction	97,00,000
Less: Contract price	85,00,000
Total foreseeable loss	12,00,000

According to para 35 of AS 7 (Revised 2002), the amount of Rs. 12,00,000 is required to be recognized as an expense.

Contract work in progress = $\frac{\text{Rs. } 64{,}99{,}000 \times 100}{97{,}00{,}000}$ = 67%

Proportion of total contract value recognized as turnover as per para 21 of AS 7 (Revised) on Construction Contracts.

= 67% of Rs.85,00,000 = Rs.56,95,000.

(c) Statement of Claim

	Rs.
Closing stock on 25th August, 2006	
(Memorandum Trading Account)	60,000
Less: Salvage	15,000
Loss	45,000
	.
Application of average clause:	
Value of stock on hand	60,000
Amount of policy	50,000
Admissible claim = (50,000/60,000) x 45,000	37,500

Memorandum Trading A/c of Mr. X
for the period ending 25.8.2006

Dr.				Cr.
		Rs.		Rs.
To Opening stock		40,000	By Sales	90,000
To Purchases	85,000		By Closing stock	60,000
Less: Drawings	5,000	80,000	(balancing figure)	
To Gross profit		30,000		
@ 33-1/3 % of sales				
		1,50,000		1,50,000

4. (a) Income and Expenditure Account of Mumbai Club

for the year ended 31st December, 2006

Dr.					Cr.
Expenditure	Rs.	Rs.	Income	Rs.	Rs.
To Salary		2,000	By Donation	5,000	
To Repair expenses		500	Less: Capitalised (50%)	2,500	2,500
To Misc expenses	500		By Subscriptions	12,000	
Less: Prepaid	90	410	Add: Outstanding	900	
To Insurance premium	200			12,900	
Add: Outstanding	40	240	Less: Advance for 2007	350	12,550
To Paper, ink etc		150	By Entrance fees		1,000
To Drama expenses		500	By Interest on investment		300
To Surplus-excess of income over expenditure		14,150	100+[(8/100)x6,000x(5/12)]		
			By Interest received from bank		400
			By Sale of old newspapers		150
			By Sale of drama tickets		1,050
		17,950			17,950

Balance Sheet of Mumbai Club
as on 31st December, 2006

Liabilities	Rs.	Rs.	Assets	Rs.
Capital fund			Billiard table	30,000
Opening balance	36,000		Furniture	6,000
Add: Surplus	14,150		Investments	6,000
Donations	2,500	52,650	Interest accrued	200
Outstanding insurance premium		40	Prepaid expenses	90
Subscription received in advance		350	Subscriptions receivable	900
			Cash in hand	2,650
			Cash at bank	7,200
		53,040		53,040

Working Note:

Balance Sheet of Mumbai Club
as on 31st December, 2005

Liabilities	Rs.	Assets	Rs
Capital fund	36,000	Billiard table	30,000

(balancing figure)		Cash in hand	4,000
Creditors for billiard table	8,000	Cash at bank	10,000
	44,000		44,000

(b) Calculation of Average Due Date

Date of bill	Term	Due date	No. of days from 10th August 2004	Amount Rs.	Product Rs.
August 10, 2004	3 months	Nov. 13, 2004	95	6,000	5,70,000
October 23, 2004	60 days	Dec. 25, 2004	137	5,000	6,85,000
December 04, 2004	2 months	Feb. 07, 2005	181	4,000	7,24,000
January 14, 2005	60 days	Mar. 18, 2005	220	2,000	4,40,000
March 08, 2005	2 months	May 11,2005	274	3,000	8,22,000
				20,000	32,41,000

Average due date=- $\frac{\text{Total of product}}{\text{Total of amount}}$

$= \frac{32,41,000}{20,000} = 162.05 \text{ days}$

=162 days (Approx.) after August10, 2004

i.e. January 19, 2005.

5. (i) True – Disclosure of significant accounting policies must form part of the financial statements and these policies must be disclosed separately, at one place in annual report e.g., policies relating to valuation of inventory, depreciation accounting, etc.

(ii) Calculation of new profit sharing ratio

D is to get 1/8th share in profit

The remaining profit of the firm = 1 – 1/8 = 7/8

Remaining profit will be shared by A, B and C in their old profit sharing ratio. Thus, the new profit sharing ratio of A, B and C will be calculated as follows:

A $7/8 \times 6/14 = 3/8$

B $7/8 \times 5/14 = 5/16$

C $7/8 \times 3/14 = 3/16$

Therefore, the new profit sharing ratio is 3/8 : 5/16 : 3/16 : 1/8 or 6: 5: 3: 2

(iii) False: According to the rule of Garner vs. Murray, the loss on account of insolvency of a partner should be borne by the solvent partners in the ratio of their capitals standing in the balance sheet, just before the dissolution of the partnership firm.

(iv) Loss arising out of obsolescence of machinery is revenue expenditure. This loss is to be charged against revenue of the year in which such loss is recognised. In this case, loss due to obsolescence is:

	Rs.
Cost	5,00,000
Less: Depreciation 2000-2006	3,50,000
Written down value at the end of 2006	1,50,000
Less: Estimated scrap value	50,000
	1,00,000

This loss is revenue loss in nature.

(v)

			Rs.
Amount received			42,000
Add : Outstanding on 31st Dec.,	2005		3,000
			45,000
Less : Received on account of	2004	1,600	
	2006	600	2,200
			42,800

(vi) As per para 5 of AS 2 on Valuation of Inventories, inventories should be valued at the lower of cost and net realizable value. Inventories should be written down to net realizable value on an item-by-item basis in the given case.

Items	Historical Cost (Rs. in lakhs)	Net Realisable Value (Rs. in lakhs)	Valuation of closing stock (Rs. in lakhs)
A	40	28	28
B	16	24	16
	56	52	44

Hence, closing stock will be valued at Rs. 44 lakhs.

(vii) As per para 21 of AS 6 on Depreciation Accounting, when a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In the given case, there is a surplus of Rs. 21.58 lakhs on account of change in method of depreciation, which will be credited to Profit and

Loss Account. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

(viii) The statement given in the question is correct and is in accordance with the Accounting Standard (AS) 5 (Revised) "Net Profit or Loss for the Period. Prior Period Items and Changes in Accounting Policies''.

The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustments within the definition of an extraordinary item or a prior period item.

(ix)

Particulars	Rs.	Rs.
Equity Shares (42,000 x 10)		4,20,000
Preference Share Capital	1,70,000	
Add: Premium on Redemption	17,000	1,87,000
Purchase Consideration		6,07,000

(x)

Calculation of the cost of construction of Assets

Particulars	Rs.
Direct Materials	1,000,000
Direct Labour	50,000
Direct Expenses	250,000
Office & Administrative Expenses	40,000
Depreciation	10,000
Cost of the Asset	1,350,000

(xi) True- In case the due date of a bill falls after the date of closing the account, then no interest is allowed for that. However, interest from the date of closing to such due date is written in 'Red-Ink' in the appropriate side of Account Current. This red-ink interest is treated as negative interest.

6. (i) According to para 13 of AS 4 "Contingences and Events occurring after the Balance Sheet Date", assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date.

In this case the sale of immovable property was carried out before the closure of the books of Accounts. This is clearly an event occurring after the balance sheet date. Agreement to sell was effected before the balance sheet date and the registration was done after the balance sheet date. So the adjustment for the sale of immovable property is necessary in the books of account for the year ended 31st March, 2006.

(ii) As per para 41 of AS 26 'Intangible Assets', no intangible asset arising from research (or from the research phase of an internal project) should be recognized. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred. Thus the company cannot treat the expenditure as deferred revenue expenditure. The entire amount of Rs. 33 lakhs spent on research project should be charged as an expense in the year ended 31st March, 2006.

(iii) Non-profit making organizations such as public hospitals, public educational institutions, clubs etc., conventionally prepare Receipt and Payment Account and Income and Expenditure Account to show periodic performance for a particular accounting period. The distinguishing features of both the accounts can be summarized as:

Receipt and Payment Account is an elementary form of account consisting of a classified summary of cash receipts and payments over a certain period together with cash balances at the beginning and close of the period. The receipts are entered on the left hand side and payments on the right hand side i.e. same sides as those on which they appear in cash book. All the receipts and payments whether of a revenue or capital nature are included in this account. The balance of the account at the end of a period represents the difference between the amount of cash received and paid up. It is always in debit since it is made up of cash in hand and at bank.

Income and Expenditure Account resembles a Profit and Loss Account and serves the same function in respect of a non-profit making concern as the last mentioned account does for a firm, carrying on business or trade. Income and Expenditure Account is drawn up in the same form as the Profit and Loss Account. Expenditure of revenue nature only is shown on the debit side, and income and gains of revenue nature are shown on the credit side. Income and Expenditure Account contains all the items of income and expenditure relevant to the period of account, whether received or paid out as well as that which have fallen due for recovery or payment. Capital receipts, prepayments of income and capital expenditures, prepaid expenses are excluded. It does not start with any opening balance. The closing balance represents the amount by which the income exceeds the expenditure only or vice-versa.

(iv) Banks have to classify their advances into four broad groups:

(i) Standard Assets—Standard assets is one which does not disclose any problems and which does not carry more than normal risk attached to the business. Such an asset is not a NPA as discussed earlier.

(ii) Sub-standard Assets—Sub-standard asset is one which has been classified as NPA for a period not exceeding 18 months. In the case of term loans, those where instalments of principal are overdue for period exceeding one year should be treated as sub-standard. In other words, such an asset will have well-defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the bank will sustain some loss, if deficiencies are not corrected.

(iii) Doubtful Assets—A doubtful asset is one which has remained NPA for a period exceeding 18 months. In the case of term loans, those where instalments of principal have remained overdue for a period exceeding 18 months should be treated as doubtful. A loan classified as doubtful has all the weaknessses inherent in that classified as sub-standard with added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

(iv) Loss Assets—A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspectors but the amount has not been written off, wholly or partly.

The classfication of advances should be done taking into account (i) Degree of well defined credit worthiness and (ii) Extent of dependence on collateral security.

The above classification is meant for the purpose of computing the amount of provision to be made in respect of advances and not for the purpose of presentation of advances in the balance sheet.

(v) Accounting Standard 19 has divided the lease into two types viz. (i) Finance Lease and (ii) Operating Lease.

Finance Lease : A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. title may or may not eventually be transferred. At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and liability should be the present value of the minimum lease payments from the standpoint of the lessee.

Operating Lease : A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

PROFESSIONAL COMPETENCE COURSE

Model Test Paper – BOS/PCC/Auditing And Assurance – 1/2007

GROUP-I

PAPTER – 2 : AUDITING AND ASSURANCE

SUGGESTED ANSWERS/HINTS

1 (a) A Government company has been defined in section 617 of the Companies Act,1956 "as any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Government company as thus defined". Therefore SG Ltd. is a Government company by definition.

(b) In terms of section 224A, a company in which not less than 25% of the subscribed capital is held by the Central Government shall appoint or re-appoint an auditor in the annual general meeting only by passing a special resolution. Therefore SBC Ltd. is required to appoint / reappoint the auditor by special resolution.

(c) As per sub-section (7) of section 224, an auditor may be removed from office before the expiry of his term, by the company in a general meeting, obtaining the prior approval of the Central Government in that behalf except that such approval is not required for the removal of the first auditor appointed by the Directors under the proviso to sub-section (5) of section 224. Thus 'Pratham' the first auditor of company Nirman Pvt. Ltd. may be removed without obtaining prior approval of Central Government.

(d) Paragraph 2 of the CARO provides that it shall not apply to a company licensed to operate under section 25 of the Companies Act, 1956 . Therefore 'Dharm Sanstha' is exempt from the applicability of CARO.

(e) Statutory auditor is appointed by the shareholders and the internal auditor is appointed by the Board of directors. Therefore this statement is false.

(f) NGOs registered under the Companies Act, 1956 must maintain their books of account under the accrual basis as required by the provisions of section 209(3)(b) of the said Act. If the accounts are not maintained on accrual basis, it would amount to non-compliance of the provision of the Companies Act, 1956.

(g) Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client. Audit working papers are the property of the auditor and he is entitled to retain them. (Chantery Martin & Co. v. Martin). Thus claim of Directors is not proper.

(h) Part I of the Second Schedule to the Chartered Accountants Act, 1949, provides that "A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force."Therefore 'D' is guilty of professinal misconduct.

(i) Control Risk is the risk that the client's system internal control will not prevent or correct such errors, to assess control risk, the auditor should consider the adequacy of control design as well as test adherence to control procedure.

(j) As required by AS 10 on "Accounting for Fixed Assets", goodwill has been recorded in the books only when some consideration in money or money's worth has been paid for. Therefore the entry passed by ACC & Co. is not in confirmity with AS 10.

(k) Creation of revaluation reserves does not result into any cash inflows and represents unrealised gains. However, brought forward losses are in the nature of revenue losses. As a matter of prudence, revenue losses can be adjusted against revenue reserves only and not the capital reserves. Therefore, the accounting treatment followed by the entity is not correct and the auditor should qualify the audit report by mentioning the above fact.

(l) Section 226(3) of the Companies Act, 1956 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding one thousand rupees. Therefore the auditor is disqualified for appointment as an auditor of the company.

2 (a) As per AAS 16 "Going Concern" when planning and performing audit procedures and in evaluating results thereof, the auditor should consider the appropriateness of going concern assumption underlying the preparation of financial statements.

The auditor should consider the risk that the going concern assumption may no longer be appropriate. There may be some indications questioning the appropriateness of going concern assumption. Those indicatorsare can be classified into three categories:

Financial Indications:

(a) Negative net worth or negative working capital.

(b) Substantial operating losses, and negative cash flows from operations.

(c) Adverse key financial ratios.

(d) Excess short-term borrowings to finance long-term assets.

(e) Arrears of dividend.

(f) Increase of creditors, and inability to pay them on due dates.

(g) Inability to repay the long-term loans on maturity.

(h) Entering into a scheme of arrangement with creditors for reduction of liability.

Operating Indications

(i) Loss of key management personnel without replacement.

(ii) Shortage of important supplies.

(iii) Loss of major market.

(iv) Industrial unrest.

Other Indications:

(i) Non compliance with statutory requirements.

(ii) Sickness of entity under any statutory definition.

(iii) Changes in laws or any government policy, adversely affecting the working of the entity.

(iv) Pending legal proceedings against the entity, which will adversely affect the entity.

(b) The purpose of the AAS 20 (Knowledge of Business) is to establish standards on what is knowledge of the business, why it is important to the auditor and to members of the audit staff working on an engagement, why it is relevant to all phases of an audit, and how the auditor obtains and uses that knowledge.

The auditor can obtain knowledge of the industry and the entity from a number of sources. For example:

- Previous experience with the entity and its industry.
- Discussion with people with the entity (for example, directors and senior operating personnel).
- Discussion with internal audit personnel and review of internal audit reports.
- Discussion with other auditors and with legal and other advisors who have provided services to the entity or within the industry.
- Discussion with knowledgeable people outside the entity (for example, industry economists, industry regulators, customers and suppliers).
- Publications related to the industry (for example, government statistics, surveys, texts, trade journals, reports prepared by banks and institutions and financial newspapers).
- Legislation and regulations that significantly affect the entity.
- Visits to the entity premises and plant facilities.
- Documents produced by the entity (for example, minutes of meetings, material sent to shareholders or furnished to regulatory authorities, promotional literature, prior years' annual and financial reports, budgets, internal management reports, interim financial reports, management policy manual,

manuals of accounting and internal control systems, chart of accounts, job descriptions, marketing and sales plans).

3. (a) Though it is true that in an EDP environment the trial balance always tallies, the same cannot imply that the job of an auditor becomes simpler. There can still be some errors of omissions like omission of certain entries, compensating errors, duplication of entries, etc. in the books of account even when the trial balance tallied. In today's complex business environment, the importance of trial balance in an audit has has to be gauzed not from the view point of arithmetical accuracy but the nature of transaction to be recorded which in fact have become very complex. The emergence of new forms of financial instruments like option and futures, derivatives, off-balance sheet financing, etc. have given rise to further complexities in recording and disclosure of transactions. In an audit besides the tallying of a trial balance, there are also other issues like estimation of depreciation, valuation of inventories, etc. which still require judgement to be exercised by the auditor. The total time taken in an audit may still be considerably higher even though the trial balance has tallied than an audit where the trial balance has not tallied. That responsibility will still remain even in an EDP environment. Therefore, simply because of EDP environment and the trial balance has tallied do not make the audit simpler.

   (b) 'Examination in Depth' implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction, i.e., from initiation to the completion of the transaction by receipt of payment of cash and delivery or receipt of the goods. This examination consists of studying the recording of transactions at the various stages through which they have passed. At each stage, relevant records and authorities are examined; it is also judged whether the person who has exercised the authority in relation to the transactions is fit to do so in terms of the prescribed procedure. For example, if payment to a creditor is to be verified "in depth", it would be necessary to examine the following documents:

   (a) The invoice and statement of account received from the supplier.

   (b) The entry in the stock record showing that the goods were received.

   (c) The Goods Received Note and Inspection Certificate showing that the goods on receipt were verified and inspected.

   (d) The copy of the original order and authority showing that the goods in fact were ordered by an authority which was competent to do so.

   It is to be emphasised that, so far as the management is concerned, the internal control should have willing acceptance at the hands of the employees and there should exist proper mechanism for such motivation.

4 (a) It is a quite normal that in any on going business entity many a times cheques are received from the customs on the last day of the accounting year. It is also quite likely, that cheques received on the last day of the accounting year could not be deposited in

the bank. Though normally speaking, it is expected that all cheques should be deposited in the bank daily. But there may be a possibility that such cheques which are received particularly during the late hours could not be deposited in the bank. Therefore, it is quite important to ensure that the system of internal control is effective and such cheques should be properly accounted for to avoid any frauds and that the financial statements reflect a true and fair view.

As far as internal control system is concerned, it should be ensured that a list of such cheques is prepared in duplicate and a copy of the same has been sent to person controlling the debtors' ledger and a second copy is handed over to cashier along with the cheques received. The person who is controlling the debtors' ledger should ensure that proper accounting entries have been passed by crediting respective debtors' accounts. The balance of cheques-in-hand should also be disclosed along with the cash and bank balances in the financial statements.

(b) A record of goods sent out on sale or return basis should preferably be kept in a specially ruled Day Book. In this book first memoranda entries are made; and only after the goods have been sold entries are made debiting the party and crediting the Sales Account. The auditor should refer to the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited, also that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or customers' accounts have been debited. Further, that the stock of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year, has been included in the closing stock.

5. The special steps involved in the audit of hospital are stated below:

(i) Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

(ii) Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

(iii) See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities settled on the hospital, has been collected.

(iv) Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(v) Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

(vi) Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.

(vii) Verify that grants, if any, received from Government or local authority have been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

(vii) Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee significant variations which have taken place.

(ix) Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Stock Register and that issues have been made only against proper authorisation.

(x) See that depreciation has been written off against all the assets at the appropriate rates.

(xi) inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

(xii) Obtain inventories, specially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.

6 (a) As per section 619 of the Companies Act, 1956,the auditor of a government company shall be appointed or re-appointed by the Comptroller and Auditor General of India. The provision applicable to the appointment of auditor of government companies also apply to another category of companies, even though they are not government companies as contained in section 619B of the Act. As per section 619B of the Companies act 1956 the provisions of section 619 apply to a company in which not less than 51% of the paid-up share capital is held by one or more of the following or any combination thereof:

(a) the Central Government and one or more government companies;

(b) any State Government or Governments and one or more government companies;

(c) the Central Government, one or more State Governments and one or more government companies;

(d) the Central Government and one or more corporations owned or controlled by the Central Government;

(e) the Central Government, one or more State Governments and one or more corporations owned or controlled by the Central Government;

(f) one or more corporations owned or controlled by the Central Government or the State Government;

(g) more than one government company; the auditor of such a company shall be appointed by the Central Government on the advice of the Comptroller and Auditor General of India.

Therefore provision of section 619 will be applicable to CG Ltd. as a Government Company and the State Government hold 51% of the paid-up share capital of CG Ltd. together.

(b) An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements. An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements. As CA. Sidharth has issued an unqualified audit report, it indicates that:

(a) the financial statements of ST Pvt. Ltd have been prepared using the generally accepted accounting principles, which have been consistently applied;

(b) the financial statements ST Pvt. Ltd comply with relevant statutory requirements and regulations; and

(c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

7 (a) Under the provisions of section 208, a company which has raised money by issue of shares to meet the cost of construction of any work or building or provision of any plant which cannot be made profitable for a long time, can pay interest on paid-up capital for a period and subject to conditions specified in sub-sections (2) to (7) of section 208. Accordingly, the payment of interest should be verified as follows:

(a) Ascertain that the payment is authorised by the Articles or by a special resolution.

(b) Verify that the previous sanction of the Central Government for making such payment has been obtained.

(c) Confirm that the interest has been paid only for such period as has been authorised by the Central Government and does not extend beyond the half-year next following during which the construction was completed or the plant was provided.

(d) Verify that the rate of interest shall, in no case exceed such rate as the Central Government may, by notification in official Gazzette direct.

(e) Check that the amount of interest paid has been added to the cost of assets created out of the capital.

The interest paid being a part of the capital expenditure incurred in bringing into existence assets, it should be added thereto. Until so added, it must be shown as a separate item in the Balance Sheet under the head 'Miscellaneous Expenditure'..

Therefore CNT Ltd. can pay interest on paid up share capital during construction period under section 208 of the Companies Act, 1956.

OR

The Companies (Amendment) Act, 1999 recognised that in the wake of globalisation of corporate sector, the employees will have to be rewarded suitably to share in the growth of company. By insertion of section 79A, the employees may be compensated in the form of "sweat equity shares". As per explanation to section 79A, the expression "sweat equity shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. The auditor may see that the sweat equity shares issued by the company are of a class of shares already issued and following conditions are fulfilled :

(a) The issue of sweat equity shares is authorised by a special resolution passed by the company in the general meeting;

(b) The resolution specifies the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

(c) Not less than one year has, at the date of the issue elapsed since the date on which the company was entitled to commence business;

(d) The sweat equity shares of a company whose equity shares are listed on a recognised stock exchange are issued in accordance with the regulations made by the Securities Exchange Board of India in this behalf:

Provided that in the case of a company whose equity shares are not listed on any recognised stock exchange, the sweat equity shares are issued in accordance with the guidelines as may be prescribed.

For the purposes of this sub-section, the expression "a company" means the company incorporated, formed and registered under this Act and includes its subsidiary company incorporated in a country outside India.

(b) Auditing is closely related with functional fields of business such as finance, production, marketing, personnel and other general areas of business management. With the overgrowing field of auditing, the financial services sectors occupy a dominant place in our system. While in general terms, the auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. The auditor is also expected to have a fair knowledge of the institutions that comprise the market place.

The knowledge of various institutions and Government activities that influence the operations of the financial market are also required to be understood by an auditor.

8 (a) Work performed by others : When the auditor delegates work to assistants or uses work performed by other auditors and experts he continues to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, as in the case of the work of branch auditors appointed under the Companies Act, 1956 the auditor's report should expressly state the fact of such reliance. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditor or experts is adequate for his purpose.

(b) Limitation on Scope: A limitation on the scope of the auditor's work may sometimes be imposed by the entity, for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary. However, when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists; the auditor should ordinarily not accept such a limited engagement as an audit engagement, unless required by statute. Also, a statutory auditor should not accept such an audit engagement when the limitation infringes on the auditor's statutory duties. A scope limitation may be imposed by circumstances, for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories. It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion. When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

(c) Qualities of Auditors: The auditor should possess specific knowledge of accountancy, auditing, taxation, etc. which are acquired by him during the course of his theoretical education.

The auditor should also have sufficient knowledge of general principles of law of contracts, partnership; specific statutes and provisions applicable, e.g. Companies Act, 1956, Co-operative Societies Act, etc.; client's nature of business and its peculiar features. Apart from the knowledge acquired by the auditor in the formal manner, the auditor should also possess certain personal qualities such as, tact;

caution; firmness; good temper; judgement; patience; clear headedness and commonsense; reliability and trust, etc.

In short, all those personal qualities that go to make a good person contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, AAS-1 mentions integrity, objectivity and independence as one of the basic principles.

Auditing is a profession calling for wide variety of knowledge to which no one has yet set a limit the most useful part of the knowledge is probably that which cannot be learnt from books because its acquisition depends on the alertness of the mind in applying to ever varying circumstances, the fruits of his own observation and reflection; only he who is endowed with common sense in adequate measure can achieve it.

PROFESSIONAL COMPETENCE COURSE

Model Test Paper – BOS/PCC/ Auditing And Assurance – 2/2007

GROUP-I

PAPTER – 2 : AUDITING AND ASSURANCE

SUGGESTED ANSWERS/HINTS

1 (a) As per AAS 4 (The Auditor's Responsibility To Consider Fraud And Error in an Audit of Financial Statements) the primary responsibility for the prevention and detection of fraud and error rests with both those charged with the governance and the management of an entity. Therefore the given statement is not true.

(b) As per AAS 12 (Responsibility of Joint Auditors) in case of difference of opinion among the joint auditors, the joint auditors having different view may report separately and in any case, are not bound by the views of the majority of joint auditors. Therefore the given statement is false.

(c) Payment of legal fees is normally revenue expenditure irrespective of the amount involved unless same is incurred to bring any new asset into existence. By the given expenditure neither any endurable benefit can be obtained in future in addition to what is presently available nor the capacity of the asset would be increased. Hence, treating such expenditure as capital expenditure is incorrect.

(d) A casual vacancy in the office of the auditor can be filled by the Board of Directors, provided such vacancy has not been caused by the resignation of the auditor. In case of a casual vacancy arising on account of resignation, only the company in general meeting can fill the vacancy by appointing another auditor.

(e) By "good evidence" we mean a highly satisfactory evidence available without any special effort or cost. For cash in hand the best evidence is 'count'; in respect of investment pledged with a bank, the banker's certificate.

(f) "Accounting Standard 1 defines, material items as relatively important and relevant items, i.e. "items the knowledge of which would influence the decisions of the users of the financial statements". Whether or not the knowledge of an item would influence the decisions of the users of the financial statements is dependent on the particular facts and circumstances of each case.

(g) Section 227 of the Companies Act, 1956 lays down the powers and duties of auditor. As per provisions of the law, it is no part of the auditor's duty to send a copy of his report to members of the company. The auditor's duty concludes once he forwards his report to the company. Hence in the given case, the auditor cannot be held liable for the failure to send the report to the shareholders.

(h) The term “private limited company”, as used in the CARO, should be construed to mean a company registered as a “private company” {as defined in clause (iii) of sub-section (1) of section 3 of the Act} and which has a limited liability. In other words, the Order would be applicable to private unlimited companies irrespective of the size of their paid-up capital and reserves, turnover, borrowings from banks/financial institutions.

(i) An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

(j) According to sub-section (2) of section 233(B), a cost auditor shall be appointed by the Board of Directors of the company in accordance with the provisions of sub-section (1B) of section 224 and with the previous approval of the Central Government. Thus Board of Directors is entitled to appoint the cost auditor with the previous approval of the Central Government.

(k) Under section 227(1) of the Companies Act, 1956, the auditor of a company has the right of access at all times to books and accounts and vouchers of the company whether kept at the head office of the company or elsewhere. Further, he is also entitled to require from the officers of the company such information and explanations which he considers necessary for the proper performance of his duties. Therefore, he has a statutory right to inspect the directors’ minutes book.

(l) As per AAS 5 (Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statement), the primary responsibility of prevention and detection of fraud and errors is of management and those charged with governance and not of the auditor.Therefore view of the director of TCG Ltd is wrong.

2 (a) AAS 22 on, “Initial Engagement-Opening Balances”, establishes standards regarding audit of opening balances in case of initial engagements, i.e., when the financial statements are audited for the first time or when the financial statements for the preceding period were audited by another auditor. It requires that the auditor should obtain sufficient appropriate audit evidence for initial audit engagements that:

(i) the closing balances of the preceding period have been correctly brought forward to the current period;

(ii) the opening balances do not contain misstatements that materially affect the financial statements for the current period; and

(iii) appropriate accounting policies are consistently applied.

As far as sufficiency and appropriateness of the audit evidence is concerned, the auditor needs to obtain regarding opening balances, would depend on the following matters:

(i) The accounting policies followed by the entity.

(ii) Whether the auditor's report contained an unqualified opinion, a qualified opinion, adverse opinion or disclaimer of opinion where the financial statements for the preceding period were audited.

(iii) The nature of the opening balances, including the risk of their misstatement in the financial statement for the current period.

(iv) The materiality of the opening balances relating to the financial statements for the current period.

When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

(b) As per AAS 28 (The Auditor's Report on Financial Statements) The auditor's report is a clear written expression of opinion on the financial statements taken as a whole.

Basic Elements Of Auditor's Report: The auditor's report includes the following basic elements, ordinarily, in the following layout:

(a) Title: The auditor's report should have an appropriate title. It may be appropriate to use the term "Auditor's Report" in the title

(b) Addressee: The auditor's report should be appropriately addressed as required by the circumstances of the engagement and applicable laws and regulations. Ordinarily, the auditor's report is addressed to the authority appointing the auditor.

(c) Opening or introductory paragraph: The auditor's report should identify the financial statements of the entity that have been audited, including the date of and period covered by the financial statements.

The report should include a statement that the financial statements are the responsibility of the entity's management and a statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.

(d) Scope paragraph: The auditor's report should describe the scope of the audit by stating that the audit was conducted in accordance with auditing standards generally accepted in India. The Auditing and Assurance Standards issued by the Institute of Chartered Accountants of India establish the auditing standards generally accepted in India. The report should include a statement that the audit was planned and performed to obtain reasonable assurance whether the financial statements are free of material misstatement.

The auditor's report should describe the audit as including:

(i) examining, on a test basis, evidence to support the amounts and disclosures in financial statements;

(ii) assessing the accounting principles used in the preparation of the financial statements;

(iii) assessing the significant estimates made by management in the preparation of the financial statements; and

(iv) evaluating the overall financial statement presentation.

The report should include a statement by the auditor that the audit provides a reasonable basis for his opinion.

(e) Opinion paragraph: The opinion paragraph of the auditor's report should clearly indicate the financial reporting framework used to prepare the financial statements and state the auditor's opinion as to whether the financial statements give a true and fair view in accordance with that financial reporting framework and, where appropriate, whether the financial statements comply with the statutory requirements.

The term used to express the auditor's opinion, "give a true and fair view", indicates, amongst other things, that the auditor considers only those matters that are material to the financial statements.

In addition to an opinion on the true and fair view, the auditor's report may need to include an opinion as to whether the financial statements comply with other requirements specified by relevant statutes or law.

(f) Date of the report: The date of an auditor's report on the financial statements is the date on which the auditor signs the report expressing an opinion on the financial statements. The date of report informs the reader that the auditor has considered the effect on the financial statements and on the report of the events and transactions of which the auditor became aware and that occurred up to that date.

Since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.

(g) Place of signature: The report should name specific location, which is ordinarily the city where the audit report is signed.

(h) Auditor's signature: The report should be signed by the auditor in his personal name. Where the firm is appointed as the auditor, the report should be signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report should also mention the membership number assigned by the Institute of Chartered Accountants of India.

A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding of the auditor's report and to identify unusual circumstances when they occur.

A statute governing the entity or a regulator may require the auditor to include certain matters in the audit report or prescribe the form in which the auditor should issue his report. In such a case, the auditor should incorporate in his audit report, the matters specified by the statute or regulator and/or report in the form prescribed by them in addition to the requirements of this AAS.

3 (a) In an CIS environment, an entity will establish an organizational structure and procedures to manage the CIS activities. Characteristics of an CIS organizational structure include:

a. Concentration of functions and knowledge: Although most systems employing CIS methods will include certain manual operations, generally the number of persons involved in the processing of financial information is significantly reduced. Furthermore, certain data processing personnel may be the only ones with a detailed knowledge of the interrelationship between the source of data, how it is processed and the distribution and use of the output. It is also likely that they are aware of any internal control weaknesses and, therefore, may be in a position to alter programs or data while stored or during processing. Moreover, many conventional controls based on adequate segregation of incompatible functions may not exist, or in the absence of access and other controls, may be less effective.

b. Concentration of programs and data: Transaction and master file data are often concentrated, usually in machine-readable form, either in one computer installation located centrally or in a number of installations distributed throughout an entity. Computer programs which provide the ability to obtain access to and alter such data are likely to be stored at the same location as the data. Therefore, in the absence of appropriate controls, there is an increased potential for unauthorized access to, and alteration of, programs and data.

(b) Personal Expenses of Directors:

(i) Check the articles of association, service contract, minutes of general meeting, etc., to check the authorisation for such payment.

(ii) Enquire to ensure that personal expenses are not camouflaged in any other revenue items as contemplated under section 227(1A) of the Companies Act, 1956.

(iii) Ascertain compliance with disclosure according to requirements of Schedule VI to the Companies Act, 1956.

(iv) Check documentary evidences to examine the payments reimbursed.

(v) Check compliance with requirements of CARO, 2003.

4 (a) in terms of section 224A, a company in which not less than 25% of the subscribed capital is held by : (i) a public financial institution or a government company or the Central Government, or any State Government, or (ii) any financial or other institution established by any Provincial or State Act in which a State Government, holds not less than 51% of the subscribed share capital, (iii) a nationalised bank or an insurance company carrying on general insurance business; or (iv) any combination of the above categories, shall appoint or re-appoint an auditor in the annual general meeting only by passing a special resolution.

As SBD Ltd. is a company in which 13% of the subscribed capital is held by a public financial institution and 14% of the subscribed capital is held by a Government company, SBD Ltd. is required to pass a special resolution for the appointment of auditor.

(b) Auditor's Lien: Under the general principles of law, if any person has lawful possession of the property of another person, on which he has worked, he may retain such property for non payment of any amount outstanding in respect of work done on the property.

Accordingly, the auditor may exercise lien on the client's documents in his possession for non payment of fees for work done for the client. Regarding books of account of a company, it may be noted that as per section 209 of the Companies Act, 1956, these must be kept at the registered office of the company. However, all or any of the books of account may be kept at any other place in India pursuant to a Board's Resolution, and notice must be filed with the Registrar.

Thus, as per such a resolution, if the Board of a company hands over the books of account to the auditor, the auditor may exercise his lien for non payment of fees. However, reasonable facilities must be provided for inspection of the books of account by the directors, members and other authorised persons.

The auditor needs to observe provisions of the Companies Act, 1956. Further, in respect of auditor exercising the lien, the views of the Institute of Chartered Accountants of England and Wales are worth noting:

(i) Documents must belong to the client who owes the money, and these documents must come to the possession of the auditor on the client's authority.

(ii) The auditor can retain such documents, only if he has done work on such documents, on which fees have not been paid.

5. A club is usually constituted as a company limited by guarantee. Therefore, various provisions of the Companies Act, 1956 relating to the audit of accounts of companies are also applicable to its audit. The special steps involved in such an audit are stated below :

(a) Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes, of the Managing Committee.

(b) Vouch member's subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.

(c) Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctly adjusted.

(d) Check totals of various columns of the Register of members and tally them across.

(e) See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.

(f) Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.

(g) Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services, to members to confirm that the account of every member has been debited with amounts recoverable from him.

(h) Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective stock registers.

(i) Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The stock of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.

(j) Check the stock of furniture, sports material and other assets physically with the respective stock registers or inventories prepared at the end of the year.

(k) Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts; also ascertain that the arrangements for their safe custody are satisfactory.

(l) Examine the financial powers of the secretary and, if these have been exceeded, report specific care for confirmation by the Managing Committee.

6 (a) Audit required under law: The organisations that require audit under law are the following:

(a) companies governed by the Companies Act, 1956;

(b) banking companies governed by the Banking Regulation Act, 1949;

(c) electricity supply companies governed by the Electricity Supply Act, 1948;

(d) co-operative societies registered under the Co-operative Societies Act, 1912;

(e) public and charitable trusts registered under various Religious and Endowment Acts;

(g) corporations set up under an Act of Parliament or State Legislature such as the Life Insurance Corporation of India.

(h) Specified entities under various sections of the Income-tax Act, 1961.

(b) Clause 4(vii) of CARO, 2003 requires the auditor to comment whether the company has an internal audit system commensurate with the size and nature of the business. The clause is required to be commented upon by the auditor in case of companies having a paid-up capital and reserves exceeding rupees 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned. This clause has a mandatory application for the listed companies irrespective of the size of paid-up capital and reserves or turnover.

It is important to note that the Companies Act, 1956 does not require a company to necessarily have an internal audit system. However, where such a system does not exist, the Order requires the auditor to mention the fact in his report. Since Order refers only to such companies which are either listed or companies having a paid-up capital and reserves in excess of rupees 50 lakhs or an average annual turnover in excess of rupees 5 crores for a period of three consecutive financial years immediately preceding the financial year concerned, it is desirable that BC Ltd. has an internal audit system. It is equally important to note that the internal audit system is a part of the overall internal control system. Therefore, the scope of the internal audit and the extent of its coverage will, to some extent, depend upon the existence or otherwise of other forms of internal control. This is also a factor to be considered when evaluating the adequacy of the internal audit system.

7 (a) Verification of Issue of Bonus Shares: Primarily, it should be ascertained whether the Articles permit capitalisation of profits; also whether the company had a sufficient number of unissued shares for allotment as bonus shares. In addition, the following steps should be taken :

(a) Inspect the Minute book of Shareholders for the resolution authorising declaration of the Bonus and Director's Minute for the resolution appropriating profits for being applied in payment of shares to be allotted to shareholders as bonus shares;

(b) Trace the allotment of shares as per particulars contained in the Allotment Book or sheets into the Register of Members; and

(c) Confirm that all statutory requirements relevant to the issue of shares have been complied with, viz., the filing of the particulars of the bonus shares allotted with the Registrar together with a copy of the resolution pursuant to which allotment has been made.

(d) Confirm that the issue of fully paid up bonus shares in pursuance of sub-section (3) of Section 205 has been kept in abeyance in respect of shares where any instrument of transfer of such shares has been delivered to the company for registration and the transfer of such shares has not been registered by the company as required by the provisions of section 206A of the Companies (Amendment) Act, 1988.

(e) Ensure that SEBI Guidelines relating to issue of bonus shares have been complied with.

The balances in the Securities Premium Account and Capital Redemption Reserve Account, which are not available for distribution as dividend, can be utilised for allotment of fully paid bonus shares to the members and the balance in the above-mentioned account are usually first utilised for the purpose.

All applications for bonus issue have to be signed by a person not below the rank of a Director together with a certificate indicating that the information furnished is true and correct and that all the data acquired in the application form and guidelines has been furnished.

OR

Audit Risk : Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated. An auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated. Such risk may exist at overall level, while verifying various transactions and balance sheets items. There are three components of audit risk:

(i) Inherent risk: is a risk that material errors will occur. Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

(ii) Control Risk: is the risk that the client's system internal control will not prevent or correct such errors, to assess control risk, the auditor should consider the adequacy of control design as well as test adherence to control procedure.

(iii) Detection Risk: is the risk that an auditor's procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes. The level of detection risk relates directly to the auditor's procedures, Some detection risk would always be present.

The inherent and control risks are functions of the entity's business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce on acceptable level of detection risk, thereby reducing audit risk to an acceptable low level.

(b) Significant matters observed during the course of audit, a record of which should be kept in the Audit Note Book :

(a) Audit queries not cleared immediately e.g. missing receipts, vouchers, etc.

(b) The mistakes or irregularities observed during the course of audit e.g. cases of failure to comply with the requirements of the Companies Act, 1956 or the provisions contained in the Memorandum or Articles; a change in the basis of valuation of finished stock and work-in-progress or in the computation of depreciation; failure to provide adequate depreciation, etc.

(c) Unsatisfactory book-keeping arrangements, costing method, internal or financial administration or organisation.

(d) Important information about the company which is not apparent from the accounts.

(e) Special points requiring consideration at the time of verification of final accounts.

(f) Important matters for future reference.

8 (a) Internal Control Questionnaire: This is a comprehensive series of questions concerning internal control. This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation.

An important advantage of the questionnaire approach is that oversight or ommission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail. In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given.

The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

(b) Director's Responsibility Statement [Section 217(2AA)]: Director's responsibility statement is aimed at highlighting the accountability of the directors with a view to ensuring good corporate governance. Director's responsibility statement shall disclose the following particulars:

(i) that in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;

(ii) that the directors had selected such accounting policies and applied them consistently and made judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit or loss of the company for that period;

(iii) that the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(iv) that the directors had prepared the annual accounts on a going concern basis.

(c) Intangible Assets: An intangible asset is that asset which does not have a physical identity but which is used by the enterprise for production or supply of goods or for retails to other or for administrative purpose. Such assets does not have any physical existence but their presence in the business is indicated with a value placed thereon. These assets include rights and benefit to owners subject to their being useful. For example : goodwill, patents, copyright etc. AS 26, "Intangible Assets", applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (for example, a prototype), the physical element of the asset is secondary to its intangible component, that is the knowledge embodied in it. This standard also applies to rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. An intangible asset should measured at cost. After initial recognition an intangible asset should be carried at its cost less any accumulated amortisation and any impairment losses.

Auditor should also ensure that proper disclosure is made in the financial statements about the carrying amount, amortisation methods, useful lives, etc.

PROFESSIONAL COMPETENCE COURSE

GROUP – I

Model Test Paper – BOS/PCC/ Law, Ethics and Communication – 1/2007

PAPER – 3 : LAW, ETHICS AND COMMUNICATION

SUGGESTED ANSWERS/HINTS

PART – I : LAW

1. Anticipatory breach of contract

   Anticipatory breach of contract occurs when the promisor refuses altogether to perform his promise and signifies his unwillingness even before the time for performance has arrived. In such a situation the promise can claim compensation by way of loss or damage caused to him by the refusal of the promisor. For this, the promisee need not wait till the time stipulated in the contract for fulfillment of the promise by the poimisor is over.

   In the given problem Dubious Textiles has indicated its unwillingness to supply the cotton shirts on 1st November 2006 itself when it has time upto 31st December 2006 for performance of the contract of supply of goods. It is therefore called anticipatory breach of contract. Thus Retail Garments show room can claim damages from Dubious Textiles immediately after 1st November, 2004, without waiting upto 31st December 2006. The damages will be calculated at the rate of Rs. 50 per shirt i.e. the difference between Rs. 350/- (the price prevailing on 1st November) and Rs. 300/- the contracted price.

2. A company can purchase its own shares or other specified securities. The Purchase should be out of:

   (i) its free reserves; or

   (ii) the securities premium account,. or

   (iii) the proceeds of any shares or other specified securities.

   However, buy back of any kind of other specified securities cannot be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities [Section 77A(i)].

   ‘Specified securities’ includes employees’ stock option or other securities as may be notified by the Central Government from time to time (Explanation (a) section 77A).

   In accordance with the provisions of the Companies Act, 1956, as contained in section 77A, the company deciding for buy back of shares must pass a special resolution in a general meeting of its members authorizing the company for the buy back. Secondly, the buy back is or less than 25% of the total paid-up capital and free reserves of the company.

Taking into account these two provisions (conditions) itself, the questions as asked in the problem can be answered as under:

1. The company's proposal for buy-back is not in order as it has passed only an ordinary resolution and the percentage of 30% buy-back is in violation of the provisions

2. The answer to the second question shall also be the same since there also the resolution passed by the company is an ordinary resolution and not special resolution, though the percentage of buy-back, i.e. 20% is not violative.

3. According Section 43 of Indian Contract Act, 1872 when two or more persons make a joint promise, the promisee may, in absence of express agreement to the contrary, compel any one or more of such joint promisers or perform the whole of the promise. Further, if any one of two or more joint promisers makes default in such contribution, the remaining joint promisors must bear the loss arising from such default in equal shares. Therefore, in this case, Robert is entitled to receive 2,500 from Rahims assets and 13,750 from Ram.

4. The word Proposal and offer are used interchangeably and it is defined under Section 2(a), Indian Contract Act, 1872 as when one person signifies to another his willingness to do or to abstain from doing anything with a view to obtaining the assent of that other to such act or abstinence, he is said to make a proposal.

   Rules: The following are the important rules of an offer: -

   Offer and an Invitation to an offer

   An offer is definite and capable of converting an intention into a contract. Where as, an invitation to an offer is only a circulation of an offer, it is an attempt to induce offers and precedes a definite offer. Acceptance of an invitation to an offer doest not result contract and only an offer emerges in the process of negotiation.

5. Holder in Due Course: It means any person who, for consideration became its possessor before the amount mentioned in it became payable. In the case of an instrument payable to order, 'holder in due course' means any person who became the payee or endorsee of the instrument before th4e amount mentioned in it became payable. In both the cases, he must receive the instrument without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title. In other words, holder in due course means a holder who takes the instrument bona fide for value before it is overdue, and without any notice of defects in the title of the person, who transferred it to him. Thus, a person who claims to be 'holder in due course' is required to prove that:

   1. on paying a valuable consideration, he became either the possessor of the instrument if payable to order;

   2. he had come into the possession of the instrument before the amount due there under became actually payable; and

3. he had come to possess the instrument without having sufficient cause to believe that any defect existed in the title of transferor's from whom derived his title.

   Distinction between Holder and Holder in Due Course:

   1. A holder may become the possessor or payee of an instrument even without consideration, whereas a holder in due course is one who acquires possession for consideration.

   2. A holder in due course as against a holder, must become the possessor payee of the instrument before the amount thereon become payable.

   3. A holder in due course as against a holder must have become the payee of the instrument in good faith i.e., without having sufficient cause to believe that any defect existed in the transferor's title.

6. Where an establishment consists of different departments or undertakings or has branches whether situated at the same place or in different places, all such departments or undertakings or branches are to be treated as parts of the same establishments for the purpose of bonus under Section 3 of the Payment of Bonus Act.

   But it has been provided that if, for any accounting year, a separate balance sheet and profit and loss account are prepared and maintained in respect of any such departments etc., then such department, undertaking or branch shall be treated as separate establishments for the purpose of calculation of bonus for that year, unless such department, etc., were immediately prior to the commencement of that accounting year, treated as part of the establishment for the purpose of computation of bonus. If these two conditions are fulfilled it is possible to provide for the payment of bonus unit-wise instead of establishment wise.

7. Section 43 of the Negotiable Instruments Act, 1881 provides that a negotiable instrument made, drawn, accepted, indorsed or transferred without consideration, or for a consideration which fails, creates no obligation of payment between the parties to the transaction. But if any such party has transferred the instrument with or without endorsement to a holder for consideration, such holder, and every subsequent holder deriving title from him, may recover the amount due on such instrument from the transferor for consideration or any prior party thereto.

   (i) In the problem, as asked in the question, A has drawn a bill on B and B accepted the bill without consideration and transferred it to C without consideration. Later on in the next transfer by C to D is for value. According to provisions of the aforesaid section 43, the bill ultimately has been transferred to D with consideration. Therefore, D can sue any of the parties i.e. A, B or C, as D arrived a good title on it being taken with consideration.

   (ii) As regards to the second part of the problem, the prior parties before D i.e., A, B, and C have no right of action inter se because first part of Section 43 has clearly lays down that a negotiable instrument, made, drawn, accepted, indorsed or transferred without consideration, or for a consideration which fails, creates no obligation of payment between the parties to the transaction prior to the parties who receive it on consideration.

8. (a) Modes of Acquiring Membership: A person may become a member of the company in any one of the following ways:

1. By subscribing to the memorandum of association: The persons who subscribe (i.e. sign) to the memorandum of association are deemed to have agreed to become the members of the company. And on the registration of the company, their names are entered as members on the register of members [Section 41].

2. By application and allotment of shares: A person, who agrees in writing to become a member of the company and whose name is entered in the register of member is also a member of the company [Section 41(2)]. The person intending to become a member has to make an application to the company for the purchase of its shares. On valid allotment, the name of the shareholder is entered in the register of member.

3. By agreeing to take qualification shares: A director of a public company is appointed when he takes or signs an undertaking to take and pay for his qualification shares. When a director signs and files with the Registrar an undertaking to take and pay for his qualification shares, he is in the same position as subscriber of the memorandum of association [Section 266(2)].

4. By transfer of shares: The Companies Act provides that the shares of a public company are freely transferable. Thus, one person may transfer his shares to any other person. On the registration of transfer of shares, the transferee becomes the member of the company.

5. By succession: The legal heirs of the deceased member/shareholder get a right to be a member of the company and be registered as a member of the company on the basis of the succession certificate. The company on the basis of the Succession Certificate enters their name in the Register of Members.

   A member and a shareholder: In the parlance of Company Law, the two words "member" and "shareholder", are similarly used by common people, thereby giving an impression that they are synonymous but in fact they can be differentiated on the following grounds:

   (1) A registered member may not be a shareholder, since a company may not be having Share Capital. For example, a company limited by guarantee and not having a share capital, does have members but not shareholders. But a registered shareholder is a member, since his name appears in the Register of Members maintained by the company.

   (2) A person who owns a share warrant (bearer), is not a member since his name does not appear in the Register of Members maintained by the company. He is a shareholder only [Section 115(1)].

(3) A legal representative of a deceased member is a shareholder but not a member, till he applies for registration and his name is entered in the Register of members.

9. One of the important features of a company is an artificial juristic person. Being a juristic person, company is capable of entering contract in its own name. According to Section 4 of the Partnership Act, 1932, partnership is a contractual relationship between persons; therefore, there should not be any objection to a company in becoming partner. Further, the limited liability element of a limited company is also do not restrict a company in becoming a partner in a unlimited liability of a partnership firm, because, it is limited liability of members of a limited company and not the company itself. However, the Department of Company Affairs (now Ministry …) is in the opinion that, a company may become a partner if the Memorandum of Association specifically allows it.

   A private company can have a greater degree of secrecy as regards its affairs and enjoys greater freedom on its operation. It enjoys some privileges and exemptions which a public company is deprived of. Briefly these are as follows:

   1. Two or more persons may form a private company [Section 12(1)].
   2. It need not hold a Statutory Meeting or file a statutory report [Section 165].
   3. The consent of directors to act as such, and to take up qualification shares need not be filed with the Registrar [Section 266].
   4. There is no restriction on the amount of overall managerial remuneration that it may pay [Section 198].
   5. The directorship of a private company is not includible in the maximum number of directorships that a person may hold [Section 310].
   6. The consent of the Central Government for advancing loans to directors is not required [Section 295].
   7. There are no restrictions on the powers of the Board of Directors [Section 293].
   8. The Central Government is not empowered to prevent a change in the Board of Directors of a company which is likely to affect management prejudicially [Section 409].
   9. It can advance loans for the purchase of its own shares [Section 77(2)].

10. A proxy is an instrument in writing executed by a shareholder authorizing another person to attend a meeting and to vote thereat on his behalf and in his absence. The term is also applied to the person so appointed.

    According to Section 176, the appointment of proxy must be in written instrument signed by the appointer or his duly authorized attorney. The instrument of proxy must be deposited with the company 48 hours before the meeting. Further, unless articles otherwise provide:

    1. a member of a company having no share capital cannot appoint a proxy;

2. a member of a private company cannot appoint more than one proxy to attend on the same occasion;

3. a proxy shall not be entitled to vote except on a poll.

11. A company desirous of declaring interim dividend should follow the procedure given below:

    1. Verify that the Board of Directors has declared the interim dividend.

    2. Ascertain whether profits for the part of the financial year up to the time of proposed declaration are sufficient to justify payment of interim dividend. Availability of profits should be ascertained after taking into account depreciation and compulsory transfer to reserves. Auditor's opinion should also be obtained.

    3. Intimate the stock exchange(s) about the Board meeting to consider the payment of interim dividend

    4. Resolution of the Board of directors should state the rate of dividend, deposit of interim dividend in a separate account within five days from the date of its declaration, the date in reference to which shareholders registered in the Register of Members are to receive interim dividend, record date or the period of closure of the Register of Members and transfer books, date of posting of dividend warrants, etc. The Secretary may be authorized to take necessary action in this regard.

    5. Inform the Stock Exchange of the date of the closure of Register of Members.

    6. At least seven days before the closure of the Register of Members or the record date fixed, publish a notice in this regard in a newspaper circulating in the district in which the registered office of the company is situate.

    7. Open a separate 'Interim Dividend Account' with a Bank and issue necessary instructions to the Bank.

    8. Post 'Dividend Warrants' within 30 days from the declaration of interim dividend.

    9. Dividend warrants to non-resident shareholders should be posted after securing necessary permission of the Reserve Bank as per the provisions of FEMA, 1999. However, if dividend-balancing rule is applicable to the company paying dividend, no foreign exchange will be released.

12. Effect of Irregular allotment: When the shares are not allotted in pursuance of Section 69 and 70 (i.e. without receiving the minimum subscription and without filing a prospectus or statement in lieu of prospectus to the registrar before the allotment) such an allotment is an irregular allotment. Inspite of the stringent provision of Section 69 and 70 one may find that allotment has been made in utter contravention thereof. The directors may choose to take a chance and proceed to allot shares although minimum subscription has not reached or a prospedctus or statement in lieu of prospectus has not been filed. Such an allotment is not void initio but as irregular.

    The applicant for the shares may avoid the allotment, if he does so within the time specified by Section 71, namely:

(a) where the allotment was made before the statutory meeting within 2 months after the holding of statutory meeting of the company and not later; or

(b) where no statutory meeting is required to be held by the company, within 2 months after the date of allotment and not later; or

(c) where the allotment was made after the statutory meeting, within 2 months of allotment (and not later) the allotment shall be voidable despite the fact that the company is in the course of being wound up.

Within the aforesaid period, the allottee must intimate to the company that he wants to avoid the allotment. If legal proceedings are required to be taken, these need not be within the period of two months provided the notice of avoidance was served on the company within the aforesaid time but they should be reasonably prompt thereafter if they are required to be brought.

Furthermore, Section 71(3) makes every director of a company, who knowingly contravenes or authorizes the contravention of any of the provisions of Section 69 or Section 70 with respect to allotment, liable to compensate the company and the allottee for any loss, damages or costs which they have sustained or incurred thereby. But the proceedings for such compensation can only be taken within 2 years from the date of allotment. As the allotment is voidable at the option of the shareholder, the shareholder may keep the shares and yet sue the directors who have knowingly contravene either of the two sections i.e. 69 and 70 to compel them to make good the loss to him as a result of the irregular allotment.

PART – II : BUSINESS ETHICS

13. (a) WORKPLACE ETHICS

"Workplace ethics" is how one applies values to work in actual decision making - a set of right and wrong actions that directly impact the workplace. They are an extension of the personal standards or lack of them that is intrinsic in the people who comprise the workplace. It is about making choices that may not always feel good or seem beneficial but are the "right" choices to make.

Ethical decisions in an organization are influenced by three key factors: individual moral standards, the influence of managers and co-workers, and the opportunity to engage in misconduct. While one may have great control over personal ethics outside the workplace, co-workers and management through authority and example, exert significant control on ones choices at work. In fact, the activities and examples set by co-workers, along with rules and policies established by the firm, are critical in gaining consistent ethical compliance in an organization. If the company fails to provide good examples and direction for appropriate conduct, confusion and conflict will develop and result in the opportunity for unethical behaviour. For example if your boss or co-workers leave work early, you may be tempted to do so as well. If you see co-workers making personal long-distance phone calls at work and charging them to the company, then you may be more likely to do so also. An individual's ethical behaviour affects not only his or her reputation within the company, but may also contribute to the way in which the company is perceived by others.The behaviour of businesspersons toward customers, suppliers, and others in their workplace may also generate ethical concerns. Ethical behaviour within a business involves keeping company secrets, meeting obligations and responsibilities, and avoiding undue pressure that may force others to act unethically. For example, should a salesperson omit the fact of frequent replacement of the filter while selling a kitchen chimney to a prospective customer? When does offering a gift to a customer become a bribe rather than a sales promotion? There are no easy answers. Employers who understands the importance of workplace ethics, provide their workforce with an effective framework and guiding principles to identify and address ethical issues as they arise. A clear code of conduct practiced at the highest level, fairness and honesty in its dealings with all stakeholders and prohibition of any kind discrimination and harassment are the characteristics of an highly ethical workplace.

(b) CORPORATE GOVERNANCE-KEY ISSUES

Corporate governance is concerned with structures and processes for decision making, accountability, control and behaviour at the top level of organisations. It influences how the objectives of an organisation are set and achieved, how risk is monitored and assessed and how performance is optimised. Corporate governance has an important role to play as an instrument of investor protection. Generally, corporate governance measures include appointing non-executive directors, placing constraints on management power and ownership concentration, as well as ensuring proper disclosure of financial information and executive compensation. The traditional governance model positions management as accountable solely to investors (shareholders). But now it is accepted that constituents other than shareholders viz. employees, trade unions, customers, suppliers, local community, Government, competitors are also affected by corporate activity, and that the corporation must therefore be answerable to them. Corporate Governance is getting a focused attention for satisfying the divergent interests of the stakeholders of a business enterprise especially after the corporate scandals and loss of shareholder value at Enron and several other large companies in 2002 and 2003, which focused more attention on the issue of shareholder rights, calling for greater transparency and accountability and enhancing corporate reporting and disclosure. The scandals led to numerous corporate governance reforms, including passage of the Sarbanes - Oxley Act and the adoption of new listing requirements by the New York Stock Exchange in the United States. Other countries have introduced similar legal requirements. In India interest was generated after the report of the Cadbury Committee in 1992 and various Committees were set up by SEBI and DCA to recommend further improvements in corporate governance applicable to Indian companies. In February, 2000, based on the recommendation of Kumar Mangalam Birla Committee, SEBI specified principles of corporate governance and introduced a new Clause 49 in the listing agreement of stock exchanges. In October 2004, SEBI amended Clause 49 in alignment with the recommendations of the Narayana Murthy Committee.

14. Business ethics is that set of principles or reasons which should govern the conduct of business both at the individual or collective level by the application of ethical reasoning to specific business situations and activities. Some of the factors justifying the need for business ethics are :

♦ Society bestows upon businesses the authority to own and use land and natural resources. In return, society has the right to expect that productive organizations will enhance the general interests of consumers, employees and community. Society may also expect that organisations honour existing rights and limit their activities within the bounds of justice. Business ethics provides this guidance, including the consequences and complications of their actions. The need for complying with rules, such as the laws of the land, the customs and expectations of the community, the principles of morality, the policies of the organization and such general concerns as the needs of others and fairness.

♦ The products and services of an organization, and the actions of its members, can affect its employees, the community and society as a whole, either positively or negatively.

OR

Sustainable development refers to maintaining development over time. The most widely cited definition of sustainable development is – “Development that meets the needs of the present without compromising the ability of future generations to meet their own needs." A nation or society should satisfy its requirements – social, economic , environmental and others – without jeopardizing the interest of future generations.

There is no economic growth without ecological costs. High economic growth means high rate of extraction, transformation and utilization of non-renewable resources.. One must realize that increased development and higher GNP are related to environmental damage and resource depletion. Therefore, an element of resource regeneration and positive approach to environment have to be incorporated in developmental programmes. Business, Industry and multinational corporations have to recognize environmental management as the priority area and a key determinant to sustainable development

15. The dynamic environment in which businesses operate today may usher a broad range of circumstances because of which compliance to principles of integrity, objectivity, confidentiality and professional competence and due care in case of a finance and accounting professional working as an employee may be threatened.Such threats can be classified as :

Self interest threat

- Financial interests, loans and guarantees in the company the professional is working.
- Incentive compensation arrangements.
- Inappropriate personal use of corporate assets.
- Concern over employment security.
- Commercial pressure from outside the employing organisation.

Self review threat

Such threats occur when business decisions or data is subjected to review and justification is required to be given by the same professional who was responsible for taking such decisions or preparing that data.

Advocacy threat

When furthering the legitimate goals and objectives of their employing organizations, finance and accounting professionals may promote the organization's position, to the point that objectivity may be compromised.

Familiarity threats

- A finance and accounting professional, in a position to influence financial or non financial reporting or business decisions having an immediate or close family member who is in a position to benefit from that influence.
- Long association with business contacts influencing business decisions.
- Acceptance of a gift or preferential treatment, unless the value is clearly insignificant.

Intimidation threat

- Threat of dismissal or replacement of the finance and accounting professional or a close or immediate family member over a disagreement about the application of an accounting principle or the way in which financial information is to be reported for external use as well as for decision making purposes.
- A dominant personality attempting to influence the decision making process, for example with regard to the exclusion of irrelevant costs from projected cost estimates.

OR

(i) Moral and Ethics: Although both words are broadly defined in contemporary English as having to do with right and wrong conduct, the root word for ethical is the Greek "ethos," meaning "character", while the root word for Moral is Latin "mos," meaning "custom." Another way to look at the distinction is to say that morals are accepted from an authority (cultural, religious, etc.), while ethics are accepted because they follow from personally accepted principles. For example, if one accepts the authority of a religion, and that religion forbids stealing, then stealing would be immoral. An ethical view might be based on an idea of personal property that should not be taken without social consent (like a court order). Moral norms can usually be expressed as general rules and statements such as “always tell the truth.” and are typically first absorbed as a child from family, friends, school, religious teachings and other associations. Morals work on a smaller scale than ethics, more reliably, but by addressing human needs for belonging and emulation, while ethics has a much wider scope.

(ii) Shareholders and Stakeholders: Shareholder are "owners", those who own stock in a particular company. The word “stakeholders’ coined only in the late part of the 20th century, describes wider constituents of an organisation - the individuals, groups or other organizations which are affected by, or can affect the organisation in pursuit of its goals. A typical list of stakeholders of a company would be employees, trade unions, customers, shareholders and investors, suppliers, local communities, Government and competitors .

(iii) Consumer Interest and Public Interest: Consumer is a member of a broad class of people who purchase, use, maintain and dispose of products and services. Consumers interests are affected by pricing policies, financing practices, quality of goods and services and various trade practices. Public interest, on the other hand, is something in which society as a whole has some interest. A justifiable apprehension that in the name of “public interest”, Governmental policies may be fashioned and introduced which may not be in the ultimate interest of the consumers. The asymmetry arises from the fact that all producers are consumers but most are producers as well. What is desirable for them in one capacity may be inimical in the other capacity. A simple example will make the point clear. A farmer wants the price of goods he consumes to be as cheap as possible but wants the highest price for his produce.

16. NOTICE [Specimen]

Notice is hereby given that the 10th Annual General Meeting of the Members of XYZ Ltd. will be held on_________, at the Registered Office of the Company at Plot Nos. 16-18, Bandra Kurla Complex, Mumbai at _____ a.m. to transact the following business –

Ordinary Business:

1. To receive, consider and adopt the Audited Balance Sheet of the company as on _________ and the Profit & Loss Account for the year ended on that date and Auditor's and Directors' Reports thereon.
2. To declare dividend for the year ending ___________.
3. To appoint a director in place of Mr. ……………………….. who retires by rotation and being eligible, offers himself for re-appointment.
4. To appoint Statutory Auditors of the company; and fix their remuneration.

Regd. Office: For and on behalf of Board of Directors

Plot No. 16-18,

Bandra Kurla Complex

Mumbai

Chairman of the Meeting

Notes:

- A member entitled to attend and vote is entitled to appoint a proxy to attend and vote instead of himself and the proxy need not be a member of the company.
- Explanatory statement relating to special business is annexed to this Notice as required under section 173 of the Companies Act, 1956.
- The Register of members and the Share Transfer Books of the Company will remain closed from ________ to ____________both days inclusive.
- Members are requested to notify immediately change of address, if any, to company's Registered Office. While communicating to the company, please quote the folio number.

  Shareholders desirous of obtaining any information concerning the accounts and operations of the company are requested to address their questions to the company's Head office, so as to reach at least 5 days before the date of the meeting so that the information may be made available at the meeting to the best extent possible.

MINUTES OF ANNUAL GENERAL MEETING [Specimen]

Third annual general meeting held at

Place…………

Date………….

Time…………

Present

1. Shri …………………………………..in the chair
2. ……………………………………..Directors.
3. ……………………………………… Members in person and
4. ………………………………………Representative of …………. C.A.
5. ……………………………………Secretary

1. Notice

   The notice convening the meeting was read by the Secretary.

2. Directors' Report and Accounts.

   With the consent of the members present, the Director's Report and Accounts having already been circulated to the members were taken as read.

3. Auditors' Report

   The Auditors' Report was read

4. Adoption of Directors' Report, etc.

   The Chairman then invited queries from the members present on Directors' report, Accounts and Auditors' and auditor's Report, but there was no query. Thereafter, the Chairman proposed the following resolution which was seconded by…………

   "Resolved that the Directors' Report, audited Balance Sheet as on ________ and Profit and Loss Account for the year ended _________ and Auditors' Report thereon be and the same are hereby received, considered and adopted."

   Carried unanimously.

5. Dividend

   Proposed by Shri …………………………….

   Seconded by Shri …………………………….

   "Resolved that the Dividend as recommended by the Board of Directors for the year ended _________ at the rate of Rs. …… per share on the equity share capital of the company, subject to deduction of tax at source be and is hereby declared for payment to those shareholders whose names appeared on the Register of Members as on ……………. ."

Carried unanimously

6. Directors

   Proposed by ……………………………..

   Seconded by …………………………….

   "Resolved that Shri ………………………. who retires by rotation and is eligible for re-appointment to and is hereby re-appointed a director of the company."

   Carried unanimously.

7. Auditors

   Proposed by ……………………………..

   Seconded by ………………………………..

   "Resolved that M/s …………………………. Chartered Accountants, be and are hereby appointed Auditors of the Company to hold office from the conclusion of this meeting until the conclusion of the next Annual General Meeting at a remuneration of Rs. ………..

   Carried unanimously.

   The meeting closed with a vote of thanks to the Chair.

   Dated …………………..

Chairman

17. The major components of a typical business letter are:

1. Heading comprising of the name, address, phone/fax number etc. of the sender firm, generally printed on the letterhead.
2. Reference number.
3. Date.
4. Name and address of the receiver person and the firm.
5. Attention line(optional).
6. Salutation.
7. Subject line.
8. Body/Text of the letter.
9. Formal closing/subscription.
10. Signature block/slot of the sender which includes (a) Signature (b) Signatory's name and designation (c) Company name.
11. Mentioning of enclosure, if any.
12. Post script noting.

13. Carbon copy noting.
14. Reference initials.

Specimen format /letter

ABC Ltd.
530/12/25
HUDA Complex
Gurgaon
Ph: Fax:
E-mail: Website:

Ref No.
Date
Name
InsideAddress
Attention line
Salutation:
Subjectline ____________________
Xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx
Xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx.
Xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx
Xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx.
Closing/Subscription
Signature
Signatory's typed name
Signatory's position in the company
Company name
Encl
P.S.
Ref. Initials

OR

No matter whether an organisation wide change is of major proportions or rather small, it is difficult to introduce the change as people in the organization are going to find reasons to resist change for various reasons:

One major reason why people resist change is the potential for loss on a personal level. Objectively there may be little threat, but people may act as if there is one. Some of the things people feel are at risk during change processes are: security, friends and contacts, money ,freedom, pride and satisfaction, responsibility, authority, good working conditions and status. While a feeling of threat is a primary reason why people resist change, there are other factors that can mobilize people into resisting any changes from a status quo. These include:

- Change not needed - status quo is working fine
- Proposed change does more harm than good
- Lack of respect for person responsible for the change
- 0bjectionable way of implementing the change
- Negative attitude towards the organization before the change
- No opportunity to have input into change
- change perceived as implying personal criticism
- Change simply adds more work and confusion.
- Change requires more effort than to keep status quo
- Bad timing of the change
- A desire to challenge authority .
- Hearing about the change secondhand

Resistance to change takes many forms. The more obvious forms consist of active resistance, where people will object, or refuse to cooperate with the change. Other, subtler forms of resistance, however, are more difficult to deal with. For example, at a staff meeting everyone agrees to utilize a new procedure, but several weeks later it is discovered that the procedure has not been implemented.

It is helpful to have an understanding of why people resist change, because understanding this allows one to plan communication strategies to reduce resistance from the beginning.

18. Guidelines for Active Listening

- Look at the person and suspend other things you are doing. Otherwise, you will be distracted from the main goal - understanding the other person's concerns, intentions.

- Be interested in what the person is saying. Everybody is interesting in some way. If you just can't make yourself interested, you will lose important information, so try taking notes. Doing so will keep your body and mind active.
- Listen to the tone of voice and inflections; look at gestures and body language - these may carry an unspoken message.
- Restate what the person said. Restating their meaning is a way for you to make sure you understand the person clearly.
- Ask questions once in a while to clarify meaning. Doing so will keep you alert. and let the other person know you have been listening and are interested in getting all the facts and ramifications.
- Be aware of your own feelings and opinions. They may cloud your perception of what is being said. Being aware of your own preconceptions prevents biasing your judgment about the other person.

OR

The press releases covering news in the case of the government are mainly of four types – press communiqués, press notes, handouts, and unofficial stories or unofficial hand-outs.

Press communiqués are issued when some important government decisions or announcements are made such as cabinet appointments, conclusion of the foreign dignitaries' visits, international agreement, etc. The press communiqué is formal in character. It carries the name of the ministry or department and the place the date at the bottom left-hand corner of the release. Generally, the press is expected to reproduce the press communiqué without any substantial change. No heading or subheading is given on press communiqués.

Press notes are less formal in character. They are issued on important matters, e.g., raising or lowering of tariff rates, etc. The press note also carries the name of the ministry/department and the place and date at the bottom left-hand corner. Heading or sub-heading are given in press notes.

Hand-outs are issued on a variety of subjects and on day-to-day activities of the ministry/department, VIP speeches, questions and answers in parliament, etc. The hand-out is a less formal type of release and not issued under the government's formal authority. It bears the name of the PIB or other releasing agency on the top without any mention of the ministry/department to which the release pertains. The place and date are indicated on top at right-hand side. One of the most important common categories of hand-outs relate to the speeches of ministers or other high officials.

Unofficial hand-outs and stories : are issued on a subject where the government would not like to assume official responsibility in the matter but feels that there may be positive advantages in making information public unofficially. These hand-outs are supplements to oral briefings. They are given across the table to press correspondents and no general release is made. The unofficial hand-out do not have the imprint of the PIB or of other releasing agencies. The date and place are indicated at bottom left-hand corner.

PROFESSIONAL COMPETENCE COURSE

GROUP – I

Model Test Paper – BOS/PCC/ Law, Ethics and Communication – 2/2007

PAPER – 3 : LAW, ETHICS AND COMMUNICATION

SUGGESTED ANSWERS/HINTS

PART – I : LAW

1. According to Section 18 of the Indian Contract Act, 1872, misrepresentation is there:

   1. When a person positively asserts that a fact is true when his information does not warrant it to be so, though he believes it to be true.
   2. When there is any breach of duty by a person, which brings an advantage to the person committing it by misleading another to his prejudice.
   3. When a party causes, however, innocently, the other party to the agreement to make a mistake as to the substance of the thing which is the subject of the agreement.

   Problem:

   The aggrieved party, in case of misrepresentation by the other party, can avoid or rescind the contract [Section 19, Indian Contract Act, 1872]. The aggrieved party loses the right to rescind the contract if he, after becoming aware of the misrepresentation, takes a benefit under the contract or in some way affirms it. Accordingly in the given case Suraj could not rescind the contract, as his acceptance to the offer of Sohan to bear 40% of the cost of repairs impliedly amount to final acceptance of the sale [Long v. Lloyd, (1958)]

2. (a) Lifting of the corporate veil and the cases in which veil of a company can be lifted:

   A company in the eyes of law is regarded as an entity separate from its members. It has an independent corporate existence. Any of its members can enter into contracts with the company in the same manner as any other individual can and he cannot be held liable for the acts of the company even if he holds virtually the entire share capital. The company's money and property belong to the company, and not to the shareholders. (Salomon v. Saloman & Co. Ltd.)

   Further, from the juristic point of view, a company is a legal person distinct from its members (Salomon v. Salomon & Co.). It has its own corporate personality. This principle may be referred to as 'the veil of incorporation'. The Courts in general consider themselves bound by this principle. The effect of this principle is that there is a fictional veil between the company and its members. That is, the company has a corporate personality which is distinct from its members.

The human ingenuity, however, started using this veil of corporate personality blatantly as a cloak for fraud or improper conduct. Thus it became necessary for the Courts to break through or lift the corporate veil or crack the shell of corporate personality or disregard the corporate personality of the company. Thus while by fiction of law a corporation is a distinct entity, yet, in reality it is an association of persons who are in fact the beneficial owners of all the corporate property (Callaghar v. Gerrnania Brewing Co.)

The circumstances or the cases in which the Courts have disregard the corporate personality of the company are:

1. Protection of revenue: The Courts may ignore the corporate entity of a company where it is used for tax evasion. (Juggilal v. Commissioner of Income tax).
2. Prevention of fraud or improper conduct: The legal personality of a company may also be disregarded in the interest of justice where the machinery of incorporation has been used for some fraudulent purpose like defrauding creditors or defeating or circumventing law. Professor Cower has rightly observed in this regard that the veil of a corporate body will be lifted where the 'corporate personality is being blatantly used as a cloak for fraud or improper conduct'. Thus where a company was incorporated as a device to conceal the identity of the perpetrator of the fraud, the Court disregarded the corporate personality. (Jones v. Lipman).
3. Determination of character of a company whether it is enemy: A company may assume an enemy character when persons in de facto control of its affairs are residents in an enemy country. In such a case, the Court may examine the character of persons in real control of the company and declare the company to be an enemy company. (Daimler Co. Ltd. V. Continental Tyre & Rubber Co. Ltd.)
4. Where the company is a sham: The Courts also lift the veil or disregard the corporate personality of a company where a company is a mere cloak or sham (hoax). (Cilford Motor Co. Ltd. V. Horne).
5. Company avoiding legal obligations: Where the use of an incorporated company is being made to avoid legal obligations, the Court may disregard the legal personality of the company and proceed on the assumption as if no company existed.
6. Company acting as agent or trustee of the shareholders: Where a company is acting as agent for its shareholders, the shareholders will be liable for the acts of the company. (F.C. Films Ltd., In re.)
7. Avoidance of welfare legislation: Where the Courts find that there is avoidance of welfare legislation, it will be free to lift the corporate veil. (Workmen of Associated Rubber Industry Ltd. V. Associated Rubber Industry Ltd.).

8. Protecting public policy: The Courts invariably lift the corporate veil or disregard the corporate personality of a company to protect the public policy and prevent transactions contrary to public policy. (Connors v. Connors Ltd.).

(b) The Experts consent to the issue of Prospectus :

A prospectus may contain a statement purporting to be made by an expert. The term expert includes an engineer, a valuer, an accountant, and any other person whose profession gives authority to a statement made by him [section 59 (2) of Companies Act, 1956.

When an expert is not liable ?

An expert who would be liable by reason of having given his consent under section 58 to the issue of the prospects containing a statement made by him would not be liable if he can prove.

(i) that having given his consent to the issue of prospectus, he withdrew it in writing before the delivery of a copy of the prospectus for registration, or.

(ii) that after the delivery of a copy of the prospectus for resignation but before allotment, he on becoming aware of the untrue statement withdrew his consent in writing and gave reasonable public notice thereof and the reason therefore, or.

(iii) that he was competent to make the statement and he had reasonable ground to believe and did up to the time of allotment of the shares or debentures believe, that the statement was true. (Section 62 (3).

3. Agency by Ratification & essentials of valid ratification:

Meaning: A person may act on behalf on another without his knowledge or consent. Later on such another person may accept the act of the former or reject it. If he accepts the act of the former done without his consent, he is said to have ratified that act and it places the parties in exactly the same position in which they would have been the former had later's authority at the time he made the contract. Likewise, when an agent exceeds the authority bestowed upon him by the principal, the principal may ratify the unauthorised act.

Essentials of a valid Ratification

1. The agent must purport to act as agent for a principal who is in contemplation and is identifiable at the time of contract.
2. The principal must be in existence at the time of contract.
3. The principal must have contractual capacity both at the time of the contract and at the time of ratification.
4. The principal must have the full knowledge of all the material facts.
5. Ratification must be done with in a reasonable time of the act purported to be ratified.

6. The act to be ratified must be lawful and not void or illegal or ultra vires in case of a company.
7. The whole transaction can be ratified.
8. Ratification must be communicated to the party who is sought to be bound by the act done by the agent.
9. Ratification can be of the acts which the principal had the power to do.
10. Ratification should not put a third party to damages.
11. Ratification relates back to the date of the act of the agent.

4. Negotiability and assignability: Following are the differences between negotiability and assignability:
   1. The assignee does not acquire the right of a holder in due course on the other hand in negotiability, the transferee acquires all the rights of a holder in due course.
   2. In negotiation, notice of transfer is not necessary whereas in assignment of chose in action, notice of assignment must be served by the assignee on his debtor.
   3. In negotiation, consideration is presumed but in case of transfer by assignment, consideration must be proved.
   4. Negotiation requires either delivery only in the case of "bearer" instrument, or endorsement and delivery only in the case of "order instrument". Whereas in case of an assignment, Section 130 of the Transfer of Property Act requires a document to be reduced into writing and signed by the transferor.
   5. Endorsement does not require payment of stamp duty whereas negotiation requires payment of stamp duty.

5. As per Section 31(A) of the Payment of Bonus Act, 1965, there may be an agreement or settlement by the employees with their employer for payment of an annual bonus linked with production or productivity in lieu of bonus based on profits, as is payable under the Act. Accordingly, when such an agreement has been entered into the employees are entitled to receive bonus as per terms of the agreement/settlement, subject to the following restriction imposed by Section 31A:

   (a) any such agreement/settlement whereby the employees relinquish their right to receive minimum bonus under Section 10, shall be null and void in so far as it purports to deprive the employees of the right of receiving minimum bonus.

   (b) If the bonus payable under such agreement exceed 20% of the salary/wages earned by the employees during the relevant accounting year, such employees are not entitled to the excess over 20% of salary/wages.

   In the given case Aryan Textile Ltd. agreed with the employees for payment of an annual bonus linked with production or productivity instead of based on profits subject to the limit of 30% of their salary/ wages during the relevant accounting year. According to Section 31A the maximum bonus under this provision can be given which should not exceed 20%

of the salary/wages earned by the employee during the relevant accounting year. Hence, the maximum bonus may be paid upto 20% of the salary/wages. If the company agrees to pay more than 20% then it will be against the provisions of the Payment of Bonus Act, 1965.

The employees of Aryan Textiles also agreed not to claim minimum bonus stated in Section 10 of the Payment of Bonus Act, 1965 such an agreement shall be null and void as it purports to deprive the employees of their right of receiving minimum bonus. Hence, the relief may be given by the court, as regards to the payment of bonus to the employees, based on the production or productivity, if it is agreed, subject to a maximum of 20%. The employees will also be entitled legally to claim bonus which is minimum prescribed under Section 10 of the Act, even though they have relinquished such right as per the agreement.

6. According to Section 10 of E.P.F. & M.P. Act, 1952 the amount standing to the credit of any member in the fund or of any exempted employee in a provident fund shall not in any way be capable of being assigned or charged and shall not be liable to attachment under any decree or order of any court in respect of any debt or liability incurred by the member or the exempted employee, and neither the official assignee appointed under the Presidency Towns Insolvency Act nor any receiver appointed under the Provincial Insolvency Act shall be entitled to or have any claim on, any such amount.

   The amounts standing to the credit of aforesaid categories of persons at the time of their death and payable to their nominees under the scheme or the rules vest in nominees, and the amount shall be free from any debt or other liability incurred by the deceased or the nominee before the death of the member or of the exempted employee and shall also not be liable to attachment under any decree or order of any court.

7. The problem as asked in the question is based on one of the essentials of a valid contract. Accordingly, one of the essential elements of a valid contract is that the agreement must not be one which the law declares to be either illegal or void. A void agreement is one without any legal effect. Thus any agreement in restraint of trade, marriage, legal proceedings etc., are void agreements. Thus Mr. X cannot recover the amount of Rs. 5 lakhs promised by Mr. Seth because it is an illegal agreement and cannot be enforced by law.

8. Sources of Dividend Declaration and Transfer of Profits:-

   The dividend can be declared or paid by a company for any financial year only;-

   (i) out of profits of the company for that year arrived at after providing for depreciation in the manner laid down in the Act; or

   (ii) out of profits of the company for any previous financial year or years arrived at after providing for depreciation, and remaining undistributed, or

   (iii) out of both, or

   (iv) out of moneys provided by Central Government or a State Government for the payment of dividend in pursuance of a guarantee given by that Government

The Central Government may, if it thinks necessary so to do in the public interest, allow any company to declare or pay dividend for any financial year out of the profits of the company for that year or any previous financial year or years without providing for depreciation. [Section 205(1)].

Transfer to Reserves Upto 10 Percent of Profits

Before any dividend is declared or paid by a company for any financial year out of the profits of the company declared or paid by a company for any financial year out of the profits of the company for that year, certain percentage of profits not exceeding 10 percent, as may be prescribed by Central Government, will be transferred to the reserves of the company. The company may, however, voluntarily transfer a higher percentage of its profits to the reserves.

The percentage of profits which have to be compulsorily transferred to reserves before declaration of dividend have been prescribed as under the Companies (Transfer of Profits to Reserves) Rules 1975:

Rate of proposed dividend as to paid up capital	Minimum Amount to be transferred to reserves out of current profits.
(a) Where it exceeds 10% but does not exceed 12.5%	(a) 2.5% of current profits
(b) Where it exceeds 12.5% but does not exceed 15%	(b) 5% of current profits
(c) Where it exceeds 15% but does not exceed 20%	(c) 7.5% of current profits
(d) Where it exceeds 20%.	(d) 10% of current profits

If the proposed dividend des not exceed 10% then there is no statutory obligation to transfer any amount to reserves out of current profits.

9. Investor Education & Protection Fund:

A Fund called Investor Education and Protection Fund is established by Central Government under section 205C of the Companies Act 1956. The fund will be utilised for promotion of investor awareness and protection of investors [Section 205C(3)].

The fund will get amounts from the following sources [Section 205C(2)].

1. Amount of unpaid dividends.
2. Application moneys received by company for allotment of any securities and due for refund.
3. Matured but unpaid deposits with companies.
4. Matured but unpaid debentures with companies.
5. Interest accured but unpaid on aforesaid amounts.

6. Grants a nd donations from Central Government, State Government, Companies or any other Institutions.
7. Interest or other income received out of the investments from the fund.

The amounts due for payment by company on account of dividend/refund of application money/debentures repayment/deposits repayment will be kept by company for seven years. If these are not claimed by investor/share holder within seven years, these will be paid by company to the prescribed authority of the fund. Once the funds are transferred, the liability of company ceases. The investor/shareho9lder is not entitled to get any amount after it is transferred by company to the Fund.

A committee appointed by the Central Government will administer the investor fund and spend moneys out of the fund for carrying out objects for which the fund has been established. [Section 205C(3) and (4)].

10. Underwriting Commission

Considering the provisions of Section 76 of the Companies Act, 1956:

(i) The payment of commission should be authorised by the articles.

(ii) The amount of commission should not exceed, in the case of shares, 5% of the price at which the shares have been issued or the amount or rate authorised by the articles whichever is less, and in the case of debentures, it should not exceed 2-1/2%.

Answer to problem:

Thus taking into account the above provisions it is concluded that the Board of Director's decision to pay 5% is not valid, since the payment cannot exceed 3% as provided in the Articles of the company. Secondly, decision of the Board to pay the commission out of capital is valid since underwriting commission can be paid both out of capital as well as out of profits (Madan Lal Fakir Chand v. Shree Changdeo Sugar Mills Ltd. MR (1962) s.c. 1543).

11. Meaning of Share Warrant

Share warrant is a document issued by a public company under its common seal stating that its bearer is entitled to the shares specified therein. It is transferable by mere delivery and is a substitute for the share certificate (Section 114 of Companies Act, 1956).

Distinction between Share Certificate & Share Warrant:

1. A share certificate is a prima facie evidence of document of title, stating that the holder is entitled to specified number of shares. Share warrant is a bearer document stating that the holder is entitled to certain number of shares specified therein.
2. The holder of a share certificate is a member of the company, but whereas the bearer of a share warrant can be a member only if the articles provide.

3. A share warrant is a negotiable instrument. A share certificate is not so.

4. A public company can only issue a share warrant, whereas, a share certificate can be issued by both the public and private companies.

5. In order to qualify as a director, the person should acquire a share certificate instead of a share warrant.

6. A share certificate can be issued for a fully paid and party paid up shares. Share warrant can be issued in respect of only fully paid up share.

12. Certification of Transfer:

Where a shareholder wishes to transfer only part of his shareholding or wishes to sell to them to two or more persons, he is required to lodge the share certificate with the company. Where he has already lodged with the company the relevant share certificate, together with an instrument of transfer for part of the shares, he may request the company to certify on the instrument of the transfer that the share certificate for the shares covered by the instrument of transfer has been lodged with the company. This is known as certification.

An instrument of transfer shall be deemed to be certified if it bears the words 'certificate lodged' or the words to the like effect. [Section 112(3)(a)]. Certification is, therefore, the act of noting by the secretary etc. stating that the share certificate has been lodged with the company. When only a portion of shares is transferred, the company usually issued him a ticket for the balance of shares which have not been transferred. Such a ticket is called a 'balance ticket'.

The certification by a company of a transfer as above is to be taken as a representation by the company to any person acting on faith of certification that there has been produced to the company such documents as, on the face of them, show prima facie title to the shares in the transfer. It is, however, not a representation that the transferor has any title to the shares. (Section 112(1)).

The company will be responsible for the certification only if:

(a) the person issuing the installment is authorised to issue such installment on the company's behalf;

(b) the certificate is signed by any officer or servant of the company or any other person authorised to certify transfer on the company's behalf.

Thus X holding 1000 shares in AJD Co. Limited is advised to act for certification of transfer in accordance with the provisions for partial transfer of his holding.

PART – II : BUSINESS ETHICS

13. (a) In a general sense, ethics is the name we give to our concern for good behaviour. We feel an obligation to consider not only our own personal well-being, but also that of others and of human society as a whole. The spiritual literature on this topic also support that ethical conduct is, the actions that can follow from the well-trained and highly disciplined actions for achieving the good of the individual concerned as well as for the people with whom one is interacting with. Business Ethics refers to the principles and standards that encompass acceptable business behaviour. This behaviour is defined by its shareholders , customers , employees, competitors, suppliers Government regulators, interest groups and the public. Being ethical in business requires acting with an awareness of:

    - The need for complying with rules, such as the laws of the land, the customs and expectations of the community, the principles of morality, the policies of the organization and such general concerns as the needs of others and fairness.
    - How the products and services of an organization, and the actions of its members, can affect its employees, the community and society as a whole, either positively or negatively.

    In the present corporate scenario of constant change and global competition; ethics is an important factor because it builds trust and confidence in business relationships and a positive image of the company. Ethics programs cultivate strong teamwork and productivity, support employee recruitment , retention and growth. Unethical actions may result in negative publicity, declining sales and even legal action as demonstrated by the recent corporate scandals leading to the downfall of giant corporations like Enron.

    (b) Business and Industry are closely linked with environment and resource utilization. Production process and strategy for eco-friendly technologies throughout the product life cycle and minimization of waste can play a major role in protecting the environment and conservation of resources. Business, Industry and multinational corporations have to recognize environmental management as the priority area and a key determinant to sustainable development. Sound management of wastes is among the major environmental issues for maintaining the quality of environment and achieving sustainable development. Accordingly, waste management can be achieved through:

    (i) Minimum production of waste.

    (ii) Maximizing reuse of waste and recycling.

    (iii) Promoting environmentally sound waste disposal practices.

Economic progress and environmental protection is not a conflicting proposition. If companies redesign products and adopt latest technologies available; they can achieve the goals of reduction in wastage and resources depletion. This requires a new thinking and strategies in respect of environment-business relationship.

14. Many business issues may seem straight forward and easy to resolve and business ethics is sometimes portrayed as a matter of resolving conflicts in which one option appears to be the clear choice, but in reality, one is faced with having to make a choice from various alternatives resulting in an ethical dilemma. Not only are we faced with questions between right and wrong, but between right and right. Ethical dilemmas faced by managers are often highly complex with no clear guidelines as there could be (1) significant value conflicts among differing interests (2) actual alternatives which can all be justified and (3) significant consequences to all stakeholders.

    Some guidelines which one can address to ease ethical dilemmas are:

    - Define the problem clearly.
    - How would you define the problem if you stood on the other side of the fence?
    - How did the situation arise?
    - To whom are you loyal as a person and as a member of the organisation?
    - What is your intention in making this decision?
    - How does this intention compare with the probable results?
    - Whom could your decision or action injure?
    - Can you discuss the problem with the affected parties before you make your decision?
    - Are you confident that your position will be as valid over a long period of time as it seems now
    - Could you disclose without any doubt your decision or action to your boss, your CEO, the Board of Directors, your family, society as a whole ?
    - What is the symbolic potential of your action if understood? Misunderstood ?
    - Under what conditions would you allow exceptions to your stand ?

    OR

    (i) Ethical Conflict Resolution: While evaluating compliance with the fundamental principles, a professional may be required to resolve a conflict in the application of fundamental principles. The following needs to be considered, either individually or together with others, during a conflict resolution process,

    (a) Relevant facts;

    (b) Ethical issues involved;

    (c) Fundamental principles related to the matter in question;

(d) Established internal procedures; and

(e) Alternative courses of action.

Having considered these issues, a professional should determine the appropriate course of action that is consistent with the fundamental principles identified. The professional should also weigh the consequences of each possible course of action. If the matter remains unresolved, the professional should consult with other appropriate persons within the firm or employing organization for help in obtaining resolution. During times where a matter involves a conflict with, or within, an organization, the professional should also consider consulting with those charged with governance of the organisation, such as the board of directors .

It may be in the best interests of the professional to document the substance of the issue and details of any discussions held or decisions taken, concerning that issue.

If a significant conflict cannot be resolved, a professional may wish to obtain professional advice from the relevant professional body or legal advisors, and thereby obtain guidance on ethical issues without breaching confidentiality.

(ii) Conservation of natural resources: Economic progress and environmental protection is not a conflicting proposition. If companies redesign products and adopt latest technologies available; they can achieve the goals of reduction in wastage and conservation of resources. Eco-friendly technologies throughout the product life cycle and minimization of waste play major role in protecting the environment and conservation of resources. Business, Industry and multinational corporations have to recognize environmental management as the priority area and a key determinant to sustainable development. Sound management of wastes is among the major environmental issues for maintaining the quality of environment and achieving sustainable development. Accordingly, waste management can be achieved by:

- Minimum production of waste.
- Maximizing reuse of waste and recycling.
- Promoting environmentally sound waste disposal practices.

(iii) The Global Reporting Initiative (GRI): is a reporting standard rather than a performance standard. It was established in 1997 with the mission of designing globally applicable guidelines for preparing enterprise-level sustainability reports including both social and environmental indicators. The GRI is convened by CERES (Coalition for Environmentally Responsible Economies) and incorporates the active participation of corporations, non-governmental organizations, international organizations, United Nations agencies, consultants, accountancy organizations, business associations, universities, and other stakeholders from around the world. The GRI first released its Sustainability Reporting Guidelines in 1999 and is now a permanent, independent, international body with a multi-stakeholder governance structure. Its core mission is maintenance, enhancement, and dissemination of the Guidelines through a process of ongoing consultation and stakeholder engagement.

The GRI has begun to add sector-specific supplements, beginning with financial services and tour operators.

15. Companies are using a variety of formal mechanisms and processes to raise Corporate Social Responsibility (CSR) issues with their Boards for the purpose of incorporating them into business strategies and decision-making. Some companies have established committees that are specifically responsible for identifying and addressing social or environmental issues, or have broadened the scope of more traditional standing committees to include responsibility for CSR. Other companies are choosing to address CSR issues at the full-board level. Still others have strategically appointed directors to the board based on the unique expertise and experience they bring on specific issues, who then serve as advisors to others on the Board . Companies implement CSR by putting in place internal management systems that promote

    - Adherence to labour standards by corporations and their business partners;
    - Respect for human rights;
    - Protection of the local and global environment;
    - Reducing the negative impacts of corporations operating in conflict zones;
    - Avoiding bribery and corruption; and;
    - Consumer protection.

    Each company differs in how it implements corporate social responsibility. The differences depend on such factors as the company's size, sector, culture and the commitment of its leadership. Some companies focus on a single area – the environment, for example, or community economic development - while others aim to integrate a CSR vision into all aspects of their operations.

    OR

    The World Trade Organisation's (WTO) treaties and agreements, their implications on trade and commerce have already compelled many countries to review their competitiveness of trade and economic policies not only within their economy but across the frontiers of other countries also. In India, in the recent years, the corporate and economic reforms and policies had pervasive effects on the structure of domestic trade and competition. The law which was originally enacted to deal with market and competition (i.e., the Monopolies and Restrictive Trade Practices Act, 1969) addressed the problems concerning Monopolistic, Restrictive and Unfair Trade Practices only. There was no genesis to a comprehensive competition policy. Given the fact that the structure of world economy and trade has taken rapid strides and undergone vast changes, India has been taking adequate steps for integrating itself with the new changes and challenges whereby market functioning, positioning becomes effective and competitive. In this regard, Government constituted a High Level Committee on Competition Policy and Law on 15.10.1999 under the Chairmanship of Mr. S.V.S. Raghavan, to recommend a legislative framework relating to Competition Law including mergers and demergers. The Committee submitted its report on 22nd May 2000. The Government, after considering the report and suggestions from various organizations, institutions and general public, introduced the Competition Bill in the Parliament. This Bill became an Act after receiving assent from the President on 13th January 2003 and a few sections of the Act have already come into force by virtue of two separate Government notifications [i.e., S.O.340 (E) dated 31st March, 2003 and S.O.715 (E) dated 19th June, 2003]. This Act extends to the whole of India except the State of Jammu and Kashmir. The central economic goal of the Competition Policy is the preservation and promotion of the competitive process. It is a symbolic process, which encourages efficiency in the production and allocation of goods and services over a period of time through its effects on innovation and adjustment to technological change. In conditions of effective competition, competitors will be having equal opportunities to compete for their own economic interest and therefore the quality of their outputs and resource deployment will be given top priority in order to sustain and succeed in the market by meeting consumers' demand at the lowest possible cost.

PART – III : BUSINESS COMMUNICATION

16. (a) Chairman's Speech (Annual General Meeting 2003-04 , Infosys Technologies Limited)

Dear shareholder:

A warm welcome to every one of you to the 23rd Annual General Meeting of your company. Your trust and support serve as great motivators for us, to work harder and smarter. On behalf of all , I thank you for your encouragement.

Fiscal 2004 has been a historic year for your company. Your company became the first listed Indian software company to cross the magical "Billion Dollar" mark in its revenue. It is also the fastest in reaching this milestone revenue mark. What is equally satisfying is the fact that your company continues to be the largest (in revenue) and the most profitable listed software company in India. Under Indian GAAP, our revenues grew by 31.0% over fiscal 2003, while our profit after tax from ordinary activities grew by 30.0%. According to US GAAP, revenues grew by 41.0% over fiscal 2003, while net income grew by 38.7%. This exceeded our initial estimates for the year. In fact, during the year, we increased our guidance for revenues and Earnings Per Share (EPS) for fiscal 2005.As I stand here, my mind goes back to that wintry day in December 1992 when we took the decision to have our Initial Public Offering (IPO) in India. As is our norm, we debated the underlying philosophy that would motivate us in this initiative. I am happy to say that the unanimous decision was that we would maximize shareholder value on a sustainable basis, while ensuring fairness to every stakeholder - all of you (the investors), customers, employees, vendor-partners, government of the land and the community. This, as you know, is the fundamental principle of corporate governance. We resolved to assure our investors of our consistent commitment to fairness, transparency and accountability., We use simple yet powerful expressions to remind us of our values. Some of these expressions are - The softest pillow is a clear conscience, and When in doubt, disclose. I am glad that we have followed these precepts over the ten odd years we have been listed.

Last year was a tumultuous year. The jobless recovery in the US, slow growth in Europe and the outcry against outsourcing were all part of the landscape. Amidst all of these, we witnessed several interesting global phenomena last year. While most companies in the global market places shrank in revenue, we sustained a healthy growth. While reduced margins were accepted as inevitable, we protected our margins. While companies were retrenching their employees on a mass scale, we hired aggressively. These happy events were not due to serendipity but due to the customer focus, dedication, commitment, hard work and creativity of every Infoscion. These men and women showed that Infosys can and will succeed despite any challenge that confronts us.

As an organization ever watchful of the marketplace, we helped our customers define a new game with a new set of rules. The battle is now being fought on our terms. Infosys and offshore companies have become leaders, and the global incumbents have become the followers. Offshore development is now a mandatory component of any offering in our marketplace. The Global Delivery Model (GDM) invented and refined by Infosys has become the mainstream model for every player in the market. In fact, your company is now taking the power and benefits of the GDM to activities like consulting. These activities were, hitherto, not considered amenable to offshore. Having tasted the success of the Infosys experience, the customers now want every player to demonstrate precept to practice. Thus, there is now an even greater focus on walking the talk.

Business value creation with measurable EVA has become the mantra among Infoscions. The creation of Integrated Business Units and the strengthening of our research activities in business areas are aimed at better value creation for our customers. Our customers want tangible demonstration of the benefits that accrue to them from our expertise and skills. Thus, at Infosys, every project - either for the customer or internal - has to be justified using quantifiable models for return on investment (ROI).

I have articulated our strategy for acquisition several times in the past. Let me restate it here. The company that we acquire must bring scalable complementary revenue streams, skills and expertise. It should have industry-respected senior management. It must have an enduring valuesystem, similar to Infosys. Finally, it should be possible to bring up the net income margin over a reasonable period to the level of your company. Obviously, these are very stringent conditions. I am glad that we could find such a suitable candidate in Expert Information Services, Australia.

Infosys - Australia, the result of amalgamation of Expert Information Services - Australia and our Australian operations, gives us greater depth in market access in Australia. Since our search for a top-quality consulting firm in the US did not yield success, we decided to build our own with a team of top-notch consultants from the industry. That is how Infosys Consulting was born in April. We believe that Infosys Consulting will position us as a premier, one-stop, board-room-to-boiler-room company, delivering robust and effective technology-leveraged, end-to-end business solutions to our customers.

China will play an important role in the future of any multinational corporation. Hence, it is important for Infosys to have a presence in China. Keeping this in mind, your company has started a subsidiary in China, headquartered at Shanghai. We believe this will be a very important initiative. Our liquidity policy is dictated by Return on Capital Employed (ROCE) and Return on Invested Capital (ROIC). Your company's target is to earn an ROCE which is at least twice the cost of capital, and an ROIC which is at least thrice the cost of capital. Our dividend policy dictates that we limit any dividend payout to 20% of the net income generated during the year. In keeping with our dividend policy, your directors recommend a final dividend of Rs. 15 per share (300%), making it a total dividend of Rs. 29 per share (590%) for the year. Personally, I am averse to huge dividend payouts since I believe in the adage:

The real happiness in a company is cash in the bank. However, I have received hundreds of letters from you expressing your opinion that there is excess liquidity in your company. Our board listened to your request, ensured that our ROCE and ROIC requirements were met, and decided to recommend a one-time dividend of Rs. 100 per share (2000%). This year, being the "Billion Dollar Revenue" year, was perhaps the most fitting year for such a special dividend. After making a detailed analysis of the business parameters of Infosys, the board also felt that this was the right time to accede to your other constant request - issue of bonus shares. The board has recommended a bonus share issue of 3 bonus shares for every subscribed share. I have often said that the market capitalization of your company is zero at 5.15 pm when our employees leave for home. Our employees are our soul, in addition to being our engines of growth. In the words of J. Stanford: We get our power from the people we lead. Any decision that does not uplift them is not a welcome decision at Infosys. The board felt that the employees we have helped us take these positive decisions for you should also be rewarded on this occasion. Consequently, the board decided to distribute Rs. 100 Crores as a special bonus for our employees. As in the past, our performance this year has been driven by the commitment of our fellow Infoscions. On your behalf and on behalf of the board of directors, I salute them on yet another year of sterling achievements. We also place on record our appreciation of our clients, vendor-partners, investors and bankers, for their unwavering trust and support. We are also grateful to the Government of India, particularly the Ministry of Communication and Information Technology, the Customs and Excise Departments, the Software Technology Parks - Bangalore, Chennai,Hyderabad, Mangalore, Mohali, Mysore, Pune, Bhubaneswar, Tiruvanantapuram and New Delhi, the Ministry of Commerce, the Ministry of External Affairs, the Ministry of Finance, the Reserve Bank of India, the state governments, and other government agencies for their support. We are thankful to the trustees of the Infosys Foundation for sparing their valuable time and energy for its activities. Your company has redeemed the promise that it has made to its investors, year after year, for the last ten odd years. Our desire is to continue to do so. As we do so, we keep in mind the words of our national poet, Rabindranath Tagore: Where tireless striving stretches its arms towards perfection.

Your trust, confidence and encouragement will continue to motivate us in this pursuit.

Thank you.

17. Listening skills are essential for a manager. It provides information that helps managers in doing their own jobs well. It also helps to build strong personal relationships and advancement in their careers. According to a research, an average manager in general spends only 9% of his/her time in writing, 16% in reading, 30% in speaking and 45% in listening. Poor listening may lead to serious communication problems resulting in incomplete information and poor retention. The manager may not be effective if this keeps on happening. Many managers, are so used to helping people solve problems that their first course of action is to begin brainstorming solutions and giving advice

instead of listening with full attention directed toward understanding what the co worker or staff member needs . If one does not listen, a great deal of vital information necessary for effective people management and decision making would be missed. In addition, appropriate response would not be possible.

OR

(i) Feedback is reaction, without which the sender of the message cannot know whether the recipient has received the entire message or grasped its intent.

(ii) The leader helps the discussion to flow smoothly and keep the planned agenda on track by moderating diverse views, resolving differences and helping the group to reach logical conclusions in an unanimous way. In the absence of a leader the whole activity may become chaotic.

(iii) Well-drafted business letters not only communicate clearly but also serve as messengers of goodwill and contribute to positive image building of an organization.

(iv) Sign language, whether using visual signs or sound signals can communicate only elementary and simple ideas. It can not be a substitute for verbal communication and is quite likely to be misunderstood.

(v) Written communication provides permanent records which can be checked for accuracy or legal defense. It also promotes uniformity of policy and procedure and builds up proper guidelines for the working of the organization besides building its image

18. Press Release

DRESS CODE FOR CAS BY AUGUST END 2006 AS APPEARED IN NATIONAL BUSINESS NEWSPAPER.

A dress code for practicing CAs will be out by August end, with the Institute of Chartered Accountants of India giving finishing touches to the recommendatory proposal to give its professionals a corporate look and don a new brand identity. ICAI President, TN Manoharan said the proposal would not be mandatory. “It will be more of a recommendation, though we expect it to be followed by professionals,” Mr. Manoharan said.

He said the code would not be for day-to-day affairs, but for events like business meetings and other official representations and engagements. Mr. Manoharan clarified the code would be applicable only to professionals working in individual or partnership capacity. “Those who are employed with firms are not bound to follow, as they will be acting as per the requirements and stipulations of the firm they work for,” he added. A formal dress code, he said, could be a full-sleeve shirt, tie and shoes.

OR

(i) Three format styles are generally used: Full Block, Modified Block and Semi- Block.

(ii) The main differences among them are:

FULL BLOCK	MODIFIED BLOCK	SEMI BLOCK
All lines including date line are set flush with the left margin.	Date line is flush with right margin. Inside address, salutation, reference lines and paragraphs set flush with the left margin.	Date line , inside address and salutation are set flush with the left margin.
Paragraphs are not indented.	Paragraphs are not indented.	Each paragraph is indented.
	Complimentary close and signature are aligned with the date.	Complimentary close and signature line are to the right of the page.

PROFESSIONAL COMPETENCE COURSE

Model Test Paper – BOS/PCC/Cost Accounting and Financial Management-1/2007

GROUP-II

PAPER – 4 : COST ACCOUNTING AND FINANCIAL MANAGEMENT

SUGGESTED ANSWERS/HINTS

PART – I : COST ACCOUNTING

1. (a) Fixed costs are costs which do not change in total quantum till the time the capacity is reached. If the production is less than the capacity, the actual fixed cost per unit is more than what was budgeted. As production increases the fixed cost per unit goes on decreasing Hence , we can say that fixed costs per unit are variable in nature.

   (b) The most appropriate basis for apportioning is "The value of the machinery in each cost centre" since the number of machines or the floor area or the operating hours do not give any indication of the value on which insurance amounts and premiums are decided upon.

   (c) Since overheads are over absorbed , the budgeted quantum shall be Rs 24,000 more than what has actually been incurred. Hence Budgeted Overheads for 1,00,000 labour hours will be Rs 24,000 + 5,16,000 = Rs 5,40,000 or Rs 5.40 per labour hour

   (d) The Weighted Average method is most suitable at times when prices fluctuate widely because this method incorporates fluctuations in prices by identifying a weighted average price rather than individual prices as used under both FIFO and LIFO.

   (e) A favourable production variance indicates that the actual production has exceeded the budgeted capacity. The very fact that the actual production has exceeded capacity indicates that the capacity was not budgeted at the optimum.

   (f) Overheads are over absorbed when the allocated amount of overheads in an accounting period is greater than the actual overheads incurred in that period.

2. Computation of Standard Cost

Material Cost	:	Rs 4100 per unit
Fixed Cost	:	Rs 750 per unit
Other Variable Cost	:	Rs 1000 per unit
Standard Cost	:	Rs 5850 per unit

Computation of Overhead Expense Variance

Standard variable OH for actual output	:	= 175 Uts × Rs 1000 = 1,75,000	
Standard fixed overhead for actual output	:	= Rs.1,50,000	
Total standard overhead	:	= Rs. 3,25,000	(A)
Actual variable OH on actual production	:	= Rs. 1,57,500	
Actual fixed OH on actual production	:	= Rs. 2,00,000	
Total actual OH	:	= Rs. 3,57,500	(B)
Overhead expense variance (A-B)	:	= (Rs. 32,500)	

Computation of Production Volume Variance

Unutilised Capacity	:	25 Units.
Standard Fixed Cost	:	Rs 750 per Unit
Production Volume Variance	:	(25 units × Rs 750)
		= (Rs 18,750)

3. The use of a blanket overhead rate 150% of direct wages has been adopted for all the three departments. This procedure is incorrect and faulty. Direct wages for all the three departments are given and as such it is possible to work out separate overhead rates for each department. Correct overhead recovery rates for each department will be as follows:

$$\frac{\text{Overhead for each department} \times 100}{\text{Direct wages for each department}}$$

(i) Foundry = (5,000÷ 10,000) x 100 = 50%

(ii) Machine Shop = (90,000 ÷ 50,000) x 100 = 180%

(iii) Assembling = (10,000 ÷10,000) x 100 = 100%

So, a better way of arriving at the Product cost of manufacturing the 'Metal Ingot' will be as a follows:

Material			Rs. 16.00
Direct wages:			
	Foundry	Rs. 2	
	Machine Shop	4	
	Assembling	2	8.00
Factory Overhead			
	Foundry (2x50)) ÷ 100	1.00	
	Machine Shop (4x180) ÷ 100	7.20	
	Assembling (2x100) ÷ 100	2.00	10.20
Revised Product Cost.			34.20

(b) The following are the various characteristics of Job, Batch and Contract Costing:

- ♦ Job Costing is an appropriate method to use in cases where individual jobs are of significance or are customised as per the order. In such cases there is a need to identify the cost of such unique jobs. Thus, time sheet / log book labour details and material usage from material requisitions shall be used to assign labour and material costs to the respective jobs. The cost of audits is usually accumulated on a job-costing basis, as is the cost of servicing a motorcar.
- ♦ In Batch Costing, large numbers of identical products are accumulated as a 'batch', to which costs are assigned in much the same way as costs are assigned to a particular job in Job Costing. Batch Costing is of use in cases where the individual unit of production is not costly enough or is sufficiently differentiated from all other units of production. Shoes or Picture Tubes can be costed on batch costing lines.
- ♦ Contract Costing is used in cases where individual cost unit is large, and its completion is liable to be extended over a number of accounting periods. The determination of period profits for reporting purposes is a complex process when Contract Costing is being used. The proportion of direct costs to the total costs is usually larger in contract costing when compared with the other specific order costing methods. This form of costing is appropriate in the construction of power stations, flyovers etc.

4. (a) Cost Centre may be defined as a location, person, or an item of equipment for which cost may be ascertained and used for the purpose of cost control. In such a responsibility centre, the manager is responsible for costs only.

Cost Unit is a unit of product, service or time (or combination of these) in relation to whom the costs may be ascertained or expressed.

(b) Period costs are costs which are not assigned to products but are charged as expenses against revenue of the period in which they are incurred.All non manufacturing costs such as selling and distribution expenses, administration expenses etc are recognised as period costs.

Product costs are those costs which are associated with the purchase and sale of goods (in the case of merchandise inventory). In a manufacturing scenario, inventoriable costs are known as Product Costs.

(c) Fixed Budget is a budget designed to remain unchanged irrespective of the level of activity actually attained. Such a budget shows the expected results of a responsibility centre for only one activity level.

Unlike Fixed Budgets, Flexible Budgets show the expected results of a responsibility centre for several activity levels.

(d) Absorption costing is a method of inventory costing in which the variable manufacturing costs and all fixed manufacturing costs are included as inventoriable costs.

Marginal costing can be defined as" the ascertainment of marginal costs and of the effect on profit of changes in volume or type of output by differentiating between fixed and variable costs" In a Marginal costing system, fixed costs are not included as inventoriable cost.

PART – II : FINANCIAL MANAGEMENT

5 (a) Rs. 3,741

PVA = R (PVIFA at 6% for 3 years)

10,000 = R (2.673)

$$R = \frac{10,000}{2.673} = 3,741$$

(b) 9 percent

$$K_e = \left(\frac{D_1}{P_0}\right) + g = \left(\frac{4}{10}\right) + 0.05$$

= 0.09 = 9 per cent

(c) False. Interest rates and bond prices move in opposite directions.

(d) False. Liquidity varies inversely with profitability.

(e) False. EOQ is the order quantity that minimizes total inventory costs over our planning horizon.

(f) 1.60

$$\text{Total asset turnover} = \frac{\text{Return on Investment}}{\text{Net Profit Margin}}$$

$$= \frac{0.08}{0.05}$$

= 1.6

6. Statement showing Working Capital for each policy

(Rs. in crores)

	Working Capital Policy		
	Conservative	Moderate	Aggressive
Current Assets: (i)	4.50	3.90	2.60
Fixed Assets: (ii)	2.60	2.60	2.60

Total Assets: (iii)	7.10	6.50	5.20
Current liabilities: (iv)	2.34	2.34	2.34
Net Worth: (v)=(iii)-(iv)	4.76	4.16	2.86
Total liabilities: (iv)+(v)	7.10	6.50	5.20
Estimated Sales: (vi)	12.30	11.50	10.00
EBIT: (vii)	1.23	1.15	1.00
(a) Net working capital position: (i)-(iv)	2.16	1.56	0.26
(b) Rate of return: (vii)/(iii)	17.3%	17.7%	19.2%
(c) Current ratio: (i)/(iv)	1.92	1.67	1.11

Statement Showing Effect of Alternative Financing Policy

(Rs. in crores)

Financing Policy	Conservative	Moderate	Aggressive
Current Assets: (i)	3.90	3.90	3.90
Fixed Assets: (ii)	2.60	2.60	2.60
Total Assets: (iii)	6.50	6.50	6.50
Current Liabilities: (iv)	2.34	2.34	2.34
Short term Debt: (v)	0.54	1.00	1.50
Long term Debt: (vi)	1.12	0.66	0.16
Equity Capital	2.50	2.50	2.50
Total liabilities	6.50	6.50	6.50
Forecasted Sales	11.50	11.50	11.50
EBIT: (vii)	1.15	1.15	1.15
Less: Interest short-term debt : (viii)	0.06 (12% of Rs. 0.54)	0.12 (12% of Rs. 1.00)	0.18 (12% of Rs. 1.50)
Long term debt : (ix)	0.18 (16% of Rs. 1.12)	0.11 (16% of Rs. 0.66)	0.03 (16% of Rs. 1.16)
Earning before tax : (x)-(viii+ix)	0.91	0.92	0.94
Taxes @ 35%	0.32	0.32	0.33
Earning after tax: (xi)	0.59	0.60	0.61
(a) Net Working Capital Position : (i)-[(iv)+(v)]	1.02	0.56	0.06
(b) Rate of return on shareholders Equity capital : (xi)	23.6%	24%	24.4%

(c) Current Ratio : [(i)/(iv)+(v)]	1.35%	1.17	1.02

7 (a) Working Notes:

Capital employed before expansion plan:

	Rs.
Equity shares	8,00,000
Debentures (Rs.1,20,000/12) × 100	10,00,000
Retained earnings	12,00,000
Total capital employed	30,00,000

Earnings before the payment of interest and tax (EBIT)

	Rs.
Profit	3,00,000
Interest	1,20,000
EBIT	4,20,000

Return on investment (ROI)

$$\text{ROI} = \frac{\text{EBIT}}{\text{Capital employed}} \times 100 = \frac{\text{Rs.}4{,}20{,}000}{\text{Rs.}30{,}00{,}000} \times 100 = 14\%$$

Earnings before the payment of interest and tax (EBIT) after expansion

After expansion, capital employed = Rs.34,00,000

Desired EBIT = 14% × Rs.34,00,000 = Rs.4,76,000

(i) Statement showing Earning Per Share (EPS)

(Under present and anticipated expansion scheme)

	Present situation	Expansion scheme Additional funds raised as	
		Debt	Equity
	Rs.	Rs.	Rs.
EBIT: (A)	4,20,000	4,76,000	4,76,000
	(Refer to Working note 2)	(Refer to Working note 4)	
Interest – Old capital	1,20,000	1,20,000	1,20,000
– New capital	–	48,000 (Rs.4,00,000 × 12%)	–

Total interest : (B)	1,20,000	1,68,000	1,20,000
EBT:{(A) – (B)}	3,00,000	3,08,000	3,56,000
Less: Tax (50% of EBT)	1,50,000	1,54,000	1,78,000
PAT	1,50,000	1,54,000	1,78,000
EPS	1.875	1.925	1.48
	(Rs.1,50,000/ 80,000)	(Rs.1,54,000/ 80,000)	(Rs.1,78,000/ 1,20,000)

(ii) Advise to the Company: Since EPS is greater in the case when company arranges additional funds as debt. Therefore, debt scheme is better.

(b) (1) Computation of Net Present Values of Projects

Year	Cash flows		Discounting factor @ 16%	Discounted Cash flow	
	Project A Rs. (1)	Project B Rs. (2)	(3)	Project A Rs. (3) – (1)	Project B Rs. (3) –-(2)
0	1,35,000	2,40,000	1.000	1,35,000	2,40,000
1	–	60,000	0.862	–	51,720
2	30,000	84,000	0.743	22,290	62,412
3	1,32,000	96,000	0.641	84,612	61,536
4	84,000	1,02,000	0.552	46,368	56,304
5.	84,000	90,000	0.476	39,984	42,840
Net present value				58,254	34,812

(2) Computation of Cumulative Present Values of Projects Cash inflows

	Project A		Project B	
Year	PV of cash inflows Rs.	Cumulative PV Rs.	PV of cash inflows Rs.	Cumulative PV Rs.
1	–	–	51,720	51,720
2	22,290	22,290	62,412	1,14,132
3	84,612	1,06,902	61,536	1,75,668
4	46,368	1,53,270	56,304	2,31,972
5	39,984	1,93,254	42,840	2,74,812

(i) Discounted payback period: (Refer to Working note 2)

Cost of Project A = Rs.1,35,000

Cost of Project B = Rs.2,40,000

Cumulative PV of cash inflows of Project A after 4 years = Rs.1,53,270

Cumulative PV of cash inflows of Project B after 5 years = Rs.2,74,812

A comparison of projects cost with their cumulative PV clearly shows that the project A's cost will be recovered in less than 4 years and that of project B in less than 5 years. The exact duration of discounted pay back period can be computed as follows:

	Project A	Project B
Excess PV of cash inflows over the project cost (Rs.)	18,270 (Rs.1,53,270 - Rs.1,35,000)	34,812 (Rs.2,74,812 - Rs.2,40,000)
Computation of period required to recover excess amount of cumulative PV over project cost (Refer to Working note 2)	0.39 year (Rs.18,270 / Rs.46,368)	0.81 years (Rs.34,812 / Rs.42,840)
Discounted payback period	3.61 year (4 - 0.39) years	4.19 years (5 - 0.81) years

(ii) Profitability Index: $= \frac{\text{Sum of discounted cash inflows}}{\text{Initial cash outlay}}$

Profitability Index (for Project A) $= \frac{\text{Rs.1,93,254}}{\text{Rs.1,35,000}} = 1.43$

Profitability Index (for Project B) $= \frac{\text{Rs.2,74,812}}{\text{Rs.2,40,000}} = 1.15$

(iii) Net present value = Rs.58,254

(for Project A)

(Refer to Working note 1)

Net present value = Rs.34,812

(for Project B)

8 (a) Basic Functions of Financial Management

Financial Management deals with the procurement of funds and their effective utilization in the business. The first basic function of financial management is procurement of funds and the other is their effective utilization.

(i) Procurement of funds: Funds can be procured from different sources, their procurement is a complex problem for business concerns. Funds procured from different sources have different characteristics in terms of risk, cost and control.

(1) The funds raised by issuing equity share poses no risk to the company. The funds raised are quite expensive. The issue of new shares may dilute the control of existing shareholders.

(2) Debenture is relatively cheaper source of funds, but involves high risk as they are to be repaid in accordance with the terms of agreement. Also interest payment has to be made under any circumstances. Thus there are risk, cost and control considerations, which must be taken into account before raising funds.

(3) Funds can also be procured from banks and financial institutions subject to certain restrictions.

(4) Instruments like commercial paper, deep discount bonds, etc also enable to raise funds.

(5) Foreign direct investment (FDI) and Foreign Institutional Investors (FII) are two major routes for raising funds from international sources, besides ADR's and GDR's.

(ii) Effective utilisation of funds: Since all the funds are procured at a certain cost, therefore it is necessary for the finance manager to take appropriate and timely actions so that the funds do not remain idle. If these funds are not utilised in the manner so that they generate an income higher than the cost of procuring them then there is no point in running the business.

(b) Effect of Inflation on Inventory Management

The main objective of inventory management is to determine and maintain the optimum level of investment in inventories. For inventory management a moderate inflation rate say 3% can be ignored but if inflation rate is higher it becomes important to take into consideration the effect of inflation on inventory management. The effect of inflation on goods which the firm stock is relatively constant can be dealt easily, one simply deducts the expected annual rate of inflation from the carrying cost percentage and uses this modified version in the EOQ model to compute the optimum stock. The reason for making this deduction is that inflation causes the value of the inventory to raise, thus offsetting somewhat the effects of depreciation and other carrying cost factors. Since carrying cost will now be smaller, the calculated EOQ and hence the average inventory will increase. However, if rate of inflation is higher the interest rates will also be higher, and this will cause carrying cost to increase and thus lower the EOQ and average inventories.

Thus, there is no evidence as to whether inflation raises or lowers the optimal level of inventories of firms in the aggregate. It should still be thoroughly considered, however, for it will raise the individual firm's optimal holdings if the rate of inflation for its own inventories is above average and is greater than the effects of inflation on interest rates and vice-versa.

(c) Advantages of Debt Securitisation

Debt securitisation is a method of recycling of funds and is especially beneficial to financial intermediaries to support lending volumes. Simply stated, under debt securitisation a group of illiquid assets say a mortgage or any asset that yields stable and regular cash flows like bank loans, consumer finance, credit card payment are pooled together and sold to intermediary. The intermediary then issues debt securities.

The advantages of debt securitisation to the originator are the following:

(i) The asset are shifted off the Balance Sheet, thus giving the originator recourse to off balance sheet funding.

(ii) It converts illiquid assets to liquid portfolio.

(iii) It facilitates better balance sheet management, assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms.

(iv) The originator's credit rating enhances.

For the investors securitisation opens up new investment avenues. Though the investor bears the credit risk, the securities are tied up to definite assets.

(d) Limitations of Financial Ratios

The limitations of financial ratios are listed below:

(i) Diversified product lines: Many businesses operate a large number of divisions in quite different industries. In such cases ratios calculated on the basis of aggregate data cannot be used for inter-firm comparisons.

(ii) Financial data are badly distorted by inflation: Historical cost values may be substantially different from true values. Such distortions of financial data are also carried in the financial ratios.

(iii) Seasonal factors may also influence financial data.

(iv) To give a good shape to the popularly used financial ratios (like current ratio, debt- equity ratios, etc.): The business may make some year-end adjustments. Such window dressing can change the character of financial ratios which would be different had there been no such change.

(v) Differences in accounting policies and accounting period: It can make the accounting data of two firms non-comparable as also the accounting ratios.

(vi) There is no standard set of ratios against which a firm's ratios can be compared: Some times a firm's ratios are compared with the industry average. But if a firm desires to be above the average, then industry average becomes a low standard. On the other hand, for a below average firm, industry averages become too high a standard to achieve.

(vii) It is very difficult to generalise whether a particular ratio is good or bad: For example, a low current ratio may be said 'bad' from the point of view of low liquidity, but a high current ratio may not be 'good' as this may result from inefficient working capital management.

(viii) Financial ratios are inter-related, not independent: Viewed in isolation one ratio may highlight efficiency. But when considered as a set of ratios they may speak differently. Such interdependence among the ratios can be taken care of through multivariate analysis.

Financial ratios provide clues but not conclusions. These are tools only in the hands of experts because there is no standard ready-made interpretation of financial ratios.

PROFESSIONAL COMPETENCE COURSE

Model Test Paper – BOS/PCC/Cost Accounting and Financial Management-2/2007

GROUP-II

PAPER – 4 : COST ACCOUNTING AND FINANCIAL MANAGEMENT

SUGGESTED ANSWERS/HINTS

PART – I : COST ACCOUNTING

1. (a) Fixed cost per unit is zero since incremental production of 5 units corresponds to an incremental cost of Rs 5 giving Variable cost per unit as Re1. Hence total variable cost for 10 units of production is Rs. 10. Since the total cost given is also Rs. 10, hence fixed cost =zero.

   (b) Category A items should be physically checked most frequently since these items are of the highest value.

   (c) A semi automated company will have both machine intensive and labour intensive cost centres because of which a blanket overhead rate like labour hours or machine hours shall not be giving precise product costs. Hence , in a semi automated plant , the use of a blanket overhead rate shall not be advisable.

   (d) The cost shall decrease because of the "fixed cost per unit component", which shall decrease as production is increased

   (e) Both 2 and 3 as the Contribution per unit equals 'Sales price per unit less Variable costs per unit'. An increase in the former or a reduction in the latter shall have the same effect i.e. increase in Contribution.

   (f) Overheads are under absorbed when the allocated amount of overheads in an accounting period is less than the actual overhead incurred in that period.

2. Computation of Production Volume Variance

   Maximum capacity : 1000 Units

   Standard fixed cost per Unit : Rs 1,000

   Actual production : 800 Units

   Production volume variance = (Unutilised capacity × Standard fixed cost per unit)

   = (200 Units × Rs 1,000)

   = (Rs 2,00,000)

Usage and Material price variance(Actual production :800 units)

Raw Material (RM)	Std Quantity of RM per unit of FG (a)	Std price of RM per unit (Rs) (b)	Std quantity of RM on actual prod (Rs) (c)	Actual quantity of RM on actual prod (d)	Actual price of RM (Rs) (e)	Usage variance (Rs) (c – d) × (b)	Price variance (Rs) (b – e) × (d)
Glass shell	01No	1,000	800 No	800	1,200	Nil	(1,60,000)
Phosphor	100 grams	5 per gram	80,000 grams	96,000 grams	5 per gram	(80,000)	Nil
Laquor	50 grams	5 per gram	40,000 grams	48,000 grams	5 per gram	(40,000)	Nil
Electron guns	02 No	125	1,600	1,600	150	Nil	(40,000)
						(1,20,000)	(2,00,000)

Computation of profit

	Rs
Standards Sales (800 units × Rs 5,000)	40,00,000
Less Standard cost (800 units × Rs 4,000)	32,00,000
Standard profit	8,00,000
Production volume variance	(2,00,000)
Usage variance	(1,20,000)
Price variance	(2,00,000)
Selling price variance	8,00,000
Actual profit	10,80,000

3. (a) Statement Showing the Optimum Ordering Quantity of Materials

		Rs.	Rs.	Rs.	Rs.	Rs.
1	Order size (tons)	200	250	800	2,000	4,000
2.	No. of orders (annual demand ÷ order size	20	16	5	2	1
3.	Value per order (order size × price per ton	1,200	1,475	4,640	11,400	22,400

4.	Average inventory (value per order $\div$ 2)	600	738	2,320	5,700	11,200
	Ordering cost (no. of orders $\times$ ordering cost per order)	120	96	30	12	6
	*Carrying cost (20% of item 4)	120	148	464	1,140	2,240
	Total	240	244	494	1,152	2,246
	Annual cost of material (annual demand $\times$ price)	24,000	23,600	23,200	22,800	22,400
	Total annual cost	24,240	23,844	23,694	23,952	24,646

Rs.23,694 is the total minimum cost at 800 order size. Therefore, the best quantity to be ordered is 800 tons.

3. (b) (1) Statement showing the Number of Bonus Hours and Amount of Bonus Earned

		Worker X	Worker Y
		Hours	Hours
1.	Time allowed (12 minutes per dozen or one minute per unit of X	$\left(\frac{1}{60}\times 3{,}600\right)=60$	$\left(\frac{3}{200}\times 4{,}200\right)=63$
2.	Hours worked	<u>45</u>	<u>50</u>
3.	Hours for which bonus is earned(1 – 2)	<u>15</u>	<u>13</u>
4.	Amount of bonus earned (bonus hours $\times$ hourly wage rate $\times$ $\frac{2}{3}$)		
	X – 15 $\times$ 5 $\times$ $\frac{2}{3}$ =	Rs.50	
	Y – 13 $\times$ 6 $\times$ $\frac{2}{3}$ =		Rs.52

(2) Statement showing Total Wages Earned

		Worker X	Worker Y
1.	Basic wages (X – 45 hours $\times$ Rs.5) =	Rs.225	
	(Y – 50 hours $\times$ Rs.6) =		Rs.300

2. Overtime premium (hours worked less normal working hours)

X – (45 – 42) $\times$ Rs.5 $\times$ $\frac{1}{3}$ =	5	
Y – total overtime worked		
(50 – 42 = 8 hours)		
For first 4 hours = 4 $\times$ Rs.6 $\times$ $\frac{1}{3}$ =		8
For second 4 hours = 4 $\times$ Rs.6 $\times$ ½ =		12
3. Bonus as per (a) above =	50	52
Total wages =	Rs.280	Rs.372

4\. (a) Budget can be defined as " A financial and / or quantitative statement , prepared and approved prior to a defined time of the policy to be pursued during that period for the purpose of attaining a given objective . It may include income, expenditure and employment of capital".

Budgetary Control can be defined as " the establishment of budgets relating the responsibilities of executives to the requirements of a policy , and the continous comparison of actual with budgeted results either to secure by individual action the objective of that policy or to provide a base for its revision".

(b) Functional budgets are those budgets which can be related to the individual functions in an organisation. For example production budget, purchase budget etc.

Master budget is the consolidated summary of the various functional budgets. It serves as the basis upon which budgeted P&L A/c and forecasted Balance Sheet are build up.

(c) Marginal costing can be defined as the ascertainment of marginal cost and of the effect on profit of changes in volume or type of output by differentiating between fixed costs and variable costs.

Direct costing is the practise of charging all direct costs to operations, processes or products, leaving all indirect costs to be written off against profits in the period in which they arise. Under direct costing stocks are valued at direct costs i.e. costs which can be related directly with the cost object. Such direct costs may be both fixed or variable.

(d) Centres which have the responsibility of generating and maximising profits are called Profit centres.

Those centres which are concerned with earning an adequate return on investment are called Investment centres.

PART – II : FINANCIAL MANAGEMENT

5. (a) False. The trade terms "2/15, net 30" indicate that a 2% discount is offered if payment is made within 15 days.

   (b) False. The estimated benefits from a project are expressed as cash flows instead of income flows because it is cash, not accounting income, that is central to the firm's capital budgeting decision.

   (c) 9.6 percent and 13.2 percent

   Beta Company's required return = 0.06 + [(0.90) (0.10 – 0.06)] = 0.096

   Alpha Company's required return = 0.06 + [(1.8) (0.10 – 0.06)] = 0.132

   (d) Rs. 4,80,000

   $$\text{Total asset turnover} = \frac{\text{Return on Investment}}{\text{Net Profit Margin}}$$

   $$= \frac{0.08}{0.05} = 1.6$$

   Sales = Total asset turnover × total assets

   = 1.6 × 3,00,000

   = 4,80,000

   (e) 0.667

   If debt to total assets = 0.4 then, equity to total assets must equal to 0.6

   $$\frac{\text{Debt}}{\text{Equity}} = \frac{\text{Debt}}{\text{Total assets}} \div \frac{\text{Earnings}}{\text{Total assets}}$$

   $$= \frac{0.4}{0.6}$$

   = 0.667

   (f) False. An EBIT-EPS indifference analysis chart is used for examining EPS results for alternative financing plans at varying EBIT levels.

6. Workings:

	Rs.
Sales	75,00,000
Less: Variable cost	42,00,000
Contribution	33,00,000
Less: Fixed costs	6,00,000

EBIT	27,00,000
Less: 9% interest on Rs. 45,00,000	4,05,000
EBT	22,95,000

(i) ROI = $\frac{\text{EBIT}}{\text{Investment}} = \frac{\text{EBIT}}{\text{Debt} + \text{Equity}} = \text{Rs.}\frac{27,00,000}{1,00,00,000} = 27\%$

(ii) Since the return on investment (27%) is higher than the interest payable on debt at 9%, the firm has a favourable financial leverage.

(iii) $\text{Asset Turnover} = \frac{\text{Net Sales}}{\text{Total assets} (= \text{Total Investment})}$

Firm's Asset Turnover = $\frac{75,00,000}{1,00,00,000}$ = 0.75

The industry average is 3. Hence the firm has low asset leverage.

(iv) Operating leverage = $\frac{\text{Contribution}}{\text{EBIT}} = \frac{33,00,000}{27,00,000}$ = 1.2222

Financial leverage = $\frac{\text{EBIT}}{\text{EBT}} = \frac{27,00,000}{22,95,000}$ = 1.1764

Combined leverage = $\frac{\text{Contribution}}{\text{EBT}} = \frac{33,00,000}{22,95,000}$ = 1.438

(OR)

Combined leverage = Operating leverage x Financial leverage

= 1.2222 x 1.1764 =1.438

(v) If the sales drop to Rs. 50,00,000 from Rs. 75,00,000, the fall is by 33.33%. Hence EBIT will drop by 40.73% (%Fall in sales x operating leverage).

Hence the new EBIT will be Rs. 27,00,000 x (1- 40.73%) = Rs. 16,00,290 or rounded upto Rs. 16,00,000

(vi) EBT to become zero means 100% reduction in EBT. Since the combined leverage is 1.438, sales have to drop by 100/1.438 i.e. 69.54%. Hence the new sales will be Rs. 75,00,000 x (1- 69.54%) = Rs. 22,84,500 (approx.)

7 (a) (i) Weighted Average Cost of Capital of the Company

(Based on Existing Capital Structure)

	After tax cost (a)	Weights (Refer to working note 4) (b)	Weighted cost (a) × (b)
Equity share capital cost (Refer to working note 1)	0.15	0.50	0.075
Cost of preference share capital @11.5% (Refer to working note 2)	0.115	0.125	0.014375
Cost of debentures (Refer to working note 3)	0.065	0.375	0.02437
Weighted average cost of capital			11.375%

Working Notes:

1. Cost of equity capital:

$$K_e = \frac{\text{Dividend}}{\text{Current market price of share}} + g$$

$$= \frac{\text{Rs. }2}{\text{Rs. }20} + 5\% = 15\% \text{ or } 0.15$$

2. Cost of preference share capital:

$$= \frac{\text{Annual preference share dividend}}{\text{Net proceeds in the issue of preference share}}$$

$$= \frac{\text{Rs.}1{,}15{,}000}{\text{Rs.}10{,}00{,}000} = 0.115$$

3. Cost of Debentures:

$$= \frac{1}{\text{Net proceeds}}(\text{Interest} - \text{Tax})$$

$$= \frac{1}{\text{Rs.}30{,}00{,}000}(\text{Rs.}3{,}00{,}000 - \text{Rs.}1{,}05{,}000)$$

$$= 0.065$$

4. Weights of equity share capital, preference share capital and debentures in total investment of Rs.80,00,000:

$$\text{Weight of equity share capital} = \frac{\text{Total equity share capital}}{\text{Total investments}}$$

$$= \frac{\text{Rs.}40{,}00{,}000}{\text{Rs.}80{,}00{,}000} = 0.50$$

$$\text{Weight of preference share capital} = \frac{\text{Total preference share amount}}{\text{Total investments}}$$

$$= \frac{\text{Rs.}10{,}00{,}000}{\text{Rs.}80{,}00{,}000} = 0.125$$

$$\text{Weight of debentures} = \frac{\text{Total debentures}}{\text{Total investments}}$$

$$= \frac{\text{Rs.}30{,}00{,}000}{\text{Rs.}80{,}00{,}000} = 0.375$$

(ii) New Weighted Average Cost of Capital of the Company

(Based on new capital structure)

	After tax cost (a)	Weights (Refer to working note 4) (b)	Weighted cost (a) × (b)
Cost of equity share capital (Refer to working note 2)	0.20	0.40	0.080
Cost of preference share	0.115	0.10	0.0115
Cost of debentures @ 10%	0.065	0.30	0.0195
Cost of debentures @12%	0.078	0.20	0.0156
Weighted average cost of capital			12.66%

Working Notes:

(1) Weights of equity share capital, preference share and debentures in total investment of Rs.1,00,00,000

$$\text{Weight of equity share capital} = \frac{\text{Rs.}40{,}00{,}000}{\text{Rs.}1{,}00{,}00{,}000} = 0.4$$

$$\text{Weight of preference share capital} = \frac{\text{Rs.}10{,}00{,}000}{\text{Rs.}1{,}00{,}00{,}000} = 0.1$$

Weight of debentures @10% = $\frac{\text{Rs.}30,00,000}{\text{Rs.}1,00,00,000} = 0.30$

Weight of debentures @12% = $\frac{\text{Rs.}20,00,000}{\text{Rs.}1,00,00,000} = 0.20$

2. Cost of equity capital:

$$K_e = \frac{\text{Dividend}}{\text{Current market price of share}} + g$$

$$= \frac{\text{Rs.}2.40}{\text{Rs.}16} + 5\% = 20\%$$

(iii) Comment: In the computation of weighted average cost of capital weights are preferred to book value. For example, weights representing the capital structure under a corporate financing situation, its cash flows are preferred to earnings and market. Balance sheet is preferred to book value balance sheet.

(b) (i) Estimation of net present value (NPV) of the Project 'A' and 'B' using 15% as the hurdle rate:

NPV of Project 'A' :

$$= -40,000 + \frac{13,000}{(1.15)^1} + \frac{8,000}{(1.15)^2} + \frac{14,000}{(1.15)^3} + \frac{12,000}{(1.15)^4} + \frac{11,000}{(1.15)^5} + \frac{15,000}{(1.15)^6}$$

= - 40,000 + 11,304.35 + 6,049.15 + 9,205.68 + 6,861.45 + 5,469.37 + 6,485.65

= Rs. 5,375.65 or Rs.5,376

NPV of Project 'B ' :

$$= -20,000 + \frac{7,000}{(1.15)^1} + \frac{13,000}{(1.15)^2} + \frac{12,000}{(1.15)^3}$$

= - 20,000 + 6,086.96 + 9,829.87 + 7,890.58

= Rs.3,807.41

(ii) Estimation of internal rate of return (IRR) of the Project 'A' and 'B'

Internal rate of return 'r' (IRR) is that rate at which the sum of cash inflows after discounting equals to the discounted cash out flows. The value of r in the case of given projects can be determined by using the following formula:

$$CO_o = \frac{CF_0}{(1+r)^0} + \frac{CF_1}{(1+r)^1} + \text{--------} + \frac{CF_n}{(1+r)^n} + \frac{SV + WC}{(1+r)^n}$$

Where,

Co = Cash flows at the time zero

CF_t = Cash inflow at the end of year t

r = Discount rate

n = Life of the project

SV & WC = Salvage value and working capital at the end of n years.

In the case of project 'A' the value of r (IRR) is given by the following relation:

$$40,000 = \frac{13,000}{(1+r\%)^1} + \frac{8,000}{(1+r\%)^2} + \frac{14,000}{(1+r\%)^3} + \frac{12,000}{(1+r\%)^4} + \frac{11,000}{(1+r\%)^5} + \frac{15,000}{(1+r\%)^6}$$

r = 19.73%

Similarly we can determine the internal rate of return for the project 'B' . In the case of project 'B' it comes to:

r = 25.20%

(iii) The conflict between NPV and IRR rule in the case of mutually exclusive project situation arises due to re-investment rate assumption. NPV rule assumes that intermediate cash flows are reinvested at k and IRR assumes that they are reinvested at r. The assumption of NPV rule is more realistic.

(iv) When there is a conflict in the project choice by using NPV and IRR criterion, we would prefer to use "Equal Annualized Criterion". According to this criterion the net annual cash inflow in the case of Projects 'A' and 'B' respectively would be:

Project 'A' = (Net present value/ cumulative present value of Re.1 p.a @15% for 6 years)

= (Rs.5,375.65 / 3.7845)

= Rs.1,420.44

Project 'B'= (Rs.3807.41/2.2832)

= Rs.1667.58

Since the cash inflow per annum in the case of project 'B' is more than that of project 'A', so Project 'B' is recommended.

8 (a) Functions of a Chief Financial Officer

The twin aspects viz procurement and effective utilization of funds are the crucial tasks, which the CFO faces. The Chief Finance Officer is required to look into financial implications of any decision in the firm. Thus all decisions involving management of funds comes under the purview of finance manager. These are namely

– Estimating requirement of funds
– Decision regarding capital structure

- Investment decisions
- Dividend decision
- Cash management
- Evaluating financial performance
- Financial negotiation
- Keeping touch with stock exchange quotations & behaviour of share prices.

(b) William J Baumal vs Miller- Orr Cash Management Model

According to William J Baumal's Economic order quantity model optimum cash level is that level of cash where the carrying costs and transactions costs are the minimum. The carrying cost refers to the cost of holding cash, namely, the interest foregone on marketable securities. The transaction cost refers to the cost involved in getting the marketable securities converted into cash. This happens when the firm falls short of cash and has to sell the securities resulting in clerical, brokerage, registration and other costs.

The optimim cash balance according to this model will be that point where these two costs are equal. The formula for determining optimum cash balance is:

$$C = \sqrt{\frac{2U \times P}{S}},$$

Where,

C = Optimum cash balance

U = Annual (monthly) cash disbursements

P = Fixed cost per transaction

S = Opportunity cost of one rupee p.a. (or p.m)

Miller-Orr cash management model is a net cash flow stochastic model. This model is designed to determine the time and size of transfers between an investment account and cash account. In this model control limits are set for cash balances. These limits may consist of h as upper limit, z as the return point, and zero as the lower limit.

When the cash balances reach the upper limit, the transfer of cash equal to h-z is invested in marketable securities account. When it touches the lower limit, a transfer from marketable securities account to cash account is made. During the period when cash balance stays between (h,z) and (z, o) i.e high and low limits no transactions between cash and marketable securities account is made. The high and low limits of cash balance are set up on the basis of fixed cost associated with the securities transactions, the opportunity cost of holding cash and the degree of likely fluctuations in cash balances. These limits satisfy the demands for cash at the lowest possible total costs.

(c) Bridge Finance

Bridge finance refers, normally, to loans taken by the business, usually from commercial banks for a short period, pending disbursement of term loans by financial institutions, normally it takes time for the financial institution to finalise procedures of creation of security, tie-up participation with other institutions etc. even though a positive appraisal of the project has been made. However, once the loans are approved in principle, firms in order not to lose further time in starting their projects arrange for bridge finance. Such temporary loan is normally repaid out of the proceeds of the principal term loans. It is secured by hypothecation of moveable assets, personal guarantees and demand promissory notes. Generally rate of interest on bridge finance is higher as compared with that on term loans.

(d) Funds Flow Statement versus Cash Flow Statement

Both funds flow and cash flow statements are used in analysis of past transactions of a business firm. The difference between these two statements is given below:

Funds flow statement is based on the accrual accounting system. In case of preparation of cash flow statements all transactions effecting the cash or cash equivalents only is taken into consideration.

Funds flow statement analyses the sources and application of funds of long-term nature and the net increase or decrease in long-term funds will be reflected on the working capital of the firm. The cash flow statement will only consider the increase or decrease in current assets and current liabilities in calculating the cash flow of funds from operations.

Funds Flow analysis is more useful for long range financial planning. Cash flow analysis is more useful for identifying and correcting the current liquidity problems of the firm.

Funds flow statement tallies the funds generated from various sources with various uses to which they are put. Cash flow statement starts with the opening balance of cash and reach to the closing balance of cash by proceeding through sources and uses.

PROFESSIONAL COMPETENCE COURSE

Model Test Paper – BOS/PCC/Taxation – 1/2007

GROUP – II

PAPER – 5 : TAXATION

SUGGESTED ANSWERS/HINTS

PART – I : INCOME TAX

1. (i) True – The due dates for payment of advance tax in the case of corporate assessees are 15th June, 15th September, 15th December and 15th March.

   (ii) False – Only fixed deposits with scheduled banks qualify for deduction under section 80C.

   (iii) False - The scheme for filing of returns under the 'One-by-six' scheme stipulated in the proviso to section 139(1) has been dispensed with w.e.f. A.Y.2006-07.

   (iv) False – It is compulsory for both companies and firms to file a return of income or loss every previous year on or before the due date.

   (v) True – Sub-section (4) of section 73 has been amended by the Finance Act, 2005 to reduce the period of carry forward of speculation losses from eight assessment years to four assessment years.

   (vi) False – Long-term capital loss can be set-off only against long-term capital gains and not against short-term capital gains.

2. Computation of total income of Mr. Ganesh for the A.Y.2007-08

Particulars	Rs.	Rs.	Rs.
Income from Salaries			
Basic Salary (25,000×12)		3,00,000	
Dearness allowance (12,000×12)		1,44,000	
Bonus		50,000	
Entertainment allowance (5,000×12)		60,000	
House rent allowance	1,20,000		
Exempt up to least of the following			
(1) Actual HRA – Rs.1,20,000			
(2) 50% of salary – 50% of 3,00,000 – Rs.1,50,000			

(3) Excess of rent paid over 10% of salary = [(12000×12)-(10% of 3,00,000)]=1,44,000-30,000=Rs.1,14,000	1,14,000	6,000	
Children education and hostel allowance	30,000		
Less: Exempt u/s 10(14) – Rs.100 per month per child for two children. (100 ×2×12) He is not entitled to any deduction for hostel allowance since his children do not stay in a hostel.	2,400	27,600	
Leave travel allowance (fully taxable since no journey has been undertaken)		25,000	
			6,12,600
Income from house property			
Gross Annual Value [See Note 1 below]		Nil	
Less: Municipal taxes (not allowable in case of self-occupied property)		Nil	
Net Annual Value		Nil	
Less: Deduction u/s 24 – Interest on loan		60,000	(60,000)
Capital gains			
Long-term capital gains on sale of jewellery [See Note 2 below]		7,500	
Short-term capital gains on sale of equity shares		15,000	22,500
Gross Total Income			5,75,100
Less: Deduction under Chapter VI-A			
Section 80C [See Note 3 below]		1,00,000	
Section 80D [See Note 4 below]		7,000	1,07,000
Total Income			4,68,100
Computation of tax payable			
On long-term capital gains on sale of jewellery @ 20%		1,500	
On short-term capital gains on sale of equity shares@10%		1,500	
On the balance total income of Rs.4,45,600			
On the first 1,00,000	Nil		
On the next Rs.50,000 @10%	5,000		
On the next Rs.1,00,000@20%	20,000		

On the balance Rs.1,95,600@30%	58,680	83,680	
			86,680
Add: Education cess@2%			1,734
Total tax payable			88,414

Note –

1. Ganesh owns a house in Chennai but cannot occupy it since he is employed in Mumbai. Therefore, he is living in a rented accommodation in Mumbai. In such a case, Ganesh can claim the benefit of self-occupation in respect of his property in Chennai, since he does not derive any income from such property. Further, since he is living in a rented accommodation in Mumbai, he is entitled to claim deduction u/s 10(13A) for house rent allowance.
2. Long-term capital gains on sale of units of equity oriented mutual fund is exempt u/s 10(38). Therefore, Long-term capital loss on sale of units of equity oriented fund cannot be set-off against long-term capital gains on sale of jewellery because loss from an exempt source cannot be set-off against gains from a taxable source. In the case of JCIT vs. Thyagarajan.S.S (1981) 129 ITR 115 (Mad), the Madras High Court held that loss incurred by an assessee from a source, income from which is exempted, cannot be set off against income from a taxable source. In view of the same, the set off in the instant case is not permissible.
3. The qualifying limit under section 80C is Rs.1,00,000 [PPF –Rs.60,000; Infrastructure bonds – Rs.50,000; RPF – Rs.30,000 totalling Rs.1,40,000 but restricted to Rs.1,00,000]
4. Under section 80D, medical insurance premium paid by cheque only can be claimed as deduction.

3. (a) Computation of income from house property of Sahasra for the A.Y. 2007-08

Since Sahasra owns two house properties for self-occupation, she has to opt any one of the properties for claiming the benefit of self-occupation. The other property would be deemed to be let out.

Calculation of income from each house property assuming that they are deemed to be let out.

Particulars	Amount in Rs.	
	House I	House II
Gross Annual Value (GAV)		
In respect of deemed let-out property, Annual Letting Value (ALV) is the GAV of house property		
ALV is the higher of municipal value and fair rent, but restricted to standard rent	1,80,000	3,20,000

Less: Municipal taxes (paid by the owner during the previous year)	20,000	18,000
Net Annual Value (NAV)	1,60,000	3,02,000
Less: Deductions u/s 24		
(a) 30% of NAV	48,000	90,600
(b) Interest on borrowed capital	-	40,000
Income from house property	1,12,000	1,71,400

OPTION 1 (House I – self-occupied and House II – deemed to be let out)

If House I is opted to be self-occupied, the income from house property shall be–

Particulars	Amount in Rs.
House I (Self-occupied)	Nil
House II (Deemed to be let-out)	1,71,400
Income from house property	1,71,400

OPTION 2 (House I – deemed to be let out and House II – self-occupied)

If House II is opted to be self-occupied, the income from house property shall be–

Particulars	Amount in Rs.
House I (Deemed to be let-out)	1,12,000
House II (Self-occupied) (interest deduction restricted to Rs.30,000)	-30,000
Income from house property	82,000

Since Option 2 is more beneficial, Sahasra should opt to treat House II as self-occupied and House I as deemed to be let out. Her income from house property would be Rs.82,000 for the A.Y. 2007-08.

(b) Profits and gains of business or profession of Mr. Sridhar for the year ended 31.3.2007

Particulars	Rs.	Rs.
Net profit as per Profit and Loss Account		81,400
Add: Expenses not allowable		
(i) Expenses on raising a compound wall, as it is a capital expenditure	32,000	

(ii)	Interest payable outside India to a resident, as tax has not been deducted on the same [Section 40(a)]	7,000	
(iii)	Penalty for contravention of excise laws [Penalty paid for violation or infringement of any law is not allowable as deduction under section 37(1)]	8,000	
(iv)	Contribution for scientific research (to be treated separately)	60,000	1,07,000
			1,88,400
Less:	Income not forming part of business income		
	Interest from bank deposits	8,000	
	Dividend	5,000	
	Income-tax refund	6,000	19,000
			1,69,400
Less:	Deduction under section 35 for scientific research [See Note 2 below]		75,000
	Profit and gains of business or profession		94,400

Note:

(1) Banking cash transaction tax is allowable as deduction under section 36(1)(xiii) from business income.

(2) Contribution to approved scientific research association qualifies for deduction @ 1¼ times under section 35(1)(ii).

4. (a) Computation of gross total income of Mr. Rajesh for the A.Y. 2007-08

Particulars	Rs.	Rs.
Income from house property		75,000
Income from business		
Profits before depreciation (Textile Business)	2,10,000	
Less : current year depreciation	15,000	
Less : brought forward business loss	30,000	
	1,65,000	
Income from tea business (40% is business income)	64,000	2,29,000
Capital Gains		
Short term capital gains		70,000
Gross Total Income		3,74,000

Note

1. Dividend from Indian companies is exempt from tax.
2. 60% of the income from tea business is treated as agricultural income and therefore, exempt from tax.
3. Long-term capital loss can be set-off only against long-term capital gains. Therefore, long-term capital loss of A.Y.2006-07 has to be carried forward, since the same cannot be set-off against short-term capital gains of A.Y.2007-08. Such loss can be carried forward for a maximum period of 8 assessment years.

(b) Computation of total income of Mr. Manas for A.Y.2007-08

	Particulars	Resident & ordinarily resident	Resident but not ordinarily resident	Non-resident
(i)	Salary income received in India for services rendered in Sri Lanka	25,000	25,000	25,000
(ii)	Income from profession in Bangalore, but received in Sri Lanka.	30,000	30,000	30,000
(iii)	Property income in Nepal	40,000	-	-
(iv)	Profits earned from business in Mysore.	22,000	22,000	22,000
(v)	Profits from a business carried on in Sri Lanka but controlled from India	50,000	50,000	-
(vi)	Past untaxed profits remitted to India during the previous year – not taxable since it is not income of the previous year.	-	-	-
(vii)	Agricultural income from land in Karnataka [exempt under section 10(1)]	-	-	-
	Total Income	1,67,000	1,27,000	77,000

5. (a) Tax return preparers

(i) A new section 139B has been inserted with effect from June 1, 2006 so as to provide that, for the purpose of enabling any specified class or classes of persons to prepare and furnish their returns of income, the CBDT may notify a Scheme to provide that such persons may furnish their returns of income through a Tax Return Preparer authorised to act as such under the Scheme.

(ii) The Tax Return Preparer shall assist the persons furnishing the return in a manner that will be specified in the Scheme, and shall also affix his signature on such return.

(iii) A Tax Return Preparer can be an individual, other than

(1) any officer of a scheduled bank with which the assessee maintains a

current account or has other regular dealings.

(2) any legal practitioner who is entitled to practice in any civil court in India.

(3) a chartered accountant.

(4) an employee of the 'specified class or classes of persons'.

(iv) The "specified class or classes of persons" for this purpose means any person other than a company or a person whose accounts are required to be audited under section 44AB (tax audit) or under any other existing law, who is required to furnish a return of income under the Act.

(b) Meaning of "Infrastructure capital company"

As per section 2(26A),"infrastructure capital company" means such company which makes investments by way of acquiring shares or providing long-term finance to -

(1) any enterprise or undertaking wholly engaged -

(a) in the business referred to in Section 80-IA(4) i.e. business of

(i) developing/operating and maintaining/developing, operating and maintaining any infrastructure facility fulfilling the specified conditions

(ii) providing telecom services, whether basic or cellular

(iii) developing, developing and operating or maintaining and operating an industrial park or special economic zone notified by the Central Government

(iv) generating, transmitting or distributing power or undertaking substantial renovation and modernization of the existing network of transmission or distribution lines.

(b) in the business referred to in Section 80-IAB(1) i.e. any business of developing a SEZ.

(2) an undertaking developing and building a housing project referred to in sub-section (10) of section 80-IB i.e. approved before 31.3.2007 by a local authority and commences or commenced development and construction on or after 1.10.98 and completes or completed development and construction within the time specified.

(3) a project for constructing a hotel of not less than three-star category as classified by the Central Government or

(4) a project for constructing a hospital with at least 100 beds for patients.

(c) Schools of Hindu Law

There are two schools of hindu law. They are –

(1) Mithakshara school of hindu law

(2) Dayabhaga school of hindu law

Mithakshara law is followed by entire India except West Bengal and Assam. There is a basic difference between the two schools of thought with regard to succession. Under the Mithakshara law, the inheritance is by birth. One acquires the right to the family property by his birth and not by succession irrespective of the fact that his elders are living. Thus, every child born in the family acquires a right/share in the family property.

Dayabagha law prevails in West Bengal and Assam. In Dayabagha law, nobody acquires the right, share in the property by birth as long as the head of family is living, that is, the children do not acquire any right, share in the family property, as long as their father is alive and only on death of the father, the children will acquire right/share in the property. Thus, the father and his brothers would be the coparceners of the HUF

(d) Persons responsible for paying taxes deducted at source [Section 204]

For purposes of deduction of tax at source the expression "person responsible for paying" means:

	Nature of income / payment	Person responsible for paying tax
(1)	Salary (other than payment of salaries by the Central or State Government)	(i) the employer himself; or (ii) if the employer is a company, the company itself, including the principal officer thereof.
(2)	Interest on securities (other than payments by or on behalf of the Central or State Government)	The local authority, corporation or company, including the principal officer thereof.
(3)	Any sum payable to a non-resident Indian, representing consideration for the transfer by him of any foreign exchange asset, which is not a short term capital asset	The authorised dealer responsible for remitting such sum to the non-resident Indian or for crediting such sum to his Non-resident (External) Account maintained in accordance with the Foreign Exchange Regulation Act, 1973 and any rules made thereunder.
(4)	Credit/payment of any other sum chargeable under the provisions of the Act	(i) the payer himself; or (ii) if the payer is a company, the company itself including the principal officer thereof.

(e) Aggregation of agricultural income

Agricultural income is exempt from tax under section 10(1). However, it is to be included for determining the rate at which non-agricultural income is chargeable to tax. This is provided for in the Finance Act each year. The procedure for computation of tax payable on non-agricultural income after aggregation of agricultural income is as follows -

(i) Aggregate the agricultural income with non-agricultural income and determine the tax payable on such amount.

(ii) Aggregate the agricultural income with the basic exemption limit and determine the tax payable on such amount.

(iii) The difference between the tax computed in step (i) and step (ii) will be the tax payable in respect of non-agricultural income.

The income-tax so arrived at by the method of aggregation described above, has to be reduced by rebate under Chapter VIII-A and increased by surcharge, where applicable, and education cess.

In the case of assessees such as partnership firms, companies etc., whose income is chargeable to tax at a flat rate, aggregation of agricultural income has no effect. In the case of every individual, HUF, AOP or BOI and every artificial juridical person, the Finance Act prescribes slab rates of income-tax and in such cases agricultural income has to be aggregated for rate purposes.

If the non-agricultural income does not exceed the basic exemption limit, then the agricultural income should not be aggregated. No tax will be payable by the assessee in such a case. Further, aggregation of agricultural income for rate purposes is not required if the agricultural income does not exceed Rs.5,000 during the previous year.

PART – II : SERVICE TAX AND VAT

6. (a) (i) The three different methods of computation of VAT are:

(a) Addition method

(b) Subtraction method

(c) Invoice method

(ii) VAT was present in India in the form of Central value added tax in respect of excise duty before the introduction of State-Level VAT in respect of sales-tax.

(b) (i) Services provided beyond Indian territorial waters, i.e. 12 nautical miles from Indian land mass are not liable to service tax. Thus, the drilling in respect of exploration of oil done beyond 12 nautical miles from the Indian land mass would not be liable to service tax.

(ii) The advance of Rs.5000 would be liable to service tax as the payments received before, during or after the provision of taxable services form part of the gross amount charged for taxable services.

(iii) Construction of a residential housing complex having more than 12 residential units is chargeable to service tax. Therefore, construction of a residential housing complex consisting of 10 bungalows would not be chargeable to service tax.

(iv) Transport of passengers embarking on international journey by air, other than economy class passengers has been brought under service tax net by the Finance Act, 2006. Therefore, in this case service tax would not be attracted as such service is provided to a passenger of economy class.

7. (a) Computation of service tax liability of M/s. X & Y for the month of December 2006

Particulars	Amount (Rs.)
Preparation and filing of Form 'A' with BIFR	10,000
Preparation and filing of Income tax returns (See Note 1)	-
Concurrent Audit	2,500
Certification under the provisions of Income tax Act, 1961	4,500
Services rendered to a Nationalised bank to recover non performing assets (NPA) (See Note 1)	-
Advice on amalgamations and mergers	15,000
Representing the client before Income-tax Appellate Tribunal (See Note 2)	-
Total	32,000
Service tax @12%	3840.00
Education cess @ 2%	76.8
Total service tax and education cess for the month of December 2006	3916.80

(b) Computation of service tax payable by M/s. X & Y by January 5th

October	Rs.55,000
November	Rs.60,000
December	Rs.32,000
Total	Rs.1,47,000
Service tax @ 12%	Rs.17,640
Education cess @ 2%	Rs.352.80
Total service tax and education cess payable for the quarter ending December 2006	Rs.17992.80

Notes:

(1) Service tax is payable only on the value of taxable services received. Therefore, the value of taxable services received in January would not be liable to service tax during the month of December 2006.

(2) The taxable services provided by a practicing chartered accountant in his professional capacity, to a client, relating to representing the client before any statutory authority in the course of proceedings initiated under any law for the time being in force, by way of issue of notice, is exempt from the whole of service tax leviable thereon.

(3) In case of partnership firm, service tax is payable quarterly. Therefore, on 5th of January service tax for the quarter October-December 2006 shall be payable.

8. (a) In case the assessee is unable to correctly estimate, at the time of the deposit, the actual amount of service tax for any month or quarter, he may make a written request to Assistant/Deputy Commissioner of Central Excise for making payment of service tax on provisional basis. The concerned officer may allow payment of service tax on provisional basis on such value of taxable service as may be specified by him.

For the purpose of provisional assessment at the time of filling the return, the assessee is required to file a statement in form ST-3A giving detail of difference between service tax deposited and the service tax liable to be paid for each month. The quarterly or half yearly statements should also accompany. Assistant/Deputy Commissioner of Central Excise, on the basis of memorandum in form ST-3A may complete the assessment after calling for necessary documents or records, if need be.

(b) Packaging service includes any service provided or to be provided to any person, by any other person, in relation to packaging activity. Packaging activity means packaging of goods including pouch filling, bottling, labeling or imprinting of the package, but does not include any packaging activity that amounts to 'manufacture' within the meaning of clause (f) of section 2 of the Central Excise Act, 1944.

(c) Along with ST-3 return the following documents should be attached:

(i) copies of TR-6 challans which indicate the payment of service tax for the months/quarter covered in the half-yearly return

(ii) a memorandum in form ST-3A giving full details of the difference between the amount of provisional amount of tax deposited and the actual amount payable for each month. Form-ST-3A is to be attached only when the assessee opts for provisional payment of service tax.

(d) The gross product variant of VAT allows deductions for taxes on all purchases of raw materials and components, but no deduction is allowed for taxes on capital inputs. That is, taxes on capital goods such as plant and machinery are not deductible from the tax base in the year of purchase and tax on the depreciated part of the plant and machinery is not deductible in the subsequent years. In this variant of VAT, capital goods carry a heavier tax burden as they are taxed twice. Modernization and upgrading of plant and machinery is delayed due to this double tax treatment.

PROFESSIONAL COMPETENCE COURSE

Model Test Paper – BOS/PCC/Taxation – 2/2007

GROUP – II

PAPER – 5 : TAXATION

SUGGESTED ANSWERS/HINTS

PART I : INCOME TAX

1. (i) False – The rate of surcharge applicable to foreign companies is 2½% of tax on total income.

   (ii) True – The Finance Act, 2006 has inserted section 80AC which stipulates compulsory filing of return of income on or before the due date specified under section 139(1) to avail the benefit of deduction, inter alia, under section 80-IB.

   (iii) False – Section 139B(3)(a) defining the meaning of "Tax Return Preparer" specifically excludes, inter alia, any legal practitioner who is entitled to practise in any civil court in India from the definition.

   (iv) True – The Finance Act, 2006 has increased the maximum permissible deduction under section 80CCC from Rs.10,000 to Rs.1,00,000.

   (v) False – Section 71(2A) disallows set-off of loss computed under the head "Profits and gains of business or profession" against income under the head "Salaries".

   (vi) False – Under section 10(38), only long-term capital gains on sale of equity shares of a company is exempt, provided the transaction is chargeable to securities transaction tax. Short-term capital gains on such transactions are subject to tax @10% under section 111A.

2. Computation of total income and tax liability of the HUF for the A.Y.2007-08

Particulars	Rs.	Rs.
Income from house property		
Rental receipt (taken as Annual Value in the absence of other information)	1,05,000	
Less: Deduction u/s 24		
30% of Net Annual Value of Rs.1,05,000	31,500	73,500

Profit and gains of business or profession		
Business Income	6,00,000	
Share of profit from firm – Exempt u/s 10(2A)	-	6,00,000
Capital gains		
Long-term capital gains (on sale of house)	1,20,000	
Short-term capital gains (on sale of shares)	1,00,000	2,20,000
Income from other sources		
Dividend from Indian company – Exempt u/s 10(34)		Nil
Gross Total Income		8,93,500
Less: Deductions under Chapter VI-A		
Section 80C – Deposit in PPF	50,000	
Section 80D – Medical insurance premium	8,000	
Section 80G – Donation to Prime Minister's National Relief Fund – 100% of Rs.35,000	35,000	93,000
Total Income		8,00,500
Tax on total income of Rs.8,00,500		
Tax on long-term capital gains of Rs.1,20,000 @ 20%		24,000
Tax on short-term capital gain covered under section 111A [10% on Rs.1,00,000]		10,000
Tax on balance income of Rs.5,80,500		1,24,150
		1,58,150
Add: Surcharge		Nil
		1,58,150
Add: Education cess @ 2%		3,163
Total tax payable		1,61,313

Computation of total income and tax liability of members of HUF

Particulars	Rs.	Rs.
Computation of total income of Pranav		
Short-term capital gains on sale of shares of Indian company	75,000	
Dividend from Indian company [Exempt u/s 10(34)]	-	
Gross Total Income	75,000	

Less: Deductions under Chapter VI-A	-	
Total Income	75,000	
Tax on total income		Nil

Computation of total Income of Pratyoosh		
Income from salaries	3,00,000	
Gross Total Income	3,00,000	
Less: Deductions under Chapter VI-A	-	
Total Income	3,00,000	
Tax on Rs.3,00,000		40,000
Add: Education cess @ 2%		800
Total tax payable		40,800

Computation of total income of Anirudh		
Income from salaries	3,52,000	
Gross Total Income	3,52,000	
Less: Deduction under Chapter VI-A	-	
Total Income	3,52,000	
Tax on Rs.3,52,000		55,600
Add: Education cess @ 2%		1,112
Total tax payable		56,712

Total Income of Arvind		Nil

3. (a) Computation of Gross Salary of Mr. Ganesh for the AY 2007-08

Particulars	Rs.	Rs.
Basic Salary [Rs.12,000 × 12]		1,44,000
Dearness Allowance [Rs.6,000 × 12]		72,000
Commission on turnover [2% × Rs.7,00,000]		14,000
Bonus		55,000
Gratuity [Note 1]		32,000
Ganesh's contribution to RPF [Note 2]		-

Employer's contribution to RPF[18% of Rs.1,44,000]	25,920	
Less : Exempt [Note 3]	22,416	3,504
Interest accrued in the RPF @ 14% p.a.	21,000	
Less : Exempt @ 9.5% p.a.	14,250	6,750
Gross Salary		3,27,254

Note 1 : Gratuity received during service is fully taxable.

Note 2 : Employee's contribution to RPF is not taxable. It is eligible for deduction u/s 80C.

Note 3 : Employers contribution in the RPF is exempt up to 12% of the salary.

i.e. 12% of [Basic salary+ D.A. forming part of retirement benefits + Commission based on turnover]

= 12% of [Rs.1,44,000 + (40% × Rs.72,000) + Rs.14,000]

= 12% of Rs.1,86,800

= Rs.22,416

(b) There are two units of the house. Unit I with ¾th area is used by Raghav for self-occupation throughout the year and no benefit is derived from that unit, hence it will be treated as self-occupied and its annual value will be nil. Unit 2 with ¼th area is let-out throughout the previous year and its annual value has to be determined as per section 23(1).

Computation of Income from house property of Mr.Raghav for A.Y. 2007-08

Particulars	Amount in rupees
Unit I (¾th area – self-occupied)	
Annual Value	Nil
Less: Deduction u/s 24(b)	
¾th of Rs.80,000	60,000
Income from Unit I (self-occupied)	– 60,000
Unit II (¼th area – let out)	
Gross Annual Value (higher of annual letting value and actual rent)	
Annual letting value (ALV) is the higher of municipal value (MV) and fair rent (FR), but restricted to standard rent (SR). However, in this case, SR of Rs.55,000 (¼th of Rs.2,20,000) is more than the higher of MV of Rs.50,000	

(¼th of Rs.2,00,000) and FR of Rs.45,000 (¼th of Rs.1,80,000). Hence the higher of MV and FR is the ALV. In this case, it is the MV.	50,000	
Actual rent received/ receivable [5,000 × 12]	60,000	
GAV is the higher of ALV and actual rent received/receivable i.e. higher of Rs.60,000 and Rs.50,000	60,000	
Gross Annual Value(GAV)		60,000
Less: Municipal taxes paid by the owner during the previous year relating to let-out portion		
¼th of (10% of Rs.2,00,000) = 20,000/4 = 5,000		5,000
Net Annual Value(NAV)		55,000
Less: Deductions u/s 24		
(a) 30% of NAV = 30% of Rs.55,000	16,500	
(b) Interest paid on borrowed capital (relating to let out portion) ¼th of Rs.80,000	20,000	36,500
Income from Unit II (let-out)		18,500

Loss under the head "Income from house property" = - 60,000+18,500 = 41,500

4. (a) Section 64(1)(iv) of the Income-tax Act, 1961 provides for the clubbing of income in the hands of the individual, if the income earned is from the assets transferred directly or indirectly to the spouse of the individual, otherwise than for adequate consideration. In this case, Mrs. Sridhar received a gift of Rs.3,00,000 from her husband Mr. Sridhar which she invested in her business. The income to be clubbed in the hands of Mr. Sridhar for A.Y.2007-08 is computed as under:

Particulars	Mrs. Sridhar's capital contribution	Capital contribution out of gift from Mr.Sridhar	Total
	Rs.	Rs.	Rs.
Capital as at 1.4.2005	4,00,000	-	4,00,000
Investment on 3.4.2005 out of gift received from Mr.Sridhar	-	3,00,000	3,00,000
Total	4,00,000	3,00,000	7,00,000

Profit for F.Y. 2005-06 to be apportioned on the basis of capital employed on the first day of the previous year i.e. on 1.4.2005	3,50,000	-	3,50,000
Capital employed as at 1.4.2006	7,50,000	3,00,000	10,50,000
Profit for F.Y.2006-07 to be apportioned on the basis of capital employed as at 1.4.06 i.e. in the ratio of 5:2	3,50,000	1,40,000	4,90,000

Therefore, the income to be clubbed in the hands of Mr.Sridhar for A.Y.2007-08 is Rs.1,40,000.

(b) The taxability of the various incomes does not depend on whether Smita Mishra is an Indian citizen or not. Since Smita Mishra has been out of India continuously for the last 11 years, she is a non-resident under the Income-tax Act. Her tax liability will be as follows:

(i) Her rental income accrues in India and is received in India. Therefore, it will be included in her taxable income in India even though she is a non-resident. [Section 5(2)]

(ii) Agricultural income is exempt under section 10(1). It will be included only for determining the rate of tax.

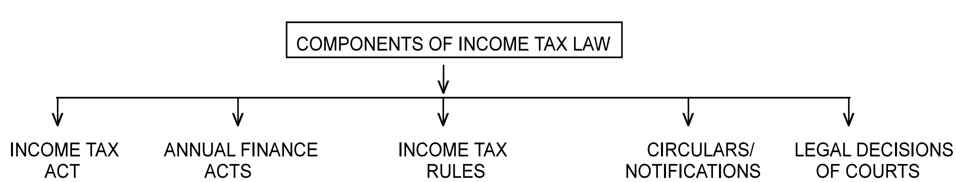
(iii) Her salary income will not form part of her taxable income in India since it is both earned and received abroad.

(iv) Dividend received by her in India from an Indian company is exempt under section 10(34).

(v) Income received by her outside India will not form part of her taxable income in India, even though it is subsequently remitted to India.

5. (a) Components of Income-tax law

The income-tax law in India consists of the following components–



Income-tax Act

The levy of income-tax in India is governed by the Income-tax Act, 1961. The Act contains 298 sections and XIV schedules. These undergo change every year with additions and deletions brought about by the Finance Act passed by Parliament. In pursuance of the power given by the Income-tax Act, rules have been framed to facilitate proper administration of the Income-tax Act.

The Finance Act

Every year, the Finance Minister of the Government of India presents the Budget to the Parliament. Part A of the budget speech contains the proposed policies of the Government in fiscal areas. Part B of the budget speech contains the detailed tax proposals. In order to implement the above proposals, the Finance Bill is introduced in the Parliament. Once the Finance Bill is approved by the Parliament and gets the assent of the President, it becomes the Finance Act.

Income-tax Rules

The administration of direct taxes is looked after by the Central Board of Direct Taxes (CBDT). The CBDT is empowered to make rules for carrying out the purposes of the Act. For the proper administration of the Income-tax Act, the CBDT frames rules from time to time. These rules are collectively called Income-tax Rules, 1962.

Circulars and Notifications

Circulars are issued by the CBDT from time to time to deal with certain specific problems and to clarify doubts regarding the scope and meaning of the provisions. These circulars are issued for the guidance of the officers and/or assessees. The department is bound by the circulars. While such circulars are not binding the assessees they can take advantage of beneficial circulars.

Case Laws

The study of case laws is an important part of the study of income-tax law. It is not possible for the Parliament to conceive and provide for all possible issues that may arise in the implementation of any Act. Hence the judiciary will hear the disputes between the assessees and the department and give decisions on various issues. The Supreme Court is the Apex Court of the country and the law laid down by the Supreme Court is the law of the land. The decisions given by various High Courts will apply in the respective states in which such High Courts have jurisdiction.

(b) Marginal relief

In case of such individuals/HUFs/AOPs/BOIs having a total income exceeding Rs.10,00,000, the additional amount of income-tax payable (together with surcharge) on the excess of income over Rs.10,00,000 should not be more than the amount of income exceeding Rs.10,00,000. This is called ‘marginal relief’.

Income-tax on total income of Rs.10 lakhs works out to Rs.2,50,000. Surcharge is not attracted on this tax since the total income does not exceed Rs.10 lakhs. However, if the total income is say, Rs.10,30,000, tax on the same would be Rs.2,84,900 (i.e. 2,59,000+ 25,900, being surcharge of 10%). The additional tax works out to Rs.34,900 (i.e., 2,84,900-2,50,000). However, the additional tax cannot exceed the amount by which Rs.10,30,000 exceeds Rs.10,00,000. That is, the additional tax cannot exceed Rs.30,000. Therefore, the total tax payable would be only Rs.2,80,000 (i.e. 2,50,000 + 30,000). The marginal relief is Rs.4,900 (i.e. 34,900-30,000).

(c) Profits in lieu of salary [Section 17(3)]

It includes the following:

(i) The amount of any compensation due to or received by an assessee from his employer or former employer at or in connection with the termination of his employment.

(ii) The amount of any compensation due to or received by an assessee from his employer or former employer at or in connection with the modification of the terms and conditions of employment.

(iii) Any payment due to or received by an assessee from his employer or former employer from a provident fund or any other fund to the extent to which it does not consist of employee's contributions or interest on such contributions.

Note: It does not include exempt payments from superannuation fund, gratuity, commuted pension, retrenchment compensation and house rent allowance.

(iv) Any payment due to or received by an assessee under a Keyman Insurance policy including the sum allocated by way of bonus on such policy.

(v) Any amount, whether in lumpsum or otherwise, due to the assessee or received by him, from any person -

(a) before joining employment with that person, or

(b) after cessation of his employment with that person.

(d) Authorised signatories to the return of income in case of a company

Circumstance	Authorised signatory
(i) in circumstances not covered under (ii) to (v) below	- the managing director of the company
(ii)	
(a) where for any unavoidable reason such managing director is not able to sign and verify the return; or	- any director of the company
(b) where there is no managing director	- any director of the company
(iii) where the company is not resident in India	- a person who holds a valid power of attorney from such company to do so (such power of attorney should be attached to the return).

(iv)

(a) Where the company is being wound up (whether under the orders of a court or otherwise); or	- Liquidator
(b) where any person has been appointed as the receiver of any assets of the company	- Liquidator
(v) Where the management of the company has been taken over by the Central Government or any State Government under any law	- the principal officer of the company

(e) Deduction of tax at source from payment of compensation on acquisition of immovable property

(1) Section 194LA provides for deduction of tax at source by a person responsible for paying to a resident any sum in the nature of –

(i) compensation or the enhanced compensation or

(ii) the consideration or the enhanced consideration

on account of compulsory acquisition, under any law for the time being in force, of any immovable property (other than agricultural land).

(2) Immovable property means any land (other than agricultural land) or any building or part of a building.

(3) The amount of tax to be deducted is 10% (plus surcharge, if applicable, plus education cess) of such sum mentioned in (1) above.

(4) The tax should be deducted at the time of payment of such sum in cash or by issue of a cheque or draft or by any other mode, whichever is earlier.

(5) No tax is required to be deducted where the amount of such payment or, as the case may be, the aggregate amount of such payments to a resident during the financial year does not exceed Rs.1 lakh.

PART – II : SERVICE TAX AND VAT

6. (a) (i) Directorate of (Service Tax) coordinates between Central Board of Excise and Customs and Central Excise Commissionerates.

(ii) Invoice method is being used in India for computation of VAT. Under this method, tax is imposed at each stage of sales on the entire sale value and the tax paid at the earlier stage is allowed as set-off.

(b) (i) The taxable services provided to any person by a mandap keeper for the use of the precincts of a religious place as a mandap are exempt from service tax leviable thereon.

(ii) Cleaning services other than in relation to agriculture, horticulture, animal husbandry or dairying has been brought under the service tax net by the Finance Act, 2005. Disinfecting service, though a cleaning service, shall not be liable to service tax in this case as the service is rendered in relation to agriculture.

(iii) Excavation services provided to any person in relation to construction of a dam are exempt from the whole of service tax leviable thereon.

(iv) Government buildings or civil constructions used for residential, office purposes or for providing civic amenities are not chargeable to service tax under the category of commercial or industrial construction services. However, if such constructions are for commercial purposes, like local government bodies getting shops constructed for letting them out, such activity would be commercial and builders are subjected to service tax.

7. (a) Section 68 casts the liability to pay service tax upon the service provider or upon the person liable to pay service tax as per Rule 2(1)(d). The statutory liability does not get extinguished if the service provider fails to realize or charge the service tax from the service receiver. Therefore, Secure Services Ltd. shall have to pay service tax.

Section 67 inter alia specifies that where the gross amount charged by a service provider, for the service provided or to be provided is inclusive of service tax payable, the value of such taxable service shall be such amount as, with the addition of tax payable, is equal to the gross amount charged.

Thus, service tax liability of Secure Services Ltd. can be computed as follows:

Value of taxable service	= [Gross amount charged/(100 + rate of tax)] x 100
Value of taxable service	= [124000/(100 + 12.24)] x 100
	= Rs.1,10,477.55
Service tax plus education cess	= [Gross amount charged/(100 + rate of tax)] x rate of tax
	= [124000/(100 + 12.24)] x 12.24
	= Rs.13,522.45

(b) As per section 67, if the consideration for a taxable service is in terms of money, the value of such service shall be the gross amount charged by the service provider for such service provided or to be provided by him. Therefore, Mr. Ramesh should raise the bill for Rs.25,000 and not for the adjusted amount of Rs.15,000.

Therefore, service tax liability of Mr. Ramesh would be

Service tax	25,000 x 12%	= Rs.3,000
Education cess	3,000 x 2%	= Rs. 600
Total service tax and education cess		= Rs.3,600

8. (a) The conditions necessary for availing the exemption on goods and materials sold by the service provider to the recipient of service vide Notification No. 12/2003 ST, dated 20.06.2003 are:

    (a) there should be a documentary proof specifically indicating the value of the said goods and materials.

    (b) no credit of duty paid on such goods and materials sold should have been taken under the provisions of the CENVAT Credit Rules, 2004; or

    (c) where such credit has been taken by the service provider on such goods and materials, such service provider has paid the amount equal to such credit availed before the sale of such goods and materials.

   (b) Rule 6(1) provides that service tax on the value of taxable services received:

    (i) by an individual or a proprietary firm or a partnership firm during any quarter is payable by the 5th of the month immediately following the said quarter; and

    (ii) in other cases (company and HUF) during any calendar month is payable by the 5th of the month immediately following the said calendar month.

   However, the month of March is an exception to this general rule. The service tax on the value of taxable services received during the month of March, or the quarter ending in March, as the case may be, shall be paid to the credit of the Central Government by the 31st day of March of the calendar year. For the month of March there is no distinction between the assessees.

   If the last day of payment of service tax is a public holiday, tax can be paid on next working day.

   (c) Pandal and shamiana includes any service provided or to be provided to a client, by a pandal or shamiana contractor in relation to a pandal or shamiana in any manner and also includes the services, if any, provided or to be provided as a caterer. For this purpose, pandal or shamiana means a place specially prepared or arranged for organizing an official, social or business function. Pandal or shamiana contractor means a person engaged in providing any service, either directly or indirectly, in connection with the preparation, arrangement, erection or decoration of a pandal or shamiana and includes the supply of furniture, fixtures, lights and lighting fittings, floor coverings and other articles for use therein.

   (d) Under VAT, credit of duty paid is allowed against the liability on the final product manufactured or sold. Therefore, unless proper records are kept in respect of various inputs, it is not possible to claim credit. Hence, suppression of purchases or production will be difficult because it will lead to loss of revenue. A perfect system of VAT will be a perfect chain where tax evasion is difficult.

PROFESSIONAL COMPETENCE COURSE

Model Test Paper – BOS/PCC/Information Technology And Strategic Management – 1/2007

GROUP – II

PAPER – 6 : INFORMATION TECHNOLOGY AND STRATEGIC MANAGEMENT

PART – I : INFORMATION TECHNOLOGY

PART – II : STRATEGIC MANAGEMENT

SUGGESTED ANSWERS/HINTS

1. (a) Incorrect: A customer is the person who buys the product. Consumer is the one who ultimately consumes or uses the product. Head of family may buy products as customer and his family who actually uses the product will be consumer.

   (b) Correct: The statement reflect to the concept of direct marketing. Organisation do marketing through various advertising media that interact directly with consumers, generally calling for the consumer to make a direct response. Direct marketing includes channels such as Catalogue Selling, Mail, Telecomputing, Electronic Marketing, Shopping, and TV shopping.

   (c) Incorrect: In the dynamic environment it is necessary that the strategies are action oriented and flexible enough to take on the changes in the environment. In a sound strategy allowances are made for possible miscalculations and unanticipated events.

   (d) Incorrect: Benchmarking is an approach of setting goals and measuring productivity based on best industry practices. It developed out of need to have information against which performances can be measured. Benchmarking helps in improving performance by learning from best practices and the processes by which they are achieved.

2. (a) A Strategic vision is a road map of a company's future – providing specifics about technology and customer focus, the geographic and product markets to be pursued, the capabilities it plans to develop, and the kind of company that management is trying to create.

   (b) In concentric diversification, the new business is linked to the existing businesses through process, technology or marketing. The new product is a spin-off from the existing facilities and products/processes. In concentric diversification there are benefits of synergy with the current operations.

(c) Marketing mix is the set of controllable marketing variables that the firm blends to produce the response it wants in the target market. The marketing mix consists of everything that the firm can do to influence the demand for its product. Primarily, these variables are often referred to as the "four Ps" – Product, Price, Place, Promotion

3. Strategic thinking requires generation of a series of strategic alternatives given the company's internal strengths and weaknesses and its external opportunities and threats. The comparison of strengths, weaknesses, opportunities, and threats is normally referred to as a SWOT analysis

   - Strength: Strength is an inherent capability of the organization which it can use to gain strategic advantage over its competitors.
   - Weakness: A weakness is an inherent limitation or constraint of the organization which creates strategic disadvantage to it.
   - Opportunity: An opportunity is a favourable condition in the organisation's environment which enables it to strengthen its position.
   - Threat: A threat is an unfavourable condition in the organisation's environment which causes a risk for, or damage to, the organisation's position.

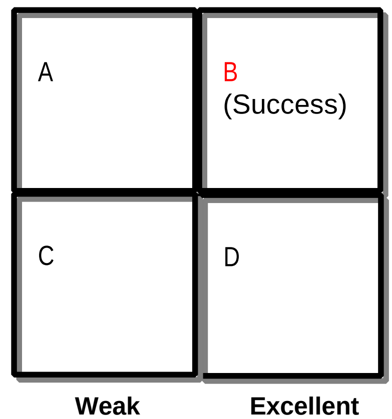
   The significance of SWOT analysis lies in the following points:

     - It provides a Logical Framework: SWOT analysis provides us with a logical framework for systematic and sound thrashing of issues having bearing on the business situation, generation of alternative strategies and the choice of a strategy. Variation in managerial perceptions about organizational strengths and weaknesses and the environmental opportunities and threats lead to differences is approaches to specific strategies and finally the choice of strategy that takes place through an interactive process in dynamic backdrop.
     - It presents a Comparative Account: SWOT analysis presents the information about both external and internal environment in a structured form where it is possible to compare external opportunities and threats with internal strengths and weaknesses. The helps in matching external and internal environments so that a strategist can come out with suitable strategy by developing certain patterns of relationship. The patterns are combinations say, high opportunities and high strengths, high opportunities and low strengths, high threats and high strengths, high threats and low strengths. In case a different strategy is needed, as situation varies.
     - It guides the strategist in Strategy Identification: It is natural that a strategist faces a problem when his organization cannot be matched in the four patterns. It is possible that the organization may have several opportunities and some serious threats. It is equally, true that the organization may have powerful strengths coupled with major weaknesses in the light of critical success factors. In such situation, SWOT analysis guides the strategist to think of overall

position of the organization that helps to identify the major purpose of the strategy under focus.

4. Strategy implementation concerns the managerial exercise of putting a freshly chosen strategy into place. Strategy execution deals with the managerial exercise of supervising the ongoing pursuit of strategy, making it work, improving the competence with which it is executed and showing measurable progress in achieving the targeted results. Strategic implementation is concerned with translating a decision into action, with presupposes that the decision itself (i.e., the strategic choice) was made with some thought being given to feasibility and acceptability. The allocation of resources to new courses of action will need to be undertaken, and there may be a need for adapting the organization's structure to handle new activities as well as training personnel and devising appropriate system.

   Many managers fail to distinguish between strategy formulation and strategy implementation. Yet, it is crucial to realize the difference between the two because they both require very different skills. Also, a company will be successful only when the strategy formulation is sound and implementation is excellent. There is no such thing as successful strategic design per se. This sounds obvious, but in practice the distinction is not always made. Often people, blame the strategy model for the failure of a company while the main flaw might lie in failed implementation. Thus organizational success is a function of good strategy and proper implementation. The matrix in the figure below represent various combination of strategy formulation and implementation:



Strategy implementation

Figure: Strategy formulation and implementation matrix

The Figure shows the distinction between sound/flawed strategy formulation and excellent/ weak strategy implementation. Square B is the ideal situation where a company has succeeded in designing a sound and competitive strategy and has been successful in implementing it.

Square A is the situation where a company apparently has formulated a very competitive strategy, but is showing difficulties in implementing it successfully. This can be due to various factors, such as the lack of experience (e.g. for start-ups), the lack of resources, missing leadership and so on. In such a situation the company will aim at moving from square A to square B, given they realize their implementation difficulties. Square D is the situation where the strategy formulation is flawed, but the company is showing excellent implementation skills. When a company finds itself in square D the first thing they have to do is to redesign their strategy before readjusting their implementation/execution skills.

Square C is reserved for companies that haven't succeeded in coming up with a sound strategy formulation and in addition are bad at implementing their flawed strategic model. Their path to success also goes through business model redesign and implementation/execution readjustment.

Successful strategy formulation does not guarantee successful strategy implementation. It is always more difficult to do something (strategy implementation) than to say you are going to do it (strategy formulation). Although inextricably linked, strategy implementation is fundamentally different from strategy formulation. Strategy formulation and implementation can be contrasted in the following ways:

Strategy formulation	Strategy implementation
♦ Strategy formulation is positioning forces before the action.	♦ Strategy implementation is managing forces during the action.

♦ Strategy formulation focuses on effectiveness.	♦ Strategy implementation focuses on efficiency.
♦ Strategy formulation is primarily an intellectual process.	♦ Strategy implementation is primarily an operational process.
♦ Strategy formulation requires good intuitive and analytical skills.	♦ Strategy implementation requires special motivation and leadership skills
♦ Strategy formulation requires coordination among a few individuals	♦ Strategy implementation requires combination among many individuals.

5. This case is for your practise. Remember, there is no rigid solution to a case problem. You can arrive at your own solutions. The opinions differ and your approach will also be different. However, you must offer supporting evidence for your views and judgements. You should draw inferences from theoretical concepts of strategic management and integrate them in the decisions. You should not rely upon unsupported opinions and over generalisations and clearly demonstrate that your interpretations are reasonable, logical and objective.

PROFESSIONAL COMPETENCE COURSE

Model Test Paper – BOS/PCC/Information Technology And Strategic Management – 2/2007

GROUP – II

PAPER – 6 : INFORMATION TECHNOLOGY AND STRATEGIC MANAGEMENT

PART – I : INFORMATION TECHNOLOGY

PART – II : STRATEGIC MANAGEMENT

SUGGESTED ANSWERS/HINTS

1. (a) Incorrect: Although the term retrenchment relates to removal of employees in management, it is used differently in business policy and strategic management. A business organisation can redefine its business by divesting a major product line. Retrenchment or retreat becomes necessary or expedient for coping with particularly hostile and adverse situations in the environment.

   (b) Incorrect: Primarily Six Sigma means maintenance of the desired quality in processes and end products. It means taking systemic and integrated efforts toward improving quality and reducing cost. It has its base in the concept of probability and normal distribution in statistics.

   (c) Correct: A company's strategy is typically a blend of (1) proactive actions on the part of managers to improve the company's market position and financial performance and (2) as needed reactions to unanticipated developments and fresh market conditions. The biggest portion of a company's current strategy flows from previously initiated actions and business approaches that are working well enough to merit continuation and newly launched managerial initiatives to strengthen the company's overall position and performance.

   (d) Often term objectives is considered as synonymous with goals. However, to distinguish, the objectives may be considered as open-ended attributes that denote the future states or outcomes. On the other hand goals are close-ended attributes which are precise and expressed in specific terms. Thus the goals are more specific and translate the objectives to short term perspective.

2. (a) Social Marketing refers to the design, implementation, and control of programs seeking to increase the acceptability of a social ideas, cause, or practice among a target group. For instance, the publicity campaign for prohibition of smoking in Delhi explained the place where one can and can't smoke in Delhi.

(b) An industry's Key Success Factors (KSFs) are those things that most affect industry members' ability to prosper in the marketplace - the particular strategy elements, product attributes, resources, competencies, competitive capabilities, and business outcomes that spell the difference between profit and loss and, ultimately, between competitive success or failure. KSFs by their very nature are so important that all firms in the industry must pay close attention to them - they are - the prerequisites for industry success or, to put it another way,

(c) Corporate culture refers to a company’s values, beliefs, business principles, traditions, ways of operating, and internal work environment. Every company has a unique organizational culture. Each has its own business philosophy and principles, its own ways of approaching problems and making decisions, its own work climate, and so on define its corporate culture.

3. Although competition makes organizations work harder, intense competition is neither a coincidence nor bad luck. All organizations have competition. Multinationals and large organizations clash directly on every level of product and service. Mid-sized and small business also chase same customers and find that prices and product quality are bounded by the moves of their competitors. Even large public sector monopolies are gradually getting privatised and facing competition. The monopolies enjoyed by the Bharat Sanchar Nigam Ltd and Mahanagar Telephone Nigam Ltd have faded away after entry of private players. For a single business organization the competition spells out freedom of entry and exit in the market and affects its prices and scale of operations

The benefit of competition are also enjoyed by the markets in which organisations operate. The customers are able to get products at lower costs and better quality. They get better value of their money because of competition.

Porter’s Five forces Model

To gain a deep understanding of a company’s industry and competitive environment, managers do not need to gather all the information they can find and waste a lot of time digesting it. Rather, the task is much more focused. Thinking strategically about a company’s competitive environment entails using some well defined concepts and analytical tools. A powerful and widely used tool for systematically diagnosing the significant competitive pressures in a market and assessing the strength and importance of each is the Porter’s five-forces model of competition. This model holds that the state of competition in an industry is a composite of competitive pressures operating in five areas of the overall market:

- Competitive pressures associated with the market manoeuvring and jockeying for buyer patronage that goes on among rival sellers in the industry.
- Competitive pressures associated with the threat of new entrants into the market.
- Competitive pressures coming from the attempts of companies in other industries to win buyers over to their own substitute products.

- Competitive pressures stemming from supplier bargaining power and supplier-seller collaboration.
- Competitive pressures stemming from buyer bargaining power and seller-buyer Collaboration.

The way one uses the five-forces model to determine what competition is like in a given industry is to build the picture of competition in three steps:

Step 1: Identify the specific competitive pressures associated with each of the five forces.

Step 2: Evaluate how strong the pressures comprising each of the five forces are (fierce, strong, moderate to normal, or weak).

Step 3: Determine whether the collective strength of the five competitive forces is conducive to earning attractive profits.

Threat of new entrants: New entrants are always a powerful source of competition. The new capacity and product range they bring in throw up new competitive pressure. And the bigger the new entrant, the more severe the competitive effect. New entrants also place a limit on prices and affect the profitability of existing players.

Bargaining power of customers: This force will become heavier depending on the possibilities of the buyers forming groups or cartels. Mostly, this is a phenomenon seen in industrial products. Quite often, users of industrial products come together formally or informally and exert pressure on the producer in matters such as price, quality and delivery.

Bargaining power of suppliers: Quite often suppliers, too, exercise considerable bargaining power over companies. The more specialised the offering from the supplier, greater is his clout. And, if the suppliers are also limited in number they stand a still better chance to exhibit their bargaining power. The bargaining power of suppliers determines the cost of raw materials and other inputs of the industry and, therefore, industry attractiveness and profitability.

Rivalry among current players: The rivalry among existing players is an idea that can be easily understood. This is what is normally understood as competition. And it is obvious that for any player, the competitors influence prices as well as the costs of competing in the industry, in production facilities product development, advertising, sales force, etc.

Threats from substitutes: Substitute products are a latent source of competition in an industry. In many cases they become a major constituent of competition. Substitute products offering a price advantage and/or performance improvement to the consumer can drastically alter the competitive character of an industry. And they can bring it about all of a sudden. For example, coir suffered at the hands of synthetic fibre. Wherever substantial investment in R&D is taking place, threats from substitute products can be expected. Substitutes, too, usually limit the prices and profits in an industry.

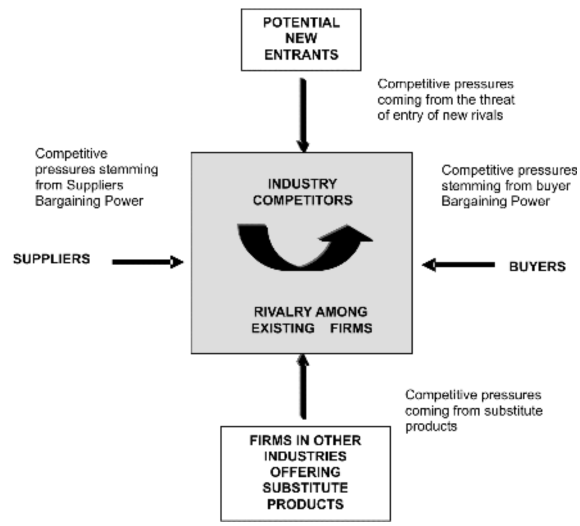


Figure: The Five Force model of Competition

4. The Total Quality Management movement (or simply TQM, as it is more commonly known) has caught on in essentially every corner of industry. A definition that was endorsed in 1992 by the chairs and CEOs of nine major U.S. corporations in cooperation with deans of business and engineering departments of major universities and recognized consultants is ‘ Total Quality Management (TQM) is a people-focused management system that aims at continual increase in customer satisfaction at continually lower real cost.’ TQM is a total system approach (not a separate area or program) and an integral part of high-level strategy; it works horizontally across functions and departments, involves all employees, top to bottom, and extends backward and forward to include the supply chain and the customer chain. TQM stresses learning and adaptation to continual change as keys to organizational success.

   Principles guiding TQM

   Implementing TQM requires organization wide support. There are several principles that guide success of TQM as follows:

   - A sustained management commitment to quality: An organization's personality and culture will ultimately reflect its senior management's values. If an organization is serious about implementing TQM, the commitment to do so has to start at the top, and the organization's senior management has to be unwavering in its commitment to quality. Almost any organization's senior managers will claim they are committed to quality, but how they act at the end sets the tone for the entire organization.
   - Focusing on the customer: According to Lee Iacocca had only three rules: Satisfy the customer, satisfy the customer, and satisfy the customer. Ultimately it the satisfaction of the customers that determines the success of an organisation.

- Preventing rather than detecting defects: TQM is a management philosophy that seeks to prevent poor quality in products and services, rather than simply to detect and sort out defects. "An ounce of prevention is worth a pound of cure." A little precaution before a crisis occurs is preferable to a lot of fixing up afterward. This also saves cost and time.
- Universal quality responsibility: Another basic TQM precept is that the responsibility for quality is not restricted to an organization's quality assurance department, but is instead a guiding philosophy shared by everyone in an organization. TQM requires that everyone takes responsibility for quality. As quality improves, the quality assurance department gets smaller.
- Quality measurement: The quality measurement aspect of TQM asks the question: Where are we and where are we going? A basic TQM concept is that quality is a measurable commodity, and in order to improve, we need to know where we are (or stated differently, what the current quality levels are), and we need to have some idea where we are going (or what quality levels we aspire to). This is an extremely important concept
- Continuous improvement and learning: TQM espouses a philosophy of continuous improvement in all areas of an organization. This philosophy ties in closely with the quality measurement and universal quality responsibility concepts. Continuous improvement is part of the management of all systems and processes. Achieving the highest levels of performance requires a well-defined and well-executed approach to continuous improvement and learning. "Learning" refers to adaptation to change, leading to new goals or approaches. Improvement and learning need to be embedded in the way an organization operates.
- Root cause corrective action: Most of us have experienced instances in which problems we thought were corrected continued to occur. TQM seeks to prevent this by identifying the root causes of problems, and by implementing corrective actions that address problems at the root cause level.
- Employee involvement and empowerment: Another fundamental TQM concept is that employees must be involved and empowered. Employee involvement means every employee is involved in running the business and plays an active role in helping the organization meet its goals. Employee empowerment means employees and management recognize that many obstacles to achieving organizational goals can be overcome by employees who are provided with the necessary tools and authority to do so.
- The synergy of teams: In addition to the TQM concepts of empowerment and involvement of employees, taking advantage of the synergy of teams is an effective way to address the problems and challenges of continuous improvement. Dr. Kaoru Ishikawa first formalized the teams concept as part of the TQM philosophy by developing quality circles in Japan.

- Thinking statistically: Statistical thinking is another basic TQM philosophy. Quality efforts often require reducing process or product-design variation, and statistical methods are ideally suited to support this objective.
- Inventory reduction: Largely in response to their lack of natural resources (as well as the 1970s worldwide oil shortages), the Japanese pioneered the concept of reducing inventories. This management philosophy became known as Just-in- Time (or JIT, for short) inventory management. The Japanese JIT inventory management concepts caught on in the United States and other nations. Although the concept was originally intended to address material shortages, an interesting side effect immediately emerged: As inventories grew smaller, quality improved.
- Value improvement: The linkage between continuous improvement and value improvement is simultaneously obvious and subtle. This linkage becomes apparent when one considers the definition of quality, which is the ability to meet or exceed customer requirements and expectations. The essence of value improvement is the ability to meet or exceed customer expectations while removing unnecessary cost. But simply cutting costs, however, will not improve value if the focus does not remain on satisfying customer requirements and expectations.
- Supplier teaming: Another principle of the TQM philosophy is to develop long-term relationships with a few high-quality suppliers, rather than simply selecting those suppliers with the lowest initial cost.
- Training: Training is basic to the TQM process. The concept is based on of empowering employees by providing the tools necessary for continuous improvement. One of the most basic tools is training.

Strategic-management process does not end when the firm decides what strategies to pursue. There must be a translation of strategic thought into strategic action. Translation requires support of all managers and employees of the business. Implementing strategy affects an organization from top to bottom; it affects all the functional and divisional areas of a business.

5. This case is for your practise. Remember, there is no rigid solution to a case problem. You can arrive at your own solutions. The opinions differ and your approach will also be different. However, you must offer supporting evidence for your views and judgements. You should draw inferences from theoretical concepts of strategic management and integrate them in the decisions. You should not rely upon unsupported opinions and over generalisations and clearly demonstrate that your interpretations are reasonable, logical and objective.