

Test Series: February, 2015

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

SUGGESTED ANSWERS/HINTS

1. (a) Even if the cheques bear the date 31st March or before, the cheques received after 31st March do not represent any condition existing on the balance sheet date i.e. 31st March. Thus, the collection of cheques after balance sheet date is not an adjusting event. Cheques that are received after the balance sheet date should be accounted for in the period in which they are received even though the same may be dated 31st March or before as per AS 4 “Contingencies and Events Occurring after the Balance Sheet Date”. Moreover, the collection of cheques after balance sheet date does not represent any material change affecting financial position of the enterprise on the balance sheet date, so no disclosure is necessary.

- (b) Research Expenditure – According to AS 26 ‘Intangible Assets’, the expenditure on research of new process design for its product Rs. 10 lakhs should be charged to Profit and Loss Account in the year in which it is incurred. It is presumed that the entire expenditure is incurred in the financial year 2013-14. Hence, it should be written off as an expense in that year itself.

Cost of internally generated intangible asset – it is given that development phase expenditure amounting Rs. 8 lakhs incurred upto 31st March, 2014 meets asset recognition criteria. As per para 53 of AS 26, the cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use.

Accordingly new process design will be recorded in the books at Rs. 8 lakhs at the end of the year 2013-14. However, in the year 2014-15, on the basis of the discounted estimated net cash flows, fair value of new process design comes to Rs. 7.582 lakhs as follows:

Savings (after tax) from implementation of new design for next 5 years	Rs. 2 lakhs p.a.
Company's cost of capital	10%
Annuity factor @ 10% for 5 years	3.7908
Present value of net cash flows (Rs. 2 lakhs x 3.7908)	Rs. 7.582 lakhs

The cost of an internally generated intangible asset would be lower of cost value Rs. 8 lakhs or recoverable value i.e. present value of future net cash flows Rs. 7.582 lakhs.

Hence, in 2014-15 the carrying value of an internally generated intangible asset will be Rs. 7.582 lakhs.

The difference of Rs. 0.418 lakhs (i.e. Rs. 8 lakhs – Rs. 7.582 lakhs) will be charged to the Profit and Loss Account by Explore Ltd. for the financial year 2013-14.

(c) Calculation of Defined Benefit Obligation

Expected last drawn salary = Rs. 14,90,210 x 110% x 110% x 110% x 110% x 110%

= Rs. 24,00,000

Defined Benefit Obligation (DBO) = Rs. 24,00,000 x 25% x 5 = Rs. 30,00,000

Amount of Rs. 6,00,000 (i.e. Rs. 30,00,000 / 5) will be charged to Profit and Loss Account of the company every year as cost for Defined Benefit Obligation.

Calculation of Current Service Cost

Year	Equal apportioned amount of DBO [i.e. Rs. 30,00,000/5 years]	Discounting @ 8% PV factor	Current service cost (Present Value)
a	b	c	d = b x c
1	6,00,000	0.735 (4 Years)	4,41,000
2	6,00,000	0.794 (3 Years)	4,76,400
3	6,00,000	0.857 (2 Years)	5,14,200
4	6,00,000	0.926 (1 Year)	5,55,600
5	6,00,000	1 (0 Year)	6,00,000

Calculation of Interest Cost to be charged per year

Year	Opening balance	Interest cost	Current service cost	Closing balance
a	b	c = b x 8%	d	e = b + c + d

1	0	0	4,41,000	4,41,000
2	4,41,000	35,280	4,76,400	9,52,680
3	9,52,680	76,214	5,14,200	15,43,094
4	15,43,094	1,23,447	5,55,600	22,22,141
5	22,22,141	1,77,859*	6,00,000	30,00,000

*Due to approximations used in calculation, this figure is adjusted accordingly.

(d) Multi-tasking Limited

Calculation of Deferred Tax Asset / Liability

Year	Accounting Income	Taxable Income	Timing Difference		Deferred Tax Liability @ 35%	
				balance		balance
2012-2013	11,00,000	7,00,000	4,00,000	4,00,000	1,40,000	1,40,000
2013-2014	16,00,000	18,00,000	2,00,000	2,00,000	70,000 (Reversal of DTL)	70,000
2014-2015	21,00,000	23,00,000	2,00,000	NIL	70,000 (Reversal of DTL)	NIL
	48,00,000	48,00,000				

	00	000			
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2. Journal Entries in the books of Pratham Ltd.
(Rs. in crores)

		Dr.	Cr.
Redeemable preference share capital Account	Dr.	75	
To Bank Account			75
(Being redemption of 12% preference shares pursuant to capital re-organisation)			
Profit and Loss Account	Dr.	75	
To Capital redemption reserve Account			75
(Being amount equal to par value of preference shares redeemed out of profits transferred to capital redemption reserve)			
Equity share capital Account	Dr.	5	
Securities Premium Account	Dr.	20	
To Bank Account			25
(Being buy-back of 50 lakh equity shares* of Rs. 10 each from the members at a price of Rs. 50 per share, premium paid transferred to Securities Premium Account – Refer Section 52(2)(e) of the Companies Act, 2013)			

* It may be noted that according to Securities and Exchange Board of India (Buy-back of Securities Amendment) Regulations, 2013, no offer of buy-back for fifteen per cent or more of the paid up capital and free reserves of the company shall be made from the open market by a listed company. Since Pratham Ltd. is a non-listed company, this Regulation is not applicable to it.

Profit and Loss Account	Dr.	5	
To Capital redemption reserve Account			5
(Being transfer to capital redemption reserve, on buy-back out of reserves)			

Pratham Ltd.

Balance Sheet (after reconstruction)

		Note No.	(Rs. in crores)	
I.	Equity and liabilities			
	(1) Shareholders' funds			
	(a) Share Capital	1	20	
	(b) Reserves and Surplus	2	<u>280</u>	300
	(2) Current liabilities			<u>40</u>
	Total			<u>340</u>
II	Assets			
	(1) Non Current Assets			
	(a) Fixed Assets (100 -100)			-
	(b) Non-current investments (market value Rs. 400 crores)			100
	(2) Current assets (340 - 75 - 25)			<u>240</u>

	Total			<u>340</u>
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Notes to Accounts

		(Rs. in crores)	
1. Share Capital			
Authorised Capital			<u>100</u>
Issued, Subscribed and Paid-up			
200 lakhs Equity Shares of Rs. 10 each fully paid up			20
(50 lakhs Equity Shares of Rs. 10 each have been bought back out of Securities Premium account at Rs. 50 per share and 12%, 75 lakhs Redeemable Preference Shares of Rs. 100 each fully paid up, have been redeemed on 1st April, 2015)			
2. Reserves and Surplus			
(1) Capital Reserve			15
(2) Capital Redemption Reserve			
As per last account		—	
Add: Transfer from Profit and Loss Account (75 + 5)			80
(3) Securities Premium Reserve (25 - 20)			5
(4) Profit and Loss Account			
As per last account		260	
Less: Transfer to Capital Redemption		<u>(80)</u>	<u>180</u>

Reserve (75+5)		<u>280</u>
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Net asset value of an equity share

	(Rs. in crores)
Investments (at market value)	400
Net current assets (240 - 40)	<u>200</u>
Net assets available to equity shareholders	<u>600</u>
Number of equity shares : 2 crores	
Value of an equity share = $\frac{600 \text{ crores}}{2 \text{ crores}}$ = Rs. 300 per share	

Note: As regards treatment of loss (profit) on buy-back, there is no authoritative pronouncement as to whether the difference between the nominal value and the amount paid should be treated as capital or revenue in nature. In the given case, the debit has been given to Securities premium account. Also, in the absence of any other information, it may be assumed that shares have been bought back out of free reserves.

Though the securities premium account has restrictive use yet as per Section 52 of the Companies Act, 2013, it may be used for purchase of its own shares as per Section 68. Therefore, the companies may opt to utilize the securities premium account for buy back, if available, rather to use the free reserves which can be used for other purposes in future.

3. Fair value under equity settlement= 250 shares x Rs. 68 = Rs. 17,000

Fair value under cash settlement = 200 shares x Rs. 70 = Rs. 14,000

So, fair value of equity component = Rs. 17,000 - Rs. 14,000 = Rs. 3,000

Fair value of liability component = Rs. 14,000

Fair value of liability component should be accounted for as per cash-settled employee share-based plan. Fair value of equity component should be accounted for as per equity-settled employee share-based payment plan.

Amounts to be recognised for liability component:

	<i>Particulars</i>	<i>31.12.12</i>	<i>31.12.13</i>	<i>31.12.14</i>
A	Fair value of share without restrictions	75	80	85
B	Closing provision required	5,000	10,667	17,000
		[200x75x1/3]	[200x80x2/3]	[200x85x3/3]
C	Opening provision	0	5,000	10,667
D	Expense for the year (B-C)	5,000	5,667	6,333

Amounts to be recognised for equity component:

	<i>Particulars</i>	<i>31.12.12</i>	<i>31.12.13</i>	<i>31.12.14</i>
E	Cumulative expense to be recognised till date	1,000	2,000	3,000
		[3,000 x 1/3]	[3,000 x 2/3]	[3,000 x 3/3]
F	Cumulative expense	0	1,000	2,000

	already recognised			
G	Expense for the year (E - F)	1,000	1,000	1,000

Journal Entries

Particulars	Debit (Rs.)	Credit (Rs.)
Year 31.12.12		
Employee compensation expense A/c Dr. To Provision for liability component of employee share-based payment plan A/c (Being expense recognised in respect of liability component of the plan with cash alternative)	5,000	5,000
Year 31.12.12		
Employee compensation expense A/c Dr. To Stock options outstanding A/c (Being expense recognised in respect of equity component of the plan with cash alternative)	1,000	1,000
Year 31.12.13		
Employee compensation expense A/c Dr. To Provision for liability component of employee share-based payment plan A/c (Being expense recognised in respect of liability component of the plan with cash alternative)	5,667	5,667

Year 31.12.13		
Employee compensation expense A/c Dr.	1,000	
To Stock options outstanding A/c		1,000
(Being expense recognised in respect of equity component of the plan with cash alternative)		
Year 31.12.14		
Employee compensation expense A/c Dr.	6,333	
To Provision for liability component of employee share-based payment plan A/c		6,333
(Being expense recognised in respect of liability component of the plan with cash alternative)		
Year 31.12.14		
Employee compensation expense A/c Dr.	1,000	
To Stock options outstanding A/c		1,000
(Being expense recognised in respect of equity component of the plan with cash alternative)		
Case (1) - When cash settlement is made:		
Provision for liability component of employee share-based payment plan A/c Dr.	17,000	
To Bank A/c		17,000
(Being cash paid under the plan with cash alternative)		
Stock options outstanding A/c Dr.	3,000	
To General reserve A/c		3,000

(Being balance in the equity account transferred to general reserve)		
Case (2) - When equity settlement is made:		
Stock options outstanding A/c Dr.	3,000	
Provision for liability component of employee share-based payment plan A/c Dr.	17,000	
To Share capital A/c (250 x 10)		2,500
To Securities premium A/c		17,500
(balancing figure)		
(Being shares issued under the plan on exercise of equity alternative)		

4. (a) 1. Analysis of Reserves and Surplus of B Ltd.

		Pre-acquisition	Post-acquisition
		Rs.	Rs.
Reserves and Surplus as per the B/S on 31.3.2015	5,00,000		
Add back: Dividend for the year 2014-15	<u>2,50,000</u>		
	<u>0</u>		
	<u>7,50,000</u>	<u>50,000</u>	<u>7,00,000</u>
	<u>0</u>		<u>0</u>
Share of A Ltd. (25%)		<u>12,500</u>	<u>1,75,000</u>
			<u>0</u>

2. Calculation of Goodwill / Capital Reserve

		Rs.
Investment in B Ltd.		3,00,000

Less: Pre-acquisition dividend (25% of 40% of Rs. 5,00,000)		<u>(50,000)</u>
		2,50,000
Less: Nominal Value of share capital	1,25,000	
Capital Profit	<u>12,500</u>	<u>(1,37,500)</u>
Goodwill		<u>1,12,500</u>

3. Investment under equity method

		Rs.
Goodwill	1,12,500	
Net worth	<u>1,37,500</u>	
Cost		2,50,000
Add: Share of Revenue Profit for the year 2014-15		<u>1,75,000</u>
		<u>4,25,000</u>

Note: Though dividend for the year 2014-15 has been accounted for but it has been added back as per ASI 16 for classification purpose.

- (b) Present value of Debentures redeemable in 2018
Rs. 71,23,200

$$[\text{Rs. } 1,00,00,000 \times 1.12 \times 0.636]$$

Present value of interest on debentures

$$[\text{Rs. } 8,00,000 \times 3.038 \text{ (sum of 4 years discount factors @ 12\%)}]$$

Rs. 24,30,400

Value of Debt component of the convertible debentures
Rs. 95,53,600

* Interest payable on debentures every year = Rs. 1,00,00,000 x 8% = Rs. 8,00,000.

5. (1) Average Capital employed

	(Rs. in lakhs)	
	As at 31.3.20 14	As at 31.3.201 5
Current cost of fixed assets other than non trade investments	2,200.0	2,532.8
Current cost of stock	670.0	750.0
Debtors	340.0	222.8
Cash and Bank	<u>92.5</u>	<u>100.0</u>
(A)	3,302.5	3,605.6
Less: Outside Liabilities:		
Term loans	370.0	330.0
Sundry creditors	70.0	96.0
Tax provision	22.5	25.0
Tax payable for adjustments in current assets (W.N.4)	<u>-</u>	<u>13.4</u>
(B)	<u>462.5</u>	<u>464.40</u>
Capital Employed (A-B)	<u>2,840.0</u>	<u>3,141.20</u>
Average Capital Employed at current value = $\frac{2,840.0 + 3,141.20}{2} =$		2,990.60

(2) Future maintainable profit

		(Rs. in lakhs)
Increase in General Reserve (850 - 800)		50
Increase in Profit and Loss Account (175 - 120)		55
Proposed Dividend		<u>250</u>
Profit after tax		<u>355</u>
Pre-tax profit = $\frac{355}{1 - 0.5}$		710.00
Less: Non-trading income	49.00	
Exchange loss on creditors	<u>6.00</u>	<u>(55.00)</u>
		655.00
Add: Exchange gain on debtors	2.80	
Stock adjustment	<u>30.00</u>	<u>32.80</u>
Adjusted pre-tax profit		687.80
Adjustments for future maintainable profit		
Less: Subsidy		(120.00)
Add: R & D costs		<u>247.00</u>
		814.80
Less: Tax @ 40%		<u>(325.92)</u>
Future maintainable profit		<u>488.88</u>

Valuation of Goodwill

		(Rs. in lakhs)
(1)	Capitalisation Method	
	Capitalised value of future maintainable profit	3,259.20

	$\left(\frac{488.88}{0.15} \right)$	
	Less: Average Capital Employed	<u>(2,990.60)</u>
	Goodwill	<u>268.60</u>
(2)	Super Profit Method	
	Future Maintainable Profit	488.88
	Normal Profit @ 15% on average capital employed	<u>(448.60)</u>
	Goodwill	<u>40.28</u>

Under capitalisation method, the amount of goodwill is larger than the amount of goodwill computed under super profit method. In either case, the existence of Goodwill cannot be doubted. The director's view cannot, therefore, be upheld.

Working Notes:

		(Rs. in lakhs)
(1)	Stock adjustment	
)	Difference between current cost and historical cost of closing stock	150.00
	Difference between current cost and historical cost of opening stock	<u>(120.00)</u>
		<u>30.00</u>
(2)	Debtors' adjustment	
)	Value of foreign exchange debtors at the closing exchange rate (\$ 70,000 × 21.5)	15.05

	Value of foreign exchange debtors at the original exchange rate (\$ 70,000 × 17.5)	<u>(12.25)</u>
		<u>2.80</u>
(3)	Creditors' adjustment	
)	Foreign exchange creditors at the closing exchange rate (\$ 1,20,000 × 21.5)	25.80
	Foreign exchange creditors at the original exchange rate (\$ 1,20,000 × 16.5)	<u>(19.80)</u>
		<u>6.00</u>
(4)	Tax Payable for Adjustment in current assets	
)	Increase in profit on account of Exchange gain on debtors	2.80
	Stock Adjustment	<u>30.00</u>
		32.80
	Less: Decrease in Profit on account of exchange loss on creditors	<u>(6.00)</u>
		<u>26.80</u>
	Tax @ 50%	13.40

6 (a)

Welfare Ltd.

Value Added Statement for the year ended 31st March, 2015

	<i>Rs. in lakhs</i>	<i>Rs. in lakhs</i>	<i>%</i>
Sales		206.42	
Less: Cost of bought in material and			

services:			
Production and operational expenses	150.57		
Administration expenses	3.92		
Interest on working capital loans	<u>2.30</u>	<u>(156.79)</u>	
Value Added by manufacturing and trading activities		49.63	
Add: Other income		<u>10.20</u>	
Total Value Added		<u>59.83</u>	
Application of Value Added:			
To Pay Employees:			
Salaries, Wages, Bonus and other benefits		12.80	21.39
To Pay Directors:			
Salaries and Commission		2.20	3.68
To Pay Government:			
Cess and Local Taxes	3.20		
Income Tax	<u>3.00</u>	6.20	10.36
To Pay Providers of Capital:			
Interest on Debentures	1.80		
Interest on Fixed Loans	3.90		

Dividend	<u>3.00</u>	8.70	14.54
To Provide for maintenance and Expansion of the company:			
Depreciation	5.69		
General Reserve (24.30 – 0.46)	23.84		
Retained profit (1.75 – 1.35)	<u>0.40</u>	<u>29.93</u>	
			<u>50.03</u>
		<u>59.83</u>	<u>100.00</u>

(b)

Computation of EVA

Particulars	Rs. in crores
Net Operating Profit after Tax (NOPAT)	252.00
Less: Cost of Operating Capital Employed (COCE) [13.25% of Rs. 1,100 crores]	<u>(145.75)</u>
Economic Value Added (EVA)	<u>106.25</u>

Working Notes:

- Calculation of Equity Shareholders' Funds

$$\text{Debt Equity Ratio} = \frac{\text{Longterm debts}}{\text{Shareholders' funds}}$$

$$2 = \text{Rs. 800 crores} / \text{Shareholders' Funds}$$

$$\text{Shareholders' Funds} = \text{Rs. 800 crores} / 2 = \text{Rs. 400 crores}$$

$$\text{Supposing Preference share capital} = x$$

Equity shareholders' funds = Rs.400 crores – x

2. Calculation of Preference Share Capital

$$\text{Capital Gearing ratio} = \frac{\text{Long term debts} + \text{Preference share Capital}}{\text{Equity Shareholders' funds}}$$

$$3 = \frac{\text{Rs.800 crores} + x}{\text{Rs.400 crores} - x}$$

$$\text{Rs. 1200 crores} - 3x = \text{Rs. 800 crores} + x$$

$$x = (1200 - 800)/4 = 100$$

Equity shareholders' funds = Rs. 400 crores – Rs. 100 crores = Rs. 300 crores

3. Cost of Debt = Interest Rate (1 – Tax Rate) = 15% (1 - 30) = 10.50%

4. Cost of Preference Share = 15%

5. Cost of Equity = 1/PE Ratio = 1/5 = 20%

6. Total Capital Employed = 800 + 100 + 300 = Rs. 1,200 crores

$$\begin{aligned} 7. \quad \text{WACC} &= \left(\frac{800}{1,200} \times 10.50\% \right) + \left(\frac{100}{1,200} \times 15\% \right) + \left(\frac{300}{1,200} \times 20\% \right) \\ &= 7\% + 1.25\% + 5\% = 13.25\% \end{aligned}$$

$$\begin{aligned} 8. \quad \text{Financial Leverage} &= \frac{\text{EBIT}}{\text{EBIT} - \text{Interest}} = \frac{\text{EBIT}}{\text{EBIT} - 120} = 1.5 \\ \text{EBIT} &= (120 \times 1.5)/0.5 = 360 \end{aligned}$$

9. Net Operating Profit after Tax = 360 - 30% of 360 = Rs. 252 crores

10. Operating Capital Employed = Total Capital Employed - Non-Operating Capital

Employed

$$= 1,200 - 100 = \text{Rs.}$$

1,100 crores

7. (a) As the borrower does not have an unconditional right to defer the settlement as on the reporting date in the instant case, accordingly entire loan is to be shown as current. The waiver by bank on 5th April, 2015, is a non-adjusting event as per AS 4, 'Contingencies and Events Occurring after the Balance Sheet Date'.
- (b) The net asset value of a mutual fund scheme is basically the Per Unit Market value of all the assets of the scheme.

Formula:

NAV = (Market Value of All Securities Held by Fund + Cash and Cash Equivalent Holdings by a fund – Fund Liabilities) / Total outstanding units of a Fund.

Net assets value is like a stock price which measures the value of single unit of a fund. At the time of investment in a particular scheme of mutual fund, it gives investors a factor to compare a fund's performance with market or industry benchmarks. However, once an investor invests in a fund at a particular NAV, that initial NAV becomes a sinking cost. Therefore, later on what matters is the change in NAV over a period i.e. if NAV increases with time then it implies that your investment is giving a higher or good return and you will earn at the time of selling that investment; reverse is the case in the vice versa situation.

- (c) Although legal title has not been transferred, the economic reality and substance is that the rights and beneficial interest in the immovable property have been transferred. Therefore, recording of disposal by the transferor would in substance represent the transaction entered into.

In view of this, X Ltd. should record the sales and recognize the profit of Rs. 15 lakhs in its Statement of Profit & Loss. It should remove building account from its balance sheet. Further, in its 'Notes to Accounts', X Ltd. should disclose the following:

"Building has been sold and full consideration has been received and possession of the same has been handed over to the buyer. However, documentation and legal formalities are pending as on 31.3.2015."

- (d) Market Value Added (MVA) is the difference between the current market value of a firm and the capital contributed by investors (both debenture holders and shareholders). In other words, it is the sum of all capital claims held against the company plus market value of debt and equity. If MVA is positive, firm has added value.

Market Value Added = Market value of firm less amount invested in the firm

		<i>Rs. in lakhs</i>
Equity Share Capital (market value) (505 lakhs x 600%)		3,030
Preference share capital (15,00,000 x 30)		450
Debentures		50
Current market value of firm		3,530
Less: Equity Share Capital	505	
Preference share capital	150	
Reserves	101	

Debentures	50	
Statutory Reserve	50.50	(856.50)
Market Value Added		2,673.50
The significant Market Value addition implies that the management of W Ltd. has created wealth for its shareholders and that market investors are willing to pay a price greater than the historical net worth of the company.		

- (e) As per AS 13 'Accounting for Investments', where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer. And where investments are reclassified from current to long term, transfers are made at lower of cost and fair value on the date of transfer.

Accordingly, the re-classification will be done on the following basis:

- (i) In this case, carrying amount of investment on the date of transfer is less than the cost; hence this re-classified current investment should be carried at Rs. 6.5 lakhs in the books.
- (ii) The carrying/book value of the long term investment is same as cost i.e. Rs. 7 lakhs. Hence this long term investment will be reclassified as current investment at book value of Rs. 7 lakhs only.
- (iii) In this case, reclassification of current investment into long-term investments will be made at Rs. 10 lakhs as cost is less than its market value of Rs. 12 lakhs.
- (iv) In this case, market value is Rs. 14 lakhs which is lower than

the cost of Rs. 15 lakhs. The reclassification of current investment as long-term investments will be made at Rs. 14 lakhs.

Test Series: February, 2015

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – I

PAPER – 2: STRATEGIC FINANCIAL MANAGEMENT

SUGGESTED ANSWERS/HINTS

1. (a) Number of index future to be sold by the Fund Manager is:

$$\frac{1.1 \times 90,00,00,000}{4,300 \times 50} = 4,605$$

Justification of the answer:

Loss in the value of the portfolio if the index falls by 10% is Rs.

$$\frac{11}{100} \times 90 \text{ Crore} = \text{Rs. } 9.90 \text{ Crore.}$$

$$\text{Gain by short covering of index future is: } \frac{0.1 \times 4,300 \times 50 \times 4,605}{1,00,00,000} = 9.90$$

Crore

This justifies the answer cash is not part of the portfolio.

- (b) To purchase Rupee, XYZ Bank shall first sell £ and purchase \$ and then sell \$ to purchase Rupee. Accordingly, following rate shall be used:

$$(\text{£/Rs.})_{\text{ask}}$$

The available rates are as follows:

$$(\text{\$/£})_{\text{bid}} = \$1.5260$$

$$(\$/\text{£})_{\text{ask}} = \$1.5270$$

$$(\text{Rs.}/\$)_{\text{bid}} = \text{Rs. } 61.3625$$

$$(\text{Rs.}/\$)_{\text{ask}} = \text{Rs. } 61.3700$$

From above available rates we can compute required rate as follows:

$$\begin{aligned} (\text{£}/\text{Rs.})_{\text{ask}} &= (\text{£}/\$)_{\text{ask}} \times (\$/\text{Rs.})_{\text{ask}} \\ &= (1/1.5260) \times (1/61.3625) \\ &= \text{£ } 0.01068 \text{ or } \text{£ } 0.0107 \end{aligned}$$

Thus amount of £ to be credited

$$\begin{aligned} &= \text{Rs. } 25,000,000 \times \text{£ } 0.0107 \\ &= \text{£ } 267,500 \end{aligned}$$

(c) (1) Expected Share Price

$$\begin{aligned} &= \text{Rs. } 120 \times 0.05 + \text{Rs. } 140 \times 0.20 + \text{Rs. } 160 \times 0.50 + \text{Rs. } 180 \times 0.10 + \text{Rs. } 190 \times 0.15 \\ &= \text{Rs. } 6 + \text{Rs. } 28 + \text{Rs. } 80 + \text{Rs. } 18 + \text{Rs. } 28.50 = \text{Rs. } 160.50 \end{aligned}$$

(2) Value of Call Option

$$= \text{Rs. } 150 - \text{Rs. } 150 = \text{Nil}$$

(3) If the option is held till maturity the expected Value of Call Option

Expected price (X)	Value of call (C)	Probability (P)	CP
Rs.120	0	0.05	0
Rs.140	0	0.20	0
Rs.160	Rs.10	0.50	Rs.5
Rs.180	Rs.30	0.10	Rs.3
Rs.190	Rs.40	0.15	<u>Rs.6</u>

Total	Rs.14
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(d) Suppose if Mr. X deposits this amount wit bank the accumulated amount would have been:

$$907.60(1+0.11)^5 = \text{Rs. } 1529.36$$

$$\text{Total Return} = \text{Rs. } 1529.36 - \text{Rs. } 907.60 = \text{Rs. } 621.76$$

Decomposition of Rs. 621.76

Interest Amount (Rs. 85 X 5)	Rs. 425.00
Capital Gain (Rs. 1000 – Rs. 907.60)	Rs. 92.40
Interest on Interest Accumulated (Balancing Figure)	Rs. 104.36

Alternative Answer

Interest of First Rs. 85 coupon amount reinvested for 4 years	Rs. 44.04
Interest of Second Rs. 85 coupon amount reinvested for 3 years	Rs. 31.25
Interest of Third Rs. 85 coupon amount reinvested for 2 years	Rs. 19.73
Interest of Fourth Rs. 85 coupon amount reinvested for 1 years	Rs. 9.35
Interest of Fifth Rs. 85 coupon amount reinvested for 0 years	Rs. 0
	Rs. 104.37

2. (a) Capital sum to be placed under Lease

Rs. in lakhs

Cash Down price of machine
300.00

Less: Present value of depreciation

Tax Shield

$$100 \times .35 \times \frac{1}{(1.10)} \quad 31.82$$

$$100 \times .35 \times \frac{1}{(1.10)^2} \quad 28.93$$

$$100 \times .35 \times \frac{1}{(1.10)^3} \quad \underline{26.30} \quad \underline{87.05}$$

212.95

If the normal annual lease rent per annum is x, then cash flow will be:

Year	Post-tax cash flow	P.V. of post-tax cash flow
1	$x \times (1 - .35) = 0.65x$	$0.65 \times (1/1.10) = 0.5910x$
2	$2x \times (1 - .35) = 1.3x$	$1.30 \times [(1/(1.10)^2)] = 1.0744x$
3	$3x \times (1 - .35) = 1.95x$	$1.95 \times [1/(1.10)^3] = \underline{1.4651x}$ $= \underline{3.1305x}$

Therefore $3.1305x = 212.95$ or $x = \text{Rs. } 68.0243 \text{ lakhs}$

Year-wise lease rentals:

Rs. in lakhs

Year 1	$1 \times 68.0243 \text{ lakhs} = 68.0243$
2	$2 \times 68.0243 \text{ lakhs} = 136.0486$
3	$3 \times 68.0243 \text{ lakhs} = 204.0729$

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

Particulars	Rs.
Cash balance in the beginning (Rs. 100 lakhs – Rs. 98 lakhs)	2,00,000
Dividend Received	12,00,000
Interest on 7% Govt. Securities	56,000
Interest on 9% Debentures	45,000
Interest on 10% Debentures	<u>50,000</u>
	15,51,000
(-) Operating expenses	<u>5,00,000</u>
Net cash balance at the end	<u>10,51,000</u>
<u>Calculation of NAV</u>	Rs.
Cash Balance	10,51,000
7% Govt. Securities (at par)	8,00,000
50,000 equity shares @ Rs. 175 each	87,50,000
9% Debentures (Unlisted) at cost	5,00,000
10% Debentures @90%	<u>4,50,000</u>
Total Assets	<u>1,15,51,000</u>
No. of Units	10,00,000
NAV per Unit	Rs. 11.55

Calculation of NAV, if dividend of Rs. 0.80 is paid –

Net Assets (Rs. 1,15,51,000 – Rs. 8,00,000) Rs. 1,07,51,000

No. of Units	10,00,000
NAV per unit	Rs. 10.75

3. (a) 1. 3 Months Interest rate is 4.50% & 6 Months Interest rate is 5% p.a.

Future Value 6 Months from now is a product of Future Value 3 Months now & 3 Months

Future Value from after 3 Months.

$$(1+0.05*6/12) = (1+0.045*3/12) \times (1+i_{3,6} *3/12)$$

$$i_{3,6} = [(1+0.05*6/12) / (1+0.045*3/12) - 1] *12/3$$

i.e. 5.44% p.a.

2. 6 Months Interest rate is 5% p.a & 12 Month interest rate is 6.5% p.a.

Future value 12 month from now is a product of Future value 6 Months from now and 6

Months Future value from after 6 Months.

$$(1+0.065) = (1+0.05*6/12) \times (1+i_{6,6} *6/12)$$

$$i_{6,6} = [(1+0.065/1.025) - 1] *12/6$$

6 Months forward 6 month rate is 7.80% p.a.

The Bank is quoting 6/12 USD FRA at 6.50 – 6.75%

Therefore there is an arbitrage Opportunity of earning interest @ 7.80% p.a. & Paying @ 6.75%

Borrow for 6 months, buy an FRA & invest for 12 months

To get \$ 1.065 at the end of 12 months for \$ 1 invested today

To pay \$ 1.060# at the end of 12 months for every \$ 1 Borrowed today

Net gain \$ 0.005 i.e. risk less profit for every \$ borrowed

$$\# (1+0.05/2) (1+.0675/2) = (1.05959) \text{ say } 1.060$$

(b) (i) Forward contract: Dollar needed in 180 days =
 $\text{£}3,00,000 \times \$ 1.96 = \$5,88,000/-$

(ii) Money market hedge: Borrow \$, convert to £, invest £, repay \$ loan in 180 days

Amount in £ to be invested = $3,00,000/1.045 = \text{£ } 2,87,081$

Amount of \$ needed to convert into £ = $2,87,081 \times 2 = \$ 5,74,162$

Interest and principal on \$ loan after 180 days = $\$5,74,162 \times 1.055 = \$ 6,05,741$

(iii) **Call option:**

<i>Expected Spot rate in 180 days</i>	<i>Prem./ unit</i>	<i>Exercise Option</i>	<i>Total price per unit</i>	<i>Total price for £3,00,000 xi</i>	<i>Prob. Pi</i>	<i>pixi</i>
1.91	0.04	No	1.95	5,85,000	0.25	1,46,250
1.95	0.04	No	1.99	5,97,000	0.60	3,58,200
2.05	0.04	Yes	2.01*	6,03,000	0.15	90,450
						5,94,900

* ($\$1.97 + \0.04)

(iv) **No hedge option:**

<i>Expected Future spot rate</i>	<i>Dollar needed Xi</i>	<i>Prob. Pi</i>	<i>Pi xi</i>
1.91	5,73,000	0.25	1,43,250

1.95	5,85,000	0.60	3,51,000
2.05	6,15,000	0.15	92,250
			5,86,500

The probability distribution of outcomes for no hedge strategy appears to be most preferable because least number of \$ are needed under this option to arrange £3,00,000.

4. (a)

	12 Months	24 Months
1. Total Annual Charges for Loan	Rs. 3,800 X 12 – Rs.40,000 = Rs. 5,600	(Rs. 2,140X24 – Rs. 40,000)/2 = Rs. 5,680
2. Flat Rate of Interest (F)	$\frac{5,600}{40,000} \times 100 = 14\%$	$\frac{5,680}{40,000} \times 100 = 14.20\%$
3. Effective Interest Rate	$\frac{n}{n+1} \times 2F = \frac{12}{13} \times 28 = 25.85\%$	$\frac{n}{n+1} \times 2F = \frac{24}{25} \times 28.40 = 27.26\%$

(b) (i) Expected rate of return

	Total Investments	Dividends	Capital Gains
Epsilon Ltd.	25	2	25
Sigma Ltd.	35	2	25
Omega Ltd.	45	2	90
GOI Bonds	<u>1,000</u>	<u>140</u>	<u>5</u>
	<u>1,105</u>	<u>146</u>	<u>145</u>

$$\text{Expected Return on market portfolio} = \frac{146 + 145}{1105} = 26.33\%$$

$$\text{CAPM } E(R_p) = R_F + \beta [E(R_M) - R_F]$$

Epsilon Ltd	$14 + 0.8 [26.33 - 14] = 14 + 9.86 = 23.86\%$
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Sigma Ltd.	$14+0.7 [26.33-14] = 14+8.63 = 22.63\%$
Omega Ltd.	$14+0.5 [26.33-14] = 14+6.17 = 20.17\%$
GOI Bonds	$14+0.01 [26.33-14] = 14+0.12 = 14.12\%$

(ii) Average Return of Portfolio

$$\frac{23.86+22.63+20.17+14.12}{4} = \frac{80.78}{4} = 20.20\%$$

$$\text{Alternatively } \frac{0.8+0.7+0.5+0.01}{4} = \frac{2.01}{4} = 0.5025$$

$$14+0.5025(26.33-14)$$

$$14+6.20 = 20.20\%$$

5. (a) No. of Shares = $\frac{1,300 \text{ crores}}{40} = 32.5 \text{ Crores}$

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

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

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

$$\text{FCFE} = 8.923 - [(1-0.27) (47-39) + (1-0.27) (3.45)]$$

$$= 8.923 - [5.84 + 2.5185] = 0.5645$$

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

$$= 8.7 + 0.1 (10.3 - 8.7) = 8.86\%$$

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

(b) **Proforma profit and loss account of the Indian software development unit**

	Rs.	Rs.
Revenue		48,00,00,000
Less: Costs:		
Rent	15,00,000	
Manpower (Rs.400 x 80 x 10 x 365)	11,68,00,000	
Administrative and other costs	12,00,000	11,95,00,000
Earnings before tax		36,05,00,000
Less: Tax		10,81,50,000
Earnings after tax		25,23,50,000
Less: Withholding tax(TDS)		2,52,35,000
Repatriation amount (in rupees)		22,71,15,000
Repatriation amount (in dollars)		\$4.7 million

Note: Students may assume the year of 360 days instead of 365 days as has been done in the answer provided above. In such a case where a year is assumed to be of 360 days, manpower cost is Rs. 11,52,00,000 and repatriated amount Rs. 22,87,15,000.

Advise: The cost of development software in India for the US based company is \$5.268 million. As the USA based Company is expected to sell the software in the US at \$12.0 million, it is advised to develop the software in India.

6. (a) Total Market Value = Rs. 8,00,00,000 + Rs. 10,00,00,000 = Rs. 18,00,00,000

Total Earnings = Rs. 4,00,00,000 + Rs. 10,00,00,000 = Rs. 14,00,00,000

EPS of Rs. 5.33 implies

Number of shares outstanding = $\frac{\text{Rs. } 1,40,00,000}{\text{Rs. } 5.33} = 26,26,642 \text{ shares}$

$$\text{Market Price Per Share} = \frac{\text{Rs. } 18,00,00,000}{26,26,642} = \text{Rs. } 68.53$$

$$\text{PE Ratio} = \frac{\text{Rs. } 68.53}{\text{Rs. } 5.33} = 12.86$$

- (b)** (i) First of all we shall compute Cost of Capital (K_e) of these companies using CAPM as follows:

$$\begin{aligned} K_{e(A)} &= 7.00\% + (13\% - 7\%)0.95 \\ &= 7.00\% + 5.7\% = 12.7\% \end{aligned}$$

$$\begin{aligned} K_{e(B)} &= 7.00\% + (13\% - 7\%)1.42 \\ &= 7.00\% + 8.52\% = 15.52\% \end{aligned}$$

$$P_A = \frac{3.50(1.08)}{0.127 - 0.08} = \frac{3.78}{0.047} = \text{Rs. } 80.43$$

$$P_B = \frac{3.50(1.08)}{0.1552 - 0.08} = \frac{3.78}{0.0752} = \text{Rs. } 50.27$$

- (ii) The valuation of share of B Ltd. is higher because of systematic risk is higher though both have same growth rate.
- (iii) If the price of share of A Ltd. is Rs. 74, the share is undervalued and it should be bought. If price of share is Rs. 55, it is overvalued and should not be bought.
- 7. (a)** It is increasingly realised that commercial evaluation of projects is not enough to justify commitment of funds to a project especially when the project belongs to public utility and irrespective of its financial viability it needs to be implemented in the interest of the society as a whole. Huge amount of funds are committed every year to various public projects of all types—industrial, commercial and those providing basic infrastructure facilities. Analysis of such projects has to be done with reference to the social costs and benefits since they cannot be expected to yield an adequate

commercial rate of return on the funds employed at least during the short period. A social rate of return is more important. The actual costs or revenues do not necessarily reflect the monetary measurement of costs or benefits to the society. This is because the market price of goods and services are often grossly distorted due to various artificial restrictions and controls from authorities, hence a different yardstick has to be adopted for evaluating a particular project of social importance and its costs and benefits are valued at 'opportunity cost' or shadow prices to judge the real impact of their burden as costs to the society. Thus, social cost benefit analysis conducts a monetary assessment of the total cost and revenues or benefits of a project, paying particular attention to the social costs and benefits which do not normally feature in conventional costing.

United Nations Industrial Development Organisation (UNIDO) and Organisation of Economic Cooperation and Development (OECD) have done much work on Social Cost Benefit analysis. A great deal of importance is attached to the social desirability of projects like employment generation potential, value addition, foreign exchange benefit, living standard improvement etc. UNIDO and OECD approaches need a serious consideration in the calculation of benefits and costs to the society. This technique has got more relevance in the developing countries where public capital needs precedence over private capital.

- (b) Cross-border leasing is a leasing agreement where lessor and lessee are situated in different countries. This raises significant additional issues relating to tax avoidance and tax shelters. It has been widely used in some European countries, to arbitrage the difference in the tax laws of different countries.

Cross-border leasing have been in practice as a means of financing infrastructure development in emerging nations. Cross-border leasing may have significant applications in financing infrastructure development in emerging nations - such as rail and

air transport equipment, telephone and telecommunications, equipment, and assets incorporated into power generation and distribution systems and other projects that have predictable revenue streams.

A major objective of cross-border leases is to reduce the overall cost of financing through utilization by the lessor of tax depreciation allowances to reduce its taxable income. The tax savings are passed through to the lessee as a lower cost of finance. The basic prerequisites are relatively high tax rates in the lessor's country, liberal depreciation rules and either very flexible or very formalistic rules governing tax ownership.

(c) Factors Determining the Dividend Policy of a Company

- (i) Liquidity: In order to pay dividends, a company will require access to cash. Even very profitable companies might sometimes have difficulty in paying dividends if resources are tied up in other forms of assets.
- (ii) Repayment of debt: Dividend payout may be made difficult if debt is scheduled for repayment.
- (iii) Stability of Profits: Other things being equal, a company with stable profits is more likely to pay out a higher percentage of earnings than a company with fluctuating profits.
- (iv) Control: The use of retained earnings to finance new projects preserves the company's ownership and control. This can be advantageous in firms where the present disposition of shareholding is of importance.
- (v) Legal consideration: The legal provisions lay down boundaries within which a company can declare dividends.
- (vi) Likely effect of the declaration and quantum of dividend on market prices.
- (vii) Tax considerations and
- (viii) Others such as dividend policies adopted by units similarly

placed in the industry, management attitude on dilution of existing control over the shares, fear of being branded as incompetent or inefficient, conservative policy Vs non-aggressive one.

(ix) Inflation: Inflation must be taken into account when a firm establishes its dividend policy.

(d) Equity Curve out can be defined as partial spin off in which a company creates its own new subsidiary and subsequently bring out its IPO. It should be however noted that parent company retains its control and only a part of new shares are issued to public.

On the other hand in Spin off parent company does not receive any cash as shares of subsidiary company are issued to existing shareholder in the form of dividend. Thus, shareholders in new company remain the same but not in case of Equity curve out.

(e) The underlying may be a share, a commodity or any other asset which has a marketable value which is subject to market risks. The importance of underlying in derivative instruments is as follows:

- All derivative instruments are dependent on an underlying to have value.
- The change in value in a forward contract is broadly equal to the change in value in the underlying.
- In the absence of a valuable underlying asset the derivative instrument will have no value.
- On maturity, the position of profit/loss is determined by the price of underlying instruments. If the price of the underlying is higher than the contract price the buyer makes a profit. If the price is lower, the buyer suffers a loss.

Test Series: February, 2015

MOCK TEST PAPER – 1
FINAL COURSE: GROUP – I
PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS
SUGGESTED ANSWERS/ HINTS

1. (a) **Reliability of Responses to Confirmation Requests received electronically:** According to SA 505 on External Confirmations, if the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts.

Responses received electronically, for example by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect. A process used by the auditor and the respondent that creates a secure environment for responses received electronically may mitigate these risks. If the auditor is satisfied that such a process is secure and properly controlled, the reliability of the related responses is enhanced. An electronic confirmation process might incorporate various techniques for validating the identity of a sender of information in electronic form, for example, through the use of encryption, electronic digital signatures, and procedures to verify website authenticity.

The auditor is required by SA 500 “Audit evidence” to determine whether to modify or add procedures to resolve doubts over the reliability of information to be used as audit evidence. The auditor may choose to verify the source and contents of a response to a confirmation request by contacting the confirming party. For example, when a confirming party responds by electronic mail, the auditor may telephone the confirming party to determine whether the confirming party did, in fact, send the response.

In the given case, Mr. GN, the auditor of Galaxy Limited, has received a response, for confirmation of balances request, through

e-mail. Here, the risk as to reliability of the response exists because proof of origin and authority of the respondent is difficult to establish. He may ask the party to incorporate some of the techniques, for validity of identity and the confirmation received, like, digital signatures etc. He may also contact the party through telephone to check the authenticity of the confirmation received.

- (b) **Fraud committed by management of the company:** As per SA 240 on “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, fraud can be committed by management overriding controls using such techniques as recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

In the given case, Innocent Ltd. has entered into an agreement with Mr. Intelligent, at year-end, for consultation in IT department. It also charged yearly fee of Rs. 72 lakhs in the Statement of Profit and Loss, however, no documentary or other evidence of receipt of such service was found, on investigation. It is clear that company has passed fictitious journal entries, near year-end, to manipulate the operating results.

Accordingly, the auditor would adopt the approach which will be based on the result of misstatement on the basis of such fictitious journal entry, i.e. if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor’s ability to continue performing the audit, the auditor shall determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities; or the auditor may consider for appropriateness of withdrawal from such engagement, where withdrawal from the engagement is legally permitted.

In addition, the auditor is required to report according to section 143(12) of the Companies Act, 2013. As per Section 143(12), if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

In case if the auditor decides to withdraw, then the auditor should discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal. Further, the auditor is required to comply with the professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

- (c) **Reporting Requirement as per Schedule III to the Companies Act, 2013:** As per the general instructions for preparation of Balance Sheet, provided under Schedule III to the Companies Act, 2013, current maturities of long-term debt is required to be disclosed under the head "Other Current Liabilities" in the notes to accounts.

It may be noted that "Current Maturities of Long-Term Debt" refers to that portion of liabilities of a company that are becoming due in next 12 months. Since, these obligations are repayable in next 12 months, they are shifted from Long-Term Liabilities section of the Balance Sheet to Current Liabilities section.

In the given case, Happy Ltd. has taken a loan, from Fine bank, of Rs. 90 lakhs, repayable in 10 equal yearly instalments (including interest) of Rs. 10 lakhs. The company has repaid its four instalments upto 31st March, 2014. Further, due to good financial condition of the company, it decided for its entire outstanding loan

as on 31st March, 2014, to be repaid in August, 2014.

Thus, it is clear that the outstanding loan of Rs. 55 lakhs, taken from Fine Bank, is repayable in next 12 months. However, the accountant of the company has disclosed the said loan under the head “Long-term Borrowings”. Therefore, the management of the company is advised to show the amount of outstanding loan under the head “Other Current Liabilities” and further classify it under sub-heading “Current Maturities of Long-Term Debt” of heading “Other Current Liabilities” in the notes to accounts.

- (d) **Capitalisation of Borrowing Costs:** Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for intended use or sale are interrupted. According to Accounting Standard 16 “Borrowing Costs”, capitalisation of such borrowing costs should be suspended during extended periods in which active development is interrupted. The standard, however, clarifies that capitalisation of borrowing costs is not suspended when a temporary delay is necessary as a part of the process or substantial technical and administrative work is being carried out. Thus, the test as to whether or not to capitalise the borrowing costs depends primarily upon the nature of interruption of activities during “extended periods”.

In the instant case, it has been mentioned that the construction activity was interrupted due to seasonal rain and hence being regular feature. Though the rain was heavy, the period cannot be considered as an “extended period” leading to substantial delay in suspension of construction activities.

Therefore, borrowing cost of Rs. 15.50 lakhs incurred by Roadrash Ltd. should be capitalized. Hence, suspension of capitalization by the company is not a correct treatment and statutory auditor should report accordingly.

2. (a) **Failed to supply information called for:** As per Clause (2) of

Part III of the First Schedule to the Chartered Accountants Act, 1949, a member, whether in practice or not, will be deemed to be guilty of professional misconduct if he does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate authority.

In the given case, Mr. Altar has failed to reply to the letters of the Institute asking him to confirm the date of leaving the service as a paid assistant.

Therefore, he will be held guilty of professional misconduct under Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949.

- (b) **Disclosure of Client's Information:** According to Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice shall be guilty of professional misconduct, if he discloses information acquired in the course of his professional engagement to any person other than his client so engaging him without the consent of his client or otherwise than as required by any law for the time being in force. The Code of Ethics further clarifies that such a duty continues even after completion of the assignment. The Chartered Accountant may however, disclose the information in case it is required as a part of performance of his professional duties.

In the given case, Mr. Clever has disclosed vital information of his client's business without the consent of the client under the impression that it will help the nation to compete with other countries at International level.

Thus, Mr. Clever will be held guilty of professional misconduct under Clause (1) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

- (c) **Sale of Goodwill:** With reference to Clause (2) of Part I of the

First Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India had an occasion to consider whether the goodwill of a proprietary concern of chartered accountant can be sold to another member who is otherwise eligible, after the death of the proprietor.

The Council resolved that the sale/transfer of goodwill in the case of a proprietary firm of chartered accountant to another eligible member of the Institute shall be permitted. It further laid down that in cases where the death of proprietor occurs after 30.08.1998, the goodwill of the deceased member's practice can be sold to another member and permission of the Institute has to be obtained within a year of the death of the proprietor concerned. It is even laid down that in such cases the name of the proprietary firm concerned would not be removed up to a period of one year from the death of the proprietor.

Thus, in the instant case, when the widow of Mr. Unlucky sold the practice to Mr. Lucky, it is nothing but sale of goodwill. The sale of the practice and the right to use the name is also allowed in terms of the above decision of the Council. Therefore, the above act of the widow of Mr. Unlucky is permissible.

- (d) **Solicitation of Professional Work:** As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

In the given case, Mr. Dozy published an advertisement in a Newspaper containing his photograph on the occasion of the opening ceremony of his office which amounts to soliciting professional work by advertisement directly or indirectly. Therefore, Mr. Dozy will be held guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

3. (a) **Appointment of First Auditors in the case of a Government Company:** According to section 2(45) of the Companies Act, 2013, a Government Company is defined 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.

Further, according to Section 139 (7) of the Companies Act, 2013, the first auditors of a government company shall be appointed or re-appointed by the Comptroller and Auditor General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting.

In the given case, Apsara Ltd. is a government company as its 55% shares have been held by State Governments (15% held by Bihar Government, 10% held by Jharkhand Government and 30% held by Uttar Pradesh Government).

Further, Angel Ltd. is a subsidiary company of Apsara Ltd., therefore, Angel Ltd. is also covered in the definition of a government company. However, the procedure followed by Angel Ltd., for appointment of first auditor, is valid for a company, other than a government company. Hence, the first Auditor of Angel Ltd. can be appointed only by C& AG within 60 days from the date of registration of the company. In case of failure of C& AG, to appoint such auditor, the Board of Directors may appoint such auditor within the next 30 days.

Consequently, the appointment of first auditor made by the members of the company is invalid and the auditor should not give his acceptance to the Company.

- (b) **Appointment of relative of Director as the Auditor:** Section 141 of the Companies Act, 2013 (herein after referred as the Act) deals with the eligibility, qualifications and disqualifications of Auditors. Sub-section (3)(f) of the Section 141 of the Act, explicitly disqualifies a person from being appointed as an auditor of a company whose relative is a director or is in employment of the company as a director or key managerial personnel. Further, the definition of the term “relative”, as defined under the Companies Act, 2013, includes step- son.

Further, as per Council Guidelines 2008, a member of the Institute shall desist from expressing his opinion on financial statements of any business or enterprise in which one or more persons, who are relatives within the meaning of section 6 of the Companies Act, 1956 (now Section 2(77) of the Companies Act, 2013), have either by way of themselves or in conjunction with such members, a substantial interest in the said business or enterprise. Therefore, if the director has substantial interest in the company then his relative should not accept the appointment of auditor of that company.

In the instant case, Mr. A is the director of OPQ Ltd. and holding 30% shares of the company. Further, Mr. B is his step-son i.e. a relative according to the definition of “relative” given under the Companies Act, 2013. Therefore, he should not accept the appointment as an auditor of that company. If he accepts such appointment, he would be guilty of professional misconduct and would also be liable for punishment for contravention of the provisions of the Companies Act.

- (c) **Filling of Casual Vacancy in case of resignation:** According to section 139(8) of the Companies Act, 2013, in the case of a company other than a company whose accounts are subject to

audit by an auditor appointed by the Comptroller and Auditor-General of India, any casual vacancy in the office of an auditor shall be filled by the Board of Directors within 30 days.

However, if such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within 3 months of the recommendation of the Board. The appointed auditor shall hold the office till the conclusion of the next annual general meeting.

In the given case, Ms. Mini, the statutory auditor of X Ltd., has resigned from the office of auditor. Therefore, such casual vacancy can be filled by the Board of Directors subject to approval by the company at a general meeting convened within 3 months of the recommendation of the Board. Thus the appointment made by the Board of Directors without the approval of the company at a general meeting is invalid. Furthermore, the appointment cannot be made for one year. The auditor can hold office only till the conclusion of the next AGM.

- (d) **Liability of Auditor Under Section 35:** According to section 35 of the Companies Act, 2013 where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person whoever consented for such mislead, includes the auditor as referred in section 26, shall be liable to pay compensation to every person who has sustained such loss or damage.

In addition where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, the auditor as an expert shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus. Until unless if it is

proved that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.

4. (a) Current Period Consolidation Adjustments: Current period consolidation adjustments are those adjustments that are made in the accounting period for which the consolidation of financial statements is done. Current period consolidation adjustments primarily relate to elimination of intra-group transactions and account balances. The auditor should review the memorandum records to verify the adjustment entries made in the preparation of consolidated financial statements. This would also help the auditor in ascertaining whether there is any difference in the elimination. Following are the current period consolidation adjustments while making consolidation of financial statements -

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

(b) Modifications in Audit Report: As per SA 705, “Modifications to the Opinion in the Independent Auditor’s Report”, the auditor may modify the opinion in the auditor’s report in the following circumstances-

- (i) If the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- (ii) If the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor’s report in accordance with SA 705.

Types of Modification to the Auditor’s Opinion: As per SA 705, “Modifications to the Opinion in the Independent Auditor’s Report”, modified opinion may be defined as a qualified opinion, an adverse opinion or a disclaimer of opinion.

Types of modifications possible to the said report are below-mentioned-

- (i) **Qualified Opinion:** The auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.
- (ii) **Adverse Opinion:** The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit

evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

- (iii) **Disclaimer of Opinion:** The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

(c) The main features of a qualified and independent audit committee to be set up under clause 49 of listing agreement are as follows:

- (i) The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors;
- (ii) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise;

Explanation (1): The term “financially literate” means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

Explanation (2): A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual’s financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

- (iii) The Chairman of the Audit Committee shall be an independent director;

- (iv) The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;
- (v) The Audit Committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;
- (vi) The Company Secretary shall act as the secretary to the committee.

5. **(a) Provision for Claim:** No risk can be assumed by the insurer unless the premium is received. According to section 64VB of the Insurance Act, 1938, no insurer should assume any risk in India in respect of any insurance business on which premium is ordinarily payable in India unless and until the premium payable is received or is guaranteed to be paid by such person in such manner and within such time, as may be prescribed, or unless and until deposit of such amount, as may be prescribed, is made in advance in the prescribed manner. The premium receipt of insurance companies carrying on general insurance business normally arise out of three sources, viz., premium received from direct business, premium received from re-insurance business and the share of co-insurance premium.

In view of the above, the insurance company is not liable to pay the claim and hence no provision for claim is required to be maintained.

- (b) Some special points that may be covered in the audit of an investment company, an NBFC, are given below:**

- (i) Physically verify all the shares and securities held by an NBFC. Where any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified.

- (ii) NBFC Prudential Norms stipulates that NBFCs should not lend more than 15% of its owned funds to any single borrower and not more than 25% to any single group of borrower. The ceiling on investments in shares by a NBFC in a single entity and the aggregate of investments in a single group of entities has been fixed at 15% and 25% respectively. Moreover, a composite limit of credit to and investments in a single entity/group of entities has been fixed at 25% and 40% respectively of the owned fund of the concerned NBFC. Verify that the credit facilities extended and investments made by the concerned NBFC are in accordance with the prescribed ceiling.
- (iii) Verify whether the NBFC has not advanced any loans against the security of its own shares.
- (iv) Verify that dividend income wherever declared by a company, has been duly received by a NBFC and interest wherever due [except in case of NPAs] has been duly accounted for. NBFC Prudential Norms directions require dividend income on shares of companies and units of mutual funds to be recognised on cash basis. However, the NBFC has an option to account for dividend income on accrual basis, if the same has been declared by the body corporate in its Annual General Meeting and its right to receive the payment has been established. Income from bonds/debentures of corporate bodies is to be accounted on accrual basis only if the interest rate on these instruments is predetermined and interest is serviced regularly and not in arrears.
- (v) Test check bills/contract notes received from brokers with reference to the prices vis-à-vis the stock market quotations on the respective dates.
- (vi) Verify the Board Minutes for purchase and sale of investments. Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so

acquired are current investments or Long Term Investments.

- (vii) Check whether the investments have been valued in accordance with the NBFC Prudential Norms Directions and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the Directions.
- (viii) Obtain a list of subsidiary/group companies from the management and verify the investments made in subsidiary/group companies during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares.
- (ix) Check whether investments in unquoted debentures/bonds have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.
- (x) An auditor will have to ascertain whether the requirements of AS 13 "Accounting for Investments" (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.
- (xi) In respect of shares/securities held through a depository, obtain a confirmation from the depository regarding the shares/securities held by it on behalf of the NBFC.
- (xii) In the case of securities lent/borrowed under the Securities Lending Scheme of SEBI, verify the agreement entered into with the approved intermediary (i.e. the person through whom the lender will deposit and the borrower will borrow the securities for lending/borrowing) with regards to the period of depositing/lending securities, fees for depositing/lending, collateral securities and provision for the return including pre-mature return of the securities deposited/lent.
- (xiii) Verify that securities of the same type or class are received back by the lender/paid by the borrower at the end of the specified

period together with all corporate benefits thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon.)

(xiv) Verify charges received or paid in respect of securities lend/borrowed.

(xv) Obtain a confirmation from the approved intermediary regarding securities deposited with/borrowed from it as at the year end.

(c) Reporting for issue of shares for value exceeding fair market value: In this case, AB Ltd. is a company, other than a company in which the public are substantially interested. During the previous year 2013-14, it receives consideration for issue of shares (i.e. Rs. 80 per share) which exceeds the face value (i.e. Rs. 10 per share) and fair market value of the shares (i.e. Rs. 60 per share).

Provisions and Explanations: A tax auditor has to furnish the details of shares issued during the previous year, under clause 29 of Form 3CD, in case, the assessee received any consideration for issue of shares which exceeds the fair market value of the shares as referred to in section 56(2)(viib) of the Income Tax Act, 1961.

Section 56(2)(viib) provides that where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares shall be chargeable to income-tax under the head "Income from other sources".

Since section 56(2)(viib) is applicable to companies in which public is not substantially interested, reporting under this clause is to be done only for corporate assessee. The auditor should obtain from the auditee, a list containing the details of shares issued, if any, by him to any person being a resident and verify the same from the books of accounts and other relevant documents.

Conclusion: As per the facts of the case, provisions and explanations given above, the income generated by AB Ltd., due to differences in consideration received and fair market value of shares issued, is chargeable to income-tax under the head “Income from other sources” as per section 56(2)(viib) of the Income Tax Act, 1961.

Therefore, the tax auditor of AB Ltd. is required to furnish the details of shares issued under clause 29 of Form 3CD. The contention of the management of the company, behind non-reporting, that it is a normal issue of shares, is not acceptable.

(d) Qualification and appointment of Cost Auditor: According to section 148(3) of the Companies Act, 2013 read with Companies (Audit & Auditors) Rules, 2014-

- (i) in the case of companies which are required to constitute an audit committee, the Board shall appoint an individual, who is a cost accountant in practice, or a firm of cost accountants in practice, as cost auditor on the recommendations of the Audit committee;
- (ii) in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant in practice or a firm of cost accountants in practice as cost auditor.

It is also provided that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records.

In the given case, the members of XY Ltd. appointed Mr. AB, a practicing Chartered Accountant and the statutory auditor of the company, as the cost auditor.

Therefore, the appointment of Mr. AB, as cost auditor, made by the company is not valid. The Board shall appoint a cost accountant in practice or a firm of cost accountants in practice to conduct such cost audit.

6. (a) **Decline in Net Profits despite Increasing Sales:** As per the facts that there has been consistently high turnover but declining net profits is an anomalous situation. It may be attributed to one or more following reasons requiring further investigation -
- (i) **Unfavourable Sales mix:** Where the company sells different chemical products with different product margins, the product with the maximum PV ratio/margin should have a higher share in the total sales. If due to revision of sales mix, more quantities of unprofitable products are sold, profits will be reduced in spite of an increase in sales.
 - (ii) **Negative Impact of Financial Leverage:** Where the company does not have sufficient own funds (equity) but has a higher debt-equity ratio, the interest commitments will be higher. As the volume of its operation increases, higher debt and interest charges would result in lower profits.
 - (iii) **Other Items Included in Sales:** The figure of sales as per Statement of Profit and Loss may include incidental revenues, e.g., freight, excise duty, sales-tax, etc. where the amount of excise duty goes up considerably the total sales may show an increase which is not represented by a real increase in sales quantity/value.
 - (iv) **High Administrative and Selling Expenses:** Administrative and selling costs are generally period costs which are fixed in nature. Their increase is generally not proportional to sale increase. However, a reduction in profit could also be due to increase in administrative overheads and sales overheads at a rate higher than the rate of increase in sales.
 - (v) **Cost-Price Relationship:** If the increases in cost of raw materials and labour has not been compensated by a corresponding increase in the sales price this would also result in higher sales and declining profits. In spite of same sales quantity, for the increasing cost of raw materials and

other services, per unit values of the product has been increased which is however unmatched by the increase in cost.

- (vi) **Competitive Price:** Where sales have been made at cut-throat prices in order to eliminate competition from the market, the profits would be in the declining trend in the short-run.
- (vii) **Additions to Fixed Assets:** Where there are heavy additions to fixed assets and consequent depreciation charges in the initial years of additions, there may be reduction in profits in spite of increased sales.
- (viii) **Trend:** Whether in the past sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.
- (ix) **Comparison with other industries:** What is the position of similar kind of other industries? To compare with and assess the position with respect to other industries who are indulged in manufacturing of chemicals.

(b) Factors to be considered while planning the Performance

Audit: While planning a performance audit, the auditors should take care of certain factors which are listed below-

- (i) to consider significance and the needs of potential users of the audit report.
- (ii) to obtain an understanding of the program to be audited.
- (iii) to consider legal and regulatory requirements.
- (iv) to consider management controls.
- (v) to identify criteria needed to evaluate matters subject to audit.
- (vi) to identify significant findings and recommendations from previous audits that could affect the current audit objectives. Auditors should determine if management has corrected the conditions causing those findings and implemented those

recommendations.

- (vii) to identify potential sources of data that could be used as audit evidence and consider the validity and reliability of these data, including data collected by the audited entity, data generated by the auditors, or data provided by third parties.
- (viii) to consider whether the work of other auditors and experts may be used to satisfy some of the auditors' objectives.
- (ix) to provide sufficient staff and other resources to do the audit.
- (x) to prepare a written audit plan.

(c) Behavioural aspects encountered in Management Audit:

Financial auditors deal mainly with figures. Management auditors deal mainly with people. There are many causes for behavioural problems arising in the review function of management audit. Particularly, when management auditors performs comprehensive audit of operations, they cannot be as well informed about such operations as a financial auditor in a financial department. Operating processes may be unfamiliar and complex. The operating people may be speaking a language and using terms that are foreign to the auditor's experience. The nature and causes of behavioural problems that the management auditor is likely to face in the discharge of the review function that is expected of him and possible solutions to overcome these problems are discussed below -

- (1) **Staff / Line conflict:** Management auditors are staff people while the members of other departments are line people. Management auditors tend to discount the difficulties the line staff may face, if called on to act on the ideas of management auditors. Management auditors are specialists in their field and they may think their approach and solutions are the only answers.
- (2) **Control:** The management auditor is expected to evaluate the effectiveness of controls. There is an instinctive reaction from

the auditee that the report of the auditor may affect them. There is a fear that the action taken based on the management audit report will affect the line people. It breeds antagonism. The causes are as under:

- (i) Fear of criticism stemming from adverse audit findings.
- (ii) Fear of change in day to day working habits because of changes resulting from audit recommendations.
- (iii) Punitive action by superior prompted by reported deficiencies.
- (iv) Insensitive audit practices.
- (v) Hostile audit style.

Solution to behavioural problems: The following steps may be taken to overcome the aforesaid problems -

- (i) To demonstrate that audit is part of an overall programme of review for protective and constructive benefit.
- (ii) To demonstrate the objective of review is to provide maximum service in all feasible managerial dimensions.
- (iii) To demonstrate the review will be with minimum interference with regular operation.
- (iv) The responsible officers will be involved in the process of review of the findings and recommendations before the audit report is formally released.

It is essential to create an atmosphere of trust and friendliness so that audit reports will be understood in their proper perspective.

Finally, it needs hardly any emphasis that there should be right management culture, enlightened auditees and auditors of the right calibre. May be to expect a combination at all times of all the three is asking for the impossible. But, a concerted effort by the management, auditors and auditees to achieve a more acceptable climate would go a long way to achieve the goal.

7. (a) **Special Report by Auditor to Registrar of Co-operative Societies:** Under the following circumstances, an auditor has to issue special report to the Registrar of Co-operative Societies (This report should be in addition to the regular report)-

- (i) (1) Any member of the managing committee is involved in personal profit making by using the properties or assets of the society, resulting into the loss to the society.
(2) Frauds are detected from the society's transactions.
- (ii) There is mismanagement in the society and the principles of co-operative are not maintained by the management.
- (iii) In the respect of audit of Urban Co-operative Banks, disproportionate advances to vested interest groups. Such as relative of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

(b) **Tolerable Misstatement:** As per SA 530, "Audit Sampling", it is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

Tolerable rate of deviation: It is a rate of deviation from prescribed internal control procedures set by the auditor in respect of which the

auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

(c) Areas excluded from scope of Peer Reviewer are:

- (i) Management Consultancy Engagements;
- (ii) Representation before various Authorities;
- (iii) Engagements to prepare tax returns or advising clients in taxation matters;
- (iv) Engagements for the compilation of financial statements;
- (v) Engagements solely to assist the client in preparing, compiling or collating information other than financial statements;
- (vi) Testifying as an expert witness;
- (vii) Providing expert opinion on points of principle, such as Accounting Standards or the applicability of certain laws, on the basis of facts provided by the client; and
- (viii) Engagement for Due diligence.

(d) Corresponding Figures: As per SA 710 “Comparative Information—Corresponding Figures and Comparative Financial Statements”, “corresponding figures” is a comparative information where amounts and other disclosures for the preceding period are included as part of the current period financial statements, and are intended to be read in relation to the amounts and other disclosures relating to the current period. These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures.

(e) Sauda Book: All members of the Stock Exchange are required to maintain a ‘Sauda Book’, which contains details of all deals transacted by them on a day to day basis. This is a basic record, which contains the details regarding the name of the code of the client on whose behalf the deals have been done, rate and quantity

of bought or sold. These details are maintained date wise. This register contains all the transactions, which may be of any of the kind mentioned below -

- (i) member's own business on the Exchange;
- (ii) member's business on the Exchange on behalf of clients;
- (iii) member's business with the clients on principal-to-principal basis;
- (iv) member's business with the members of other Stock Exchanges;
- (v) member's business on behalf of his clients with the members of other Stock Exchanges;
- (vi) Spot transactions, etc.

Test Series: February, 2015

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – I

PAPER – 4 : CORPORATE AND ALLIED LAWS

Question No.1 is compulsory.

*Attempt any **five** questions from the remaining **six** Questions.*

Time Allowed – 3 Hours

Maximum Marks – 100

1. (a) Director elected by small shareholders

Section 151 of the Companies Act, 2013 provides that a listed company may have one director elected by such small shareholders in such manner and with such terms and conditions as may be prescribed. Further, the explanation to section 151 clarifies that for the purposes of this section “small shareholders”

means a shareholder holding shares of nominal value of not more than twenty thousand rupees or such other sum as may be prescribed.

As the company given in the question is an unlisted company, it is not bound by section 151 and hence, it is not necessary for the company to appoint a director to represent the “small shareholders”.

- (b) Where a company, owing to inadequacy or absence of profits in any financial year, proposes to declare dividend out of the accumulated profits earned by it in previous years and transferred by the company to the reserves, such declaration of dividend shall be made only in accordance with prescribed rules. Such dividend shall be declared or paid by a company only from its free reserves. No other reserve can be utilized for the purposes of declaration of such dividend

The second proviso to section 123 (1) of the Companies Act, 2013 permits a company to declare dividend out of the accumulated profits earned by it in previous years and transferred by the company to the reserves subject to the rules prescribed in this behalf. *The Companies (Declaration and Payment of Dividend) Rules, 2014* provide for the rules for declaring dividends out of the reserves as under:

- (i) The rate of dividend declared does not exceed the average of the rates at which dividend was declared by it in the 3 years immediately preceding that year.
- However, this rule will not apply if a company has not declared any dividend in each of the 3 preceding financial year.
- (ii) The total amount to be drawn from the accumulated profits earned in previous years and transferred to the reserves does not exceed an amount equal to 1/10th of the sum of its paid-up capital and free reserves as appearing in the latest audited financial statement.

- (iii) The amount so drawn must first be utilized to set off losses incurred in the financial year before any dividend in respect of equity shares is declared.
- (iv) The balance of reserves after such drawl shall not fall below 15% of its paid-up capital as appearing in the latest audited financial statement.
- (v) No company shall declare dividend unless carried over previous losses and depreciation not provided in previous year or years are set off against profit of the company of the current year.

(c) Members not to act as principals in certain circumstances:

- 1. According to Section 15 of the Securities Contract (Regulation) Act, 1956, members of stock exchange normally carry out transactions on behalf of investors and hence principal agent relationship exists. A Member can enter into transaction as principal with another member of the Exchange only. If he desires to enter into contract as principal with a nonmember, then he has to get written consent from such person to act as principal. Contract note should indicate that he is acting as principal.
- 2. Where the member has secured the consent of such person otherwise than in writing he shall secure written confirmation by such person or such consent within three days from the date of the contract [Proviso to Section 15].
- 3. According to section 18, spot delivery contracts are outside the preview of section 15.

M/s Mathew & Company., stock broker must bear in mind the above restrictions while entering into any transaction as principal with a non member.

- (d)** Section 165 of the Companies Act, 2013 debars any person from holding office as a director of more than 20 companies at the same

time out of which directorships in public companies cannot exceed ten.

In the given case, as on 26th September, 2014, Mr. Rajat is already holding directorship in 9 public companies. Therefore, he can be appointed as a Director in Makeshift Ltd. on 27th September, 2014. This will make his total number of directorship in public companies as 10 (i.e. within the limits prescribed under section 165 of the Companies Act, 2013). Now, he cannot be appointed as a Director in any other public company and hence, cannot be appointed as Director in Kalpesh Ltd. on 29th September, 2014.

However, he can accept directorship in a Private Ltd. Company. Thus, he can be appointed as director in Patkara Private Ltd. as total number of directorship does not exceed 20 in the present case.

- 2. (a)** While sanctioning the scheme of amalgamation, the Court under section 394 of the Companies Act, 1956 may make provision for all or any of the following matters:
- (i) The transfer to the transferee company of the whole or any part of the undertaking, property or liabilities of the transferor company.
 - (ii) The allotment by the transferee company of any shares, debenture etc, in that company which under the scheme are to be allotted by that company to any person.
 - (iii) The continuation of any legal proceedings by or against any transferor and transferee company.
 - (iv) The dissolution, without winding up of any transferor company.
 - (v) The provisions to be made for any persons who within such time and in such manner as the court directs, dissent from the scheme of amalgamation.
 - (vi) Such incidental matters as are necessary to secure that the amalgamation shall be fully and effectively carried out.

An order under section 394 of the Companies Act, 1956 transferring the property, rights and liabilities of one company to another does not automatically transfer contracts of personal service which are in their nature incapable of being transferred and no contract of service is thereby created between an employee of the transferor company on the one hand and the transferee company on the other.

In *Nokes vs. Doucaster Amalgamated collieries Ltd.* (1940 (3) all 2k 549) the House of Lords clearly stated that the workers are not furniture and their services cannot be transferred without their consent. Thus, the contention of the workers of Onshore Company Limited against the Offshore Company Limited is correct and justified.

- (b) Accounting standards:** As per Section 2(2) of the Companies Act, 2013, the expression “accounting standards” means the standards of accounting or any addendum thereto for companies or class of companies referred to in section 133.

As per Section 133, the standards of accounting recommended by the Institute of Chartered Accounts of India constituted under the Chartered Accountants Act, 1949 as may be prescribed by the Central Government in consultation with and after examination of the recommendations made by the National Financial Reporting Authority established under section 132 of the said Act.

Rule 7 of the Companies (Accounts) Rules, 2014, further states that the standards of accounting specified under the Companies Act, 1956 shall be deemed to be the accounting standards until the accounting standards are prescribed by the Central Government under section 133.

Sub-section (1) of the section 129 states that financial statement of the company shall comply with the accounting standards notified under section 133.

Responsibility of directors and other officers:

Disclosure in financial statement: As per section 129(5), where the Financial Statements of the company do not comply with the accounting standards, such companies shall disclose in its financial statements, the following, namely:

- (a) the deviation from the accounting standards;
- (b) the reasons for such deviation; and
- (c) the financial effect, if any, arising due to such deviation.

Apart from the above consequence on non compliance, section 129(7) further provides that if a company contravenes the provisions of section 129 (dealing with financial statement), the managing director, whole-time director in charge of finance, the Chief Financial Officer or any other person charged by the Board with the duty of complying with the requirements of this section and in the absence of any of the officers mentioned above, all the directors shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

Disclosure in Directors Responsibility Statement: Moreover, the Board of directors is also required under section 134 of the Companies Act, 2013 to include a Directors Responsibility Statement indicating therein that in the preparation of the financial statements the applicable accounting standards had been followed along with proper explanation relating to material departures, if any. If such person (as above referred) fails to take all reasonable steps to secure compliance by the company, as respects any accounts laid before the company in general meeting, with the provisions of this section and with the other requirements of this Act as to the matters to be stated in the accounts, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to 1 year, or with fine not less than Rs. 50,000 but which may extend to Rs. 5,00,000 or with both.

Responsibilities of auditors: As per section 143(3) (e) of the Companies Act, 2013, the statutory auditor's responsibility is to state in his report, whether in his opinion, the profit and loss account and balance sheet comply with the accounting standards.

3. (a) 1. The Companies Act, 2013 permits a decision of the Board of Directors to be taken by means of a resolution by circulation. Board approvals can be taken in one of the two ways, one by a resolution passed at a Board Meeting and the other, by means of a resolution passed by circulation.

In terms of section 175(1) of the Companies Act, 2013 no resolution shall be deemed to have been duly passed by the Board or by a committee thereof by circulation, unless the following have been complied with:

- (a) the resolution has been circulated in draft, together with the necessary papers, if any,
- (b) the draft resolution has been circulated to all the directors, or members of the committee, as the case may be;
- (c) the draft resolution has been sent at their addresses registered with the company, in India;
- (d) such delivery has been made by hand or by post or by courier, or through prescribed electronic means;

The *Companies (Meetings of Board and its Powers) Rules, 2014* provides that a resolution in draft form may be circulated to the directors together with the necessary papers for seeking their approval, by electronic means which may include E-mail or fax.

- (e) such resolution has been approved by a majority of the directors or members, who are entitled to vote on the resolution;
2. However, if at least 1/3rd of third of the total number of directors of the company for the time being require that any

resolution under circulation must be decided at a meeting, the chairperson shall put the resolution to be decided at a meeting of the Board (instead of being decided by circulation).

3. A resolution that has been passed by circulation shall have to be necessarily be noted in the next meeting of board or the committee, as the case may be, and made part of the minutes of such meeting.

(b) 1. **Formation of an Audit Committee:** An audit committee shall be constituted by the Board of directors of:

- (a) Every listed company, and
- (b) Such other class or classes of companies as may be prescribed.

The *Companies (Meetings of Board and its Powers) Rules, 2014* have prescribed the following classes of companies that shall constitute Audit Committee:

- (a) all public companies with a paid up capital of 10 crore rupees or more;
- (b) all public companies having turnover of 100 crore rupees or more;
- (c) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding 50 crore rupees or more.

Thus, the said public Limited Company with a turnover of Rs. 249 crores, falls in the prescribed limit and has to form the Audit committee.

2. As per Section 177(2) and (3) of the Companies Act, 2013 an audit committee must be formed within a year of the commencement of the Act or within a year of the incorporation of a company as the case may be, and will consist of at least 3 directors out of which the independent directors shall constitute the majority.

3. Under section 177(8) the Board's Report which is laid before a general meeting of the company under section 134 (3) where the financial statements of the company are placed before the members, must disclose the composition of the audit committee and also where the Board has not accepted any recommendations of the Audit Committee the same shall be disclosed along with the reasons therefor. Therefore, the Board is empowered not to accept the recommendations of the Audit Committee, but should do so only under genuine circumstances and with legitimate reasons.
- 4 (a) Under section 129(3) of the Companies Act, 2013, where a company has one or more subsidiaries, it shall, in addition to financial statements provided under sub-section (2), prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own which shall also be laid before the annual general meeting of the company along with the laying of its financial statement under sub-section (2).

Provided that the company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in such form as may be prescribed.

For reference, sub section 2 of section 129 provides that at every annual general meeting of a company, the Board of Directors of the company shall lay before such meeting financial statements for the financial year.

The above provisions do not make any distinction between a domestic subsidiary company and a foreign subsidiary. Therefore, Geeta manufacturing Ltd. has contravened the provisions of Section 129 of the Companies Act, 2013 by not furnishing the consolidated financial statements on the one hand and not attaching with its financial statements a separate statement containing the salient features of the financial statement of its foreign subsidiary.

Section 129(7) lays down the punishment for violation of section 129 and provides that if a company contravenes the provisions of this section, the managing director, the whole-time director in charge of finance, the Chief Financial Officer or any other person charged by the Board with the duty of complying with the requirements of this section and in the absence of any of the officers mentioned above, all the directors shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

Thus, the management of Geeta manufacturing Ltd. will accordingly be punishable as above.

- (b) (i) **Power of Central Government to appoint company prosecutors:** This section 443 of the Companies Act, 2013 lays down the provisions seeking to provide that the Central Government may appoint company prosecutors with the same powers as given under the Cr. PC on Public Prosecutors.
- (a) **Appointment of company prosecutors:** The Central Government may appoint (generally, or for any case, or in any case, or for any specified class of cases in any local area) one or more persons, as company prosecutors for the conduct of prosecutions arising out of this Act; and
- (b) **Powers and Privileges:** The persons so appointed as company prosecutors shall have all the powers and privileges conferred on Public Prosecutors appointed under section 24 of the Cr. PC.
- (ii) (1) The workmen portion of the security is therefore 1/4th of the value of the security, i.e. 25,000, [Section 529(3) of the Companies Act, 1956].
- (2) If the liquidators incur Rs. 10,000 for the preservation, it is equal to the following equation:

$$\text{Whole of expenses} - \text{Whole of expenses} \times$$

$$\frac{\text{Workmen 's portion}}{\text{Value of the security}}$$

$$= \text{Rs. } 10,000 - \frac{10,000 \times 25,000}{1,00,000}$$

$$= \text{Rs. } 10,000 - 2,500$$

= Rs. 7,500. This is the amount to be borne by the secured creditors.

5. (a) **Producer Company - Vacation of Office of a Director:**

(i) According to provisions of Companies Act, 1956, as contained in section 581Q, if the producer company in which a director has made a default in repayment of any advances or loans taken from any company or institution or any other person and such default continues for 90 days, the office of such director shall become vacant. In the given case the default on the part of X, the director continues for less than 90 (i.e. only 60 days) days, the office of director shall not fall vacant.

(ii) The office of director of a producer company shall become Vacant if the Annual General Meeting or extraordinary general meeting of the producer company, in which he is a director, is not called in accordance with the provisions of this Act except due to natural calamity or such other reason.

In the given case, Annual General Meeting could not be held due to the cause of natural calamity by way of continuous heavy rainfall, destruction and blockage of road. Thus, the office of Mr. Nirman, the director shall not fall vacant.

(b) **Record Date**

- (1) A listed issuer making a rights issue shall announce a record date for the purpose of determining the shareholders eligible to apply for specified securities in the proposed rights issue.
- (2) The issuer shall not withdraw rights issue after announcement of the record date.

- (3) If the issuer withdraws the rights issue after announcing the record date, it shall not make an application for listing of any of its specified securities on any recognised stock exchange for a period of twelve months from the record date announced under sub-regulation (1):

Provided that the issuer may seek listing of its equity shares allotted pursuant to conversion or exchange of convertible securities issued prior to the announcement of the record date, on the recognised stock exchange where its securities are listed.

Restriction on rights issue

- (1) No issuer shall make a rights issue of equity shares unless it has made reservation of equity shares of the same class in favour of the holders of outstanding compulsorily convertible debt instruments if any, in proportion to the convertible part thereof.
- (2) The equity shares so reserved for the holders of fully or partially compulsorily convertible debt instruments shall be issued at the time of conversion of such convertible debt instruments on the same terms at which the equity shares offered in the rights issue were issued.

- 6. (a) Removal of a Director of a banking company:** According to Section 36AA of the Banking Regulation Act, 1949, Reserve Bank of India (RBI) can terminate/ remove any Chairman, Director, Chief Executive, other officials or any employee of the bank where it considers desirable to do so particularly when RBI is of the opinion that conduct of such persons is detrimental to the interest of the depositors or for secure proper management of the banking company.

Accordingly as per the above provision, RBI has power to remove Mr. Murti who was working as director in a banking company.

Remedies available: The same provision prescribes the remedies available to the Mr. Murti against his removal-

- (i) Before such removal, he should be given an opportunity to be heard of.
- (ii) He can make an appeal to the Central Government within 30 days from the date of communication of such termination order.
- (iii) The decision of the Central Government on the appeal cannot be called into question.

(b) Particulars to be contained in the prospectus- As per the section 387 (1) of the Companies Act, 2013 no person shall issue, circulate or distribute in India any prospectus offering to subscribe for securities of a company incorporated or to be incorporated outside India, unless the prospectus is dated and signed, and contains particulars with respect to the following matters:

- (i) the instrument constituting or defining the constitution of the company;
- (ii) the enactments or provisions by or under which the incorporation of the company was effected;
- (iii) the address in India where the said instrument, enactments or provisions, or copies thereof can be inspected. If the same are not in the English language, a certified translation thereof in the English language should be available for inspection;
- (iv) the date on which and the country in which the company would be or was incorporated; and
- (v) Whether the company has established a place of business in India and, if so, the address of its principal office in India, and

In addition, the prospectus shall state the matters specified under section 26 (so far as they are applicable) which lays down the matters to be included in a prospectus issued by an Indian Company.

In terms of the proviso to section 387 (1) the above referred points (i), (ii) and (iii), shall not be applicable if the prospectus is issued more than 2 years after the date at which the company is entitled to commence business.

7. (a) The word “repatriate to India” is defined in section 2(y) of the FEMA, Act 1999. ‘Repatriate to India’ means bringing into India the realized foreign exchange and the realized foreign exchange should be sold to an authorised person in India in exchange for rupees. It also includes the holding of realised amount in an account with an authorised person in India to the extent notified by the Reserve Bank and includes use of the realised amount for discharge of a debt or liability denominated in foreign exchange.

Exemption from holding/repatriation: Section 4 of the FEMA, 1999 prohibits holding of foreign exchange by a resident in India. Section 8 requires that foreign exchange earned by a resident in India is realised and repatriated to India.

However, in the following cases, the foreign exchange can be held or need not be repatriated to India:-

1. Possession of foreign currency – possession of foreign currency or foreign coins up to limit prescribed by Reserve Bank of India (RBI).
2. Foreign currency account – foreign currency account held or operated by such person or class of persons and the limit up to which the Reserve Bank may specify;
3. Foreign currency acquired before July 1947 – foreign exchange acquired or received before the 8th day of July, 1947 or any income arising or accruing there on which is held outside India by any person in pursuance of a general or special permission granted by the Reserve Bank
4. Gift or inheritance – foreign exchange held by a person resident in India up to such limit as the RBI may specify, if such foreign exchange was acquired by way of gift or

inheritance from a person referred to in point 3, including any income arising there from;

5. Foreign exchange acquired abroad – foreign exchange acquired from employment, business, trade, vocation, service, honorarium, gifts, inheritance or any other legitimate means up to such limit as the Reserve Bank may specify; and
6. Any other receipts specified by RBI

(b) Anti-Competitive Agreements: Under section 3 of the Competition Act, 2002 any agreement amongst enterprises of persons at different stages or levels of the production chain in different markets, in respect of production, supply, distribution, storage, sale or price of, or trade in goods or provision of service, shall be a void agreement if it causes or is likely to cause an appreciable adverse effect on competition. According to the problem, there are two conditions given in the agreement, which fall under the following stages-

- (i) exclusive supply agreement: includes any agreement restricting in any manner the purchaser in the course of his trade from acquiring or otherwise dealing in any goods other than those of the seller or any other person.
- (ii) exclusive distribution agreement: includes any agreement to limit, restrict or withhold the output or supply of any goods or allocate any area or market for the disposal or sale of the goods.

In view of the above provisions of the Competition Act, 2002 validity of the clauses of the agreement as given in the question can be determined as follows:

Part (i) of the question restricts the dealer to deal in the goods of other manufacturers. Hence, the proposed agreement is anti-competitive and void.

Part (ii) of the question restricts the dealers not to sell the goods outside the territory assigned to them. Hence, the proposed agreement is anti competitive and void.

- (c) **Nomination by Life Insurance Policy Holder:** As per section 39 of the Insurance Act, 1938, the holder of a policy of life insurance on his own life may nominate a person or persons to whom the money secured by the life insurance policy shall be paid in the event of his death. Such nomination can be made either at the time of taking the policy or at any time before the maturity of the policy. Such nomination is either incorporated in the text of the policy or is stated as an endorsement on the policy document. The nomination can be cancelled or altered by the policyholder at any time before the maturity of the policy. The insurer is required to communicate to the policyholder that it has recorded the nomination, its cancellation or alteration as the case may be. In case the policyholder survives the full term of policy, the insurer shall pay the maturity amount to him only and the nomination becomes redundant. In a case where the nominee dies before the maturity of the policy and if no new nomination is made, the maturity proceeds of the policy shall be paid to the policy holder and if dies before the maturity, to the legal heirs of the policy holders.

Minor as a nominee: A minor can be nominated as a nominee in life insurance policy by its holder. The only other requirement as per Proviso to section 39(1) of the said Act is that the policyholder is to appoint, in the prescribed manner, an adult person to receive the money secured by the policy on behalf of the minor in the event of death of the policyholder during the minority of the nominee.

- (d) **Preamble:** The Preamble expresses the scope, object and purpose of the Act more comprehensively than the Long Title. The Preamble may recite the ground and the cause making a statute and the evil which is sought to be remedied by it.

Like the Long Title, the Preamble of a Statute is a part of the enactment and can legitimately be used for construing it. However,

the Preamble does not over-ride the plain provision of the Act but if the wording of the statute gives rise to doubts as to its proper construction, e.g., where the words or phrase has more than one meaning and a doubt arises as to which of the two meanings is intended in the Act, the Preamble can and ought to be referred to in order to arrive at the proper construction. In short, the Preamble to an Act discloses the primary intention of the legislature but can only be brought in as an aid to construction if the language of the statute is not clear. However, it cannot override the provisions of the enactment.

Proviso: The normal function of a proviso is to except something out of the enactment or to qualify something stated in the enactment which would be within its purview if the proviso were not there. The effect of the proviso is to qualify the preceding enactment which is expressed in terms which are too general. As a general rule, a proviso is added to an enactment to qualify or create an exception to what is in the enactment: ordinarily a proviso is not interpreted as stating a general rule.

It is a cardinal rule of interpretation that a proviso to a particular provision of a statute only embraces the field which is covered by the main provision. It carves out an exception to the main provision to which it has been enacted as a proviso and to no other. (*Ram Narain Sons Ltd. vs. Assistant Commissioner of Sales Tax, AIR 1955 SC 765*).

- (e) **Money Laundering:** Whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of offence of money laundering. [Section 3 of the Prevention of Money Laundering Act, 2002]

Paragraph 2 of Part A of the Schedule to the Prevention of Money Laundering Act, 2002, covers Offences under the Narcotic Drugs And Psychotropic Substances Act, 1985. Whereby, illegal import into

India, export from India or transshipment of narcotic drugs and psychotropic substances (section 23) is covered under paragraph 2 of Part A.

Punishment: Section 4 of the said Act provides for the punishment for Money-Laundering. Whoever commits the offence of money-laundering shall be punishable with rigorous imprisonment for a term which shall not be less than 3 years but which may extend to 7 years and shall also be liable to fine. But where the proceeds of crime involved in money-laundering relate to any offence specified under paragraph 2 of Part A of the Schedule, the maximum punishment may extend to 10 years instead of 7 years.

Thus, Mr. Halo is liable to punishment of maximum 10 years with fine.

Test Series: February, 2015

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – II

PAPER – 5: ADVANCED MANAGEMENT ACCOUNTING

SUGGESTED ANSWERS/HINTS

1. (a)

Contribution *per unit*

Particulars	(Rs.)
Selling Price	200
Variable Cost (Rs.65 + Rs.33 + Rs.16)	114
Contribution per unit (Excluding Direct Labour, Considered Irrelevant and Fixed)	86

Savings and Earnings if the Plant is Shut Down

Particulars	(Rs.)
Savings in Fixed Cost (Rs.14,00,000* – Rs.1,25,000)	12,75,000
Contribution from Alternate Activity (Rs.40 x 50% of 2,00,000 hrs)	40,00,000
Shutting Down and Reopening Cost (Rs.50,000 + Rs.100,000)	(1,50,000)
Total	51,25,000

* [2,00,000 units x Rs.7]

Indifference Point: Rs.51,25,000 / Rs.86 = 59,593 units

Minimum Level of Production to Justify Continuation = 59,594 units

- (b) Opportunity Cost of Labour - The G₂ labour has zero opportunity cost as there is no other use for the time already paid for and is available. However, XL Polymers needs to pay an additional amount for G₁ labour. This amount can be save if the special job were not there.

G₁ labour:

Hours Required	250
Hours Available	<u>150</u>
Extra Hours Needed	100
Cost per hour (Rs.630/42hrs)	<u>Rs. 15</u>
Opportunity Cost	<u>Rs.1,500</u>

Thus, the 'Opportunity Cost of Labour' for completing the special job is Rs.1,500.

Opportunity Cost of Material – XL Polymers has no alternative use for the R₁, they must dispose of it at a cost of Rs.1,250. Thus, XL Polymers actually saves Rs.1,250 by using the materials for the

AT Industries' special job. Consequently, the 'Opportunity Cost of Material' is - Rs.1,250 (i.e., the opportunity cost of this resource is negative).

The *minimum price* is the price at which XL Polymers just recovers its 'Opportunity Cost. XL Polymers's 'Total Opportunity Cost' is Rs.250 (Rs.1,500 – Rs.1,250). Accordingly, minimum Price for the Special Job is Rs.250.

- (c) (i) Cost incurred on Product 'KC' *upto point of separation* is irrelevant for decision making as Product 'KC' is a Joint Product. Joint Products are the result of same raw material & same process Operations.

Cost incurred *after point of separation* will be considered for decision making as *specifically* incurred for Product 'KC'.

After further processing Product 'KC' will *contribute* Rs.43 per unit toward 'Joint Production Cost'.

Calculation is as follows:

Particulars	Amount (Rs.)	Amount (Rs.)
Selling Price <i>per unit</i>		93.00
Less: Cost after Separation:		
Marginal Cost <i>per unit</i>	38.00	
Fixed Cost <i>per unit</i>	12.00	50.00
Contribution toward 'Joint Production Cost'		43.00

Hence, *further processing* of Product 'KC' is recommended.

- (ii) If Product 'KC' is not a joint product with same cost structure. In this case there will be *negative contribution* on production of Product 'KC'. The calculation is as follows:

Particulars	Amount (Rs.)
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Selling Price <i>per unit</i>	93.00
Less: Marginal Cost (Rs.75 + Rs.38)	113.00
Contribution	(20.00)

Hence, production of Product 'KC' will not be recommended.

- (d) The assignment problem is special case of transportation problem; it can also be solved by transportation method. But the solution obtained by applying this method would be typically degenerate. This is because the optimality test in the transportation method requires that there must be $m+n-1$ allocations/assignments. But due to the special structure of assignment problem of order $n \times n$, any solution cannot have more than n assignments. Thus, the assignment problem is naturally degenerate. In order to remove degeneracy, $n-1$ * number of dummy allocations will be required in order to proceed with the transportation method. Thus, the problem of degeneracy at each solution makes the transportation method computationally inefficient for solving an assignment problem.

$$m+n-1 - n \Rightarrow n+n-1 - n \Rightarrow 2n-1 - n \Rightarrow n-1$$

2. (a) **Statement Showing the Selling Price of a Super Computer in India**

	(Rs.)
A. Landed Cost of a Dismantled Kit (Refer to Working Note: 2)	81,340
B. Cost of Local Procurement (Refer to Working Note: 1)	67,320
C. Cost of Assembly and Other Overheads <i>per computer</i>	8,000
D. Total Cost of Manufacture (A + B + C)	1,56,660
E. Technology Fee <i>per computer</i> (Rs. 8,00,00,000 / 8,00,000 Computer)	100

F. Royalty Payment <i>per unit</i> (Refer to Working Note: 4)	9,251
G. Total Cost (D + E+ F)	166,011
H. Profit (20% on Selling Price of 25% of Total Cost)	41,503
I. Selling Price <i>per computer</i>	207,514

Working Notes

1. Cost of Local Procurements:

150% of the cost of supplies made by Comp Inc.

$$[(150\%) \times (100/125) \times (\$2,040 \times \text{Rs.}55 \times 50\%)] \quad \text{Rs.}67,320$$

2. Landed Cost of a Dismantled Kit:

	(Rs.)
FOB Price (\$2,040 × Rs.55 × 50%)	56,100
Add: Insurance & Freight	2,000
CIF Price	58,100
Add: Customs Duty (40% × Rs.58,100)	23,240
Landed Cost of a Dismantled Kit	81,340

3. Cost of the Standard Items Procured Locally:

50% of the cost of locally procured Goods

$$(50\% \times \text{Rs.}67,320) \quad \text{Rs.}33,660$$

4. Royalty Payment *per computer*:

Let $X = \text{Selling Price per unit of Super Computer}$

$Y = \text{Royalty Paid per computer}$

Since 20% is the Margin of Profit on Selling Price. It means Margin of 25% on Cost Price.

Therefore we have

$$X = 1.25 \times (\text{Rs.}81,340 + \text{Rs.}67,320 + \text{Rs.}8,000 + \text{Rs.}100 + Y)$$

$$Y = 10\% \times \{X - (\text{Rs.}33,660 + \text{Rs.}81,340)\}$$

On solving the above equations we get:

$$X = \text{Rs.}2,07,514 \text{ (Approx)}$$

$$Y = \text{Rs.}9,251 \text{ (Approx)}$$

- (b) (i) 'Learning Curve Theory' will not be applicable as *alloy combination of the input metal is quite different* among the suppliers hence learning experience with one type of metal may not be beneficial for the workers to deal with other metal with separate alloy composition.
- (ii) 'Learning Curve Theory' will not be applicable as in this situation *rotation of labour is done frequently*, labours will not be able to get the benefit of learning and apply their learning. Hence, learning curve theory can not be applied.
- (iii) 'Learning Curve Theory' will not be applicable as in this situation as *workers are skilled and employed for a long time*, they have already achieved maximum level of expertise by taking advantage of learning. Hence, at this point of time learning curve theory can not be applied.
- (iv) 'Learning Curve Theory' will not be applicable as indirect materials are the materials which are not used directly in the production (not directly proportionate with volume of output) and usually used machines (e.g. lubricants, spares parts etc.) with less human interactions. Adverse usage of indirect materials can be controlled through proper monitoring and appropriate standard settings and not from applying learning curve theory.

3. (a)

$C_j \rightarrow$			6	4	10	0	0	0	Min. Ratio
C_B	Basic Variable	Quantity	X_1	X_2	X_3	S_1	S_2	S_3	
0	S_1	400	0	$4/3$	0	1	$-1/3$	0	300
6	X_1	400	1	$2/3$	2	0	$1/3$	0	600
0	S_3	400	0	$5/3$	0	0	$-2/3$	1	$\leftarrow 240$
$Z_j = \sum C_{Bi} X_j$			6	4	12	0	2	0	
$C_j - Z_j$			0	$0\uparrow$	-2	0	-2	0	

(i) Yes, because the given solution has no artificial variables in the basic column.

(ii) Perform one more iteration with X_2 :

$C_j \rightarrow$			6	4	10	0	0	0
C_B	Basic Variable	Quantity	X_1	X_2	X_3	S_1	S_2	S_3
0	S_1	80	0	0	0	1	$1/5$	$-4/5$
6	X_1	240	1	0	2	0	$3/5$	$-2/5$
4	X_2	240	0	1	0	0	$-2/5$	$3/5$
$Z_j = \sum C_{Bi} X_j$			6	4	12	0	2	0
$C_j - Z_j$			0	0	-2	0	-2	0

(iii) Shadow Price is Rs.0, Rs.2 and Rs.0 (or any other given monetary unit) for Constraint 1, Constraint 2 and Constraint 3 respectively and same has been obtained from row $C_j - Z_j$.

(iv) $C_j - Z_j$ for X_3 being -2, production of each unit of X_3 would cause a reduction of Rs.2 (or any other given monetary unit). Thus, the price for X_3 should be increased by at least two rupee per unit to ensure no reduction of profits.

(v) Original Constraint Inequality with the coefficient of variables:

Let us consider the given iteration is the 2nd one. The first iteration (I_1) must have had S_2 instead of X_1 . Row X_1 of I_2 has been computed by dividing the S_2 row of I_1 by 3. S_2 of I_1 (in

Identity Matrix) would have been 1. Now it is 1/3. Working backwards, we multiply row X_1 of I_2 by 3 to get Row S_2 of I_1 .

Original Row S_2 [X_1 of $I_2 \times 3$]:

$$(1X_1 + 2/3X_2 + 2X_3) \times 3 \leq 400 \times 3$$

Or

$$3X_1 + 2X_2 + 6X_3 \leq 1,200$$

Similarly **Original Row S_1** [S_1 of $I_2 + X_1$ of I_2]:

$$(0X_1 + 4/3X_2 + 0X_3) + (1X_1 + 2/3X_2 + 2X_3) \leq 400 + 400$$

Or

$$X_1 + 2X_2 + 2X_3 \leq 800$$

Similarly **Original Row S_3** [S_3 of $I_2 + 2 \times X_1$ of I_2]:

$$0X_1 + 5/3X_2 + 0X_3 + (1X_1 + 2/3X_2 + 2X_3) \times 2 \leq 400 + 400 \times 2$$

Or

$$2X_1 + 3X_2 + 4X_3 \leq 1,200$$

Original Constraint Inequality (with the coefficient of variables) can also be traced through algebraic method by solving through system of equations.

(b) Fitness Solution's main Critical Success Factors are

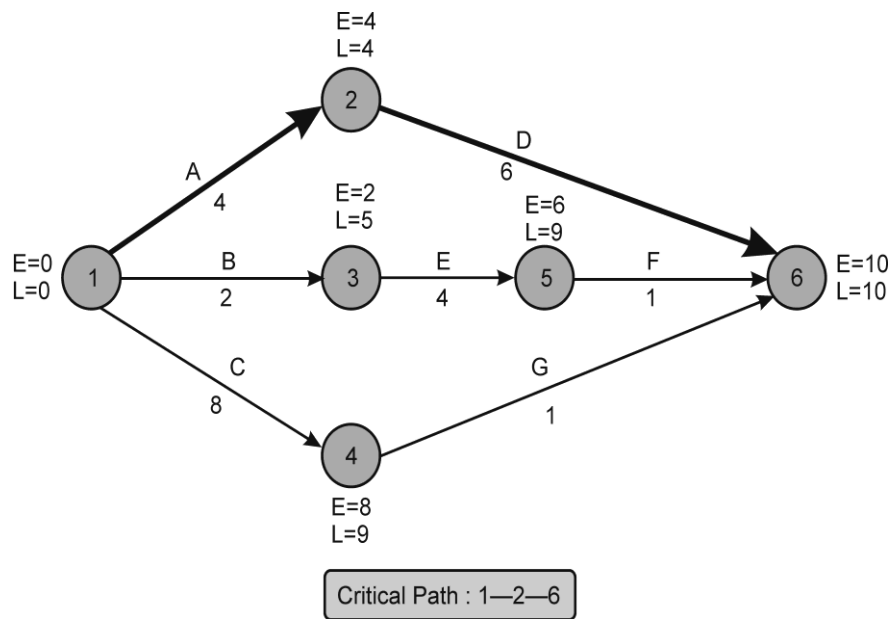
- (i) Developing and maintaining a high level of customer satisfaction.
- (ii) Offering facilities that are not much below that offered by competition.

- (iii) Keeping a tight cap on costs as there is considerable competitive pressure in this industry and entry barriers are not high.

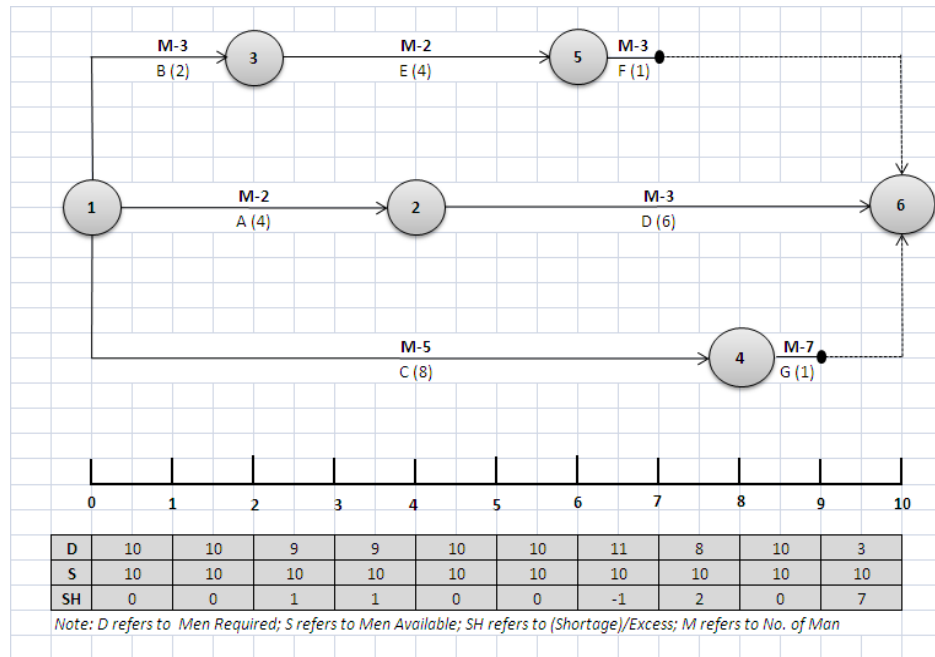
The following is a possible **Balance Scorecard** for Fitness Solution

Financial Perspective	Return on investment
	Cash flow
	Quarterly growth in revenue
Customer Perspective	Turnover rate among members
	Customer satisfaction rate
Internal Perspective	Number of member complaints
	Number of equipment not available on average day
Innovation and Learning	Number of new equipment put into service
	Number of staff gaining professional certification

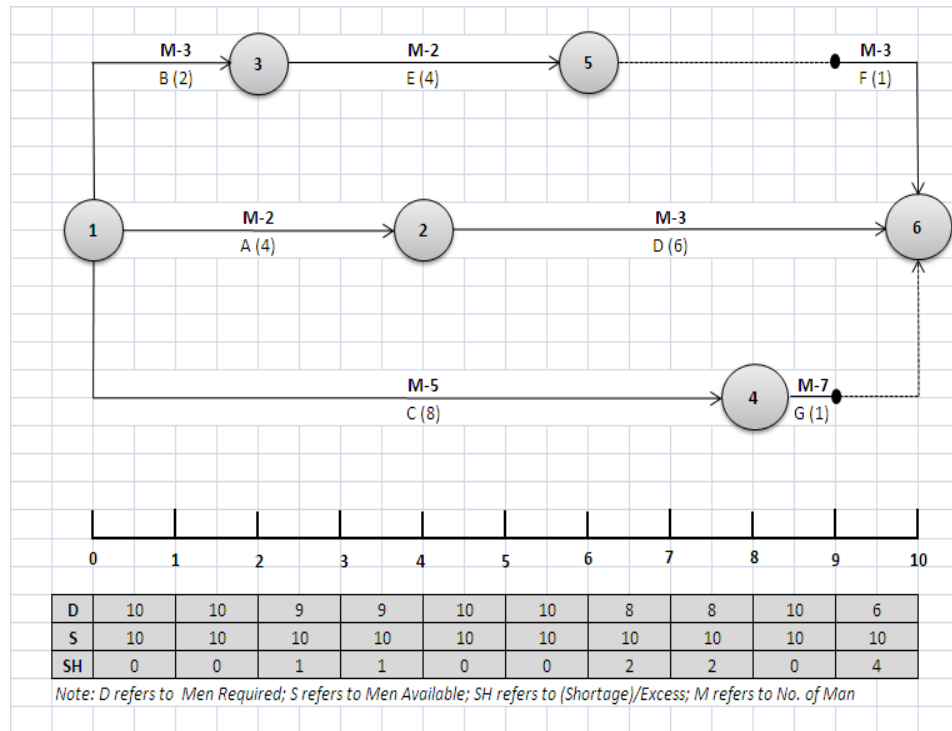
4. (a) The network for the given problem:



Peak requirement is 11 men and same is required on 7th Day
(Refer below Time Scale Diagram).



The project can be completed in 10 days. For this, we have to shift Activity F to 10th Day as only 10 men are available on any day. (Refer below Time Scale Diagram)



(b) Traditional Variance (Actual Vs Original Budget)

$$\text{Usage Variance} = (\text{Standard Quantity} - \text{Actual Quantity}) \times \text{Standard Price}$$

$$= (2,500 \text{ Kg} - 2,700 \text{ Kg}) \times \text{Rs.1.50}$$

$$= \text{Rs.300 (A)}$$

$$\text{Price Variance} = (\text{Standard Price} - \text{Actual Price}) \times \text{Actual Quantity}$$

$$= (\text{Rs.1.50} - \text{Rs.2.40}) \times 2,700 \text{ Kg}$$

$$= \text{Rs.2,430 (A)}$$

$$\text{Total Variance} = \text{Rs.300 (A)} + \text{Rs.2,430 (A)}$$

$$= \text{Rs.2,730 (A)}$$

Operational Variance (Actual Vs Revised)

$$\begin{aligned}
 \text{Usage Variance} &= (2,500 \text{ Kg} - 2,700 \text{ Kg}) \times \text{Rs.}2.25 \\
 &= \text{Rs.}450 \text{ (A)} \\
 \text{Price Variance} &= (\text{Rs.}2.25 - \text{Rs.}2.40) \times 2,700 \text{ Kg} \\
 &= \text{Rs.}405 \text{ (A)} \\
 \text{Total Variance} &= \text{Rs.}450 \text{ (A)} + \text{Rs.}405 \text{ (A)} \\
 &= \text{Rs.}855 \text{ (A)}
 \end{aligned}$$

Planning Variance (Revised Vs Original Budget)

$$\begin{aligned}
 \text{Controllable Variance} &= (\text{Rs.}2.00 - \text{Rs.}2.25) \times 2,500 \text{ Kg} \\
 &= 625 \text{ (A)} \\
 \text{Uncontrollable Variance} &= (\text{Rs.}1.50 - \text{Rs.}2.00) \times 2,500 \text{ Kg} \\
 &= 1,250 \text{ (A)} \\
 \text{Total Variance} &= \text{Rs.}625 \text{ (A)} + \text{Rs.}1,250 \text{ (A)} \\
 &= \text{Rs.}1,875 \text{ (A)}
 \end{aligned}$$

$$\begin{aligned}
 \text{Traditional Variance} &= \text{Operational Variance} + \text{Planning} \\
 \text{Variance} &= 855 \text{ (A)} + 1,875 \text{ (A)} \\
 &= 2,730 \text{ (A)}
 \end{aligned}$$

5. (a) 1. Projected Raw Material Issues (Kg):

	'A'	'B'	'C'
'X' (48,000 units-Refer Note)	60,000	24,000	---
'Y' (36,000 units-Refer Note)	<u>72,000</u>	<u>-</u>	<u>54,000</u>
Projected Raw Material Issues	<u>1,32,000</u>	<u>24,000</u>	<u>54,000</u>

Note:

- Based on this experience and the projected sales, the FML has budgeted production of 48,000 units of 'X' and 36,000 units of 'Y' in the eighth period.

$$=52,500 \times 40\% + 45,000 - 18,000 = 48,000$$

$$=27,000 \times 40\% + 42,000 - 16,800 = 36,000$$

- Production is assumed to be uniform for both products within each four-week period.

2. and 3. Projected Inventory Activity and Ending Balance (Kg):

	'A'	'B'	'C'
Average Daily Usage	6,600	1,200	2,700
Beginning Inventory	96,000	54,000	84,000
Add: Orders Received:			
Ordered in 5 th period	90,000	-	60,000
Ordered in 6 th period	90,000	-	-
Sub Total	276,000	54,000	144,000
Less: Issues	132,000	24,000	54,000
Projected ending inventory balance	144,000	30,000	90,000

Note:

- Ordered 90,000 Kg of 'A' on fourth working day.
- Order for 90,000 Kg of 'A' ordered during fifth period received on tenth working day.
- Order for 90,000 Kg of 'A' ordered on fourth working day of sixth period received on fourteenth working day.
- Ordered 30,000 Kg of 'B' on eighth working day.

- Order for 60,000 Kg of 'C' ordered during fifth period received on fourth working day.
- No orders for 'C' would be placed during the sixth period.

4. Projected Payments for Raw Material Purchases:

Raw Material	Day/Period Ordered	Day/Period Received	Quantity Ordered	Amount Due	Day/Period Due
'A'	20 th /5 th	10 th /6 th	90,000 Kg	Rs.90,000	20 th /6 th
'C'	4 th /5 th	4 th /6 th	60,000 Kg	Rs.60,000	14 th /6 th
'A'	4 th /6 th	14 th /6 th	90,000 Kg	Rs.90,000	4 th /7 th
'B'	8 th /6 th	18 th /7 th	30,000 Kg	Rs.60,000	8 th /8 th

(b)

Cost Reduction	Cost Control
Cost Reduction is the achievement of real and permanent reduction in unit cost of products manufactured.	Cost Control involves a comparison of actual with the standards or budgets, to regulate the actual costs.
Realistic savings in cost.	There could be temporary savings in cost.
Product's Utility, Quality and Characteristics are retained.	Quality Maintenance is not a guarantee.
It is not concerned with maintenance of performance	The process involves setting up a target, investing

according to standards	variances and taking remedial measures to correct them.
Continuous process of critical examination includes analysis and challenge of standards.	Control is achieved through compliance with standards. Standards by themselves are not examined.
Fully dynamic approach.	Less dynamic than Cost Reduction.
Universally applicable to all areas of business. Does not depend upon standards, though target amounts may be set.	Limited applicability to those items of cost for which standards can be set.
Emphasis here is partly on present costs and largely on future costs.	Emphasis on present and past behaviour of costs.
The function of Cost Reduction is to find out substitute ways and new means like waste reduction, expense reduction and increased production	Cost Control does competitive analysis of actual results with established standards.
Cost reduction is a corrective measure.	Cost Control is a preventive measure.

...Any Four

6. (a) To overcome the ***optimum decision making*** and ***performance evaluation conflicts*** that can occur with ***marginal cost-based transfer pricing*** following methods has been proposed:

Dual Rate Transfer Pricing System

“With a ‘Dual Rate Transfer Pricing System’ the ‘Receiving Division’ is charged with marginal cost of the intermediate product and ‘Supplying Division’ is credited with full cost per unit plus a profit margin”.

Accordingly Division 'Dx' should be allowed to record the transactions at *full cost per unit plus a profit margin*. On the other hand Division 'Dz' may be charged only *marginal cost*. Any inter divisional profits can be eliminated by accounting adjustment.

Impact:

- Division 'Dx' will earn a profit on inter Division transfers.
- Division 'Dz' can chose the output level at which the marginal cost of the product 'X' is equal to the net marginal revenue of the product 'Z'.

Two Part Transfer Pricing System:

"The 'Two Part Transfer Pricing System' involves transfers being made at the marginal cost per unit of output of the supplying Division plus a lump-sum fixed fee charged by the supplying Division to the receiving Division for the use of the capacity allocated to the intermediate product."

Accordingly Division 'Dx' can transfer its products to Division 'Dz' at *marginal cost per unit and a lump-sum fixed fee*.

Impact:

- 'Two Part Transfer Pricing System' will inspire the Division 'Dz' to choose the optimal output level.
- This pricing system also enable the Division 'Dx' to obtain a profit on inter Division transfer.

(b) Statement Showing 'Customer Profitability Analysis'

Particulars	V ₁	V ₂	Channel Total	V ₃	V ₄	Channel Total
	Small Stores			Large Stores		
Revenue at List Price	1,60,000	1,80,000	3,40,000	25,50,000	12,00,000	37,50,000

Discount	8,000	18,000	26,000	4,59,000	1,44,000	6,03,000
Net Revenue	152,000	1,62,000	3,14,000	20,91,000	10,56,000	31,47,000
Variable Costs	1,28,000	1,44,000	2,72,000	20,40,000	9,60,000	30,00,000
Contribution Margin	24,000	18,000	42,000	51,000	96,000	1,47,000
Order Processing	3,000	6,750	9,750	4,500	2,250	6,750
Regular Deliveries	1,500	3,375	4,875	2,250	1,125	3,375
Expedited Deliveries	2,500	---	2,500	2,500	---	2,500
Customer Profit	17,000	7,875	24,875	41,750	92,625	1,34,375
Channel Cost			20,250			48,375
Channel Profit			4,625			86,000

Suggestions

VMCC is only just at breakeven point with small pharmaceuticals. To improve profit VMCC should:

- (i) Coordinate with V_2 to *increase order size* and try to *negotiate a smaller discount*.
- (ii) Try to work with V_1 to *reduce number of expedited deliveries*.

VMCC makes substantial profit from the large pharmaceuticals.

VMCC may give *little extra attention* on V_4 as V_4 is most favorable customer and its order is for large quantities. For V_3 , VMCC may have *no options* as V_3 accounts more than 50% of Sales.

7. (a) Role of Pareto Analysis in Pricing of Product *in the case of firm dealing with multiple products*

In the case of firm dealing with multi products, it would not be possible for it to analyse price-volume relationship for all of them. Pareto Analysis is used for analysing the firm's estimated sales revenue from various products and it might indicate that approximately 80% of its total sales revenue is earned from about 20% of its products. Such analysis helps the top management to delegate the pricing decision for approximately 80% of its products to the lower level of management, thus freeing them to concentrate on the pricing decisions for products approximately 20% of which is essential for the company's survival. Thus, a firm can adopt more sophisticated pricing methods for small proportion of products that jointly account for 80% of total sales revenue. For the remaining 80% products, which account for 20% of the total sales value the firm may use cost based pricing method.

(b) Benefits of Customer Profitability Analysis

- (i) It helps the supplier to identify which customers are eroding overall profitability and which customers are contributing to it.
- (ii) It can help to provide a basis for constructive dialogue between buyer and seller to improve margins.
- (iii) It enhances decision making related to customers.
- (iv) It helps in effective cost reporting, communication and information.
- (v) It helps to find out the value and profitability of each customer segment.

(c)

Three Measures of Theory of	Item
-----------------------------	------

Constraints	
Throughput Contribution	(vii) Sales
Investments	(i) Research and Development Cost
	(iii) Finished Goods Inventory
	(vi) Stock of Raw material
	(viii) Cost of Equipment and Building
Operating Costs	(ii) Rent/Utilities
	(iv) Depreciation
	(v) Labour Cost

(d) **The initial solution need not be the same under both methods.**

Vogel's Approximation Method (VAM) uses the differences between the minimum and the next minimum costs for each row and column. This is the penalty or opportunity cost of not utilising the next best alternative. The highest penalty is given the 1st preference. This need not be the lowest cost.

For example if a row has minimum cost as 2, and the next minimum as 3, penalty is 1; whereas if another row has minimum 4 and next minimum 6, penalty is 2, and this row is given preference. But Least Cost Method gives preference to the lowest cost cell, irrespective of the next cost. Solution obtained using Vogel's Approximation Method is more optimal than Least Cost Method.

Initial solution will be same only when the maximum penalty and the minimum cost coincide.

(e) The Initial solution obtained by the North-West Corner Rule in transportation need not always contain the R_2C_1 cell. In the North-West Corner Rule the first allocation is made at R_1C_1 cell and then

it only moves towards R_2C_1 cell when the resources at the first row i.e. R_1 is exhausted first than the resources of first column i.e. C_1 . On the contrary if resources at first column i.e. C_1 is exhausted first then the next allocation will be at R_1C_2 .

For example the resource availability at first row (R_1) is 1,500 units and the demand in first column (C_1) is 1,000 units. In this case resource availability of first row (R_1) will be exhausted to the extent of the demand in first column (C_1) first and then the remaining resource availability at first row (R_1) will be used to meet the demand of the second column (C_2). In this example cell R_2C_1 will not come in initial solution obtained by the North-West Corner Rule.

Test Series: February, 2015

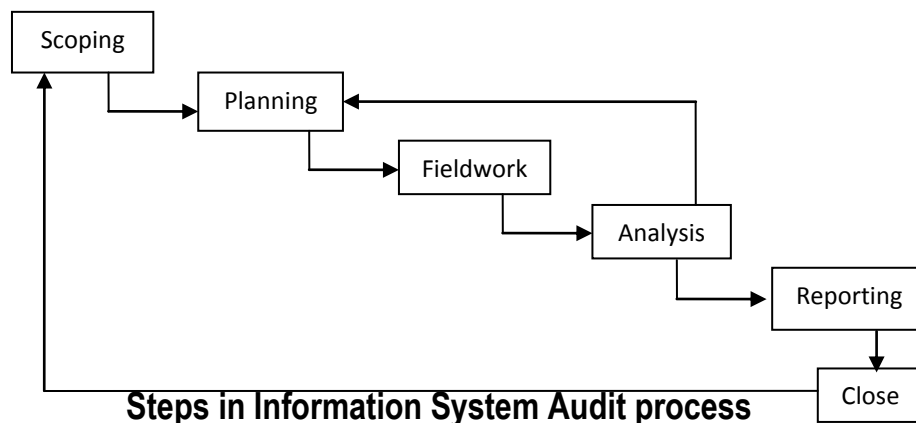
MOCK TEST PAPER – 1

FINAL COURSE: GROUP – II

PAPER – 6: INFORMATION SYSTEMS CONTROL & AUDIT

SUGGESTED ANSWERS/HINTS

1. (a) Steps that an Auditor follows during Information System Audit are as follows:



- (i) **Scoping and pre-audit survey:** Auditors determine the main

area/s of focus and any areas that are explicitly out-of-scope, based on the scope-definitions agreed with management. Information sources at this stage include background reading and web browsing, previous audit reports, pre audit interview, observations and, sometimes, subjective impressions that simply deserve further investigation.

- (ii) **Planning and preparation:** During this step, the scope is broken down into greater levels of detail, usually involving the generation of an audit work plan or risk-control-matrix.
- (iii) **Fieldwork:** This step involves gathering of evidence by interviewing staff and managers, reviewing documents, and observing processes etc.
- (iv) **Analysis:** This step involves desperately sorting out, reviewing and trying to make sense of all that evidence gathered earlier. SWOT (Strengths, Weaknesses, Opportunities, and Threats) or PEST (Political, Economic, Social, and Technological) techniques can be used for analysis.
- (v) **Reporting:** Reporting to the management is done after analysis of evidence is gathered and analyzed.
- (vi) **Closure:** Closure involves preparing notes for future audits and follow up with management to complete the actions they promised after previous audits.

Analysis and reporting may involve the use of automated data analysis tools such as ACL or IDEA, if not Excel, Access and hand-crafted SQL queries. Automated system security analysis, configuration or vulnerability management and security benchmarking tools are also used for reviewing security parameters, and the basic security management functions that are built-in to modern systems can help with log analysis, reviewing user access rights etc.

- (b) Some of the most notable issues because of which an enterprise

at times fails to achieve the objectives of the system development are described briefly as follows:

- (i) **User Related Issues:** It refers to those issues where user/customer is reckoned as the primary agent. Some of the aspects with regard to this problem are mentioned as follows:
- **Shifting User Needs:** User requirements for IT are constantly changing. As these changes accelerate, there will be more requests for Information systems development and more development projects. When these changes occur during a development process, the development team faces the challenge of developing systems whose very purpose might change since the development process began.
 - **Resistance to Change:** People have a natural tendency to resist change, and information systems development projects signal changes - often radical - in the workplace. When personnel perceive that the project will result in personnel cutbacks, threatened personnel will dig in their heels, and the development project is doomed to failure.
 - **Lack of Users' Participation:** Users must participate in the development efforts to define their requirements, feel ownership for project success, and work to resolve development problems. User participation also helps to reduce user resistance to change.
 - **Inadequate Testing and User Training:** New systems must be tested before installation to determine that they operate correctly. Users must be trained to effectively utilize the new system.
- (ii) **Developer Related Issues:** It refers to the issues and challenges with regard to the developers. Some of the critical bottlenecks are mentioned as follows:

- **Lack of Standard Project Management and System Development Methodologies:** Some organizations do not formalize their project management and system development methodologies, thereby making it very difficult to consistently complete projects on time or within budget.
- **Overworked or Under-Trained Development Staff:** In many cases, system developers often lack sufficient educational background and requisite state of the art skills. Furthermore, many companies do a little to help their development personnel stay technically sound, and more so a training plan and training budget do not exist.

(iii)

Management Related Issues: It refers to the bottlenecks with regard to organizational set up, administrative and overall management to accomplish the system development goals. Some of such bottlenecks are mentioned as follows:

- **Lack of Senior Management Support and Involvement:** Developers and users of information systems watch senior management to determine 'which systems development projects are important' and act accordingly by shifting their efforts away from any project, which is not receiving management attention. In addition, management can see that adequate resources, as well as budgetary control over use of those resources, are dedicated to the project.
- **Development of Strategic Systems:** Because strategic decision making is unstructured, the requirements, specifications, and objectives for such development projects are difficult to define.

(iv)

New Technologies: When an organization tries to create a competitive advantage by applying advance technologies, it generally finds that attaining system development objectives is more difficult because personnel are not as familiar with the

technology.

- (c) In Information Technology (Amendment) Act, 2008; Section 7 is related to the “Retention of Electronic Records” and Section 7A is related to the “Audit of documents in electronic form”.

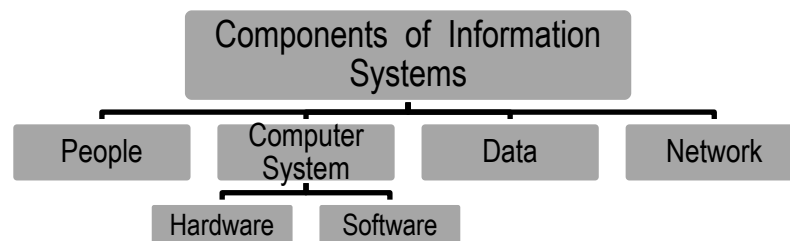
[Section 7] Retention of Electronic Records

- (1) Where any law provides that documents, records or information shall be retained for any specific period, then, that requirement shall be deemed to have been satisfied if such documents, records or information are retained in the electronic form, -
- (a) the information contained therein remains accessible so as to be usable for a subsequent reference;
- (b) the electronic record is retained in the format in which it was originally generated, sent or received or in a format which can be demonstrated to represent accurately the information originally generated, sent or received;
- (c) the details which will facilitate the identification of the origin, destination, date and time of dispatch or receipt of such electronic record are available in the electronic record.
- However, this clause does not apply to any information which is automatically generated solely for the purpose of enabling an electronic record to be dispatched or received.
- (2) Nothing in this section shall apply to any law that expressly provides for the retention of documents, records or information in the form of electronic records, publication of rules, regulation, etc. in Electronic Gazette.

[Section 7A] Audit of Documents etc. in Electronic form

Where in any law for the time being in force, there is a provision for audit of documents, records or information, that provision shall also be applicable for audit of documents, records or information processed and maintained in electronic form.

2. (a) **Information System:** An Information System comprises of people, hardware, software, data and network for communication support.
- People mean the IT professionals i.e. system administrator, programmers and end users i.e. the persons, who can use hardware and software for retrieving the desired information;
 - Computer system consisting of hardware and software where -
 - The hardware means the physical components of the computers;
 - The software means the system software (different types of operating systems e.g. UNIX, LINUX, WINDOWS etc.) and application software (different type of computer programs designed to perform specific task) and utility software (e.g. tools);
 - The data is the raw fact, which may be in the form of database. The data may be alphanumeric, text, image, video, audio, and other forms; and
 - The network means communication media (Internet, Intranet, Extranet etc.).



Components of Information Systems

The basics activities of an Information System model are as follows:

- Data is collected from an organization or from external environments and converted into suitable format required for processing (Input);

- This is converted into information (more meaningful form) obtained after manipulation of these collected data (Processing); and
- Then information is stored for future use or communicated to user after application of respective procedure on it (Output).

The activities that are defined above help enterprises in making decisions, control operations, analyze problems and create new products or services. Apart from these activities, information systems also need feedback, which is output that is returned to appropriate members of the enterprises to help them to evaluate at the input stage.

(b) **Backup Plan:** The Backup Plan specifies the type of backup to be kept, frequency with which backup is to be undertaken, procedures for making backup, location of backup resources, site where these resources can be assembled and operations restarted, personnel who are responsible for gathering backup resources and restarting operations, priorities to be assigned to recovering the various systems, and a time frame for recovery of each system. The Backup Plan is intended to restore operations quickly so that information system function can continue to service an organization. For example, it might be difficult to specify; exactly how an organization's mainframe facility will be recovered in the event of a fire. The backup plan needs continuous updating as changes occur. Similarly, lists of hardware and software must be updated to reflect acquisitions and disposals.

Recovery Plan: Recovery plan sets out procedures to restore full information system capabilities. Recovery Plan should identify a recovery committee that will be responsible for working out the specifics of the recovery to be undertaken. The plan should specify the responsibilities of the committee and provide guidelines on priorities to be followed. The plan might also indicate which applications are to be recovered first. Members of a recovery committee must understand their responsibilities.

Periodically, they must review and practice executing their responsibilities so they are prepared should a disaster occur. If committee members leave the organization, new members must be appointed immediately and briefed about their responsibilities.

(c) Some of the strengths of Agile Model identified by the experts and practitioners include the following:

- Agile methodology has the concept of an adaptive team, which enables to respond to the changing requirements.
- The team does not have to invest time and efforts and finally find that by the time they delivered the product, the requirement of the customer has changed.
- Face to face communication and continuous inputs from customer representative leaves a little space for guesswork.
- The documentation is crisp and to the point to save time.
- The end result is generally the high quality software in least possible time duration and satisfied customer.

Some of the weaknesses of Agile Model identified by the experts and practitioners include the following:

- In case of some software deliverables, especially the large ones, it is difficult to assess the efforts required at the beginning of the software development life cycle.
- There is lack of emphasis on necessary designing and documentation.
- Agile increases potential threats to business continuity and knowledge transfer. By nature, Agile projects are extremely light on documentation because the team focuses on verbal communication with the customer rather than on documents or manuals.
- Agile requires more re-work and due to the lack of long-term planning and the lightweight approach to architecture, re-work is often required on Agile projects when the various

components of the software are combined and forced to interact.

- The project can easily get taken off track if the customer representative is not clear about the final outcome.
- Agile lacks the attention to outside integration.

3. (a) Green IT: Green IT refers to the study and practice of establishing / using computers and IT resources in a more efficient and environmentally friendly and responsible way. Computers consume a lot of natural resources, from the raw materials needed to manufacture them, the power used to run them, and the problems of disposing them at the end of their life cycle.

Green computing is the environmentally responsible use of computers and related resources. Such practices include the implementation of energy-efficient Central Processing Units (CPUs), servers and peripherals as well as reduced resource consumption and proper disposal of electronic waste (e-waste). Some of such steps for Green IT include the following:

- Power-down the CPU and all peripherals during extended periods of inactivity.
- Try to do computer-related tasks during contiguous, intensive blocks of time, leaving hardware off at other times.
- Power-up and power-down energy-intensive peripherals such as laser printers according to need.
- Use Liquid Crystal Display (LCD) monitors rather than Cathode Ray Tube (CRT) monitors.
- Use notebook computers rather than desktop computers whenever possible.
- Use the power-management features to turn off hard drives and displays after several minutes of inactivity.
- Minimize the use of paper and properly recycle waste paper.

- Dispose of e-waste according to central, state and local regulations.
- Employ alternative energy sources for computing workstations, servers, networks and data centers.

(b)

Risk Assessment: The Risk Assessment is assessment of the disruption to critical activities, which are supported by resources such as people, process, technology, information, infrastructure supplies and stakeholders. The enterprise should determine the threats and vulnerabilities of each resource, and the impact that would have, in case it becomes a reality. It is the decision of the enterprise to select a risk assessment approach, but it is important that it is suitable and appropriate to address all of the enterprise's requirements.

Specific threats may be described as events or actions, which could, at some point, cause an impact to the resources, e.g. threats such as fire, flood, power failure, staff loss, staff absenteeism, computer viruses and hardware failure.

Vulnerabilities might occur as weaknesses within the resources and can, at some point be exploited by the threats, e.g. single points of failure, inadequacies in fire protection, electrical resilience, staffing levels, IT security and IT resilience. The Security Assessment will enable the business continuity team to improve any existing emergency plans and to implement required emergency plans where none exist. This is similar to vulnerability assessment phase of developing a BCP.

Impacts might result from the exploitation of vulnerabilities by threats. As a result of the Business Impact Assessment (BIA) and the risk assessment, the enterprise should identify measures that reduce the likelihood of a disruption; shorten the period of disruption; and limit the impact of a disruption on the enterprise's key products and services. These measures are known as loss mitigation and risk treatment.

- (c) **Integration Testing:** Integration testing is an activity of software testing in which individual software modules are combined and tested as a group. It occurs after unit testing and before system testing with an objective to evaluate the validity of connection of two or more components that pass information from one area to another. Integration testing takes as its input modules that have been unit tested, groups them in larger aggregates, applies tests defined in an integration test plan to those aggregates, and delivers as its output the integrated system ready for system testing. This is carried out in the following two manners:
- **Bottom-up Integration:** It is the traditional strategy used to integrate the components of a software system into a functioning whole. It consists of unit testing, followed by sub-system testing, and then testing of the entire system. Bottom-up testing is easy to implement as at the time of module testing, tested subordinate modules are available. The disadvantage; however is that testing of major decision / control points is deferred to a later period.
 - **Top-down Integration:** An incomplete portion of a program code that is put under a function in order to allow the function and the program to be compiled and tested is referred to as a Stub. Top down integration starts with the main routine, and stubs are substituted, for the modules directly subordinate to the main module. A stub does not go into the details of implementing details of the function or the program being executed. Once the main module testing is complete, stubs are substituted with real modules one by one, and these modules are tested with stubs. This process continues till the atomic modules are reached.
4. (a) **Boundary Controls:** Boundary controls are the major controls of the boundary system that provide access control mechanisms. Access controls mechanism links the authentic users to the authorized resources, they are permitted to access. The access control mechanism has three steps of Identification, Authentication and Authorization with respect to the access control policy

implemented.

Major Boundary Control techniques are given as follows:

- **Cryptography:** It deals with programs for transforming data into cipher text that are meaningless to anyone, who does not possess the authentication to access the respective system resource or file. A cryptographic technique encrypts data (clear text) into cryptograms (cipher text) and its strength depends on the time and cost to decipher the cipher text by a cryptanalyst. Three techniques of cryptography are Transposition (permute the order of characters within a set of data), Substitution (replace text with a key-text) and Product Cipher (combination of Transposition and Substitution).
- **Passwords:** User identification by an authentication mechanism with personal characteristics like name, birth date, employee code, function, designation or a combination of two or more of these can be used as a password boundary access control. A few best practices followed to avoid failures in this control system are; minimum password length, avoid usage of common dictionary words, periodic change of passwords, hashing of passwords and number of entry attempts.
- **Personal Identification Numbers (PIN):** PIN is similar to a password assigned to a user by an institution a random number stored in its database independent to a user identification details, or a customer selected number. Hence, a PIN may be exposed to vulnerabilities while issuance or delivery, validation, transmission and storage.
- **Identification Cards:** Identification cards are used to store information required in an authentication process. These cards are to be controlled through the application for a card, preparation of the card, issue, use and card return or card termination phases.

- **Biometric Devices:** Biometric identification e.g. thumb and/or finger impression, eye retina etc. are also used as boundary control techniques.

(b) The key functions of IT steering committee include the following:

- To ensure that long and short-range plans of the IT department are in tune with enterprise goals and objectives;
- To establish size and scope of IT function and sets priorities within the scope;
- To review and approve major IT deployment projects in all their stages;
- To approve and monitor key projects by measuring result of IT projects in terms of return on investment, etc.;
- To review the status of IS plans and budgets and overall IT performance;
- To review and approve standards, policies and procedures;
- To make decisions on all key aspects of IT deployment and implementation;
- To facilitate implementation of IT security within enterprise;
- To facilitate and resolve conflicts in deployment of IT and ensure availability of a viable communication system exists between IT and its users; and
- To report to the Board of Directors on IT activities on a regular basis.

(c) **Physical Access Controls:** Physical Access Controls are personnel; hardware and software related and include procedures exercised on access to IT resources by employees/outside. These controls relate to establishing appropriate physical security and access control measures for IT facilities, including off-site use of information devices in conformance with the general security policy.

These Physical security and access controls should address supporting services (such as electric power), backup media and any other elements required for the system's operation. Access should be restricted to authorized individuals where IT resources are located in public areas; they should be appropriately protected to prevent or deter loss or damage from theft or vandalism. Further, IT management should ensure zero visibility.

Logical Access Controls: Logical Access Controls are implemented to ensure that access to systems, data and programs is restricted to authorized users so as to safeguard information against unauthorized use, disclosure or modification, damage or loss. The key factors considered in designing logical access controls include confidentiality and privacy requirements, authorization, authentication and incident handling, reporting and follow-up, virus prevention and detection, firewalls, centralized security administration, user training and tools for monitoring compliance, intrusion testing and reporting.

5. (a) **COBIT 5:** COBIT 5 is a globally recognized framework that acts as a benchmark for reviewing and implementing governance and management of enterprise IT. It explains how it can be used as an effective tool to help enterprises to simplify complex issues, deliver trust and value, manage risk, reduce potential public embarrassment, protect intellectual property and maximize opportunities.

Need of Enterprises to Use COBIT 5

- Using a comprehensive framework such as COBIT 5 enables enterprises in achieving their objectives for the governance and management of enterprise IT. The best practices of COBIT 5 help enterprises to create optimal value from IT by maintaining a balance between realizing benefits and optimizing risk levels and resource use.

- COBIT 5 enables IT to be governed and managed in a holistic manner for the entire enterprise, taking in the full end-to-end business and IT functional areas of responsibility, considering the IT related interests of internal and external stakeholders.
- COBIT 5 helps enterprises to manage IT related risk and ensures compliance, continuity, security and privacy.
- COBIT 5 enables clear policy development and good practice for IT management including increased business user satisfaction.
- COBIT 5 provides the tools necessary to understand, utilize, implement and direct important IT related activities, and make more informed decisions through simplified navigation and use.
- COBIT 5 is intended for enterprises of all types and sizes, including non-profit and public sector and is designed to deliver business benefits to enterprises, including:
 - Increased value creation from use of IT;
 - User satisfaction with IT engagement and services;
 - Reduced IT related risks and compliance with laws, regulations and contractual requirements;
 - Development of more business-focused IT solutions and services; and
 - Increased enterprise wide involvement in IT-related activities.

(b) Major limitations of Management Information System (MIS) are as below:

- The quality of the output of MIS is basically governed by the quantity of input and processes.
- MIS is not a substitute for effective management, which means that it cannot replace managerial judgment in making decisions in different functional areas. It is merely an important tool in the hands of executives for decision making and problem solving.

- MIS may not have requisite flexibility to quickly update itself with the changing needs of time, especially in fast changing and complex environment.
- MIS cannot provide tailor-made information packages suitable for the purpose of every type of decision made by executives.
- MIS takes into account mainly quantitative factors, thus it ignores the non-quantitative factors like morale and attitude of members of organization, which have an important bearing on the decision making process of executives or senior management.
- MIS is less useful for making non-programmed decisions. Such types of decisions are not of the routine type and thus require information, which may not be available from existing MIS to executives.
- The effectiveness of MIS is reduced in enterprises, where the culture of hoarding information and not sharing with other holds.
- MIS effectiveness decreases due to frequent changes in top management, organizational structure and operational team.

(c) **Business Continuity Management (BCM) Process:** The Business Continuity Management (BCM) process enables the business continuity, capacity and capability to be established and maintained. The capacity and capability are established in accordance to the requirements of the enterprise. The stages involved in BCM Process are as follows:

- **BCM – Information Collection Process:** The activities of assessment process do the prioritization of an enterprise's products and services and the urgency of the activities that are required to deliver them. This sets the requirements that will determine the selection of appropriate BCM strategies in the next process.
- **BCM – Strategy Process:** Finalization of business continuity strategy requires assessment of a range of strategies. This

requires an appropriate response to be selected at an acceptable level and during and after a disruption within an acceptable timeframe for each product or service, so that the enterprise continues to provide those products and services. The selection of strategy will take into account the processes and technology already present within the enterprise.

- **BCM – Development and Implementation Process:** Development of a management framework and a structure of incident management, business continuity and business recovery and restoration plans.
- **BCM Testing and Maintenance Process:** BCM testing, maintenance and audit testify the enterprise BCM to prove the extent to which its strategies and plans are complete, current and accurate and identifies opportunities for improvement.
- **BCM Training Process:** Extensive trainings in BCM framework, incident management, business continuity and business recovery and restoration plans enable it to become part of the enterprise's core values and provide confidence in all stakeholders in the ability of the enterprise to cope with minimum disruptions and loss of service.

6. (a) Some of the controls for environmental exposures are as follows:

- **Water Detectors:** In the computer room, water detectors should be placed under the raised floor, near drain holes, and near any unattended equipment storage facilities.
- **Hand-Held Fire Extinguishers:** Fire extinguishers should be in calculated locations throughout the area. They should be tagged for inspection and inspected at least annually.
- **Manual Fire Alarms:** Hand-pull fire alarms should be purposefully placed throughout the facility. The resulting audible alarm should be linked to a monitored guard station.

- **Smoke Detectors:** Smoke detectors are positioned at places above and below the ceiling tiles. Upon activation, these detectors should produce an audible alarm and must be linked to a monitored station (for example, a fire station) Fire repression systems should be supplemented and not replaced by smoke detectors.
- **Fire Suppression Systems:** These alarms are activated when extensive heat is generated due to fire. Like smoke alarms they are designed to produce audible alarms when activated and should be regularly monitored.
- **Strategically Locating the Computer Room:** To reduce the risk of flooding, the computer room should not be located in the basement or ground floor of a multi-storey building. The computer room located in the top floors is less prone to the risk of fire, smoke and water.
- **Regular Inspection by Fire Department:** An annual inspection by the fire department should be carried out to ensure that all fire detection systems act in accordance with building codes.
- **Fireproof Walls, Floors and Ceilings surrounding the Computer Room:** Information processing facility should be surrounded by walls that should control or block fire from spreading. The surrounding walls should have at least three hour fire resistance rating.
- **Electrical Surge Protectors:** The risk of damage due to power spikes can be reduced to a great extent using electrical surge protectors. Such protectors are typically built into the Uninterruptible Power System (UPS).
- **Uninterruptible Power System (UPS)/Generator:** In case of a power failure, the UPS provides the back up by providing electrical power from the battery to the computer for a certain span of time.

- **Power Leads from Two Substations:** Electrical power lines that are exposed to many environmental dangers such as waters fire, lightning, cutting due to careless digging etc. To avoid these types of events, redundant power links should feed into the facility. Interruption of one power supply does not adversely affect electrical supply.
- **Emergency Power-Off Switch:** When the need arises for an immediate power shut down during situations like a computer room fire or an emergency evacuation, an emergency power-off switch at the strategic locations would serve the purpose. They should be easily accessible and yet secured from unauthorized people.
- **Wiring Placed in Electrical Panels and Conduit:** To reduce the risk of electrical fires occurring and spreading, wiring should be placed in the fire resistant panels and conduit. This conduit generally lies under the fire-resistant raised floor in the computer room.
- **Prohibitions against Eating, Drinking and Smoking within the Information Processing Facility:** These activities should be prohibited from the information processing facility. This prohibition should be clear, e.g. a sign on the entry door.
- **Fire Resistant Office Materials:** The materials used in the information processing facility such as Wastebaskets, curtains, desks, cabinets and other general office materials should be fire proof.
- **Documented and Tested Emergency Evacuation Plans:** Relocation plans should emphasize human safety, but should not leave information processing facilities physically unsecured.

(b) **Control Risk:** Control Risk is the risk that could occur in an audit area and which could be material, individually or in combination with other errors, will not be prevented or detected and corrected

on a timely basis by the internal control system. Control risk is a measure of the auditor's assessment of the likelihood that risk exceeding a tolerable level and will not be prevented or detected by the client's internal control system. This assessment includes an assessment of whether a client's internal controls are effective for preventing or detecting gaps and the auditor's intention to make that assessment at a level below the maximum (100 percent) as a part of the audit plan.

Detection Risk: Detection Risk is the risk that the IT auditor's substantive procedures will not detect an error which could be material, individually or in combination with other errors. For example, the detection risk associated with identifying breaches of security in an application system is ordinarily high because logs for the whole period of the audit are not available at the time of the audit. The detection risk associated with lack of identification of disaster recovery plans is ordinarily low since existence is easily verified.

(c) **Audit of Environmental Controls:** Audit of environmental controls requires the Information System auditor to conduct physical inspections and observe practices. The Auditor should verify that:

- The Infrastructure Planning and Facilities (IPF) and the construction with regard to the type of materials used for construction;
- The presence of water and smoke detectors, power supply arrangements to such devices, and testing logs;
- The location of fire extinguishers, firefighting equipment and refilling date of fire extinguishers;
- Emergency procedures, evacuation plans and marking of fire exists. There should be half-yearly Fire drill to test the preparedness;

- Documents for compliance with legal and regulatory requirements with regards to fire safety equipment, external inspection certificate and shortcomings pointed out by other inspectors/auditors;
- Power sources and conduct tests to assure the quality of power, effectiveness of the power conditioning equipment, and generators. Also the power supply interruptions must be checked to test the effectiveness of the back-up power;
- Environmental control equipment such as air-conditioning, dehumidifiers, heaters, ionizers etc;
- Compliant logs and maintenance logs to assess if Mean Time Between Failures (MTBF) and Mean Time To Repair (MTTR) are within acceptable levels; and
- Identify undesired activities such as smoking, consumption of eatables etc.

7. (a) **Strategic Planning:** In the context of Information systems, strategic planning refers to the planning undertaken by top management towards meeting long-term objectives of the enterprise. Strategic planning is the process by which top management determines overall organizational purposes and objectives and how they are to be achieved. It is defined as the process of deciding on objectives of the enterprise, on changes in these objectives, on the resources used to attain these objectives, and on the policies that are to govern the acquisition, use, and disposition of these resources.

(b) **Back-up Controls:** Backup controls ensure the availability of system in the event of data loss due to unauthorized access, equipment failure or physical disaster; the organization can retrieve its files and databases.

Backup refers to making copies of the data so that these additional copies may be used to restore the original data after a data loss. Backup controls ensure the availability of system in the event of

data loss due to unauthorized access, equipment failure or physical disaster; the organization can retrieve its files and databases. Various backup strategies are given as follows:

- **Dual recording of data:** Under this strategy, two complete copies of the database are maintained. The databases are concurrently updated.
- **Periodic dumping of data:** This strategy involves taking a periodic dump of all or part of the database. The database is saved at a point in time by copying it onto some backup storage medium – magnetic tape, removable disk, Optical disk. The dump may be scheduled.
- **Logging input transactions:** This involves logging the input data transactions which cause changes to the database. Normally, this works in conjunction with a periodic dump. In case of complete database failure, the last dump is loaded and reprocessing of the transactions are carried out which were logged since the last dump.
- **Logging changes to the data:** This involves copying a record each time it is changed by an update action. The changed record can be logged immediately before the update action changes the record, immediately after, or both.

(c) Following are some of the limitations of the use of the continuous audit system:

- Auditors should be able to obtain resources required from the organization to support development, implementation, operation, and maintenance of continuous audit techniques.
- Continuous audit techniques are more likely to be used if auditors are involved in the development work associated with a new application system.

- Auditors need the knowledge and experience of working with computer systems to be able to use continuous audit techniques effectively and efficiently.
- Continuous auditing techniques are more likely to be used where the audit trail is less visible and the costs of errors and irregularities are high.
- Continuous audit techniques are unlikely to be effective unless they are implemented in an application system that is relatively stable.

(d) **ISO 27001:** ISO 27001 is the international best practice and certification standard for an Information Security Management System (ISMS). An ISMS is a systematic approach to manage Information security in an IS environment. It encompasses people and, processes. ISO 27001 defines how to organize information security in any kind of organization, profit or non-profit, private or state-owned, small or large. Four phases of ISMS are as follows:

- **The Plan Phase** – This phase serves to plan the basic organization of information security, set objectives for information security and choose the appropriate security controls (the standard contains a catalogue of 133 possible controls).
- **The Do Phase** – This phase includes carrying out everything that was planned during the previous phase.
- **The Check Phase** – The purpose of this phase is to monitor the functioning of the ISMS through various “channels”, and check whether the results meet the set objectives.
- **The Act Phase** – The purpose of this phase is to improve everything that was identified as non-compliant in the previous phase.

(e) Some of the characteristics of Cloud Computing are as follows:

- **High Scalability:** Cloud environments enable servicing of business requirements for larger audiences, through high scalability.
- **Agility:** The cloud works in the 'distributed mode' environment. It shares resources among users and tasks, while improving efficiency and agility (responsiveness).
- **High Availability and Reliability:** Availability of servers is supposed to be high and more reliable as the chances of infrastructure failure are minimal.
- **Multi-sharing:** With the cloud working in a distributed and shared mode, multiple users and applications can work more efficiently with cost reductions by sharing common infrastructure.
- **Services in Pay-Per-Use Mode:** Service Level Agreements (SLAs) between the provider and the user must be defined when offering services in pay per use mode. This may be based on the complexity of services offered.
- **Virtualization:** This technology allows servers and storage devices to increasingly share and utilize applications, by easy migration from one physical server to another.
- **Performance:** It is monitored and consistent and loosely coupled architectures are constructed using web services as the system interface.
- **Maintenance:** The cloud computing applications are easier, because they are not to be installed on each user's computer and can be accessed from different places.

Test Series: February, 2015

MOCK TEST PAPER – 1

FINAL: GROUP – II

PAPER – 7 : DIRECT TAX LAWS

SUGGESTED ANSWERS/HINTS

1. (a) Computation of total income of Mr. Shivpal for the A.Y.2015-16

Particulars	Rs.	Rs.
<u>Income from house property</u>		
Self-occupied portion (50%)		
Annual Value under section 23(2)	Nil	
Less: Deduction under section 24(b)		
Interest on housing loan [Rs. 52,000 × 50%]	26,000	(26,000)
Let-out portion (50%)		
Income of rented out portion being rent of Rs. 8,500 p.m. received for 12 months (Rent received has been taken as the GAV in the absence of other information).	1,02,000	
Gross Annual Value under section 23(1) (Rs. 8,500×12)		
Less: 50% of municipal taxes paid allowable in respect of rented out portion (i.e., 50% of Rs. 2,500)	<u>1,250</u>	
Net Annual Value (NAV)	1,00,750	
Less: Deduction under section 24		
30% of NAV under section 24(a)	30,225	
Interest on housing loan under section 24(b)	26,000	44,525
		18,525

<u>Profits and gains of business or profession</u>		
Net profit as per profit and loss account of wholesale business of textiles and fabrics	3,35,500	
<i>Add:</i> Expenses charged in profit and loss account either not allowable or to be considered separately -		
Personal travelling expenses of proprietor	12,750	
Purchase of furniture wrongly debited to shop expenses	25,000	
	3,73,250	
 <i>Less:</i> Depreciation on furniture @ 10% on Rs. 25,000	 <u>2,500</u>	 <u>3,70,750</u>
Gross Total Income		3,89,275
 <i>Less:</i> Deduction under Chapter VI-A		
Under section 80C		
- Life insurance premium		
Self	12,500	
Wife	13,500	
Son and daughter	28,000	
- Bonds issued by NABARD	50,000	
	1,04,000	

Maximum allowable upto Rs. 1.50 lakh (section 80CCE)	1,04,000	
Under section 80D [Medical insurance premium]		
Mediclaim insurance premium of Rs. 22,500, restricted to Rs. 20,000 being maximum allowable for a Senior Citizen	20,000	1,24,000
Total Income		<u>2,65,275</u>
Total Income (rounded off)		2,65,280
Tax on total income of Rs. 2,65,280 (The basic exemption limit for senior citizen is Rs. 3,00,000)		Nil

- (b) As per section 64(1)(iv), income arising from assets transferred without adequate consideration by an individual to his spouse is liable to be clubbed in the hands of the individual. It may be noted that income on the asset transferred has to be clubbed but if there is accretion to the asset, any further income derived on such accretion should not be clubbed.

Therefore, applying the provisions of section 64(1)(iv), Rs. 30,000, being the interest on debentures received by Mrs. Sushma Thakur in September, 2014 will be clubbed with the income of Mr. Thakur, since he had transferred the debentures of the company without consideration to her in October, 2012.

However, the interest of Rs. 3,000 upto March 2015 earned by Mrs. Sushma Thakur on the interest on the debentures deposited by her with Sridhar Finance Company shall be taxable in her individual capacity and will not be clubbed with the income of Mr. Thakur.

**(c) Computation of Net Wealth of Mr. Gupta on valuation date 31st
March, 2015**

	Particulars	Rs.
(i)	Cars used for professional work is an asset u/s 2(ea)(ii)	25,00,000
(ii)	Car used for personal purpose is an asset u/s 2(ea)(ii)	15,00,000
(iii)	Laptop used for personal purposes is not an asset u/s 2(ea)	Nil
(iv)	Desktop/Scanner/Printer used in office for professional work are not assets u/s 2(ea)	Nil
(v)	Bank term deposits is not an asset u/s 2(ea)	Nil
(vi)	Shares of various listed and unlisted companies is not an asset under section 2(ea)	Nil
(vii)	Urban land purchased in the name of handicapped son is not a deemed asset as per section 4(1)(a)(ii)	Nil
(viii)	Jewellery purchased from NRE account on 1.12.2013 is exempted under section 5(v)	Nil
(ix)	House purchased from NRE account prior to one year of return and also was on rent for less than 300 days (i.e. 274 days) is an asset under section 2(ea), but exempt by virtue of section 5(vi)	Nil
(x)	Amount withdrawn from bank and held in the form of cash on valuation date in excess of Rs. 50,000 is an asset u/s 2(ea)(vi)	1,50,000
(xi)	Value of jewellery gifted to wife is includible under section 4(1)(a)(i) as deemed wealth.	
		<u>2,00,000</u>
		<u>0</u>

Gross Wealth	43,50,000
Less: Debts incurred in relation to an asset u/s 2(ea), namely, loan against cars used for professional work is deductible	<u>5,00,000</u>
Net Wealth	<u>38,50,000</u>

Reasons for inclusion or exclusion of the various items are furnished below:

- (i) Motor Cars, whether used for professional or personal purposes is an asset as per section 2(ea)(ii) and, therefore, included in the net wealth. Only motor cars used by the assessee in the business of running on hire are exempt from wealth-tax.
- (ii) Laptop used for personal purposes is not an asset under section 2(ea). Hence, the same is not to be included in net wealth.
- (iii) Desktop/Scanner/Printer used in office for professional work are not assets under section 2(ea) and hence are not to be included in net wealth.
- (iv) Bank term deposits are not assets under section 2(ea) and hence are not to be included in the net wealth.
- (v) Shares of various listed and unlisted companies are not assets under section 2(ea) and hence are not to be included in net wealth.
- (vi) According to section 4(1)(a)(ii), net wealth of an individual shall include assets held by his minor child, other than a minor suffering from any disability of any nature specified in section 80U of the Income-tax Act, 1961. Therefore, urban land purchased in the name of handicapped son is not to be included in the hands of the individual, assuming that the

disability is of the nature specified in section 80U of the Income-tax Act, 1961.

- (vii) Clause (v) of section 5 seeks to provide wealth-tax exemption in respect of assets acquired by an individual out of moneys brought into India within one year immediately preceding the date of his return and at any time thereafter. Moneys standing to the credit of the person (to whom this clause is applicable) in a NRE account in any Bank in accordance with the Foreign Exchange Regulation Act, 1973 and rules made thereunder on the date of his return shall be deemed to be moneys brought by him into India on that date. Since section 5(v) exempts the value of asset acquired out of money from NRE account within one year immediately preceding the date of return or at any time thereafter, jewellery purchased from NRE account on 1.12.2013 is exempt from wealth-tax.
- (viii) According to section 2(ea)(i), any residential property that has been let out for a minimum period of 300 days in the previous year is not an asset. Since the house purchased from NRE account is prior to one year of return of Mr. Gupta and also was on rent for less than 300 days (i.e. 274 days) and, therefore, it is an asset under section 2(ea). However, one house belonging to an individual is exempt under section 5(vi). Exemption under section 5(vi) can, therefore, be claimed in respect of this house.
- (ix) Cash in hand, in excess of Rs. 50,000 constitute an asset in case of an individual. Therefore, Rs. 1,50,000, being cash in hand in excess of Rs. 50,000, is to be included in net wealth.
- (x) According to section 4(1)(a)(i), net wealth of an individual shall include assets held by spouse of such individual to whom such assets have transferred by the individual, otherwise than for inadequate consideration. Therefore, by virtue of this deeming provision, jewellery worth of Rs. 2,00,000 gifted to

wife would be included in the net wealth of Mr. Gupta.

- (xi) Cars used for professional work is an asset under section 2(ea) and therefore debt incurred in relation to such asset is a deductible as per section 2(m) in computing the net wealth.

2. (i) Computation of total income of TPO Ltd. for the A.Y.2015-16

Particulars	Rs.	Rs.
Net profit as per profit and loss account		9,00,000
<i>Add</i> Cost of the new building – written off is a capital expenditure – disallowed (Notes 1 & 2)	10,00,000	
Land development charges paid to State Industrial Development Corporation is a capital expenditure – hence disallowed (Note 5)	1,50,000	
Fees paid to ROC for issuing bonus shares is revenue expenditure – hence allowed. [<i>CIT v. General Insurance Corpn (2006) 156 Taxman 96 (SC)</i>] (Note 7)	Nil	
Interest on deposit to non-resident buyers without deduction of tax at source – disallowed under section 40(a)(i) (Note 8)	70,000	
Interest to bank on overdraft for payment of income-tax dues – disallowed as per Supreme Court's decision in <i>East India Pharmaceutical Works Ltd. v. CIT (1997) 224 ITR 627</i> (Note 9)	40,000	
Depreciation on investments not held as stock-in-trade (Note 11)	4,80,000	
Under valuation of stock (Rs. 1,17,000)		

- Rs. 90,000) x 10/90 (Note 10)	3,00 0	17,43,0 00
		26,43,0 00
Less Depreciation on building @10% on Rs. : 10 Lacs (Notes 1 & 2)		1,00,00 0
Business Income		25,43,0 00
Les Set-off of business loss and s: unabsorbed depreciation Business loss of A.Y.2006-07 cannot be set-off against business income of the current year, since business loss can be carried forward for a maximum period of 8 years only. Business loss of A.Y.2012-13	- 4,00,00 0	
Long-term capital loss of A.Y.2013-14 cannot be set-off against business income since as per section 74, long- term capital loss can be set-off only against long-term capital gains. Unabsorbed depreciation	- 12,50,0 00	
Total Income		16,50,0 00 = 8,93,0 00

(ii) Tax on total income as computed under the Income-tax Act, 1961

Particulars	Rs.
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Tax on total income of Rs. 8.93 Lacs	2,67,900
Add: Education cess and SHEC @ 3%	<u>8,037</u>
Tax on total income	<u>2,75,937</u>

Computation of tax as per section 115JB

Particulars	Rs.
Net profit as per profit and loss account	9,00,000
Add: Decrease in value of investment not eligible for deduction if the amount is set aside by way of provision for diminution in value of asset	<u>4,80,000</u>
	13,80,000
Less: Business loss of Rs. 2 Lacs (as per books of account as on 01.04.2014), since it is lower than the unabsorbed depreciation of Rs. 12.50 Lacs	<u>2,00,000</u>
Book Profit	<u>11,80,000</u>
18.50% of book profit	2,18,300
Add: Education cess and SHEC @ 3%	

	<u>6,549</u>
	<u>2,24,84</u>
	<u>9</u>

Since the income-tax payable on the total income of the company computed under the Income-tax Act, 1961 is not less than 18.50% of its book profit, section 115JB will not apply for A.Y.2015-16.

Notes:

1. As per *Explanation 1 to section 32(1)*, where an assessee carries on business or profession in a building which is not owned by him but in respect of which he holds a lease or other right of occupancy, depreciation is to be allowed on account of any capital expenditure incurred by the assessee on construction of any structure for improvement/ renovation of the building as if the structure is a building owned by the assessee. Therefore, depreciation is allowable on the capital expenditure of Rs. 10 Lacs incurred by TPO Ltd. towards the cost of the new building put up after demolition of the old building.
2. The rate of depreciation on buildings is 10%. Since it is put to use for more than 180 days during the previous year 2014-15, full depreciation is allowable.
3. Payment of annual fees for technical services to a foreign collaborator is an allowable business expense and has been correctly charged to profit and loss account. Therefore, no adjustment is required.
4. Sales tax refund from the Government has to be treated as a revenue receipt. Since it has been correctly credited to profit and loss account, no adjustment is required.
5. Land development charges paid to SIDC on allotment of a commercial plot is a capital expenditure [*Jaswant Trading Co. v. CIT (1995) 212 ITR 293 (Raj)*]

6. Section 37(1) does not make any distinction between expenditure incurred in civil litigation and that incurred in criminal litigation. If the expenditure is *bona fide* incurred wholly and exclusively for the purpose of the business, it is allowable as deduction [*CIT v. Birla Cotton Spinning & Weaving Mills Ltd. (1971) 82 ITR 166 (SC)*]. Therefore, in this case, since legal expenses were incurred by the company for defending the Director in a criminal case filed against him in his official capacity, it is allowable as deduction.
7. Fees paid to Registrar of Companies for enhancement of authorised capital to issue bonus shares is deductible since it is related to issue of bonus shares. Alternatively, if it is a mere increase in authorized capital then such expenditure is a capital expenditure and not deductible under section 37(1)[*Punjab State Industrial Development Corporation Ltd. v. CIT (1997) 225 ITR 792 (SC)*].
8. Since no tax has been deducted at source on payment of interest to non-residents, interest paid will not be allowed as a deduction as per section 40(a)(i).
9. Interest paid to bank on overdraft for payment of income-tax dues is not an expenditure incurred wholly and exclusively for the purpose of business and is hence, not deductible under section 37(1) as per the Supreme Court's decision in *East India Pharmaceutical Works Ltd. v. CIT (1997) 224 ITR 627*.
10. The under valuation of both opening and closing stocks will have an impact on the profits for the year and accordingly, the difference in valuation of stock has to be credited to profit and loss account to the extent of 10% of cost.
11. Value of investment written down is on capital account and hence not allowed, even if such write down was on a directive from the Government. Clause (i) of *Explanation 1* to section 115JB provides for increasing the net profit if any amount is set

side as provision for diminution in the value of any asset. Though it is stated as written off in the question, it is assumed that the charge to profit and loss account is by way of provision to meet possible loss in future and accordingly adjusted in the solution while computing book profit.

3. (a) The allowability/chargeability of each of the transactions entered into by M/s Bajrangi Enterprises for the purpose of computation of income for Assessment Year 2015-16 shall be as under:-
- (i) The surgical instruments used by a firm engaged in the business of running a hospital are covered under the category of Plant & Machinery, on which the rate of depreciation is 15%. The depreciation on the instruments imported from U.K. is allowable to the firm since the same were put to use during the previous year ended on 31.3.2015 because of performing of one operation. However, the same were used in the previous year for less than 180 days and accordingly the allowable depreciation will be one half of the normal depreciation. The cost of instruments is Rs. 3 lacs and the amount of depreciation thereon works out to Rs. 22,500 [$\text{Rs. } 3,00,000 \times 15\% \times 50\%$].
 - (ii) As per section 40(b), payment of remuneration to a working partner is allowable as deduction only if it is authorised by and in accordance with the terms of the partnership deed. *CBDT Circular No.739 dated 25.3.1996* clarifies that no deduction in respect of remuneration paid to partners is allowable unless the partnership deed either specifies the amount of remuneration payable to each individual working partner or lays down the manner of quantifying such remuneration. If the partnership deed contains a clause for payment of salary to working partners without specifying the manner of quantification or manner of distribution of such salary, the payment of salary to the working partners cannot be construed to be authorised by and in

accordance with the partnership deed and hence the same shall not be allowable.

- (iii) Section 40A(2) provides that if any expenditure in respect of which payment has been made to, *inter alia*, any relative of the partner of a firm and the Assessing Officer is of the opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the services for which the payment is made, then disallowance under this section is attracted to the extent the same is excessive or unreasonable. In this case, salary of Rs. 10,000 p.m. is paid to the partner's wife, who is working as an anesthetist. The fair market value of a similar service is Rs. 7,500 p.m. Therefore, disallowance under section 40A(2) is attracted to the extent of Rs. 2,500 p.m., since to that extent, the same is excessive.
- (iv) Section 40A(3) provides for 100% disallowance of an expenditure, in respect of which payment is made in a sum exceeding Rs. 20,000 otherwise than by way of account payee cheque or account payee bank draft. Therefore, the entire amount of Rs. 35,000 incurred for purchase of medicines in cash is disallowed under section 40A(3).
- (v) Section 36(1)(ix) provides for deduction of 1/5th of capital expenditure incurred by companies to promote family planning amongst its employees. However, since the assessee in this case is a partnership firm, such expenses are not allowable as deduction under section 36(1)(ix).
- (vi) Interest on the overdraft taken for making payment of installment of advance tax is not allowable under section 37(1) since it is not an expenditure wholly and exclusively incurred for the purpose of business as held by the Apex Court in the case of *East India Pharmaceutical Works Ltd. v. CIT (1997) 224 ITR 627*.

(b) Computation of income under the head "Salaries" for the

A.Y.2015-16

Particulars	Rs.
Salary (Rs. 12,000 x 9)	1,08,000
Dearness allowance (Rs. 2,000 x 9)	18,000
City coampensatory allowance (Rs. 300 x 9)	2,700
Entertainment allowance (Rs. 1,000 x 9)	9,000
House rent allowance [See Note 1]	6,300
Pension (Uncommuted) (Rs. 6,000 + Rs. 3,000 x 2) [See Note 4]	12,000
Commuted pension (Rs. 1,80,000 – Rs. 1,20,000) [See Note 3]	60,000
Gross salary	2,16,000
Less: Deduction under section 16 [See Note 5]	<i>Nil</i>
Income from salary	2,16,000

Note:

1. As per section 10(13A), house rent allowance will be exempt to the extent of minimum of the following three amounts:
 - (i) 50% of salary i.e. Rs. 54,000 (Assuming the dearness allowance is not included in for superannuation benefits).
 - (ii) Rent paid minus 10% of salary i.e., Rs. 4,500 – Rs. 1,200 = Rs. 3,300 x 9 = Rs. 29,700
 - (iii) HRA received Rs. 4,000 x 9 = Rs. 36,000

Therefore, out of Rs. 36,000, Rs. 29,700 will be exempt and the balance Rs. 6,300 will be included in Gross Salary.
2. Gratuity of Rs. 80,000 is fully exempt under section 10(10)(iii), being the minimum of the following amounts:

- (i) Actual gratuity received, i.e., Rs. 80,000
- (ii) Half month's average salary for every completed year of service i.e.,

$$\frac{\text{Average monthly salary}}{2} \times 18 \text{ i.e. } \frac{12,000 \times 18}{2} = \text{Rs. } 1,08,000$$

- (iii) Notified limit i.e., Rs. 10,00,000

3. As Raman is receiving gratuity, one-third of commuted pension will be exempt and the balance would be taxable. 50% of the pension commuted is Rs. 1,80,000. Therefore, 100% would be Rs. 3,60,000 and one-third of the same would be Rs. 1,20,000. The taxable portion of the commuted pension would be Rs. 60,000 (i.e. Rs. 1,80,000 - Rs. 1,20,000).

4. Since employer's contribution to recognized provident fund is less than 12% of salary, it is not taxable. Accumulated balance of the recognized provident fund received is exempt from tax, since Raman has rendered continuous service of more than five years.

5. Deduction under section 16(ii) in respect of entertainment allowance can be claimed only by Government employees. Therefore, Raman is not eligible for any deduction in respect of entertainment allowance received by him.

6. Pension of January 2015 Rs. 6,000 plus pension after commutation (Rs. 6,000 less 50%) Rs. 3,000 for February and March 2015. (Rs. 6,000 + Rs. 3,000 + Rs. 3,000).

(c) The following category of individuals will be treated as resident in India only if the period of their stay in India during the relevant previous year is 182 days or more :-

- (i) Indian citizens, who leave India in any previous year, *inter alia*, for purposes of employment outside India, or
- (ii) Indian citizen or person of Indian origin engaged outside India,

inter alia, in an employment, who comes on a visit to India in any previous year.

- (1) Since Garima is leaving India for the purpose of employment outside India, she will be treated as resident only if the period of her stay during the previous year amounts to 182 days or more. Therefore, Garima should leave India on or before 28th September, 2014, in which case, her stay in India during the previous year would be less than 182 days and she would become non-resident for the purpose of taxability in India. In such a case, only the income which accrues or arises in India or which is deemed to accrue or arise in India or received or deemed to be received in India shall be taxable.

The income earned by her in Australia would not be chargeable to tax in India for A.Y. 2015-16, if she leaves India on or before 28th September, 2014.

- (2) If any part of Garima's salary will be credited directly to her bank account in Kolkata then, that part of her salary would be considered as income received in India during the previous year under section 5 and would be chargeable to tax under Income-tax Act, 1961, even if she is a non-resident. Therefore, Garima should receive her entire salary in Australia and then remit the required amount to her bank account in Kolkata in which case, the salary earned by her in Australia would not be subject to tax in India.
- (3) In case Garima visits India after taking up employment outside India, she would be covered in the exception provided in (ii) above and she will be treated as resident only if the period of her stay during the relevant previous year amounts to 182 days or more.

Therefore, when Garima comes India on leave, she should

stay in India for less than 182 days during the relevant previous year so that her status remains as a non-resident for the relevant previous year. Moreover, she should not visit India again during the current previous year i.e. P.Y. 2014-15.

4. (a) Computation of total income of A Limited for the A.Y. 2015-16

Particulars	Rs.(in lacs)	
Business income		
Business income before setting-off brought forward losses of S Ltd.		140
Add: Excess depreciation claimed in the scheme of amalgamation of S Limited with A Limited.		
Value at which assets are transferred by S Ltd.	150	
WDV in the books of S Ltd.		
	<u>100</u>	
Excess accounted	50	
Excess depreciation claimed in computing taxable income of A Ltd. [Rs. 50 lacs × 15 %] [Explanation 2 to section 43(6)]		<u>7.50</u>
		147.50
Set-off of brought forward business loss of S Ltd. (See Notes 2 & 4)		(120.00)
Set-off of unabsorbed depreciation under section 32(2) read with section 72A (See Notes 2 & 4)		(18.00)
Set-off of unabsorbed capital expenditure under section 35(1)(iv) read with section 35(4) (See Note 5)		<u>(2.00)</u>

Notes:

1. It is presumed that the amalgamation is within the meaning of section 72A of the Income-tax Act, 1961.
2. In the case of amalgamation of companies, the unabsorbed losses and unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or unabsorbed depreciation of the amalgamated company for the previous year in which the amalgamation was effected and such business loss and unabsorbed depreciation shall be carried forward and set-off by the amalgamated company for a period of 8 years and indefinitely, respectively.
3. As per section 72A(7), the accumulated loss to be carried forward specifically excludes loss sustained in a speculative business. Therefore, speculative loss of Rs. 4 lacs of S Ltd. cannot be carried forward by A Ltd.
4. Section 72(2) provides that where any allowance or part thereof unabsorbed under section 32(2) (i.e., unabsorbed depreciation) or section 35(4) (i.e., unabsorbed scientific research capital expenditure) is to be carried forward, effect has to be first given to brought forward business losses under section 72.
5. Section 35(4) provides that the provisions of section 32(2) relating to unabsorbed depreciation shall apply in relation to deduction allowable under section 35(1)(iv) in respect of capital expenditure on scientific research related to the business carried on by the assessee. Therefore, unabsorbed capital expenditure on scientific research can be set-off and carried forward in the same manner as unabsorbed depreciation.

6. The restriction contained in section 73 is only regarding set-off of loss computed in respect of speculative business. Such a loss can be set-off only against profits of another speculation business and not non-speculation business. However, there is no restriction under the Income-tax Act, 1961 regarding set-off of normal business losses against speculative income. Therefore, normal business losses can be set-off against profits of a speculative business.

Consequently, there is no loss or allowance to be carried forward by A Ltd. to the F.Y. 2014-15.

(b) Computation of tax liability of Shivani for the A.Y. 2015-16

Particulars	Rs.
Indian Income	5,10,000
Foreign Income	<u>1,10,000</u>
	<u>0</u>
Gross Total Income	6,20,000

Less: <u>Deduction under section 80C</u>		
Deposit in PPF	1,50,000	
	<u>0</u>	
<u>Under section 80CCC</u>		
Contribution to approved Pension Fund of LIC	<u>32,000</u>	
	<u>1,82,000</u>	
	<u>0</u>	
<u>Under section 80CCE</u>		
The aggregate deduction under section 80C, 80CCC and 80CCD(1) has to		

be restricted to	Rs. 1,50,000	1,50,000	
		0	
<u>Under section 80D</u>			
Contribution to Central Government Health Scheme Rs. 18,000 is also allowable as deduction under section 80D. Since she is a senior citizen, the deduction is allowable to a maximum of Rs. 20,000 (See Note 1)			
		18,000	
Medical insurance premium of Rs. 21,000 paid for father aged 84 years. Since the father is a non-resident in India, he will not be entitled for the higher deduction of Rs. 20,000 eligible for a senior citizen, who is resident in India. Hence, the deduction will be restricted to maximum of Rs. 15,000.			
		15,000	1,83,000
			0
Total Income			4,37,000
			0
<u>Tax on Total Income</u>			
Income-tax (See Note below)		13,700	
Less: Rebate u/s 87A		2,000	
		11,700	
Add : Education cess @ 2%		234	
Add: Secondary and higher education cess @ 1%		117	12,051
Average rate of tax in India (i.e. Rs. 12,051/ Rs. 4,37,000 × 100)	2.7577		
	%		
Average rate of tax in foreign country	10%		

(i.e. Rs. 11,000/ Rs. 1,10,000 ×100)			
Rebate under section 91 on Rs. 1,10,000 @ 2.7577% (lower of average Indian-tax rate or average foreign tax rate)			3,033
Tax payable in India (Rs. 12,051 – Rs. 3,033)			9,018

Notes:

1. Section 80D allows a higher deduction of up to Rs. 20,000 in respect of the medical premium paid to insure the health of a senior citizen. Therefore, Shivani will be allowed deduction of Rs. 18,000 under section 80D, since she is a resident Indian of the age of 60 years.
2. The basic exemption limit for senior citizens is Rs. 3,00,000 and the age criterion for qualifying as a “senior citizen” for availing the higher basic exemption limit is 60 years. Accordingly, Shivani is eligible for the higher basic exemption limit of Rs. 3,00,000, since she is 60 years old.
3. An assessee shall be allowed deduction under section 91 provided all the following conditions are fulfilled:-
 - (a) The assessee is a resident in India during the relevant previous year.
 - (b) The income accrues or arises to him outside India during that previous year.
 - (c) Such income is not deemed to accrue or arise in India during the previous year.
 - (d) The income in question has been subjected to income-tax in the foreign country in the hands of the assessee and

the assessee has paid tax on such income in the foreign country.

- (e) There is no agreement under section 90 for the relief or avoidance of double taxation between India and the other country where the income has accrued or arisen.

In this case, since all the above conditions are satisfied, Shivani is eligible for deduction under section 91.

- 5. (a) The company had advanced a loan to an employee who in turn had advanced the same to the Managing Director of the company holding 70% of its capital. By virtue of the provisions of section 2(22)(e), the same shall be treated as the payment by a company in which public are not substantially interested, on behalf of, or for individual benefit of any such share holder (who holds not less than 10% of the voting power), to the extent to which the company possesses accumulated profits.

In this case, the company has reserves of Rs. 6 Lacs on 31st March of the preceding year and the amount of loan advanced on 1st July is Rs. 5 Lacs. Therefore, the payment is to be treated as deemed dividend. The amount of interest-free loan of Rs. 5 Lacs given by the company to the supervisor who in turn had given the same to Mr. Prem, shall be construed as the amount given for the benefit of Mr. Prem and is treated as deemed dividend chargeable to tax in the hands of Mr. Prem. This has been held by the Supreme Court in the case of *L. Alagusundaram Chettiar v. CIT (2001) 252 ITR 893/(2002) 121 Taxman 587*.

- (b) The cost of inherited property to Mr. Arjun shall be the cost to the previous owner as per provisions of section 49(1)(iii) and therefore, Rs. 5 lacs, being the cost to his father (amount paid by his father on 26.3.1981 for acquiring the property) shall be the cost to Mr. Arjun, who is the new owner. Payment of outstanding loan of the predecessor by the successor for obtaining a clear title of the property by release of Mortgage Deed shall be the cost of

acquisition of the successor under section 48 read with section 55(2) of the Act as held by the Apex Court in case of *RM. Arunachalam v. CIT* [1997] 227 ITR 222.

Computation of Taxable Capital Gain for the A.Y. 2015-16

Particulars	Rs.
Consideration of house property	50,00,000
Less: Indexed cost of acquisition (see Note below)	
(i) Cost to previous owner (Rs. 5,00,000 × 1024 / 582)	8,79,725
(ii) Loan amount paid by Mr. Arjun (Benefit of CII is available since the loan amount was paid in the financial year 2008-09) (Rs. 15,00,000 × 1024/582)	26,39,175
	<u>35,18,900</u>
Capital gains	<u>14,81,100</u>

Note: Since the property was acquired by Mr. Arjun through inheritance, the cost of acquisition will be cost to the previous owner. As per the definition of indexation cost of acquisition under *clause (iii) of Explanation below section 48*, indexation benefit will be available only from the previous year in which Arjun first held the asset i.e. P.Y. 2008-09.

However, as per the view expressed by Bombay High Court, in the case of *CIT v. Manjula J. Shah* (2012) 204 Taxman 691, in case the cost of acquisition of the capital asset in the hands of the assessee is taken to be cost of such asset in the hands of the previous owner, the indexation benefit would be available from the year in which the capital asset is acquired by the previous owner.

If this view is considered, the indexed cost of acquisition would be Rs. 77,59,175 and long term capital loss would be Rs. 27,59,175.

- (c) Section 11(1)(a) stipulates that in order to avail exemption of income derived from property held under trust wholly for charitable or religious purposes, the trust is required to apply for charitable or religious purposes, 85% of its income from such property. In this case, the trust has earned income of Rs. 3,90,000 for the year ended 31.3.2015. It has also earned short term capital gain from sale of capital asset for Rs. 9,60,000. The trust had utilized the entire amount of Rs. 13,50,000 for the purchase of a building meant for charitable purposes.

The Supreme Court in *S.R.M. M. CT. M. Tiruppani Trust v. CIT* (1998) 230 ITR 636 ruled that the assessee-trust, which applied its income for charitable purposes by purchasing a building for use as a hospital, was entitled to exemption under section 11(1) in respect of such income.

The ratio of the decision squarely applies to the case of the charitable trust in question. Therefore, the charitable trust is justified in claiming that the purchase of the building amounted to application of its income for charitable purposes.

Under section 11(1A), where the whole of the sale proceeds of a capital asset held by a charitable trust is utilised by it for acquiring another capital asset, the capital gain arising therefrom is deemed to have been applied to charitable purposes and would be exempt. Section 11(1A) does not make any distinction between a long-term capital asset and a short-term capital asset. The claim of the charitable trust to the effect that the capital gain is deemed to have been applied to charitable purposes is tenable in law.

- (d) The issue raised in the problem is based on the concept of diversion of income by overriding title, which is well recognised in the income-tax law. In the instant case, the amount of Rs. 1 lakh, being 20% of profits of the firm, paid to the mother gets diverted at

source by the charge created in her favour as per the terms of the partnership deed. Such income does not reach the assessee-firm.

Rather, such income stands diverted to the other person as such other person has a better title on such income than the title of the assessee. The firm might have received the said amount but it so received for and on behalf of the mother, who possesses the overriding title. Therefore, the amount paid to the mother should be excluded from the income of the firm. This view has been confirmed in *CIT vs. Nariman B. Bharucha & Sons (1981) 130 ITR 863 (Bom)*.

(e) Section 80-IB provides for allowing deduction in respect of profits and gains derived from eligible business of the industrial undertaking.

The issue under consideration is whether duty drawback can be regarded as “profits and gains derived from eligible business of the industrial undertaking”.

For a receipt to be treated as having been “derived from” the industrial undertaking, the same should be directly and inextricably connected with the business of the industrial undertaking. The connection should be direct and not remote.

The facts of the case are similar to the facts of the case in *Liberty India v. CIT (2009) 317 ITR 218*, wherein the Supreme Court observed that duty drawback is an incentive which flows from the schemes framed by the Central Government or from the Customs Act, 1962. Profits derived by way of incentives such duty drawback cannot be credited against the cost of manufacture of goods debited in the profit and loss account and they do not fall within the expression “profits derived from industrial undertaking” under section 80-IB. They belong to the category of ancillary profits of such undertaking. Hence, duty drawback receipts cannot form part of the profits derived from the eligible business for the purpose of the deduction under section 80-IB.

Applying the same rationale to the present case, duty drawback would not form part of profit of eligible undertaking for the purpose of deduction under section 80-IB.

6. (a) The amount of capital gains arising to Rakesh has to be computed applying the provisions of sub-section (7) of section 94, which provides that “where:
- (a) any person buys or acquires any securities or unit within a period of three months prior to the record date; and
 - (b) such person sells or transfers -
 - (i) such securities within a period of three months after such date; or
 - (ii) such unit within a period of nine months after such date; and
 - (c) the dividend or income on such securities or unit received or receivable by such person is exempted, then the loss, if any, arising to him on account of such purchase and sale of securities or unit, to the extent such loss does not exceed the amount of dividend or income received or receivable on such securities or unit, shall be ignored for the purpose of computing his income chargeable to tax”.

For this purpose, “record date” means such date as may be fixed by a company for the purpose of entitlement of the holder of the securities to receive dividend; “securities” includes stocks and shares.

Computation of capital gains of Mr. Rakesh for the assessment year 2015-16

Particulars	Rs.	Rs.
Long-term capital gain on sale of building		75,000
Less: Short-term capital loss on sale of shares		

700 shares	7,000	
300 shares	7,500	14,500
Taxable long-term capital gains		60,500

Computation of capital gain on sale of shares of P Ltd. by Mr. Rakesh

Date of purchase of shares		30.5.2014
Record date		10.8.2014
Date of sale of shares	30.9.2014	20.12.2014
Number of shares sold	700	300
Sale price per share	Rs. 35	Rs. 25
Particulars	Rs.	Rs.
Sale consideration	24,500	7,500
Less: Cost of acquisition	35,000	15,000
	10,500	7,500
Less: Dividend income as per section 94(7) [700×10×50%] [See Note below]	3,500	Not deductible
Short-term capital loss on sale of shares	7,000	7,500

Notes:

- (1) 700 shares are sold within 3 months after the record date. Hence, as per section 94(7), the related dividend income should be deducted from the loss.
- (2) 300 shares having been sold after 3 months of record date, section 94(7) is not attracted. Therefore, the dividend income of Rs. 1,500 should not be deducted. Such dividend is exempt

under section 10(34).

- (3) Short-term capital loss can be set-off against long-term capital gains as per the provisions of section 74(1)(a). Therefore, short-term capital loss on sale of shares can be set-off against long-term capital gains on sale of building.

(b) Under section 44BBA, a sum equal to 5% of the aggregate of the following amount is deemed to be the profits and gains chargeable to tax under the head "Profits and gains of business or profession" in respect of a non-resident, engaged in the business of operation of aircraft -

- (i) the amount paid or payable, whether in or out of India, to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods from any place in India; and
- (ii) the amount received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods from any place outside India.

In the present case, the income chargeable to tax of M/s Worlwide Airlines is as follows:

Particulars	Fare booked from India to outside India whether received in India or not (Rs.)	Fare booked from New York to Mumbai	
		If received in India (Rs.)	If not received in India (Rs.)
Fare	60,00,000 (1,25,00,000 – 65,00,000)	65,00,000	65,00,000
Deemed income @5% u/s 44BBA	3,00,000 (60,00,000 × 5%)	3,25,000 (65,00,000 × 5%)	Nil

- (c) The Supreme Court in its judgment in the case of *Sahney Steel And Press Works Ltd v. CIT* (1997) 228 ITR 253 (SC) has held that the payment from public funds to assist the assessee in carrying on trade or business must be treated as revenue receipt. The subsidy granted to the assessee such as sales tax refund, power concession or refund of bills paid and exemption from payment of water charges are to be treated as revenue receipts chargeable to tax. It was held that the character of the subsidy in the hands of the recipient will have to be determined having regard to the purpose for which the subsidy is given.

The subsidy in this case, was received as a matter of encouragement to commence an industry in a backward area. Whether it is received before or after commencement of production is of no consequence. Therefore, the subsidy so received as a matter of incentive is not liable to tax. However, if the subsidy was by way of refund of sales tax or power consumption etc then it is liable to tax.

7. (a) As per the facts of the case, the Assessing Officer completed the assessment before the valuation report was received. The valuation report was received subsequent to completion of the assessment. However, it may be noted that the said report forms part of the 'record', which the Commissioner may call for and examine under section 263(1). A perusal of the valuation report revealed a variation of Rs. 3 lacs and to that extent it can be said that the order of the Assessing Officer was prejudicial to the interests of Revenue and also erroneous. The Commissioner is absolutely justified in issuing notice under section 263 since the term "record" used in the said section includes all the records available at the time of examination by the Commissioner even though such records may not have been available at the time of regular assessment. This view was upheld by the Supreme Court in *CIT v. Shree Manjunathesware Packing & Camphor Works* (1998) 231 ITR 53.

- (b) The powers under section 131(1A) deal with power of discovery

and production of evidence. They do not confer the power of seizure of cash or any asset. The Director General, for the purposes of making an enquiry or investigation relating to any income concealed or likely to be concealed by any person or class of persons within his jurisdiction, shall be competent to exercise powers conferred under section 131(1), which confine to discovery and inspection, enforcing attendance, compelling the production of books of account and other documents and issuing commissions. Thus, the power of seizure of unaccounted cash is not one of the powers conferred on the Director General under section 131(1A).

However, under section 132(1), the Director General has the power to authorize any Additional Director or Additional Commissioner or Joint Director or Joint Commissioner etc. to seize money found as a result of search [Clause (iii) of section 132(1)], if he has reason to believe that any person is in possession of any money which represents wholly or partly income which has not been disclosed [Clause (c) of section 132(1)]. Therefore, the proper course open to the Director General is to exercise his power under section 132(1) and authorize the Officers concerned to enter the premises where the cash is kept by Mr. Mayank and seize such unaccounted cash.

- (c) Section 245A(b) defines the term 'case' to mean any proceeding for assessment under the Act of any person in respect of any assessment year or years which is pending before the Assessing Officer on the date on which an application is made to the Settlement Commission.

With effect from 01st October, 2014, there is no specific exclusion from the definition of 'case'. Even prior to 1st October, 2014, search and seizure cases were not excluded from the definition of 'case'. Therefore, the search cases are eligible for settlement through the Settlement Commission. Further, *Explanation* to section 245A(b), provides that in case of a person referred to in section 153A or section 153C, a proceeding for assessment or reassessment shall be deemed to have been commenced on the date of issue of notice

initiating such proceeding for assessment under section 153A or section 153C and concluded on the date on which the assessment is made. During this period, application for settlement of the case could be filed by the assesseees.

Further, section 245C provides that an application before the settlement commission in cases falling under section 153A and 153C can be made, where the additional amount of income-tax payable on income disclosed in the application exceeds Rs. 50 lakh, in respect of the tax payer who is the subject matter of search and Rs. 10 lakh, in respect of entities related to such a tax payer, who are also the subject matter of search.

Moreover, such tax and interest thereon, which would have been payable had such income been disclosed in the return of income before the Assessing Officer on the date of application, should be paid on or before the date of making the application. Further, proof of such payment should be attached with the application.

As per the provisions of section 194H, a person is liable to deduct tax at source at the time of credit or payment, whichever is earlier, of income in the nature of commission to any resident.

- (d) In the present case, Timepass Airways Ltd. correctly deducted tax at source under section 194H from the commission@9% of the published price paid to the travel agents, who were allowed to sell the air tickets at any price higher than the minimum fixed commercial price subject to a maximum of published price. However, the Assessing Officer raised a contention that the airline company was required to deduct tax at source on the difference between the published price and the minimum fixed commercial price by treating it as “additional special commission” in the hands of the agents.

The facts of the case are similar to the case of *CIT v. Qatar Airways (2011) 332 ITR 253*, where the Bombay High Court held that **the difference between the published price and the minimum fixed commercial price of the tickets cannot be**

taken as “additional special commission” in the hands of the agents. This is because the published price was the maximum price and the airline company had granted permission to the agents to sell the tickets at a price lower than the published price. Further, the airline company would have no information about the exact rate at which the tickets were ultimately sold by its agents. **In order to deduct tax at source on the difference between actual sale price and minimum fixed commercial price, the exact income in the hands of the agents must necessarily be ascertainable by the airline company.** However, it is not so ascertainable in this case, since the agents had been given discretion to sell the tickets at any rate between the minimum fixed commercial price and the published price. It would be impracticable and unreasonable to expect the airline company to get a feedback from its numerous agents in respect of the price at which tickets were sold by them.

Applying the rationale of the above case to the case on hand, Timepass Airways Ltd. is not liable to deduct tax at source under section 194H on the difference between the published price and the minimum fixed commercial price, even though the amount earned by the agent over and above minimum fixed commercial price would be taxable as income in the hands of the agent.

Therefore, the contention raised by the Assessing Officer is not tenable in law.

Test Series: February, 2015

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – II

PAPER – 8: INDIRECT TAX LAWS

SUGGESTED ANSWERS / HINTS

1. (a) Calculation of value of clearances during financial year 2013-14

Particulars	Rs. (in lakhs)
Total value of clearances during the financial year 2013-14	910
Less: VAT included in above	<u>60</u>
	850
Less:	
1. Exports excluding exports to Nepal and Bhutan Rs. (500-200) lakh	300
2. Clearances of excisable goods without payment of duty to a unit in Software Technology Park	40
3. Job work done under <i>Notification No. 84/94-CE dated 11.04.94</i> and under <i>Notification No. 214/86-CE dated 25.3.86</i> i.e..Rs. (60 + 50) lakh	<u>110</u>
Value of clearances during the financial year 2013-14	<u>400</u>

Notes:-While computing value of clearances during financial year 2013-14 (as shown above),

1. export turnover has been excluded. However, export to Nepal and Bhutan cannot be excluded as these are treated as "clearances for home consumption".
2. job work under *Notification No. 214/86 - CE* and *Notification No. 84/94-CE* is not taken into consideration.
3. clearances of excisable goods without payment of duty to a unit in Software Technology Park are deducted.
4. clearances of excisable goods bearing brand name of Khadi and Village Industries Commission are included.

In order to claim the benefit of exemption under *Notification No. 8/2003 – C.E.* in a financial year, the total turnover of a unit should not exceed Rs. 400 lakh in the preceding year. Since the value of clearances in the previous financial year 2013-14 does not exceed Rs. 400 lakh, Star & Company is eligible to claim the benefit of *Notification No. 8/2003 dated 1st March, 2003* in the financial year 2014-15.

- (b) (i) Selling of space for advertisements in print media is included in the negative list of services under clause (g) of section 66D of the Finance Act, 1994. Thus, the service tax levy extends to advertisement in all media except print media. Hence, sale of time for advertisement in radio and TV channel are liable to service tax. Similarly, advertising via banners at public places and aerial bill boards are also liable to service tax.

As per section 65B(39a) of the Finance Act, 1994, print media *inter alia* means newspaper but does not include yellow pages. Hence, sale of space for advertisements in newspapers is not liable to service tax but sale of space for advertisements in yellow pages attracts service tax.

Services relating to preparation of advertisements and canvassing advertisement for publishing on a commission basis are liable to service tax since they are not included in the negative list.

Particulars	Amount (Rs.)
Sale of space for advertisement in newspaper	-
Services related to preparation of advertisement	70,000
Sale of time for advertisement to be broadcast on radio	80,000
Advertising via banner at public places	90,000
Sale of time for advertisement to be broadcast on	1,10,00

TV Channel	0
Sale of space for advertisement in yellow pages	15,000
Advertising via aerial bill-boards	50,000
Canvassing advertisement for publishing on a commission basis	<u>35,000</u>
Value of taxable service	4,50,000
Service tax @ 12% [4,50,000 × 12%]	54,000
Education cess @ 2% [54,000 × 2%]	1,080
Secondary and higher education cess @ 1% [54,000 × 1%]	<u>540</u>
Service tax liability	<u>55,620</u>

- (ii) Since the contract entered into by PQR Construction Ltd. requires the provision of both services and material, it is 'works contract' [Section 65B(54) of the Finance Act, 1994]. Thus, services of PQR Construction Ltd. will be subject to service tax as declared service under section 66E(h) of Finance Act, 1994.

Further, since the contract is for carrying out alterations in respect of an abandoned building with a view to make it workable, it falls within the purview of term "original works" [Clause (a) of explanation 1 to rule 2A of the Service Tax (Determination of Value) Rules, 2006].

In the given case, the value of the service portion in the execution of the works contract will be determined as per rule 2A(ii)(A) of the Service Tax (Determination of Value) Rules, 2006. It provides that service tax shall be payable on 40% of the total amount charged for the works contract.

The computation of service tax payable is exhibited below:

40% of the total amount charged	Rs. 60 lakh [Rs. 150 lakh × 40%]
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Rate of service tax	12.36%
Amount of service tax payable	Rs. 7,41,600/-[which is 4.944% of the total amount charged of Rs. 150 lakh]

(c) **Computation of customs duty payable**

Particulars	Rs.
Total CIF value in INR = US \$ 50,000 x Rs. 50	25,00,000
Add: Landing charges @1%	<u>25,000</u>
Assessable value (AV)	<u>25,25,000</u>
Basic customs duty (BCD) @10%	2,52,500
Education cess (EC) @ 2% on BCD	5,050
Secondary and higher education cess (SAHEC) @ 1% on BCD	<u>2,525</u>
Landed value of imported goods	<u>27,85,075</u>
Total customs duty payable (BCD + EC+ SAHEC)	<u>2,60,075</u>

Computation of anti – dumping duty payable

Particulars	Rs.
Value of goods in INR as per Notification = 1,000 Kgs x US \$ 60 x Rs. 50	30,00,000
Less : Landed value of goods	<u>27,85,075</u>
Anti-dumping duty payable	<u>2,14,925</u>

2. (a) The proviso to rule 9 of the Central Excise Valuation (Determination of Excisable Goods) Rules, 2000 lays down that in a case where the related person does not sell the goods but uses or consumes such goods in the production or manufacture of articles, the value thereof shall be determined in the manner specified in rule 8 of the Valuation Rules which provides that the value will be 110% of the cost of production or manufacture of such goods.

Therefore, when the goods are sold to ABC Ltd., the assessable value shall be 110% of Rs. 14,000 (Rs. 14,000 × 110%) i.e., Rs. 15,400.

However, in the instant case, if ABC Ltd. is an unrelated buyer, the assessable value will be the transaction value of the goods i.e. Rs. 30,000.

- (b) Since Mr. Y has started its business in the year 2014-15, he would be entitled for small service providers exemption available under *Notification No. 33/2012 ST dated 20.06.2012*. Thus, Mr. Y will be exempt from paying service tax on the taxable services of aggregate value up to Rs.10 lakh.

However, section 69 of the Finance Act, 1994 read with the Service Tax (Registration of Special Category of Persons) Rules, 2005 provides that a provider of taxable service whose aggregate value of taxable services in a financial year exceeds Rs. 9,00,000 has to make an application for registration within a period of 30 days of exceeding the aggregate value of taxable service of Rs. 9,00,000.

The aggregate value of taxable services of Mr. Y exceeds Rs. 9,00,000 on 30.05.2014 when it issues Bill No. 7 of Rs. 1,07,000. Thus, Mr. Y should apply for registration on or before 29.06.2014. However, the application for registration is made on 22.08.2014. Thus, there is delay of total 54 days.

Mr. Y will, therefore, be liable to a penalty which may extend upto Rs.10,000.

- (c) (i) As per section 74 of the Customs Act, 1962, the duty paid imported goods are required to be entered for export within two years from the date of payment of duty on the importation. This period can be extended by CBEC if the importer shows sufficient reason for not exporting the goods within two years.
- (ii) If duty paid imported goods are exported without use, then 98% of such duty is re-paid as drawback.

(iii) Yes, duty drawback is allowed when wearing apparels are re-exported without being used. However, *Notification No. 19/65 Cus. dated 06.02.1965* as amended provides that if wearing apparels have been used after their importation into India, drawback of import duty paid thereon shall not be allowed when they are exported out of India.

3. (a) The facts of the given case are similar to the case of *Medley Pharmaceuticals Ltd. v. CCE & C., Daman 2011 (263) E.L.T. 641 (S.C.)*. In the instant case, the Supreme Court observed that merely because a product was statutorily prohibited from being sold would not mean that the product was not marketable. Sale is not a necessary condition for charging duty as excise duty is payable in case of free supply also. The Supreme Court observed that since physician samples were capable of being sold in open market, the same were marketable and thus, liable to excise duty.

Moreover, since the Drugs and Cosmetics Act, 1940 (Drugs Act) and the Central Excise Act, 1944 operated in two different fields, the restrictions imposed under Drugs Act could not lead to non-levy of excise duty under the Central Excise Act.

Therefore, in view of the above-mentioned ruling of the Supreme Court, the contention of the assessee is not valid in law.

- (b) No, the proceedings initiated by the Department are not justified. The High Court, in case of *CCE & ST v. Adecco Flexione Workforce Solutions Ltd. 2012 (26) S.T.R 3 (Kar)* has held that the Department has no authority to issue a show cause notice when the tax payer has paid service tax along with interest for delayed payments promptly.

The High Court noted that section 73(3) of the Finance Act, 1994 categorically stated that if the payment of service tax and interest has been intimated to the authorities in writing, the authorities should not serve any notice for the amount so paid. The authorities can initiate penal proceedings only against the

defaulters who have not paid tax and not against the persons who have paid tax with interest on their own. The High Court observed that if the notices are issued contrary to this section, the person who has issued notice should be punishable and not the person to whom it has been issued.

- (c) The facts of the given case are similar to the case of *Uniworth Textiles Ltd. vs. CCE*, 2013 (288) ELT 161 (SC), wherein the Supreme Court noted that section 28 of the Customs Act, 1962 clearly contemplates that for invoking extended period of limitation, the intention to deliberately default is a mandatory pre-requisite.

However, the assessee acted *bona fide* and claimed exemption by seeking clarification from the Development Commissioner. Hence, it could be inferred that assessee made efforts to adhere to the law rather than its breach.

The Apex Court held that mere non-payment of duties could not be equated with collusion or wilful misstatement or suppression of facts as then there would be no form of non-payment which would amount to ordinary default. Something more must be shown to construe the acts of the assessee as fit for applicability of extended period of limitation.

Therefore, in view of the above-mentioned ruling of the Supreme Court, the action of the Department of invoking extended period of limitation is not justified in the light of the provisions of the Customs Act, 1962.

4. (a) (1) A new section 15A has been inserted in Central Excise Act, 1944 to empower the Central Government to prescribe an authority or agency with whom an Information Return shall be filed by the specified persons. Information can be collected for the purposes of the Act, such as, to identify tax evaders or recover confirmed dues. The specified persons required to file the said return are responsible for maintaining record of registration or statement of accounts or any periodic return or

document containing details of payment of tax and other details or transaction of goods or services or transactions related to a bank account or consumption of electricity or transaction of purchase, sale or exchange of goods or property or right or interest in a property, under any law for the time being in force.

- (2) Such persons shall furnish an information return of the details given above in respect of such periods, within such time, form (including electronic form) and manner, to the prescribed authority or agency.
- (3) Any defect found in the return by the prescribed authority can be rectified within a period of 30 days from the date of intimation of such defect to the said person. The period of 30 days can be extended further by the prescribed authority on request.
- (4) However, if the defect is not rectified within 30 days or the extended period, such information return shall be treated as not submitted and the provisions of this Act shall apply.
- (5) If the return, including return after rectification of defect, is not submitted within the specified time, the prescribed authority may issue a notice requiring furnishing of such information return within a period not exceeding 90 days from the date of service of the notice.

(b) (i) Exempt. With effect from 11.07.2014, services received by Reserve Bank of India from outside India in relation to management of foreign exchange reserves have been exempted from service tax. External asset management services received by Reserve Bank of India from overseas financial institutions is a specialized financial service in the course of management of foreign exchange reserves [*Mega Exemption Notification No. 25/2012 ST dated 20.06.2012 amended*].

- (ii) **Exempt.** With effect from 11.07.2014, services provided by an Indian tour operator to a foreign tourist in relation to a tour wholly conducted outside India have been exempted from service tax *[Mega Exemption Notification No. 25/2012 ST dated 20.06.2012 amended]*.
- (iii) **Taxable.** With effect from 11.07.2014, only the following specific services provided **TO** an educational institution (which provides education covered under negative list of services) have been exempted from service tax:
 - (i) transportation of students, faculty and staff;
 - (ii) catering, including any mid-day meals scheme sponsored by the Government;
 - (iii) security or cleaning or house-keeping services performed in such educational institution;
 - (iv) services relating to admission to, or conduct of examination by, such institution.

Services **by** way of education up to higher secondary or equivalent fall within the purview of negative list of services. Thus, the education provided by the Higher Secondary School is not liable to tax. However, the **services of a development of software** provided **to** it are not covered under any of the specific services given above. Thus, the same will be liable to service tax *[Mega Exemption Notification No. 25/2012 ST dated 20.06.2012 amended]*.
- (c) According to section 127B of the Customs Act 1962, the following conditions are to be fulfilled for filing an application for settlement of cases:
 - (i) the applicant has filed a bill of entry, or a shipping bill, or a bill of export, or made a baggage declaration, or a label or declaration accompanying the goods imported or exported through post or courier, as the case may be, and in relation to

such document or documents, a show cause notice has been issued to him by the proper officer.

- (ii) the additional duty accepted is more than Rs. 3 lakhs.
- (iii) the applicant has paid the additional amount of customs duty accepted by him alongwith interest due under section 28AA.
- (iv) the case is not pending with CESTAT or any Court.
- (v) the application does not relate to goods to which section 123 applies or to goods in relation to which any offence under the Narcotic Drugs and Psychotropic Substances Act, 1985 has been committed.
- (vi) the application is not for the interpretation of the classification of the goods under the Customs Tariff Act, 1975

Further, application before Settlement Commission can be made only when adjudication is pending.

5. (a) Where the central excise officers during scrutiny or otherwise find that self-assessment is not in order, they may ask the assessee to provide all necessary documents, records or other information for issue of duty demand for differential duty, if any, after conducting inquiry.

If the assessee fails to provide such records or information and the Department is unable to issue demand, 'Best Judgement' method, may be used to raise the demand based on collateral evidences. In such a case, the burden will be on the assessee to provide information for appropriate re-determination of duty.

- (b) (i) **Exempt.** Services provided **TO** an educational institution by way of transportation of students are exempt from service tax vide *Notification No. 25/2012 ST dated 20.06.2012*.
- (ii) **Taxable.** Services provided by way of vehicle parking to general public are not exempt from service tax.
- (iii) **Taxable.** Services provided to Government, a local authority

or a Governmental authority by way of repair or maintenance of vessel are specifically exempt from service tax vide *Notification No. 25/2012 ST dated 20.06.2012* amended. However, services of repair or maintenance of aircraft owned by Government are not so exempt.

- (iv) **Taxable.** The benefit of exemption in relation to services provided by way of transfer of copyrights of cinematograph films is available only when such films are exhibited in a cinema hall or theatre. Therefore, exhibition of cinematograph films on television channels is taxable [*Notification No. 25/2012 ST dated 20.06.2012* amended].

- (c) The safeguard duty under section 8B of the Customs Tariff Act, 1975 is not imposed on the import of the following types of articles:

- (i) Articles originating from a developing country, so long as the share of imports of that article from that country does not exceed 3% of the total imports of that article into India;
- (ii) Articles originating from more than one developing country, so long as the aggregate of imports from developing countries each with less than 3% import share taken together does not exceed 9% of the total imports of that article into India;
- (iii) Articles imported by a 100% EOU or units in a Free Trade Zone or Special Economic Zone unless the duty is specifically made applicable on them.

6. (a) As per section 9(3) of the Central Excise Act, 1944, for the purposes of section 9(1) or 9(2), the following shall not be considered as special and adequate reasons for awarding a sentence of imprisonment for a term of less than six months, namely:

- (i) the fact that the accused has been convicted for the first time for an offence under this Act;
- (ii) the fact that in any proceeding under this Act, other than a

prosecution, the accused has been ordered to pay a penalty or the goods in relation to such proceedings have been ordered to be confiscated or any other action has been taken against him for the same act which constitutes the offence;

- (iii) the fact that the accused was not the principal offender and was acting merely as a carrier of goods or otherwise was a secondary party in the commission of the offence:
- (iv) the age of the accused (too young or too old)

Or

The procedure for warehousing of goods removed from a factory is detailed below:

- (i) The consignor shall prepare an application for removal of goods from a factory to a warehouse in quadruplicate and also prepare an invoice for goods to be warehoused.
- (ii) He has to send original, duplicate and triplicate application and duplicate invoice along with goods to the warehouse of destination. The quadruplicate copy of application has to be sent to the Superintendent of Central Excise in-charge of his factory within 24 hours.
- (iii) Within 24 hours of receipt of the goods the consignee shall verify the goods with all the copies of application.
- (iv) The consignee has to send:
 - (a) Original copy to Superintendent-in-charge of his warehouse.
 - (b) Duplicate copy to consignor and retain the triplicate for record.
- (v) The Superintendent-in-charge of the warehouse shall countersign the application received by him and send the same to Superintendent-in-charge of the consignor.
- (vi) The consignor shall retain the duplicate application duly endorsed by the consignee for his record.

(b) The facts of the given case are similar to the case of *Ankleshwar Taluka ONGC Land Loosers Travellers Co. OP. v. C.C.E., Surat-II 2013 (29) STR 352 (Guj.)*. In this case, the High Court made the following three important observations:

- (i) Service tax levy was comparatively new and therefore, both unawareness and confusion were quite possible particularly considering the strata to which the members of the society (assessee) belonged to. They were essentially agriculturists, who lost their lands when plant of service receiver was set up, and therefore, had created society and for many years they were providing rent-a-cab service to the service receiver.
- (ii) There were divergent views of different Benches of Tribunal, which may have added to such confusion.
- (iii) The fact that the assessee had persuaded their right of reimbursement of payment of service tax with the service receiver by way of conciliation and arbitration cannot deprive them of the defence of bona fide belief of applicability of service tax.

The High Court held that even if the assessee was aware of the levy of service tax and was not paying the amount on the ground of dispute with the service receiver, there could be no justification in levying the penalty in absence of any fraud, misrepresentation, collusion or wilful mis-statement or suppression.

Moreover, when the entire issue for levying the tax was debatable, that also would surely provide legitimate ground for not imposing the penalty.

Therefore, in view of the above-mentioned ruling of the High Court, the contention of assessee is acceptable in law.

(c) The above scenario is a case of third-party exports.

Third-party exports means exports made by an exporter or manufacturer on behalf of another exporter(s). The conditions for

being allowed as third-party exports under FTP are:

- (i) Export documents such as shipping bills shall indicate name of both manufacturing exporter/manufacture and third party exporter(s).
- (ii) BRC, GR declaration, export order and invoice should be in the name of third party exporter.

In the above case, though BRC, GR declaration, export order and invoice are in the name of LM Corporation (third party exporter), the shipping bill does not have the name of ST Corporation (manufacturer). Therefore, ST Corporation will not be treated as the exporter in this case.

7. (a) The Settlement Commission can grant immunity under section 32K of Central Excise Act, 1944 from prosecution for any offence under the Act and either wholly or in part from the imposition of penalty if it is satisfied that the applicant has made full and true disclosure and co-operated with the Commission.

If the payment is not made as per the settlement order or any particulars are concealed or any false evidence is given, the immunity can be withdrawn.

If prosecution has already been launched before submission of application for settlement, the immunity against such prosecution cannot be granted.

- (b) (i) Charging section-section 66B, *inter alia*, provides that service tax shall be levied on the services provided in the taxable territory by one person to another. Taxable territory means the territory to which the provisions of this Chapter apply i.e. whole of territory of India other than the State of Jammu and Kashmir.

The vessels located in the continental shelf of India for the purpose of prospecting natural gas fall within the ambit of definition of 'India' [Section 65B(27)].

Since in the present case, Krishna Ltd. provided services to Shiv Oil Corporation from vessels located in the continental shelf of India for the purposes of prospecting natural gas, it implies that services have been provided in taxable territory by one person to another for consideration. Thus, service tax is leviable on such services.

- (ii) Section 96E of the Finance Act, 1994, an advance ruling pronounced by the Authority under section 96D shall be binding only-
 - (a) on the applicant who had sought it;
 - (b) in respect of any matter referred to in sub-section (2) of section 96C;
 - (c) on the Commissioner, and the Central Excise authorities subordinate to him, in respect of the applicant.

Such advance ruling shall be binding as aforesaid unless there is a change in law or facts on the basis of which the advance ruling has been pronounced.

- (c) DFIA is issued to allow duty free import of inputs, fuel, oil, energy sources, catalyst which are required for production of export product. DFIA is of two types:
 - (i) Pre export Authorization and
 - (ii) Post export Authorization

Pre-export DFIA is issued with actual user condition. In case of actual user DFIA and where CENVAT credit facility on inputs have been availed for the exported goods, even after completion of export obligation, the goods imported against such DFIA should be utilized in the manufacture of dutiable goods whether within the same factory or outside (by a supporting manufacturer). In case of Post-export DFIA, a merchant exporter is required to mention only name(s) and address(s) of manufacturer(s) of the export product(s).

DFIA or the inputs imported against it can be transferred after the fulfillment of the export obligation. A minimum 20% value addition is required for issuance of DFIA except for items in gems and jewellery sector.

Inputs imported against DFIA are exempt from payment of basic customs duty, additional customs duty/ excise duty, education cess, anti-dumping duty and safeguard duty.