MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

SUGGESTED ANSWERS/HINTS

1. (a) WDV of asset at the end of year 2013-14= Rs. 5,00,000 – Rs. 45,000 x 3 = Rs. 3,65,000

WDV of asset at the end of year 2013-14 (by reducing balance method)

= Rs. 5,00,000 $(1 – 0.15)^3$ = Rs. 3,07,062.50

Depreciation to be charged in year 2014-15

= (Rs. 3,65,000 – Rs. 3,07,062.50) + 15% of Rs. 3,07,062.50

= Rs. 57,937.50 + Rs. 46,059.38 = Rs. 1,03,997 (approx.)

As per AS 5 'Net profit or loss for the period, Prior Period Items and Changes in Accounting Policies' the revision of remaining useful life is change in accounting estimate, and adoption of reducing balance method of depreciation instead of the straight-line method is change in accounting policy. Since it is difficult to segregate impact of these two changes, the entire amount of difference between depreciation at old rate and depreciation charged in 2014-15 (Rs. 1,03,997- Rs. 45,000 = Rs. 58,997) is regarded as an effect of change in accounting estimate as per provisions of the standard. The effect of this change in accounting estimate should be properly disclosed in the financial statements of the company for the year ended 31st March, 2015.

(b) As per AS 11 (Revised) 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as an expense in the period in which they arise. However, Ministry of Corporate Affairs has amended AS 11 through a notification. As per the notification, exchange difference arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to requisition of depreciable capital asset, can be added to or deducted from cost of asset and shall be depreciated over the balance life of the asset. Thus the company can capitalize the exchange differences arising due to long term loans linked with the acquisition of fixed assets.

Transaction 1: Calculation of exchange difference on fixed assets

Foreign Exchange Liability = $\frac{5,000}{50}$ = US \$ 100 lakhs

Exchange Difference = US \$ 100 lakhs x (Rs. 54.98 – Rs. 50) = Rs. 498 lakhs.

Loss due to exchange difference amounting Rs. 498 lakhs will be capitalised and to be added in the carrying value of fixed assets. Depreciation on the unamortised amount will be provided in the remaining years

Transaction 2: Soft loan exchange difference (US \$ 1 lakh i.e Rs. 50 lakhs)

Value of loan 31.3.15 → US \$ 1 lakh x Rs. 54.98 = Rs. 54,98,000

AS 11 also provides that in case of liability designated as long-term foreign currency monetary item (having a term of 12 months or more at the time of origination) the exchange difference is to be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITD) and should be written off over the useful life of such long-term liability, by recognition as income or expenses in each of such periods.

Exchange difference between reporting currency (INR) and foreign currency (USD) as on 31.03.2015 = US\$ 1.00 lakh x Rs. (54.98 – 50) = Rs. 4.98 lakh.

Loan account is to be increased to Rs. 54.98 lakh and FCMITD account is to be debited by Rs. 4.98 lakh. Since loan is repayable in 3 equal annual instalments, Rs. 4.98 lakh/3 = Rs. 1.66 lakh is to be charged to Profit and Loss Account for the year ended 31st March, 2015 and balance in FCMITD A/c Rs. (4.98 lakh – 1.66 lakh) = Rs. 3.32 lakh is to be shown on the 'Equity & Liabilities' side of the Balance Sheet as a negative figure under the head 'Reserve and Surplus' as a separate line item.

Note: The above answer is given on the basis that the company has availed the option under para 46A of AS 11.

(c) As per section 3 of the Central Excise Act, 1944, excise duty is levied upon the manufacture or production of excisable goods. Rule 4 of the Central Excise Rules, 2002 provides that the same is collected only at the time of removal of goods from factory premises or factory warehouse.

Guidance Note on 'Accounting Treatment for Excise Duty' says that excise duty is a duty on manufacture or production of excisable goods in India.

As explained in the Guidance Note, the liability for excise duty arises at the point of time at which the manufacture is completed. The excise duty paid or provided on finished goods should, therefore, be included in the inventory valuation.

Further, the Guidance Note states that excise duty should be considered as a manufacturing expense and like other manufacturing expenses are considered as an element of cost for the purpose of inventory valuation, excise duty should also be considered as an element of cost while valuing the inventory.

Therefore, in the given case of Giant Ltd., the Managing Director's contention that "excise duty is payable only on clearance of goods and hence is not a cost" is incorrect. Excise duty on the goods meant for local sales should be provided for at the rate of 12.5% on the selling price, that is, on Rs. 100 lakhs for valuation of inventory.

Excise duty on goods meant for exports, should also be provided for, since the liability for excise duty arises when the manufacture of the goods is completed. However, since in the given case, excisable goods are exported under Rule 19 of the Central Excise Rules, 2002 without payment of duty, Giant Ltd. may not provide for excise duty.

(d) L Ltd. had sold goods to V Ltd on credit worth for Rs. 250 crores and the sale was completed in all respects. V Ltd's decision to sell the same in the domestic market at a discount does not affect the amount recorded as sales by L Ltd. The price discount of 15% offered by L Ltd. after request of V Ltd. was not in the nature of a discount given during the ordinary course of trade because otherwise the same would have been given at the time of sale itself. Now, as far L Ltd is concerned, there appears to be an uncertainty relating to the collectability of the debt, which has arisen subsequent to the time of sale therefore, it would be appropriate to make a separate provision to reflect the uncertainty relating to collectability rather than to adjust the amount of revenue originally recorded. Therefore, such discount should be written off to the profit and loss account and not shown as deduction from the sales figure.

2. (1) Capital employed as on 31st March, 2015 (Refer to 'Note')

		Rs. in lakhs
Land and Buildings		1,850
Machinery		3,760
Furniture and Fixtures		1,015
Patents and Trade Marks		32
Stock		873
Debtors		614

Cash in hand and at bank		546
		8,690
Less: Trade creditors	568	
Provision for taxation (net)	22	(590)
		8,100

(2) Future maintainable profit

(Amounts in lakhs of rupees)

	1910-2011 *Rs.*	*2011-2012* *Rs.*	*2012-2013* *Rs.*	*2013-2014* *Rs.*
Profit before tax	3,190	2,500	3,108	2,900
Less: Extra-ordinary income due to foreign contract	100			
Add: Loss due to earthquake		50		
Less: Income from non-trading investments			54	54
	3,090	2,550	3,054	2,846

As there is no trend, simple average profits will be considered for calculation of goodwill.

Total adjusted trading profits for the last four years

= Rs. (3,090 + 2,550 + 3,054 + 2,846) lakhs

= Rs. 11,540 lakhs

	Rs. in lakhs	
Average trading profit before tax = $\left(\frac{\text{Rs. 11,540 lakhs}}{4}\right)$	2,885	
Less: Additional remuneration to directors	(50)	
Less: Income tax @ 35%(approx.)	(992)	(Approx)

	1,843

(3) Valuation of goodwill on super profits basis

Future maintainable profits	1,843
Less: Normal profits (20% of Rs. 8,100 lakhs)	(1,620)
Super Profits	223

Goodwill at 3 years' purchase of super profits = 3 x Rs. 223 lakhs = Rs. 669 lakhs

3. (i) Computation of Purchase Consideration

		Rs.
(a)	*Preference Shareholders*	
	Current income of preference shareholders of P Ltd.	40,000
	Add: 10% increase thereof	4,00
		44,000
	Preference shares to be issued	
	$= 44,000 \times \frac{100}{8}$	5,50,000
(b)	*Equity Shareholders*	
	(1) Issue of Equity Shares	
	Profit before tax of R Ltd.	10,64,000
	Less: Tax	(4,00,000)
		6,64,000
	Less: Preference dividend	(64,000)
	Profit available for equity shareholders of R Ltd.	6,00,000

Basic EPS = Earning available for Shareholders / Average no. of shares

Earnings per share (EPS) = $\frac{6,00,000}{2,40,000}$ = Rs. 2.50

PE Ratio = Market Price / EPS

Price earnings ratio (P/E) = $\frac{40}{2.50}$ = 16

EPS of P Ltd.

	Rs.

Profit before tax	4,80,000
Less: Tax	(2,00,000)
Profit after tax	2,80,000
Less: Preference dividend	(40,000)
Profit available for equity shareholders	2,40,000

EPS = $\frac{2,40,000}{1,20,000}$ = Rs. 2

Valuation of equity shares of P Ltd.

= 1,20,000 shares × (Rs. 2 × 16 × 0.75 i.e. Rs. 24) = Rs. 28,80,000

Number of equity shares to be issued = $\frac{28,80,000}{40}$ = 72,000

	Rs.
Equity Share Capital	7,20,000
Securities Premium	21,60,000
	28,80,000
(2) Issue of Preference Shares to make up loss to equity shareholders	*Rs.*
Current equity dividend	1,92,000
Less: Expected equity dividend from R Ltd. i.e. in proportion of the existing dividend policy (Rs. 7,20,000 × 2,88,000/24,00,000)	(86,400)
Loss in income	1,05,600
8% Preference Shares to be issued = $\frac{1,05,600}{0.08}$ = Rs. 13,20,000	
Total Purchase Consideration:	*Rs.*
8% Preference shares to be issued to Preference shareholders to Equity shareholders 5,50,000	
	18,70,00

13,20,000	0
Equity shares to be issued (at premium)	28,80,00 0
	47,50,00 0

(ii) R Ltd.

Balance Sheet as at 31st March, 2014
(after absorption)

Particulars				*Note No.*	*Amount (Rs.)*
I.	**Equity and Liabilities**				
	(1)	**Shareholder's Funds**			
	(a)	Share Capital		1	57,90,000
	(b)	Reserves and Surplus		2	51,60,000
	(2)	**Current Liabilities**		3	27,60,000
			Total		1,37,10,000
II.	**Assets**				
	(1)	**Non-current assets**			
		(a)	Fixed assets		
			i. Tangible assets	4	83,00,000
		ii.	Intangible assets	5	8,10,000
	(2)	**Current assets**		6	46,00,000
			Total		1,37,10,000

Notes to Accounts

		(Rs.)	(Rs.)
1.	Share Capital		
	3,12,000 Equity Shares of Rs. 10 each (of the above shares, 72,000 Equity shares are allotted as fully paid up for consideration other than cash)	31,20,000	
	2,67,000 8% Preference Shares of Rs. 10 each (of the above, 1,87,000 are allotted as fully paid up for consideration other than cash)	26,70,000	57,90,000
2.	Reserves and surplus		
	Reserves (As per last Balance Sheet)	30,00,000	
	Securities Premium	21,60,000	51,60,000
3.	Current Liabilities		
	As per last balance sheet	18,00,000	
	Taken over on absorption of P Ltd. Rs. (10,00,000-40,000)	9,60,000	27,60,000
4.	Tangible assets		
	As per last Balance Sheet	55,00,000	
	Taken over on absorption of P Ltd.	28,00,000	83,00,000
5.	Intangible assets		
	Goodwill (See Working Note)		8,10,000
6.	Current assets		
	As per last Balance Sheet	25,00,000	
	Taken over on absorption of P Ltd. Rs. (23,00,000-2,00,000)	21,00,000	46,00,000

Working Note:

Calculation of Goodwill on Absorption

		Rs.
Purchase consideration		47,50,000
Fixed assets taken over [27,00,000 + 1,00,000]	28,00,000	
Current assets taken over [23,00,000 – 2,00,000]	21,00,000	
	49,00,000	
Less: Current liabilities [10,00,000 – 40,000]	(9,60,000)	
Net assets taken over		(39,40,000)
Goodwill		8,10,000

4. (a) Value Added Statement of Heaven Ltd.

		Rs. in lakhs
Sales		254.00
Less: Cost of bought in material and services:		
Operating cost (Rs. 222.00 lakhs – Rs. 82 lakhs)	140.00	
Excise duty	11.20	
Interest on bank overdraft	1.00	(152.20)
Value added by trading activities		101.80
Add: Other income		6.00
Total Value Added		107.80

Application of value added

			Rs. in lakhs	*%*
To	pay Employees:			
	Wages, salaries and other benefits		82.00	76.07
To	pay Government : Corporate tax		2.40	2.23
To	pay Providers of Capital :			
	Interest on 9% debentures	15.00		

	Dividends	0.30	15.30	14.19
To	provide for Maintenance and Expansion of the Company			
	Depreciation	4.10		
	Retained profit	4.00	8.10	7.51
			107.80	100

Reconciliation between Total Value Added and Profit before Taxation:

	Rs. in lakhs
Profit before tax	6.70
Add back:	
Depreciation	4.10
Wages, salaries and other benefits	82.00
Interest on debentures	15.00
Total Value Added	107.80

(b) Calculation of Economic Value Added

	Rs.
Net Operating Profit After Tax	25,00,000
Less: Cost of capital employed (Refer W.N.)	(6,00,000)
Economic Value Added	19,00,000

Economic value added is greater than zero. Therefore, the company qualifies for the loan.

Working Note:

Calculation of Cost of Capital employed	*Rs.*
Average total assets	75,00,000
Less: Average current liabilities	(15,00,000)
Capital employed	60,00,000

Cost of capital = Capital employed x Weighted average cost of capital $= \text{Rs. } 60{,}00{,}000 \times \frac{10}{100} = \text{Rs. } 6{,}00{,}000$

5. **(a)** Fair value of an ESPP = Rs. 56 – Rs. 50 = Rs. 6

Number of shares issued = 400 employees x 100 shares/employee = 40,000 shares

Fair value of ESPP which will be recognized as expenses in the year 2014-15

= 40,000 shares x Rs. 6 = Rs. 2,40,000

Vesting period = 1 month

Expenses recognized in 2014-15 = Rs. 2,40,000

Journal Entry

Date	*Particulars*	*Dr. (Rs.)*	*Cr. (Rs.)*
30.04.2014	Bank A/c (40,000 shares x Rs. 50) Dr.	20,00,000	
	Employees compensation expense A/c Dr.	2,40,000	
	To Share Capital A/c (40,000 shares x Rs. 10)		4,00,000
	To Securities Premium (40,000 shares x Rs. 46)		18,40,000
	(Being shares issued under ESPP @ Rs. 50)		

(b) On the basis of the information given, in respect of hire purchase and leased assets, additional provision shall be made as under:

			(Rs. in crore)
(a)	Where hire charges are overdue upto 12 months	Nil	-
(b)	Where hire charges are overdue for more than 12 months but upto 24 months	10% of the net book value 10% x 2,410	241
(c)	Where hire charges are overdue for more than 24 months but upto 36 months	40 percent of the net book value 40% x 1,280	512
(d)	Where hire charges or lease rentals are overdue for more than 36 months but	70 percent of the net book value	452.90

upto 48 months	70% x 647	
	Total	1,205.90

6. Consolidated Balance Sheet of Aman Ltd. and its subsidiary Shanti Ltd. as at 31st March, 2015

Particulars	*Note No.*	*(Rs.)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	10,50,000
(b) Reserves and Surplus	2	3,42,000
(2) Minority Interest [W.N.6(b)]		92,000
(3) Non-current Liabilities		
Long-term borrowings	3	6,00,000
Total		20,84,000
II. Assets		
(1) Non-current assets		
(a) Fixed assets	4	7,10,000
(b) Intangible assets	5	2,24,000
(2) Net current assets	6	11,50,000
Total		20,84,000

Notes to Accounts

			Rs.
1.	Share Capital Issued and Subscribed:		

	1,05,000 shares of Rs. 10 each fully paid up		10,50,000
2.	Reserves & surplus		
	Securities premium	1,20,000	
	General Reserve	1,60,000	
	Profit and Loss Account [W.N.6(d)]	62,000	3,42,000
3.	Long Term Borrowings		
	6,000, 8% Debentures of Rs. 100 each		6,00,000
4.	Tangible Assets		
	Aman Ltd. [W.N.3]	5,50,000	
	Shanti Ltd. [W.N.3]	1,60,000	7,10,000
5.	Intangible assets		
	Goodwill [W.N.6(c)]		2,24,000
6.	Net current assets		
	Aman Ltd. [W.N.5]	8,50,000	
	Shanti Ltd. [W.N.5]	3,00,000	11,50,000

Working Notes:

Percentage of shareholding of Aman Ltd. in Shanti Ltd.:

48,000 shares out of 60,000 shares i.e $\frac{48,000}{60,000} \times 100 = 80\%$

1. Investment in Shanti Ltd.

	Rs.
Face value of shares (48,000 shares x Rs. 10)	4,80,000
Premium (50%) over face value	2,40,000
Cost of investment	7,20,000

Acquired by issue of debentures at 20% premium:

	Rs.
8% Debentures	6,00,000
(Nominal value = 7,20,000/120 × 100)	
Add: Securities premium @ 20%	1,20,000
	7,20,000
Writing down of investment to face value in 10 years	
2013-14 : 1/10 × 2,40,000	(24,000)
2014-15: 1/10 × 2,40,000	(24,000)
Investment as on 31.3.2015	6,72,000

2. Balance of Profit and Loss Account for the year ended on 31st March, 2015

	Aman Ltd.	*Shanti Ltd.*
	Rs.	*Rs.*
Balance as on 31.3.2013	80,000	(80,000)
Profit/(Loss)		
For 2013-14	1,60,000	(40,000)
For 2014-15	2,00,000	(60,000)
Less: Transfer to General Reserve		
2013-14	(20,000)	
2014-15	(20,000)	
Dividend @ 10%		
2013-14	(1,05,000)	
2014-15	(1,05,000)	
Investment written off		
2013-14	(24,000)	
2014-15	(24,000)	
Provision for share of loss in subsidiary		
2013-14: (40,000 × 80%)	(32,000)	
2014-15: (60,000× 80%)	(48,000)	
	62,000	(1,80,000)

Note: In the absence of information, taxation has not been considered.

3. Fixed Assets as on 31st March, 2015

	Aman Ltd. Rs.	Shanti Ltd. Rs.
Fixed assets on 31.3.2013	6,50,000	2,00,000
Less: Depreciation for		
2013-2014	(60,000)	(20,000)
2014-2015	(40,000)	(20,000)
	5,50,000	1,60,000

4. General reserve of Aman Ltd.

	Rs.
Balance as on 31.03.2013	1,20,000
Add: Transfer from Profit and loss account	
in 2013-2014	20,000
in 2014-2015	20,000
	1,60,000

5. Separate Balance Sheets as at 31st March, 2015 to calculate net current assets

Particulars	*Note No.*	*Aman Ltd.*	*Shanti Ltd.*
		(Rs.)	*(Rs.)*
I. Equity and Liabilities			
(1) Shareholder's Funds			
(a) Share Capital	1	10,50,000	6,00,000
(b) Reserves and Surplus	2	3,42,000	(1,40,000)
(2) Non-Current Liabilities			
Long-term borrowings	3	6,00,000	
Long term provision	4	80,000	
Total		20,72,000	4,60,000
II. Assets			
(1) Non-current assets			
(a) Fixed assets			

(i) Tangible assets*(W.N.3)		5,50,000	1,60,000
(b) Non-current investment		6,72,000	
(2) Net current assets (bal. fig.) (see note)		8,50,000	3,00,000
Total		20,72,000	4,60,000

Notes to Accounts

			Aman Ltd. *Rs.*	*Shanti Ltd.* *Rs.*
1.	Share Capital			
	Issued and Subscribed:			
	1,05,000 shares of Rs. 10 each fully paid up		10,50,000	
	60,000 shares of Rs. 10 each fully paid up			6,00,000
2.	Reserves & surplus			
	Securities premium	1,20,000		-
	General Reserve (W.N. 4)	1,60,000		40,000
	Profit and Loss Account	62,000	3,42,000	(1,80,000)
	Total		3,42,000	(1,40,000)
3.	Long Term Borrowings			
	8% Debentures		6,00,000	
4.	Long term Provision			
	Provision for loss in subsidiary		80,000	

Note: In the absence of information about the movement in individual current assets and current liabilities, balance sheets as on 31.3.2015 have been prepared

* Fixed assets given in the question are assumed to be tangible fixed assets.

on the basis of net current assets, which is the difference of total current assets and total current liabilities. However, Schedule III requires separate disclosure of current liabilities and current assets in the balance sheet.

(6) Computations for Consolidation

(a) Analysis of General reserve and Profits (Losses) of Shanti Ltd.

	Pre-acquisition Capital Profit or loss Rs.	*Post acquisition Profit or loss Rs.*
General Reserve on 31.3.2013	40,000	–
Profit and Loss Account on 31.3.2013	(80,000)	
Profit/(Loss) for the years 2013 – 2014		(40,000)
2014 – 2015		(60,000)
	(40,000)	(1,00,000)
Minority Interest (20%)	(8,000)	(20,000)
Share of Aman Ltd. (80%)	(32,000)	(80,000)

(b) Minority Interest

	Rs.
Share Capital	1,20,000
Add: Pre-acquisition capital loss	(8,000)
Post-acquisition loss	(20,000)
	92,000

(c) Cost of Control

		Rs.
Investment in Shanti Ltd.		6,72,000
Less: Paid up value of investment	4,80,000	
Capital profit/(losses)	(32,000)	(4,48,000)
Goodwill		2,24,000

(d) Consolidated Profit and Loss Account

	Rs.
Balance of Profit and Loss Account of Aman Ltd.	62,000
Less: Share of loss in Shanti Ltd.	(80,000)

	(18,000)
Add back: Provision for loss in subsidiary (mutual transaction) (32,000 + 48,000)	80,000
	62,000

(e) Long term provision for loss in subsidiary as

	Rs.
Provision for loss in subsidiary as shown in Aman Ltd.	80,000
Less: Intra company transaction	(80,000)
	Nil

7. (a) As per para 21 of AS - 12, 'Accounting for Government Grants', "the amount refundable in respect of a grant related to specific fixed asset should be recorded by reducing the deferred income balance. To the extent the amount refundable exceeds any such deferred credit, the amount should be charged to profit and loss statement.

(i) In this case the grant refunded is Rs. 30 lakhs and balance in deferred income is Rs. 21 lakhs, Rs. 9 lakhs shall be charged to the profit and loss account for the year 2014-15. There will be no effect on the cost of the fixed asset and depreciation charged will be on the same basis as charged in the earlier years.

(ii) If the grant was deducted from the cost of the plant in the year 2011-12 then, para 21 of AS-12 states that the amount refundable in respect of grant which relates to specific fixed assets should be recorded by increasing the book value of the assets, by the amount refundable. Where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Therefore, in this case, the book value of the plant shall be increased by Rs. 30 lakhs. The increased cost of Rs. 30 lakhs of the plant should be amortized over 7 years (residual life). Depreciation charged during the year 2014-15 shall be (84 + 30)/7 years = Rs. 16.286 lakhs presuming the depreciation is charged on SLM.

(b) (i) Presentation of associate results

ASs	IFRS/IAS
In consolidated financial statements equity method is used. Share of post-tax results is shown in standalone financials at cost less impairment.	In consolidated financial statements equity method is used. Share of post-tax results is shown in standalone financials at cost or in accordance with IFRS 9.

(ii) Definition of joint venture

Contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control. Exclusion if it meets the definition of a subsidiary.	A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

(iii) Definition of subsidiary

Definition of subsidiary is based on voting control or control over the composition of the board of directors. The existence of currently exercisable potential voting rights is not taken into consideration.	Control is presumed to exist when parent owns, directly or indirectly through subsidiaries, more than one half of an entity's voting power. The existence of currently exercisable potential voting rights is also taken into considerations. A parent could have control over an entity in circumstances where it holds less than 50% of the voting rights of an entity.

(c) Cost vs. Fair value

Cost basis: The term cost refers to cost of purchase, costs of conversion on other costs incurred in bringing the goods to its present condition and location. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Fair value: Fair value of an asset is the amount at which an enterprise expects to exchange an asset between knowledgeable and willing parties in an arm's length transaction.

- Accounting Standards are generally based on historical cost with a very few exceptions:
- AS 2 "Valuation of Inventories" – Inventories are valued at net realizable value (NRV) if cost of inventories is more than NRV.

- AS 10 "Accounting for Fixed Assets" – Items of fixed assets that have been retired from active use and are held for disposal are stated at net realizable value if their net book value is more than NRV.
- AS 13 "Accounting for Investments" – Current investments are carried at lower of cost and fair value. The carrying amount of long term investments is reduced to recognize the permanent decline in value.
- AS 15 "Employee Benefits" – The provision for defined benefits is made at fair value of the obligations.
- AS 26 "Intangible Assets" – If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.
- AS 28 "Impairment of Assets"– Provision is made for impairment of assets.
- On the other hand IFRS is more towards fair value. Fair value concept requires a lot of estimation and to the extent, it is subjective in nature.

(d)

Capital Base	=	Rs. 1,00,00,000
Actual Profit	=	Rs. 11,00,000
Target Profit @ 12.5%	=	Rs. 12,50,000

Expected Profit on employing the particular executive

= Rs. 12,50,000 + Rs. 2,50,000 = Rs. 15,00,000

Additional Profit = Expected Profit – Actual Profit

= Rs. 15,00,000 – Rs. 11,00,000 = Rs. 4,00,000

$$\text{Maximum bid price} = \frac{\text{Additional Profit}}{\text{Rate of Return on Investment}}$$

$$= \frac{4,00,000}{12.5} \times 100 = \text{Rs. } 32,00,000$$

Maximum salary that can be offered = 12.5% of Rs. 32,00,000 i.e., Rs. 4,00,000

Maximum salary can be offered to that particular executive upto the amount of additional profit i.e., Rs. 4,00,000.

(e) As per Para 24 of AS 2 (Revised) "Valuation of Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. Therefore, in this case, Flat Ltd. will value the inventory of raw material at Rs. 30,00,000 (10,000 kg. @ Rs. 300 per kg.).

Test Series: March, 2015

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 2: STRATEGIC FINANCIAL MANAGEMENT

SUGGESTED ANSWERS/HINTS

1. (a) Let annual inflow after defraying management expenses be x. Then

Period	Inflow	PVF @ 8%	Year	PV × Years
2015	x	0.926	1	0.926x
2016	x	0.857	2	1.714x
2017	x	0.794	3	2.382x
2018	x	0.735	4	2.94x
2019	x	0.681	5	3.405x
2020	x	0.630	6	3.78x
2021	x	0.583	7	4.081x
2021	100	0.583	7	408.10
				19.228x + 408.10

$$\frac{19.228x + 408.10}{100} = 5.5$$

19.228x = 141.90

x = 7.38 i.e. 7.38% (Post Management Expenses)

Return before management expenses = $\frac{7.38}{0.90} = 8.20\%$

(b) Amount realized on selling Danish Kroner 10,00,000 at Rs. 6.5150 per Kroner = Rs. 65,15,000.

Cover at London:

Bank buys Danish Kroner at London at the market selling rate.

Pound sterling required for the purchase (DKK 10,00,000 ÷ DKK 11.4200) = GBP 87,565.67

Bank buys locally GBP 87,565.67 for the above purchase at the market selling rate of Rs. 74.3200.

The rupee cost will be
= Rs. 65,07,88

Profit (Rs. 65,15,000 - Rs. 65,07,881) = Rs. 7,119

Cover at New York:

Bank buys Kroners at New York at the market selling rate.

Dollars required for the purchase of Danish Kroner (DKK10,00,000 ÷ 7.5670) = USD 1,32,152.77

Bank buys locally USD 1,32,152.77 for the above purchase at the market selling rate of Rs. 49.2625.

The rupee cost will be
= Rs. 65,10,176

Profit (Rs. 65,15,000 - Rs. 65,10,176) = Rs. 4,824

The transaction would be covered through London which gets the maximum profit of Rs. 7,119 or lower cover cost at London Market by (Rs.65,10,176 - Rs.65,07,881) = Rs.2,295

(c) (i) Present Value of the stock:-

$$Vo = \frac{5.00(1.02)}{0.10-0.02} = Rs.63.75/-.$$

(ii) Value of stock under the PE Multiple Approach

Particulars	
Actual Stock Price	Rs. 40.00
Return on equity	8%
EPS	Rs. 3.00

PE Multiple (1/Return on Equity) = 1/8%	12.50
Market Price per Share	Rs. 37.50

Since, Actual Stock Price is higher, hence it is overvalued.

(iii) Value of the Stock under the Earnings Growth Model

Particulars	
Actual Stock Price	Rs. 40.00
Return on equity	8%
EPS	Rs. 3.00
Growth Rate	2%
Market Price per Share [EPS ×(1+g)]/(K_e – g) = Rs. 3.00 × 1.02/0.06	Rs. 51.00

Since, Actual Stock Price is lower, hence it is undervalued.

(d) (i) Calculation of theoretical minimum price of a 6 months forward contract-

Theoretical minimum price = Rs. 1,800 + (Rs. 1,800 x 12/100 x 6/12) = Rs. 1,908

(ii) Arbitrage Opportunity-

The arbitrageur can borrow money @ 12 % for 6 months and buy the shares at Rs. 1,800. At the same time he can sell the shares in the futures market at Rs. 1,950. On the expiry date 6 months later, he could deliver the share and collect Rs. 1,950 pay off Rs. 1,908 and record a profit of Rs. 42 (Rs. 1,950 – Rs. 1,908)

2. (a) Working Notes:

(i) Calculation of Tax Benefit on Depreciation/ Short Term Capital Loss

Year	Opening WDV	Depreciation	Closing WDV	Tax Shield
1	1000000	250000	750000	82500
2	750000	187500	562500	61875
3	562500	140625	421875	46406
4	421875	105469	316406	34805
5	316406	249406*	-	82304

* Short Term Capital Loss

(ii) PV of cash outflow under Borrowing Option

Year	Investment/Salvage	Tax Benefit on Dep.	PVF @ 8.04%	PV
0	(1000000)	-	1.00	(1000000)
1	-	82500	0.925	76313
2	-	61875	0.857	53027
3	-	46406	0.793	36800
4	-	34805	0.734	25547
5	-	82304	0.679	55885
5	67000	-	0.679	45493
				(706935)

(iii) PV of cash outflow under Leasing Option

Year	Lease Rental after Tax	PVAF@8.04%	PV
1-5	270000(1-0.33) = (180900)	3.988	(721429)

(a) Since PV of cash outflows is least in case of Borrowing option hence it shall be more advantageous to go for the same.

(b) (i) Sensitivity to Borrowing Rate can be calculated by determining the rate of borrowing (post tax) at which PV of cash flows shall be equal under both options i.e. IRR.

Let us discount the cash flow using discount rate of 10%.

PV of cash outflow under Borrowing Option

Year	Investment /Salvage	Tax Benefit on Dep.	PVF@ 10%	PV
0	(1000000)	-	1.00	(1000000)
1	-	82500	0.909	74993
2	-	61875	0.826	51109
3	-	46406	0.751	34851
4	-	34805	0.683	23772
5	-	82304	0.621	51111
5	67000	-	0.621	41607

				(722557)

PV of cash outflow under Leasing Option

Year	Lease Rental after Tax	PVAF@10%	PV
1-5	270000(1-0.33) = (180900)	3.79	(685611)

NPV @ 8.04% = 706935 – 721429 = -14494

NPV @ 10% = 722557 – 685611 = 36946

Using IRR Formula:

$$= 8.04 + \frac{-14494}{-14494-36946} \times (10-8.04)$$

= 8.55%

Sensitivity of Borrowing Rate = $\frac{8.55-8.04}{8.55} \times 100$ = 5.96%

(ii) Sensitivity of Residual Value

Let R be Residual Value at which PV of cash flow shall be equal under both options.

PV of cash outflow under Borrowing Option

Year	Investment/Salvage	Tax Benefit	PVF@ 8.04%	PV
0	(1000000)	-	1.00	(1000000)
1	-	82500	0.925	76313
2	-	61875	0.857	53027
3	-	46406	0.793	36800
4	-	34805	0.734	25547
5	-	(316406-R) 0.33	0.679	70897 – 0.224R
5	R	-	0.679	0.679 R
				(737416)+0.455 R

Accordingly (737416) + 0.455R = (721429)

R = 35136

Sensitivity of Residual Value = $\frac{35136-67000}{67000} \times 100$ = 47.56%

(iii) Sensitivity of Initial Outlay

Let Initial Outlay be I then PV of Cash Outflow under Borrowing option shall be:

= I – 293065 and accordingly

(I – 293065) = (721429)

I = 1014494

Sensitivity of Initial Investment = $\frac{1014494-1000000}{1000000} \times 100 =$ 1.4494%

Thus from above it is clear that among above sensitivity of Residual Value is the most.

(b)

	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) 3. Effective Interest Rate	$\frac{Rs.5,600}{Rs.40,000} \times 100 = 14\%$ $\frac{n}{n+1} \times 2F = \frac{12}{13} \times 28 =$ 25.85%	$\frac{Rs. 5,680}{Rs. 40,000} \times 100 = 14.20\%$ $\frac{n}{n+1} \times 2F = \frac{24}{25} \times 28.40 =$ 27.26%

3. (a) Total market value of C Ltd is = 1,00,000 x Rs. 15 = Rs. 15,00,000

PE ratio (given) = 10

Therefore, earnings = Rs. 15,00,000 /10

= Rs. 1,50,000

Total market value of B Ltd. is = 5,00,000 x Rs. 12 = Rs. 60,00,000

PE ratio (given) = 17

Therefore, earnings = Rs. 60,00,000/17

= Rs. 3,52,941

The number of shares to be issued by B Ltd.

Rs. 15,00,000 ÷ 12 = 1,25,000

Total number of shares of B Ltd = 5,00,000 + 1,25,000 = 6,25,000

The EPS of the new firm is = (Rs. 3,52,941+Rs.1,50,000)/6,25,000

= Re. 0.80

The present EPS of B Ltd is = Rs. 3,52,941 /5,00,000

= Rs. 0.71

So the EPS affirm B will increase from Re. 0.71 to Rs. 0.80 as a result of merger.

(b) Working Notes:

Required Rate of Return using CAPM

6% + 1.5(10% - 6%) = 12%

Average Growth Rate = $\left(\frac{14.00}{12.20}\right)^{1/4} - 1$ =3.5%

Payout Ratio =

$$\left(\frac{8.20+8.10+7.90+7.80+7.70}{5}\right) \div \left(\frac{14.00+13.60+13.10+12.70+12.20}{5}\right)$$

= $\frac{7.94}{13.12}$= 0.605 say 60%

1. Market Price of Share using Dividend Valuation Model if there is no change in Dividend Policy and assuming constant growth rate,

$$P = \frac{D_1}{k_e - g} = \frac{8.20 \times 1.035}{0.12 - 0.035} = \frac{8.487}{0.085} = \text{Rs. } 99.85$$

2. Market Price of Share using Earning Growth Model assuming retention ratio inconstant and return on investment perpetual:

$$P = \frac{E(1-b)(1+br)}{k_e - br} = \frac{14.00(1-0.50)(1+0.50 \times 15\%)}{0.12-(0.50 \times 15\%)} = \frac{7.525}{0.12-0.075}$$

= Rs. 167.22

4. (a) (i) Calculation of Portfolio Beta

Security	Price of the Stock	No. of shares	Value	Weightage w_i	Beta B_i	Weighted Beta
A	349.30	5,000	17,46,500	0.093	1.15	0.107
B	480.50	7,000	33,63,500	0.178	0.40	0.071
C	593.52	8,000	47,48,160	0.252	0.90	0.227
D	734.70	10,000	73,47,000	0.390	0.95	0.370
E	824.85	2,000	16,49,700	0.087	0.85	0.074
			1,88,54,860			0.849

Portfolio Beta = 0.849

(ii) Calculation of Theoretical Value of Future Contract

Cost of Capital = 10.5% p.a. Accordingly, the Continuously Compounded Rate of Interest ln(1.105) = 0.0998

For February 2013 contract, t= 58/365= 0.1589

Further $F = Se^{rt}$

$F = \text{Rs. } 5{,}900e^{(0.0998)(0.1589)}$

$F = \text{Rs. } 5{,}900e^{0.015858}$

F= Rs. 5,900X1.01598 = Rs. 5,994.28

(iii) When total portfolio is to be hedged:

$$= \frac{\text{Value of Spot Position requiring hedging}}{\text{Value of Future Contract}} \times \text{Portfolio Beta}$$

$$= \frac{1{,}88{,}54{,}860}{5994.28 \times 200} \times 0.849$$ = 13.35 contracts say 13 or 14 contracts

(iv) When total portfolio beta is to be reduced to 0.6:

Number of Contracts to be sold = $\frac{P(\beta_P - \beta'_P)}{F}$

= $\frac{1,88,54,860\,(0.849 - 0.600)}{5994.28 \times 200}$ = 3.92 contracts say 4 contracts

(b) (a) The Betas of two stocks:

Aggressive stock - 40% - 4%/25% - 7% = 2

Defensive stock - 18% - 9%/25% - 7% = 0.50

(b) Expected returns of the two stocks:-

Aggressive stock - 0.5 x 4% + 0.5 x 40% = 22%

Defensive stock - 0.5 x 9% + 0.5 x 18% = 13.5%

(c) Expected return of market portfolio = 0.5 x 7% + 0.5% x 25% = 16%

$\therefore$ Market risk prem. = 16% - 7.5% = 8.5%

$\therefore$ SML is, required return = 7.5% + βi 8.5%

(d) $R_s = \alpha + \beta R_m$

Where

α = Alpha

β = Beta

R_m= Market Return

For Aggressive Stock

22% = α_A + 2(16%)

α_A = -10%

For Defensive Stock

13.5% = α_D + 0.50(16%)

α_D = 5.5%

5. (a) (i) Current price of the Bond = 100 x [1-{45/360} x 0.06] = Rs.99.25

Alternatively, the current price of bond may also be calculated as follows:

$$\frac{D}{100 - D} \times \frac{360}{45} = 0.06$$

$$\frac{D}{100-D}=0.06\times\frac{45}{360}$$

$$\frac{D}{100-D}=0.06\times\frac{1}{8}$$

8D = 6 – 0.06D

8.06D = 6

D = $\frac{6}{8.06}=0.7444$

Current price of the bond = Face value – D

= Rs.100 – 0.7444 = Rs.99.2556

(ii) Bond equivalent yield = $\frac{100-99.25}{99.25}\times\frac{360}{45}=6.045\%$ P.A.

(iii) Effective annual return = $\left[1+(0.06045/8)^{8}\right]$-1 = 6.207% P.A..

Note: If a year of 365 days is considered the Bond equivalent yield and Effective annual return works out to 6.296% P.A.

(b) In the given case, the exchange rates are indirect. These can be converted into direct rates as follows:

Spot rate

GBP = $\frac{1}{USD1.5617}$ to $\frac{1}{USD1.5673}$

USD = GBP 0.64033 - GBP 0.63804

6 months' forward rate

GBP = $\frac{1}{USD1.5455}$ to $\frac{1}{USD1.5609}$

USD = GBP 0.64704 - GBP 0.64066

Payoff in 3 alternatives

i. Forward Cover

Amount payable	USD 3,64,897
Forward rate	GBP 0.64704
Payable in GBP	GBP 2,36,103

ii. Money market Cover

Amount payable	USD 3,64,897
PV @ 4.5% for 6 months i.e. $\frac{1}{1.0225} = 0.9779951$	USD 3,56,867
Spot rate purchase	GBP 0.64033
Borrow GBP 3,56,867 x 0.64033	GBP 2,28,512
Interest for 6 months @ 7 %	7,998
Payable after 6 months	GBP 2,36,510

iii. Currency options

Amount payable	USD 3,64,897
Unit in Options contract	GBP 12,500
Value in USD at strike rate of 1.70 (GBP 12,500 x 1.70)	USD 21,250
Number of contracts USD 3,64,897/ USD 21,250	17.17
Exposure covered USD 21,250 x 17	USD 3,61,250
Exposure to be covered by Forward (USD 3,64,897 – USD 3,61,250)	USD 3,647
Options premium 17 x GBP 12,500 x 0.096	USD 20,400
Premium in GBP (USD 20,400 x 0.64033)	GBP 13,063
Total payment in currency option	
Payment under option (17 x 12,500)	GBP 2,12,500
Premium payable	GBP 13,063
Payment for forward cover (USD 3,647 x 0.64704)	GBP 2,360
	GBP 2,27,923

Thus total payment in:

(i) Forward Cover	2,36,103 GBP
(ii) Money Market	2,36,510 GBP
(iii) Currency Option	2,27,923 GBP

The company should take currency option for hedging the risk.

6. (a) Share holders' funds
(Rs. Lakhs)

Particulars	*Fortune India Ltd.*	*Fortune Pharma Ltd.*	*Fortune India (FMCG) Ltd.*
Assets	70,000	25,100	44,900
Outside liabilities	25,000	4,100	20,900
Net worth	45,000	21,000	24,000

1. Calculation of Shares of Fortune Pharma Ltd. to be issued to shareholders of Fortune India Ltd.

	Fortune Pharma Ltd.
Estimated Profit (Rs. in lakhs)	1,470
Estimated market price (Rs.)	24.5
Estimated P/E	25
Estimated EPS (Rs.)	0.98
No. of shares lakhs	1,500

Hence, Ratio is 1 share of Fortune Pharma Ltd. for 2 shares of Fortune India Ltd.

2. Expected market price of Fortune India Ltd.

	Fortune India (FMCG) Ltd.

Estimated Profit (Rs. in lakhs)	11,400
No. of equity shares (Rs. in lakhs)	3,000
Estimated EPS (Rs.)	3.8
Estimated P/E	42
Estimated market price (Rs.)	159.60

3. Book value per share

	Fortune Pharma Ltd.	*Fortune India (FMCG) Ltd.*
Net worth (Rs.in lakhs)	21,000	24,000
No. of shares (Rs. in lakhs)	1,500	3,000
Book value of shares	Rs. 14	Rs. 8

(b) Since the direct quote for ¥ and Rs. is not available it will be calculated by cross exchange rate as follows:

Rs./\$ x \$/¥ = Rs./¥

62.22/102.34 = 0.6080

Spot rate on date of export   1¥ = Rs. 0.6080

Expected Rate of ¥ for August 2014 = Rs. 0.5242 (Rs. 65/¥124)

Forward Rate of ¥ for August 2014 = Rs. 0.6026 (Rs. 66.50/¥110.35)

(i) Calculation of expected loss without hedging

Value of export at the time of export (Rs. 0.6080 x ¥10,000,000)	Rs. 60,80,000
Estimated payment to be received on Aug. 2014 (Rs. 0.5242 x ¥10,000,000)	Rs. 52,42,000
Loss	Rs. 8,38,000

Hedging of loss under Forward Cover

Rs. Value of export at the time of export (Rs. 0.6080 x ¥10,000,000)	Rs. 60,80,000
Payment to be received under Forward Cover (Rs. 0.6026 x ¥10,000,000)	Rs. 60,26,000
Loss	Rs. 54,000

By taking forward cover loss is reduced to Rs. 54,000.

(ii) Actual Rate of ¥ on August 2014 = Rs. 0.5977 (Rs. 66.25/¥110.85)

Value of export at the time of export (Rs. 0.6080 x ¥10,000,000)	Rs. 60,80,000
Estimated payment to be received on Aug. 2014 (Rs. 0.5977 x ¥10,000,000)	Rs. 59,77,000
Loss	Rs. 1,03,000

The decision to take forward cover is still justified.

7. (a) The success of any business is measured in financial terms. Maximising value to the shareholders is the ultimate objective. For this to happen, at every stage of its operations including policy-making, the firm should be taking strategic steps with value-maximization objective. This is the basis of financial policy being linked to strategic management.

The linkage can be clearly seen in respect of many business decisions. For example:

(i) Manner of raising capital as source of finance and capital structure are the most important dimensions of strategic plan.

(ii) Cut-off rate (opportunity cost of capital) for acceptance of investment decisions.

(iii) Investment and fund allocation is another important dimension of interface of strategic management and financial policy.

(iv) Foreign Exchange exposure and risk management.

(v) Liquidity management

(vi) A dividend policy decision deals with the extent of earnings to be distributed and a close interface is needed to frame the policy so that the policy should be beneficial for all.

(vii) Issue of bonus share is another dimension involving the strategic decision.

Thus from above discussions it can be said that financial policy of a company cannot be worked out in isolation to other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth.

(b) **Cap:** It is a series of call options on interest rate covering a medium-to-long term floating rate liability. Purchase of a Cap enables the a borrowers to fix in advance a maximum borrowing rate for a specified amount and for a specified duration, while allowing him to avail benefit of a fall in rates. The buyer of Cap pays a premium to the seller of Cap.

Floor: It is a put option on interest rate. Purchase of a Floor enables a lender to fix in advance, a minimal rate for placing a specified amount for a specified duration, while allowing him to avail benefit of a rise in rates. The buyer of the floor pays the premium to the seller.

Collars: It is a combination of a Cap and Floor. The purchaser of a Collar buys a Cap and simultaneously sells a Floor. A Collar has the effect of locking its purchases into a floating rate of interest that is bounded on both high side and the low side.

(c) Exchange Traded Funds (ETFs) were introduced in US in 1993 and came to India around 2002. ETF is a hybrid product that combines the features of an index mutual fund and stock and hence, is also called index shares. These funds are listed on the stock exchanges and their prices are linked to the underlying index. The authorized participants act as market makers for ETFs.

ETF can be bought and sold like any other stock on stock exchange. In other words, they can be bought or sold any time during the market hours at prices that are expected to be closer to the NAV at the end of the day. NAV of an ETF is the value of the underlying component of the benchmark index held by the ETF plus all accrued dividends less accrued management fees.

There is no paper work involved for investing in an ETF. These can be bought like any other stock by just placing an order with a broker.

Some other important features of ETF are as follows:

1. It gives an investor the benefit of investing in a commodity without physically purchasing the commodity like gold, silver, sugar etc.
2. It is launched by an asset management company or other entity.
3. The investor does not need to physically store the commodity or bear the costs of upkeep which is part of the administrative costs of the fund.
4. An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value.

(d) The term Repurchase Agreement (Repo) and Reverse Repurchase Agreement (Reverse Repo) refer to a type of transaction in which money market participant raises funds by selling securities and simultaneously agreeing to repurchase the same after a specified time generally at a specified price, which typically includes interest at an agreed upon rate. Such a transaction is called a Repo when viewed from the perspective of the seller of securities (the party acquiring funds) and Reverse Repo when described from the point of view of the supplier of funds.

Indian Repo market is governed by Reserve Bank of India. At present Repo is permitted between 64 players against Central and State Government Securities (including T-Bills) at Mumbai.

(e) The Dow Jones Theory is probably the most popular theory regarding the behaviour of stock market prices. The theory derives its name from Charles H. Dow, who established the Dow Jones & Co., and was the first editor of the Wall Street Journal – a leading publication on financial and economic matters in the U.S.A. Although Dow never gave a proper shape to the theory, ideas have been expanded and articulated by many of his successors. Let us study the theory once again but in detail.

The Dow Jones theory classifies the movements of the prices on the share market into three major categories:

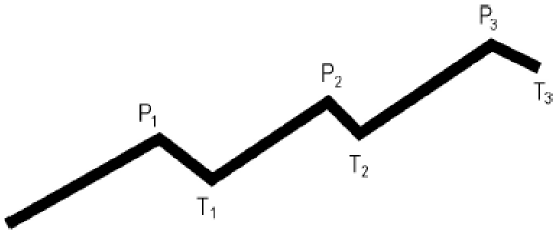
- Primary movements,

- Secondary movements, and
- Daily fluctuations.

(i) ***Primary Movements****:* They reflect the trend of the stock market and last from one year to three years, or sometimes even more.

If the long range behaviour of market prices is seen, it will be observed that the share markets go through definite phases where the prices are consistently rising or falling.

These phases are known as bull and bear phases.

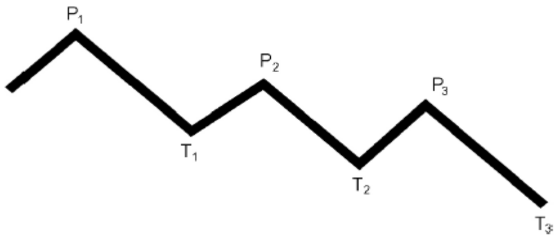


Graph 1

During a bull phase, the basic trend is that of rise in prices. Graph 1 above shows the behaviour of stock market prices in bull phase.

Students would notice from the graph that although the prices fall after each rise, the basic trend is that of rising prices, as can be seen from the graph that each trough prices reach, is at a higher level than the earlier one. Similarly, each peak that the prices reach is on a higher level than the earlier one. Thus P2 is higher than P1 and T2 is higher than T1. This means that prices do not rise consistently even in a bull phase. They rise for some time and after each rise, they fall. However, the falls are of a lower magnitude than earlier. As a result, prices reach higher levels with each rise.

Once the prices have risen very high, the b.ear phase in bound to start, i.e., price will start falling. Graph 2 shows the typical behaviour of prices on the stock exchange in the case of a bear phase. It would be seen that prices are not falling consistently and, after each fall, there is a rise in prices. However, the rise is not much as to take the prices higher than the previous peak. It means that each peak and trough is now lower than the previous peak and trough.



Graph 2

The theory argues that primary movements indicate basic trends in the market. It states that if cyclical swings of stock market price indices are successively higher, the market trend is up and there is a bull market. On the contrary, if successive highs and lows are successively lower, the market is on a downward trend and we are in a bear market. This theory thus relies upon the behaviour of the indices of share market prices in perceiving the trend in the market.

According to this theory, when the lines joining the first two troughs and the lines joining the corresponding two peaks are convergent, there is a rising trend and when both the lines are divergent, it is a declining trend.

(ii) ***Secondary Movements**:* We have seen that even when the primary trend is upward, there are also downward movements of prices. Similarly, even where the primary trend is downward, there is an upward movement of prices also. These movements are known as secondary movements and are shorter in duration and are opposite in direction to the primary movements. These movements normally last from three weeks to three months and retrace 1/3 to 2/3 of the previous advance in a bull market or previous fall in the bear market.

(iii) ***Daily Movements**:* There are irregular fluctuations which occur every day in the market. These fluctuations are without any definite trend. Thus if the daily share market price index for a few months is plotted on the graph it will show both upward and downward fluctuations. These fluctuations are the result of speculative factors. An investment manager really is not interested in the short run fluctuations in share prices since he is not a speculator. It may be reiterated that any one who tries to gain from short run fluctuations in the stock market, can make money only by sheer chance. The investment manager should scrupulously keep away from the daily fluctuations of the market. He is not a speculator and should always resist the temptation of speculating.

Such a temptation is always very attractive but must always be resisted. Speculation is beyond the scope of the job of an investment manager.

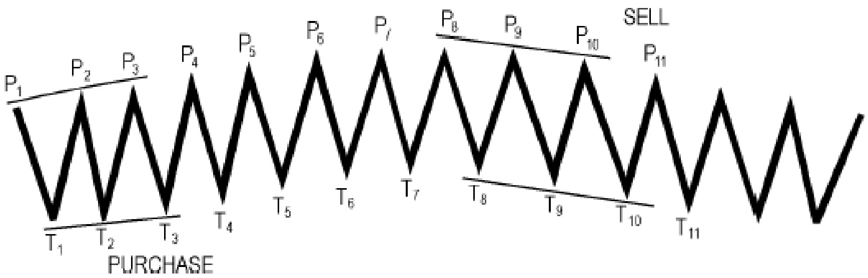
Timing of Investment Decisions on the Basis of Dow Jones Theory:

Ideally speaking, the investment manager would like to purchase shares at a time when they have reached the lowest trough and sell them at a time when they reach the highest peak.

However, in practice, this seldom happens. Even the most astute investment manager can never know when the highest peak or the lowest trough has been reached. Therefore, he has to time his decision in such a manner that he buys the shares when they are on the rise and sells them when they are on the fall. It means that he should be able to identify exactly when the falling or the rising trend has begun.

This is technically known as identification of the turn in the share market prices. Identification of this turn is difficult in practice because of the fact that, even in a rising market, prices keep on falling as a part of the secondary movement. Similarly even in a falling market prices keep on rising temporarily. How to be certain that the rise in prices or fall in the same is due to a real turn in prices from a bullish to a bearish phase or *vice versa* or that it is due only to short-run speculative trends?

Dow Jones theory identifies the turn in the market prices by seeing whether the successive peaks and troughs are higher or lower than earlier. Consider the following graph:



Graph 3

According to the theory, the investment manager should purchase investments when the prices are at T1. At this point, he can ascertain that the bull trend has started, since T2 is higher than T1 and P2 is higher than P1.

Similarly, when prices reach P7 he should make sales. At this point he can ascertain that the bearish trend has started, since P9 is lower than P8 and T8 is lower than T7.

Test Series: March, 2015

MOCK TEST PAPER -2

FINAL COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

SUGGESTED ANSWERS/ HINTS

1. (a) **Compliance with Other Laws:** As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", the auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements including tax and labour laws.

Further, non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements.

If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management. If management does not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.

If the auditor is precluded by management from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA 705 "Modifications to the Opinion in the Independent Auditor's Report".

In the instant case, most of the labourers employed in Apparel Ltd. are of the age between 12-13 years. While enquiring, management denied the fact of boundation on child labour and also contends that it was outside the scope of audit to look into the compliance with other laws. Here, it seems that the management is deliberately involved in the non-compliance of labor laws and hence precluding Mr. X, the auditor of the company, from obtaining sufficient appropriate audit evidence for further evaluation.

Thus, Mr. X should ensure the disclosure of above fact and provision for the cost of fines, litigation or other consequences for the entity. In case, the auditor concludes that non-compliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statement.

(b) **Verification of Accounts Receivable:** As per SA 510 "Initial Audit Engagements – Opening Balances", while conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

(i) Opening balances contain misstatements that materially affect the current period's financial statements; and

(ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements.

Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures, say, the collection of opening accounts receivable during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In addition, according to SA 580 "Written Representations", the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements; in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent in relation to, or the completeness of, a specific assertion. Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

In the given case, the management of Futura (P) Ltd. has restrained Mr. Meh, its auditor, from obtaining appropriate audit evidence for balances of Accounts Receivable outstanding as it is from the preceding year. Mr. Meh, on believing that the preceding year balances have already been audited and on the statement of the management that there are no receipts and credits during the current year, therefore excluded the verification of Accounts Receivable from his audit programme.

Thus, Mr. Meh should have requested the management to provide written representation for their views and expressions; and he should also not exclude the audit procedure of closing balances of Accounts Receivable from his audit programme. Consequently, Mr. Meh shall also be held guilty for professional misconduct for not exercising due diligence, or grossly negligence in the conduct of his professional duties as per the Code of Ethics.

(c) **Change in Accounting Estimate:** As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The change in estimated useful life of a depreciable asset does not constitute prior period adjustment since it neither constitutes error nor omission but it merely involves making estimates based on prevailing circumstances when financial statements were being prepared. It is a mere estimate process involving judgement based on the latest information available.

An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

A change in an accounting estimate may affect the current period only, or both, the current period and future periods. For example, a change in the estimate of the amount of bad debts is recognised immediately and therefore affects only the current period. However, a change in the estimated useful life of a depreciable asset affects the depreciation in the current period and in each period during the remaining useful life of the asset. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed.

Further, as per SA 540 “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”, the auditor shall review the outcome of accounting estimates included in the prior period financial statements or where applicable, their subsequent re-estimation for the purpose of the current period.

In this case, M/s iMax & Co. has prepared its books of accounts assuming estimated useful life of a depreciable asset being 15 years for the accounting year 2014-15. However, due to change in current market scenario, it was determined to revise the estimated useful life of that depreciable asset to 10 years.

Revision of such an estimate does not bring the resulting amount within the definition either of a prior period item or of an extraordinary item. Therefore, the effect of change relating to the current period is to be recognised as income or expense in the current period and the effect relating to future periods is to be recognised in future periods. Accordingly, adjustment in the value of the depreciation through prior period item would not be proper.

(d) Fraud Committed by Managing Director: As per SA 240 "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements", the auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence.

When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable.

If the auditor identifies a misstatement and has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. He may also consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

As per the facts of the case, the circumstances provided is basically known as "Teeming and Lading" fraud. The fact that the amount involved has been subsequently deposited at the year-end is not important because the auditor is required to perform his responsibilities. In view of the fact that the fraud has been committed at the highest level of management, it affects the reliability of audit evidence previously obtained since there is a genuine doubt about representations of management.

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.

However, if, as a result of a misstatement resulting from fraud, the auditor encounters any 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(s) who made the audit appointment or, in some cases, to regulatory authorities. The auditor shall consider for appropriateness of withdrawal from such engagement, where withdrawal from the engagement is legally permitted.

2. (a) **Printing of Designation "Chartered Accountant" on Marriage Invitations:** 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.

However, the Council of the ICAI is of the view that the designation "Chartered Accountant" as well as the name of the firm may be used in greeting cards, invitations for marriages and religious ceremonies and any other specified matters, provided that such greeting cards or invitations etc. are sent only to clients, relatives and close friends of the members concerned.

In the given case, Mr. Raj instructed to write designation "Chartered Accountant" on his marriage invitation cards and distributed the same to all his relatives, close friends and clients.

On this context, it may be noted that the Council has allowed using designation "Chartered Accountant" in invitations for marriages, provided these are sent only to clients, relatives and close friends of the members concerned. Therefore, Mr. Raj would not be held guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(b) **Permission for Providing Private Tutorship:** As per Clause (11) 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 engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage.

Further, regulation 190A of the Chartered Accountants Regulation, 1988 provides that a Chartered Accountant in practice shall not engage in any other business or occupation other than the profession of accountancy except with the permission granted in accordance with a resolution of the Council. According to the same there is no specific permission from the council would be necessary in the case of private tutorship.

In the given case, CA Ram has started providing private tutorship to Mr. Ratan along with some other aspirants, without obtaining specific or prior approval of the Council.

On this context, it may be noted that the Council has provided general permission for providing such private tutorship. Therefore, CA Ram would not be held guilty of professional misconduct under Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(c) Advising on Portfolio Management Services: The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services". A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, underwriters etc., advice regarding post issue activities, like, follow up steps for listing of instruments, dispatch of certificates, refunds etc. It is, however, specifically stated that Chartered Accountants in practice are not permitted to undertake the activities of broking, underwriting and portfolio management services.

In the given case, Mr. Sam has started advising his clients on portfolio management along with other management consultancy services related to an issue.

Therefore, Mr. Sam would be guilty of misconduct under the Chartered Accountants Act, 1949 as a chartered accountant in practice is not permitted to manage portfolios of his clients.

(d) Submitting Wrong Information to the Institute: As per Clause (3) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct if he includes in any information, statement, return or form to be submitted to the Institute, Council or any of its committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

In the instant case, Mr. P and Mr. Q, partners of M/s PQ & Co., included the name of Mr. R, another Chartered Accountant, as partner in their firm, without his knowledge, in their application for empanelment as auditor of branches of Public Sector Banks submitted to the Institute. However, such a member was not a partner of the said firm as on the date of application submitted. Here, Mr. P and Mr. Q have submitted wrong information to the Institute.

Therefore, Mr. P and Mr. Q, both, would be held guilty of professional misconduct under Clause (3) of Part II of the Second Schedule to the Chartered Accountants Act, 1949.

3. (a) **Ceiling on Number of Audits:** As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than 20 companies. Therefore, the total number of company audits that can be accepted by all the three partners of M/s PQR & Associates is 60 (20 audits *3 partners).

Further, as per the Council guidelines, the specified number of tax audit assignments that an auditor, as an individual or as a partner of a firm, can accept is 60 numbers. Therefore, the total number of tax audit assignments that can be accepted by all the three partners of M/s PQR & Associates is 180 (60 audits *3 partners).

In the given case, Mr. P, Mr. Q and Mr. R, partners of M/s PQR & Associates do not hold any audits in their personal capacity, however, the firm is already holding company audit of 55 companies. Further, the firm has been offered 5 company audit assignments and 10 tax audit assignments.

In view of the above facts and provisions, M/s PQR & Associates is suggested to accept all the audit assignments as it is well within the limit, prescribed under the Companies Act, 2013 and the Council guidelines.

(b) **Services not to be rendered by the Auditor:** Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), as prescribed. The list of the services that has been prohibited to be rendered by the auditor of the company includes designing and implementation of any financial information system.

Further, section 141(3)(i) of the Companies Act, 2013 also disqualifies a person for appointment as an auditor of a company who is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

Furthermore, section 141(4) of the Companies Act, 2013 also requires an appointed auditor to vacate his office as such auditor on incurring any of the disqualifications mentioned in section 141(3).

In the given case, M/s Quality & Co. has been appointed as an auditor of Dazzle Ltd. The firm has been offered additional services of designing and implementation of financial information system of the company. The firm is advised not to accept the services as these services are specifically covered in the services not to be rendered by an auditor as per section 144 of the Companies Act, 2013.

(c) **Preparation of Financial Statements:** Section 128 of the Companies Act, 2013 requires every company to prepare its financial statements for every financial year which gives a true and fair view of the state of the affairs of the company and such books shall be kept on accrual basis, and according to the double entry system of accounting. Further, the definition of "financial statement", given under section 2(40) of the Companies Act, 2013, includes a profit and loss account also.

In the given case, AR PE LTD. did not carry any activity in the business except raising of share capital, purchase of land, acquisition of plant and machinery and construction of factory sheds.

Though the company did not carry any activity during the year, the company has carried on certain activities like construction of factory shed, acquisition of plant and machinery etc. In such a case, it is necessary to provide for depreciation and other expenses.

The mere fact that there was no activity proceeded during the year cannot be the basis for not preparing the Statement of Profit and Loss. Therefore, the management of the company would be suggested to prepare the statement of profit and loss or any other statement which is a part of financial statement.

(d) **Auditing Procedures Using CAATs:** CAATs may be used by Eco & Co., a firm of Chartered Accountants, in performing various auditing procedures, including the following-

(i) tests of details of transactions and balances, for example, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records;

(ii) analytical procedures, for example, identifying inconsistencies or significant fluctuations;

(iii) tests of general controls, for example, testing the set-up or configuration of the operating system or access procedures to the program libraries or by using code comparison software to check that the version of the program in use is the version approved by management;

(iv) sampling programs to extract data for audit testing;

(v) tests of application controls, for example, testing the functioning of a programmed control; and

(vi) Reperforming calculations performed by the entity's accounting systems.

4. **(a) Disclosure in Audit Report:** As per SA 570 "Going Concern", when the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements-

(i) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(ii) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

In the given case, Giant Ltd. has sold out its manufacturing fixed assets during the year ending on 31st March, 2015. However, it intends to continue its operations as a trading company. Therefore, selling of manufacturing fixed assets does not affect the going concern assumption of the company. Additionally, while carrying out physical verification of fixed assets, a material discrepancy to the tune of Rs. 80,000 was found, which was written off and disclosed separately in the Statement of Profit and Loss. Hence, this fact needs to be disclosed in the Audit Report as follows:

Para in the Audit Report-

We have made our viewpoint from the facts of the case and on the basis of guidance drawn from AS 1. We report as under-

As per Accounting Standard (AS) 1, "Disclosure of Accounting Policies", "the enterprise is normally viewed as a going concern that is as continuing its operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations." Although the company has disposed off its manufacturing fixed assets during the financial year ending on 31-03-2015, it is still a going concern in the form of a trading company. We also report that on physical verification of other fixed assets, a material discrepancy to the tune of Rs. 80,000 was noticed and that the same has been properly dealt with in the books of account.

(b) Current Period Consolidation Adjustments: Current period 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 to be taken into account, 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.

(c) Independent Director under Clause 49 of the Listing Agreement: As per Clause 49 of the listing agreement, an Independent Director shall mean a non-executive director, other than a nominee director of the company:

(1) who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;

(2) (i) who is or was not a promoter of the company or its holding, subsidiary or associate company;

(ii) who is not related to promoters or directors in the company, its holding, subsidiary or associate company;

(3) apart from receiving director's remuneration, has or had no pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;

(4) none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to 2% or more of its gross turnover or total income or Rs. 50 lakhs or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;

(5) who, neither himself nor any of his relatives —

(i) holds or has held the position of a key managerial personnel or is or has been employee of the company or its holding, subsidiary or associate company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed;

(ii) is or has been an employee or proprietor or a partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of —

(A) a firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or

(B) any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to ten per cent or more of the gross turnover of such firm;

(iii) holds together with his relatives 2% or more of the total voting power of the company; or

(iv) is a Chief Executive or director, by whatever name called, of any non-profit organisation that receives 25% or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds 2% or more of the total voting power of the company;

(v) is a material supplier, service provider or customer or a lessor or lessee of the company;

(6) who is not less than 21 years of age.

5. (a) Restrictions on Investment of Funds of a Central Co-operative Society: Provisions of the Co-operative Societies Act, 1912 (Central Act) put some restrictions on investments of funds of a Central Co-operative Society. According to Section 32 of the Central Act, a Central Co-operative Society may invest its funds only in any one or more of the following-

(i) In the Central or State Co-operative Bank.

(ii) In any of the securities specified in Section 20 of the Indian Trusts Act, 1882.

(iii) In the shares, securities, bonds or debentures of any other society with limited liability.

(iv) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.

(v) In any other moneys permitted by the Central or State Government.

In the principal provision relating to the investments of funds of a Co-operative Society, the Central as well as State Acts does not mention anything about the investment of reserve fund outside the business specifically.

(b) Audit of a Hire Purchase Finance Company: Following are the exceptional points to be kept in mind while auditing an NBFC providing finance on hire purchase of assets-

(i) Ascertain whether the NBFC has an adequate appraisal system for extending hire purchase finance. The system of appraisal is basically concerned with obtaining information regarding the credit worthiness of the hirer, his experience in the field, assets owned, his past track record and future projections of his income.

(ii) Verify that the payment for acquiring an asset should be made directly to the supplier/dealer and that the original invoice has been drawn out in the name of the NBFC.

(iii) In the case of high value hire purchase items relating to machinery/equipment, an auditor should ascertain whether the valuation reports and installation reports are called for. In case of some high value items, he should also physically verify the asset in possession of the hirers, particularly in a situation where he has any doubts as regards the genuineness of the transaction.

(iv) If the hire purchase finance is against vehicles, check whether the registration certificate contains an endorsement in favour of the hire purchase company.

(v) The auditor should verify whether the NBFC has a system in place for verifying the hire purchase assets periodically to ensure that the hirers have not sold the assets or otherwise encumbered them.

(vi) Check whether hire purchase instalments are being received regularly as and when they fall due. Check whether adequate provision has been made for overdue hire purchase instalments as required by the NBFC Prudential Norms directions.

(vii) Examine the method of accounting followed by the hire purchase finance company for appropriation of finance charges over the period of the hire purchase contract. Ascertain that there is no change in the method of accounting as compared to the immediately preceding previous year.

(viii) Verify that the assets given on hire purchase have been adequately insured against.

(ix) In case the goods are repossessed by the hire purchase finance company on account of non-repayment of hire purchase instalments, verify that the repossessed goods have been valued on a realistic basis by the hire purchase finance company.

(c) Reporting for Receipt of Shares, the Aggregate Fair Market Value of Which Exceeds Rs. 50,000: In this case, ABC Pvt. Ltd. is a company, other than a company in which the public are substantially interested. During the previous year

2014-15, the company received property, being shares, for no consideration, the aggregate fair market value of which is Rs. 75,000.

Provisions and Explanations: A tax auditor has to furnish the details of shares received during the previous year, under clause 28 of Form 3CD, in case, the assessee has received any property, being share of a company not being a company in which public are substantially interested, without consideration or for inadequate consideration as referred to in section 56(2)(viia) of the Income Tax Act, 1961.

Section 56(2)(viia) provides that where a firm or a company not being a company in which the public are substantially interested, receives, in any previous year any property being shares of a company not being a company in which the public is substantially interested,

(i) without consideration, the aggregate fair market value of which exceeds Rs. 50,000, the whole of the aggregate fair market value of such property;

(ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding Rs. 50,000, the aggregate fair market value of such property as exceeds such consideration,

shall be chargeable to income-tax under the head "Income from other sources".

The fair market value of shares means the value as determined in accordance with the method prescribed in Income Tax Rules, 1962.

Conclusion: As per the facts of the case, provisions and explanations given above, the income generated by ABC Pvt. Ltd., being whole of the aggregate fair market value of shares received (i.e. Rs. 75,000), is chargeable to income-tax under the head "Income from other sources" as per section 56(2)(viia) of the Income Tax Act, 1961.

Therefore, the tax auditor of ABC Pvt. Ltd. is required to furnish the details of such shares received under clause 28 of Form 3CD. The contention of the management of the company, for not reporting such receipt of shares, is not acceptable.

6. (a) The Factors Responsible for High Employee Attrition Rate: The internal auditor of Perfect Ltd. is required to consider the following factors in analyzing the high employee attrition rate-

(i) Job Stress & work life imbalance.

(ii) Wrong policies of the Management.

(iii) Unbearable behaviour of Senior Staff.

(iv) Safety factors.

(v) Limited opportunities for promotion.

(vi) Low monetary benefits.

(vii) Lack of labour welfare schemes.

(viii) Whether the organization has properly qualified and experienced personnel for the various levels of works?

(ix) Is the number of people employed at various work centres excessive or inadequate?

(x) Does the organization provide facilities for staff training so that employees and workers keep themselves abreast of current techniques and practices?

(b) Procedure, Powers etc. of Inspectors: Section 217 of the Companies Act, 2013 states the procedures, powers of the Inspectors as follows-

(i) **Duty of officers and employees of the company towards inspector:** It shall be the duty of all officers and other employees and agents including the former officers, employees and agents of a company which is under investigation to preserve and to produce to an inspector or any person authorised by him, all books and papers relating to the company or the person; and to provide assistance in connection with the investigation which they are reasonably able to give.

(ii) **Inspector may ask information from any body corporate:** The inspector may require any body corporate, other than a body corporate referred to in point(1), to furnish such information to, or produce such books and papers before him as he may consider necessary.

(iii) **Not to keep Books and Papers in custody for more than 180 days:** The inspector shall not keep in his custody any books and papers produced for more than 180 days and return the same to whom the books and papers were produced.

The inspector may call the books and papers again, if needed, for a further period of 180 days by an order in writing.

(iv) **Examine on oath:** The inspector may examine on oath any of the persons referred above; and with the prior approval of the Central Government, any other person in relation to the affairs of the company, or other body corporate or person, as the case may be.

(v) **Inspector to possess all the Powers of Civil Court:** The inspector, being an officer of the Central Government, making an investigation shall have all the powers as are vested in a civil court under the Code of Civil Procedure, while trying a suit in respect of specified matters under the Companies Act.

(vi) **Assistance of Officers of Government to Inspector:** The officers of the Central Government, State Government, police or statutory authority shall provide necessary assistance to the inspector for the purpose of inspection, investigation etc.

(vii) **Evidence from place outside India:** If in the course of an investigation into the affairs of the company, an application is made to the competent court in India by the inspector stating that evidence may be available in a country or place outside India, such court may issue a letter of request to a court or an authority in such country or place.

It may be noted that the letter of request shall be transmitted in such manner as the Central Government may specify in this behalf.

(c) Comprehensive Audit of Public Enterprises: The scope and extent of audit of public sector enterprises is determined by the Comptroller and Auditor General of India. Audit of public enterprises in India is not restricted to financial and compliance audit; it extends also to efficiency, economy and effectiveness with which these operate and fulfill their objectives and goals. Another aspect of such audit relates to questions of propriety; this audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety. Comprehensive audit involves assessing efficiency and effectiveness of public enterprises in its entirety to be conducted on the basis of certain standards and criterion. Public enterprises have been set-up with socio-objectives. An objective assessment with reference to such objectives' fulfillment would require comprehensive audit.

Areas to be covered: The areas covered in comprehensive audit will naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations. Some of the broad areas are listed below-

(i) Comparison of overall capital cost of the project with the approved planned costs.

(ii) Production or operational outputs vis-a-vis under-utilisation of the installed capacity.

(iii) Systems of project formulation and implementation.

(iv) Planned rate of return.

(v) Cost control measures.

(vi) Research and development programmes.

(vii) System of repairs and maintenance.

(viii) Adequate purchase policies.

(ix) Effective and economical procedures.

(x) Project planning.

(xi) Undue waste, unproductive time for men and machines, wasteful utilisation or even non-utilisation of resources.

7. (a) Facultative Re-insurance under Insurance Act: It is that type of reinsurance whereby the contract relates to one particular risk and is expressed in the reinsurance policy. This is the oldest method of reinsurance and it necessitates consideration of each risk separately. Each transaction under facultative reinsurance has to be negotiated individually. Each party to the transaction has a free choice, i.e., for the ceding company to offer and the reinsurer to accept. The main drawbacks of this type of insurance are the volume of work involved and time taken to cover the risk. It is, however, still used even today, mainly when:

(i) automatic covers have already been exhausted.

(ii) the risk is excluded from the Treaties.

(iii) the insurer does not want his reinsurance treaties overburdened with particularly heavy and abnormal risks.

(iv) the insurer has no automatic cover at his disposal in a particular branch, where he issues policies rarely.

(v) the nature of business is such that technical guidance or consultation with the reinsurer is required at every stage of acceptance of the risk itself or for a type of business where the number of risks is very small, for example, in atomic energy installations, oils rigs, etc.

(b) Reversal of Income under Bank Audit: If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s).

(c) Environmental Audit: To understand environmental audit, firstly environmental reporting need to be understood. Environmental reporting deals with the disclosure by an entity of environmentally related data, regarding environmental risks, environmental impacts, policies, strategies, targets, costs, liabilities or environmental performance to those who have an interest in such information as an aid to enabling/enriching their relationship with the reporting entity via either the annual report; a stand-alone corporate environmental performance report; or some other medium (e.g. staff newsletter, video, CD ROM, internet site). The reports that are generated after such audits can be either compliance-based reporting or impact-based performance reporting.

Environmental audit deals with verification of information contained in such reports with a view to expressing an opinion thereon. Environmental audit can be performed by external agencies or internal experts (including internal auditors). In practice, environmental audit is not done by a single agency but by various agencies who are experts in the field. Since the subject matter of environmental audit involves multi-disciplinary knowledge and skill, it is preferable to form a team of persons drawn from different disciplines who may assist the chartered accountant in performing the task in an effective manner, generally environmental audits are not required by any statute but are sometimes done at the request of the management to address issues like compliance with environmental laws and regulations, etc.

(d) Cut-off Procedures: Cut-off procedures mean procedures employed to ensure the separation of transactions at the end of one year from those in the commencement of the next year. Usually, the problem of overlapping is found in inventory accounting since quite often goods are sold but passed on to the buyer only after the year is over or goods are bought but received only after the close of the year. This situation may create considerable problem for the proper stock taking of inventory. Therefore, the principal areas of application of cut-off procedures involve sales, purchases and stock. The auditor should satisfy himself by examination and test check that these procedures adequately ensure that:

(i) Goods purchased for which property has passed to the client have in fact been included in inventories and that the liability if any, has been provided for.

(ii) Goods sold have been excluded from the inventories and credit has been taken for sales.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to period shortly before and shortly after the cut-off date, and check whether the stocks represented by those documents were included or excluded, as appropriate, during the stock-taking.

(e) Peer Review: The term "peer" means a person of similar standing and term "review" means conduct of re-examination or retrospective evaluation of the subject matter. In general, for a professional, the term "peer review" would mean review of work done by a professional, by another professional of similar standing. 'Peer Review' is defined as, a regulatory mechanism for monitoring the performances of professionals for maintaining quality of service expected of them for enhancing the reliance placed by the users of financial statements for economic decision-making.

As per the Statement of Peer Review issued by the Institute of Chartered Accountants of India, Peer Review - means an examination and Review of the systems and procedures to determine whether the same have been put in place by the Practice Unit for ensuring the quality of assurance services as envisaged by the Technical, Professional and Ethical Standards and whether the same were consistently applied in the period under review. The examination and review of a practice unit would be carried out by a "reviewer", i.e., a member, selected from a panel of reviewers maintained by the Board. The term "practice unit" means members in practice, whether practicing individually or as a firm of Chartered Accountants.

Test Series: March, 2015

MOCK TEST PAPER – 2

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) Under section 137(1) of the Companies Act, 2013, a copy of the financial statements, including consolidated financial statement, if any, along with all the documents which are required to be or attached to such financial statements under this Act, duly adopted at the annual general meeting of the company, shall be filed with the Registrar within thirty days of the date of annual general meeting in such manner, with such fees or additional fees as may be prescribed within the time specified. Every company shall file the financial statements with the Registrar together with *Form AOC-4*.

Provided that where the financial statements under sub-section (1) are not adopted at annual general meeting or adjourned annual general meeting, such unadopted financial statements along with the required documents under sub-section (1) shall be filed with the Registrar within thirty days of the date of annual general meeting and the Registrar shall take them in his records as provisional till the financial statements are filed with him after their adoption in the adjourned annual general meeting for that purpose.

Further under section 137(2) of the Companies Act, 2013 where the annual general meeting of a company for any year has not been held, the financial statements along with the documents required to be attached under sub-section (1), duly signed along with the statement of facts and reasons for not holding the annual general meeting shall be filed with the Registrar within thirty days of the last date before which the annual general meeting should have been held and in such manner, with such fees or additional fees as may be prescribed within the time specified.

Accordingly,

(i) In the present case though Annual General Meeting was not held, and it ought to have been held by 30th September, 2014 under sections 96 of the Companies Act, 2013.

Therefore, under the provisions of section 137(2) the financial statements along with the documents required to be attached under this Act, duly signed along with the statement of facts and reasons for not holding the annual general meeting shall be filed with the Registrar within thirty days of the last date before which the annual general meeting should have been held i.e. by 30th October 2014 along with such fees or additional fees as may be prescribed.

(ii) Since the Annual General Meeting has been held in time on 27th September 2014, the unadopted financial statements along with the required documents under sub-section (1) of section 137 shall be filed with the Registrar within thirty days of the date of annual general meeting and the Registrar shall take them in his records as provisional till the financial statements are filed with him after their adoption in the adjourned annual general meeting for that purpose.

(b) (i) The appointment and re-appointment of auditor of a Government Company or a government controlled company is governed by the provisions of section 139(7) of the Companies Act, 2013 which are summarized as under:

The first auditor in the Government Company or any other company owned or controlled, directly or indirectly, by the Central Government, State Government or Governments , or partly by the Central Government and partly by one or more State Government, shall be appointed by the Comptroller and Auditor General of India within 60 days from the date of registration of the company and in case of failure to do so, the Board shall appoint auditor within next 30 days and on failure to do so by Board of Directors, it shall inform the members, who shall appoint the auditor within 60 days at an extraordinary general meeting (EGM), such auditor shall hold office till conclusion of first Annual General Meeting.

In case of subsequent auditor for existing Government companies, the Comptroller & Auditor General of India in respect of a financial year, shall appoint an duly qualified auditor within a period of 180 days from the commencement of the financial year and the auditor so appointed shall hold his position till the conclusion of the Annual General Meeting.

(ii) The situation as stated in the question relates to the creation of a casual vacancy in the office of an auditor due to resignation of the auditor before the AGM. Under section 139 (8) any casual vacancy in the office of an auditor arising as a result of his resignation, such vacancy can be filled by the Board of Directors within thirty days thereof, and in addition such appointment of the auditor shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

(c) Under section 149(1) of the Companies Act, 2013 every company shall have a Board of Directors consisting of individuals as directors and shall have a minimum number of three directors in the case of a public company, two directors in the case of a private company, and one director in the case of a One Person Company; and a maximum of fifteen directors.

The proviso to section 149(1) states that a company may appoint more than fifteen directors after passing a special resolution.

From the provisions of section 149 (1) as above, though the minimum number of directors may vary depending on whether the company is a public company, private or a One Person Company, the maximum number of directors is the same for all types at 15 directors.

In the given case since the number of directors is proposed to be increased to 16, the company will be required to comply with the following provisions:

(i) Alter its Articles of Association under section 14 of the Act;

(ii) Authorise the maximum number of directors to 16 by means of a special resolution of members passed at a duly convened general meeting of the company.

(d) Title to dividends: Section 27(1) of Securities Contracts (Regulation) Act, 1956 provides that a holder of security can legally receive and retain any dividend declared by the company even if he has transferred the security for valuable consideration. However, he (i.e. holder of security who is a transferor) cannot receive or retain the dividend if the transfer deed with all other documents required for transfer are lodged with the company within 15 days of the date on which the dividend became due.

The period of 15 days shall be extended: - (1) In case of death of the transferee by the actual period taken by his legal representative to establish his claim to the dividend. (2) In case of loss of the transfer deed by theft or any other cause beyond the control of the transferee, by the actual period taken for the replacement thereof and (3) In case of delay in the lodging of any security and other documents relating to the transfer due to causes connected with the post, by the actual period of delay (Explanation to Section 27(1) of SCRA).

In view of the above, Mr. Patel is entitled to retain the dividend received by him if the transferee, Mr. Mehta has not lodged the transfer deed with the company within 15 days of the date on which the dividend became due or the extended period as per explanation to section 27(1).

However, section 27(1) will not affect the right of the transferee to enforce his rights, if any against the transferor or any other person, if the company refuses to register the transfer of security in the name of the transferee.

2. (a) (i) Under section 152(6) (a) unless the articles provide for the retirement of all directors at every annual general meeting, not less than two-thirds of the total number of directors of a public company shall be persons whose period of office is liable to determination by retirement of directors by rotation.

In the given case, it is assumed that the 6 directors appointed at the first general meeting of the company constitute at least two thirds of the total number of directors.

Section 152(6)(c) further states that at every annual general meeting, one-third of such of the directors for the time being as are liable to retire by rotation, or if their number is not three or a multiple of three, then, the number nearest to one-third, shall retire from office.

Therefore, in the given case 2 directors will be liable to retire by rotation at the next AGM of the Company.

Section 152(6)(d) further states that the directors to retire by rotation at every annual general meeting shall be those who have been longest in office since their last appointment, but as between persons who became directors on the same day, those who are to retire shall, in default of and subject to any agreement among themselves, be determined by lot.

In the given case, all the 6 directors were appointed on the same date. Hence, the choice of the 2 directors who would retire at the next AGM of the company will be made either mutually by these 6 directors failing which; it will be decided by lots.

It will not make any difference under the Companies Act, 2013 if the company is a non profit organization.

(ii) Section 197(5) of the Companies Act, 2013 provides that a director may receive remuneration by way of fee for attending the Board/Committee meetings or for any other purpose as may be decided by the Board, provided that the amount of such fees shall not exceed the amount as may be prescribed. The Central Government through rules prescribed [under the Rule 4 of the Companies(Appointment and Remuneration of Managerial Personnel) Rules, 2014] that the amount of sitting fees payable to a director for attending meetings of the Board or committees thereof may be such as may be decided by the Board of directors or the Remuneration Committee thereof which shall not exceed the sum of rupees 1 lakh per meeting of the Board or committee thereof. Further, the Board may decide different sitting fee payable to independent and non-independent directors other than whole-time directors.

They shall be entitled for the sitting fees not less than the sitting fee payable to other directors.

From the above, it is clear that fee to independent directors can be increased from Rs. 30,000 to Rs 45,000 per meeting by passing a Board Resolution.

(b) (I) (i) There is no provison in the Companies Act, 2013 under which the Board meetings must be held at any particular place. The Companies Act, 2013 lays down the provisions for holding meetings by video conferencing, sending notices, procedures at the meeting etc. Therefore, there is no difficulty in holding the board meeting at Chennai even if all the directors of the company reside at Calcutta and the registered office is situated at Calcutta provided that the requirements regarding the holding of a valid board meeting and the other proivisions relating to the signing of register of contracts, taking roll calls, etc. are complied with.

(ii) Section 173 (3) of the Companies Act, 2013 provides for the giving of notice of every board meeting of not less than seven days to every director of the company. There is no provision in the Act laying down the contents of the notice. Hence, it may be construed that notice may be interpreted as intimation of the meeting and does not necessarily include the sending of the Agenda of the meeting. However, considering the importance of Board Meetings and the responsibilities placed on the directors for decisions taken at the meetings, it is inevitable for them to be properly prepared and informed about the items to be discussed at the Board Meetings. As a matter of good secretarial practice, the notice should include full details and particulars of the business to be transacted at the Board Meetings.

The articles of association of the company may make it mandatory to do so in almost all cases.

(b) (II) Appointment of Independent Director – Ordinary Resolution

"RESOLVED that pursuant to the provisions of Sections 149, 150, 152 and any other applicable provisions of the Companies Act, 2013 and the rules made thereunder (including any statutory modification(s) or re-enactment thereof for the time being in force) read with Schedule IV to the Companies Act, 2013, Mr. Smith (holding DIN -------), Director of the Company who retires by rotation at the Annual General Meeting and in respect of whom the Company has received a notice in writing from a member proposing his candidature for the office of Independent Director not liable to retire by rotation, is hereby appointed as an Independent Director of the Company to hold office for a period of five consecutive years for a term up to ---, 20---."

3. (a) Price manipulation in the shares of ABC Ltd. can be considered as fraudulent and unfair trade practices relating to securities market. In this case SEBI may exercise the following powers under section 11(4) of securities and Exchange Board of India Act, 1992.

(i) Suspend the trading of any security (in this case the securities of ABC Ltd.) in a recognized stock exchange.

(ii) Restrain persons (in this case ABC Ltd.) from accessing the securities market. It can also prohibit any person associated with securities market (i.e. brokers who have indulged in price manipulation) to buy, sell or deal in securities market.

SEBI may issue the above orders for reasons to be recorded in writing. SEBI shall, either before or after passing such orders give an opportunity of hearing to company and brokers concerned (proviso 2 to Section 11(4)) SEBI may also appoint an adjudicating officer who may levy penalty under section 15 HA after holding an enquiry in the prescribed manner. According to section 15HA if any person indulges in fraudulent and unfair trade practices relating to securities, he shall be liable to a penalty of ` 25 crores or 3 times the amount of profits made out of such practices, whichever is higher.

Prohibition on manipulation and deceptive practices: Further according to section 12A, no person shall directly or indirectly indulge in following- (a) using in manipulative or deceptive device in connection with purchase, sale or securities listed (b) Employ any scheme or device to defraud in connection with dealing in securities which are listed (c) engage in an act which would operate as fraud or deceit upon any person in connection with dealing in securities which are listed. SEBI may impose penalty upto ` 1 crore on any person who fails to comply with any provisions of SEBI Act (Section 15 HB).

(b) Sub-section (1) of the section 129 of this Act states that financial statement of the company shall comply with the accounting standards notified under section 133. As per sub–section (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 (which requires compliance with accounting standards), 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.

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 3 year, or with fine not less than Rs. 50,000 but which may extend to ` 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 referred to in section 143 of the Companies Act, 2013.

4. (a) (i) Compromise or Arrangement: The scheme must be approved by a resolution passed with the special majority stipulated in section 391(2) of the Companies Act, 1956, namely a majority in number representing three-fourths in value of the creditors, or members, or class of members, as the case may be, present and voting either in person or, by proxy.

The majority is dual, in number and in value. A simple majority of those voting is sufficient. Whereas the 'three-fourths' requirement relates to value. The three-fourths value is to be computed with reference to paid-up capital held by members present and voting at the meeting.

In this case out of 700 members, 400 members attended the meeting, but only 310 members voted at the meeting. As 160 members voted in favour of the scheme the requirement relating to majority in number (i.e. 156) is satisfied 310 members who participated in the meeting held 12,40,000, three-fourth of which works out to 9,30,000 while 160 members who voted for the scheme held 10,00,000 shares. As both the requirements are fulfilled, the scheme is approved by the requisite majority. (It is presumed that all the shares are fully paid-up).

(ii) Preference shareholders: The term 'member' includes preference shareholders also. Further, preference shareholders are a class of members and their rights may be affected differently in the proposed scheme of arrangement. Hence their approval is also required.

If the Court directs separate meeting of preference shareholders and equity shareholders, then the scheme should be approved by requisite majority in both such meetings held as per directions of the Court.

(b) Oppression: The term oppression' is not defined in the Companies Act, 1956. Oppression, according to the Dictionary meaning of the word, is any act exercised in a manner burdensome, harsh and wrongful. The meaning of the term 'oppression' was explained by Lord Cooper in the Scottish case of *Elder v. Elder and Watson Ltd*, as given below:

"The conduct complained of should be at the lowest involve a feasible departure from the standards of fair dealing and the violation of the conditions of fair play on which every shareholder entrusting his money to the company is entitled to rely.

(i) Oppression of a member as a director: The oppression dealt with by section 397 is only oppression of members in their character as such; and it is only in that character they can involve section 397. The harsh treatment, for instance, of a member who is a director or other officer or employee, by the Board of directors or management does not come within (section 397). It has been held in *Re. Bellador Silk Ltd.* that if the majority of the Board of directors override the minority directors the latter cannot resort to section 397 and hence the minority directors will not succeed in getting relief from CLB on the ground of oppression.

(ii) Right not confined to minority: According to section 399, the right to apply for relief under section 397/398 is given to 100 members or 1/10th of the total number of members or any member or members holding not less than 1/10th of the issued share capital of the company. There is nothing in this section which suggests even indirectly that unless the application is made by minority shareholders it is not maintainable. The right to apply is, therefore, not confined to oppressed minority of the shareholders alone. It was held by Calcutta High Court in *Re. Sindhri Iron Foundry (P) Ltd*. that the oppressed majority also might apply for relief under section 397. Therefore, the petitioners are likely to succeed in getting relief provided the other condition laid down in section 397 (i.e. that to wind up the company would unfairly prejudice such members, but that otherwise the facts would justify the making of a winding-up order on just and equitable ground) is satisfied, even though the Delhi High Court held a contrary view in *Suresh Kumar Sanghi v. Supreme Motors Ltd*.

5. (a) In this case the company is proposed to be wound up as the business for which it was formed has been complied. As the company is solvent, the voluntary winding up can be member's voluntary winding up and for this purpose the following steps is to be taken:

(1) **Declaration by directors-** All the directors or atleast majority of directors have to make declaration at the meeting of Board of Directors that they have made

full enquiry into the affairs of the company and they are of the opinion that the company has no debts at all or it will be able to pay all its debts within three years from the date of commencement of winding up proceedings [section 488(1) Companies Act, 1956]. Such declaration should be made within five weeks preceding the date of general meeting where winding up petition is proposed to be passed.

(2) **Filing of declaration-** The declaration should be filed with Registrar of Companies before the date of general meeting. The declaration should be accompanied by report of auditors of the company giving profit and loss account for the period commencing from date upto which last accounts were prepared and ending with latest practicable date before the making of declaration. A balance sheet on that date should also be prepared. [Section 488(2)].

(3) **Passing of resolution-** Next, the company has to pass at its general meeting a resolution called 'resolution for voluntary winding up'. Ordinary resolution will do in this case, if the articles provide that the company is to be dissolved on completion of the business (section 484). Otherwise, special resolution is required.

(4) **Appointment of Liquidator-** At this meeting or any meeting subsequent thereto, one or more liquidators are to be appointed and their remuneration should be fixed. (Section 490).

(5) **Notice of Resolution passed-** After the resolution is passed, company must give notice of such resolution by advertisement within 14 days in Official Gazette and also in some newspaper circulating in the District where the registered office is situated. (Section 485).

(6) **Notice to Registrar-** Under section 494, the company has to give notice of appointment of the liquidator to the Registrar of Companies.

(7) **Commencement of winding up-** The voluntary winding up commences at the time when the resolution for voluntary winding up is passed. (Section 486).

(b) In accordance with the provisions of the Banking Regulation Act, 1949 as contained in section 17, every banking company incorporated in India must create a reserve fund and transfer a sum equal to not less than 20% of its net profits. However, Central Government is empowered to exempt from this requirement on the recommendation of the RBI. Such exemption will be allowed only:

1 when the amount in the reserve fund and the share premium account are equal to the paid-up share capital of the banking company.

2. when the Central Govt. feels that its paid-up share capital and reserves are adequate to safeguard the interest of the depositors.

If the banking company appropriates any sum from the Reserve Fund or the Share Premium account, it must be reported to RBI within 21 days explaining the circumstances leading to such appropriation.

Therefore, applying the above provisions:

(i). Contention of share holders shall be tenable since the %age of transfer of profits to Reserve Fund is lower than statutory limits, as provided in the Act.

(ii). In the second case the contention of shareholders shall not be tenable, since 30% is more than the minimum statutory limit of 20% of the net profits.

6. (a) (i) According to the provisions of section 581ZD (1) and (2) of the Companies Act, 1956, the shares of a member of a Producer Company shall not be transferable but a member of a Producer Company may after obtaining the previous approval of the Board, transfer the whole or part of his shares along with any special rights, to an active member at par value.

Based on the above provisions relating to the transfer of shares of a member in a Producer Company, Mr. Zameen has to obtain prior approval of the Board and then transfer his shares to an active member of the Producer Company at par value.

(ii) Under Section 581ZK of the Companies Act, 1956, the Board of the Producer Company may, subject to the provision in the Articles of Association, provide financial assistance by way of loan and advances against such security as may be specified in its Articles of Association to any member repayable within a period exceeding three months but not exceeding seven years from the date of disbursement of such loan or advances. In the instant case, member has applied for loan of ` 25,000. The period is not specified in the question. The Company may grant the member a loan of ` 25,000 against such security and at such rate of interest as may be specified in the Articles. However, in the case of a director, loan of ` 2 lakh can be granted only after its approval by the members in general meeting.

(b) Companies, particularly public listed companies raise huge amounts of monies from the members of the public and public financial institutions. They owe it to all the vast number of persons and institutions who have reposed their faith in them and have invested in them, that their faith is rewarded both in terms of annual return and in terms of wealth appreciation in real terms. In order to achieve this it is vital to have the highest quality of corporate governance in the conduct of affairs of such companies. Thus, the role of audit committees have been enhanced, their responsibilities made more objective and the accountability has increased substantially.

In this context the provisions of the Companies Act, 2013 have been framed to improve corporate governance standards and protect the interests of the public and the financial institutions who have invested in companies. These provisions may be highlighted as under:

1. The constitution of Audit Committees under section 177(2) requires the majority representation from independent directors. In other words, persons from within the management cannot form a majority in the Committee, thereby making the functioning of these committees more transparent;

2. The proviso to section 177(2) further requires the majority of members and the chairperson of the Audit Committees to be persons who can understand financial statements. This enables a meaningful exercise of the committee's functions by knowledgable persons thereby increasing the effectiveness of such committees.

3. Now the terms of reference or the minimum scope of work of an Audit Committee has been laid down in the act itself under section 177(4). By doing this the vagueness and doubt in the role and functions of such committees has been removed.

4. The Audit Committee shall have authority to investigate into any matter in relation to the areas of its scope of functioning or referred to it by the Board and for this shall have power to obtain professional advice from external sources and have full access to information contained in the records of the company. This provides the Audit Committee to function with a high degree of effectiveness by accessing external professional advice and the records of the company.

5. The recommendations of the Audit Committee are binding on the Board to take appropriate corrective actions. In case the Board of Director refuses to accept the recommendations of the Audit Committee, it bound to disclose the same with the reasons for non acceptance, in its report to the members of the company under section 134 (3) which relates to the Directors Report on Financial Statements to the members of the company.

It will be seen from the above provisions of the Companies Act, 2013 that efforts have been made to make such committees more impartial, effective and accountable which will enable to company to improve the quality of its corporate governance thereby improving accountability and avoiding financial impropriety.

7. (a) "Export," means the taking out of India to a place outside India any goods [Section 2(1) of Foreign Exchange Management Act, 1999]. Hence sending 100 trucks on lease to Italy is an 'export' within the meaning of Section 2(1).

Under provisions of section 7 of the Foreign Exchange Management Act, 1999 rules have been made governing export of goods and services. Regulation 14-A of the Foreign Exchange Management (Export of Goods and Services) Regulations, 2000 prescribes that no person shall, except with prior permission of the Reserve Bank of

India, take or send out by land, sea or air any goods from India to any place outside India on lease or hire or under any arrangement or in any other manner other than sale or disposal of such goods.

Based on the above provisions, it can be concluded that if the company, namely, Tomco Ltd. wants to accept the order for despatching 100 trucks to Italy on lease, it has to take prior permission of the Reserve Bank of India.

(b) **Removal of Member of Competition Commission:** Section 11(2) of the Competition Act, 2002 empowers the Central Government to remove, by an order, a member of the Competition Commission of India from his office if such member has become physically or mentally incapable of acting as a member. However, provisions of Section 11(3) of the said Act put some restrictions on such power of the Central Government. According to this Section, the Central Government has to make a reference to the Supreme Court of India under the two conditions- where the member has acquired such financial or other interest as is likely to affect prejudicially his functions as a Member; or where a member has abused his position as to render his continuance in office prejudicial to the public interest.

As the ground of removal mentioned in the question does not fall under these two categories, thus, the Central Government can remove a member of the Competition Commission of India without referring the matter to the Supreme Court for Inquiry.

In view of the above, the action of the Central Government is in order and removal of member is valid.

(c) Under 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:

1. the instrument constituting or defining the constitution of the company;
2. the enactments or provisions by or under which the incorporation of the company was effected;
3. 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;
4. the date on which and the country in which the company would be or was incorporated; and
5. 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 (a), (b) and (c), 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.

(d) The normal function of a provisio 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 it 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 provision to which it has been enacted as a proviso and not to the other. (*Ram Narain Sons Ltd. Vs. Assistant Commissioner of Sales Tax.,A.I.R,1995 SC 765*)

An explanation is at times appended to a section to explain the meaning of the text of the section. An explanation may be added to include something within the Section or to exclude something from it. An explanation should normally be so read as to harmonise with and clear up any ambiguity in the main section. It should not be so construed as to widen the ambit of the section.

(e) Section 12 provides for the obligation of Banking Companies, Financial Institutions and Intermediaries or a person carrying on a designated business or profession. According to sub-section (1), every banking company, financial institution and intermediary or a person carrying on a designated business or profession shall –

(i) maintain a record of all transactions, including information relating to transactions covered under clause (b), in such manner as to enable it to reconstruct individual transactions;

(ii) furnish to the Director within such time as may be prescribed, information relating to such transactions, whether attempted or executed, the nature and value of which may be prescribed;

(iii) verify the identity of its clients in such manner and subject to such conditions, as may be prescribed;

(iv) identify the beneficial owner, if any, of such of its clients, as may be prescribed;

(v) maintain record of documents evidencing identity of its clients and beneficial owners as well as account files and business correspondence relating to its clients.

Every information maintained, furnished or verified, save as otherwise provided under any law for the time being in force shall be kept confidential.

The records referred to in clause (a) of sub-section (l) shall be maintained for a period of five years from the date of transaction between a client and the reporting entity.

The records referred to in clause (e) of sub-section (I) shall be maintained for a period of five years after the business relationship between a client and the reporting entity has ended or the account has been closed, whichever is later.

The Central Government may, by notification, exempt any reporting entity or class of reporting entities from any obligation under this chapter

Test Series: March, 2015

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – II

PAPER – 5: ADVANCED MANAGEMENT ACCOUNTING

SUGGESTED ANSWERS/HINTS

1. (a) Primary activities are the activities that are directly involved in transforming inputs into outputs and delivery and after-sales support to output. Following are the primary activities in the value chain of ABC Ltd.:-

(i) Inbound Logistics: These activities are related to the material handling and warehousing. It also covers transporting raw material from the supplier to the place of processing inside the factory.

(ii) Operations: These activities are directly responsible for the transformation of raw material into final product for the delivery to the consumers.

(iii) Outbound Logistics: These activities are involved in movement of finished goods to the point of sales. Order processing and distribution are major part of these activities.

(iv) Marketing and Sales: These activities are performed for demand creation and customer solicitation. Communication, pricing and channel management are major part of these activities.

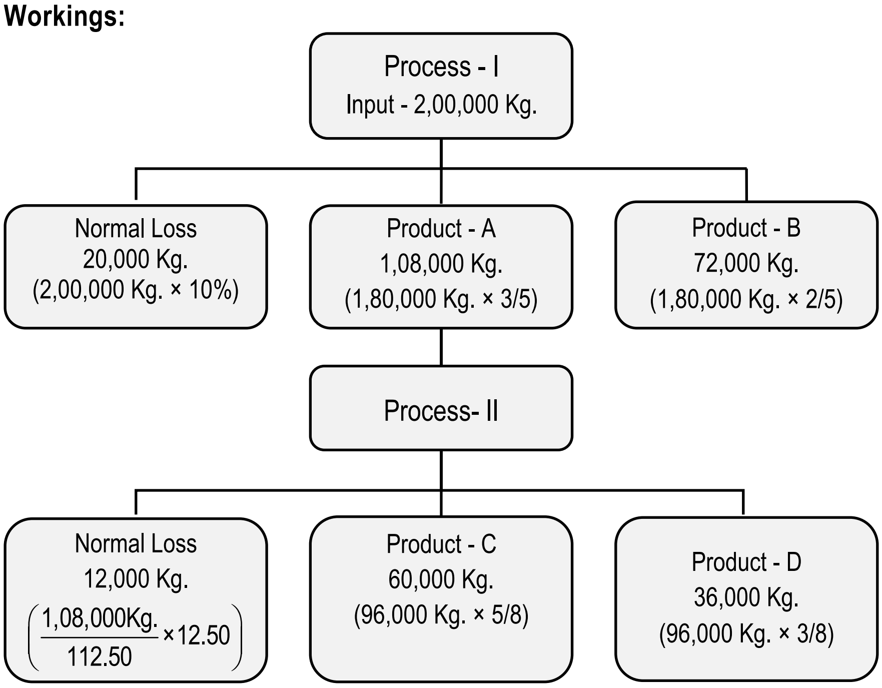
(v) Service: These activities are performed after selling the goods to the consumers. Repair and replacement are some examples of these activities.

(b) Statement Showing Decision on Sale at - Split-off Point or After Further Processing

Product	Product – C	Product - D

Quantity at Split off Point (Kg.)	60,000	36,000
Selling Price at Split off Point (Rs.)	55	40
Sales Revenue (Rs.) ... [A]	33,00,000 (60,000 Kg. × Rs.55)	14,40,000 (36,000 Kg × Rs.40)
Quantity if Processed Further (Kg.)	57,000 (60,000 Kg. × 95%)	32,000 $\left(\frac{36{,}000\text{Kg.}}{112.5}\times 100\right)$
Selling Price (Rs.) *per unit*	66	55
Sales Revenue (Rs.) ...[B]	37,62,000 (57,000 Kg. × Rs.66)	17,60,000 (32,000 Kg. × Rs.55)
Incremental Revenue ...[C] = [B] − [A]	4,62,000	3,20,000
Incremental Cost (Rs.) ...[D]	3,95,600	3,82,500
Profit / (Loss) ...[C] − [D]	66,400	(62,500)
Decision	**Process Further**	**Sale at Split-off Point**

Workings:



☞ It is not necessary *to show* above presentation.

(c) Discretionary costs are those that are incurred, typically each year, in an amount that is approved as part of the normal budget process. However, there is no clear relationship between the volume of services and the amount of cost that must be incurred. Manager must decide and justify the level that is deemed to be appropriate. This justification is to be made a fresh without making reference to previous level of spending in his/her department.

Zero based budgeting is undoubtedly most effective in terms of discretionary costs. The bottom line of a zero based budgeting is that it is important to understand what types of objectives are being accomplished by discretionary cost centers and what resources being devoted to accomplishing various objectives. This will allows a prioritization, so that organization can evaluate the likely impact of substantial increase or decrease in the resources allocated to the discretionary center.

Accordingly, ZBB has extensive potential application to the division T, A and RD.

(d) Cumulative Average Time for 256 parts = 48.43 hrs.*

[112.50 × (0.90^8)]

Total Time for 256 parts = 12,398.08 hrs.

[48.43 hrs.× 256 parts]

Total Labour Cost of 256 parts = Rs.3,09,952.00

[12,398.08 hrs. × Rs.25]

Revised Labour Cost for *zero profit* = Rs.4,03,702.00

[Rs.3,09,952.00 + Rs. 93,750]

Total Time for 256 parts (Revised) = 16,148.08 hrs.

[Rs.4,03,702.00/ Rs.25]

Cumulative Average Time for 256 parts (Rev.) = 63.08 hrs.

[16,148.08/256]

The usual learning curve model is

$$y = ax^b$$

Where

y = Cumulative Average Time per part for x parts

a = Time required for first part

x = Cumulative number of parts

b = Learning coefficient (log r/log 2)

Accordingly

$\Rightarrow \quad 63.08 = 112.50 \times (256)^{b}$

$\Rightarrow \quad 0.5607 = 2^{8b}$

$\Rightarrow \quad \log 0.5607 = \log 2^{8b}$

$\Rightarrow \quad \log 0.5607 = 8 \times b \times \log 2$

$\Rightarrow \quad \log 0.5607 = 8 \times \frac{\log r}{\log 2} \times \log 2$

$\Rightarrow \quad \log 0.5607 = 8 \log r$

$\Rightarrow \quad \log 0.5607 = \log r^{8}$

$\Rightarrow \quad 0.5607 = r^{8}$

$\Rightarrow \quad r = \sqrt[8]{0.5607}$

$\Rightarrow \quad r = 0.9302$

Learning Rate (r) = 93.02%.

Therefore

Sensitivity = 3.02/90

= 3.36%

> ☞ Students may also take 48.38 hrs. (112.50 × 0.43)

2. (a) (i) Calculation of Contribution Margin *per machine hour*

	Jaya (Rs.)	**Surya (Rs.)**
Selling Price *per unit*	1,500	2,000
Less: Variable Manufacturing Cost *per unit*	(900)	(1,600)

Less: Variable Marketing Cost *per unit*	(250)	(150)
Contribution Margin *per unit*	350	250
Number of Regular Machine Hours	2.0	1.0
Contribution Margin *per machine hour*	175	250
Ranking	II	I

Based on the ranking above, manufacturing preference will be given to Surya but after the committed production of 12,500 units of Jaya.

Since to manufacture Surya, a hiring cost of Rs. 60,00,000 is also paid for high precision machine, so the result obtained through the above ranking may not be beneficial. For this purpose we solve this problem taking two options.

Option 1: 12,500 units of Jaya and 35,000* units of Surya:

*[60,000 hours – (12,500 units of Jaya × 2 hours) ÷ 1 hour to produce one unit of Surya]

	Amount (Rs.)
Contribution Margin on Jaya (12,500 units × Rs. 175)	21,87,500
Contribution Margin on Surya (35,000 units × Rs. 250)	87,50,000
Total Contribution Margin	1,09,37,500
Less: Hire Charges on High Precision Machine	(60,00,000)
Net Relevant Contribution	49,37,500

Option 2: Produce only Jaya i.e. 30,000 units :

Contribution Margin (30,000 units × Rs. 175) = Rs. 52,50,000

Even though Surya has the higher contribution margin per machine hour but relevant contribution margin under option 1 is lower than the option 2. Hence, JSL should produce 30,000 units of Jaya only to earn more profit.

(ii) Based on the above ranking, if preference is given to production of Surya after the production of committed units of Jaya i.e. 12,500 units of Jaya and 65,000 units of Surya.

Option 1: 12,500 units of Jaya and 65,000* units of Surya:

*[90,000 hours – (12,500 units of Jaya × 2 hours) ÷ 1 hour to produce one unit of Surya]

	Amount (Rs.)
Contribution Margin on Jaya (12,500 units × Rs. 175)	21,87,500

Contribution Margin on Surya (65,000 units × Rs. 250)	1,62,50,000
Total Contribution Margin	1,84,37,500
Less: Hire Charges on High Precision Machine	(60,00,000)
Less: Capacity Enhancement Cost	(28,00,000)
Net Relevant Contribution	96,37,500

Option 2: Produce only Jaya i.e. 45,000 units:

	Amount (Rs.)
Contribution Margin (45,000 units × Rs. 175)	78,75,000
Less: Capacity Enhancement Cost	(28,00,000)
Net Relevant Contribution	50,75,000

When capacity of the regular machine is enhanced by 30,000 hours, the optimum product mix will be 12,500 units of Jaya and 65,000 units of Surya.

Increase in operating profit will be Rs. 43,87,500 (Rs. 96,37,500 – Rs. 52,50,000).

☞ While calculating relevant contribution from the option 1 and option 2 in requirements (i) and (ii) above, the contribution from the 12,500 units of Jaya may also be ignored as this is same under the two options.

(b) Cost Classification

(i) Committed Cost

Reason: Company cannot negotiate the price of advertisement in future and it has to make payment as soon as advertisement is prepared.

(ii) Differential Cost

Reason: In case of decision making among two alternatives, every manager has to compare the difference in cost involved.

(iii) Sunk Cost

Reason: Research expense has already been incurred and it will not affect any decision making in future.

(iv) Opportunity Cost

Reason: Income from government securities is the amount that company has forgone to earn income from its investment in the project.

3. (a) Computation of Requirements of Question

Budgeted output in units:

Fixed Overhead Expenditure Variance = Budgeted Fixed Overheads – Actual Fixed Overheads

$\Rightarrow$ Rs.8,000 (A) = Budgeted Output × (Rs. 6 × 5 hrs.) – Rs.1,58,000

$\Rightarrow$ Budgeted Output = 5,000 units

Number of litres purchased:

Material Price Variance = Actual Quantity × (Std. Price – Actual Price)

$\Rightarrow$ Rs.8,000 (F) = No. of litres purchased × (Rs.2 – Rs.1.95)

$\Rightarrow$ No. of litres purchased = 1,60,000 litres

Number of litres used above standard allowed:

Material Usage Variance = Standard Price × (Standard Quantity – Actual Quantity)

$\Rightarrow$ Rs.5,000 (A) = Rs.2 × (Standard Quantity – 1,60,000 litres)

$\Rightarrow$ Standard Quantity = 1,57,500 litres

No. of litres above Standard = 1,60,000 litres – 1,57,500 litres

= 2,500 litres

Actual units produced:

Labour Cost Variance = Rate Variance + Efficiency Variance

= Rs.5,760 (A) + Rs.2,760 (F)

= Rs.3,000 (A)

Labour Cost Variance = Standard Cost – Actual Cost

$\Rightarrow$ Rs.3,000 (A) = Actual Output × (Rs.6 × 5 hrs.) – Rs.1,56,000

$\Rightarrow$ Actual Output = 5,100 units

Actual hours worked:

Labour Efficiency Variance = Standard Rate × (Standard Hours – Actual Hours)

⇒ Rs.2,760 (F) = Rs.6 x (5,100 units × 5 hrs. – Actual Hours)

⇒ Actual Hours = 25,040 hours

Average actual wage rate per hours:

Labour Rate Variance = Actual Hours × (Standard Rate – Actual Rate)

⇒ Rs.5,760 (A) = 25,040 hours × (Rs. 6 – Actual Rate)

⇒ Actual Rate = Rs.6.23...*per hour*

3. (b) The profits for each arrangement are:

Economy = 10.00 – 5 (0.40) – 3(0.20) – 9 (0.10)

= Rs.6.50

May time = 12.00 – 9 (0.20) – 6 (0.20) – 11 (0.10) – 5 (0.30)

= Rs.6.40

Spring colour = 13.00 – 10 (0.40) – 11 (0.10) – 10 (0.20) – 7 (0.30)

= Rs.3.80

Deluxe rose = 15.00 – 13 (0.40) – 13 (0.20) – 13 (0.30)

= Rs.3.30

Let x_1, x_2, x_3, x_4 be number of units arrangements of type Economy, May time, Spring colour & Deluxe rose.

Then the objective is Maximise

$Z = 6.50x_1 + 6.40x_2 + 3.80x_3 + 3.30x_4$

Subject to

$$5x_1 + 10x_3 + 13x_4 \leq 400$$

(Red Roses)

$$3x_1 + 6x_2 \leq 228 \quad \text{(Gardenias)}$$

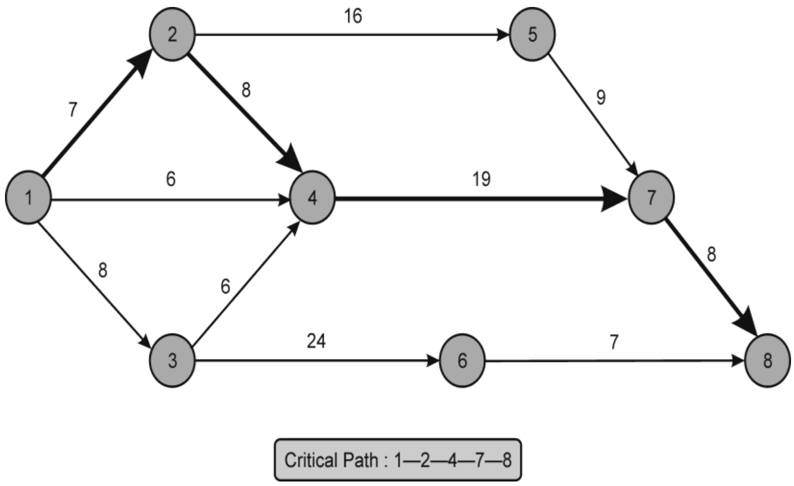
$$9x_1 + 11x_2 + 11x_3 \leq 2{,}000 \quad \text{(Carnations)}$$

$$9x_2 + 10x_3 + 13x_4 \leq 460 \quad \text{(White Roses)}$$

$$5x_2 + 7x_3 + 13x_4 \leq 211 \quad \text{(Yellow Roses)}$$

$$\text{All } x_i\text{'s} \geq 0$$

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



Various Paths of the network are as follows:

Path	Duration (Days)
1–2–5–7–8	40 (7 + 16 + 9 + 8)
1–2–4–7–8	42 (7 + 8 + 19 + 8)
1–4–7–8	33 (6 + 19 + 8)
1–3–4–7–8	41 (8 + 6 + 19 + 8)
1–3–6–8	39

	(8 + 24 + 7)

Critical Path is 1–2–4–7–8 with duration of 42 days.

The new formulation of the problem is as follows:

(i) Activities 1–2, 1–3 and 1–4 need 7 Days, 8 Days and 6 Days respectively as per Original Programme.

(ii) Activity 2–4 needs 12 Days (15 + 4 – 7) instead of Original Programme of 8 Days.

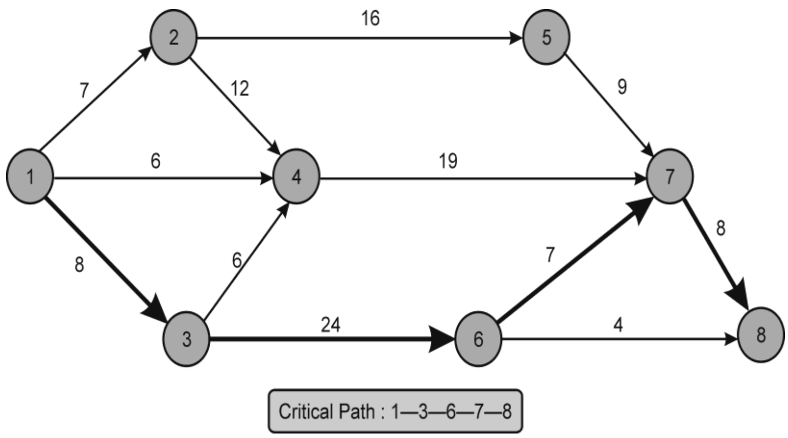
(iii) Activity 3–6 needs 24 Days (15 + 17 – 8) as per Original Schedule.

(iv) New Activity 6–7 needs 7 Days.

(v) Activity 6–8 needs lesser duration of 4 Days instead of Original Planned 7 Days.

(vi) Activities 2–5, 3–4, 4–7, 5–7, 7–8 need 16 Days, 6 Days, 19 Days, 9 Days, 8 Days respectively as per Original Schedule.

The new network based on the above listed activities will be as follows:



Various Paths of revised network are as follows:

Path	Duration (Days)
1–2–5–7–8	40 (7 + 16 + 9 + 8)
1–2–4–7–8	46

	(7 + 12 + 19 + 8)
1–4–7–8	33 (6 + 19 + 8)
1–3–4–7–8	41 (8 + 6 + 19 + 8)
1–3–6–7–8	47 (8 + 24 + 7 + 8)
1–3–6–8	36 (8 + 24 + 4)

Critical Path is 1–3–6–7–8 with duration of 47 Days.

(b) Statement of Profitability

Product	Sales Value (Rs.)	P / V Ratio (%)	Contribution (Rs.)
X	3,25,000	34	1,10,500
Y	5,20,000	50	2,60,000
Z	7,80,000	30	2,34,000
Total	16,25,000		6,04,500
Less: Fixed Overheads			6,52,860
Profit / (Loss)			(48,360)

Additional Sale Value of *each* Product (which will eliminate the Loss)

Product	Sales Value (Rs.)
X	Rs.1,42,236 (Rs.48,360 ÷ 0.34)
Y	Rs.96,720 (Rs. 48,360 ÷ 0.50)
Z	Rs.1,61,200 (Rs.48,360 ÷ 0.30)

Additional Total Sales Value maintaining the Same Sale – Mix (which will eliminate the Loss)

= Rs.48,360 ÷ 0.372*

= Rs.1,30,000

* Combined P / V Ratio $= \frac{\text{Total Contribution}}{\text{Total Sales}} \times 100$

$$= \frac{\text{Rs. }6,04,500}{\text{Rs.}16,25,000} \times 100$$

$$= 37.2\%$$

5. (a) 1. The transfer price should be Rs. 35 per unit, the regular price charged to other customers. Since the 'Dx' Division is operating at capacity, it will lose Rs.14 in contribution margin for each outside sale given up in favor of sales to the 'Dz' Division (Rs.35 - Rs.21= Rs.14).

Transfer Price = Variable Cost per unit + Lost Contribution Margin per unit on outside sales

= Rs.21 + Rs.14 = Rs.35

2. The lower limit is Rs.35, the price obtained in (1). The upper limit is also Rs.35, since Rs.35 is the intermediate market price. That is, it would not be fair to charge the other division more than the price being charged to regular customers. However, an upper limit is not really relevant in this situation since no transfers will be made between the two divisions.

3. The price being paid to the outside supplier, net of the quantity discount, is only Rs.31.50. If this price is met by the 'Dx' Division, then profits in the 'Dx' Division and in the company as a whole will drop by Rs. 8,750 per year

Minimum Transfer Price	Rs.35.00
Outside Supplier's Price	Rs. 31.50
Loss in contribution margin per unit	Rs.3.50
No. of units per year	x 2,500
Total loss in profits	Rs. 8,750

Profits in the 'Dz' Division will remain unchanged, since it will be paying the same price internally as it is now paying externally.

4. Yes, if costs can be avoided as a result of the inside business. The price would then be Rs. 35 less the avoided costs.

(b) Statement Showing Impact on Airline's Profit if Flight GB-022 is Discontinued

	Rs.	Rs.

Contribution Margin lost if the flight is discontinued		(5,13,500)
Less: Flight Costs which can be avoided if the flight is discontinued:		
Flight Promotion	19,000	
Fuel for Aircraft	1,98,000	
Liability Insurance (1/3 x Rs.1,48,470)	49,490	
Salaries, Flight Assistants	42,300	
Overnight Costs for Flight Crew and Assistants	17,000	3,25,790
		(1,87,710)

If Golden Bird Airlines Ltd. goes for discontinuation of flight GB-022, its profit will go down by Rs.1,87,710.

Following costs are not relevant to the decision:

- Salaries, flight crew - Fixed annual salaries which will not change
- Baggage loading and flight preparation- This is an allocated cost, which will continue even if the flight is discontinued.
- Depreciation of aircraft -Sunk Cost
- Liability insurance (two third) - Sunk Cost
- Hanger parking fee- This cost will be incurred regardless of whether the flight is made.

6. (a)

Point	Valid/Invalid	Reason
(i)	Invalid	TQM advocates focus to be given on both external and internal customers. Hence, focus satisfying the needs of the external customers only will not be valid for the successful implementation of TQM.
(ii)	Valid	Training at the beginning would improve productivity by bringing standardization in work habits and eliminating variations in production.

(iii)	Invalid	For implementation of TQM, Management by Objectives should be eliminated as targets of production will encourage delivery of poor quality goods and thus will defeat the collective nature of TQM.
(iv)	Invalid	Documentation, procedures and awareness of current best practice are essential in TQM implementation. If documentation and procedures are in place then only improvement can be monitored & measured and consequently deficiency can be corrected.

☞ Conceptually correct brief reason along with the validity of recommendation (Valid or Invalid) is sufficient.

(b) Fixed Overhead Expenditure Variance = Budgeted Fixed Overheads – Actual Fixed Overheads

Rs.10,000 (F) = Rs.3,60,000 – Actual Fixed Production Overheads

Actual Fixed Overheads = Rs.3,50,000

Absorbed Fixed Overheads = Actual Fixed Overheads + Over Absorbed Fixed Overheads

= Rs.3,50,000 + Rs.1,600

= Rs.3,51,600

Standard Absorption Rate *per unit* = Rs.3,60,000 / 18,000 units

= Rs.20

So, Actual Number of Units = Rs.3,51,600 / Rs.20

= 17,580 units

(c) Solution to this problem can be solved by the Assignment method. To solve the problem first we will have to make the given matrix into a balanced one by introducing a dummy column having zero values in each cell, the balanced matrix will be as follows:

No. of Days	**Subjects**			
	X	**Y**	**Z**	**Dummy**
0	50	60	50	0
1	60	60	60	0

2	60	80	80	0
3	80	100	80	0

The objective of this problem is to maximize the sum of the marks in all the subjects. This matrix will be converted into the loss matrix by deducting the values in each cell from the highest value i.e. 100.

The loss matrix will be as follows:

No. of Days	**Subjects**			
	X	**Y**	**Z**	**Dummy**
0	50	40	50	100
1	40	40	40	100
2	40	20	20	100
3	20	0	20	100

Row Operation:

No. of Days	**Subjects**			
	X	**Y**	**Z**	**Dummy**
0	10	0	10	60
1	0	0	0	60
2	20	0	0	80
3	20	0	20	100

Column Operation:

No. of Days	**Subjects**			
	X	**Y**	**Z**	**Dummy**
0	10	0	10	0
1	0	0	0	0
2	20	0	0	20
3	20	0	20	40

The assignment will be as follows:

No. of Days	**Subjects**

	X	Y	Z	Dummy
0	10	0	10	$\boxed{0}$
1	$\boxed{0}$	0	0	0
2	20	0	$\boxed{0}$	20
3	20	$\boxed{0}$	20	40

Since the number of lines is equal to the order of matrix, hence, this is the optimum solution. Optimum plan for study and sum of expected marks:

Subject	No. of Days to be Studied	Expected Marks
X	1	60
Y	3	100
Z	2	80
	Total	240

7. **(a)** Essential requisites for the installation of uniform costing are as under:

(i) The firm's in the industry should be willing to share / furnish relevant data or information.

(ii) A spirit of cooperation and mutual trust should prevail among the participating firms.

(iii) Mutual exchange of ideas, methods used, special achievement made, research and know how etc. should be frequent.

(iv) Bigger firms should take the lead towards sharing their experience and know how with the smaller firm to enable the latter to improve their performance.

(v) In case of accounting methods, principles, procedure and production method uniformity must be established.

(b) The Δ_{ij} matrix or $C_{ij} - (u_i + v_j)$ matrix, where C_{ij} is the cost matrix and $(u_i + v_j)$ is the cell evaluation matrix for unallocated cell.

The Δ_{ij} matrix has one or more 'Zero' elements, indicating that, if that cell is brought into the solution, the optional cost will not change though the allocation changes.

Thus, a 'Zero' element in the Δ_{ij} matrix reveals the possibility of an alternative solution.

(c) The conventional product cost system was in vogue when companies manufactured narrow range of products, overhead costs were relatively small and distortions arising from inappropriate overhead allocations were not significant. It used volume measures like direct labour hours or machine hours for charging overhead costs to products. In the case of a company using highly automated plant, direct labour is a small fraction of cost when compared with overheads (because of higher amount of depreciation). In case where such a company is multi product, overheads which are large in proportion to direct labour are influenced by number of set up, inspection, number of purchases etc. In these circumstances, the volume based method of recovery of overheads is no longer appropriate and such a measure will report inaccurate product costs. Hence, the traditional system of costing was found to over cost high volume products and under cost low volume products.

Activity Based Costing (ABC) system aims at refining the costing system used in automated plants in the following manner:

- ABC systems trace more costs as direct costs.
- ABC systems create homogeneous cost pools linked to different activities.
- For each activity cost pool, ABC systems seek a cost allocation base that has a cause-and-effect relationship with costs in the cost pool.

(d) Multinational companies use transfer prices to minimize worldwide income taxes, import duties, and tariffs. For example, Nike might prefer to make its profits in a country, with its maximum corporate tax rate of 28%, rather than in some other place where the rate is 35%.

Suppose a division in a high-income-tax-rate country produces a sub-assembly for another division in a low-income-tax-rate country. By setting a low transfer price, the company can recognize most of the profit from the production in the low-income-tax-rate country, thereby minimizing taxes. Likewise, items produced by divisions in a low-income-tax-rate country and transferred to a division in a high-income-tax-rate country should have a high transfer price to minimize taxes.

Sometimes import duties offset income tax effects. Most countries base import duties on the price paid for an item, whether bought from an outside company or transferred from another division. Therefore, low transfer prices generally lead to low import duties.

Financial restrictions imposed by some governments may be avoided by an effective use of transfer price. For example, in case a country restricts the amount of dividend paid to foreign owners, it may be easier for a company to get cash from a foreign division in form of payments for product transferred rather than cash dividend.

(e) Cost is not only criterion for deciding in the favour of shut down. Non-cost factors worthy of consideration in this regard are as follows:

(i) Interest of workers, if the workers are discharged, it may become difficult to get skilled workers later, on reopening of the factory. Also shut-down may create problems.

(ii) In the face of competition it may difficult to re-establish the market for the product.

(iii) Plant may become obsolete or depreciate at a faster rate or get rusted. Thus, heavy capital expenditure may have to be incurred on re-opening.

Test Series: March, 2015

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – II

PAPER – 6: INFORMATION SYSTEMS CONTROL & AUDIT

SUGGESTED ANSWERS/HINTS

1. (a) During the Technical Feasibility of new proposed system, the following issues may be raised:

- Does the necessary technology exist to do what is suggested (and can it be acquired)?
- Does the proposed equipment have the technical capacity to hold the data required to use the new system?
- Can the proposed application be implemented with existing technology?
- Will the proposed system provide adequate responses to inquiries, regardless of the number or location of users?
- Can the system be expanded if developed?
- Are there technical guarantees of accuracy, reliability, ease of access, and data security?

(b) Provisions of authentication of electronic records are given under Section 3 of Information Technology (Amendment) Act, 2008, which is given as follows:

***[Section 3]* Authentication of Electronic Records:**

(1) Subject to the provisions of this section any subscriber may authenticate an electronic record by affixing his Digital Signature.

(2) The authentication of the electronic record shall be effected by the use of asymmetric crypto system and hash function which envelop and transform the

initial electronic record into another electronic record.

Explanation—

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

(a) to derive or reconstruct the original electronic record from the hash result produced by the algorithm;

(b) that two electronic records can produce the same hash result using the algorithm.

(3) Any person by the use of a public key of the subscriber can verify the electronic record.

(4) The private key and the public key are unique to the subscriber and constitute a functioning key pair.

(c) Major Information Security Policies are given as follows:

- **Information Security Policy:** This policy provides a definition of Information Security, its overall objective and the importance applies to all users.
- **User Security Policy:** This policy sets out the responsibilities and requirements for all IT system users. It provides security terms of reference for Users, Line Managers and System Owners.
- **Acceptable Usage Policy:** This sets out the policy for acceptable use of email and Internet services.
- **Organizational Information Security Policy:** This policy sets out the Group policy for the security of its information assets and the Information Technology (IT) systems processing this information.
- **Network & System Security Policy:** This policy sets out detailed policy for system and network security and applies to IT department users.
- **Information Classification Policy:** This policy sets out the policy for the classification of information.
- **Conditions of Connection:** This policy sets out the Group policy for connecting to the network. It applies to all organizations connecting to the Group, and relates to the conditions that apply to different suppliers' systems.

2. (a) Major characteristics of an effective Management Information System (MIS) are as follows:

- **Management Oriented –** It means that efforts for the development of the information system should start from an appraisal of management needs and overall business objectives. Such a system is not necessarily for top management only but may also meet the information requirements of middle level or operating levels of management as well.

- **Management Directed –** Because of management orientation of MIS, it is necessary that management should actively direct the system's development efforts. For system's effectiveness, it is necessary for management to devote their sufficient time not only at the stage of designing the system but for its review as well to ensure that the implemented system meets the specifications of the designed system.
- **Integrated –** The best approach for developing information systems is the integrated approach as all the functional and operational information sub-systems are tied together into one entity. An integrated Information system has the capability of generating more meaningful information to management as it takes a comprehensive view or a complete look at the interlocking sub-systems that operate within a company.
- **Common Data Flows –** It means the use of common input, processing and output procedures and media whenever required. Data is captured by the system analysts only once and as close to its original source as possible. Afterwards, they try to utilize a minimum of data processing procedures and sub-systems to process the data and strive to minimize the number of output documents and reports produced by the system. This eliminates duplication in data collections, simplifies operations and produces an efficient information system.
- **Heavy Planning Element –** An MIS usually takes one to three years and sometimes even longer period to get established firmly within a company. Therefore, a MIS designer must be present in MIS development and should consider future enterprise objectives and requirements of information as per the organization structure of the enterprise as per requirements.
- **Sub System Concept –** Even though the information system is viewed as a single entity, it must be broken down into digestible sub-systems, which can be implemented one at a time by developing a phased plan. The breaking down of MIS into meaningful sub-systems sets the stage for this phasing plan.
- **Common Database –** Database is the mortar that holds the functional systems together. It is defined as a "super-file", which consolidates and integrates data records formerly stored in many separate data files. The organization of a database allows it to be accessed by several information sub-systems and thus, eliminates the necessity of duplication in data storage, updating, deletion and protection.
- **Computerized -** Though MIS can be implemented without using a computer; the

use of computers increases the effectiveness of the system. In fact, its use equips the system to handle a wide variety of applications by providing their information requirements quickly. Other necessary attributes of the computer to MIS are accuracy and consistency in processing data and reduction in clerical staff. These attributes make computer a prime requirement in management information system.

(b) Audit Trail: Audit trails are logs that can be designed to record activity at the system, application, and user level. When properly implemented, audit trails provide an important detective control to help accomplish security policy objectives. Many operating systems allow management to select the level of auditing to be provided by the system. This determines 'which events will be recorded in the log'. An effective audit policy will capture all significant events without cluttering the log with trivial activity. Audit trail controls attempt to ensure that a chronological record of all events that have occurred in a system is maintained. This record is needed to answer queries, fulfill statutory requirements, detect the consequences of error and allow system monitoring and tuning.

Audit trails can be used to support security objectives in three ways:

- **Detecting Unauthorized Access to the system:** Detecting unauthorized access can occur in real time or after the fact. The primary objective of real-time detection is to protect the system from outsiders who are attempting to breach system controls. A real-time audit trail can also be used to report on changes in system performance that may indicate infestation by a virus or worm. Depending upon how much activity is being logged and reviewed; real-time detection can impose a significant overhead on the operating system, which can degrade operational performance. After-the-fact detection logs can be stored electronically and reviewed periodically or as needed. When properly designed, they can be used to determine if unauthorized access was accomplished, or attempted and failed.
- **Reconstructing Events:** Audit analysis can be used to reconstruct the steps that led to events such as system failures, security violations by individuals, or application processing errors. Knowledge of the conditions that existed at the time of a system failure can be used to assign responsibility and to avoid similar situations in the future. Audit trail analysis also plays an important role in accounting control. For example, by maintaining a record of all changes to account balances, the audit trail can be used to reconstruct accounting data files that were corrupted by a system failure.
- **Personal Accountability:** Audit trails can be used to monitor user activity at the lowest level of detail. This capability is a preventive control that can be used to influence behavior. Individuals are likely to violate an organization's security policy if they know that their actions are not recorded in an audit log.

(c) Economic Feasibility: Economic Feasibility includes an evaluation of all the incremental costs and benefits expected if the proposed system is implemented. After problems or opportunities are identified, the analysts must determine the scale of response needed to meet the user's requests for a new system as well as the approximate amount of time and money that will be required in the effort. The financial and economic questions raised by analysts during the preliminary investigation are for the purpose of estimating the cost of conducting a full systems investigation; the cost of hardware and software for the class of applications being considered; the benefits in the form of reduced costs or fewer costly errors; and the cost if nothing changes (i.e. the proposed system is not developed).

Operational Feasibility: Operational Feasibility is concerned with ascertaining the views of workers, employees, customers and suppliers about the use of computer facility. A system can be highly feasible in all respects except the operational and fails miserably because of human problems. Some of the questions, which help in testing the operational feasibility of a project, may include the following:

- Is there sufficient support for the system from management and from users?
- Are current business methods acceptable to users?
- Have the users been involved in planning and development of the project?
- Will the proposed system cause harm? Will it produce poorer results in any respect or area? Will loss of control result in any areas? Will accessibility of information be lost?
- Will individual performance be poorer after implementation than before?

This analysis may involve a subjective assessment of the political and managerial environment in which the system is to be implemented. In general, the greater the requirements for change in the user environment in which the system will be installed, greater is the risk of implementation failure.

3. (a) The Business Continuity Management (BCM) policy document is a high level document which shall be the guide to make a systematic approach for disaster recovery, to bring about awareness among the persons in scope about the business continuity aspects and its importance and to test and review the business continuity planning for the enterprise in scope. While developing the BCM policy, the enterprise should consider defining the scope; BCM principles, guidelines and minimum standards for the enterprise. They should refer any relevant standards, regulations or policies that have to be included or can be used as a benchmark.

The objective of this policy is to provide a structure through which:

- Critical services and activities undertaken by the enterprise operation for the customer will be identified.
- Plans will be developed to ensure continuity of key service delivery following a business disruption, which may arise from the loss of facilities, personnel, IT and/or communication or failure within the supply and support chains.

- Invocation of incident management and business continuity plans can be managed.
- Incident Management Plans & Business Continuity Plans are subject to ongoing testing, revision and updation as required.
- Planning and management responsibility are assigned to a member of the relevant senior management team.

The BCM policy defines the processes of setting up activities for establishing a business continuity capability and the ongoing management and maintenance of the business continuity capability. The set-up activities incorporate the specification, end-to-end design, build, implementation and initial exercising of the business continuity capability. The ongoing maintenance and management activities include embedding business continuity within the enterprise, exercising plans regularly, and updating and communicating them, particularly when there is significant change in premises, personnel, process market, technology or organizational structure.

(b) Mobile Computing: It refers to the technology that allows transmission of data via a computer without having to be connected to a fixed physical link. Mobile voice communication is widely established throughout the world and has had a very rapid increase in the number of subscribers to the various cellular networks over the last few years. An extension of this technology is the ability to send and receive data across these cellular networks.

The ability to share information across a wireless platform is becoming more vital to the today's business communication needs. Various companies design and develop several wireless applications and solutions for Blackberry, iPhone, Google Android G1, iPad, Windows Mobile, Symbian, Brew devices, PDA, Palm & Pocket PC. Mobile Computing Services allow mobile workforces to access a full range of corporate services and information from anywhere, at any time and it improves the productivity of a mobile workforce by connecting them to corporate information systems and by automating paper-based processes.

The mobile computing is a versatile and strategic technology that increases information quality and accessibility, enhances operational efficiency, and improves management effectiveness. But, more specifically, it leads to a range of tangible benefits, including the following:

- It provides mobile workforce with remote access to work order details, such as work order location, contact information, required completion date, asset history relevant warranties/service contracts.
- It enables mobile sales personnel to update work order status in real-time, facilitating excellent communication.
- It facilitates access to corporate services and information at any time, from anywhere.

- It provides remote access to the corporate Knowledgebase at the job location.
- It enables to improve management effectiveness by enhancing information quality, information flow, and ability to control a mobile workforce.

(c) **Hardware Acquisition:** In case of procuring machinery such as machine tools, transportation equipment, air conditioning equipment etc., the management can normally rely on the time tested selection techniques and the objective selection criteria can be delegated to the technical specialist. The management depends upon the vendor for support services, systems design, education and training etc., and expansion of computer installation for almost an indefinite period; therefore, this is not just buying the machine and paying the vendor for it, but it amounts to an enduring alliance with the supplier.

Software Acquisition: Once user output and input designs are finalized, the nature of the application software requirements must be assessed by the systems' analyst. This determination helps the systems development team to decide 'what type of application software products is needed' and consequently, the degree of processing that the system needs to handle. This helps the system developers in deciding about the nature of the systems software and computer hardware that will be most suitable for generating the desired outputs, and also the functions and capabilities that the application software must possess. At this stage, the system developers must determine whether the application software should be created in-house or acquired from a vendor.

4. **(a)** A good security policy should clearly state the following:

- Purpose and Scope of the Document and the intended audience;
- The Security Infrastructure;
- Security policy document maintenance and compliance requirements;
- Incident response mechanism and incident reporting;
- Security organization Structure;
- Inventory and Classification of assets;
- Description of technologies and computing structure;
- Physical and Environmental Security;
- Identity Management and access control;
- IT Operations management;
- IT Communications;
- System Development and Maintenance Controls;
- Business Continuity Planning;
- Legal Compliances; and

- Monitoring and Auditing Requirements.

(b) **Preventive Controls:** Preventive controls are those inputs which are designed to prevent an error, omission or malicious act occurring. The broad characteristics of preventive controls are:

- A clear-cut understanding about the vulnerabilities of the asset;
- Understanding probable threats; and
- Provision of necessary controls for probable threats from materializing.

Some of the examples of preventive controls are to employ qualified personnel; Segregation of duties; Access control, Documentation, Prescribing appropriate books for a course, Training and retraining of staff, Authorization of transaction, Validation, edit checks in the application, Firewalls, Anti-virus software (sometimes this acts like a corrective control also), etc., and Passwords.

The above list contains both of manual and computerized preventive controls. The following Table shows how the same purpose is achieved by using manual and computerized controls.

Preventive Controls

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

(c) Some of the key Management Practices of Risk Management are as follows:

- **Collect Data:** Identify and collect relevant data to enable effective IT related risk identification, analysis and reporting.
- **Analyze Risk:** Develop useful information to support risk decisions that take into account the business relevance of risk factors.
- **Maintain a Risk Profile:** Maintain an inventory of known risks and risk attributes, including expected frequency, potential impact, and responses, and of related resources, capabilities, and current control activities.

- **Articulate Risk:** Provide information on the current state of IT- related exposures and opportunities in a timely manner to all required stakeholders for appropriate response.
- **Define a Risk Management Action Portfolio:** Manage opportunities and reduce risk to an acceptable level as a portfolio.
- **Respond to Risk:** Respond in a timely manner with effective measures to limit the magnitude of loss from IT related events.

5. (a) Five Principles of COBIT 5 are as follows:

- **Principle 1: Meeting Stakeholder Needs:** Enterprises exist to create value for their stakeholders by maintaining a balance between the realization of benefits and the optimization of risk and use of resources. COBIT 5 provides all of the required processes and other enablers to support business value creation through the use of IT. Because every enterprise has different objectives, an enterprise can customize COBIT 5 to suit its own context through the goals cascade, translating high-level enterprise goals into manageable, specific, IT related goals and mapping these to specific processes and practices.
- **Principle 2: Covering the Enterprise End-to-End:** COBIT 5 integrates governance of enterprise IT into enterprise governance. It covers all functions and processes within the enterprise; COBIT 5 does not focus only on the 'IT function', but treats information and related technologies as assets that need to be dealt with just like any other asset by everyone in the enterprise.
- **Principle 3: Applying a Single Integrated Framework:** There are many IT related standards and best practices, each providing guidance on a subset of IT activities. COBIT 5 is a single and integrated framework as it aligns with other latest relevant standards and frameworks, thus allows the enterprise to use COBIT 5 as the overarching governance and management framework integrator. It is complete in enterprise coverage, providing a basis to integrate effectively other frameworks, standards and practices used.
- **Principle 4: Enabling a Holistic Approach:** Efficient and effective governance and management of enterprise IT require a holistic approach, taking into account several interacting components. COBIT 5 defines a set of enablers to support the implementation of a comprehensive governance and management system for enterprise IT.
- **Principle 5: Separating Governance from Management:** The COBIT 5 framework makes a clear distinction between governance and management.

Governance ensures that stakeholder needs, conditions and options are evaluated to determine balanced, agreed-on enterprise objectives to be achieved; setting direction through prioritization and decision making; and monitoring performance and compliance against agreed-on direction and objectives.

Management plans, builds, runs and monitors activities in alignment with the direction set by the governance body to achieve the enterprise objectives.

(b) Some of the examples of Decision Support Systems in Accounting are as follows:

- **Cost Accounting System -** The health care industry is well known for its cost complexity. Managing costs in this industry require controlling costs of supplies, expensive machinery, technology, and a variety of personnel. Cost accounting applications help health care enterprises calculate product costs for individual procedures or services. One health care organization, for example, combines a variety of DSS applications in productivity, cost accounting, case mix, and nursing staff scheduling to improve its management decision making.
- **Capital Budgeting System -** Companies require new tools to evaluate high-technology investment decisions. Decision makers need to supplement analytical techniques, such as net present value and internal rate of return, with decision support tools that consider some benefits of new technology not captured in strict financial analysis. One DSS designed to support decisions about investments in automated manufacturing technology is Auto Man, which allows decision makers to consider financial, non financial, quantitative, and qualitative factors in their decision-making processes.
- **Budget Variance Analysis System-** Financial institutions rely heavily on their budgeting systems for controlling costs and evaluating managerial performance. These systems allow the comptrollers to graph, view, analyze, and annotate budget variances, as well as create additional one-and five-year budget projections using the forecasting tools provided in the system. The DSS thus helps the comptrollers to create and control budgets for the cost-center managers reporting to them.
- **General Decision Support System-** Some planning languages used in DSS are general purpose and therefore have the ability to analyze many different types of problems. In a sense, these types of decision support systems are a decision-maker's tools. The user needs to input data and answer questions about a specific problem domain to make use of this type of decision support system. An example is a program called Expert Choice which supports a variety of problems requiring decisions. The user works interactively with the computer to develop a hierarchical model of the decision problem. The decision support system then asks the user to compare decision variables with each other.

(c) Some of the advantages of continuous audit techniques are given as under:

- **Timely, Comprehensive and Detailed Auditing –** Evidence would be available more timely and in a comprehensive manner. The entire processing can be evaluated and analyzed rather than examining the inputs and the outputs only.
- **Surprise test capability –** As evidences are collected from the system itself by using continuous audit techniques, auditors can gather evidence without the systems staff and application system users being aware that evidence is being collected at that particular moment. This brings in the surprise test advantages.
- **Information to system staff on meeting of objectives -** Continuous audit techniques provides information to systems staff regarding the test vehicle to be used in evaluating whether an application system meets the objectives of asset safeguarding, data integrity, effectiveness, and efficiency.
- **Training for new users –** Using the Integrated Test Facilities (ITFs), new users can submit data to the application system, and obtain feedback on any mistakes they make via the system's error reports.

6. (a) Various types of Data Back-ups are given as follows:

- **Full Backup:** A Full Backup captures all files on the disk or within the folder selected for backup. With a full backup system, every backup generation contains every file in the backup set. However, the amount of time and space such a backup takes prevents it from being a realistic proposition for backing up a large amount of data.
- **Incremental Backup:** An Incremental Backup captures files that were created or changed since the last backup, regardless of backup type. This is the most economical method, as only the files that changed since the last backup are backed up. This saves a lot of backup time and space.

  Normally, incremental backup are very difficult to restore. One will have to start with recovering the last full backup, and then recovering from every incremental backup taken since.
- **Differential Backup:** A Differential Backup stores files that have changed since the last full backup. Therefore, if a file is changed after the previous full backup, a differential backup takes less time to complete than a full back up. Comparing with full backup, differential backup is obviously faster and more economical in using the backup space, as only the files that have changed since the last full backup are saved.

  Restoring from a differential backup is a two-step operation: Restoring from the last full backup; and then restoring the appropriate differential backup. The downside to using differential backup is that each differential backup probably includes files that were already included in earlier differential backups.

- **Mirror back-up:** A Mirror Backup is identical to a full backup, with the exception that the files are not compressed in zip files and they cannot be protected with a password. A mirror backup is most frequently used to create an exact copy of the backup data.

(b) Changes to Evidence Collection: Existence of an audit trail is a key financial audit requirement; since without an audit trail, the auditor may have extreme difficulty in gathering sufficient, appropriate audit evidence to validate the figures in the client's accounts. The performance of evidence collection and understanding the reliability of controls involve issues like -

- **Data retention and storage:** A client's storage capabilities may restrict the amount of historical data that can be retained "on-line" and readily accessible to the auditor. If the client has insufficient data retention capacities, the auditor may not be able to review a whole reporting period transactions on the computer system. For example, the client's computer system may save data on detachable storage device by summarising transactions into monthly, weekly or period end balances.
- **Absence of input documents:** Transaction data may be entered into the computer directly without the presence of supporting documentation e.g. input of telephone orders into a telesales system. The increasing use of EDI will result in less paperwork being available for audit examination.
- **Non-availability of audit trail:** The audit trails in some computer systems may exist for only a short period of time. The absence of an audit trail will make the auditor's job very difficult and may call for an audit approach which involves auditing around the computer system by seeking other sources of evidence to provide assurance that the computer input has been correctly processed and output.
- **Lack of availability of output:** The results of transaction processing may not produce a hard copy form of output, i.e. a printed record. In the absence of physical output it may be necessary for the auditor to directly access the electronic data retained on the client's computer. This is normally achieved by having the client provide a computer terminal and being granted "read" access to the required data files.
- **Audit evidence:** Certain transactions may be generated automatically by the computer system. For example, a fixed asset system may automatically calculate depreciation on assets at the end of each calendar month. The depreciation charge may be automatically transferred (journalised) from the fixed assets register to the depreciation account and hence to the client's income and expenditure account.

- **Legal issues:** The use of computers to carry out trading activities is also increasing. More organisations in both the public and private sector intend to make use of EDI and electronic trading over the Internet. This can create problems with contracts, e.g. when is the contract made, where is it made (legal jurisdiction), what are the terms of the contract and are the parties to the contract.

(c) **Executive Information Systems (EIS) –** It is sometimes referred to as an Executive Support System (ESS). It serves the strategic level i.e. top level managers of the organization. ESS creates a generalized computing and communications environment rather than providing any preset applications or specific competence.

Major Characteristics of an EIS are given as follows:

- EIS is a Computer-based-information system that serves the information need of top executives.
- EIS enables users to extract summary data and model complex, problems without the need to learn query languages statistical formulas or high computing skills.
- EIS provides rapid access to timely information and direct access to management reports.
- EIS is capable of accessing both internal and external data.
- EIS provides extensive online analysis tool like trend analysis, market conditions etc.
- EIS can easily be given as a DSS support for decision making.

7. **(a)** **Governance of Enterprise IT (GEIT):** Governance of Enterprise IT is a sub-set of corporate governance and facilitates implementation of a framework of IS controls within an enterprise as relevant and encompassing all key areas. The primary objectives of GEIT are to analyze and articulate the requirements for the governance of enterprise IT, and to put in place and maintain effective enabling structures, principles, processes and practices, with clarity of responsibilities and authority to achieve the enterprise's mission, goals and objectives.

Benefits of GEIT are as follows:

- It provides a consistent approach integrated and aligned with the enterprise governance approach.
- It ensures that IT-related decisions are made in line with the enterprise's strategies and objectives.
- It ensures that IT-related processes are overseen effectively and transparently.
- It confirms compliance with legal and regulatory requirements.

- It ensures that the governance requirements for board members are met.

(b) Major Data Integrity Policies are given as under:

- **Virus-Signature Updating:** Virus signatures must be updated automatically when they are made available from the vendor through enabling of automatic updates.
- **Software Testing:** All software must be tested in a suitable test environment before installation on production systems.
- **Division of Environments:** The division of environments into Development, Test, and Production is required for critical systems.
- **Offsite Backup Storage:** Backups older than one month must be sent offsite for permanent storage.
- **Quarter-End and Year-End Backups:** Quarter-end and year-end backups must be done separately from the normal schedule, for accounting purposes
- **Disaster Recovery:** A comprehensive disaster-recovery plan must be used to ensure continuity of the corporate business in the event of an outage.

(c) **PDCA Cyclic Proces under ISO 27001:** ISO 27001 prescribes 'how to manage information security through a system of information security management'. Such a management system, just like ISO 9001 or ISO 14001, consists of four phases that should be continuously implemented in order to minimize risks to the Confidentiality, Integrity and Availability (CIA) of information. These phases are given 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 Information Security Management System (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.

The cycle of these four phases never ends, and all the activities must be implemented cyclically in order to keep the ISMS effective. The detail description of all these aforementioned phases is given as follows:

(d) **Infrastructure as a Service (IaaS):** Infrastructure as a Service (IaaS) providers in cloud computing offer computers, more often virtual machines and other resources as service. It provides the infrastructure/ storage required to host the services ourselves i.e. makes us the system administrator and manage hardware/storage, network and computing resources. In order to deploy their applications, cloud clients install operating-system images and their application software on the cloud infrastructure. Examples of IaaS providers include Amazon EC2, Azure Services Platform, Dyn DNS, Google Compute Engine, HP Cloud, iI and etc.

(e) Weaknesses of Agile Model: Some of the weaknesses 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.

Test Series: March, 2015

MOCK TEST PAPER – 2

FINAL: GROUP – II

PAPER – 7 : DIRECT TAX LAWS

SUGGESTED ANSWERS/HINTS

1. (a) Computation of depreciation allowance under section 32 for the A.Y. 2015-16

Particulars		Plant and	Plant and

	Rs.	Machinery (15%) (Rs.)	Machinery (100%) (Rs.)
Opening WDV as on 01.04.2014		5,78,000	-
Add: Plant and Machinery acquired during the year			
- Second hand machinery	2,00,000		
- Machinery Y	8,00,000		
- Air conditioner for office	3,00,000		
- Machinery Z	3,25,000	16,25,000	
- Air pollution control equipment		-	2,50,000
		22,03,000	2,50,000
Less: Asset sold during the year		3,10,000	Nil
Written down value before charging depreciation		18,93,000	2,50,000
Normal depreciation			
100% on air pollution control equipment		-	2,50,000
Depreciation on plant and machinery put to use for less than 180 days@ 7.5% (i.e., 50% of 15%)			
- Second hand machinery (Rs.2,00,000 × 7.5%)	15,000		
- Machinery Z (Rs. 3,25,000 × 7.5%)	24,375	39,375	
15% on the balance WDV being put to use for more than 180 days (Rs. 13,68,000 × 15%)		2,05,200	
Additional depreciation			
- Machinery Y (Rs. 8,00,000 × 20%)	1,60,000		
- Machinery Z (Rs. 3,25,000 × 10%)	32,500	1,92,500	Nil
Total depreciation		**4,37,075**	**2,50,000**

Notes:

(1) Power generation equipments qualify for claiming additional depreciation in respect of new plant and machinery.

(2) Additional depreciation is not allowed in respect of second hand machinery.

(3) No additional depreciation is allowed in respect of office appliances. Hence, no depreciation is allowed in respect of air conditioner installed in office premises.

(4) Additional depreciation is not allowed in respect of an asset whose actual cost is allowed as deduction in computing the income chargeable under the head "Profit and Gains of business or profession". It is presumed that the new air pollution control equipment installed is eligible for 100% depreciation. Therefore, no additional depreciation is allowed in respect of the same.

(b) Since the capital asset, in respect of which deduction of Rs. 50 lacs was claimed under section 35AD, has been transferred by Unit A carrying on specified business to Unit B carrying on non-specified business in the P.Y.2014-15, the deeming provision under section 35AD(7B) is attracted during the A.Y.2015-16.

Particulars	Rs.
Deduction allowed under section 35AD for A.Y.2014-15	50,00,000
Less: Depreciation allowable u/s 32 for A.Y.2014-15 [10% of Rs. 50 lacs]	5,00,000
Deemed income under section 35AD(7B)	45,00,000

(c) Computation of net wealth of Mr. Devansh as on valuation date 31.03.2015

Particulars	Note	Rs.
Plot of land of 1,200 sq. mts. at Bhopal	(a)	25,00,000
Building constructed on land at Bhopal – construction without the approval of appropriate authority – not an asset under section 2(ea) since used for business purposes	(b)	Nil
Motor cars held as stock-in-trade – not an asset under section 2(ea)	(c)	Nil
Gold jewellery brought from Singapore on 1.11.2011 on his return to India for permanently residing in India – Exempt under section 5(v)	(d)	Nil
Jewellery made of platinum	(e)	9,00,000
Interest in coparcenary property of the HUF– Exempt under section 5(ii)	(f)	Nil
Cash in hand in excess of Rs. 50,000	(g)	4,50,000
Fixed deposits in a co-operative bank–not an asset under section 2(ea)	(h)	Nil
Gross wealth		**38,50,000**
Less: Liabilities		
Loan borrowed for marriage of daughter – not deductible	(i)	Nil
Loan borrowed for construction of building at Bhopal – not deductible	(j)	Nil

Net wealth		**38,50,000**

The reasons for the inclusion or exclusion of the various items are furnished below -

(a) Plot of land at Bhopal on which building has been constructed without the approval of the appropriate authority is an asset under section 2(ea) and is, therefore, includible in the net wealth. Since the plot of land comprises an area of more than 500 square meters, it is not eligible for exemption under section 5(vi).

(b) Building constructed on land at Bhopal without the approval of the appropriate authority is not a specified asset under section 2(ea) since it is used for business purposes by Devansh. It is, therefore, not includible in the net wealth.

(c) Motor cars held as stock-in-trade do not fall under the purview of 'asset' under section 2(ea) and are, therefore, not chargeable to wealth tax.

(d) Gold jewellery brought into India on 1.11.2011 from Singapore is exempt under section 5(v) for seven successive assessment years beginning with the A.Y. 2012-13.

(e) Jewellery made of platinum is an asset under section 2(ea) and is, therefore, included in the net wealth.

(f) Interest in the coparcenary property of the Hindu undivided family of which Devansh is a member is exempt under section 5(ii).

(g) Cash in hand, in excess of Rs. 50,000, is includible in the net wealth of an individual, whether such cash is recorded in the books of account or not.

(h) Fixed deposits in a co-operative bank do not constitute 'assets' within the meaning of section 2(ea) and, therefore, are excluded from net wealth.

(i) Only loans borrowed in relation to the 'assets' as per section 2(ea) are deductible. Hence, loan borrowed for marriage of daughter is not deductible.

(j) Since building at Bhopal is used for business purposes and is, therefore, not an asset and excluded while computing the net wealth, the loan borrowed for its construction is not a deductible debt.

(k) Assets held by a minor married daughter are not includible in the net wealth of any parent as per section 4(1)(a)(ii). Hence, the value of the plot of land at Indore, held by the minor married daughter, does not form part of the net wealth of Devansh.

2. Computation of total income of Gopi Tea Ltd. for the A.Y.2015-16

Particulars	Rs.	
Profit and Gain from Business and Profession		

Net profit as per Profit & Loss Account		5,50,00,000
***Add:* Items debited but to be considered separately or to be disallowed**		
Depreciation as per accounts	40,00,000	
Repairs to factory building to the extent of amount spent by withdrawal from Tea Deposit Account **(Note 2)**	10,00,000	
Sales tax not paid **(Note 4)**	10,00,000	
Contribution to Employees' Welfare Trust disallowed under section 40A(9) **(Note 6)**	2,00,000	
Interest on inter-corporate deposit for February, 2015 and March 2015 for which tax deducted at source was deducted and deposited in June 2015 allowed under section 40(a)(ia) **(Note 7)**	NIL	62,00,000
		6,12,00,000
Less: Amount credited to profit & loss account but not chargeable to tax		
Profit on sale of green tea leaves plucked in own gardens is agricultural income and the same is exempt under section 10(1)		20,00,000
		5,92,00,000
Less: Deductions allowable while computing business income		
Depreciation as per Income-tax Rules	55,00,000	
Payment of new loan converted from arrear interest **(Note 8)**	2,00,000	57,00,000
		5,35,00,000
Deduction under section 33AB for making deposit in an account with NABARD as per scheme approved by the Tea Board, being lower of the following two amounts:		
Amount deposited	2,50,00,000	
40% of the profit from business of growing and manufacturing tea computed under the head "profits and gains from business and profession" before making this deduction (Rs. 5,35,00,000 x 40%)	2,14,00,000	2,14,00,000

		3,21,00,000
Less : 60% of above, being agricultural income as per Rule 8		1,92,60,000
Business income		**1,28,40,000**
Gross Total Income		1,28,40,000
Less : Deduction under Chapter VIA		Nil
Total Income		**1,28,40,000**

Notes:

1. As per section 36(1)(iii), interest paid in respect of capital borrowed for the purpose of business or profession is allowed as deduction. The term loan was taken for purchasing machinery for use in a tea factory. Thus, the term loan was used for the purpose of business. Hence, interest on term loan is allowable as deduction. As interest has already been debited to the profit and loss account, no adjustment is required. It is assumed that–

   (i) the new machinery was not acquired for extension of the business of the company; and

   (ii) the interest has been actually paid.

2. As per section 33AB(6), where any amount standing to the credit of the assessee in the account maintained with NABARD is utilized by the assessee for the purpose of any expenditure in connection with such business in accordance with the scheme approved by the Tea Board, such expenditure shall not be allowed as deduction. Therefore, the amount of Rs. 10 lacs withdrawn and utilized for incurring expenditure on repair to factory building is to be disallowed.

3. The Supreme Court, in the case of *CIT vs. General Insurance Corporation (2006) 286 ITR 232,* observed that there is no inflow of fresh funds or increase in capital employed on account of issue of bonus shares. There is only reallocation of company's fund on account of issue of bonus shares by capitalization of reserves. The company has not acquired any benefit of enduring nature. There is no increase in capital base of the company. Therefore, stamp duty and registration fee in connection with issue of bonus shares is allowable as revenue expenditure under section 37(1).

4. According to section 43B, any tax, duty, cess or fee (by whatever name called) is allowed as deduction if they are actually paid on or before the due date of filing return of income under section 139(1) irrespective of the method of accounting followed by the assessee.

   In the case of *CIT vs. Udaipur Distillery Company Limited (2004) 268 ITR 305 (Raj),* it was held that actual payment requires that amount must flow from the assessee to the public exchequer as specified in section 43B. Mere furnishing of bank guarantee by the assessee towards sales tax dues does not mean actual payment of sales tax dues. Therefore, sales tax liability determined on appeal shall be disallowed under section 43B for non-payment. This decision was affirmed by the Apex Court in *CIT v. Mc Dowell and Co. Ltd. (2009) 314 ITR 167.*

5. Under section 36(1)(vii) read with section 36(2), an assessee can claim deduction in respect of bad debt, provided the amount of such debt has been taken into account in computing total income of the assessee and it is written off in the books of account of the assessee. In the case of *CIT vs. T.Veerabhadra Rao, K.Koteswara Rao & Co. (1985) 155 ITR 152 (SC),* the Apex Court held that the successor of a business is entitled to write off the predecessor's debt as a bad debt and claim deduction if the other conditions are fulfilled. This is so because the benefit of deduction in respect of bad debt is not accrued to the assessee by way of personal relief but relates to the business. Therefore, the assessee company is entitled to deduction under section 36(1)(vii) read with section 36(2) in respect of debt transferred from the amalgamating company, Saraswati Tea Limited.

6. As per section 40A(9), any contribution made by the assessee as an employer to any fund, trust, company, association of persons, body of individuals, society registered under the Societies Registration Act or other institution for any purpose shall be disallowed, except where such contribution is paid to a recognised provident fund or approved superannuation fund or approved gratuity fund. Therefore, contribution to the Employees' Welfare Trust is to be disallowed.

7. Section 40(a)(ia) seeks to disallow 30% of any sum paid to any resident, if tax is not deducted at source or, after deduction, tax is not deposited to the Central Government on or before the due date prescribed under section 139(1) of the Act.

   In this case, tax has been deducted on interest and paid before the due date prescribed under section 139(1). Hence, the expenditure shall be allowed.

8. As per *Explanation 3C* below section 43B, a deduction of any sum, being interest payable on any loan or borrowing from a public financial institution shall be allowed, if such interest has been actually paid and such interest which has been converted into a loan or borrowing shall not be deemed to have been actually paid.

The manner in which the converted interest will be allowed as deduction has been clarified vide *Circular No.7/2006 dated 17.7.2006*.The unpaid interest, whenever actually paid to the financial institution, will be in the nature of revenue expenditure deserving deduction in the computation of income. Therefore, irrespective of the nomenclature, the deduction will be allowed in the previous year in which the converted interest is actually paid. Accordingly, the sum of Rs. 2 lacs, being installment paid in February, 2015 shall be allowed as deduction while computing business income of P.Y.2014-15.

3. (a) Section 54G deals with deduction in respect of any capital gain that may arise from the transfer of an industrial undertaking situated in an urban area in the course of or in consequence of shifting to a non-urban area.

If the assessee purchases new machinery or plant or acquires a building or land or constructs a new building or shifts the original asset and transfers the establishment to the new area, within 1 year before or 3 years after the date on which the transfer takes place, then, instead of the capital gain being charged to tax, it shall be dealt with as under:

1. If the capital gain is greater than the cost of the new asset, the difference between the capital gain and the cost of the new asset shall be chargeable as income 'under section 45'.
2. If the total gain is equal to or less than the cost of the new asset, section 45 is not to be applied.

The capital assets referred to in section 54G are machinery or plant or land or building or any rights in building or land. Capital gain arising on transfer of furniture does not qualify for exemption under section 54G. No exemption is therefore available under section 54G in respect of investment of Rs. 2 lacs in acquiring furniture.

The first step therefore is to determine the capital gain arising out of the transfer and thereafter apply the provisions of section 54G.

	Particulars	Rs.
(a)	**Land** – Sale proceeds (Non depreciable)	8,00,000
	Less: Indexed cost	4,00,000
	Long term capital gain	4,00,000
	Less: Cost of new assets purchased within one year before the transfer (under section 54G)	3,00,000
	Taxable Long term capital gain	**1,00,000**
(b)	**Building** – sale proceeds (depreciable assets)	18,00,000
	Less : W.D.V. is deemed as cost of acquisition under section 50	4,00,000
	Short term capital gain	**14,00,000**
(c)	**Plant & machinery-** sale proceeds (depreciable asset)	16,00,000
	Less: WDV is deemed cost under section 50	5,00,000
	Short term capital gain	**11,00,000**
(d)	**Furniture -** sale proceeds (depreciable asset)	3,00,000
	Less: WDV is deemed cost under section 50	2,00,000
	Short term capital gain (A)	**1,00,000**

Summary	
Short term capital gain : Building	14,00,000
Short term capital gain : Plant & machinery	11,00,000
	25,00,000
Less: Section 54G [New assets purchased] (See Note below)	25,00,000
Net short term capital gain (B)	**Nil**
Total short term capital gain (A)+(B) = Rs. 1 lac	

Note – Total exemption available under section 54G is Rs. 28 lacs (Rs. 4 lacs + Rs. 7 lacs + Rs. 17 lacs). The exemption should first be exhausted against short term capital gain as the incidence of tax in case of short-term capital gain is more than in case of long term capital gain. Therefore, Rs. 25 lacs is exhausted against short term capital gain and the balance of Rs. 3 lacs against long term capital gain.

The taxable capital gains would be:

Long term capital gains	Rs. 1,00,000 (taxable @ 20% under section 112)
Short term capital gains	Rs. 1,00,000 (taxable @30%)
Total	**Rs. 2,00,000**

(b) (i) Computation of total income of Shri Radhakrishnan Public Charitable Trust for A.Y. 2015-16

	Particulars	Rs. (in Lacs)
(i)	Income from Engineering College – exempt under section 10(23C) (iiiad) as gross receipts do not exceed Rs. 1 crore.	Nil
(ii)	Income from properties held under trust	26.00
(iii)	Income from business undertaking held under trust (assumed that the business is incidental to the attainment of objectives of the trust and separate books are maintained satisfying section 11(4A))	2.00
		28.00
	85% of the income required to be spent (85% of Rs. 28 Lacs)	23.80
	Less: Option exercised under *Explanation 2* to section 11(1)	
	(i) Amount not received during the previous year	2.00
	(ii) Income received on the last day to be spent in the next year	2.00
		19.80

	Less: Amount spent on free scholarship, free meals and free medical centre	9.00
	Repayment of loans for construction of health centre (this is utilized for the fulfillment of the objects of the trust) (See *CIT v.Janmbhoomi Press Trust (2000) 242 ITR 703)*	3.00
	Income of the trust liable to tax	**7.80**

(ii) In order to minimize and / or reduce the tax liability, the trustees may give a notice in writing to the Assessing Officer in the prescribed manner about their intention to accumulate minimum of Rs. 5.30 lacs [Rs. 7.80 lacs minus Rs. 2.50 lacs (basic exemption limit)] specifying the period and the purpose for which the accumulation is proposed to be made and invest such sum in specified assets as per section 11(5). This accumulation would be in compliance with section 11(2) and in such case, no tax will be payable on the whole sum of Rs. 7.80 lacs.

4. (a) Chapter XII–A, comprising of sections 115C to 115I, contains special provisions which provide concessional tax treatment in relation to certain incomes of non-residents (i.e. investment income and long term capital gains). Therefore, in this case, the income of the non-resident has to be computed applying the provisions of Chapter XII-A.

According to section 115C –

(a) The income derived by a non-resident Indian from any foreign exchange asset other than dividend referred to in section 115-O is called as "Investment income"

(b) Foreign exchange asset includes debentures issued by an Indian public company acquired or purchased with or subscribed to in, convertible foreign exchange.

Section 115D provides that in computing such "Investment income" or "Long-term capital gains" of a non-resident Indian –

No deduction in respect of any expenditure or allowance under any provision of the Income-tax Act, 1961 is allowable in computing such investment income;

No deduction under Chapter VI-A shall be allowed in respect of both investment income and long term capital gains; and

No indexation will be applicable in respect of long term capital gains.

Section 115E provides that the investment income and/or long-term capital gains in respect of foreign exchange asset will constitute a separate block of income and investment income will be charged to income-tax at a flat rate of 20% and long term capital gains at a flat rate of 10%. If the non-resident Indian has any other income in India, such other income will constitute altogether a separate block of income and will be charged to tax as if such other income is the total income. The aggregate of the income-tax so calculated in respect of the said two blocks of income will be the total tax payable.

Computation of total income for A.Y. 2015-16

Particulars		Rs.
1. Dividend income – Exempt under section 10(34)		Nil
2. Debenture Interest [interest on loans borrowed for investment not allowable as deduction as per section 115D(1)]		75,000
3. Long-term capital gains - Assuming it was subjected to Securities Transaction Tax, the entire long term capital gain from sale of shares is exempt under section 10(38)		NIL
4. Property Income (Net) [assuming net of all deductions]		3,00,000
Gross Total Income		**3,75,000**
Less: Deduction under section 80C in respect of housing loan repaid	20,000	
Deduction under section 80E allowable in respect of interest paid on loan taken for higher education	20,000	
Deduction under section 80G in respect of donation to Prime Minister's National Relief Fund (100%)	10,000	50,000
Total income		**3,25,000**

Computation of tax payable

Particulars	Rs.	Rs.
Tax at 20% on debenture interest of Rs. 75,000		15,000
Total Income (as reduced by investment income) i.e. Rs. 3,25,000 minus Rs. 75,000	2,50,000	
Tax thereon		Nil
		15,000
Add: Education cess @ 2% & secondary and higher education cess @ 1%		450
		15,450
Less: Tax deducted at source		30,000

Balance tax refundable		**14,550**

(b) Computation of capital gains and business income of Teena for A.Y.2015-16

Particulars	Rs.
Capital Gains	
Fair market value of land on the date of conversion deemed as the full value of consideration for the purposes of section 45(2)	1,50,00,000
Less: Indexed cost of acquisition [Rs. 10,00,000 × 711/109]	65,22,936
	84,77,064
Proportionate capital gains arising during A.Y.2015-16 [Rs. 84,77,064 × ¾]	63,57,798
Less: Exemption under section 54EC	50,00,000
Capital gains chargeable to tax for A.Y.2015-16	**13,57,798**
Business Income	
Sale price of flats [15 × Rs. 20 lakhs]	3,00,00,000
Less: Cost of flats	
Fair market value of land on the date of conversion [Rs. 150 lacs × ¾]	1,12,50,000
Cost of construction of flats [15 × Rs. 8 lakhs]	1,20,00,000
Business income chargeable to tax for A.Y.2015-16	**67,50,000**

Alternate presentation for computation of capital gains

	Rs.
Proportionate Fair Market Value as on 1st April 2010 - the date of conversion – to be taken as deemed consideration (Rs. 150 lakhs × 15 /20)	1,12,50,000
Less: Proportionate indexed cost of acquisition of land (Note1) (Rs. 10,00,000 × 711/109 × 15/20)	48,92,202
Long term capital gain	**63,57,798**
Less: Exemption under section 54EC	
Investment in bonds issued by Rural Electrification Corporation Ltd	50,00,000
Taxable long-term capital gain	**13,57,798**

Notes:

(1) The conversion of a capital asset into stock-in-trade is treated as a transfer under section 2(47). It would be treated as a transfer in the year in which the capital asset is converted into stock-in-trade.

(2) However, as per section 45(2), the capital gains arising from the transfer by way of conversion of capital assets into stock-in-trade will be chargeable to tax only in the year in which the stock-in-trade is sold.

(3) The indexation benefit for computing indexed cost of acquisition would, however, be available only up to the year of conversion of capital asset to stock-in-trade and not up to the year of sale of stock-in-trade.

(4) For the purpose of computing capital gains in such cases, the fair market value of the capital asset on the date on which it was converted into stock-in-trade shall be deemed to be the full value of consideration received or accruing as a result of the transfer of the capital asset.

In this case, since only 75% of the stock-in-trade (15 flats out of 20 flats) is sold in the P.Y.2014-15, only proportionate capital gains (i.e., 75%) would be chargeable in the A.Y.2015-16.

(5) On sale of such stock-in-trade, business income would arise. The business income chargeable to tax would be the difference between the price at which the stock-in-trade is sold and the fair market value on the date of conversion of the capital asset into stock-in-trade.

(6) In case of conversion of capital asset into stock-in-trade and subsequent sale of stock-in-trade, the period of 6 months is to be reckoned from the date of sale of stock-in-trade for the purpose of exemption under section 54EC [*CBDT Circular No.791 dated 2.6.2000]*. In this case, since the investment in bonds of RECL has been made within 6 months of sale of flats, the same qualifies for exemption under section 54EC.

5. (a) (i) Immovable property, being land or building or both, received without consideration by a HUF from its relative is not taxable under section 56(2)(vii).Since Madhu is a member of Suresh HUF, she is a "relative" of the HUF. Therefore, if Suresh HUF receives a house property from its member, Madhu, without consideration, the stamp duty value of such property will **not** be chargeable to tax in the hands of the HUF, since such receipt from a "relative" is excluded from the scope of section 56(2)(vii).

(ii) The provisions of section 56(2)(viib) are attracted in this case since the shares of a closely held company are issued at a premium (i.e., the issue price of Rs. 70 per share exceeds the face value of Rs. 10 per share).

The consideration received by the company in excess of the fair market value of the shares would be taxable under section 56(2)(viib).

Therefore, Rs. 10,00,000 {i.e., (Rs. 70 – Rs. 50) x 50,000 shares} shall be the income chargeable under the head "Income from other sources" in the hands of XY Private Limited.

(b) If any expenditure is incurred by an assessee in any financial year in respect of which he is not able to offer explanation about the source of such expenditure or the explanation offered by him is not satisfactory in the opinion of the Assessing Officer, then the amount of such unexplained expenditure may be deemed as income of the assessee for such financial year as per section 69C.

Therefore, in this case, the expenditure of Rs. 20 lakhs incurred by Mr. Ramesh on the wedding of his daughter may be deemed as income of Mr. Ramesh as per section 69C.

Further, such unexplained expenditure which is deemed as the income of Mr. Ramesh shall not be allowed as deduction under any head of income.

Where the total income of Mr. Ramesh includes such unexplained expenditure of Rs. 20 lakhs, which is deemed as his income under section 69C, such deemed income would be taxed at the maximum marginal rate of 30% as per section 115BBE (plus surcharge, education cess@2% and secondary and higher education cess@1%).

Further, no basic exemption or allowance or expenditure shall be allowed to Mr. Ramesh under any provision of the Income-tax Act, 1961 in computing such deemed income.

Penalty under section 271(1)(c) shall be levied for concealment of income.

(c) Where any relief was allowed under section 89 for any assessment year in respect of any amount received or receivable on voluntary retirement, no exemption under section 10(10C) shall be allowed in respect of the said sum in that assessment year or any other assessment year.

Similarly, relief under section 89 cannot be claimed if benefit of exemption has been claimed under section 10(10C).

Mr. Devraj can, therefore, opt to claim exemption of Rs. 5 lacs under section 10(10C) or relief under section 89(1) in respect of compensation received on voluntary retirement, but not both. Accordingly, the advice given by his tax consultant is not correct.

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

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

The amount of income to be declared by the assessee for A.Y. 2015-16 will be as under:

Particulars	Rs.

Net loss for the year ended on 31.03.2014	(100 lacs)
Add: Amount of head office expenses to be considered separately as per section 44C	200 lacs
Adjusted total income	100 lacs
Less: Head Office expenses allowable under section 44C is the lower of (i) Rs. 5 lacs, being 5% of Rs. 100 lacs and (ii) Rs. 200 lacs.	5 lacs
Income to be declared in return	**95 lacs**

(e) The Supreme Court has, in *Goetze (India) Ltd. v. CIT (2006) 284 ITR 323,* ruled that the assessing authority has no power to entertain a claim for deduction made after filing of the return of income otherwise than by way of a revised return. In the instant case, Rajat has claimed the deduction under section 80C, which he omitted to claim in the original return of income, through a letter addressed to the Assessing Officer and not by filing a revised return under section 139(5). In view of the decision of the Supreme Court cited above, the Assessing Officer was justified in completing the assessment without allowing the deduction under section 80C.

6. (a) (i) Computation of deduction allowable under section 36(1)(iva) and disallowance under section 40A(9) while computing business income of MNO Ltd.

Particulars	Rs.
Basic Salary	1,00,00,000
Dearness Allowance is 40% of basic salary, 50% of which forms part of pay for retirement benefits	20,00,000
Salary for the purpose of section 36(1)(iva) (Basic Salary + DA which forms part of pay for retirement benefits)	1,20,00,000
Actual contribution (20% of basic salary i.e., 20% of Rs. 100 lakh)	20,00,000
***Less:* Permissible deduction under section 36(1)(iva) (10% of salary computed as above = 10% of Rs. 1,20,00,000 = Rs. 12,00,000)**	12,00,000
Excess contribution disallowed under section 40A(9)	8,00,000

(ii) Tax treatment in the hands of the finance executive in respect of employer's and own contribution to pension scheme referred to in section 80CCD

(a) Employer's contribution to such pension scheme would be treated as salary since it is specifically included in the definition of "salary" under section 17. Therefore, Rs. 48,000, being 20% of basic salary of Rs. 2,40,000, will be included in salary.

(b) Own contribution to pension scheme is allowable as deduction under section 80CCD(1). However, the deduction is restricted to 10% of salary. Salary, for this purpose, means basic pay plus dearness allowance, if it forms part of pay for retirement benefits. Therefore, salary for the purpose of deduction under section 80CCD, in this case, would be –

Particulars	Rs.
Basic salary (Rs. 20,000 × 12)	2,40,000
Dearness allowance = 40% of Rs. 2,40,000 = Rs. 96,000	
50% of DA forms part of pay = 50% of Rs. 96,000	48,000
Salary for the purpose of deduction under section 80CCD	**2,88,000**
Deduction u/s 80CCD(1) = 10% of Rs. 2,88,000 (as against actual contribution of Rs. 48,000, being 20% of basic salary of Rs. 2,40,000)	28,800
Rs. 28,800 is allowable as deduction under section 80CCD(1). This would be taken into consideration and be subject to the overall limit of Rs. 1.50 lakh under section 80CCE.	

(c) Employer's contribution to pension scheme would be allowable as deduction under section 80CCD(2), subject to a maximum of 10% of salary. Therefore, deduction under section 80CCD(2), would also be restricted to Rs. 28,800, even though the entire employer's contribution of Rs. 48,000 is included in salary under section 17.

However, this deduction of employer's contribution of Rs. 28,800 to pension scheme would be outside the overall limit of Rs. 1.50 lakh under section 80CCE i.e., this deduction would be over and above the other deductions which are subject to the limit of Rs. 1.50 lakh.

(b) (i) The proposition is correct in law. The Supreme Court has, in *CIT vs. McMilan & Co. (1958) 33 ITR 182 and CIT vs. Kanpur Coal Syndicate (1964) 53 ITR 225*, held that in disposing of an appeal before him, the appellate authority can travel over a whole range of the assessment order. The scope of his powers is co-terminus with that of the Assessing Officer. He can do what the Assessing Officer can do and can also direct him to do, what he has failed to do. He can assess income from sources which have been considered by the Assessing Officer but not brought to tax. He can consider every aspect of the assessment order and give appropriate reliefs.

The Allahabad High Court has, in *CIT v. Kashi Nath Chandiwala (2006) 280*

ITR 318, held that the appellate authority is empowered to consider and decide any matter arising out of the proceedings in which the order appealed against was passed notwithstanding the fact that such matter was not raised before him by the assessee. The Commissioner (Appeals) is entitled to direct additions in respect of items of income not considered by the Assessing Officer.

Further, the Apex Court has, in the case of *Jute Corporation of India Ltd. vs. CIT (1991)* 187 *ITR* 688, held that the appellate authority is vested with all the plenary powers which the subordinate authority may have in the matter.

Thus, the powers of the Commissioner of Income-tax (Appeals) in enhancing the assessment are very wide and plenary.

(ii) The proposition is correct in law. A finding of fact cannot be disturbed by the High Court in exercise of its powers under section 260A. The Income-tax Appellate Tribunal is the final fact finding authority and the findings of fact recorded by the Tribunal can be interfered with by the High Court under section 260A only on the ground that the same were without evidence or material, or if the finding is contrary to the evidence, or is perverse or there is no direct nexus between conclusion of fact and the primary fact upon which that conclusion is based.

In *CIT vs. P. Mohanakala (2007) 291 ITR 278 and M. Janardhana Rao v. Joint CIT (2005) 273 ITR 50*, the Apex Court observed that the High Court had set aside the factual findings of the lower authorities and the Tribunal without any valid reason. The Apex Court held that the findings of fact could not be interfered with by the High Court without carefully considering the facts on record, the surrounding circumstances and the material evidence. There is no scope for interference with the factual findings, unless the findings are *per se* without reason or basis, perverse and/or contrary to the material on record.

Hence, only if the issue gives rise to a substantial question of law, an appeal shall lie before the High Court.

7. (a) (i) The services of Event Managers in relation to sports activities alone have been notified by the CBDT as "professional services" for the purpose of section 194J. In this case, payment of Rs. 5 lacs has been made to an event management company for organization of a debate competition. Hence, the TDS provisions under section 194J would not be attracted in this case.

However, TDS provisions under section 194C relating to payment to contractors would be attracted and consequently, tax has to be deducted @ 2% under section 194C. The tax deductible under section 194C would be Rs. 10,000, being 2% of Rs. 5 lacs.

(ii) Section 194D requires deduction of tax at source@10% from insurance commission.

Reinsurance, however, differs from insurance since there is no direct contractual relationship between the person insured and the reinsurer.

In order to attract section 194D, the commission or any other payment covered under the section should be a remuneration or reward for soliciting or procuring the insurance business; the insurance companies do not procure business for the reinsurance company nor does the reinsurer pay commission or other payment for soliciting the business from the insurance companies; therefore, section 194D has no application.

Hence, when profit commission is paid by a reinsurance company to an insurance company, after the expiry of the term of insurance, in respect of such cases where there is no claim during the operation of the reinsurance treaty, TDS under section 194D is not attracted.

(iii) Section 194J provides for deduction of tax at source @10% on any remuneration or fees or commission, by whatever name called, paid to a director, which is not in the nature of salary on which tax is deductible at source under section 192.

Hence, tax is to be deducted at source under section 194J @10% by PQR Pvt. Ltd. on the commission of Rs. 2,25,000 paid to Mr. Raman, a part-time director. The tax deductible under section 194J would be Rs. 22,500, being 10% of Rs. 2,25,000

(b) Section 275(1) provides for the time limit for imposing penalty. According to this section, the time limit for imposition of penalty under section 271(1)(c) in the following cases would be :

(i) If S Limited did not contest the assessment order

Where the relevant assessment order is not the subject matter of either appeal or revision, an order imposing penalty shall not be passed -

(a) after the expiry of the financial year in which the proceedings, in the course of which action for the imposition of penalty has been initiated, are completed, i.e. 31st March, 2014, or

(b) six months from the end of the month in which action for imposition of penalty is initiated, i.e. 30th June, 2014,

whichever is later.

Therefore, the time limit for imposing penalty in this case would be 30th June, 2014.

(ii) If S Limited made an appeal to the Commissioner (Appeals) against the assessment order and the appeal was dismissed on 30th December, 2014, on which date the Commissioner received the appeal order

Where the assessment order or other order is the subject matter of an appeal to the Commissioner (Appeals) under section 246A, and the Commissioner (Appeals) passes the order disposing of such appeal, an order imposing penalty shall be passed –

(a) before the expiry of the financial year in which the proceedings, in the course of which action for imposition of penalty has been initiated, are completed i.e. 31st March, 2014 or

(b) within one year from the end of the financial year in which the order of the Commissioner (Appeals) is received by the Chief Commissioner or Commissioner i.e. 31st March, 2016,

whichever is later.

Therefore, the time limit for imposing penalty in this case would be 31st March, 2016.

(iii) If the penalty proceeding is stayed by the High Court on 25th June, 2014 and the stay is vacated by the Supreme Court on 25th November, 2014.

As per the provisions of the *Explanation* below section 275(2), the period of stay is to be excluded from the time limit for imposition of penalty. In this case, the time limit for imposing penalty would expire on 30th June, 2014, being the date of expiry of six months from the end of the month in which action for imposition of penalty is initiated (since it is later than 31.3.2014, being the date of expiry of the financial year in which the assessment proceedings are completed). The stay order was passed by the High Court on 25th June, 2014 and vacated by the Supreme Court on 25th November, 2014. The time limit for imposing penalty will, accordingly, get extended to 30th November, 2014.

(c) Section 264(4) provides that the Principal Commissioner or Commissioner shall not revise any order under section 264 in the following cases –

(a) Where any appeal against the order lies to the Commissioner (Appeals) or to the Appellate Tribunal but has not been made and the time within which such appeal may be made has not expired or, in the case of an appeal to the Commissioner (Appeals) or the Appellate Tribunal the assessee has not waived his right of appeal ; or

(b) Where the order has been made the subject of an appeal to the Commissioner (Appeals) or to the Appellate Tribunal.

Even though the provisions of section 246A do not specifically bar an appeal being filed simultaneously along with a revision petition under section 264, it is clear from a reading of section 264 that the assessee is barred from seeking revision unless he has waived the right of appeal.

Therefore, it is clear that the assessee can either apply for revision before the Principal Commissioner or Commissioner under section 264 or file an appeal before the Commissioner of Income-tax (Appeals), but cannot invoke both the remedies simultaneously.

Test Series: March, 2015

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – II

PAPER – 8: INDIRECT TAX LAWS

SUGGESTED ANSWERS / HINTS

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

Particulars	Rs.
Sale price of the machine excluding taxes and duties	2,00,000
Add : Design and development charges (Note-3)	20,000
Add: Warranty charges (Note-4)	5,000
Assessable value	2,25,000
Excise duty @ 12%	27,000
Education cess @ 3% on excise duty	810
Total excise duty payable on the machine	27,810

Notes:

1. Sales tax is not included since the definition of transaction value as per section 4(3)(d) specifically excludes sales tax paid or payable on the goods.
2. Since the cost of durable and returnable packing has been amortised and is included in the cost of the product, it is not required to be added again [Circular No. 643/34/2002-CX dated 01.07.2002].
3. Design and development charges are essential for the purpose of manufacture and to make the product marketable. Hence, they have to be included in the assessable value, since the payment is 'in connection with sale'

4. As per the definition of the transaction value under section 4(3)(d) of the Central Excise Act, 1944, warranty charges are includible in the assessable value.

(b) Computation of service tax liability of Pure Agro Industries Ltd. for the month of June, 2014

Particulars	Rs.
Supply of farm labour [Note 1]	Nil
Warehousing of refined vegetable oil [Note 2]	1,25,000
Sale of wheat on commission basis [Note 3]	Nil
Trucks given on hire for transport of minerals [Note 4]	2,50,000
Leasing of vacant land to a stud farm [Note 5]	30,000
Renting of farmhouse for marriage and birthday parties [since not used for agricultural purposes]	45,000
Dehusking of paddy in rice mill [Note 6]	Nil
Total taxable services	4,50,000
Service tax payable @ 12.36% (inclusive of 3% education cesses) [Rs. 4,50,000 × 12.36%] [Note 7]	**55,620**

Notes:

1. Supply of farm labour is covered in negative list of services under services relating to agriculture or agricultural produce and thus, will not be liable to service tax [Section 66D(d)(ii) of the Finance Act, 1994].
2. Since refined vegetable oil is not an agricultural produce, warehousing thereof will not be covered under negative list of services [Section 65B(5) read with section 66D(d)(v) of Finance Act, 1994].
3. Since, wheat is an agricultural produce, services provided for its sale on commission basis will be covered in negative list of services and thus, will not be liable to service tax [Section 65B(5) read with section 66D(d)(vii) of Finance Act, 1994].
4. Transfer of goods (trucks) by way of hiring without transfer of right to use such goods is a declared service as per section 66E(f) of the Finance Act, 1994 and hence, will be liable to service tax.
5. Services relating to agriculture or agricultural produce by way of renting or leasing of vacant land are covered in the negative list of services. However, since rearing of horses is specifically excluded from the definition of agriculture, leasing of vacant land to stud farm will not be covered thereunder [Section 65B(3) read with section 66D(d)(iv) of Finance Act, 1994].

6. Carrying out an intermediate production process (dehusking of paddy) as job work in relation to agriculture is exempt from service tax [Notification No. 25/2012 ST dated 20.06.2012].
7. Since service tax of Rs. 3,18,000 had been paid during the preceding financial year, turnover of services would have been more than Rs. 10,00,000 during the preceding financial year. Hence, small service provider's exemption under Notification No. 33/2012 ST dated 20.06.2012 cannot be availed.

(c) Computation of assessable value of the imported goods

		US $
(i)	Cost of the machine at the factory	10,000
(ii)	Transport charges upto port	500
(iii)	Handling charges at the port	50
	F.O.B.	10,550
(iv)	Freight charges upto India	1,000
(v)	Insurance charges @ 1.125% of F.O.B. [Note 1]	118.69
	C.I.F.	11,668.69
	C.I.F. in Indian rupees @ Rs. 60/- per $	Rs. 7,00,121.40
(vi)	Add: Landing charges @ 1% of CIF [Note 1]	Rs. 7,001.21
	Assessable Value	Rs. 7,07,122.61

Notes:

(1) Insurance charges and landing charges have been included @ 1.125% of FOB value of goods and 1% of CIF value of goods respectively [First proviso to rule 10(2) of the Customs Valuation (Determination of Value of Imported Goods) Rules, 2007].

(2) Buying commission is not included in the assessable value [Rule 10(1)(a)(i) of the Customs Valuation (Determination of Value of Imported Goods) Rules, 2007].

2. (a) Computation of CENVAT credit available

Particulars	Amount (Rs.)
Raw Steel	22,000
Water pipe making machine (Rs. 18,000 × 50%) (Note-1)	9,000
Grease and Oil	2,800

Spare parts for the machinery (Rs. 7,500 × 50%) (Note-1)	3,750
CENVAT credit admissible	**37,550**

Notes: In respect of:-

1. Water pipe making machine and spare parts, being capital goods, only 50% of CENVAT credit is available [Rule 2(a) along with rule 4(2)(a) of the CENVAT Credit Rules, 2004].
2. A manufacturer cannot avail credit on office equipment since the definition of capital goods under rule 2(a) of the CENVAT Credit Rules, 2004 specifically excludes any equipment/ appliance used in an office.
3. No credit is available on light diesel oil since the definition of input under rule 2(k) of the CENVAT Credit Rules, 2004 specifically excludes the same.

(b) Computation of value of taxable service and service tax payable by Safe Bank Ltd.

Sl. No.	Particulars	Amount (Rs.)
(i)	Administration charges for extending home loans [Note 1]	10,00,000
(ii)	Discount earned on bills discounted [Note 2]	-
(iii)	Value of sale and purchase of forward contract [Note 3]	-
(iv)	Charges received on credit and debit card facilities extended [Note 4]	3,80,000
(v)	Commission received for service rendered to Government for tax collection [Note 5]	6,00,000
(vi)	Margin earned on reverse repo transaction [Note 6]	-
	Total	19,80,000
	Value of taxable service $\left[19,80,000 \times \frac{100}{112.36}\right]$ rounded off [since all the amounts are total amounts **received**]	**17,62,193**
	Service tax payable [Rs. 17,62,193 × 12%]	2,11,463
	Education cess [Rs. 2,11,463 × 2%]	4229
	Secondary and higher education cess [Rs. 2,11,463 × 1%]	2115
	Total service tax payable	**2,17,807**

Notes:

1. Service of extending loans in so far as the consideration is represented by way of interest is covered in the negative list. However, any charges collected over and above the interest represent taxable consideration and is thus, liable to

service tax.

2. Services of bills discounting, to the extent the consideration is represented by way of discount, is covered in the negative list of services as such discounting is also a manner of extending credit facility or a loan.

3. Sale or purchase of forward contracts, being transaction in money, is outside the scope of the definition of service.

4. Credit extended through credit and debit cards is not in the nature of loan or advance for interest and thus, the charges received on account of such extended credit is in fact, the consideration for the services rendered by way of credit card.

5. Commission received for service rendered to Government for tax collection is neither transactions in money which is excluded from the definition of service nor covered in negative list or under any exemption notification and is thus, liable to service tax.

6. Reverse repo being a security, which is goods is excluded from the definition of service.

(c) **(i)** As per Rule 8(1) of the Customs, Central Excise Duties and Service Tax Drawback Rules, 1995, no amount of drawback shall be allowed if the rate of drawback is less than 1% of the FOB value, except where the amount of drawback per shipment exceeds Rs. 500. Further, as per section 76(1)(c) of the Customs Act, 1962 drawback is not allowed where the drawback due in respect of any goods is less than Rs. 50.

In the given case, since the rate of duty drawback is not less than 1% and drawback due is Rs. 500 (1% of FOB value) which is more than Rs. 50, duty drawback shall be allowed.

(ii) Section 76(1)(b) of the Customs Act, 1962 inter alia provides that no drawback shall be allowed in respect of any goods, the market price of which is less than the amount of drawback due thereon. In this case, the market price of the goods is Rs. 50,000, which is less than the amount of duty drawback, i.e. 2,000 kgs x Rs. 30 = Rs. 60,000. Hence, no drawback shall be allowed.

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) The facts of the given case are similar to the case of *Infotech Software Dealers Association (ISODA) v. Union of India 2010 (20) STR 289 (Mad.).*

(i) No, the transaction cannot be called as sale or deemed sale.

The High Court, in ISODA case, observed that whether a transaction amounts to sale or service depends upon the nature of individual transaction and the dominant intention of the parties.

Since the developer retained the copyright of each software, the dominant intention was to transfer, to the subscribers or the members, only the right to use with copyright protection. However, the transactions in the instant case could not be treated as deemed sale as that requires a transfer of right to use any goods but in the instant case, the goods as such are not transferred.

(ii) Yes, the transaction is liable to service tax.

The High Court, in ISODA case, held that in the transactions taking place between the assessee and its customers, the software is not sold as such, but only the contents of the data stored in the software are sold which would only amount to service and not sale.

Such service is liable to service tax as a declared service under clause (d) of section 66E of the Finance Act, 1994.

(c) Yes, the company will succeed. The facts of the given situation are similar to the case of CCus vs. Biecco Lawrie Ltd. 2008 (223) ELT 3 (SC) wherein the Supreme Court has held that where duty on the warehoused goods is paid and out of charge order for home consumption is made by the proper officer in compliance of the provisions of section 68, the goods removed in smaller lots have to be treated as cleared for home consumption and importer would not be required to pay anything more.

Further, section 49 of the Customs Act, 1962 inter alia also provides that imported goods entered for home consumption if stored in a public warehouse, or in a private warehouse on the application of the importer and if the same cannot be cleared within a reasonable time, shall not be deemed to be warehoused goods for the purposes of this Act, and accordingly the provisions of Chapter IX shall not apply to such goods.

4. (a) Section 35F of Central Excise Act, 1944 has been substituted with a new section to provide as under:

(i) The Commissioner (Appeals) shall not entertain any appeal under section

35(1), unless the appellant has deposited **7.5%** of the duty, in case where duty or duty and penalty are in dispute, or penalty, where such penalty is in dispute, in pursuance of a decision or an order passed by an officer of Central Excise lower in rank than the Commissioner of Central Excise;

(ii) The Tribunal shall not entertain any appeal against the decision or order passed by Commissioner of Central Excise under section 35B(1)(a), unless the appellant has deposited **7.5%** of the duty, in case where duty or duty and penalty are in dispute, or penalty, where such penalty is in dispute, in pursuance of the decision or order appealed against;

(iii) The Tribunal shall not entertain any appeal against the decision or order passed by Commissioner (Appeals) under section 35B(1)(b), unless the appellant has deposited **10%** of the duty, in case where duty or duty and penalty are in dispute, or penalty, where such penalty is in dispute, in pursuance of the decision or order appealed against:

(iv) The amount of pre-deposit shall not exceed Rs. 10 crores.

(v) Duty demanded shall include,—

(i) amount determined under section 11D;

(ii) amount of erroneous CENVAT credit taken;

(iii) amount payable under rule 6 of the CENVAT Credit Rules, 2004.

(b) (i) As per rule 9(c) of Place of Provision of Services Rules, 2012 (POPS Rules), place of provision of intermediary services is the location of service provider.

With effect from 01.10.2014, definition of term “intermediary” as provided under rule 2(f) of POPS Rules has been substituted to include the intermediary of goods in its scope. The substituted definition provides that “intermediary” means a broker, an agent or any other person, by whatever name called, who arranges or facilitates a provision of a service (hereinafter called the main ‘service) or a supply of goods, between two or more persons, but does not include a person who provides the main service or supplies the goods on his account.

Accordingly, commission agent of goods will be covered under rule 9(c) of POPS Rules. Thus, the place of provision of services provided or agreed to be provided by PQ Trade Links (as commission agent of goods) to foreign company will be the location of service provider i.e., New Delhi.

(ii) Rule 4(a) of POPS Rules provides that the place of provision of services provided in respect of goods that are required to be made physically available by the recipient of service to the provider of service in order to provide the service, is the location where the services are actually performed.

However, with effect from 01.10.2014, second proviso to rule 4(a) has been substituted to lay down that clause (a) of rule 4 will not apply in the case of a service provided in respect of goods that are temporarily imported into India for repairs and are exported after the repairs without being put to any use in the taxable territory, other than that which is required for such repair. Consequently, such a case will be covered under rule 3 of POPS Rules (general rule) and the place of provision of service will be the location of service receiver.

In the given case, goods have been temporarily imported by CD Fabricators and have been re-exported after the repairs without being put to any use in Mumbai (taxable territory). Therefore, place of provision of repair services carried out by CD Fabricators will be determined by rule 3 of POPS Rules. Consequently, the place of provision of service will be the location of service receiver i.e. Hongkong

(c) Section 8B of Customs Tariff Act, 1975 which provides for imposition of safeguard duty has now been amended with effect from from 11.07.2014, to provide for levy of safeguard duty on articles imported by an 100% EOU/unit in a SEZ that are cleared as such into DTA or are used in the manufacture of goods that are cleared into DTA. In such cases safeguard duty shall be levied on that portion of the article so cleared or so used as was leviable when it was imported into India.

5. (a) Section 12F of the Central Excise Act, 1944 contains the provisions relating to search by a Central Excise Officer. Section 12F(1) lays down that where the Joint Commissioner of Central Excise or Additional Commissioner of Central Excise or such other Central Excise Officer as may be notified by the Board has reasons to believe that any goods liable to confiscation or any documents or books or things, which in his opinion shall be useful for or relevant to any proceedings under this Act, are secreted in any place, he may authorise in writing any Central Excise Officer to search and seize or may himself search and seize such documents or books or things.

Sub-section (2) of section 12F lays down that the provisions of the Code of Criminal Procedure, 1973, relating to search and seizure, apply to search and seizure under this section. However the police officer would have to submit the copies of any record made, to the Principal Commissioner/ Commissioner of Central Excise.

(b) (i) Housing loan of Rs. 50 lakh extended by the bank to Mr. T will not be taxable as the same being a transaction in money, does not represent the value of taxable services.

(ii) Rs. 50,000 received as loan processing fees by the bank from Mr. T will be taxable as any charges or amounts, collected in respect of a loan. The same being over and above the interest or discount amounts are not covered in the negative list [Section 66D(n)(i)] and thus, represent taxable consideration.

(iii) Rs. 6 lakh received by bank from Mr. T as interest on loan will not be taxable as services by way of extending loans in so far as the consideration is represented by way of interest are covered in the negative list [Section 66D(n)(i)].

(c) Section 124 of the Customs Act, 1962 provides that before confiscating goods or imposing any penalty on any person, a show cause notice [SCN] must be issued to the owner of goods giving grounds for confiscation or imposition of penalty and he should be given an opportunity to make representation and being heard. The show cause notice can be issued only with the prior approval of the officer of customs not below the rank of Assistant Commissioner of Customs. The notice and the representation, at the request of the person concerned, can be oral.

Therefore, since no show cause notice has been issued, the order of confiscation of goods is not valid.

6. (a) Under section 11A of the Central Excise Act, 1944, extended period of limitation can be invoked and penalty be reduced to 50% on fulfillment of the following conditions:

- duty has not been levied or paid or has been short-levied or short-paid or erroneously refunded by the reason of fraud, collusion, any wilful mis-statement, suppression of facts, contravention of any of the provisions of this Act or of the rules made thereunder with intent to evade payment of duty;
- the said default has been found during the course of any audit, investigation or verification; and
- details relating to the transactions are available in the specified records.

Or

Risk factors under Excise Audit, 2000 means that the assessees who have a bad track record are taken up for audit on priority as opposed to those who enjoy a clean track record.

For example:

(i) assessee having past duty evasion cases

(ii) late payment of duty/late filling returns

(iii) major audit objections against them

(iv) no cash payment of duty (all CENVAT adjustment)

(v) past duty dues, etc

(b) Amount of service tax which Sai failed to deposit = Rs.15,00,000

Due date of depositing service tax is 6th November

Date on which service tax actually deposited is 17th November

No. of days by which service tax was deposited late = 11 days [7th November – 17th November]

(Penalty under section 76 is computed for a period beginning with the first day after the due date and ending with the date of actual payment.)

Computation of quantum of penalty that can be imposed

Maximum penalty for delayed payment of service tax under section 76 is as follows:-

(A) Rs. 100/- per day for every day during which such default continues

=Rs.100/- per day for 11 days = Rs.100× 11 days= Rs.1,100

or

(B) 1% per cent of amount of default, per month

$$= \text{Rs.}15,00,000 \times 1\% \times \frac{11}{31} = \text{Rs.}5,323$$

whichever is higher.

However, total amount of penalty payable under this section shall not exceed 50% of the service tax that the assessee has failed to pay i.e.:-

Rs. 5,323 or Rs. 7,50,000 [50% of Rs.15,00,000], whichever is lower.

The maximum amount of penalty that can be imposed on Sai is Rs. 5,323/-.

Note: Penalty under section 76 of the Finance Act, 1994 can be waived off under section 80 if the assessee proves that there was reasonable cause for the said failure.

(c) Focus Market Scheme (FMS) has been introduced under FTP to penetrate those markets [primarily Latin America, Africa, Eastern Europe, etc.] which Indian exports have been neglecting (owing to high freight costs and other externalities). Eligible exporters to notified countries are entitled for duty credit scrip equivalent to 3% of FOB value of exports (in free foreign exchange) for exports. No, export of diamonds and other precious, semi precious stones is not eligible for duty credit scrip, under FMS scheme:

7. (a) Bonds may be accepted by any of the following officers:

(i) Deputy/Assistant Commissioner of Central Excise having jurisdiction over the factory or warehouse or any other premises approved by the Principal Commissioner/Commissioner for storing non-duty paid goods

(ii) Jurisdictional Maritime Commissioner in case of exports or

(iii) Deputy/Assistant Commissioner of Central Excise (Export) as officers authorized by the Board for this purpose.

Exporters are required to indicate on the ARE-1 the complete postal address of the authority before whom the bond is executed and to whom the documents are to be submitted for admission of proof of export.

(b) **(i)** The following services have been notified vide Notification No. 30/2012 ST dated 20.06.2012 under reverse charge mechanism where service tax is jointly payable by both, service provider and service receiver:-

(i) services provided or agreed to be provided by way of renting of a motor vehicle designed to carry passengers on non abated value to any person who is not engaged in the similar line of business

(ii) services provided or agreed to be provided by way of supply of manpower for any purpose or security services

(iii) services provided or agreed to be provided in service portion in execution of works contract.

Service tax will be jointly payable only if the above services are provided by any individual, HUF or partnership firm including association of persons, located in the taxable territory to a body corporate, located in the taxable territory.

(ii) The time-limit for issuance of show cause notice for demand of service tax under section 73 of the Finance Act, 1994 -

(a) in case of fraud, collusion, wilful mis-statement, suppression of facts, or contravention of any of the provisions of this Act or of the rules made thereunder with intent to evade payment of service tax, is 5 years from the relevant date.

(b) for any other reason, is 18 months from the relevant date.

If the service of the notice is stayed by an order of a Court, the period of such stay should be excluded in computing the aforesaid period of 5 years or 18 months.

(c) Yes, 'X' can do so. In case of part duty free and part duty paid imports, both Advance Authorization and drawback will be available. Drawback can be obtained for any duty paid material, whether imported or indigenous, used in goods exported, as per drawback rate fixed by DoR, Ministry of Finance (Directorate of Drawback). Advance Authorization can be used for importing duty free material. Drawback allowed must be mentioned in the application for Advance Authorization. In such case, All Industry Brand Rates are not applicable. The manufacturer has to get specific brand rate fixed from Commissioner for these exported goods.