

MOCK TEST PAPER – 2
FINAL COURSE: GROUP – I
PAPER – 1: FINANCIAL REPORTING

Question No. 1 is compulsory.

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

Working notes should form part of the answer.

Wherever necessary, suitable assumption(s) may be made and disclosed by the candidates.

1. (a) Explain whether the following will constitute a change in accounting policy or not as per AS 5.
- (i) Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.
 - (ii) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organisation. Such employees will get pension of Rs. 20,000 per month. Earlier there was no such scheme of pension in the organization.
- (b) Suryansh Ltd. contracted with a supplier to purchase a specific machinery to be installed in Department A in two months time. Special foundations were required for the plant, which were to be prepared within this supply lead time. The cost of site preparation and laying foundations were Rs. 47,290. These activities were supervised by a technician during the entire period, who is employed for this purpose for Rs.15,000 per month. Technician's services were given to Department A by Department B, which billed the services at Rs. 16,500 per month after adding 10% profit margin.
- The machine was purchased at Rs. 52,78,000. Sales tax was charged at 4% on the invoice, Rs. 18,590 transportation charges were incurred to bring the machine to the factory. An Architect was engaged at a fee of Rs. 10,000 to supervise machinery installation at the factory premises. Also, payment under the invoice was due in 3 months. However, the Company made the payment in 2nd month. The company operates on Bank Overdraft @ 11%.
- Ascertain the amount at which the asset should be capitalized under AS 10.
- (c) Chance Ltd. purchased an equipment costing Rs. 24,00,000 lakhs on 1.4.2015 and the same was fully financed by foreign currency loan (US Dollars) payable in four annual equal installments. Exchange rates were 1 Dollar = Rs. 60.00 and Rs. 62.50 as on 1.4.2015 and 31.3.2016 respectively. First installment was paid on 31.3.2016. The entire difference in foreign exchange has been capitalized. You are required to state that how these transactions would be accounted for.

- (d) Shilpa Ltd. has undertaken a project for expansion of capacity as per the following details:

	Plan (Rs.)	Actual (Rs.)
October, 2015	5,00,000	4,00,000
November, 2015	6,50,000	7,95,000
December, 2015	20,00,000	-
January, 2016	2,00,000	50,000
February, 2016	9,00,000	2,00,000
March, 2016	10,00,000	12,00,000

The company pays to its bank interest at a rate of 15% p.a., which is debited on a monthly basis. During the half year, company had Rs. 20 lakhs overdraft up to 31st December, surplus cash in January and again overdraft of Rs. 14 lakhs from 1.2.2016 and Rs. 30 lakhs from 1.3.2016. The company had a strike during December and hence could not continue the work during said period. However, the substantial administrative work related to the project was continued. Onsite work was again commenced on 1st January and all the work were completed on 31st March. Assume that expenditure was incurred on 1st day of each month.

Calculate interest to be capitalized giving reason wherever necessary. Assume overdraft will be less, if there is no capital expenditure. (4 x 5 = 16 Marks)

2. A Ltd acquired 25% of shares in B Ltd. as on 31.3.2015 for Rs. 3,00,000. The Balance Sheet of B Ltd. as on 31.3.2016 is given below:

Liabilities	Rs.
Share Capital	5,00,000
Reserves and Surplus	<u>5,00,000</u>
Total	<u>10,00,000</u>
Assets	
Fixed Assets	5,00,000
Investment	2,00,000
Current Assets	<u>3,00,000</u>
Total	<u>10,00,000</u>

During the year-ended 31.3.2016, the following are the additional information available:

- A Ltd. received dividend from B Ltd. for the year ended 31.3.2015 at 40% from the reserves.
- B Ltd. made a profit after tax of Rs. 7,00,000 for the year ended 31.3.2016.
- B Ltd. declared and accounted for the dividend @ 50% for the year ended 31.3.2016 on 30.4.2016.

A Ltd. is preparing Consolidated Financial Statements in accordance with AS 21 for its various subsidiaries. Calculate:

- (a) Goodwill if any on acquisition of B Ltd.'s shares.
- (b) How A Ltd. will reflect the investment in the shares of B Ltd. in the Consolidated Financial Statements? (16 Marks)

3. AB Ltd. and CD Ltd. two private companies, decide to amalgamate their business into a new holding company EF Ltd., which was incorporated on 1st August, 2015 with an authorised capital of Rs. 40,00,000 in equity shares of Rs. 10 each. The new company plans to commence operations on 1st October, 2015.

From the information given below, and assuming that all transactions are completed by 31st March, 2016, you are required to:

- (a) Prepare Projected Statement of Profit & Loss of EF Ltd. for the six months ending 31st March, 2016.
- (b) Prepare Projected Balance Sheet of EF Ltd. as on 31st March, 2016.
- (c) Show the computation of number of shares to be issued to the former shareholders of AB Ltd. and CD Ltd.

Information

- (1) EF Ltd. will acquire the whole of the Equity share capital of AB Ltd. and CD Ltd. by issuing its fully paid own shares.
- (2) The number of shares to be issued is to be calculated by multiplying the future annual maintainable profits available to the Equity shareholders in each of the two companies by agreed price earnings ratios.

The following information is relevant:

	<i>AB Ltd.</i> (Rs.)	<i>CD Ltd.</i> (Rs.)
Equity Shares of Rs. 10 each fully paid	10,00,000	4,00,000
8% Cumulative Preference shares		1,00,000
10% Debentures	2,00,000	
Future annual maintainable pre tax profits (before interest/dividend)	2,30,000	1,12,000
Price Earnings Ratio	10 times	8 times

- (3) Shares in the holding company are to be issued to the shareholders in subsidiary companies at a premium of 20% and thereafter these shares will be marketed on the stock exchange.
- (4) It is expected that the Group profits of the new company in 2015-16 will be at least Rs. 4,50,000 but that will be required as additional working capital to facilitate

expansion. Accordingly it is planned to make a further issue of 37,500 Equity shares to the public for cash at a premium of 30% on 1st February, 2016. The new shares will not rank for interest/dividend to be paid on 31st March, 2016.

- (5) Out of the proceeds of the right issue EF Ltd. will advance Rs. 2,50,000 to AB Ltd. and Rs. 2,00,000 to CD Ltd. on 1st February, 2016 for working capital. These advances will carry interest @ 15% p.a. to be paid monthly.
 - (6) Preliminary Expenses are estimated at Rs. 8,000 and Administrative Expenses for the half-year ended 31st March, 2016 at Rs. 16,000 but this expenditure will be covered by temporary overdraft facility. It is estimated that Interest on Bank Overdraft cost will be Rs. 1,600 in the first six months.
 - (7) A provision for Rs. 7,500 should be made for Directors Fee for the half-year.
 - (8) On 31st March, 2016, Interim Dividends on Equity Shares, will be paid by AB Ltd. @ 5%, by CD Ltd. @ 4.4% and by EF Ltd. @ 4%.
 - (9) Income tax is to be taken @50% for calculation of number of shares. However, ignore tax effect while preparing Projected Statement of Profit and Loss. (16 Marks)
4. (a) On 1.4.2015, a mutual fund scheme had 18 lakh units of face value of Rs.10 each outstanding. The scheme earned Rs.162 lakhs in 2015-16, out of which Rs.90 lakhs was earned in the first half of the year. On 30.9.2015, Rs.2 lakh units were sold at a NAV of Rs.70.

Pass Journal entries for sale of units and distribution of dividend at the end of 2015-16. (8 Marks)

- (b) From the following information of Prahlad Ltd., compute the economic value added:

(i)	Share capital	Rs.2,000 lakhs
(ii)	Reserve and surplus	Rs.4,000 lakhs
(iii)	Long-term debt	Rs.400 lakhs
(iv)	Tax rate	30%
(v)	Risk free rate	9%
(vi)	Market rate of return	16%
(vii)	Interest	Rs.40 lakhs
(viii)	Beta factor	1.05
(ix)	Profit before interest and tax	Rs.2,000 lakhs

(8 Marks)

5. (a) As point of staff welfare measures, Y Co. Ltd. has contracted to lend to its employees sums of money at 5 percent per annum rate of interest. The amounts lent are to be repaid alongwith the interest in five equal annual instalments. The market rate of interest is 10 per cent per annum.

Y lent Rs. 16,00,000 to its employees on 1st January, 2016.

Following the principles of recognition and measurement as laid down in Ind AS 109, you are required to record the entries for the year ended 31st December, 2016 for the transaction and also calculate the value of the loan initially to be recognized and the amortized cost for all the subsequent years.

For purposes of calculation, the following discount factors at interest rate of 10 percent may be adopted.

At the end of year

1	.909
2	.827
3	.751
4	.683
5	.620

(10 Marks)

- (b) Lucky Limited grants 180 share options to each of its 690 employees. Each grant containing condition on the employees working for Lucky Ltd. over the next 4 years. Lucky Ltd. has estimated that the fair value of option is Rs. 15. Lucky Ltd. also estimated that 30% of employees will leave during four year period and hence forfeit their rights to the share option. If the above expectations are correct, what amount of expenses to be recognised during vesting period? (6 Marks)

6. The Balance Sheets of X Ltd. are as follows:

	(Rs. in lakhs)	
	As at 31.3.2015	As at 31.3.2016
Liabilities		
Share Capital	1,000.0	1,000.0
General Reserve	800.0	850.0
Profit and Loss Account	120.0	175.0
Term Loans	370.0	330.0
Sundry Creditors	70.0	90.0
Provision for Tax	22.5	25.0
Proposed Dividend	<u>200.0</u>	<u>250.0</u>
	<u>2,582.5</u>	<u>2,720.0</u>
Assets		
Fixed Assets and Investments (Non-trade)	1,600.0	1,800.0
Stock	550.0	600.0
Debtors	340.0	220.0
Cash and Bank	<u>92.5</u>	<u>100.0</u>
	<u>2,582.5</u>	<u>2,720.0</u>

Other Information:

1. Current cost of fixed assets excluding non-trade investments on 31.3.2015 Rs. 2,200 lakhs and on 31.3.2016 Rs. 2,532.8 lakhs.
2. Current cost of stock on 31.3.2015 Rs. 670 lakhs and on 31.3.2016 Rs. 750 lakhs.
3. Non-trade investments in 10% government securities Rs. 490 lakhs.
4. Debtors for 2015-16 include foreign exchange debtors amounting to \$ 70,000 recorded at the rate of \$ 1 = Rs. 17.50 but the closing exchange rate was \$ 1 = Rs. 21.50.
5. Creditors for 2015-16 include foreign exchange creditors amounting to \$ 1,20,000 recorded at the rate of \$ 1 = Rs. 16.50 but the closing exchange rate was \$ 1 = Rs. 21.50.
6. Profit included Rs. 120 lakhs being government subsidy which is not likely to recur.
7. Rs. 247 lakhs being the last instalment of R and D cost were written off to the profit and loss account. This expenditure is not likely to recur.
8. Tax rate during 2015-16 was 50%. Effective future tax rate is estimated at 40%.
9. Normal rate of return is expected at 15%.

Based on the information furnished, Mr. Shah, a director contends that the company does not have any goodwill. Examine his contention. (16 Marks)

7. Answer any **four** sub-parts out of five.
- (a) A Ltd. entered into a contract with B Ltd. to dispatch goods valuing Rs. 25,000 every month for 4 months upon receipt of entire payment. B Ltd. accordingly made the payment of Rs. 1,00,000 and A Ltd. started despatching the goods. In third month, due to a natural calamity, B Ltd. requested A Ltd. not to despatch goods until further notice though A Ltd. is holding the remaining goods worth Rs. 50,000 ready for despatch. A Ltd. accounted Rs. 50,000 as sales and transferred the balance to Advance Received against Sales. Comment upon the treatment of balance amount with reference to the provisions of Accounting Standard 9.
- (b) What is the tax effect of sale of fixed assets, considering the block of assets approach followed in the Income-tax Act, 1961?
- A company has a block of assets with a written down value of Rs. 1,00,000 on April 1, 2014 for tax purposes. The book value of the assets for accounting purposes is also Rs. 1,00,000. The assets are depreciated on written down value basis at 25 percent per annum for both accounting and tax purposes. Of the entire block, assets costing Rs. 5,000 on April 1, 2014, were sold for Rs. 10,000 on March 31, 2016. Compute the deferred tax asset/liability assuming tax rate of 40 per cent.
- (c) A Ltd. has a share capital of 50,000 shares @ Rs. 100 per share. H Ltd. acquired 15% shares in A Ltd. on 1.4.2015. It also acquired all the 5,000, 12% convertible debentures of Rs. 100 each of A Ltd. These debentures will be converted at par into

equity shares of A Ltd. after 3 years. State whether A Ltd. is an Associate of H Ltd. or not with reasons?

- (d) A publisher owns 150 magazine titles of which 70 were purchased and 80 were self-created. The price paid for a purchased magazine title is recognised as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognised as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment.

What is the cash-generating unit?

- (e) Who are the beneficiaries of convergence with IFRS i.e. Ind AS in India?

(4 x 4 = 16 Marks)

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SUGGESTED ANSWERS/HINTS

1. (a) As per para 31 of AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy.
- (i) Accordingly, introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is not a change in an accounting policy.
- (ii) Similarly, the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial will not be treated as a change in an accounting policy.

(b) **Calculation of Cost of Fixed Asset (i.e. Machine) as per AS 10**

	Particulars	Detail	Rs.
	Purchase price	Given	52,78,000
Add:	Sales tax at 4%	Rs. 52,78,000 x 4%	2,11,120
	Site preparation cost	Given	47,290
	Technician's salary	Specific/Attributable overheads for 2 months [See Note (ii)]	30,000
	Initial delivery cost	Transportation	18,590
	Professional fee for installation	Architect's fee	<u>10,000</u>
	Total cost of asset		55,95,000

Note:

- (i) Interest on bank overdraft for earlier payment of invoice is not relevant under AS 10.
- (ii) Internally booked profits should be eliminated in arriving the cost of fixed assets as per para 10 of AS 10 'Accounting for Fixed Assets'.
- (iii) It has been assumed that the purchase price of Rs. 52,78,000 excludes amount of sales tax.

- (c) As per para 13 of AS 11 (Revised 2003) 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, should be recognized as income or expenses in the period in which they arise. Thus, exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets will be recognized as income or expense.

Calculation of Exchange Difference:

Foreign currency loan =	Rs. 24,00,000/60 = 40,000 US Dollars
Exchange difference =	40,000 US Dollars × (62.50-60.00) =Rs.1,00,000
(including exchange loss on payment of first instalment)	

Therefore, entire loss due to exchange differences amounting Rs. 1,00,000 should be charged to profit and loss account for the year.

Note: The above answer has been given on the basis that the company has not availed the option for capitalisation of exchange difference as per para 46/46A of AS 11.

However, as per para 46A of the standard, the exchange differences arising on reporting of long term foreign currency monetary items at rates different from those at which they were initially recorded during the period, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset.

Accordingly, in case Chance Ltd. opts for capitalizing the exchange difference, then the entire amount of exchange difference of Rs. 1,00,000 will be capitalized to 'Equipment account'. This capitalized exchange difference will be depreciated over the useful life of the asset.

Cost of the asset on the reporting date

Initial cost of Equipment	Rs. 24,00,000
Add: Exchange difference as on 31.3.2016	Rs. <u>1,00,000</u>
Total cost on the reporting date	Rs. <u>25,00,000</u>

- (d) **Shilpa Ltd.**

Month	Actual Expenditure (Rs.)	Interest capitalized (Rs.)	Cumulative amount (Rs.)
October, 2015	4,00,000	5,000	4,05,000
November, 2015	7,95,000	15,000	12,15,000
December, 2015	-	15,188	12,30,188

January, 2016	50,000	-	12,80,188
February, 2016	2,00,000	17,500	14,97,688
March, 2016	<u>12,00,000</u>	<u>33,721</u>	27,31,409
	<u>26,45,000</u>	<u>86,409</u>	

Note:

- As per para 18 of AS 16, 'Borrowing Cost', capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Therefore, the interest for that period i.e. for the month of December has also been capitalized.
- During January, the company did not incur any interest as there was surplus cash in January. Therefore, no amount should be capitalized during January as per para 14(b) of AS 16.
- During February, actual overdraft (borrowings) was Rs. 14 lakhs only. Hence, interest of Rs. 17,500 on Rs. 14,00,000 has been calculated even though actual expenditure on project exceed Rs. 14 lakhs.

2. 1. Analysis of Reserves and Surplus of B Ltd.

		Pre-acquisition	Post-acquisition
		Rs.	Rs.
Reserves and Surplus as per the B/S on 31.3.2016	5,00,000		
Add back: Dividend for the year 2015-16	<u>2,50,000</u>		
	<u>7,50,000</u>	<u>50,000</u>	<u>7,00,000</u>
Share of A Ltd. (25%)		<u>12,500</u>	<u>1,75,000</u>

2. Calculation of Goodwill / Capital Reserve

		Rs.
Investment in B Ltd.		3,00,000
Less: Pre-acquisition dividend (25% of 40% of Rs. 5,00,000)		<u>(50,000)</u>
		2,50,000
Less: Nominal Value of share capital	1,25,000	
Capital Profit	<u>12,500</u>	<u>(1,37,500)</u>
Goodwill		<u>1,12,500</u>

3. Investment under equity method

		Rs.
Goodwill	1,12,500	
Net worth	<u>1,37,500</u>	
Cost		2,50,000
Add: Share of Revenue Profit for the year 2015-16		<u>1,75,000</u>
		<u>4,25,000</u>

Note: Though dividend for the year 2015-16 has been accounted for but it has been added back as per the standard for classification purpose.

3. (a) Projected Profit and Loss Account of EF Ltd. for the period ending 31st March, 2016

Particulars	Rs.
Total Revenue	
Dividend Income [50,000 + 17,600]	67,600
Interest Income	11,250
	<u>78,850</u>
Less: Expenses	
Finance Costs (Interest on Bank Overdraft)	(1,600)
Other Expenses [Directors Fee (7,500) + Administrative Expenses (16,000) + Preliminary expenses (8,000)]	(31,500)
Profit before tax	<u>45,750</u>

(b) Projected Balance Sheet of EF Ltd. as on 31st March, 2016

	Particulars	Note No.	(Rs.)
I.	Equity and Liabilities		
	(1) Shareholders' Funds		
	(a) Share Capital	1	15,70,000
	(b) Reserves and Surplus	2	3,49,450
	(2) Non-Current Liabilities		
	(3) Current Liabilities		
	(a) Other Current Liabilities	3	<u>23,500</u>
	Total		<u>19,42,950</u>
II.	Assets		
	(1) Non-Current Assets		

	Non-current Investments	4	14,34,000
(2)	Current Assets		
	(a) Cash and Cash Equivalents (W.N.1)		58,950
	(b) Other Current Assets		<u>4,50,000</u>
	Total		<u>19,42,950</u>

Notes to Accounts:

	Particulars	(Rs.)
1.	Share Capital	
	Authorised share capital	
	4,00,000 Equity shares of Rs. 10 each	<u>40,00,000</u>
	Issued share capital	
	1,57,000 Equity Shares of Rs. 10 each	15,70,000
	(Of the above 1,19,500 shares were issued for consideration other than cash)	
2.	Reserves and Surplus	
	Securities Premium [2,39,000 + 1,12,500]	3,51,500
	Profit & Loss Account	45,750
	Less: Interim dividend (Rs. 95,000 x 4%)	<u>(47,800)</u>
		<u>3,49,450</u>
3.	Other Current Liabilities	
	Bank Overdraft	16,000
	Directors Fee	<u>7,500</u>
		23,500
4.	Non-current investment	
	Investment in shares of AB Ltd. @ Rs. 12	10,50,000
	Investment in shares of CD Ltd. @ Rs. 12	<u>3,84,000</u>
		14,34,000

(c) Computation of Number of Shares to be issued to former shareholders

Particulars	AB Ltd.	CD Ltd.
	Rs.	Rs.
Future Maintainable EBIT	2,30,000	1,12,000
Less: Interest on Debentures	<u>(20,000)</u>	-
	2,10,000	1,12,000
Less: Income tax @ 50%	<u>(1,05,000)</u>	<u>(56,000)</u>
Profit after tax	1,05,000	56,000

Less: Preference Dividend	-	(8,000)
Profit to Equity Shareholders	<u>1,05,000</u>	<u>48,000</u>
PE Ratio	10	8
Capitalised Earning	10,50,000	3,84,000
Number of shares to be exchanged in EF Ltd.		
@ Rs. 12 (including Premium of Rs.2 each)	87,500	32,000

Working Note:

Bank Account

Particulars	Rs.	Particulars	Rs.
To Equity Share Capital A/c	3,75,000	By Preliminary Expenses	8,000
To Securities Premium A/c	1,12,500	By Interest on Bank Overdraft	1,600
To Dividends from AB Ltd.	50,000	By Advance to AB Ltd.	2,50,000
To Dividends from CD Ltd.	17,600	By Advance to CD Ltd.	2,00,000
To Interest Income	11,250	By Interim Dividend	47,800
	<u>5,66,350</u>	By Balance c/d (Bal. fig.)	<u>58,950</u>
			<u>5,66,350</u>

4. (a)

Allocation of Earnings	Old Unit Holders	New Unit Holders	Total
	[18 Lakh Units]	[2 Lakh Units]	
	Rs. in Lakhs	Rs. in Lakhs	Rs. in Lakhs
First half year (Rs. 5 per unit)	90.00	Nil	90.00
Second half year (Rs. 3.60 per unit)	<u>64.80</u>	<u>7.20</u>	<u>72.00</u>
	154.80	7.20	162.00
Add: Equalization payment recovered	-	-	<u>10.00</u>
Total available for distribution			<u>172.00</u>

Equalization Payment:-Rs. 90 lakhs ÷ 18 Lakhs = Rs. 5 per unit.

Distribution of earning per unit	Old Unit Holders	New Unit Holders
	Rs.	Rs.
Dividend distributed	8.60	8.60
Less: Equalisation payment	-	<u>(5.00)</u>
	<u>8.60</u>	<u>3.60</u>

Journal Entries

			(Rs. in lakhs)
30.9.2015	Bank A/c	Dr.	150.00
	To Unit Capital A/c		20.00
	To Reserve A/c		120.00
	To Dividend Equalisation A/c		10.00
	(Being the amount received on sale of 2 lakhs unit at a NAV of Rs. 70 per unit)		
31.3.2016	Dividend Equalization A/c	Dr.	10.00
	To Revenue A/c		10.00
	(Being the amount transferred to Revenue Account)		
30.9.2016	Revenue A/c	Dr.	172.00
	To Bank A/c		172.00
	(Being the amount distributed among 20 lakhs unit holders @ Rs. 8.60 per unit)		

(b)

Prahlad Limited

Computation of Economic Value Added

Economic Value Added	Rs.in lakhs
Net Operating Profit after Tax (Refer Working Note 5)	1,372.00
Add: Interest on Long-term Fund (Refer Working Note 2)	<u>28.00</u>
	1,400.00
Less: Cost of Capital [Rs.6,400 lakhs × 15.77% (Refer working notes 3 and 4)]	<u>(1,009.28)</u>
Economic Value Added	<u>390.72</u>

Working Notes:

1. Cost of Equity	= Risk free Rate + Beta Factor (Market Rate – Risk Free Rate)	
	9% + 1.05 (16 – 9) = 9% + 7.35% = 16.35%	
2. Cost of Debt		
Interest		Rs.40 lakhs
Less: Tax (30%)		(Rs.12 lakhs)
Interest after Tax		Rs.28 lakhs
Cost of Debt	$= \frac{28}{400} \times 100 = 7\%$	
3. Weighted Average Cost of Capital		
Cost of Equity	Rs.6,000 lakhs × 16.35% (W.N.1)	Rs.981 lakhs
Cost of Debt	Rs.400 lakhs × 7% (W.N.2)	Rs.28 lakhs
		Rs.1,009 lakhs
WACC	$= \frac{1,009}{6,400} \times 100 = 15.77\%$ (approx.)	

4. Capital Employed

	Rs. in Lakhs
Share Capital	2,000
Reserves and Surplus	4,000
Long term debts	<u>400</u>
	<u>6,400</u>

5. Net Operating Profit after Tax

Profit before Interest and Tax	2,000
Less: Interest	<u>(40)</u>
	1,960
Less: Tax 30% on 1,960 Lakhs	<u>(588)</u>
Net Operating Profit after Tax	<u>1,372</u>

5. (a) (i) Calculation of initial recognition amount of loan to employees

Year end	Cash Inflow		Total Rs.	P.V. factor @10%	Present value Rs.
	Principal Rs.	Interest @ 5% Rs.			
2016	3,20,000	80,000	4,00,000	0.909	3,63,600

2017	3,20,000	64,000	3,84,000	0.827	3,17,568
2018	3,20,000	48,000	3,68,000	0.751	2,76,368
2019	3,20,000	32,000	3,52,000	0.683	2,40,416
2020	3,20,000	16,000	3,36,000	0.620	<u>2,08,320</u>
Present value or Fair value					<u>14,06,272</u>

(ii) Calculation of amortised cost of loan to employees

Year	Amortised cost (Opening balance) [1] Rs.	Interest to be recognised@10% [2] Rs.	Repayment (including interest) [3] Rs.	Amortised Cost (Closing balance) [4]=[1]+ [2]-[3] Rs.
2016	14,06,272	1,40,627	4,00,000	11,46,899
2017	11,46,899	1,14,690	3,84,000	8,77,589
2018	8,77,589	87,759	3,68,000	5,97,348
2019	5,97,348	59,735	3,52,000	3,05,083
2020	3,05,083	30,917*	3,36,000	Nil

* Rs. 3,05,083 x 10% = Rs. 30,508. The difference of Rs. 409 (Rs. 30,917 – Rs. 30,508) is due to approximation in computation.

(iii) Journal Entries in the books of Y Ltd.

For the year ended 31st December, 2016 (regarding loan to employees)

	Dr. Amount (Rs.)	Cr. Amount (Rs.)
Staff loan A/c Dr. To Bank A/c (Being the disbursement of loans to staff)	16,00,000	16,00,000
Staff cost A/c Rs. (16,00,000 – 14,06,272) [Refer part (ii)] Dr. To Staff loan A/c (Being the write off of excess of loan balance over present value thereof in order to reflect the loan at its present value of Rs. 14,06,272)	1,93,728	1,93,728
Staff loan A/c Dr. To Interest on staff loan A/c (Being the charge of interest @ market rate of 10% on the loan)	1,40,627	1,40,627

Bank A/c	Dr.	4,00,000	
To Staff loan A/c			4,00,000
(Being the repayment of first instalment with interest for the year)			
Interest on staff loan A/c	Dr.	1,40,627	
To Profit and loss A/c			1,40,627
(Being transfer of balance of staff loan Interest account to profit and loss account)			

(b) Expense to be recognized during 4 years' vesting period

Year	Calculation	Expenses for the period Rs.	Cumulative expenses Rs.
1	690 employees x 180 options x 70% x Rs. 15 x 1/4	3,26,025	3,26,025
2	[690 employees x 180 options x 70% x Rs. 15 x 2/4 years] – Rs. 3,26,025	3,26,025	6,52,050
3	[690 employees x 180 options x 70% x Rs. 15 x 3/4 years] – Rs. 6,52,050	3,26,025	9,78,075
4	[690 employees x 180 options x 70% x Rs. 15 x 4/4 years] – Rs. 9,78,075	3,26,025	13,04,100

Total amount of the expenses to be recognized during 4 years' vesting period will be Rs.13,04,100.

6. (1) Average Capital employed

	(Rs. in lakhs)	
	As at 31.3.2015	As at 31.3.2016
Current cost of fixed assets other than non-trade investments	2,200.0	2,532.8
Current cost of stock	670.0	750.0
Debtors	340.0	222.8
Cash and Bank	<u>92.5</u>	<u>100.0</u>
(A)	3,302.5	3,605.6
Less: Outside Liabilities:		
Term loans	370.0	330.0
Sundry creditors	70.0	96.0

Tax provision	22.5	25.0
Tax payable for adjustments in current assets (W.N.4)	-	13.4
	(B) <u>462.5</u>	<u>464.40</u>
Capital Employed (A-B)	<u>2,840.0</u>	<u>3,141.20</u>
Average Capital Employed at current value = $\frac{2,840.0 + 3,141.20}{2}$		2,990.60

(2) Future maintainable profit

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

Valuation of Goodwill

		(Rs. in lakhs)
(1)	Capitalisation Method	
	Capitalised value of future maintainable profit $\left(\frac{488.88}{0.15} \right)$	3,259.20

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

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

Working Notes:

		(Rs. in lakhs)
(1)	Stock adjustment	
	Difference between current cost and historical cost of closing stock	150.00
	Difference between current cost and historical cost of opening stock	<u>(120.00)</u>
		<u>30.00</u>
(2)	Debtors' adjustment	
	Value of foreign exchange debtors at the closing exchange rate (\$ 70,000 × 21.5)	15.05
	Value of foreign exchange debtors at the original exchange rate (\$ 70,000 × 17.5)	<u>(12.25)</u>
		<u>2.80</u>
(3)	Creditors' adjustment	
	Foreign exchange creditors at the closing exchange rate (\$ 1,20,000 × 21.5)	25.80
	Foreign exchange creditors at the original exchange rate (\$ 1,20,000 × 16.5)	<u>(19.80)</u>
		<u>6.00</u>
(4)	Tax Payable for Adjustment in current assets	
	Increase in profit on account of	
	Exchange gain on debtors	2.80
	Stock Adjustment	<u>30.00</u>
		32.80

Less: Decrease in Profit on account of exchange loss on creditors	<u>(6.00)</u>
	<u>26.80</u>
Tax @ 50%	13.40

7. (a) As per para 11 of AS 9 "Revenue Recognition", in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions are fulfilled:

- (i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and
- (ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

In the given case, transfer of property in goods results in or coincides with the transfer of significant risks and rewards and ownership to the buyer. Also, the sale price has been recovered by the seller. Hence, the sale is complete. However, delivery has been postponed at buyer's request. Merely postponement of delivery at buyers request shall not postpone the recognition of sale. Therefore, A Ltd. should recognize the entire sale of Rs. 1,00,000 (Rs. 25,000 x 4) and no part of the same should be treated as Advance Receipt against Sales.

(b) In the case of a company, the following computations will be made:

2014-15

In this year, depreciation for both accounting and taxation purposes would be Rs. 25,000 (25 per cent of Rs. 1,00,000). Accordingly, no timing difference arises on this account.

2015-16

Depreciation for the year would be Rs. 18,750 (25 percent of Rs. 75,000) as per the books of account, while for tax purposes it would be Rs. 16,250 as sale proceeds of Rs. 10,000 would be reduced from the block of assets prior to the computation of depreciation. Accordingly, the following timing differences arise:

- Depreciation for tax purposes is Rs. 16,250 and for accounting purposes Rs. 18,750 giving rise to a timing difference of Rs. 2,500.
- Profit on sale of fixed asset amounting to Rs. 7,188 (Rs. 10,000 - Rs. 2,812 being the WDV of the asset as on 31st March, 2016) is recognized for accounting purposes. However, for tax purposes this income is not considered. This will result in a timing difference of Rs. 7,188.

The net timing difference would be Rs. 4,688 (Rs. 7,188 – Rs.2,500) by which the accounting income would exceed the taxable income, thus requiring creation of a deferred tax liability of Rs.1,875 (4,688 X 0.4).

The difference of Rs. 4,688 would reverse in future years when depreciation for accounting purposes would be higher as compared to depreciation for tax purposes because depreciation for accounting purposes would be computed on higher carrying amount of fixed assets as compared to carrying amount of those assets for tax purposes.

- (c) As per para 3 of AS 23 'Accounting for Investments in Associates in Consolidated Financial Statements', an associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

Standard further explains in para 4 that as regards share ownership, if an investor holds, directly or indirectly through subsidiary(ies), 20% or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiary(ies), less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated.

Further as per an explanation to para 4 of the standard, for the purpose of classification of associate, the potential equity shares of the investee held by the investor will not be taken into account for determining the voting power of the investor. In other words the voting power should be determined on the basis of the current outstanding securities with voting rights.

As per the information given in the question, H Ltd. presently holds indirectly 22.7% shares (with and without voting rights) (Refer W.N.) in A Ltd. However, the current outstanding securities with voting rights in A Ltd. is only 15% and the remaining holding is on account of potential equity shares. Since potential equity shares do not have voting rights they will not be taken into consideration while determining the significant influence of H Ltd. on A Ltd. Hence, A Ltd. is not an associate of H Ltd.

Working Note:

Calculation of percentage of holding of shares after conversion

	Rs.
Current holding is 15% i.e. 7,500 shares of Rs. 100 each	7,50,000
Potential equity shares i.e. 5,000 shares of Rs.100 each	<u>5,00,000</u>
	<u>12,50,000</u>

Total share capital of A Ltd. after conversion of debentures into equity shares will be

$$= \text{Rs.}50,00,000 + \text{Rs.} 5,00,000 = \text{Rs.} 55,00,000$$

Percentage of holding = $\text{Rs.}(12,50,000/55,00,000) \times 100 = 22.7\%$ approx.

- (d) It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title. In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis.

Therefore, it is likely that individual magazine titles generate cash inflows that are largely independent one from another and that each magazine title is a separate cash-generating unit.

- (e) There are many beneficiaries of convergence with IFRSs as Ind AS in India such as-

The Economy: When the markets expand globally the need for convergence increases since the convergence benefits the economy by increasing growth of its international business. It facilitates maintenance of orderly and efficient capital markets and also helps to increase the capital formation and thereby economic growth. It encourages international investing and thereby leads to more foreign capital flows to the country.

Investors: Investors want the information that is more relevant, reliable, timely and comparable across the jurisdictions. Financial statements prepared using a common set of accounting standards help investors better understand investment opportunities as opposed to financial statements prepared using a different set of national accounting standards. Investors' confidence is strong when accounting standards used are globally accepted.

The Industry: The industry is able to raise capital from foreign markets at lower cost if it can create confidence in the minds of foreign investors that their financial statements comply with globally accepted accounting standards. With the diversity in accounting standards from country to country, enterprises which operate in different countries face a multitude of accounting requirements prevailing in the countries. The burden of financial reporting is lessened with convergence of accounting standards because it simplifies the process of preparing the individual and group financial statements and thereby reduces the costs of preparing the financial statements using different sets of accounting standards.

Test Series: September, 2016

MOCK TEST PAPER – 2

FINAL COURSE : GROUP – I

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

Question No. 1 is compulsory. Attempt any **five** questions from the remaining **six** questions.
Working notes should form part of the answer.

Time Allowed – 3 Hours

Maximum Marks – 100

1. (a) Gibraltar Limited has imported 5000 bottles of shampoo at landed cost in Mumbai, of US \$ 20 each. The company has the choice for paying for the goods immediately or in 3 months' time. It has a clean overdraft limited where 14% p.a. rate of interest is charged.

Calculate which of the following method would be cheaper to Gibraltar Limited.

- (i) Pay in 3 months' time with interest @ 10% and cover risk forward for 3 months.
(ii) Settle now at a current spot rate and pay interest of the overdraft for 3 months.

The rates are as follows:

Mumbai Rs. /\$ spot	:	60.25-60.55	
3 months swap	:	35/25	(5 Marks)

- (b) Calculate economic value added (EVA) with the help of the following information of Hypothetical Limited:

Financial leverage	:	1.4 times	
Capital structure	:	Equity Capital Rs. 170 lakhs Reserves and surplus Rs. 130 lakhs 10% Debentures Rs. 400 lakhs	
Cost of Equity	:	17.5%	
Income Tax Rate	:	30%	(5 Marks)

- (c) Amal Ltd. has been maintaining a growth rate of 12% in dividends. The company has paid dividend @ Rs. 3 per share. The rate of return on market portfolio is 15% and the risk-free rate of return in the market has been observed as 10%. The beta co-efficient of the company's share is 1.2.

You are required to calculate the expected rate of return on the company's shares as per CAPM model and the equilibrium price per share by dividend growth model.

(5 Marks)

- (d) X Ltd. earns Rs. 6 per share having a capitalization rate of 10 percent and has a return on investment of 20%. According to Walter's model, what should be the price of the share at 25% dividend payout? (5 Marks)

2. (a) New Projects Ltd. is evaluating 3 projects, P-I, P-II, P-III. Following information is available in respect of these projects:

	P-I	P-II	P-III
Cost	Rs. 15,00,000	Rs. 11,00,000	Rs. 19,00,000
Inflows-Year 1	6,00,000	6,00,000	4,00,000
Year 2	6,00,000	4,00,000	6,00,000
Year 3	6,00,000	5,00,000	8,00,000
Year 4	6,00,000	2,00,000	12,00,000
Risk Index	1.80	1.00	0.60

Minimum required rate of return of the firm is 15% and applicable tax rate is 40%. The risk free interest rate is 10%.

Required:

- (i) Find out the risk-adjusted discount rate (RADR) for these projects.
(ii) Which project is the best? (8 Marks)
- (b) Ms. Sunidhi is working with an MNC at Mumbai. She is well versant with the portfolio management techniques and wants to test one of the techniques on an equity fund she has constructed and compare the gains and losses from the technique with those from a passive buy and hold strategy. The fund consists of equities only and the ending NAVs of the fund he constructed for the last 10 months are given below:

Month	Ending NAV (Rs./unit)	Month	Ending NAV (Rs./unit)
December 2008	40.00	May 2009	37.00
January 2009	25.00	June 2009	42.00
February 2009	36.00	July 2009	43.00
March 2009	32.00	August 2009	50.00
April 2009	38.00	September 2009	52.00

Assume Sunidhi had invested a notional amount of Rs. 2 lakhs equally in the equity fund and a conservative portfolio (of bonds) in the beginning of December 2008 and the total portfolio was being rebalanced each time the NAV of the fund increased or decreased by 15%.

You are required to determine the value of the portfolio for each level of NAV following the Constant Ratio Plan. (8 Marks)

3. (a) Simple Ltd. and Dimple Ltd. are planning to merge. The total value of the companies are dependent on the fluctuating business conditions. The following information is given for the total value (debt + equity) structure of each of the two companies.

Business Condition	Probability	Simple Ltd. Rs. Lacs	Dimple Ltd. Rs. Lacs
High Growth	0.20	820	1050
Medium Growth	0.60	550	825
Slow Growth	0.20	410	590

The current debt of Dimple Ltd. is Rs. 65 lacs and of Simple Ltd. is Rs. 460 lacs.

Calculate the expected value of debt and equity separately for the merged entity.

(8 Marks)

- (b) Rahul Ltd. has surplus cash of Rs. 100 lakhs and wants to distribute 27% of it to the shareholders. The company decides to buy back shares. The Finance Manager of the company estimates that its share price after re-purchase is likely to be 10% above the buyback price-if the buyback route is taken. The number of shares outstanding at present is 10 lakhs and the current EPS is Rs. 3.

You are required to determine:

- (i) The price at which the shares can be re-purchased, if the market capitalization of the company should be Rs. 210 lakhs after buyback,
- (ii) The number of shares that can be re-purchased, and
- (iii) The impact of share re-purchase on the EPS, assuming that net income is the same.

(8 Marks)

4. (a) P Ltd. has decided to acquire a machine costing Rs. 50 lakhs through leasing. Quotations from 2 leasing companies have been obtained which are summarised below:

	Quote A	Quote B
Lease term	3 years	4 years
Initial lease rent (Rs. lakhs)	5.00	1.00
Annual lease rent (payable in arrears) (Rs. lakhs)	21.06	19.66

P Ltd. evaluates investment proposals at 10% cost of capital and its effective tax rate is 30%. Terminal payment in both cases is negligible and may be ignored.

Make calculations and show which quote is beneficial to P Ltd. Present value factors at 10% rate for years 1-4 are respectively 0.91, 0.83, 0.75 and 0.68. Calculations may be rounded off to 2 decimals in lakhs. (8 Marks)

- (b) Electraspace is consumer electronics wholesaler. The business of the firm is highly seasonal in nature. In 6 months of a year, firm has a huge cash deposits and especially near Christmas time and other 6 months firm cash crunch, leading to borrowing of money to cover up its exposures for running the business.

It is expected that firm shall borrow a sum of €50 million for the entire period of slack season in about 3 months.

A Bank has given the following quotations:

Spot 5.50% - 5.75%

3 × 6 FRA 5.59% - 5.82%

3 × 9 FRA 5.64% - 5.94%

3 month €50,000 future contract maturing in a period of 3 months is quoted at 94.15 (5.85%).

You are required to determine:

- (a) How a FRA, shall be useful if the actual interest rate after 3 months turnout to be:
- (i) 4.5%
 - (ii) 6.5%
- (b) How 3 months Future contract shall be useful for company if interest rate turns out as mentioned in part (a) above. (8 Marks)

5. (a) Trouble Free Solutions (TFS) is an authorized service center of a reputed domestic air conditioner manufacturing company. All complaints/ service related matters of Air conditioner are attended by this service center. The service center employs a large number of mechanics, each of whom is provided with a motor bike to attend the complaints. Each mechanic travels approximately 40000 kms per annum. TFS decides to continue its present policy of always buying a new bike for its mechanics but wonders whether the present policy of replacing the bike every three year is optimal or not. It is of believe that as new models are entering into market on yearly basis, it wishes to consider whether a replacement of either one year or two years would be better option than present three year period. The fleet of bike is due for replacement shortly in near future.

The purchase price of latest model bike is Rs. 55,000. Resale value of used bike at current prices in market is as follows:

Period	Rs.
1 Year old	35,000
2 Year old	21,000
3 Year old	9,000

Running and Maintenance expenses (excluding depreciation) are as follows:

Year	Road Taxes Insurance etc. (Rs.)	Petrol Repair Maintenance etc. (Rs.)
1	3,000	30,000
2	3,000	35,000
3	3,000	43,000

Using opportunity cost of capital as 10% you are required to determine optimal replacement period of bike. *(8 Marks)*

- (b)** An investor has decided to invest to invest Rs. 1,00,000 in the shares of two companies, namely, ABC and XYZ. The projections of returns from the shares of the two companies along with their probabilities are as follows:

Probability	ABC(%)	XYZ(%)
.20	12	16
.25	14	10
.25	-7	28
.30	28	-2

You are required to

- Comment on return and risk of investment in individual shares.
- Compare the risk and return of these two shares with a Portfolio of these shares in equal proportions.
- Find out the proportion of each of the above shares to formulate a minimum risk portfolio. *(8 Marks)*

- 6. (a)** An importer requests his bank to extend the forward contract for US\$ 20,000 which is due for maturity on 30th October, 2010, for a further period of 3 months. He agrees to pay the required margin money for such extension of the contract.

Contracted Rate – US\$ 1= Rs. 42.32

The US Dollar quoted on 30-10-2010:-

Spot – 41.5000/41.5200

3 months' Premium -0.87% /0.93%

Margin money for buying and selling rate is 0.075% and 0.20% respectively.

Compute:

- (i) The cost to the importer in respect of the extension of the forward contract, and
- (ii) The rate of new forward contract. (8 Marks)

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

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

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

Required:

- (i) What will be the EPS subsequent to merger?
- (ii) What is the change in EPS for the shareholders of companies Rama Ltd. and Krishna Ltd.?
- (iii) Determine the market value of the post-merger firm. PE ratio is likely to remain the same.
- (iv) Ascertain the profits accruing to shareholders of both the companies. (8 Marks)

7. Write short notes on any of **four** of the following:

- (a)** Cross Border Leasing
- (b)** Assumptions of Black Scholes Model
- (c)** Timing of Investment Decisions as per Dow Jones Theory
- (d)** Nostro, Vostro and Loro A/c
- (e)** Takeover by Reverse Bid

(4 × 4 = 16 Marks)

MOCK TEST PAPER – 2
FINAL COURSE: GROUP – I
PAPER – 2: STRATEGIC FINANCIAL MANAGEMENT
SUGGESTED ANSWERS/HINTS

1. (a) **Option - I**

$$\$20 \times 5000 = \$ 1,00,000$$

$$\text{Repayment in 3 months time} = \$1,00,000 \times (1 + 0.10/4) = \$ 1,02,500$$

$$\text{3-months outright forward rate} = \text{Rs. } 59.90 / \text{Rs. } 60.30$$

$$\text{Repayment obligation in Rs. } (\$1,02,500 \times \text{Rs. } 60.30) = \text{Rs. } 61,80,750$$

Option - II

$$\text{Overdraft } (\$1,00,000 \times \text{Rs. } 60.55) \qquad \qquad \qquad \text{Rs. } 60,55,000$$

$$\text{Interest on Overdraft } (\text{Rs. } 60,55,000 \times 0.14/4) \qquad \qquad \qquad \underline{\text{Rs. } 2,11,925}$$

$$\underline{\text{Rs. } 62,66,925}$$

Option I should be preferred as it has lower outflow.

(b) Financial Leverage = PBIT/PBT

$$1.4 = \text{PBIT} / (\text{PBIT} - \text{Interest})$$

$$1.4 = \text{PBIT} / (\text{PBIT} - 40)$$

$$1.4 (\text{PBIT} - 40) = \text{PBIT}$$

$$1.4 \text{ PBIT} - 56 = \text{PBIT}$$

$$1.4 \text{ PBIT} - \text{PBIT} = 56$$

$$0.4 \text{ PBIT} = 56$$

$$\text{or } \text{PBIT} = \frac{56}{0.4} = \text{Rs. } 140 \text{ lakhs}$$

$$\text{NOPAT} = \text{PBIT} - \text{Tax} = \text{Rs. } 140 \text{ lakhs } (1 - 0.30) = \text{Rs. } 98 \text{ lakhs.}$$

$$\text{Weighted average cost of capital (WACC)} = 17.5\% \times \frac{(300 / 700)}{(400 / 700)} + (1 - 0.30) \times (10\%) \times$$

$$= 11.5\%$$

$$\text{EVA} = \text{NOPAT} - (\text{WACC} \times \text{Total Capital})$$

$$= \text{Rs. } 98 \text{ lakhs} - 0.115 \times \text{Rs. } 700 \text{ lakhs}$$

$$= \text{Rs. } 17.5 \text{ lakhs}$$

(c) Capital Asset Pricing Model (CAPM) formula for calculation of expected rate of return is

$$E_R = R_f + \beta (R_m - R_f)$$

E_R = Expected Return

β = Beta of Security

R_m = Market Return

R_f = Risk free Rate

$$= 10 + [1.2 (15 - 10)]$$

$$= 10 + 1.2 (5)$$

$$= 10 + 6 = 16\% \text{ or } 0.16$$

Applying dividend growth mode for the calculation of per share equilibrium price:-

$$E_R = \frac{D_1}{P_0} + g$$

$$\text{or } 0.16 = \frac{3(1.12)}{P_0} + 0.12 \quad \text{or } 0.16 - 0.12 = \frac{3.36}{P_0}$$

$$\text{or } 0.04 P_0 = 3.36 \quad \text{or } P_0 = \frac{3.36}{0.04} = \text{Rs. } 84$$

Therefore, equilibrium price per share will be Rs. 84.

(d) Walter Model is as follows:-

$$V_e = \frac{D + \frac{R_a}{R_c} (E - D)}{R_c}$$

V_e = Market value of the share

R_a = Return on retained earnings

R_e = Capitalisation rate

E = Earnings per share

D = Dividend per share

Hence, if Walter model is applied-

$$\text{Market value of the share } V_c = \frac{\text{₹ } 1.50 + \frac{0.20}{0.10} (\text{₹ } 6.00 - \text{₹ } 1.50)}{0.10}$$

or

$$V_C = \frac{\text{₹ } 1.50 + \frac{0.20}{0.10} (\text{₹ } 4.50)}{0.10}$$

or

$$V_C = \frac{\text{₹ } 1.50 + \text{₹ } 9.00}{0.10} = \frac{\text{₹ } 10.50}{0.10} = \text{₹ } 105$$

2. (a) (i) The risk free rate of interest and risk factor for each of the projects are given. The risk adjusted discount rate (RADR) for different projects can be found on the basis of CAPM as follows:

Required Rate of Return = $I_{RF} + (k_e - I_{RF}) \text{ Risk Factor}$

For P-I : RADR = $0.10 + (0.15 - 0.10) 1.80 = 19\%$

For P-II : RADR = $0.10 + (0.15 - 0.10) 1.00 = 15\%$

For P-III : RADR = $0.10 + (0.15 - 0.10) 0.60 = 13\%$

- (ii) The three projects can now be evaluated at 19%, 15% and 13% discount rate as follows:

Project P-I

Annual Inflows	Rs. 6,00,000
PVAF (19 %, 4)	2.639
PV of Inflows (Rs. 6,00,000 x 2.639)	Rs. 15,83,400
Less: Cost of Investment	<u>Rs. 15,00,000</u>
Net Present Value	<u>Rs. 83,400</u>

Project P-II

Year	Cash Inflow (Rs.)	PVF (15%,n)	PV (Rs.)
1	6,00,000	0.870	5,22,000
2	4,00,000	0.756	3,02,400
3	5,00,000	0.658	3,29,000
4	2,00,000	0.572	<u>1,14,400</u>
Total Present Value			12,67,800
Less: Cost of Investment			<u>11,00,000</u>
Net Present Value			<u>1,67,800</u>

Project P-III

Year	Cash Inflow (Rs.)	PVF (13%,n)	PV (Rs.)
1	4,00,000	0.885	3,54,000
2	6,00,000	0.783	4,69,800
3	8,00,000	0.693	5,54,400
4	12,00,000	0.613	<u>7,35,600</u>
Total Present Value			21,13,800
Less: Cost of Investment			<u>19,00,000</u>
Net Present Value			<u>2,13,800</u>

Project P-III has highest NPV. So, it should be accepted by the firm

(b) Constant Ratio Plan:

Stock Portfolio NAV (Rs.)	Value of buy – hold strategy (Rs.)	Value of Conservative Portfolio (Rs.)	Value of aggressive Portfolio (Rs.)	Total value of Constant Ratio Plan (Rs.)	Revaluation Action	Total No. of units in aggressive portfolio
40.00	2,00,000	1,00,000	1,00,000	2,00,000	-	2500
25.00	1,25,000	1,00,000	62,500	1,62,500	-	2500
	1,25,000	81,250	81,250	1,62,500	Buy 750 units	3250
36.00	1,80,000	81,250	1,17,000	1,98,250	-	3250
	1,80,000	99,125	99,125	1,98,250	Sell 496.53 units	2753.47
32.00	1,60,000	99,125	88,111.04	1,87,236.04	-	2753.47
38.00	1,90,000	99,125	1,04,631.86	2,03,756.86	-	2753.47
	1,90,000	1,01,878.43	1,01,878.43	2,03,756.86	Sell 72.46 units	2681.01
37.00	1,85,000	1,01,878.50	99,197.37	2,01,075.87	-	2681.01
42.00	2,10,000	1,01,878.50	1,12,602.42	2,14,480.92	-	2681.01
43.00	2,15,000	1,01,878.50	1,15,283.43	2,17,161.93	-	2681.01
50.00	2,50,000	1,01,878.50	1,34,050.50	2,35,929	-	2681.01
	2,50,000	1,17,964.50	1,17,964.50	2,35,929	Sell 321.72 units	2359.29
52.00	2,60,000	1,17,964.50	1,22,683.08	2,40,647.58	-	2359.29

Hence, the ending value of the mechanical strategy is Rs. 2,40,647.58 and buy & hold strategy is Rs. 2,60,000.

3. (a) Compute Value of Equity

Simple Ltd.

Rs. in Lacs

	High Growth	Medium Growth	Slow Growth
Debit + Equity	820	550	410
Less: Debt	460	460	460
Equity	360	90	-50

Since the Company has limited liability the value of equity cannot be negative therefore the value of equity under slow growth will be taken as zero because of insolvency risk and the value of debt is taken at 410 lacs. The expected value of debt and equity can then be calculated as:

Simple Ltd.

Rs. in Lacs

	High Growth		Medium Growth		Slow Growth		Expected Value
	Prob.	Value	Prob.	Value	Prob.	Value	
Debt	0.20	460	0.60	460	0.20	410	450
Equity	0.20	360	0.60	90	0.20	0	126
		820		550		410	576

Dimple Ltd.

Rs. in Lacs

	High Growth		Medium Growth		Slow Growth		Expected Value
	Prob.	Value	Prob.	Value	Prob.	Value	
Equity	0.20	985	0.60	760	0.20	525	758
Debt	0.20	65	0.60	65	0.20	65	65
		1050		825		590	823

Expected Values

Rs. in Lacs

Equity		Debt	
Simple Ltd.	126	Simple Ltd.	450
Dimple Ltd.	758	Dimple Ltd.	65
	884		515

(b) (i) Let P be the buyback price decided by Rahul Ltd.

Market Capitalisation after Buyback

1.1P (Original Shares – Shares Bought Back)

$$= 1.1P \left(10 \text{ lakhs} - \frac{27\% \text{ of } 100 \text{ lakhs}}{P} \right)$$

$$= 11 \text{ lakhs} \times P - 27 \text{ lakhs} \times 1.1 = 11 \text{ lakhs} P - 29.7 \text{ lakhs}$$

Again, $11 \text{ lakhs} P - 29.7 \text{ lakhs}$

or $11 \text{ lakhs} P = 210 \text{ lakhs} + 29.7 \text{ lakhs}$

$$\text{or } P = \frac{239.7}{11} = \text{Rs. } 21.79 \text{ per share}$$

(ii) Number of Shares to be Bought Back :-

$$\frac{= \text{Rs. } 27 \text{ lakhs}}{= \text{Rs. } 21.79} = 1.24 \text{ lakhs (Approx.) or } 123910 \text{ share}$$

(iii) New Equity Shares :-

$10 \text{ lakhs} - 1.24 \text{ lakhs} = 8.76 \text{ lakhs}$ or $1000000 - 123910 = 876090 \text{ shares}$

$$\therefore \text{EPS} = \frac{3 \times 10 \text{ lakhs}}{8.76 \text{ lakhs}} = \text{Rs. } 3.43$$

Thus, EPS of Rahul Ltd., increases to Rs. 3.43.

4. (a)

(in lakhs)

	Quote A	Quote B
Calculation of Present Value (PV) of cash payments:		
Initial lease rent (PV)	5.00	1.00
Less: PV of tax benefit on initial payment of lease rent		
Rs. 5.00 lakh x 0.30 x 0.91	(1.365)	-
Rs. 1.00 lakh x 0.30 x 0.91	-	(0.273)
PV of Annual lease rents		
Rs. 21.06 lakh x 0.7 x 2.49	36.71	-
Rs. 19.66 lakh x 0.7 x 3.17	-	43.63
Total payments in PV	40.345	44.357
Capital Recovery Factor (reciprocal of Annuity Factor)		
1/2.49	0.402	-
1/3.17	-	0.315
Equated Annual Payment or cash outflow (Rs. lakhs)	16.20	13.979

Conclusion: Since Quote B implies lesser equated annual cash outflow, it is better.

- (b) By entering into an FRA, firm shall effectively lock in interest rate for a specified future in the given it is 6 months. Since, the period of 6 months is starting in 3 months, the firm shall opt for 3 × 9 FRA locking borrowing rate at 5.94%.

In the given scenarios, the net outcome shall be as follows:

	If the rate turns out to be 4.50%	If the rate turns out to be 6.50%
FRA Rate	5.94%	5.94%
Actual Interest Rate	4.50%	6.50%
Loss/ (Gain)	1.44%	(0.56%)
FRA Payment / (Receipts)	€50 m × 1.44% × ½ = €360,000	€50m × 0.56% × ½ = (€140,000)
Interest after 6 months on €50 Million at actual rates	= €50m × 4.5% × ½ = €1,125,000	= € 50m × 6.5% × ½ = €1,625,000
Net Out Flow	€ 1,485,000	€1,485,000

Thus, by entering into FRA, the firm has committed itself to a rate of 5.94% as follows: $\frac{€ 1,485,000}{€ 50,000,000} \times 100 \times \frac{12}{6} = 5.94\%$

Since firm is a borrower it will like to off-set interest cost by profit on Future Contract. Accordingly, if interest rate rises it will gain hence it should sell interest rate futures.

$$\begin{aligned} \text{No. of Contracts} &= \frac{\text{Amount of Borrowing}}{\text{Contract Size}} \times \frac{\text{Duration of Loan}}{3 \text{ months}} \\ &= \frac{€ 50,000,000}{€ 50,000} \times \frac{6}{3} = 2000 \text{ Contracts} \end{aligned}$$

The final outcome in the given two scenarios shall be as follows:

	If the interest rate turns out to be 4.5%	If the interest rate turns out to be 6.5%
<i>Future Course Action :</i>		
Sell to open	94.15	94.15
Buy to close	95.50 (100 - 4.5)	93.50 (100 - 6.5)
Loss/ (Gain)	1.35%	(0.65%)
Cash Payment (Receipt) for Future Settlement	€50,000 × 2000 × 1.35% × 3/12 = €337,500	€50,000 × 2000 × 0.65% × 3/12 = (€162,500)

Interest for 6 months on €50 million at actual rates	€50 million × 4.5% × ½ = €11,25,000	€50 million × 6.5% × ½ = €16,25,000
	€1,462,500	€1,462,500

Thus, the firm locked itself in interest rate $\frac{€1,462,500}{€50,000,000} \times 100 \times \frac{12}{6} = 5.85\%$

5. (a) In this question the effect of increasing running cost and decreasing resale value have to be weighted upto against the purchase cost of bike. For this purpose we shall compute Equivalent Annual Cost (EAC) of replacement in different years shall be computed and compared.

Year	Road Taxes (Rs.)	Petrol etc. (Rs.)	Total (Rs.)	PVF @10%	PV (Rs.)	Cumulative PV (Rs.)	PV of Resale Price (Rs.)	Net Outflow (Rs.)
1	3,000	30,000	33,000	0.909	29,997	29,997	31,815	(1,818)
2	3,000	35,000	38,000	0.826	31,388	61,385	17,346	44,039
3	3,000	43,000	46,000	0.751	34,546	95,931	6,759	89,172

Computation of EACs

Year	Purchase Price of Bike (Rs.)	Net Outflow (Rs.)	Total Outflow (Rs.)	PVAF @ 10%	EAC (Rs.)
1	55,000	(1,818)	53,182	0.909	58,506
2	55,000	44,039	99,039	1.735	57,083
3	55,000	89,172	1,44,172	2.486	57,993

Thus, from above table it is clear that EAC is least in case of 2 years, hence bike should be replaced every two years.

- (b) (i)

Probability	ABC (%)	XYZ (%)	1X2 (%)	1X3 (%)
(1)	(2)	(3)	(4)	(5)
0.20	12	16	2.40	3.2
0.25	14	10	3.50	2.5
0.25	-7	28	-1.75	7.0
0.30	28	-2	<u>8.40</u>	<u>-0.6</u>
Average return			<u>12.55</u>	<u>12.1</u>

Hence the expected return from ABC = 12.55% and XYZ is 12.1%

Probability	(ABC- ABC)	(ABC- ABC) ²	1X3	(XYZ- XYZ)	(XYZ- XYZ) ²	(1)X(6)
(1)	(2)	(3)	(4)	(5)	(6)	
0.20	-0.55	0.3025	0.06	3.9	15.21	3.04
0.25	1.45	2.1025	0.53	-2.1	4.41	1.10
0.25	-19.55	382.2025	95.55	15.9	252.81	63.20
0.30	15.45	238.7025	<u>71.61</u>	-14.1	198.81	<u>59.64</u>
			<u>167.75</u>			<u>126.98</u>

$$\sigma^2_{ABC} = 167.75(\%)^2; \sigma_{ABC} = 12.95\%$$

$$\sigma^2_{XYZ} = 126.98(\%)^2; \sigma_{XYZ} = 11.27\%$$

- (ii) In order to find risk of portfolio of two shares, the covariance between the two is necessary here.

Probability	(ABC- ABC)	(XYZ- XYZ)	2X3	1X4
(1)	(2)	(3)	(4)	(5)
0.20	-0.55	3.9	-2.145	-0.429
0.25	1.45	-2.1	-3.045	-0.761
0.25	-19.55	15.9	-310.845	-77.71
0.30	15.45	-14.1	-217.845	<u>-65.35</u>
				<u>-144.25</u>

$$\sigma^2_P = (0.5^2 \times 167.75) + (0.5^2 \times 126.98) + 2 \times (-144.25) \times 0.5 \times 0.5$$

$$\sigma^2_P = 41.9375 + 31.745 - 72.125$$

$$\sigma^2_P = 1.5575 \text{ or } 1.56(\%)$$

$$\sigma_P = \sqrt{1.56} = 1.25\%$$

$$E(R_p) = (0.5 \times 12.55) + (0.5 \times 12.1) = 12.325\%$$

Hence, the return is 12.325% with the risk of 1.25% for the portfolio. Thus the portfolio results in the reduction of risk by the combination of two shares.

- (iii) For constructing the minimum risk portfolio the condition to be satisfied is

$$X_{ABC} = \frac{\sigma_X^2 - r_{AX} \sigma_A \sigma_X}{\sigma_A^2 + \sigma_X^2 - 2r_{AX} \sigma_A \sigma_X} \text{ or } = \frac{\sigma_X^2 - \text{Cov}_{AX}}{\sigma_A^2 + \sigma_X^2 - 2\text{Cov}_{AX}}$$

σ_X = Std. Deviation of XYZ

σ_A = Std. Deviation of ABC

r_{AX} = Coefficient of Correlation between XYZ and ABC

Cov._{AX} = Covariance between XYZ and ABC.

Therefore,

$$\% \text{ ABC} = \frac{126.98 - (-144.25)}{126.98 + 167.75 - [2 \times (-144.25)]} = \frac{271.23}{583.23} = 0.46 \text{ or } 46\%$$

% ABC = 46%, XYZ = 54%

$(1 - 0.46) = 0.54$

6. (a) (i) The contract is to be cancelled on 30-10-2010 at the spot buying rate of US\$ 1
= Rs. 41.5000

Less: Margin Money 0.075% = Rs. 0.0311
= Rs. 41.4689 or Rs. 41.47

US\$ 20,000 @ Rs. 41.47 = Rs. 8,29,400

US\$ 20,000 @ Rs. 42.32 = Rs. 8,46,400

The difference in favour of the Bank/Cost to the importer Rs. 17,000

- (ii) The Rate of New Forward Contract

Spot Selling Rate US\$ 1 = Rs. 41.5200

Add: Premium @ 0.93% = Rs. 0.3861

= Rs. 41.9061

Add: Margin Money 0.20% = Rs. 0.0838

= Rs. 41.9899 or Rs. 41.99

(b)

(i) Exchange Ratio	1:1
New Shares to be issued	2,00,000
Total shares of Rama Ltd. (4,00,000+2,00,000)	6,00,000
Total earnings (Rs. 10,00,000 + Rs. 7,00,000)	Rs. 17,00,000
New EPS (Rs. 17,00,000/6,00,000)	Rs. 2.83
(ii) Existing EPS of Rama Ltd.	Rs. 2.50
Increase in EPS of Rama Ltd (Rs. 2.83 – Rs. 2.50)	Rs. 0.33
Existing EPS of Krishna Ltd.	Rs. 3.50
Decrease in EPS of Krishna Ltd. (Rs. 3.50 – Rs. 2.83)	Rs. 0.67

(iii) P/E ratio of new firm (expected to remain same)	14 times
New market price (14 × Rs. 2.83)	Rs. 39.62
Total No. of Shares	6,00,000
Total market Capitalization (6,00,000 × Rs. 39.62)	Rs. 2,37,72,000
Existing market capitalization (Rs. 70,00,000 + Rs. 1,40,00,000)	<u>Rs. 2,10,00,000</u>
Total gain	<u>Rs. 27,72,000</u>

(iv)

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

or Rs. 27,72,000 ÷ 3 = Rs. 9,24,000 to Krishna Ltd. and Rs. 18,48,000 to Rama Ltd. (in 2: 1 ratio)

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

Cross-border leasing have been in practice as a means of financing infrastructure development in emerging nations. Cross-border leasing may have significant applications in financing infrastructure development in emerging nations - such as rail and air transport equipment, telephone and telecommunications, equipment, and assets incorporated into power generation and distribution systems and other projects that have predictable revenue streams.

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

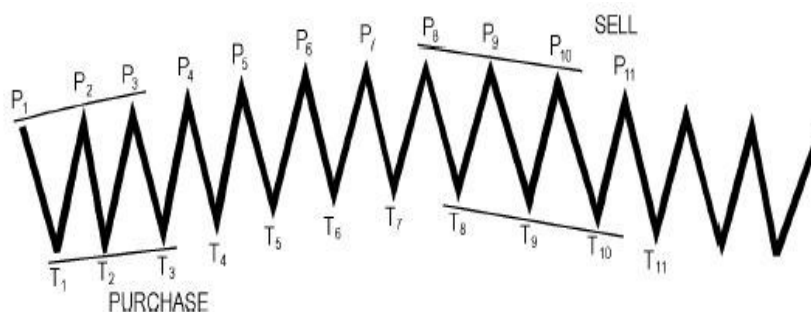
- (b) The following assumptions accompany the model:
1. European Options are considered,
 2. No transaction costs,
 3. Short term interest rates are known and are constant,

4. Stocks do not pay dividend,
 5. Stock price movement is similar to a random walk,
 6. Stock returns are normally distributed over a period of time, and
 7. The variance of the return is constant over the life of an Option.
- (c) 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.

- (d) In interbank transactions, foreign exchange is transferred from one account to another account and from one centre to another centre. Therefore, the banks maintain three types of current accounts in order to facilitate quick transfer of funds in different currencies. These accounts are Nostro, Vostro and Loro accounts meaning “our”, “your” and “their”. A bank’s foreign currency account maintained by the bank in a foreign country and in the home currency of that country is known as Nostro Account or “our account with you”. For example, An Indian bank’s Swiss franc account with a bank in Switzerland. Vostro account is the local currency account maintained by a foreign bank/branch. It is also called “your account with us”. For example, Indian rupee account maintained by a bank in Switzerland with a bank in India. The Loro account is an account wherein a bank remits funds in foreign currency to another bank for credit to an account of a third bank.
- (e) Generally, a big company takes over a small company. When the smaller company gains control of a larger one then it is called “Take-over by reverse bid”. In case of reverse take-over, a small company takes over a big company. This concept has been successfully followed for revival of sick industries.

The acquired company is said to be big if any one of the following conditions is satisfied:

- (i) The assets of the transferor company are greater than the transferee company;
- (ii) Equity capital to be issued by the transferee company pursuant to the acquisition exceeds its original issued capital, and
- (iii) The change of control in the transferee company will be through the introduction of minority holder or group of holders.

Reverse takeover takes place in the following cases:

- (1) When the acquired company (big company) is a financially weak company
- (2) When the acquirer (the small company) already holds a significant proportion of shares of the acquired company (small company)
- (3) When the people holding top management positions in the acquirer company want to be relieved off of their responsibilities.

The concept of take-over by reverse bid, or of reverse merger, is thus not the usual case of amalgamation of a sick unit which is non-viable with a healthy or prosperous unit but is a case whereby the entire undertaking of the healthy and prosperous company is to be merged and vested in the sick company which is non-viable.

Test Series: September, 2016

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory.

*Attempt any **five** questions from the Rest.*

Time Allowed – 3 Hours

Maximum Marks – 100

1. (a) CA. Yusuf has been appointed as an auditor of Ajanta Ltd., a textile entity. While going through the employee records of the company, CA. Yusuf identified that most of the labourers employed are of the age between 11-12 years. On enquiring the same, the management argues that there is no such boundation with regard to employment of such lower age children and contends that it is out of the scope of audit as well to check such compliance. Comment in the context of relevant standard on auditing whether the contention of management is tenable.
- (b) Rajpanth Ltd. appointed you as its statutory auditor for the current financial year. During the course of auditing, you meticulously analysed that the work performed by company's internal auditor is likely to be adequate for the purpose of statutory audit. Consequently, you decided to use the work of internal auditor in respect of physical verification of tangible assets specifically.
- State how you would evaluate the specific work performed by internal auditor to determine its adequacy and who would be responsible for expression of opinion on financial statements.
- (c) Gujarat Electricity Ltd. (monopoly electricity distribution company), a company owned by Gujarat government, holds 35% equity shares in Pinch Ltd. Pinch Ltd. is completely dependent on Gujarat Electricity Ltd. for electric supply. Pinch Ltd., in its draft financial statements has not disclosed anything about Gujarat Electricity Ltd. on the ground that being a government owned entity AS 18 "Related Party Disclosures" does not apply. Comment.
- (d) The management of Zuchi Ltd. has prepared its summary financial statements for the year 2015-16 to be provided to its investors. Consequently, the company wants to appoint you for conducting audit of such summary financial statements. Mention the factors you would consider before accepting such engagement to report on summary financial statements. (5 × 4 = 20 Marks)

2. Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:
- (a) Mr. Chandan, a chartered accountant in practice, created his own website in attractive format and highlighted the contents in Purple colour. He also circulated the information contained in the website through E-mail to acknowledge public at large about his expertise. However, due to shortage of time, he could not intimate his website address to the Institute.
 - (b) The manager of Norex (P) Ltd. approached CA. Kamal in the need of a certificate in respect of a consumption statement of raw material. Without having certificate of practice (CoP), CA. Kamal issued the certificate to the manager of the company, acting as a CA in practice and applied for the CoP to the Institute on very next day to avoid any dispute.
 - (c) CA. Raman is a practicing Chartered Accountant working as a proprietor of M/s R & Co. He went abroad for 2 months. He delegated the authority to CA. Raj, his employee, for taking care of routine matters of his office. During his absence, CA. Raj has issued the audit queries to clients which were raised during the course of audit.
 - (d) Mr. A and Mr. B are running a firm of Chartered Accountants in the name of M/s AB & Co. On 23.05.2016, they included the name of Mr. C, a practicing Chartered Accountant, without his knowledge, as a partner while submitting an application for empanelment as auditor for Public Sector Bank branches to the Institute. However, they added Mr. C as a partner to their firm offering a share of 25% of the profits, on 25.05.2016. (4 × 4 = 16 Marks)
3. (a) Funtush Ltd. appointed CA. Fanny as an auditor for the company for the current financial year. Further, the company offered him the services of actuarial, investment advisory and investment banking which was also approved by the Board of Directors. You are required to comment how the auditor would deal in the given situation. (4 Marks)
- (b) Mr. Rajkamal, the director of Unite Ltd., is holding 25% shares in the company. His daughter-in-law, CA. Rani, is in practice for 15 years where she provides consultancy services and conduct statutory audits. She has created her niche in statutory audits. The company wanted to appoint her as the statutory auditor of the company for the five consecutive financial years. Consequently, she was appointed by Unite Ltd. Examine the validity of appointment of CA. Rani. (4 Marks)
- (c) In the books of accounts of Alora Ltd. huge differences has been noticed between the control accounts and subsidiary records. The Chief Accountant informs that this is common due to huge volume of business done by the company during the year. As a Statutory Auditor, how would you deal with the situation? (4 Marks)

- (d) The auditor must evaluate major clauses of control used in a Computerised Information system to enhance its reliability. State the major types of controls that are used to enhance component reliability. *(4 Marks)*
4. (a) ABC Ltd. gave a donation of Rs. 50,000 each to a Charitable Society running a school and a trust set up for the service of Blind during financial year ending on 31st March, 2016 (charitable organisations are not related to the business of the company). The average net profits of the company for the last three years were Rs. 15 lakhs. Comment. *(4 Marks)*
- (b) Under CARO, 2016, as a statutory auditor, how would you report on the following:
- (i) A Term Loan was obtained from a bank for Rs. 80 lakh for acquiring R&D equipment, out of which Rs. 15 lakh was used to buy a car for use of the concerned director who was overlooking the R&D activities.
- (ii) Physical verification of only 50% of items of inventory has been conducted by the company. The balance 50% will be conducted in next year due to lack of time and resources. *(6 Marks)*
- (c) Zed Limited has defaulted in repayments of dues to a financial institution during the financial year 2015-16 and the same remained outstanding as at March 31, 2016. However, the company settled the total outstanding dues including interest in April, 2016 subsequent to the year end and before completion of the audit. Discuss how you would deal with this matter and draft a suitable Auditor's Report. *(6 Marks)*
5. (a) In the course of audit of 'Sabka Bank', your firm observed that the bank has classified some of the assets as non-performing assets (NPA), for example, bills receivables for remaining overdue more than 30 days, loans for remaining overdue for more than 60 days etc. Please guide the accountant with regard to criteria to be adopted for classifying an asset as NPA. *(4 Marks)*
- (b) You have been appointed as an auditor of a loan financing company, registered as an NBFC. You are required to state six special points to be kept in mind while auditing such company. *(4 Marks)*
- (c) The energy auditor is normally expected to give recommendations on efficiency improvements leading to monetary benefits and also advise on energy management issues. In this context, you are required to state some of the key functions of the energy auditor. *(4 Marks)*
- (d) While writing the audit program for tax audit in respect of CRAM Ltd., you wish to include possible instances of capital receipt if not credited to Statement of Profit and Loss which needs to be reported under clause 16(e) of Form 3CD. Please elucidate possible instances. *(4 Marks)*

6. (a) The 'management audit' concern with the whole field of activities of the concern, from top to bottom, starting, as always where management control is concerned because we are primarily concerned with whether the general management is functioning smoothly and satisfactorily.

Briefly explain the behavioural aspects encountered in the management audit and state the ways to solve them. *(6 Marks)*

- (b) You have been appointed to investigate the accounts of a company and informed that the accounts have already been audited. Discuss whether you can put reliance on such already audited statement of accounts for the purpose of investigation.

(4 Marks)

- (c) Being an expert in the field of government audit, you are required to briefly explain the powers of Comptroller and Auditor General of India with respect to supplementary audit and test audit as envisaged under section 143(6) and 143(7) of the Companies Act, 2013.

(6 Marks)

7. Write short notes on **any four** of the following:

- (a) Objectives of Internal Check System
- (b) Factors relevant in evaluation of Inherent Risk.
- (c) Frauds committed through supplier's ledger.
- (d) Areas excluded from the scope of peer reviewer.
- (e) General Steps in the Conduct of Risk-Based Audit.

(4 × 4 = 16 Marks)

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 the instant case, most of the labourers employed in Ajanta Ltd. are of the age between 11-12 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 CA. Yusuf from obtaining sufficient appropriate audit evidence for further evaluation.

Thus, CA. Yusuf 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) **Evaluation of Specific Work Done by Internal Auditor:** The statutory auditor should as a part of his audit, carry out general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor.

As per SA 610 "Using the Work of Internal Auditors", in order for the external auditor to use specific work of the internal auditors, the external auditor shall evaluate and perform audit procedures on that work to determine its adequacy for the external auditor's purposes. The external auditor shall evaluate whether-

- (i) The work was performed by internal auditors having adequate technical training and proficiency;
- (ii) The work was properly supervised, reviewed and documented;
- (iii) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;
- (iv) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and
- (v) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the entity as is required of the external auditor when expressing an opinion on financial statements. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal auditors.

- (c) **AS 18 "Related Party Disclosures"** exempts parties being defined on the basis of significant influence in respect of providers of finance; trade unions; public utilities; etc. by virtue of only of those dealings. If an enterprise is completely dependent on an electricity distribution company because of monopoly in that region, but other than for this reason neither enterprises exercise control/significant influence, none of the transactions between them would be related party transactions for AS 18 purposes.

If a particular enterprise exercises control/significant influence on an electricity distribution company, for example, Pinch Ltd. holds 35% equity of Gujarat Electricity Ltd. (monopoly electricity distribution company) or vice-versa, all transactions (including the supply of electricity) between Pinch Ltd. and Gujarat Electricity Ltd. will be related party transactions and disclosure is necessary for the same as per AS 18.

Similarly, a provider of finance is not a related party by virtue of providing finance, however if the lender in addition to providing finance also holds equity of more than 20% in an enterprise, then it would be deemed to be exercising significant influence on that enterprise unless demonstrated otherwise.

Based on the above cited provisions of AS 18, Pinch Ltd. should disclose about Gujarat Electricity Ltd.

- (d) Engagement to Report on Summary Financial Statements:** As per SA 810 “Engagements to Report on Summary Financial Statements”, before accepting an engagement to report on summary financial statements, the auditor shall-
- (i) Determine whether the applied criteria are acceptable;
 - (ii) Obtain the agreement of management that it acknowledges and understands its responsibility:
 - (1) For the preparation of the summary financial statements in accordance with the applied criteria;
 - (2) To make the audited financial statements available to the intended users of the summary financial statements without undue difficulty (or, if law or regulation provides that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements, to describe that law or regulation in the summary financial statements); and
 - (3) To include the auditor’s report on the summary financial statements in any document that contains the summary financial statements and that indicates that the auditor has reported on them.
 - (iii) Agree with management the form of opinion to be expressed on the summary financial statements.
- 2. (a) Circulating Information Contained in Own Website:** As per clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is 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 guidelines approved by the Council of the Institute of Chartered Accountants of India permit creation of own website by a chartered accountant in his or his firm name and no standard format or restriction on colours is there. The chartered accountant or firm, as per the guidelines, should ensure that none of the information contained in the website be circulated on their own or through E-mail or by any other mode except on a specific “Pull” request.

Further, members are not required to intimate the Website address to the Institute. Members are only required to comply with the Website Guidelines issued by the Institute in this regard.

In the given case, Mr. Chandan has circulated the information contained in the website through E-mail to public at large. Therefore, he is guilty of professional misconduct under clause (6) of Part I of the First Schedule to the said Act. However, there is no such misconduct for not intimating website address to the Institute.

- (b) Issuing Certificate without having Certificate of Practice:** As per Clause (1) of Part II of 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 contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council.

This clause requires every member of the Institute to act within the framework of the Chartered Accountants Act and the Regulations made thereunder. Any violation either of the Act or the Regulations by a member would amount to misconduct.

In the given case, CA. Kamal has issued a certificate in respect of a consumption statement of raw material to the manager of Norex (P) Ltd., as a Chartered Accountant in practice when he had not even applied for the CoP to the Institute, thereby contravening the provisions of section 6 of the Chartered Accountants Act, 1949.

Therefore, CA. Kamal will be held guilty of professional misconduct in terms of clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949 for contravention of provisions of this Act.

- (c) Delegation of Authority to the Employee:** As per Clause (12) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

However, the Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated and such delegation will not attract provisions of this clause like issue of audit queries during the course of audit, etc.

In the given case, CA. Raman proprietor of M/s R & Co., went to abroad and delegated the authority to another Chartered Accountant Mr. Raj, his employee, for taking care of routine matters of his office who is not a partner but a member of the Institute of Chartered Accountants. CA. Raj has issued audit queries which were raised during the course of audit.

Here CA. Raj is right in issuing the query, since the same falls under routine work which can be delegated by the auditor. Therefore, there is no misconduct in this case as per Clause (12) of Part I of First schedule to the Act.

- (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. A and Mr. B, partners of M/s AB & Co., included the name of Mr. C, 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. A and Mr. B have submitted wrong information to the Institute.

Therefore, Mr. A and Mr. B, 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) **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 following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:
- (i) accounting and book keeping services;
 - (ii) internal audit;
 - (iii) design and implementation of any financial information system;
 - (iv) actuarial services;
 - (v) investment advisory services;
 - (vi) investment banking services;
 - (vii) rendering of outsourced financial services;
 - (viii) management services; and
 - (ix) any other kind of services as may be prescribed.

In the given case, CA. Fanny was appointed as an auditor of Funtush Ltd. He was offered additional services of actuarial, investment advisory and investment banking which was also approved by the Board of Directors.

Therefore, the auditor is advised not to accept the services as these services are specifically notified in the services not to be rendered by him as an auditor as per section 144 of the Act.

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

Further, as per Council Guidelines 2008, a member of the Institute shall desist from expressing his opinion on financial statements of any business or enterprise in which one or more persons who are his relatives within the meaning of AS 18 have, either by way of themselves or in conjunction with such members, a substantial interest in the said business or enterprise. Therefore, if the director has substantial interest in the company then his relative should not accept the appointment of auditor of that company.

In the instant case, Mr. Rajkamal is the director of Unite Ltd. and holding 25% shares of the company. Further, CA. Rani is his son’s wife i.e. a relative according to the definition of “relative” given under the Companies Act, 2013. Therefore, she should not accept the appointment as an auditor of that company. If she accepts such appointment, she would be guilty of professional misconduct and would also be liable for punishment for contravention of the provisions of the Companies Act.

- (c) Difference between Control Accounts and Subsidiary Records:** The huge differences found between control accounts and subsidiary records in the books of Alora Ltd. indicates that there may be material misstatements requiring detailed examination by the auditor to ascertain the cause. The contention of Chief Accountant cannot be accepted simply because the company has done huge volume of business. Such a phenomenon indicates that recording of transactions is not being done properly or the accounting system in the company which might have several branches spread over the country fails to capture all transactions in time. It would also be interesting to see whether it is a recurring phenomenon or such reconciliation could not be done at a subsequent date. Having regard to all these circumstances, it appears from the facts of the case that these differences indicate the possibility of some kind of material misstatements.

As per SA 240, "The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements", when the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor shall evaluate the implications for the audit.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government or Audit Committee/Board, as the case may be, within such time and in such manner as may be prescribed.

The auditor is also required to comment under clause (x) of Para 3 of CARO, 2016 whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

- (d) **Internal Controls in a CIS Environment:** The reliability of a component is a function of control that acts on the component. In a computer system following are the major types of controls that are used to enhance component reliability which the auditor must evaluate-
- (i) **Authenticity Control:** They are exercised to verify the identity of the individuals or process involved in a system (Password, digital signature etc.).
 - (ii) **Accuracy Control:** These attempts to ensure the correctness of the data and processes in a system (Programme validation check).
 - (iii) **Completeness Control:** This ensures that no data is missing and all processing is carried through to its proper conclusion.
 - (iv) **Privacy Control:** This ensures the protection of data from inadvertent or unauthorised disclosure.
 - (v) **Audit Trail Controls:** This ensures the traceability of all events occurred in a system.
 - (vi) **Redundancy Control:** It ensures that processing of data is done only once.
 - (vii) **Existence Control:** It attempts to ensure the ongoing availability of all system resources.

- (viii) **Asset safeguarding controls:** It attempts to ensure that all resources within a system are protected from destruction or corruption.
- (ix) **Effectiveness Control:** It attempts to ensure that the system achieves its goals.
- (x) **Efficiency Control:** It attempts to ensure that a system uses minimum resources to achieve its goals.

4. (a) **Donation to Charitable Institutions:** Section 181 of the Companies Act, 2013 provides that the Board of Directors of a company may contribute to bona fide charitable and other funds with prior permission of the company in general meeting for such contribution in case any amount the aggregate of which, in any financial year, exceed five per cent of its average net profits for the three immediately preceding financial years.

In the instant case, ABC Ltd. has given donation of Rs. 50,000 each to the two charitable organisations which amounts to Rs. 1,00,000. The average profit of the last 3 years is Rs. 15 lakhs and the 5% of this works out to Rs. 75,000. Hence the maximum of donation could be Rs. 75,000 only. For excess of Rs. 25,000 the company is required to take prior permission in general meeting which is not been taken.

By paying donations of Rs. 1,00,000 which is more than Rs. 75,000, the Board has contravened the provisions of Section 181 of the Companies Act, 2013. Hence, the auditor should qualify his report accordingly.

(b) **Reporting Under CARO, 2016**

- (i) **Utilisation of Term Loans:** According to clause (ix) of Para 3 of CARO, 2016, the auditor is required to comment whether term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported.

The auditor should examine the terms and conditions of the term loan with the actual utilisation of the loans. If the auditor finds that the fund has not been utilized for the purpose for which they were obtained, the report should state the fact.

In the instant case, term loan taken for the purpose of R&D equipment has been utilized for the purchase of car which has no relation with R&D equipment.

Therefore, car though used for R&D Director cannot be considered as R&D equipment. The auditor should state the fact in his report that out of the term loan taken for R&D equipment, Rs. 15 lakh was not utilised for the purpose of acquiring R&D equipment.

- (ii) **Physical Verification of Inventory:** Clause (ii) of Para 3 of CARO, 2016 requires the auditor to report on whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account.

Physical verification of inventory is the responsibility of the management which should verify all material items at least once in a year and more often in appropriate cases. The auditor in order to satisfy himself about verification at reasonable intervals should examine the adequacy of evidence and record of verification.

In the given case, the above requirement of CARO, 2016 has not been fulfilled as such and the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable. He may consider the impact on financial statement and report accordingly.

- (c) **Reporting for Default in Repayment of Dues:** As per the general instructions for preparation of Balance Sheet, provided under Schedule III to the Companies Act, 2013, terms of repayment of term loans and other loans is required to be disclosed in the notes to accounts. It also requires specifying the period and amount of continuing default as on the balance sheet date in repayment of loans and interest, separately in each case.

Further, as per clause (viii) of Para 3 of CARO, 2016, the auditor of a company has to state in his report whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders and if yes, the period and the amount of default to be reported

In the given case, Zed Ltd. has defaulted in repayments of dues to a financial institution during the financial year 2015-16 which remain outstanding as at March 31, 2016. However, the company has settled the total outstanding dues including interest in April, 2016 but, the dues were outstanding as at March 31, 2016. Therefore, it needs to be reported in the notes to accounts.

The draft report for above matter is as under:

“The company has taken a loan during the year, from a financial institution amounting to Rs. XXXX @ X% p.a. which is repayable by monthly installment of Rs. XXXX for XX months.

The company has defaulted in repayment of dues including interest to a financial institution during the financial year 2015-16 amounting to Rs. XXXX which remained outstanding as at March 31, 2016. The period of default is XXX days. However, the outstanding sum was settled by the company in April, 2016.”

5. (a) **Classification of Non-Performing Assets:** An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.

Criteria for the classification of a Non Performing Asset (NPA) is a loan or an advance where-

- (i) Interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan.
- (ii) The account remains "out of order" in respect of an Overdraft/Cash Credit (OD/CC).
- (iii) The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
- (iv) The instalments of principal or interest thereon remain overdue for two crop seasons for short duration crops.
- (v) The instalment of principal or interest thereon remains overdue for one crop season for long duration crops.
- (vi) The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitization dated 1st February, 2006.
- (vii) In respect of derivative transactions, the overdue receivables representing positive mark to Market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

- (b) **Audit of a Loan Financing Company:** Special points to be kept in mind while auditing a loan financing company, an NBFC, are given below-

- (i) Auditor should examine whether each loan or advance has been properly sanctioned. He should verify the conditions attached to the sanction of each loan or advance i.e. limit on borrowings, nature of security, interest, terms of repayment, etc.
- (ii) Auditor should verify the security obtained and the agreements entered into, if any, with the concerned parties in respect of the advances given. He must ascertain the nature and value of security and the net worth of the borrower/guarantor to determine the extent to which an advance could be considered realisable.
- (iii) Obtain balance confirmations from the concerned parties.
- (iv) As regards bill discounting, verify that proper records/documents have been maintained for every bill discounted/rediscouted by the NBFC. Test check some transactions with reference to the documents maintained and ascertain whether the discounting charges, wherever, due, have been duly accounted for by the NBFC.

- (v) Check whether the NBFC has not lent/ invested in excess of the specified limits to any single borrower or group of borrowers as per NBFC Prudential Norms Directions.
 - (vi) Check whether the NBFC has not advanced any loans against the security of its own shares.
 - (vii) In case of companies which are engaged in the business of providing short term funds in the ICD market, the auditor should ascertain whether the NBFC has a regular system for ascertaining the credit worthiness of the clients prior to placed by the company are being rolled over and whether there is any risk of non-recovery. In addition, he should ascertain that the NBFC is receiving interest regularly in respect of these ICDs. Roll over of ICDs and non-realisation of interest and principal amounts should be thoroughly checked to determine whether the ICD is required to be treated as a NPA.
 - (viii) Auditor should verify whether the NBFC has an adequate system of proper appraisal and follow up of loans and advances. In addition, he may analyze the trend of its recovery performance to ascertain that the NBFC does not have an unduly high level of NPAs.
 - (ix) Check the classification of loans and advances (including bills purchased and discounted) made by an NBFC into Standard Assets, Sub-Standard Assets, doubtful assets and loss assets and the adequacy of provision for bad and doubtful debts as required by NBFC Prudential Norms Directions.
 - (x) An auditor should also verify whether provision for bad and doubtful debts has been disclosed separately in the Balance Sheet and the same have not been netted off against the income or against the value of assets as required by the NBFC Prudential Norms Directions.
- (c) **Key Functions of Energy Auditor:** Energy auditing is defined as an activity that serves the purposes of assessing energy use pattern of a factory or energy consuming equipment and identifying energy saving opportunities. In that context, energy management involves the basis approaches reducing avoidable losses, improving the effectiveness of energy use, and increasing energy use efficiency. The function of an energy auditor could be compared with that of a financial auditor. The energy auditor is normally expected to give recommendations on efficiency improvements leading to monetary benefits and also advise on energy management issues. Generally, energy auditor for the industry is an external party. The following are some of the key functions of the energy auditor:
- (i) Quantify energy costs and quantities.
 - (ii) Correlate trends of production or activity to energy costs.

- (iii) Devise energy database formats to ensure they depict the correct picture – by product, department, consumer, etc.
 - (iv) Advise and check the compliance of the organisation for policy and regulation aspects.
 - (v) Highlight areas that need attention for detailed investigations.
 - (vi) Conduct preliminary and detailed energy audits which should include the following:
 - (a) Data collection and analysis.
 - (b) Measurements, mass and energy balances.
 - (c) Reviewing energy procurement practices.
 - (d) Identification of energy efficiency projects and techno-economic evaluation.
 - (e) Establishing action plan including energy saving targets, staffing requirements, implementation time requirements, procurement issues, details and cost estimates.
 - (f) Recommendations on goal setting for energy saving, record keeping, reporting and energy accounting, organisation requirements, communications and public relations.
- (d) Instances of Capital Receipts to be Stated Under Clause 16(e):** The following is an illustrative list of capital receipts which, if not credited to the statement of profit and loss, are to be stated under clause 16(e) of Form 3CD-
- (i) Capital subsidy received in the form of government grants, which are in the nature of promoters' contribution i.e., they are given with reference to the total investment of the undertaking or by way of contribution to its total capital outlay. For example, Capital Investment Subsidy Scheme.
 - (ii) Government grant in relation to a specific fixed asset where such grant is shown as a deduction from the gross value of the asset by the concern in arriving at its book value.
 - (iii) Compensation for surrendering certain rights.
 - (iv) Profit on sale of fixed assets/investments to the extent not credited to the statement of profit and loss.
- 6. (a) Behavioural Aspects Encountered in Management Audit:** Financial auditors deal mainly with figures. Management auditors deal mainly with people. There are many causes for behavioural problems arising in the review function of management audit. Particularly, when management auditors performs comprehensive audit of operations, they cannot be as well informed about such operations as a financial

auditor in a financial department. Operating processes may be unfamiliar and complex. The operating people may be speaking a language and using terms that are foreign to the auditor's experience. The nature and causes of behavioural problems that the management auditor is likely to face in the discharge of the review function that is expected of him and possible solutions to overcome these problems are discussed below-

- (1) **Staff / Line conflict:** Management auditors are staff people while the members of other departments are line people. Management auditors tend to discount the difficulties the line staff may face, if called on to act on the ideas of management auditors. Management auditors are specialists in their field and they may think their approach and solutions are the only answers.
- (2) **Control:** The management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee that the report of the auditor may affect them. There is a fear that the action taken based on the management audit report will affect the line people. It breeds antagonism. The causes are under:
 - (i) Fear of criticism stemming from adverse audit findings.
 - (ii) Fear of change in day to day working habits because of changes resulting from audit recommendations.
 - (iii) Punitive action by superior prompted by reported deficiencies.
 - (iv) Insensitive audit practices.
 - (v) Hostile audit style.

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

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

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

Finally, it needs hardly any emphasis that there should be right management culture, enlightened auditees and auditors of the right calibre. May be to expect a

combination at all times of all the three is asking for the impossible. But, a concerted effort by the management, auditors and auditees to achieve a more acceptable climate would go a long way to achieve the goal.

- (b) **Reliance on Audited Statement of Accounts by Investigator:** If the investigation has been launched because of some doubt in the audited statement of account, no question of reliance on the audited statement of account arises. However, if the investigator has been requested to establish value of a business or a share or the amount of goodwill payable by an incoming partner, ordinarily the investigator would be entitled to put reliance on audited materials made available to him unless, in the course of his test verification, he finds the audit to have been carried on very casually or unless his terms of appointment clearly require to test everything afresh. It is, therefore, desirable for the investigator to ascertain from the client, in advance, in writing, whether the audited statements of account produced to him should be taken as correct.

If the statements of account produced before the investigator were not audited by a qualified accountant, then of course there arises a natural duty to get the figures in the accounts properly checked and verified. However, when the accounts produced to the investigator have been specially prepared by a professional accountant, who knows or ought to have known that these were prepared for purposes of the investigation, he could accept them as correct relying on the principle of liability to third parties. Nevertheless, it would be prudent to see first that such accounts were prepared with objectivity and that no bias has crept in to give advantage to the person on whose behalf these were prepared.

(c) **Powers of Comptroller and Auditor-General of India**

- (i) **Supplementary audit under section 143(6)(a) of the Companies Act, 2013:** The Comptroller and Auditor-General of India shall within 60 days from the date of receipt of the audit report have a right to conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct.

Comment upon or supplement such Audit Report under section 143(6)(b) of the Companies Act, 2013: Any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 of the said Act i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such

member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

- (ii) **Test audit under section 143(7) of the Companies Act, 2013:** Without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor-General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139 of the said Act, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

7. (a) Objectives of the Internal Check System: Following are the objectives of the internal check system-

- (i) To detect error and frauds with ease.
- (ii) To avoid and minimize the possibility of commission of errors and fraud by any staff.
- (iii) To increase the efficiency of the staff working within the organization.
- (iv) To locate the responsibility area or the stages where actual fraud and error occurs.
- (v) To protect the integrity of the business by ensuring that accounts are always subject to proper scrutiny and check.
- (vi) To prevent and avoid the misappropriation or embezzlement of cash and falsification of accounts.

- (b) Factors Relevant in Evaluation of Inherent Risk:** While developing an overall audit plan, the auditor is required to assess inherent risk at financial statement level and is then required to relate his assessment to material account balances and the class of transactions. To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment. Normally an auditor evaluates inherent risk by assessing factors such as integrity of the management, experience and knowledge of the management, turnover of key management personnel, circumstances which may motivate the management to misstate the financial statement when its financial performance is not satisfactory, nature of entity's business prone to rapid technological obsolescence, dealing with large number of related parties etc.

- (c) **Frauds Committed Through Supplier's Ledger:** Fraud through supplier's ledger could be made in any of the following ways, which the auditor has to take care of-
- (i) Inflating supplier's account with fictitious or duplicate invoices and subsequent misappropriations as if payments are made to the supplier.
 - (ii) Suppressing credit notes issued by the suppliers and withdrawing the corresponding amount not claimed by them.
 - (iii) Withdrawing amounts which remain unclaimed for more than the normal time limit for one reason or other by showing the same have been paid to the parties.
 - (iv) Inflating values of items purchased and collecting the excess from suppliers i.e. accepting invoices at prices considerably higher than the market price and collecting the excess claim from the suppliers directly.
- (d) **Areas Excluded from the Scope of Peer Reviewer:**
- (i) Management Consultancy Engagements;
 - (ii) Representation before various Authorities;
 - (iii) Engagements to prepare tax returns or advising clients in taxation matters;
 - (iv) Engagements for the compilation of financial statements;
 - (v) Engagements solely to assist the client in preparing, compiling or collating information other than financial statements;
 - (vi) Testifying as an expert witness;
 - (vii) Providing expert opinion on points of principle, such as Accounting Standards or the applicability of certain laws, on the basis of facts provided by the client; and
 - (viii) Engagement for Due diligence.
- (e) **General Steps in the Conduct of Risk-Based Audit:** Risk-based audit (RBA) is an approach to audit that analyzes audit risks, sets materiality thresholds based on audit risk analysis and develops audit programmes that allocate a larger portion of audit resources to high-risk areas.
- RBA consists of four main phases starting with the identification and prioritization of risks, to the determination of residual risk, reduction of residual risk to acceptable level and the reporting to auditee of audit results. These are achieved through the following:
- (i) Understanding auditee operations involves processes for reviewing and understanding the audited organization's risk management processes for its strategies, framework of operations, operational performance and information

process framework, in order to identify and prioritize the error and fraud risks that impact the audit of financial statements. The environment in which the auditee operates, the information required to monitor changes in the environment, and the process or activities integral to the audited entity's success in meeting its objectives are the key factors to an understanding of agency risks. Likewise, a performance review of the audited entity's delivery of service by comparing expectations against actual results may also aid in understanding agency operations.

- (ii) Assessment of management risk strategies and controls is the determination as to how controls within the auditee are designed. The role of internal audit in promoting a sound accounting system and internal control is recognized, thus the SAI should evaluate the effectiveness of internal audit to determine the extent to which reliance can be placed upon it in the conduct of substantive tests.
- (iii) Management of residual risk requires the design and execution of a risk reduction approach that is efficient and effective to bring down residual audit risk to an acceptable level. This includes the design and execution of necessary audit procedures and substantive testing to obtain evidence in support of transactions and balances. More resources should be allocated to areas of high audit risks, which were earlier known through the analytical procedures undertaken.
- (iv) The results of audit shall be communicated by the auditor to the audited entity. The auditor must immediately communicate to the auditee reportable conditions that have been observed even before completion of the audit, such as weaknesses in the internal control system, deficiencies in the design and operation of internal controls that affect the organization's ability to record, process, summarize and report financial data.

Test Series: September, 2016

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) X Ltd. Company has been declaring dividend at the rate of 25% on equity shares for the last three years. The Company has not made adequate profits during the year ended 31st March, 2016, but it has got adequate reserves which can be utilized for maintaining the rate of dividend at 25%.
- In the light of the Companies Act, 2013, opine the Company as to how it should go about if it wants to declare dividend at the rate of 25% for the year 2015-16.
- (6 Marks)*
- (b) The registered office of Bharat Ltd. is situated in a remote area of Rajasthan. Due to lack of development, various practical problems were faced by Company to maintained account and related matters. The Board decided to keep its books of account at its corporate office in Jaipur which is conveniently located in the heart of the city. The Board seeks your advice about the viability of maintaining the accounting records at Jaipur rather than the registered office of the company. Advise.
- (6 Marks)*
- (c) A group of petitioners suspected that Mr. Zuber who is a Member of the Securities and Exchange Board of India (SEBI) has monetary interest in some of the cases that came up before the Board and that he embezzled his position. So petitioners contended that Mr. Zuber should be removed from his office. Examine the given situation as per the SEBI Act, 1992.
- (4 Marks)*
- (d) Arahant & Company is a member of a recognised stock exchange. It proposes to buy and sell shares of a particular company on behalf of investors as well as on their own account. They seek your advice as to restrictions, if any, under Securities Contracts (Regulation) Act, 1956 for dealing in securities on their own account. Advise.
- (4 Marks)*
2. (a) (i) PC Limited appointed Mr. R as its auditor in the Annual General Meeting held on 30th July, 2016. Mr. R accepted the appointment. Later, he resigned from his office on 31st August, 2016 for the cause of his bad health. The Board of directors seeks your advice for filling up the vacancy by appointment of Mr. Appropriate as auditor. Advise as per the provisions of the Companies Act,

2013. Also suggest the procedure to be adopted in case Mr. Appropriate is proposed to be removed from his office before the expiry of his term. (4 Marks)

- (ii) The Board of directors of ABC Limited, an unlisted company having a paid-up capital of Rs. 6 crores consisting of equity share capital of Rs. 5 crores and preference share capital of Rs. 1 crore and also 1,100 'Small Shareholders' holding equity shares seek your advice on the issue that is it necessary for the Company to appoint a Director to represent the 'Small Shareholders'? Advise explaining the relevant provisions of the Companies Act, 2013 (4 Marks)
- (b) (i) Contemporary Chemicals Limited, a listed company, proposes to make a preferential issue of equity shares to the promoters of the Company. Considering the legal position, state the conditions to be complied with by the Company to give effect to the proposed preferential issue with reference to the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009. (4 Marks)
- (ii) Majestic Limited, a foreign company was required to submit the necessitated documents to the Registrar of the Company. However, Majestic Limited failed to deliver the said documents to the Registrar of Companies as per Section 380 of the Companies Act, 2013. State the provisions of penalty prescribed under the said Act, which can be levied on Majestic Limited for its failure to submit the documents. (4 Marks)
3. (a) The shareholders and creditors of Ranbaxy Company Limited, in meeting convened for approval of a scheme of reconstruction of the company, passed resolutions. The scheme of reconstruction provided for the following:
- (i) Sale of vacant land and appropriation of proceeds for payment of outstanding wages, tax dues and repayment of loan.
- (ii) Unsecured creditors to forego 40% of their claims against the company and receive debentures for the balance amount.
- A few shareholders and creditors raised objections against the said arrangements. Advise the directors about the steps to be taken to give effect to the proposed scheme under the Companies Act, 1956. (8 Marks)
- (b) (i) Mr. Giriraj, an Indian national desires to obtain Foreign Exchange on current account transactions for the following purposes:
- (1) Payment of commission on exports made towards equity investment in wholly owned subsidiary abroad of an Indian Company.
- (2) Remittance of hiring charges of transponder by TV channels
- Advise Giriraj whether he can obtain Foreign Exchange and, if so, under what conditions? (4 Marks)

- (ii) Mr. Ideal was appointed as an additional Director of Perfect Finance Ltd. w.e.f. 1st October, 2015, in a casual vacancy by way of a circular resolution passed by the Board of Directors. The next annual general meeting of the company was due on 31st March, 2016, but the same was not held due to delay in the finalisation of the accounts. Some of the shareholders of the company have questioned the validity of the appointment of Mr. Ideal and his continuation as additional director beyond 31st March, 2016. Advise the company on the complaints made by the shareholders. *(4 Marks)*
4. (a) The profits of XYZ Limited for the financial year 2015-2016 fell considerably due to recession. The Board of directors of the company, therefore, bonafide did not recommend any dividend for the year. At the Annual General Meeting of the company, a group of members objected to the Board's decision and wanted the Board to make recommendation for dividend.
- On refusal by the Board, the members, who feel oppressed by the Board's decision to skip the dividend, move to the Company Law Board and complain against the Board on the ground of oppression and mismanagement.
- Examining the provisions of the Companies Act, 1956, decide:
- (1) Whether the members contention shall be tenable?
- (2) Whether the act of Board of Directors not to recommend any dividend shall amount to oppression and mismanagement? *(8 Marks)*
- (b) (i) An understanding has been reached among the manufacturers of cement to control the price of cement, but the understanding is not in writing and it is also not intended to be enforced by legal proceedings.
- Examine whether the above understanding can be considered as an 'Agreement' with the meaning of Section 2(b) of the Competition Act, 2002. *(4 Marks)*
- (ii) Exploration Research Development Limited is a registered Public Limited Company. The company has a unique business idea emerging from research and development in a new area. However, it is a future project and the company has no significant accounting transactions and business activities at present. The company desires to obtain the status of a 'Dormant Company'.
- Advise the company regarding the provisions of the Companies Act, 2013 in this regard and the procedure to be followed in this regard. *(4 Marks)*
5. (a) Analyse and Advise with reference to the provisions of the Companies Act, 2013, the following situations.
- (i) Mr. Peak was appointed as a director at the Annual General Meeting of a limited company held on 30th September, 2015 and he carried on his duties and functions as a director. In the month of August, 2016, it was found that there were certain irregularities in his appointment and on 31st August, 2016,

his appointment was declared invalid. But Mr. Peak continued to act as director even after 31st August, 2016.

- (ii) Perfect Ltd. maintains the Minutes Book of the Board Meetings in loose-leaf system and get them bind once in three months. Board meetings were held on 2nd April, 2016 and 28th April, 2016. Mr. Super, who was the Chairman of these two Board Meetings died on 1.5.2016, without signing the Minutes. (8 Marks)
- (b) (i) Which offences are considered to be Non- cognizable offences under the Companies Act, 2013? (4 Marks)
- (ii) Various grievances have been filed against the activities of a Mahila Urban Co-operative Banking Company to the effect that if unchecked, the shareholders, depositors and others will suffer heavily and the complainants requested for the appointment of directors by Reserve Bank of India.

Discuss whether the Reserve bank has any powers to inspect the records of the Mahila Urban Co-operative Bank to ascertain the truth or otherwise in the complaints and to appoint directors in the Mahila Urban Co-operative Bank under the Banking Regulation Act, 1949. (4 Marks)

6. (a) (i) XYZ Producer Company Limited was incorporated on 1st April, 2016. At present it has got 200 members and its board consists of 10 Directors. The Board of directors of the company seeks your advice on the following proposals:
- (1) Appointment of one expert Director and one Additional Director by the Board for a period of four years.
 - (2) Loan of Rs. 10,000 to Mr. X, a Director of the company repayable within a period of six months.
 - (3) Donation of Rs.10,000 to a Political Party.
- Advise the Board of directors explaining the relevant provisions of the Companies Act, 1956. (4 Marks)
- (ii) Mr. X is an unsecured creditor and has to recover a sum of Rs. 7 lakhs from Global Footwear Company Limited. The said company has become financially insolvent and hence unable to pay its debts. With the object of recovery of the said amount Mr. X is willing to proceed for compulsory winding up of the company. Advise the steps and procedure in this relation under the provisions of the Companies Act, 1956. (4 Marks)
- (b) (i) The Board of Directors of Organized Limited decided to pass a resolution to purchase 35,000 equity shares of Rs. 100 each of PQR Limited at a meeting. Draft a Board Resolution to be passed at the said meeting. (4 Marks)

(ii) Enumerate the obligations of banking companies under the Prevention of Money Laundering Act, 2002. *(4 Marks)*

7. Attempt any Four-

(a) With reference the provisions of Insurance Act, 1938, what do you mean by "Life Insurance Business"? *(4 Marks)*

(b) What are the powers of the Central Government under the Companies Act, 2013 regarding the Appeal against acquittal. *(4 Marks)*

(c) Explain Asset Reconstruction, Financial Assets under the Securitization and Reconstruction of Financial Assets Enforcement of Security and Interest Act 2002. *(4 Marks)*

(d) Explain the principles of "Grammatical Interpretation" and "Logical Interpretation" of a Statute? *(4 Marks)*

(e) Mr. X, director of Fame Ltd. changed his correspondence address for the future business. Now he wants to incorporate this change in his DIN in the database maintained by the Central Government in this regard. Describe the manner to be followed by the Mr. X. *(4 Marks)*

Test Series: September, 2016

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 4 : CORPORATE AND ALLIED LAWS

SUGGESTED ANSWER/HINTS

Time Allowed – 3 Hours

Maximum Marks – 100

1. (a) As per Rule 3 of the Companies (Declaration and Payment of Dividend) Rules, 2014, in the event of inadequacy or absence of profits in any year, a company may declare dividend out of surplus subject to the fulfillment of the following conditions:

1. The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year;

Provided that this sub-rule shall not apply to a company, which has not declared any dividend in each of the three preceding financial year.

2. The total amount to be drawn from such accumulated profits shall not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement;

3. The amount so drawn shall first be utilised to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared;

4. The balance of reserves after such withdrawal shall not fall below 15% of its paid up share capital as appearing in the latest audited financial statement.

In the given case therefore, the company can declare a dividend of 25% provided it has the required residual reserve, after such payment, of 15% of its paid up capital as appearing in its latest audited financial statement. The company should have the dividend recommended by the Board and put up for the approval of the members at the Annual General Meeting as the authority to declare lies with the members of the company.

(b) According to section 128(1) of the Companies Act, 2013, every company is required to prepare and keep the books of accounts and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting.

The proviso to section 128(1) further provides that all or any of the books of account aforesaid and other relevant papers may be kept at such other place in India as the Board of Directors may decide and where such a decision is taken, the company shall, within seven days thereof, file with the Registrar a notice in writing giving the full address of that other place. Further company may keep such books of accounts or other relevant papers in electronic mode as per the Rule 3 of the Companies (Accounts) Rules, 2014.

Therefore, the Board of Bharat Ltd. is empowered to keep its books of account at its corporate office in Jaipur by following the above procedure.

(c) Removal of Member of the SEBI (Section 6 of the Securities and Exchange Board of India Act, 1992)

According to section 6 of the Securities and Exchange Board of India Act, 1992, the Central Government shall have the power to remove a member appointed to the Board, if he:

- (i) is, or at any time has been adjudicated as insolvent;
- (ii) is of unsound mind and stands so declared by a competent court;
- (iii) has been convicted of an offence which, in the opinion of the Central Government, involves a moral turpitude.
- (iv) has, in the opinion of the Central Government so abused his position as to render his continuance in office detrimental to the public interest.

Before removing a member, he will be given a reasonable opportunity of being heard in the matter.

In the present case, a group of petitioners alleged that Mr. Zuber a member of the SEBI has monetary interest in some of the cases that came up before the Board and he embezzled his position and therefore, he should be removed from his office.

Here, above petitioners may approach the Central Government for removal of Mr. Zuber, a member of the SEBI and if the Central Government is of the opinion that Mr. Zuber has so abused his position as to render his continuation in office detrimental to the public interest, the Central Government may remove Mr. Zuber from his office after giving him a reasonable opportunity of being heard in the matter.

- (d) Members not to act as principals in certain circumstances:** Members of stock exchange normally carry out transactions on behalf of investors and hence principal agent relationship exists. A Member can enter into transaction as principal with another member of the Exchange only. If he desires to enter into contract as principal with a non-member, then he has to get written consent from such person to act as principal. Contract note should indicate that he is acting as principal [Section 15, Securities Contract (Regulation) Act, 1956].

Where the member has secured the consent of such person otherwise than in writing he shall secure written confirmation by such person or such consent within three days from the date of the contract [Proviso to Section 15].

Spot delivery contracts are outside the preview of section 15 (Section 18).

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

2. (a) (i) Under section 139(8) of the Companies Act, 2013, any casual vacancy in the office of an auditor shall in the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within thirty days, but if such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

Therefore, in the present case, as the auditor has resigned, the casual vacancy so created can be filled up by the Board appointing Mr. Appropriate. However, the appointment of Mr. Appropriate must be approved by the company by passing of an ordinary resolution at a general meeting of the company which must be convened by the Board within 3 months of the recommendation of the Board.

Mr. Appropriate will be entitled to hold office till the conclusion of the next Annual General Meeting.

Under section 140(1) of the Companies Act, 2013, the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf in the prescribed manner:

Provided that before taking any action under this sub-section, the auditor concerned shall be given a reasonable opportunity of being heard.

Therefore, in terms of section 140 (1) of the Companies Act, 2013 read with rule 7 of the *Companies (Audit & Auditors) Rules, 2014*, the following steps should be taken for the removal of an auditor before the completion of his term:

- a. The application to the Central Government for removal of auditor shall made in Form ADT-2 and shall be accompanied with fees as provided for this purpose under the *Companies (Registration Offices and Fees) Rules, 2014*
- b. The application shall be made to the Central Government within thirty days of the resolution passed by the Board.

c. The company shall hold the general meeting within sixty days of receipt of approval of the Central Government for passing the special resolution.

(ii) **Director elected by small shareholders:** Section 151 of the Companies Act, 2013 provides that a listed company may have one director elected by such small shareholders in such manner and with such terms and conditions as may be prescribed. Further, the explanation to section 151 clarifies that for the purposes of this section “small shareholders” means a shareholder holding shares of nominal value of not more than twenty thousand rupees or such other sum as may be prescribed.

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

(b) (i) **Conditions for preferential issue:** According to regulation 72 of the SEBI (ICDR) Regulations 2009 following are the conditions to be complied with by the company-

(1) A Contemporary Chemicals Limited may make a preferential issue of specified securities, if:

- (a) a special resolution has been passed by its shareholders;
- (b) all the equity shares, if any, held by the proposed allottees in the issuer are in dematerialised form;
- (c) the issuer is in compliance with the conditions for continuous listing of equity shares as specified in the listing agreement with the recognised stock exchange where the equity shares of the issuer are listed;
- (d) the issuer has obtained the Permanent Account Number of the proposed allottees.

Explanation: Where any person belonging to promoter(s) or the promoter group has sold his equity shares in the issuer during the six months preceding the relevant date, the promoter(s) and promoter group shall be ineligible for allotment of specified securities on preferential basis.

(2) Where any person belonging to promoter(s) or the promoter group has previously subscribed to warrants of an issuer but failed to exercise the warrants, the promoter(s) and promoter group shall be ineligible for issue of specified securities of such issuer on preferential basis for a period of one year from:

- (a) the date of expiry of the tenure of the warrants due to non exercise of the option to convert; or

- (b) the date of cancellation of the warrants as the case may be.
- (ii) If a foreign company fails to deliver documents to the Registrar of Companies as required under section 380 of the Companies Act, 2013, the foreign company shall be punishable with a fine which shall be not less than Rs. 1,00,000 but which may extend to Rs. 3,00,000 and in the case of a continuing offence, with an additional fine which may extend to Rs. 50,000 for every day after the first during which the contravention continues. Also, every officer of the foreign company who is in default shall be punishable with an imprisonment for a term which may extend to six months or with a fine which shall not be less than Rs. 25,000 but which may extend to Rs. 5,00,000 or with both. The penalty is provided in section 392 and thus Majestic Ltd. is liable for the contravention of section 380 of the Act.
3. (a) **Reconstruction Scheme of Company:** The provisions contained in sections 391 to 394 of the Companies Act, 1956 are applicable to Ranbaxy Company Limited as it can be considered as a company liable to be wound up within the meaning of section 390 of the Companies Act, 1956. The proposed scheme involves a compromise or arrangement with members and creditors and it attracts section 391 of the said Act.
- (i) **Filing of application:** While the company or any creditor or member can make application to the Court under section 391, it is usual for the company to make an application. On such application the Court may order that a meeting of creditors and/or members be called and held as per the directions of the Court.
- (ii) **To serve notice of Meeting:** The company must send notice of meeting to every creditor/member containing a statement setting forth the terms of compromise or arrangement explaining its effect. Material interest of directors, Managing Director or manager of the company in the scheme and the effect of scheme on their interest should be fully disclosed (Section 393). At the meetings convened as per directions of the Court majority in number representing at least $\frac{3}{4}$ in value of creditors/members present and voting must agree to compromise or arrangement. Thereafter the company must present a petition to the Court for confirmation of the compromise or arrangement.
- (iii) **Notice of application to be served on C.G.:** The notice of application made by the company will be served on the Central Government and the Court will take into consideration representation, if any, made by the Central Government (Section 394A). The Court will sanction the scheme, if satisfied, after considering all relevant matters.
- (iv) **Copy of Order:** Copy of order issued by the Court must be filed with the Registrar of Companies and then only the order will come into effect. Copy of the said order must be annexed to every Memorandum of Association issued thereafter. The scheme sanctioned by the Court shall be binding on all members and creditors

even those who were dissenting.

(b) (i) Under Section 5 of Foreign Exchange Management Act, 1999, certain rules have been framed for drawal of foreign exchange on current account. According to the said rules, drawal of foreign exchange for certain transactions are prohibited. In respect of certain transactions drawal of foreign exchange is permissible with the prior approval of Central Government. In respect of some of the transaction, prior permission of RBI is sufficient for drawal of foreign exchange.

(1) In respect of item No.1 i.e. Payment of Commission on exports made towards equity investment in wholly owned subsidiary abroad of an Indian company is prohibited.

(2) Drawal of foreign exchange for remittance of hiring charges of transponder by TV Channels, can be made with the prior approval of the Central Government.

In the case of (2) above, approval of concerned authority is not required if the payment is made out of funds held in Resident Foreign Currency (RFC) Account or Exchange Earner's Foreign Currency (EEFC) Account of the remitter. Further foreign Exchange can be drawn only from an authorised person.

(ii) Under section 161(1) of the Companies Act, 2013, the articles of a company may confer on its Board of Directors the power to appoint any person, other than a person who fails to get appointed as a director in a general meeting, as an additional director at any time who shall hold office up to the date of the next annual general meeting or the last date on which the annual general meeting should have been held, whichever is earlier.

Further, section 161(4) states that in the case of a public company, if the office of any director appointed by the company in general meeting is vacated before his term of office expires in the normal course, the resulting casual vacancy may, in default of and subject to any regulations in the articles of the company, be filled by the Board of Directors at a meeting of the Board.

In the given case, Mr. Ideal has been appointed as an additional director in order to fill in a casual vacancy. A casual vacancy on the Board can be filled only by means of a board resolution passed at a meeting of the Board and not by circulation. Therefore, the appointment of Mr. Ideal is invalid.

However, it is rather strange that in the given case Mr. Ideal has been appointed as an additional director to fill a casual vacancy in the Board. Actually, additional directors are appointed by the Directors (if authorized by the Articles) to increase the number of directors within the legally prescribed limits and not to fill a casual vacancy. In case Mr. Ideal had been appointed as

an additional director not to fill a casual vacancy, his appointment could have been made by a resolution by circulation under section 161 (1) and he would have held office till the date of the next AGM or the last date when the next AGM should have been held, whichever is earlier. In the given case, as the AGM was due on 31st March 2016 which is presumably the last date for holding it, his appointment would terminate on 31st March 2016.

4. (a) **Oppression & Mismanagement:** Under sections 397 and 398 of the Companies Act, 1956, members may apply to the Company Law Board in cases of oppression and mismanagement. However, bona fide decisions consistent with the company's memorandum and articles are not to be equated with mismanagement even if they turn out to be wrong in the circumstances or these cause temporary losses. The Court will not permit the machinery created by the sections to be used by the minority for compelling the majority to come to terms, where the company is honestly managed. Directors' bona fide decision not to declare dividend and to accumulate available profits into reserves is not mismanagement. (*Thomas Vettom (V.J.) vs. Kuttanad Rubber Co. Ltd. (1984) 56 Com. Cases 284 (Ker)*).

Thus in the given case, the group of members who complain to CLB against the decision of the Board not to declare any dividend and to accumulate available profits into reserves, would not succeed, as the act of directors does not amount to mismanagement. Furthermore, the shareholders cannot compel the Board to recommend a dividend. The Board's recommendations are placed in the general meeting. In the general meeting company can reduce the dividend, but cannot increase the dividend as recommended by the Board. Therefore, the members cannot compel the company to declare dividend and cannot charge the directors with oppression or mismanagement.

Applying the above, answers to the question shall be as under:

- (1) The contention of members shall not be tenable.
 - (2) The act of the Board of directors who acted bona fide, not to recommend any dividend shall not amount to oppression or mismanagement.
- (b) (i) **Agreement:** 'Agreement' includes any arrangement or understanding or action in concert:
- (i) Whether or not, such arrangement, understanding or action is formal or in writing or
 - (ii) Whether or not such arrangement, understanding or action is intended to be enforceable by legal proceedings. [Section 2(b)].

In view of the above definition of 'agreement', an understanding reached by the cement manufacturers to control the price of cement will be an 'agreement' within the meaning of section 2(b) of the Competition Act, 2002 even though the understanding is not in writing and it is not intended to be enforceable by

legal proceedings.

- (ii) **Dormant Company:** According to section 455 of the Companies Act, 2013, a company formed and registered under this Act for the purpose of a future project or to hold an asset or intellectual property and has no significant accounting transaction and an inactive company may make an application to the Registrar in such manner as may be prescribed for obtaining the status of a dormant company. The Registrar shall allow the status of a dormant company to the applicant and issue a certificate after considering of the application. The Registrar shall maintain a register of dormant companies in such form as may be prescribed.

In case of a company which has not filed financial statements or annual returns for two financial years consecutively, the Register shall issue a notice to that company and enter the name of such company in the register maintained for dormant companies.

A dormant company shall have such minimum number of directors, file such documents and pay such annual fee as may be prescribed to the Registrar to retain its dormant status in the register and may become an active company on an application made in this behalf accompanied by such documents and fee as may be prescribed. However, the Registrar shall strike off the name of a dormant company from the register of dormant companies, which has failed to comply with the requirements of this section.

Thus, Exploration Research Development Limited may follow the above procedure to obtain the status of a 'Dormant Company'.

5. (a) (i) In accordance with section 176 of the Companies Act, 2013 acts done by a person as a director shall be deemed to be valid, notwithstanding that it may afterwards be discovered that his appointment was invalid by reason of any defect or disqualification or had terminated by virtue of any provision contained in this Act or in the articles of the company.

The Proviso to section 176 further provide that nothing in this section shall be deemed to give validity to acts done by a director after his appointment has been noticed by the company to be invalid or to have terminated.

In view of the above provisions of section 176 of the Companies Act, 2013, the acts done by Mr. Peak up to the date of the irregularity in his appointment coming to the notice of the company will be deemed as valid and binding on the Company.

Any act done by him after the date on which the irregularity or defect in his appointment was noticed by the company will be deemed invalid. The acts done by Mr. Peak after 31st August, 2016 shall be deemed to be invalid and not binding upon the Company

- (ii) In terms of section 118(1) of the Companies Act, 2013 every company shall cause minutes of the proceedings of every meeting of its Board of Directors or of every

committee of the Board, to be prepared and signed in such manner as may be prescribed and kept within thirty days of the conclusion of every such meeting in books kept for that purpose with their pages consecutively numbered.

According to the Companies (Management and Administration) Rules, 2014:

- (i) The minutes of proceedings of each meeting shall be entered in the books maintained for that purpose along with the date of such entry within 30 days of the conclusion of the meeting.
- (ii) Each page of every such book shall be initialled or signed and the last page of the record of proceedings of each meeting or each report in such books shall be dated and signed by the chairman of the said meeting or the chairman of the succeeding meeting.

Thus, from the clear provisions of the above referred section the Minutes must be kept in books form for that purposes with consecutively numbered pages. Therefore, Minutes cannot be kept in loose leaf system.

In case the chairman passes away before signing the Minutes, the chairman of the succeeding Board meeting shall sign the Minutes.

(b) (i) Offences to be non-cognizable: Following offences under the Companies Act, 2013 are considered to be non-cognizable. According to this section:

- (i) Notwithstanding anything in the Code of Criminal Procedure, 1973, every offence under this Act except the offences referred to in sub-section (6) of section 212 shall be deemed to be non-cognizable within the meaning of the said Code.
- (ii) No court shall take cognizance of any offence under this Act which is alleged to have been committed by any company or any officer thereof, except on the complaint in writing of the Registrar, a shareholder of the company, or of a person authorised by the Central Government in that behalf.

Whereas in case of a government companies, court shall take cognizance of an offence under this Act which is alleged to have been committed by any company or any officer thereof on the complaint in writing of a person authorized by the Central Government in that behalf.[Vide Notification G.S.R. 463(E) dated 5th June 2015]

- (iii) The court may take cognizance of offences relating to issue and transfer of securities and non-payment of dividend, on a complaint in writing, by a person authorised by the Securities and Exchange Board of India.
- (iv) Nothing in this sub-section shall apply to a prosecution by a company of any of its officers.

- (v) Where the complainant is the Registrar or a person authorised by the Central Government, the presence of such officer before the Court trying the offences shall not be necessary unless the court requires his personal attendance at the trial.
 - (vi) The above provisions shall not apply to any action taken by the liquidator of a company in respect of any offence alleged to have been committed in respect of any of the matters in Chapter XX or in any other provision of this Act relating to winding up of companies.
 - (vii) The liquidator of a company shall not be deemed to be an officer of the company.
- (ii) **Power of Reserve Bank of India to inspect banks (Section 35 of the Banking Regulation Act, 1949):** RBI is empowered to conduct inspection of any bank and to give them direction as it deems fit. All banks are bound to comply with such directions. Every directors or other officer of the bank shall produce all such books, documents as required by the inspector. The inspector may examine on oath any director or other officers.

RBI shall supply the bank a copy of such report of the inspection. RBI submits report to Central Government and the latter, on scrutiny, if is of the opinion that the affairs of the bank are being conducted detrimental to the interest of its depositors, it may, after giving an opportunity of being heard, to the bank, may order in writing prohibiting the bank from receiving fresh deposits, direct the RBI to apply section 38 for winding up of the bank.

Power of RBI to appoint Directors (Section 36AB of the Banking Regulation Act, 1949): RBI is empowered to appoint additional Directors for the banking company with effect from the date to be specified in the order, in the interest of the bank or that of depositors. Such additional directors shall hold office for a period not exceeding three years or such further periods not exceeding three years at a time.

6. (a) (i) **Producer Company**

(1) **Appointment of expert director and additional director:** Section 581P(6) of the Companies Act, 1956 empowers the Board of directors of a producer company to co-opt one or more expert directors or an additional director not exceeding one fifth of the total number of directors for such period as the Board may deem fit. But the maximum period shall not exceed the period specified in the Articles of the company [Second Proviso to section 581P(6)].

The number of directors proposed to be co-opted is only 2 and it does not exceed one-fifth of the total number of directors. They can hold office for the period specified by the Board provided it does not exceed the period specified in the Articles [Section 161(1) of the Companies Act, 2013 stipulating that the additional director can hold office only upto the date of the

next annual general meeting or the last date on which the annual general meeting should have been held, whichever is earlier, is not applicable to a producer company]. Hence the proposed appointment of one expert director and one additional director is in order.

- (2) **Loan to a director:** Section 581ZK empowers the Board of directors to provide financial assistance to the members of the producer company subject to the provisions made in articles and also subject to certain conditions laid down in 581ZK(b). But any loan or advance to any director or his relative shall be granted only after the approval by the members in general meeting. (Proviso to Section 581ZK).

In view of the above, the directors must convene the general meeting and get the approval of the members before granting the proposed loan of Rs.10,000 to X, a director of the company [According to Section 581C(5)a producer company is a private limited company and there is no limit to the number of its members].

- (3) **Donation to a Political Party:** Producer company shall not make directly or indirectly to any political party or for any political purpose to any person any contribution or subscription or make available any facilities including personnel or material [Second proviso to Section 581ZH]. As the donation to a political party is prohibited, the company cannot donate Rs.10,000 to a political party.

- (ii) **Procedure in case of Compulsory Winding-Up:** Mr. X has to take the following steps to put the company into compulsory winding up:

1. A petitions for winding up of the company is to be filed in the high court, where the registered office of the company is located under section 439(1)(b) read with section 433(e) and (f) of the Companies Act, 1956. A copy of the petition should be served on the company.
2. The petition should be filled along with an affidavit showing sufficient ground for the appointment of a provisional liquidator till an order is passed by the High Court appointing an official liquidator.
3. After obtaining the winding up order from the high court the same should be advertised within 14 days in a newspaper in English language and in the regional language of the state where the company is registered.
4. A certified copy of the winding up order passed by the court should be filed with the concerned Registrar of Companies along with the prescribed fees within 30 days from the date of the winding up order [Section 445(i)].
5. The winding up proceedings will be carried out by the official liquidator till dissolution of the company.

(b) (i) Board Resolution: Purchase of Equity Shares

Resolution passed at the meeting of the board of directors of Organised Limited held at its registered office situated at ____ on ____ (day) at ____ A.M.

“Resolved unanimously that pursuant to provisions of Section 186(2) of the Companies Act, 2013, the company be and is hereby authorized to purchase 35,000 equity shares of Rs. 100 each of PQR Limited, the investment in addition to other investments made to date in the aggregate being within the limits prescribed under the said section.”

“Resolved further that Mr., a Director of the company, be and is hereby authorised to sign /execute the necessary documents in this connection.”

Sd/-

Board of Directors

Organized Limited

(ii) Section 12 of the Prevention of Money Laundering Act, 2002 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 –

- (a) 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;
- (b) 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;
- (c) verify the identity of its clients in such manner and subject to such conditions, as may be prescribed;
- (d) identify the beneficial owner, if any, of such of its clients, as may be prescribed;
- (e) 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 (1) 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 (1) 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.

7. (a) As per section 2(11) of the Insurance Act, 1938, Life Insurance Business means the business of effecting contracts of insurance upon human life, including any contract whereby the payment of money is assured on death (except death by accident only) or the happening of any contingency dependent on human life, and any contract which is subject to payment of premiums for a term dependent on human life and shall be deemed to include:
- (i) The granting of disability and double or triple indemnity accident benefits, if so provided in the contract of insurance.
 - (ii) The granting of annuities upon human life; and
 - (iii) The granting of superannuation allowances and benefits payable out of any fund applicable solely to the relief and maintenance of persons engaged or who have been engaged in any particular profession, trade or employment or of the dependents of such persons.
- (b) **Appeal against acquittal:** According to section 444 of the Companies Act, 2013, the Central Government may, in any case arising under this Act, direct –
- (i) any company prosecutor, or
 - (ii) authorise any other person either by name or by virtue of his office, to present an appeal from an order of acquittal passed by any court, other than a High Court.
- Appeal presented by such prosecutor or other person shall be deemed to have been validly presented to the appellate court.
- (c) **Asset Reconstruction:** 'Asset Reconstruction' means acquisition by any securitization company or reconstruction company of any right or interest of any bank or financial institution in any financial assistance for the purpose of realization of such financial assistance. (Section 2(b) of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.)

Financial Assets

Financial Assets' means debt or receivables and includes:

- (i) a claim to any debt or receivables or part thereof, whether secured or unsecured; or

- (ii) any debt or receivables secured by mortgage of, or charge on, immovable property; or a mortgage, charge, hypothecation or pledge of movable property; or
 - (iii) any right or interest in the security, whether full or part underlying such debt or receivables; or
 - (iv) any beneficial interest in property, whether movable or immovable or in such debt, receivables, whether such interest is existing, future accruing, conditional or contingent; or
 - (v) any financial assistance. (Section 2(1)).
- (d) **Principles of Grammatical Interpretation and Logical Interpretation:** In order to ascertain the meaning of any law/ statute the principles of Grammatical and Logical Interpretation is applied to conclude the real meaning of the law and the intention of the legislature behind enacting it.
- Meaning-** Grammatical interpretation concerns itself exclusively with the verbal expression of law. It does not go beyond the letter of the law, whereas Logical interpretation on the other hand, seeks more satisfactory evidence of the true intention of the legislature.
- (e) **Intimation of changes in particulars specified in DIN application:** The Companies (Appointment and Qualification of Directors) Rules, 2014 provides for the procedure for intimation of changes in particulars specified in the DIN application. According to which every individual who has been allotted a DIN under these rules shall, in the event of any change in his particulars as **stated in** Form DIR-3, intimate such change(s) to the Central Government within a period of thirty days of such change(s) in Form DIR-6 in the following manner, namely :-
- A. the applicant shall download Form DIR-6 from the portal and fill in the relevant changes, attach copy of the proof of the changed particulars and verification in the Form DIR-7 all of which shall be scanned and submitted electronically;
 - B. the form shall be digitally signed by a chartered accountant in practice or a company secretary in practice or a cost accountant in practice;
 - C. the applicant shall submit the Form DIR-6