Test Series : October, 2015

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 by the candidates.

Questions

1. (a) Hari Ltd. has entered into a sale contract of Rs. 5 crores with X Ltd. during 2013-14 financial year. The profit on this transaction is Rs. 1 crore. The delivery of goods to take place during the first month of 2014-15 financial year. In case of failure of Hari Ltd. to deliver within the schedule, a compensation of Rs. 1.5 crores is to be paid to X Ltd. Hari Ltd. planned to manufacture the goods during the last month of 2013-14 financial year. As on balance sheet date (31.3.2014), the goods were not manufactured and it was unlikely that Hari Ltd. will be in a position to meet the contractual obligation.

   (i) Should Hari Ltd. provide for contingency as per AS 29?

   (ii) Should provision be measured as the excess of compensation to be paid over the profit?

   (b) Sun Ltd., has entered into a contract by which it has the option to sell its identified property, plant and equipment (PPE) to Axe Ltd. for Rs. 100 lakhs after 3 years whereas its current market price is Rs. 150 lakhs. Is the put option of Sun Ltd., a financial instrument? Explain

   (c) Light Ltd. acquired 30% of East India Ltd. shares for Rs. 2,00,000 on 01-06-14. By such an acquisition Light Ltd. can exercise significant influence over East India Ltd. During the financial year ending on 31-03-14 East India Ltd. earned profits Rs. 80,000 and declared a dividend of Rs. 50,000 on 12-08-2014. East India reported earnings of Rs. 3,00,000 for the financial year ending on 31-03-15 and declared dividends of Rs. 60,000 on 12-06-2015.

   Calculate the carrying amount of investment in:

   (i) Separate financial statements of Light Ltd. as on 31-03-15;

   (ii) Consolidated financial statements of Light Ltd.; as on 31-03-15;

   (iii) What will be the carrying amount as on 30-06-2015 in consolidated financial statements?

(d) A Ltd. purchased a plant from B Ltd. on 30-09-2014 with a quoted price of Rs. 180 lakhs. B Ltd. offer 3 months credit with a condition that discount of 1.25% will be allowed if the payment were made within one month. VAT is 12.5% on the quoted price. Company incurred 2% on transportation costs and 3% on erection costs of the quoted price. Preoperative cost amount to Rs. 1.50 lakhs. To finance the purchase of the machinery, company took a term bank loan of Rs. 125 lakhs at an interest rate of 14.50% per annum. The machine was ready for use on 31-12-2014; however, it was put to use only on 01-04-2015.

(i) Find out the original cost.

(ii) Suggest the accounting treatment for the cost incurred during the period between the date the machine was ready for use and the actual date the machine was put to use. *(4 x 5 = 20 Marks)*

2. From the following summarized Balance Sheets of a group of companies and the other information provided, draw up the consolidated Balance Sheet as on 31.3.2015. Figures given are in Rs. Lakhs:

Balance Sheets as on 31.3.2015

	X	Y	Z		X	Y	Z
Shares capital (in shares of Rs. 100 each)	*300*	*200*	*100*	*Fixed Assets less depreciation*	*130*	*150*	*100*
Reserves	*50*	*40*	*30*	*Cost of investment in Y Ltd.*	*180*	–	–
Profit and loss balance	*60*	*50*	*40*	*Cost of investment in Z Ltd.*	*40*	–	–
Trade payables	*40*	*10*	*15*	*Cost of investment in Z Ltd.*	–	*80*	–
Y Ltd. balance	–	–	*15*	*Inventory*	*50*	*20*	*20*
Z Ltd. balance	*50*	–	–	*Trade receivables*	*70*	*20*	*40*
				Z Ltd. balance	–	*10*	–
				X Ltd. balance	–	–	*30*
				Cash and bank balance	*30*	*20*	*10*
	500	*300*	*200*		*500*	*300*	*200*

X Ltd. holds 1,60,000 shares and 30,000 shares respectively in Y Ltd. and Z Ltd.; Y Ltd. holds 60,000 shares in Z Ltd. These investments were made on 1.7.2014 on which date the provision was as follows:

	Y Ltd.	*Z Ltd.*
Reserves	*20*	*10*
Profit and loss account	*30*	*16*

In December, 2014 Y Ltd. invoiced goods to X Ltd. for Rs. 40 lakhs at cost plus 25%. The closing inventory of X Ltd. includes such goods valued at Rs. 5 lakhs.

Z Ltd. sold to Y Ltd. an equipment costing Rs. 24 lakhs at a profit of 25% on selling price on 1.1.2015. Depreciation at 10% per annum was provided by Y Ltd. on this equipment.

X Ltd. proposes dividend at 10%.

Details of Trade payables and Trade receivables:

	X	Y	Z
Trade payables			
Bills Payable	10	-	5
Sundry creditors	30	10	10
	40	10	15
Trade receivables			
Debtors	70	10	20
Bills Receivables	-	10	20
	70	20	40

Bills payables of Z Ltd. represent acceptances given to Y Ltd. out of which Y Ltd. had discounted bills worth Rs. 3 lakhs.

Trade receivables of X Ltd. include Rs. 5 lakhs being the amount due from Y Ltd.

(16 Marks)

3. Given below is the summarized Balance Sheet of Hello Ltd. as on 31.3.2014:

(Rs. in lakhs)

Equity share capital	4.00	Block assets less depreciation to date	6.00
(in equity shares of Rs. 10 each)		Inventory and trade receivables	5.30
10% preference share capital	3.00	Cash and bank	0.70
General reserve	1.00		
Profit and loss account	1.00		
Trade payables	3.00		
	12.00		12.00

Good Ltd. another existing company holds 25% of equity share capital of Hello Ltd. purchased at Rs. 10 per share.

It was agreed that Good Ltd. should take over the entire undertaking of Hello Ltd. on 30.9.2014 on which date the position of current assets (except cash and bank balances) and trade payables was as follows:

Inventory and trade receivables	Rs. 4 lakhs
Trade payables	Rs. 2 lakhs

Profits earned for half year ended 30.09.2014 by Hello Ltd. was Rs. 70,500 after charging depreciation of Rs. 32,500 on block assets. Hello Ltd. declared 10% dividend for 2013-14 on 30.08.2014 and the same was paid within a week.

Goodwill of Hello Ltd. was valued at Rs. 80,000 and block assets were valued at 10% over their book value as on 31.3.2014 for purposes of take over. Preference shareholders of Hello Ltd. will be allotted 10% preference shares of Rs. 10 each by Good Ltd. Equity shareholders of Hello Ltd. will receive requisite number of equity shares of Rs. 10 each from Good Ltd. valued at Rs. 10 per share.

(a) Compute the purchase consideration.

(b) Explain, how the capital reserve or goodwill, if any, will appear in the Balance Sheet of Good Ltd. after absorption.

Assume that Block assets have been taken over at 10% appreciated value after considering depreciation. *(16 Marks)*

4. Key Ltd. is willing to sell its business. The purchaser has sought professional advice for the valuation of the goodwill of the company. He has the last audited financial statements together with some additional information. Help him to ascertain the correct price for the purpose of purchase:

The extract of the Balance Sheet as on 31-3-2014 is as under:

Liabilities	Rs.	Assets	Rs.
Equity Share Capital (shares of Rs. 100 each)	9,50,000	Goodwill	2,75,000
8% Preference Share Capital (shares of Rs. 100 each)	2,25,000	Land & Building	5,45,000
Reserves & Surplus	10,25,500	Plant & Machinery	4,55,000
9% Debentures	5,60,000	Investments in shares	4,85,000
Current Liabilities	3,25,640	Inventories	3,80,000
		Trade Receivables (net)	4,25,620
		Cash & Bank balance	5,20,520
	30,86,140		30,86,140

(1) The purchaser wants to acquire all the equity shares of the company.

(2) The Debentures will be redeemed at a discount of 25% of the value in Balance Sheet and investments in share will be sold at their present market value which is quoted as Rs. 4,95,200. The above will be prior to the purchase of the equity shares.

For the purpose of pricing of Goodwill:

(3) The normal rate of return on net assets for equity shares is 10%.

(4) Profits for the past three years after debenture interest but before Preference Share Dividend have been as under:

31-3-2014	Rs. 2,95,000
31-3-2013	Rs. 4,99,000
31-3-2012	Rs. 3,25,000

(5) Goodwill is valued at three years purchase of the adjusted average super profit.

(6) In the year 2013, 20% of the profit mentioned above was due to non recurring transaction resulting in increase of profit.

(7) The Land & Building has a current rental value of Rs. 62,400 and a 8% return is expected from the property.

(8) On 31-3-2014, 8% of debtors existing on the date had been written as bad and charged to Profit and Loss Account as Provision for Bad debts. The same are now recoverable Tax is applicable at 35%.

(9) A claim of compensation long contingent of Rs. 25,000 has perspired and is to be accounted for.

(10) No Debenture interest shall be payable in future due to its redemption. *(16 Marks)*

5. (a) Peace Ltd. granted Rs. 10,00,000 loan to its employees on January 1, 2014 at a concessional interest rate of 4% per annum. Loan is to be repaid in five equal annual instalments along with interest. Market rate of interest for such loan is 10% per annum. Following the principles of recognition and measurement as laid down in AS 30 'Financial Instruments : Recognition and Measurement', record the entries for the year ended 31st December, 2014 for the loan transaction, and also calculate the value of loan initially to be recognised and amortised cost for all the subsequent years. The present value of Rs. 1 receivable at the end of each year based on discount factor of 10% can be taken as:

Year end	1	0.9090
	2	0.8263
	3	0.7512

	4	0.6829
	5	0.6208

(b) After the havoc caused by flood in Jammu and Kashmir, a group of companies undertakes during the period from October, 2014 to December, 2014 various commercial activities, with considerable concessions/discounts, along the related affected areas. The management intends to highlight the expenditure incurred on such activities as expenditure incurred on activities undertaken to discharge corporate social responsibility, while publishing its financial statements for the year 2014-2015. State whether the management's intention is correct or not and why?

(10 + 6 = 16 Marks)

6. (a) Lock Ltd. supplies the following information using which you are required to calculate the economic value added.

Financial Leverage	1.4 times	
Capital (equity and debt)	Equity shares of Rs. 1,000 each	34,000 (number)
	Accumulated profit	Rs. 260 lakhs
	10 percent Debentures of Rs. 10 each	80 lakhs (number)
Dividend expectations of equity shareholders	17.50%	
Prevailing Corporate Tax rate	30%	

(b) Flower Ltd. grants 1,000 employees stock options on 1.4.2011 at Rs.40, when the market price is Rs.160. The vesting period is 2½ years and the maximum exercise period is one year. 300 unvested options lapsed on 1.5.2013. 600 options were exercised on 30.6.2014. 100 vested options lapsed at the end of the exercise period. Pass Journal Entries giving suitable narrations. *(6 + 10 = 16 Marks)*

7. Answer any **four** of the following:

(a) R Limited borrowed an amount of Rs. 150 crores on 1.4.2014 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. Since the weighted average cost of capital is 13% p.a., the accountant of R Ltd. capitalized Rs. 19.50 crores for the accounting period ending on 31.3.2015. Due to surplus fund out of Rs. 150 crores an income of Rs. 3.50 crores was earned and credited to profit and loss account. Comment on the above treatment of accountant with reference to relevant accounting standard.

(b) While closing its books of account on 31st March, 2015 a Non-Banking Finance Company has its advances classified as follows:

	Rs. in lakhs
Standard assets	16,800
Sub-standard assets	1,340
Secured portions of doubtful debts:	
– upto one year	320
– one year to three years	90
– more than three years	30
Unsecured portions of doubtful debts	97
Loss assets	48

Calculate the amount of provision, which must be made against the Advances.

(c) While preparing its final accounts for the year ended 31st March, 2015, a company made a provision for bad debts @ 5% of its total trade receivables. In the last week of February 2015, trade receivables for 2 lakhs had suffered heavy loss due to earthquake. The loss was not covered by any insurance policy. In April, 2015, the trade receivable became bankrupt. Can the company provide for full loss arising out of insolvency of trade receivable in the final accounts for year ended 31st March, 2015?

(d) The following data apply to 'X' Ltd. defined benefit pension plan for the year ended 31.03.15, calculate the actual return on plan assets:

- Benefits paid	2,00,000
- Employer contribution	2,80,000
- Fair market value of plan assets on 31.03.15	11,40,000
- Fair market value of plan assets as on 31.03.14	8,00,000

(e) Krishna Ltd., has provided the following information:

	Rs.
Depreciation as per accounting records	= 2,00,000
Depreciation as per income tax records	= 5,00,000
Unamortized preliminary expenses as per tax record	= 30,000

There is adequate evidence of future profit sufficiency. How much deferred tax asset/liability should be recognized as transition adjustment? Tax rate 50%.

(4 x 4 = 16 Marks)

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

SUGGESTED ANSWERS/HINTS

1. (a) (i) AS 29 "Provisions, Contingent Liabilities and Contingent Assets" provides that when an enterprise has a present obligation, as a result of past events, that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation, a provision should be recognised. Hari Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Hari Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation. Therefore, Hari Ltd. should provide for the contingency amounting Rs. 1.5 crores as per AS 29.

(ii) Provision should not be measured as the excess of compensation to be paid over the profit. The goods were not manufactured before 31st March, 2014 and no profit had accrued for the financial year 2013-2014. Therefore, provision should be made

(b) As per AS 31, Financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. In the given case, for the purpose of the definition of financial instrument, Property, Plant and Equipment do not qualify the definition of financial asset as per the standard.

To asses whether the put option of Sun Ltd., is a financial instrument or not it is necessary to evaluate the past practice of Sun Ltd. If Sun Ltd. has the past practice of settling net, then it becomes a financial instrument.

If Sun Ltd. intends to sell the identified Property, Plant and Equipment and settle by delivery and there is no past practice of settling net, then the contract should not be accounted for as financial instrument under AS 30 " Financial Instruments: Recognitions Measurement" and AS 31 "Financial Instrument: Presentation".

(c) (i) Carrying amount of investment in Separate Financial Statement of Light Ltd. as on 31.03.15

	Rs.
Amount paid for investment in Associate (on 1.06.2014)	2,00,000
Less: Pre-acquisition dividend (Rs.50,000 x 30%)	(15,000)
Carrying amount as on 31.3.2015 as per AS 13	1,85,000

(ii) Carrying amount of investment in Consolidated Financial Statements[*] of Light Ltd. as on 31.3.2015 as per AS 23

	Rs.
Carrying amount as per separate financial statements	1,85,000
Add: Proportionate share of profit of investee as per equity method (30% of Rs.3,00,000)	90,000
Carrying amount as on 31.3.2015	2,75,000

(iii) Carrying amount of investment in Consolidated Financial Statement of Light Ltd. as on 30.6.2015 as per AS 23

	Rs.
Carrying amount as on 31.3.2015	2,75,000
Less: Dividend received (Rs. 60,000 x 30%)	(18,000)
Carrying amount as on 30.6.2015	2,57,000

(d) (i) Original cost of the machine

Particulars	*Rs. in lakhs*	*Rs. in lakhs*
Quoted price	180.00	
Less: Discount @1.25%	(2.25)	177.75
Add: VAT @12.5%		22.50
Transportation @ 2%		3.60
Erection cost @ 3%		5.40
Pre-operative cost		1.50
Finance cost (14.5% on Rs. 125 lakhs for the period 01.10.14 to 31.12.14)		4.53
Total		215.28

(ii) Cost incurred during the period between the date the machine was ready for use and the actual date the machine was put to use

Finance cost amounting Rs. 4.53 lakhs (14.50% on Rs. 125 lakhs for the period 01.01.2015 to 31.03.2015) will be charged to profit and loss account as per AS 16 "Borrowing Costs".

[*] It is assumed that Light Ltd. has a subsidiary company and it is preparing Consolidated Financial Statements.

2. **Consolidated Balance Sheet of X Ltd. and its subsidiaries Y Ltd. and Z Ltd. as at 31st March, 2015**

Particulars	*Note No.*	*(Rs. in Lacs)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital		300.00
(b) Reserves and Surplus	1	151.90
(2) **Minority Interest(W.N 4)**		79.30
(3) **Current Liabilities**		
(a) Trade payables	2	58.00
(b) Other current liabilities	3	55.00
Total		644.20
II. **Assets**		
(1) **Non-current assets**		
Fixed assets		
Tangible assets	4	372.20
(2) **Current assets**		
(a) Inventories	5	89.00
(b) Trade receivables	6	123.00
(c) Cash and cash equivalents	7	60.00
Total		644.20

Notes to Accounts

			(Rs. in lacs)	*(Rs. in lacs)*
1.	**Reserves and Surplus**			
	Capital Reserve [W.N. 3]		13.40	
	Other Reserves [W.N. 7]		81.60	
	Profit and Loss Account [W.N. 6]		56.90	151.90
2.	**Trade payables**			
	X Ltd.	Rs. 40.00		
	Y Ltd.	Rs. 10.00		
	Z Ltd.	Rs. 15.00	65.00	

	Less: Mutual indebtedness	Rs. (5.00)		
	Less: Mutual indebtedness [5-3]	Rs. (2.00)	(7.00)	58.00
3.	**Other current liabilities**			
	(a) Current Account Balances			
	X Ltd.	Rs. 50.00		
	Z Ltd.	Rs. 15.00		
		Rs. 65.00		
	Less: Mutual indebtedness (Rs. 10+ 30)	(Rs. 40.00)	25.00	
	(b) Proposed Dividend		30.00	55.00
4.	**Tangible assets**			
	Fixed Assets			
	X Ltd.		130.00	
	Y Ltd.		150.00	
	Z Ltd.		100.00	
			380.00	
	Less: Unrealised profit [W.N. 5]		(7.80)	372.20
5.	**Inventories**			
	X Ltd.		50.00	
	Y Ltd.		20.00	
	Z Ltd.		20.00	
			90.00	
	Less: Unrealised profit [5 x 25 / 125]		(1.00)	89.00
6.	**Trade receivables**			
	X Ltd.	Rs. 70.00		
	Y Ltd.	Rs. 20.00		
	Z Ltd.	Rs. 40.00	130.00	
	Less: Mutual indebtedness	Rs. (5.00)		
	Less: Mutual indebtedness	Rs. (2.00)	(7.00)	123.00
7.	**Cash and Cash Equivalents**			
	X Ltd.	Rs. 30.00		
	Y Ltd.	*Rs.* 20.00		
	Z Ltd.	Rs. 10.00		60.00

Working Notes:

Shareholding Pattern

	Y Ltd.	*Z Ltd.*
Total Shares	2 lakh shares	1 lakh shares
X Ltd's holding	1.6 lakh shares [80 %]	3 lakhs [30%]
Y Ltd's holding	NA	6 lakhs [60%]
Minority Holding	4 lakh shares (20 %)	1 lakh shares (10%)

		(Rs. in lakhs)		
		Capital Profit	*Revenue Reserve*	*Revenue profit*
(1)	Analysis of Profits of Z Ltd.			
	Reserves on 1.7.2014	10.00		
	Profit and Loss A/c on 1.7.2014	16.00		
	Increase in Reserves		20.00	
	Increase in Profit	_____	_____	24.00
		26.00	20.00	24.00
	Less: Minority Interest (10%)	(2.60)	(2.00)	(2.40)
		23.40	18.00	21.60
	Share of X Ltd. [30%]	7.80	6.00	7.20
	Share of Y Ltd. [60%]	15.60	12.00	14.40
(2)	Analysis of Profits of Y Ltd.			
	Reserves on 1.7.2014	20.00		
	Profit and Loss A/c on 1.7.2014	30.00		
	Increase in Reserves		20.00	
	Increase in Profit	_____	_____	20.00
		50.00	20.00	20.00
	Share in Z Ltd. [WN 1]	_____	12.00	14.40
		50.00	32.00	34.40
	Less: Minority Interest (20%)	(10.00)	(6.40)	(6.88)
	Share of X Ltd.[80%]	40.00	25.60	27.52
(3)	Cost of Control			
	Investments in Y Ltd.			180.00

	Investments in Z Ltd.			120.00
				300.00
	Less: Paid up value of investments			
	in Y Ltd.	(160.00)		
	in Z Ltd.	(90.00)	(250.00)	
	Capital Profit			
	in Y Ltd. [WN 1]	(40.00)		
	in Z Ltd. [WN 2]	(23.40)	(63.40)	(313.40)
	Capital Reserve			13.40
(4)	Minority Interest	Y Ltd.	Z Ltd.	
	Share Capital	40.00	10.00	
	Capital Profit	10.00	2.60	
	Revenue Reserves	6.40	2.00	
	Revenue Profits	6.88	2.40	
		63.28	17.00	
	Less: Unrealised profit on inventory (20% of 1)	(.20)		
	Unrealised profit on equipment (10% of *Rs.* 7.8)	____	(.78)	
		63.08	16.22	
(5)	Unrealised Profit on equipment sale			
	Cost	24.00		
	Profit [25 % on selling price]	8.00		
	Selling Price	32.00		
	Unrealised profit = $\left[8-\left(8\times\frac{10}{100}\times\frac{3}{12}\right)\right]$			
	$= 8.00 - 0.20 = 7.80$			
(6)	Profit and Loss Account – X Ltd.			
	Balance	60.00		
	Less: Proposed Dividend	(30.00)		
		30.00		
	Share in Y Ltd.	27.52		
	Share in Z Ltd.	7.20		

		64.72		
	Less: Unrealised profit on equipment (90% of 7.8)	(7.02)		
		57.70		
	Less: Unrealised profit on inventory $\left(5 \times \frac{25}{125} \times 80\%\right)$	(.80)		
		56.90		
(7)	Reserves – X Ltd.			
	X Ltd.	50.00		
	Share in Y Ltd. [WN 2]	25.60		
	Share in Z Ltd. [WN 1]	6.00		
		81.60		

3. (a) Calculation of Purchase Consideration (for net assets of Hello Ltd. taken over)

Assets taken over:	*Rs.*
Goodwill as agreed	80,000
Block Assets at 10% over their book value as on 31.3.2014	6,60,000*
(agreed value for purposes of take over 6,00,000 X 110%)	
Inventory and trade receivables as on 30.09.2014	4,00,000
Cash and Bank (See Working Note)	1,33,000
	12,73,000
Less: Liabilities taken over:	
Trade payables as on 30.09.2014	(2,00,000)
Purchase Consideration	10,73,000
Calculation of Shares Allotted:	*Rs.*
Net Assets taken over	10,73,000
Less: Allotment of 10% preference shares to preference shareholders of Hello Ltd.	(3,00,000)
	7,73,000
Less: Belonging to Good Ltd. (1/4 × Rs. 7,73,000)	(1,93,250)
Payable to other equity shareholders	5,79,750

* It is assumed that block assets have been taken over at 10% appreciated value after considering depreciation.

Number of equity shares of Rs. 10 each to be issued (valued at Rs. 10 each) = 57,975

Calculation of Capital Reserve:	*Rs.*	*Rs.*
Net Assets taken over		10,73,000
Less: Preference shares to be allotted	(3,00,000)	
Equity shares to be allotted	(5,79,750)	
Cost of investments	(1,00,000)	(9,79,750)
Capital Reserve		93,250
Alternatively, Capital Reserve may be computed as follows:		
Value of investments in HELLO Ltd.		1,93,250
Less: Cost of investments		(1,00,000)
		93,250

(b) Balance Sheet of Good Ltd. as at 30th September, 2014 (Extract)

Particulars	*Note No.*	*Rs.*
I. **Equity and Liabilities**		
(1) Shareholder's Funds		
Reserves and Surplus	1	13,250

Notes to accounts

1. Reserves and Surplus		*Rs.*
Capital Reserve	93,250	
Less: Goodwill	(80,000)	13,250

Working Note:

Ascertainment of Cash and Bank Balances as on 30th September, 2014

Balance Sheet as at 30th September, 2014

Particulars	*Note No.*	*Rs.*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	7,00,000
(b) Reserves and Surplus	2	2,00,500

	(2) **Current Liabilities**		
	Trade Payables	3	2,00,000
	Total		11,00,500
II.	**Assets**		
	(1) **Non-current assets**		
	(a) Fixed assets		
	Tangible assets	4	5,67,500
	(2) **Current assets**		
	(a) Inventories &Trade receivables	5	4,00,000
	(b) Cash and cash equivalents *(Bal. fig.)*		1,33,000
	Total		11,00,500

Notes to Accounts

			Rs.	*Rs.*
1.	Share Capital			
	Equity Share Capital		4,00,000	
	10% Preference Share Capital		3,00,000	7,00,000
2.	Reserves and surplus			
	General Reserve			1,00,000
	Profit and Loss Account:			
	Balance brought forward	1,00,000		
	Add: Profit for the first half	70,500	1,70,500	
	Less: Dividend on preference share capital paid	30,000		
	Dividend on equity share capital paid	40,000	(70,000)	1,00,500
				2,00,500
3.	Trade Payables			2,00,000
4.	Tangible Assets			
	Block Assets		6,00,000	
	Less: Depreciation		(32,500)	5,67,500
5.	Inventories & Trade Receivables			4,00,000

4. Valuation of goodwill: Super profits method

Particulars	*Rs.*	*Rs.*
Net trading assets attributable to equity share holders		
As computing in (WN 1)	23,18,506	
Less: Preference share Capital	(2,25,000)	20,93,506
Normal Rate of Return (NRR) to equity share holders		10%
Normal Profit available to equity share holders (a × b)		2,09,351
Future Maintainable Profits (FMP) to equity share holders		
As computed in (WN 3)	3,75,096	
Less: Preference dividend* (8% of 2,25,000)	(18,000)	3,57,096
Super profits to equity share holders		1,47,745
Goodwill (1,47,745 x 3)		4,43,235

*Since, NRR is given as percentage of net assets attributable to equity shareholders, preference share capital and preference share dividend have been deducted from the net assets and future maintainable profit respectively.

Value Per Equity Share

Net Trading Assets attributable to equity shareholders	Rs. 20,93,506
Add: Goodwill	Rs. 4,43,235
	Rs. 25,36,741

Number of Equity Shares = 9,500 shares,

Value per share= $\frac{25,36,741}{9,500}$ = Rs. 267 (approx.)

Working Notes:

1. **Computation of net trading assets**

Particulars	*Rs.*	*Rs.*
Sundry assets		
i Land & Building (62,400 ÷ 8%)	7,80,000	
ii Plant and Machinery	4,55,000	
iii Inventory	3,80,000	
iv Trade receivables (4,25,620 ÷ 92%)	4,62,630	
v Bank balance (given balance 5,20,520 + Sale of investment 4,95,200 - redemption of debentures 5,60,000 × 75%)	5,95,720	26,73,350

Less: Outside liabilities:		
i Current Liabilities	3,25,640	
ii Contingent Liability now to be accounted for	25,000	
iii Tax provision (WN 2)	4,204	(3,54,844)
Net assets		23,18,506

2. **Calculation of tax provision**

	Rs.
Profit on reversal of provision for bad debts	37,010
Loss on recognizing omitted claim (assuming tax deductible)	(25,000)
Net incremental profit on which tax is payable	12,010
Tax provision 35%	4,204

3. **Computation of future maintainable profit for the year ended on 31st March**

Particulars	*2012*	*2013*	*2014*
Profit after tax	3,25,000	4,99,000	2,95,000
Less: Non-recurring profits (after tax) (20% of 2013 Profit)	-	(99,800)	-
Less: Claims not recorded (after tax) [25,000 x (1-35%)]	-	-	(16,250)
Add: Provision no longer required (net of tax) [4,25,620 × 8/92 × (1-35%)]	-	-	24,057
Adjusted profits after tax	3,25,000	3,99,200	3,02,807

Simple average of the profits (as profits are fluctuating)	3,42,336
Adjustments for items which will not be reflected in future	
Add: Debenture interest (net of tax) [5,60,000 × 9% × (1 – 0.35)]	32,760
Future maintainable profit [for shareholders- both preference and equity)	3,75,096

Assumptions

1. Tax effect has been ignored on profit on sale of investments and discount on redemption of debentures.
2. Assets and liabilities are recorded at realizable value or fair value. In the absence of information, book values are assumed to be fair values.
3. Additional depreciation on revaluation of property is ignored.

4. Profits for past three years given in the question have been assumed as profits after tax.

5. (a) (i) Journal Entries in the books of Peace Ltd.

for the year ended 31st December, 2014 (regarding loan to employees)

		Dr. (Rs.)	Cr. (Rs.)
Staff loan A/c	Dr.	10,00,000	
To Bank A/c			10,00,000
(Being the disbursement of loans to staff)			
Staff cost A/c Rs. (10,00,000 – 8,54,763) [Refer part (ii)]	Dr.	1,45,237	
To Staff loan A/c			1,45,237
(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. 8,54,763)			
Staff loan A/c	Dr.	85,476	
To Interest on staff loan A/c			85,476
(Being the charge of interest @ market rate of 10% to the loan)			
Bank A/c	Dr.	2,40,000	
To Staff loan A/c			2,40,000
(Being the repayment of first instalment with interest for the year)			
Interest on staff loan A/c	Dr.	85,476	
To Profit and loss A/c			85,476
(Being transfer of balance in staff loan Interest account to profit and loss account)			
Profit and loss A/c	Dr.	1,45,237	
To Staff cost A/c			1,45,237
(Being transfer of balance in staff cost account to profit and loss account)			

(ii) Calculation of initial recognition amount of loan to employees

Year end	*Cash Inflow*		*Total*	*P.V. factor*	*Present value*
	Principal	*Interest @ 4%*			
	Rs.	*Rs.*	*Rs.*		*Rs.*
2014	2,00,000	40,000	2,40,000	0.9090	2,18,160
2015	2,00,000	32,000	2,32,000	0.8263	1,91,702
2016	2,00,000	24,000	2,24,000	0.7512	1,68,269
2017	2,00,000	16,000	2,16,000	0.6829	1,47,506
2018	2,00,000	8,000	2,08,000	0.6208	1,29,126
Present value or fair value					8,54,763

(iii) Calculation of amortised cost of loan to employees

Year	*Amortised cost (Opening balance)* *[1]*	*Interest to be recognized @10%* *[2]*	*Repayment (including interest)* *[3]*	*Amortised Cost (Closing balance)* *[4]=[1]+ [2] – [3]*
	Rs.	*Rs.*	*Rs.*	*Rs.*
2014	8,54,763	85,476	2,40,000	7,00,239
2015	7,00,239	70,024	2,32,000	5,38,263
2016	5,38,263	53,826	2,24,000	3,68,089
2017	3,68,089	36,809	2,16,000	1,88,898
2018	1,88,898	19,102 (Bal. fig.)*	2,08,000	Nil

(b) Corporate Social Responsibility (CSR) Reporting is an information communiqué with respect to discharge of social responsibilities of corporate entity. Through 'CSR Report' the corporate enterprises disclose the manner in which they are discharging their social responsibilities. More specifically, it is addressed to the public or society at large, although it can be squarely used by other user groups also.

Section 135 of the Companies Act, 2013 mandated the companies fulfilling the criteria mentioned in the said section to spend certain amount of their profit on activities as specified in the Schedule VII to the Act. Companies not falling within that criteria can also spend on CSR activities voluntarily. However, besides the requirements of constitution of a CSR committee and a CSR policy, the corporate entities should also take care that expenditure incurred for CSR should not be the

* The difference of Rs. 212 (Rs. 19,102 - Rs. 18,890) is due to approximation in computations.

expenditure incurred for the activities in the ordinary course of business. If expenditure incurred is for the activities in the ordinary course of business, then it will not be qualified as expenditure incurred on CSR activities.

Here, it is assumed that the commercial activities performed at concessional rates are the activities done in the ordinary course of business of the companies. Therefore, the intention of the management to highlight the expenditure incurred on such commercial activities in its financial statements as the expenditure incurred on activities undertaken to discharge CSR, is not correct.

6. (a)

Computation of EVA	*(Rs. in lakhs)*
Net profit after tax (Refer Working Note 1)	140
Add: Interest adjusted for tax effect (800 × 10% × .70)	56
Return to Providers of Funds	196
Less: Cost of Capital (Refer Working Note 2)	(161)
Economic Value Added (EVA)	35

Working Notes:

1. **Interest and Net Profit**

$$\text{Financial Leverage} = \frac{\text{Profit before Interest \& Taxes (PBIT)}}{\text{Profit before Tax (PBT)}}$$

Interest on Borrowings = Rs. 800,00,000 × 10% = Rs. 80 lakhs

Therefore,

$$1.40 = \frac{\text{PBIT}}{\text{PBIT} - \text{Interest}}$$

$$1.40 = \frac{\text{PBIT}}{\text{PBIT} - 80}$$

1.40 (PBIT- 80)	=	PBIT
1.40 PBIT- 112	=	PBIT
1.40 PBIT- PBIT	=	112
0.40 PBIT	=	112
PBIT	=	112/0.40
PBIT	=	Rs. 280 Lakhs
PBT = PBIT – I=280-80	=	Rs. 200 lakhs
Less: Tax (30%)	=	(Rs. 60) lakhs
Net profit after tax	=	Rs. 140 lakhs

2. **Cost of Capital**

	(Rs. in lakhs)
Equity Shareholders' funds	600
10% Debenture holders' funds	800
Total	1,400
Weights assigned to Equity shareholders fund = $\frac{600}{1400} = 0.4286$	
Weights assigned to Debenture holders = $\frac{800}{1400} = 0.5714$	

Source of Funds (1)	*Amount Rs. (in lakhs)* (2)	*Weight* (3)	*Cost %* (4)	*WACC %* (5)=(3 × 4)%
Equity share holders' funds	600	0.4286	17.50	7.50
Debenture holders' funds	800	0.5714	7.00*	4.00
Total	1400	1.0000	----	11.50

Cost of Capital = Average Capital Employed × Weighted Average cost of Capital (WACC)

= Rs. 1,400 lakhs × 11.50% = Rs. 161 lakhs.

(b) Journal Entries in the books of Flower Ltd.

Date	*Particulars*	*Dr. (Rs.)*	*Cr. (Rs.)*
31.3.2012	Employees compensation expenses account Dr.	48,000	
	Employees stock option outstanding account		48,000
	(Being compensation expenses recognized in respect of the employees stock option i.e. 1,000 options granted to employees at a discount of Rs. 120 each, amortised on straight line basis		

* Rate of interest net of corporate tax of 30%.

	over $2\frac{1}{2}$ years)			
	Profit and loss account Dr.	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at the end of the year)			
31.3.2013	Employees compensation expenses account	Dr.	48,000	
	To Employees stock option outstanding account			48,000
	(Being compensation expenses recognized in respect of the employee stock option i.e. 1,000 options granted to employees at a discount of Rs. 120 each, amortised on straight line basis over $2\frac{1}{2}$ years)			
	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at the end of the year)			
31.3.2014	Employees stock option outstanding account (W.N.1)	Dr.	12,000	
	To General Reserve account (W.N.1)			12,000
	(Being excess of employees compensation expenses transferred to general reserve account)			
30.6.2014	Bank A/c (600 x Rs.40)	Dr.	24,000	
	Employee stock option outstanding account (600 x Rs.120)	Dr.	72,000	
	To Equity share capital account (600 x Rs. 10)			6,000
	To Securities premium account (600 x Rs.150)			90,000

	(Being 600 employees stock option exercised at an exercise price of Rs. 40 each)			
01.10.2014	Employee stock option outstanding account	Dr.	12,000	
	To General reserve account			12,000
	(Being Employees stock option outstanding A/c transferred to General Reserve A/c, on lapse of 100 options at the end of exercise of option period)			

Working Note:

On 31.3.2014, Flower Ltd. will examine its actual forfeitures and make necessary adjustments, if any to reflect expenses for the number of options that have actually vested. 700 employees stock options have completed 2.5 years vesting period, the expense to be recognized during the year is in negative i.e.

	Rs.
No. of options actually vested (700 x Rs.120)	84,000
Less: Expenses recognized Rs.(48,000 + 48,000)	96,000
Excess expenses transferred to general reserve	12,000

7. **(a)** Para 10 of AS 16 'Borrowing Costs' states "To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings." The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. Hence, in the above case, treatment of accountant of R Ltd. is incorrect. The amount of borrowing costs capitalized for the financial year 2014-15 should be calculated as follows:

	Rs. in crores
Actual interest for 2014-15 (11% of Rs. 150 crores)	16.50
Less: Income on temporary investment from specific borrowings	(3.50)
Borrowing costs to be capitalized during year 2014-15	13.00

(b) Calculation of provision required on advances as on 31st March, 2015:

	Amount Rs. in lakhs	*Percentage of provision*	*Provision Rs. in lakhs*
Standard assets	16,800	0.25	42
Sub-standard assets	1,340	10	134
Secured portions of doubtful debts–			
–upto one year	320	20	64
– one year to three years	90	30	27
–more than three years	30	50	15
Unsecured portions of doubtful debts	97	100	97
Loss assets	48	100	48
			427

(c) As per Para 8.2 and 13 of Accounting Standard 4 'Contingencies and Events occurring after the Balance Sheet Date', assets and liabilities should be adjusted for events occurring after the date of balance sheet, that provide additional evidence to assist estimation of amounts relating to conditions existing at the Balance Sheet date. Therefore, in the given case, full provision for bad debt amounting Rs. 2 lakhs should be made to cover the loss arising due to insolvency in the final accounts for the year ended 31st March, 2015 as earthquake took place before the balance sheet date.

(d)

		Rs.
Fair value of plan assets on 31.3.14		8,00,000
Add: Employer contribution		2,80,000
Less: Benefits paid		(2,00,000)
	(A)	8,80,000
Fair market value of plan assets at 31.3.15	(B)	11,40,000
Actual return on plan assets	(B-A)	2,60,000

(e) Table showing calculation of deferred tax asset / liability

Particulars	*Amount*	*Timing differences*	*Deferred tax*	*Amount @ 50%*
	Rs.			*Rs.*
Excess depreciation as per tax records (Rs.5,00,000–Rs.2,00,000)	3,00,000	Timing	Deferred tax liability	1,50,000
Unamortised preliminary expenses as per tax records	30,000	Timing	Deferred tax asset	(15,000)
Net deferred tax liability				1,35,000

Test Series : October, 2015

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) The following information is extracted from Steady Mutual Fund's Scheme:

- Asset Value at the beginning of the month	- Rs. 65.78
- Annualised return	-15 %
- Distributions made in the nature of Income & Capital gain (per unit respectively).	- Rs. 0.50 and Rs. 0.32

You are required to:

(1) Calculate the month end net asset value of the mutual fund scheme (limit your answers to two decimals).

(2) Provide a brief comment on the month end NAV. *(5 Marks)*

(b) Calculate the value of share from the following information:

Profit of the company	Rs. 290 crores
Equity capital of company	Rs. 1,300 crores
Par value of share	Rs. 40 each
Debt ratio of company	27
Long run growth rate of the company	8%
Beta 0.1; risk free interest rate	8.7%
Market returns	10.3%
Capital expenditure per share	Rs. 47
Depreciation per share	Rs. 39
Change in Working capital	Rs. 3.45 per share

(5 Marks)

(c) AXY Ltd. is able to issue commercial paper of Rs. 50,00,000 every 4 months at a rate of 12.5% p.a. The cost of placement of commercial paper issue is Rs. 2,500 per issue. AXY Ltd. is required to maintain line of credit Rs. 1,50,000 in bank balance. The applicable income tax rate for AXY Ltd. is 30%. What is the cost of funds (after taxes) to AXY Ltd. for commercial paper issue? The maturity of commercial paper is four months. *(5 Marks)*

(d) Mr. A is contemplating purchase of 1,000 equity shares of a Company. His expectation of return is 10% before tax by way of dividend with an annual growth of 5%. The Company's last dividend was Rs. 2 per share. Even as he is contemplating, Mr. A suddenly finds, due to a Budget announcement Dividends have been exempted from Tax in the hands of the recipients. But the imposition of Dividend Distribution Tax on the Company is likely to lead to a fall in dividend of 20 paise per share. A's marginal tax rate is 30%.

Required:

Calculate what should be Mr. A's estimates of the price per share before and after the Budget announcement? *(5 Marks)*

2. (a) Small Oil is wondering whether to drill for oil in Chemsfield Basin. The prospectuses are as follows:

Depth of well in feet	Total cost	Probability of		PV of Oil (if found)
	(Million €)	Finding oil	Not Finding oil	(Million €)
2000	4	0.5	0.5	10
4000	5	0.2	0.8	9
6000	6	0.25	0.75	8

Draw a decision tree showing the successive drilling decisions to be made by Small Oil. How deep should it be prepared to drill? . *(8 Marks)*

(b) Mr. Tempest has the following portfolio of four shares:

Name	Beta	Investment Rs. Lac.
Oxy Rin Ltd.	0.45	0.80
Boxed Ltd.	0.35	1.50
Square Ltd.	1.15	2.25
Ellipse Ltd.	1.85	4.50

The risk free rate of return is 7% and the Treynor Ratio of Market Portfolio is 6.50. You are required.

(i) Determine the portfolio return. (ii) Calculate the portfolio Beta. *(8 Marks)*

3. (a) Armada Leasing Company is considering a proposal to lease out a school bus. The bus can be purchased for Rs. 5,00,000 and, in turn, be leased out at Rs. 1,25,000 per year for 8 years with payments occurring at the end of each year:

(i) What should be the yearly lease payment charged by the company in order to earn 20 per cent annual compounded rate of return before expenses and taxes?

(ii) Calculate the annual lease rent to be charged so as to amount to 20% after tax annual compound rate of return, based on the following assumptions:

(a) Tax rate is 40%;

(b) Straight line depreciation;

(c) Annual expenses of Rs. 50,000; and

(d) Resale value Rs. 1,00,000 after the turn. *(8 Marks)*

(b) GKL Ltd. is considering installment sale of LCD TV as a sales promotion strategy.

In a deal of LCD TV, with selling price of Rs. 50,000, a customer can purchase it for cash down payment of Rs. 10,000 and balance amount by adopting any of the following options:

Tenure of Monthly installments	Equated Monthly installment
12	Rs. 3800
24	Rs. 2140

Required:

Estimate the flat and effective rate of interest for each alternative.

$PVIFA_{2.05\%, 12}$ =10.5429 $PVIFA_{2.10\%, 12}$ =10.5107

$PVIFA_{2.10\%, 24}$ =18.7014 $PVIFA_{2.12\%, 24}$ =18.6593 *(8 Marks)*

4. (a) A company is considering hedging its foreign exchange risk. It has made a purchase on 1st. January, 2015 for which it has to make a payment of US $ 50,000 on September 30, 2015. The present exchange rate is 1 US $ = Rs. 65. It can purchase forward 1 US $ at Rs. 64. The company will have to make a upfront premium of 3% of the forward amount purchased. The cost of funds to the company is 10% per annum and the rate of corporate tax is 30% (Don't ignore taxation). Consider the following situations and compute the Profit/Loss the company will make if it hedges its foreign exchange risk:

(i) If the exchange rate on September 30, 2015 is Rs. 67 per US $.

(ii) If the exchange rate on September 30, 2015 is Rs. 63 per US $. *(8 Marks)*

(b) ABC Ltd. manufactures Car Air Conditioners (ACs), Window ACs and Split ACs constituting 60%, 25% and 15% of total market value. The stand-alone Standard Deviation (SD) and Coefficient of Correlation with market return of Car AC and Window AC is as follows:

	S.D.	Coefficient of Correlation
Car AC	0.30	0.6
Window AC	0.35	0.7

No data for stand-alone SD and Coefficient of Correlation of Split AC is not available. However, a company who derives its half value from Split AC and half from Window AC has a SD of 0.50 and Coefficient of correlation with market return is 0.85. Market Index has a return of 10% and SD of 0.20. Further, the risk free rate of return is 4%.

You are required to determine:

(i) Beta of ABC Ltd.

(ii) Cost of Equity of ABC Ltd.

(iii) Assuming that ABC Ltd. wants to raise debt of an amount equal to half of its Market Value then determine equity beta, if yield of debt is 5%. *(8 Marks)*

5. (a) The data given below relates to a convertible bond :

Face value	Rs. 250
Coupon rate	12%
No. of shares per bond	20
Market price of share	Rs. 12
Straight value of bond	Rs. 235
Market price of convertible bond	Rs. 265

Calculate:

(i) Stock value of bond.

(ii) The percentage of downside risk.

(iii) The conversion premium

(iv) The conversion parity price of the stock. *(8 Marks)*

(b) Based on the following data, estimate the Net Asset Value (NAV) on per unit basis of a Regular Income Scheme of a Mutual Fund on 31-3-2015:

	Rs. (in lakhs)
Listed Equity shares at cost (ex-dividend)	40.00
Cash in hand (As on 1-4-2014)	5.00
Bonds & Debentures at cost of these, Bonds not listed & not quoted	8.96 2.50

Other fixed interest securities at cost	9.75
Dividend accrued	1.95
Amount payable on shares	13.54
Expenditure accrued	1.76

Current realizable value of fixed income securities of face value of Rs. 100 is Rs. 96.50.

Number of Units (Rs. 10 face value each): 275000

All the listed equity shares were purchased at a time when market portfolio index was 12,500. On NAV date, the market portfolio index is at 19,975.

There has been a diminution of 15% in unlisted bonds and debentures valuation.

Listed bonds and debentures carry a market value of Rs. 7.5 lakhs, on NAV date.

Operating expenses paid during the year amounted to Rs. 2.24 lakhs. *(8 Marks)*

6. (a) Longitude Limited is in the process of acquiring Latitude Limited on a share exchange basis. Following relevant data are available:

		Longitude Limited	Latitude Limited
Profit after Tax (PAT)	Rs. in Lakhs	140	60
Number of Shares	Lakhs	15	16
Earning per Share (EPS)	Rs.	8	5
Price Earnings Ratio (P/E Ratio)		15	10
(Ignore Synergy)			

You are required to determine:

(i) Pre-merger Market Value per Share, and

(ii) The maximum exchange ratio Longitude Limited can offer without the dilution of

(1) EPS and

(2) Market Value per Share

Calculate Ratio/s up to four decimal points and amounts and number of shares up to two decimal points. *(10 Marks)*

(b) ABC Ltd. is considering a project in US, which will involve an initial investment of US \$ 1,10,00,000. The project will have 5 years of life. Current spot exchange rate is Rs. 48 per US \$. The risk free rate in US is 8% and the same in India is 12%. Cash inflow from the project is as follows:

Year	Cash inflow
1	US $ 20,00,000
2	US $ 25,00,000
3	US $ 30,00,000
4	US $ 40,00,000
5	US $ 50,00,000

Calculate the NPV of the project using foreign currency approach. If Cost of Equity and Debt of ABC Ltd. are 15% and 10% respectively and Debt Equity Ratio is 1:4.

(6 Marks)

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

(a) Linkage between Financial Policy and Strategic Management

(b) Debt Securitisation

(c) Dow Theory

(d) Financial Restructuring

(e) Nostro, Vostro and Loro Account *(4 ×4 = 16 Marks)*

Test Series : October, 2015

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 2: STRATEGIC FINANCIAL MANAGEMENT

SUGGESTED ANSWERS/HINTS

1. **(a)** (1) Calculation of NAV at the end of month:

Given Annual Return = 15%

Hence Monthly Return = 1.25% (r)

$$r = \frac{(NAV_t - NAV_{t-1}) + I_t + G_t}{NAV_{t-1}}$$

$$0.0125 = \frac{\left(NAV_t - Rs.\ 65.78\right) + Rs.\ 0.50 + Rs.\ 0.32}{Rs.\ 65.78}$$

$0.82 = NAV_t$ - Rs. 64.96

NAV_t = Rs. 65.78

(2) There is no change in NAV.

(b) No. of Shares = $\frac{Rs.1,300\ crores}{Rs.\ 40}$ = 32.5 Crores

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

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

FCFE = Net income – [(1-b) (capex – dep) + (1-b) (ΔWC)]

FCFE = 8.923 – [(1-0.27) (47-39) + (1-0.27) (3.45)]

= 8.923 – [5.84 + 2.5185] = 0.5645

Cost of Equity = $R_f + ß (R_m – R_f)$

= 8.7 + 0.1 (10.3 – 8.7) = 8.86%

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

(c)

	Rs.
Issue Price	50,00,000
Less: Interest @ 12.5% for 4 months	2,08,333
Issue Expenses	2,500
Minimum Balance	1,50,000
	46,39,167

$$\text{Cost of Funds} = \frac{2{,}10{,}833(1-0.30)}{46{,}39{,}167} \times \frac{12}{4} \times 100 = 9.54\%$$

(d) The formula for determining value of a share based on expected dividend is:

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

Where

P_0 = Price (or value) per share

D_0 = Dividend per share

g = Growth rate expected in dividend

k = Expected rate of return

Hence,

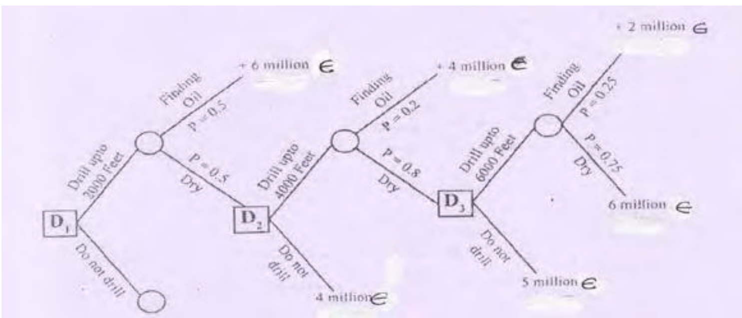
Price estimate before budget announcement:

$$P_0 = \frac{2 \times (1+0.05)}{(0.10-0.05)} = \text{Rs. } 42.00$$

Price estimate after budget announcement:

$$P_0 = \frac{1.80 \times (1.05)}{(0.07-0.05)} = \text{Rs. } 94.50$$

2. (a) The given data can be easily represented by the following decision tree diagram



There are three decision points in three indicated by D_1, D_2 and D_3

Using rolling back technique, we shall take the decision at decision point D_3 first and then it to arrive decision at a decision point D_2 and then use it to arrive decision at a point D_1.

Statement showing evaluation of decision at D_3 Point

Decision	Event	Prob.	PV. Of Oil (if fond) (Million €)	Expected PV of Oil (if fond) (Million €)
1. Drill upto 6000 feet.	Finding oil Dry	0.25	+2	0.5
	Dry	0.75	-6	-4.50
				-4.00
2. Do not Drill				-5.00

Since the expected PV of Oil (if found) on drilling upto 6000 feets 4 million is greater than the cost of not drilling 5 million. Therefore, small oil should drill upto 6000 feets.

Statement showing the evaluation of decision at point D_2

Decision	Event	Prob.	P.V. of Oil (if found (Million €)	Expected P.V. of Oil (if found) (Million €)
1. Drill upto 4000 feet.	Find Oil	0.2	4	0.80
	Dry	0.8	-4	-3.2
				-2.4
2. Do not Drill				-4.00

Since the expected P.V. of Oil (if found) an drilling upto 4000 feets 2.4 million € which is greater than the cost of not drilling Million €. Therefore, small oil should drill upto 4000 feets.

Statement showing the evaluation of decision at D_1

Decision	Event	Prob.	P.V. of Oil (if found (Million €)	Expected P.V. of Oil (if found) (Million €)
1. Drill upto 2000 feet.	Finding Oil	0.50	6	3.0
	Dry	0.50	-2.4	-1.20
				1.80
2. Do not Drill				NIL

Since the Expected P.V. of Oil (if found) on drilling upto 2000 feet is 1.8 Million € (positive). Small oil should drill upto 2000 feet.

(b) (i) Market Risk Premium (A)

$$6.50 = \frac{R_m - R_f}{\beta_m} = \frac{R_m - R_f}{1}$$

Share	*Beta*	*Risk Premium (Beta x A) %*	*Risk Free Return %*	*Return %*	*Return Rs.*
Oxy Rin Ltd.	0.45	2.93	7	9.93	7,944
Boxed Ltd.	0.35	2.28	7	9.28	13,920
Square Ltd.	1.15	7.48	7	14.48	32,580
Ellipse Ltd.	1.85	12.03	7	19.03	85,635
Total Return					1,40,079

Total Investment Rs. 9,05,000

(i) Portfolio Return = $\frac{\text{Rs.}1,40,079}{\text{Rs.}9,05,000} \times 100 = 15.48\%$

(ii) Portfolio Beta

Portfolio Return = Risk Free Rate + Risk Premium x β = 15.48%

15.48%=7% + 6.50%β

β = 1.30

Alternative Approach

First we shall compute Portfolio Beta using the weighted average method as follows:

$$\text{Beta}_P = 0.45X\frac{0.80}{9.05} + 0.35X\frac{1.50}{9.05} + 1.15X\frac{2.25}{9.05} + 1.85X\frac{4.50}{9.05}$$

= 0.45x0.0884+ 0.35X0.1657+ 1.15X0.2486+ 1.85X0.4972 = 0.0398+ 0.058 + 0.2859 + 0.9198 = 1.3035

Accordingly,

(i) Portfolio Return using CAPM formula will be as follows:

$R_P = R_F + \text{Beta}_P(R_M - R_F)$

= 7% + 1.3035 x 6.50%

= 7% + 8.47% = 15.47%

(ii) Portfolio Beta

As calculated above 1.3035

3. (a) (i) Desired lease rent to earn 20% IRR before expenses and taxes:

$$\text{Lease Rent} = \frac{5,00,000}{\text{PVIFA 8 yr, 20\%}} = \frac{5,00,000}{3.837} = \text{Rs. } 1,30,310.14 \text{ p.a.}$$

(ii) Revised lease rental on school bus to earn 20% return based on the given conditions.

PV factor [(X – E – D) (1 – T) + D] + (PV factor × S.V.) = Co

3.837 [(*x* – 50,000 – 50,000) (1 – .4) + 50,000] + (.233 × 1,00,000*) = 5,00,000

3.837 [6*x* – 60,000 + 50,000)] + 23,300 = 5,00,000

2.3022*x* = 5,15,070

x = 2,23,729.47

This may be confirmed as lease rental		2,23,729.47
Less: Expenses + Depreciation		1,00,000.00
	EBT	1,23,729.47
Less tax 40%		49,491.79
	PAT	74,237.68
Add: Depreciation		50,000.00
	CFAT	1,24,237.68

$$\frac{\text{Co - PV of SV}}{\text{CFAT}} = \frac{5,00,000 - 23,300}{1,24,237.68} = 3.837 \text{ or } 20\%$$

*** Note:** Alternatively STCG can also be considered as net of tax.

(b)

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

4. (a)

	(Rs.)
Present Exchange Rate Rs.65 = 1 US$	
If company purchases US$ 50,000 forward premium is	
50000 × 64 × 3%	96,000
Interest on Rs.96,000 for 9 months at 10%	7,200
Total hedging cost	1,03,200
Less: Tax benefit	30,960
Net Hedging Cost	72,240
If exchange rate is Rs.67	
Then gain (Rs.67 – Rs.64) for US$ 50,000	1,50,000
Less: Hedging cost	72,240
Net gain	77,760
If US$ = Rs.63	
Then loss (64 – 63) for US$ 50,000	50,000
Add: Hedging Cost	77,760
Total Loss	1,27,760

(b) (i) Determination of Beta of Car AC and Window AC

$$\frac{\sigma_{sm}\sigma_s}{\sigma_m}$$

Car AC (β_C)

$$\frac{0.6 \times 0.3}{0.2} = 0.90$$

Window AC (β_W)

$$\frac{0.7 \times 0.35}{0.2} = 1.225$$

Beta of Split AC/ Window AC is

$$\frac{0.85 \times 0.50}{0.2} = 2.125$$

The Beta of Split AC alone is

$2.125 = 0.50\beta_S + 0.50\beta_W$

$2.125 = 0.50\beta_S + 0.50 \times 1.225$

$\beta_S = 3.025$

ABC Ltd.'s Beta shall be:

$0.6 \times 0.9 + 0.25 \times 1.225 + 0.15 \times 3.025 = 1.30$

(ii) Cost of Equity of ABC Ltd.

$K_e = 4\% + 1.30(10\% - 4\%) = 11.80\%$

(iii) Calculation of Debt Beta

$$\frac{5\% - 4\%}{10\% - 4\%} = 0.167$$

Accordingly Beta of Equity shall be

$1.30 = 0.50 \times 0.167 + 0.50 \times \beta_e$

$= 2.433$

5. (a) (i) Stock value or conversion value of bond

$12 \times 20 = \text{Rs. } 240$

(ii) Percentage of the downside risk

$$\frac{\text{Rs. } 265 - \text{Rs. } 235}{\text{Rs. } 235} = 0.1277 \text{ or } 12.77\%$$

This ratio gives the percentage price decline experienced by the bond if the stock becomes worthless.

(iii) Conversion Premium

$$\frac{\text{Market Price} - \text{Conversion Value}}{\text{Conversion Value}} \times 100$$

$$\frac{\text{Rs. } 265 - \text{Rs. } 240}{\text{Rs. } 240} \times 100 = 10.42\%$$

(iv) Conversion Parity Price

$$\frac{\text{Bond Price}}{\text{No. of Shares on Conversion}} = \frac{\text{Rs. } 265}{20} = \text{Rs. } 13.25$$

This indicates that if the price of shares rises to Rs. 13.25 from Rs. 12 the investor will neither gain nor lose on buying the bond and exercising it. Observe that Rs. 1.25 (Rs. 13.25 – Rs. 12.00) is 10.42% of Rs. 12, the Conversion Premium.

(b)

Particulars	Adjustment Value Rs. lakhs
Equity Shares	63.920
Cash in hand (5.000 – 2.240)	2.760
Bonds and debentures not listed	2.125
Bonds and debentures listed	7.500
Dividends accrued	1.950
Fixed income securities	9.409
Sub total assets (A)	87.664
Amount payable on shares	13.54
Expenditure accrued	1.76
Sub total liabilities (B)	15.30
Net Assets Value (A) – (B)	72.364
No. of units	2,75,000
Net Assets Value per unit (Rs. 72.364 lakhs / 2,75,000)	Rs. 26.3142

6. (a) (i) Pre Merger Market Value of Per Share

P/E Ratio X EPS

Longitude Ltd. Rs. 8 X 15 = Rs. 120.00

Latitude Ltd. Rs.5 X 10 = Rs. 50.00

(ii) (1) Maximum exchange ratio without dilution of EPS

Pre Merger PAT of Longitude Ltd.	Rs. 140 Lakhs
Pre Merger PAT of Latitude Ltd.	Rs. 60 Lakhs
Combined PAT	Rs. 200 Lakhs
Longitude Ltd. 's EPS	Rs. 8
Maximum number of shares of Longitude after merger (Rs. 200 lakhs/Rs. 8)	25 Lakhs
Existing number of shares	15 Lakhs
Maximum number of shares to be exchanged	10 Lakhs

Maximum share exchange ratio 10:16 or 5:8

(2) Maximum exchange ratio without dilution of Market Price Per Share

Pre Merger Market Capitalization of Longitude Ltd. (Rs. 120 × 15 Lakhs)	Rs. 1800 Lakhs
Pre Merger Market Capitalization of Latitude Ltd. (Rs. 50 × 16 Lakhs)	Rs. 800 Lakhs
Combined Market Capitalization	Rs. 2600 Lakhs
Current Market Price of share of Longitude Ltd.	Rs. 120
Maximum number of shares to be exchanged of Longitude (surviving company) (Rs. 2600 Lakhs/ Rs. 120)	21.67 Lakhs
Current Number of Shares of Longitude Ltd.	15.00 Lakhs
Maximum number of shares to be exchanged (Lakhs)	6.67 Lakhs

Maximum share exchange ratio 6.67:16 or 0.4169:1

Note: Since in the question figures given of PAT of both companies are not matching with figures of EPS X Number of Shares. Hence, if students computed PAT by using this formula then alternative answer shall be as follows:

(1) Maximum exchange ratio without dilution of EPS

Pre Merger PAT of Longitude Ltd.	Rs. 120 Lakhs
Pre Merger PAT of Latitude Ltd.	Rs. 80 Lakhs
Combined PAT	Rs. 200 Lakhs
Longitude Ltd. 's EPS	Rs. 8
Maximum number of shares of Longitude after merger (Rs. 200 lakhs/Rs. 8)	25 Lakhs
Existing number of shares	15 Lakhs
Maximum number of shares to be exchanged	10 Lakhs

Maximum share exchange ratio 10:16 or 5:8

(2) Maximum exchange ratio without dilution of Market Price Per Share

Pre Merger Market Capitalization of Longitude Ltd. (Rs. 120 × 15 Lakhs)	Rs. 1800 Lakhs
Pre Merger Market Capitalization of Latitude Ltd. (Rs. 50 × 16 Lakhs)	Rs. 800 Lakhs
Combined Market Capitalization	Rs. 2600 Lakhs

Current Market Price of share of Longitude Ltd.	Rs. 120
Maximum number of shares to be exchanged of Longitude (surviving company) (Rs. 2600 Lakhs/ Rs. 120)	21.67 Lakhs
Current Number of Shares of Longitude Ltd.	15.00 Lakhs
Maximum number of shares to be exchanged (Lakhs)	6.67 Lakhs

Maximum share exchange ratio 6.67:16 or 0.4169:1

(b) First let us calculate the required rate of return on this project as follows:

15 %(4/5) + 10%(1/5) = 14%

The we shall calculate Risk Adjusted Dollar Rate

(1 + 0.12) (1 + Risk Premium) = (1 + 0.14)

Or, 1 + Risk Premium = 1.14/1.12 = 1.0179

Therefore, Risk adjusted dollar rate is = 1.0179 x 1.08 = 1.099 – 1 = 0.099

Calculation of NPV

Year	Cash flow (Million) US$	PV Factor at 9.9%	P.V.
1	2.00	0.910	1.820
2	2.50	0.828	2.070
3	3.00	0.753	2.259
4	4.00	0.686	2.744
5	5.00	0.624	3.120
			12.013
		Less: Investment	11.000
		NPV	1.013

Therefore, Rupee NPV of the project is = Rs. (48 x 1.013) Million

= Rs.48.624 Million

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

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

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

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

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

(iv) Foreign Exchange exposure and risk management.

(v) Liquidity management

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

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

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

(b) Debt Securitisation is a method of recycling of funds. This method is mostly used by finance companies to raise funds against financial assets such as loan receivables, mortgage backed receivables, credit card balances, hire purchase debtors, lease receivables, trade debtors, etc. and thus beneficial to such financial intermediaries to support their lending volumes. Thus, assets generating steady cash flows are packaged together and against this assets pool market securities can be issued. Investors are usually cash-rich institutional investors like mutual funds and insurance companies.

The process can be classified in the following three functions:

1. **The origination function –** A borrower seeks a loan from finance company, bank, housing company or a financial institution. On the basis of credit worthiness repayment schedule is structured over the life of the loan.

2. **The pooling function –** Many similar loans or receivables are clubbed together to create an underlying pool of assets. This pool is transferred in favour of a SPV (Special Purpose Vehicle), which acts as a trustee for the investor. Once the assets are transferred they are held in the organizers portfolios.

3. **The securitisation function –** It is the SPV's job to structure and issue the securities on the basis of asset pool. The securities carry coupon and an expected maturity, which can be asset base or mortgage based. These are

generally sold to investors through merchant bankers. The investors interested in this type of securities are generally institutional investors like mutual fund, insurance companies etc. The originator usually keeps the spread available (i.e. difference) between yield from secured asset and interest paid to investors.

Generally the process of securitisation is without recourse i.e. the investor bears the credit risk of default and the issuer is under an obligation to pay to investors only if the cash flows are received by issuer from the collateral.

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

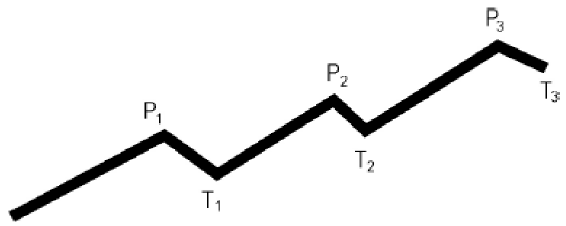
The Dow Jones theory classifies the movements of the prices on the share market into three major categories:

- Primary movements,
- Secondary movements, and
- Daily fluctuations.

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

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

These phases are known as bull and bear phases.

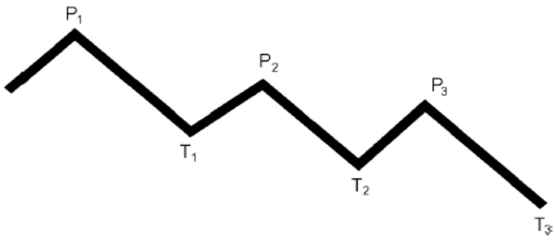


Graph 1

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

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

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



Graph 2

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

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

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

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

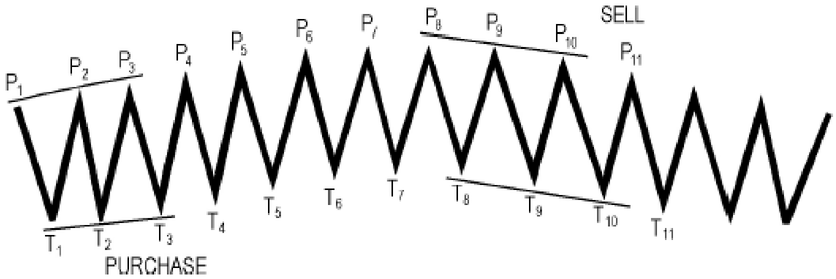
Such a t emptation is always very attractive but must always be resisted. Speculation is beyond the scope of the job of an investment manager.

Timing of Investment Decisions on the Basis of Dow Jones Theory: Ideally speaking, the investment manager would like to purchase shares at a time when they have reached the lowest trough and sell them at a time when they reach the highest peak.

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

This is technically known as identification of the turn in the share market prices. Identification of this turn is difficult in practice because of the fact that, even in a rising market, prices keep on falling as a part of th e 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) Financial restructuring, is carried out internally in the firm with the consent of its various stakeholders. Financial restructuring is a suitable mode of restructuring of corporate firms that have incurred accumulated sizable losses for / over a number of years. As a sequel, the share capital of such firms, in many cases, gets substantially eroded / lost; in fact, in some cases, accumulated losses over the years may be more than share capital, causing negative net worth. Given such a dismal state of financial affairs, a vast majority of such firms are likely to have a dubious potential for liquidation. Can some of these Firms be revived? Financial restructuring is one such a measure for the revival of only those firms that hold promise/prospects for better financial performance in the years to come. To achieve the desired objective, 'such firms warrant / merit a restart with a fresh balance sheet, which does not contain past accumulated losses and fictitious assets and shows share capital at its real/true worth.

(e) 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.

Test Series : October, 2015

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) While compiling the financial statements of a concern, you observed that the input information supplied by the concern is incomplete, incorrect and few of the Accounting Standards have not been followed. Describe, in brief, the procedure you will follow in the given situation.

(b) CA. Zed has been appointed as an auditor of Attire Ltd., a textile entity. While going through the employee records of the company, CA. Zed 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.

(c) While performing risk assessment procedures of the entity, Z Ltd., you observed that certain material financial statement assertions are based on accounting estimates made by the management. As the auditor of the company, what factors would you consider for the identification and assessment of the risks of material misstatements for such accounting estimates?

(d) The management of X Ltd. has prepared its summary financial statements for the year 2014-15 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. (a) On recommendation of the Board of Directors, VJ Ltd., a listed company, appointed CA. Ramesh as the statutory auditor of the company at its Annual General Meeting held on 1st October, 2015 for a period of 10 years. A resolution to this effect was passed unanimously with no vote against the resolution.

You are required to:

(i) Examine the validity of the above resolution with respect to appointment of CA. Ramesh as the auditor for consecutive 10 years.

(ii) Would your answer be different, in case an audit firm M/s Suresh & Associates is appointed as the auditor? *(6 Marks)*

(b) H Ltd., a company registered with SEBI, has three subsidiaries and one associate. While doing the audit of Consolidated Financial Statements (CFS) of H Ltd., you have come to know that the associate entity had made a provision for proposed dividend in its financial statements. H Ltd. computed its share of the results of operations of the associate after taking into account the proposed dividend. Comment. *(5 Marks)*

(c) The auditor must evaluate major clauses of control used in a Computerised Information system to enhance its reliability – Comment. *(5 Marks)*

3. (a) Hamma Ltd., on which the provisions of CARO, 2015 is applicable, defaulted in repayments of its dues to a Bank during the financial year 2014-15 and the same remained outstanding as at 31st March, 2015. However, the Company settled the total outstanding dues including interest on 30th April, 2015 before completion of the audit. Discuss how you would deal with this matter and draft a suitable Auditor's Report. *(5 Marks)*

(b) As a Statutory Auditor, how would you report the following under CARO, 2015:

(1) X Pvt. Ltd. has granted a loan of Rs. 25 crores to its associate Y Pvt. Ltd. during the year and it remain outstanding at the year end.

(2) LM Ltd. had obtained a Term Loan of Rs. 300 lakhs from a bank for the construction of a factory. Since there was a delay in the construction activities, the said funds were temporarily invested in short term deposits. *(6 Marks)*

(c) Mithas Ltd. is a top sugar manufacturer and exporter in India operating from Noida Specific Economic Zone, Uttar Pradesh. Its revenue from sale/export for the current year is given below:

Sale within India	Rs. 153 lakhs
Sale outside India (Export)	Rs. 357 lakhs
Total Revenue	Rs. 510 lakhs

Mr. X, the statutory auditor of Mithas Ltd., is of the view that the company is mandatorily required to include cost records in their books of account and consequently conduct cost audit. He also suggested the name of his friend, who is a Cost Accountant in Practice, for the purpose of such cost audit. However, the management is of the view that the company neither required including cost records in their books of account nor conduct cost audit.

Being an expert in cost records and audit rules, you are required to guide the management in this regard. *(5 Marks)*

4. (a) While doing the audit of a nationalized bank, your Audit Assistant informed you that there are a lot of irregularities in Telegraphic Transfers and Demand Drafts. As an auditor, what guidance would be given to the Audit Assistant? *(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. *(6 Marks)*

(c) BSL Pvt. Ltd. is a company engaged in the production of wool. Along with its production business, the company is also engaged in buying and selling of securities with the expectation of a favourable price change. It reports the following data for the current financial year:

S. No.	Particulars	Amount (in Rs.)
1	Paid up Share Capital	100 lakhs
2	Capital Reserve	33 lakhs
3	Capital Redemption Reserve	45 lakhs
4	Revaluation Reserve	32 lakhs
5	Speculation Loss on account of Purchase and Sales of Securities	12 lakhs

As a tax auditor, how would you report under Form 3CD? *(6 Marks)*

5. (a) 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.

(5 Marks)

(b) ABC, a manufacturing unit does not accept the recommendations for improvements made by the Operational Auditor. Suggest an alternative way to tackle the hostile management. *(6 Marks)*

(c) Sugandh Pan Masala Pvt. Ltd. was incurring heavy losses in the last several years since it could not withstand the competition in the market. The State in which the company had its registered office and also its major sales had moved a bill in the State Assembly to ban manufacture and sale of all kinds of Pan Masalas in the State. While finalizing the accounts for the year ended 31-03-2015, the CFO of the company created a Deferred Tax Asset for the tax benefits that would arise in future years from the earlier years losses that had remained unabsorbed in Income Tax. Comment. *(5 Marks)*

6. Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

   (a) Ms. Aabha, a Chartered Accountant in practice, entered into a partnership with Mr. Abhay, an advocate, for sharing of fees for work sent by one to the other. However, due to some disputes, the partnership was dissolved after 1 month without any fees having been received.

   (b) Mr. 'P' is a practicing Chartered Accountant working as a proprietor of M/s P & Co. He went abroad for 2 months. He delegated the authority to Mr. 'C' a Chartered Accountant his employee for taking care of routine matters of his office. During his absence, Mr. 'C' has issued the audit queries to clients which were raised during the course of audit.

   (c) M/s XYZ & Co., a firm of Chartered Accountants, has taken a loan for acquiring computers, printers and scanner from a company whose Managing Directors' son is an Articled Trainee with CA. X, a partner of M/s XYZ & Co.

   (d) CA. Panash is practicing in the name of M/s P & Associates at Chennai Office. Due to increase in the income tax assessment work, he opens another office near the income tax office within 46 kms of the municipal limits of his first office. For running the new office, he has employed a retired Income Tax Commissioner.

(4 $\times$ 4 = 16 Marks)

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

   (a) Haphazard Sampling.

   (b) Objectives of Internal Check System.

   (c) Areas excluded from the scope of peer reviewer.

   (d) General Steps in the Conduct of Risk-Based Audit.

   (e) 'Mandatory Review' areas of the audit committee as per Clause 49 of the Listing Agreement. *(4 $\times$ 4 = 16 Marks)*

Test Series : October, 2015

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

SUGGESTED ANSWERS/HINTS

1. **(a) Compilation of Financial Information:** According to SRS 4410 "Engagements to Compile Financial Information", an accountant would normally have to rely upon the management for information to compile the financial statements in a compilation engagement. If in the course of compilation of financial statements, it is observed that the information supplied by the entity is incorrect, incomplete or otherwise unsatisfactory, the accountant should perform following procedures-

   (i) Make any enquiries of management to assess the reliability and completeness of the information provided;

   (ii) Assess internal controls prevailing in the entity; and

   (iii) Verify any matters or explanations.

   The accountant may also request the management to provide additional information. This may be asked in the form of management representation letter. If the management refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for such withdrawal.

   If one or more accounting standards are not complied with, the same should be brought to the notice of the management and if the same is not rectified by the management, the accountant should include the same in notes to the accounts and the compilation report to the management.

   (b) 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 Attire 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. Zed from obtaining sufficient appropriate audit evidence for further evaluation.

Thus, CA. Zed 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.

(c) Identification and Assessment of Risks of Material Misstatements for Accounting Estimates: As per SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates-

(i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.

(ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed, in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

(iii) The estimation making process adopted by the management including-

(1) The method, including where applicable the model, used in making the accounting estimates

(2) Relevant controls

(3) Whether management has used an expert?

(4) The assumption underlying the accounting estimates

(5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and

(6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.

(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) Appointment of Auditor: Section 139(2) of the Companies Act, 2013 read with Companies (Audit and Auditors) Rules, 2014 prescribes the provisions related to rotation of auditor which provides that listed company or a company belonging to such class or classes of companies (except one person companies and small companies) shall not appoint or re-appoint-

(1) an individual as auditor for more than one term of 5 consecutive years; and

(2) an audit firm as auditor for more than two terms of 5 consecutive years i.e. 10 years.

In the given case, VJ Ltd. is a listed company. Therefore, the provisions relating to rotation of auditor shall be applicable to the company. However,

(i) On recommendation of the Board of Directors of the company, CA. Ramesh is appointed as the statutory auditor of the company at the company's Annual

General Meeting held on 1st October, 2015 for a consecutive period of 10 years.

As per the provisions of the Companies Act, 2013 discussed above, the appointment of CA. Ramesh as auditor of the company for 10 years is not valid because an individual can be appointed as an auditor only for one term of 5 consecutive years subject to ratification by members at every annual general meeting.

(ii) An audit firm can be appointed as an auditor for two terms of 5 consecutive years. This means that a firm can be appointed for 5 years and thereafter may be appointed/ reappointed for another 5 years. The total period for which a firm can be appointed is 10 years subject to ratification by members at every annual general meeting. However, a firm cannot be appointed as auditor for 10 years by a single resolution. Thus, the appointment of M/s Suresh & Associates as the company's auditor for 10 years by a single resolution is not valid.

(b) Accounting for Investments in Associate: As per AS 23 on "Accounting for Investments in Associates in Consolidated Financial Statements", adjustments to the carrying amount of investment in an investee arising from changes in the investee's equity that have not been included in the statement of profit and loss of the investee are directly made in the carrying amount of investment without routing it through the consolidated statement of profit and loss. The corresponding debit/credit is made in the relevant head of the equity interest in the consolidated balance sheet. For example, in case the adjustment arises because of revaluation of fixed assets by the investee, apart from adjusting the carrying amount of investment to the extent of proportionate share of the investor in the revalued amount, the corresponding amount of revaluation reserve is shown in the consolidated balance sheet.

In case an associate has made a provision for proposed dividend in its financial statements, the investor's share of the results of operations of the associate is computed without taking into consideration the proposed dividend.

In the given case, the associate of H Ltd. has made a provision for proposed dividend in its financial statements and H Ltd. has computed its share of the results of operations of the associate after taking into account the proposed dividend.

It may be noted that H Ltd. should have computed its share of the results of operations of the associate without taking into consideration the proposed dividend. Therefore, treatment made by H Ltd. is not correct.

(c) 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.

3. (a) 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 (ix) of Para 3 of CARO, 2015, the auditor of a company has to state in his report whether the Company has defaulted in repayment of dues to a financial institution or bank or debentures holders and if yes, the period and amount of default to be reported.

In the given case, Hamma Ltd. has defaulted in repayments of dues to a Bank during the financial year 2014-15 which remain outstanding as at 31st March, 2015. However, the company has settled the total outstanding dues including interest on 30th April, 2015 but, the dues were outstanding as at 31st March, 2015. 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 Bank 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 2014-15 amounting to Rs. XXXX which remained outstanding as at 31st March, 2015. The period of default is XXX days. However, the outstanding sum was settled by the company on 30th April, 2015."

(b) Reporting under CARO, 2015:

(1) As per clause (iii) of Para 3 of CARO, 2015, if the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 189 of the Companies Act, 2013, the auditor is required to report-

(I) whether receipt of the principal amount and interest are also regular; and

(II) if overdue amount is more than Rs. 1 lakh, whether reasonable steps have been taken by the company for recovery of the principal and interest.

In the instant case, X Pvt. Ltd. has granted a loan of Rs. 25 crores to its associate Y Pvt. Ltd. and it remain outstanding at the year end.

Therefore, the auditor should report under CARO, 2015 about the non-receipt of loan amount including interest and state whether reasonable steps were taken by the company for recovery of the dues.

(2) As per clause (xi) of Para 3 of CARO, 2015, an auditor need to state in his report that whether the term loans were applied for the purpose for which the loans were obtained.

In the present case, the term loan obtained by LM Ltd. have not been put to use for construction activities and temporarily invested the same in short term deposit.

Here, the auditor should report the fact in his report that pending utilization of the term loan for construction of a factory, the funds were temporarily used for the purpose other than the purpose for which the loan was sanctioned as per clause (xi) of Para 3 of CARO, 2015.

(c) Applicability of Provisions related to Cost Records and Audit: Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 read with section 148 of the Companies Act, 2013 provides the classes of companies, engaged in the production of goods or providing services, required to include cost records in their books of account. The said rule includes sugar industry as one of the types of companies to maintain cost records.

However, the requirement for cost audit under these rules shall not be applicable to a company which is covered under Rule 3, and which is operating from a special economic zone.

In the given case, Mithas Ltd., a sugar manufacturer and exporter in India, is operating from Noida Specific Economic Zone, Uttar Pradesh.

Therefore, Mithas Ltd. is required to include cost records in their books of account in accordance with Rule 3 of the Companies (Cost Records and Audit) Rules, 2014. However, the company is not required to conduct cost audit as it is operating from a special economic zone. The facts given on revenue are not relevant here.

4. (a) In respect of Telegraphic Transfers and Demand Drafts, the audit assistant would be given the following guidance:

(i) The bank should have a reliable private code known only to responsible officers of its branches, coding and decoding of telegrams should be done only by such officers.

(ii) The signatures on a demand draft should be checked by an officer with the Signature Book.

(iii) All the T.Ts and D.Ds. sold by a branch should be immediately confirmed by the advices to the branches concerned.

(iv) If the paying branch does not receive proper confirmation of any T.T. or D.D. from the issuing branch or does not receive credit in its account with that branch, it should take immediate steps to ascertain the reasons.

(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/rediscounted 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) Reporting Requirement Under Clause (32)(e) of Form 3CD: BSL Pvt. Ltd. is engaged in production business and side by side dealing in buying and selling of securities with the intention of speculation. During the current financial year, the company has made Speculation Loss of Rs. 12 lakhs.

Provisions and Explanations: A tax auditor has to furnish the details of speculation loss incurred during the previous year, under Clause 32(e) of Form 3CD, regarding whether the company is deemed to be carrying on a speculation business as referred in explanation to section 73.

The Explanation to section 73 provides that where any part of the business of a company (other than a company the principal business of which is the business of trading in shares or banking or the granting of loans and advances) consists in the purchase and sale of shares of other companies, such company shall, for the purposes of this section, be deemed to be carrying on a speculation business to the extent to which the business consists of the purchase and sale of such shares.

Conclusion: Therefore, the tax auditor of BSL Pvt. Ltd. is required to furnish the details under Clause 32(e) of Form 3CD with respect to the speculation loss of Rs. 12 lakhs made during the year.

5. (a) 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.

(b) Alternative Way to Tackle the Hostile Management: While conducting the operational audit the auditor has to come across many irregularities and areas where improvement can be made and therefore he gives his suggestions and recommendations.

These suggestions and recommendations for improvements may not be accepted by the hostile managers and in effect there may be cold war between the operational auditor and the managers. This would defeat the very purpose of the operational audit.

The **Participative Approach** comes to the help of the auditor. In this approach the auditor discuses the ideas for improvements with those managers that have to implement them and make them feel that they have participated in the recommendations made for improvements. By soliciting the views of the operating personnel, the operational audit becomes co-operative enterprise.

This participative approach encourages the auditee to develop a friendly attitude towards the auditors and look forward to their guidance in a more receptive fashion. When participative method is adopted then the resistance to change becomes minimal, feelings of hostility disappear and gives room for feelings of mutual trust. Team spirit is developed. The auditors and the auditee together try to achieve the common goal. The proposed recommendations are discussed with the auditee and modifications as may be agreed upon are incorporated in the operational audit report. With this attitude of the auditor it becomes absolutely easy to implement the proposed suggestions as the auditee themselves take initiative for implementing and the auditor do not have to force any change on the auditee.

Hence, Operational Auditor of ABC manufacturing unit should adopt above mentioned participative approach to tackle the hostile management of ABC.

(c) **Creation of Deferred Tax Asset:** Accounting Standard 22 on "Accounting for Taxes on Income" requires that Deferred Tax Asset (DTA) should be recognised for all timing differences, subject to the considerations of prudence. The Standard further states that unabsorbed losses of the business can be considered for creation of DTA provided there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such DTA can be realised.

In view of this, the DTA created by the CFO of Sugandh Pan Masala Pvt. Ltd. is not in order. Since the company which is in the business of manufacturing of *panmasala* has been incurring heavy losses and in addition to this the State in which the company is having its major sales is proposing the ban on sale and manufacture of pan masala, the statutory auditor would, therefore, have to qualify his report and mention the extent of amounts of loss and reserves which are under and overstated respectively.

6. **(a)** **Partnership with an Advocate:** As per Clause (4) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant will be guilty of professional misconduct if he enters into partnership with any person other than a chartered accountant in practice or a person resident without India who but for his residence abroad would be entitled to be registered as a member under Clause (v) of Sub-section (1) of Section 4 or whose qualification are recognized by the Central Government or the Council for the purpose of permitting such partnership.

However, for the purpose of Limited Liability Partnership, Regulation 53B of the Chartered Accountants Regulations, 1988 permits a Chartered Accountant in practice to enter into partnership with other prescribed Professional Bodies which includes an Advocate, a member of Bar Council of India.

In the instant case, Ms. Aabha, a chartered accountant in practice, has entered into partnership with Mr. Abhay, an advocate.

Thus, she would not be guilty of professional misconduct as per Clause (4) of Part I of First Schedule read with Regulation 53B.

(b) 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. 'P' proprietor of M/s P & Co., went to abroad and delegated the authority to another Chartered Accountant Mr. C, 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. Mr. 'C' has issued audit queries which were raised during the course of audit.

Here "C" 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.

(c) Loan from a Company: As per Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant is deemed to be guilty of professional misconduct if he contravenes any of the provisions of Chartered Accountants Act, 1949 or Regulations made thereunder.

Regulation 47 of the Chartered Accountant's Regulations, 1988, prohibits a member from accepting any premiums or loans or any deposit in any form from an articled clerk directly or indirectly.

In the given case, M/s XYZ & Co. has taken loan from a company whose Managing Director happens to be father of articled clerk with CA. X, a partner of M/s XYZ & Co. Here, the articled trainee has no direct interest in that company. There has been a case wherein a chartered accountant was held guilty of professional misconduct because he took a loan from a firm in which the articled clerk and his father were both interested. But, in this case as per the facts, the articled trainee has no direct interest in the company. However, if relationship, direct or indirect, can be established in view of relationship of articled trainee with MD of the company, CA. X of M/s XYZ & Co. would be held liable for professional misconduct. Thus, M/s XYZ & Co. would be guilty of professional misconduct under this clause if it is proved that the loan was related to the engagement of the articled clerk.

(d) **Maintenance of Branch Office:** As per section 27 of the Chartered Accountants Act, 1949, if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. However, a member can be in-charge of two offices if the second office is located in the same premises or in the same city, in which the first office is located; or the second office is located within a distance of 50 Kilometres from the municipal limits of a city, in which the first office is located.

In the given case, CA. Panash has a sole proprietorship in the name of M/s P & Associates at Chennai Office and due to increase in the work he opened another branch near the income tax office. His new office is within a distance of 46 Kilometres from the municipal limits of his first office. He also employed the income tax commissioner to run the new office.

Therefore, there will be no misconduct if CA. Panash will be in-charge of both the offices, however, he will be liable to declare which of the two offices is the main office.

7. (a) Haphazard Sampling: In haphazard selection, the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

Haphazard selection of sample, may be an acceptable alternative to random selection of sample, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units.

When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily located, as they may not be representative.

(b) 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.

(c) 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.

(d) 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.

(e) Mandatory Review Areas of the Audit Committee: The Audit Committee shall mandatorily review the following information as per Clause 49 of the Listing Agreement-

(i) Management discussion and analysis of financial condition and results of operations;

(ii) Statement of significant related party transactions (as defined by the Audit Committee), submitted by management;

(iii) Management letters / letters of internal control weaknesses issued by the statutory auditors;

(iv) Internal audit reports relating to internal control weaknesses; and

(v) The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

Test Series: October, 2015

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 4: CORPORATE AND ALLIED LAWS

*Question No.**1** is compulsory.*

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

Time Allowed – 3 Hours **Maximum Marks – 100**

1. **(a)** **(i)** Mr. Dark is working as Chief Accountant in White Metal Limited. The Board of Directors of the said company propose to charge him with the duty of ensuring compliance with the provisions of the Companies Act, 2013 so that books of account can be properly maintained and Balance Sheet and Profit and Loss Account can be prepared as per the provisions of law. Draft a "Board Resolution" for the said purpose. Also point out the consequences in case of default; when such a resolution is passed**.** *(3 Marks)*

(ii) XYZ Ltd. was registered in 2015 under the Companies Act, 2013. There are allegations that the three directors who manage the affairs of the company are siphoning the funds of the company. The company has not declared any dividends on the ground that company is incurring losses. Mr. A, who controls 51% of the share capital of the company sends a notice to the management that he will inspect the books of account to verify the allegations. Examine the right of Mr. A to carry out the inspection. State the persons who have the right to carry out the inspection under the Companies Act, 2013. *(3 Marks)*

(b) Annual general meeting of Hero Ltd. has been scheduled in compliance with the requirements of the Companies Act, 2013. In this connection, it has some directors who are rotational and out of which some have been appointed long back, some have been appointed on the same day.

Decide in this connection:

(i) Which of the directors shall be retiring by rotation and be eligible for re-election?

(ii) In case two directors were appointed on the same day, how would you decide their retirement by rotation?

(iii) In case the meeting could not decide how the vacancies caused by retirement to be dealt with, what shall be consequences? *(6 Marks)*

(c) What are the defaults for which a stock-broker may be penalized under the provisions of Securities and Exchange Board of India Act, 1992 in respect of his dealings with the investors? State the factors that must be taken into account by the adjudicating officer while determining the quantum of penalty in such cases. *(4 Marks)*

(d) M/s AB & Company, a member of a recognised stock exchange 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) Advise Kumar Ltd. in respect of the following proposals under consideration of its Board of directors:

(i) Appointment of Managing Director with more than 70 years of age;

(ii) Payment of commission of 4% of the net profits per annum to the directors of the company;

(iii) Payment of remuneration of ₹ 40,000 per month to the whole time director of the company running in loss and having an effective capital of ₹ 95.00 lacs. *(8 Marks)*

(b) (i) The Balance Sheet of Royal Ltd. as at 31-03-2011 disclosed the following details:

1.	Authorised share capital	₹ 400 crores
2.	Paid up share capital	₹ 150 crores
3.	Reserves and surplus	₹ 750 crores

The company has issued in the year 2015, Fully Convertible Debentures of ₹ 100 crores which are due for conversion in the year 2020. The company proposes, after the conversion of Debentures to issue Bonus shares in the ratio of 1: 1. Explain briefly the requirements of the Securities and Exchange Board of India (SEBI) Regulations to be followed by the company in this regard. *(4 Marks)*

(ii) State the responsibilities of the inspector as enumerated in section 223 of the Companies Act, 2013, in relation to his report. *(4 Marks)*

3. (a) (i) A director goes abroad for a period of more than 3 months and an alternate director has been appointed in his place under section 161(2). During the period of absence of the original director, a board meeting was called. In this connection, with reference to the provisions of the Companies Act, 2013, advise whom should the notice of Board meeting be given to the "original director" or to the "alternate director"? *(4 Marks)*

(ii) Mr. M was appointed as a director at the Annual General Meeting of a limited company held on 30^{th} September, 2014 and he carried on his duties and functions as a director. In the month of August, 2015, it was found out that there were certain irregularities in his appointment and on 31st August, 2015, his appointment was declared invalid. But Mr. M continued to act as director even after 31st August, 2015 You are required to state, with reference to the provisions of the Companies Act, 2013, whether the acts done by Mr. M are valid and binding upon the company ? *(4 Marks)*

(b) **(i)** ABC Company Limited was amalgamated with and merged in XYZ Company Limited. Some workers of ABC Company Limited refuse to join as workers of XYZ Company Limited and claim compensation for premature termination of service. XYZ Company Limited resists the claim on the ground that their services are transferred to XYZ Company Limited by the order of amalgamation and merger and, therefore, the workers must join service of XYZ Company Limited and cannot claim any compensation. According to the provisions of the Companies Act, 1956, examine whether the workers' contention is correct. *(4 Marks)*

(ii) Mr. Bhartiya., 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 Bhartiya whether he can obtain Foreign Exchange and, if so, under what conditions? *(4 Marks)*

4. **(a)** What are the steps to be taken for up in a case, where the company is solvent, but the business for which it was formed has been completed. Give your answer referring to the provisions of the Companies Act, 1956. *(8 Marks)*

(b) **(i)** Explain how the auditor will be appointed in the following cases:

1. The Auditor of the company has resigned on 31st December, 2013, while the financial year of the company ends on 31st March, 2014.
2. A company, whose shareholders include the following:
   - (I) Bank of Baroda (A Nationalized Bank) holding 12% of the subscribed capital in the company.
   - (II) National Insurance Company Limited (carrying on General Insurance Business) holding 10% of the subscribed capital in the company.

(4 Marks)

(ii) An arrangement has been made among the automobile manufactures that the automobile parts produced by them will not be sold to industries below a certain price. The arrangement was in writing but it was not intended to be enforced by legal proceeding. Examine whether the above arrangement can be considered as an agreement within the meaning of Section 2(b) of the Competition Act, 2002. *(4 Marks)*

5. (a) Prince Ltd. desires to appoint an additional director on its Board of directors. The Articles of the company confer upon the Board to exercise the power to appoint such a director. As such M is appointed as an additional director. In the light of the provisions of the Companies Act, 2013, examine:

(i) Whether M can continue as director if the annual general meeting of the company is not held within the stipulated period and is adjourned to a later date?

(ii) Can the power of appointing additional director be exercised by the Annual General Meeting?

(iii) As the Secretary of the company what checks would you make after M is appointed as an additional director? *(8 Marks)*

(b) (i) Under Section 387 of the Companies Act, 2013, what are particulars required for incorporating a prospectus to be issued by an existing foreign company?

(4 Marks)

(ii) The Central Government acquired a Banking Company. The scheme of acquisition, apart from other matters, provided for the quantum of compensation payable to the shareholders of acquired bank. Some shareholders are not satisfied with the amount of compensation fixed under the scheme of acquisition.

Is there any remedy available to the share holders under the provisions of the Banking Regulation Act, 1949?. *(4 Marks)*

6. (a) (i) A Producer Company has received applications from Mr. Raman, a Director of the Company, and Mr. P, a member of the Company, for grant of loan of ₹ 2,00,000 and ₹ 25,000 respectively. Discuss the relevant provision of the Companies Act, 1956 as to how the applications for grant of loan will be disposed of by the Company. *(4 Marks)*

(ii) ABC Private Limited is a company in which there are eight shareholders. Can a member holding less than one-tenth of the share capital of the company apply to the Company Law Board for relief against oppression and mismanagement? *(4 Marks)*

(b) (i) What is Director Identification Number (DIN) and What is the procedure of obtaining DIN? What are the scanned documents required to be attached with e form DIR-3? *(4 Marks)*

(ii) "Money Laundering" does not mean just siphoning of fund."Comment on this statement explaining the significance and aim of the Prevention of Money Laundering Act, 2002. *(4 Marks)*

7. **(a)** Mr. Shri has a unique business idea emerging from research and development in new commercial area, however, it is a future project and recently has no significant transactions, business activities in this regard. Mr. Shri wants to know that there is any concept under Companies Act, 2013 to form a company whose business activities would be commenced subsequently. Explain the provision of Dormant Company under Companies Act, 2013. *(4 Marks)*

(b) What are the powers of the Central Government under the Companies Act, 2013 regarding the appointing of company prosecutors. *(4 Marks)*

(c) State giving reasons whether the following are true or false under the provisions of the Companies Act, 2013? The Board of Directors of ABC Ltd. wants to circulate unaudited accounts before the Annual General Meeting of the shareholders of the Company. *(4 Marks)*

(d) State the law amended by Insurance Laws (Amendment) Act, 2015 in the Insurance Act, 1938 with respect to the time period for the policy that can be called in question on the ground of fraud. *(4 Marks)*

(e) What is meant by 'disclaimer of onerous property' and how the same is exercised during winding up. Explain the circumstances under which such a disclaimer is not allowed. *(4 Marks)*

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 4: CORPORATE AND ALLIED LAWS

SUGGESTED ANSWER

1. (a) (i) Board Resolution for charging Mr. Dark, Chief Accountant, with the duty of Compliance with the requirements of Sections 129 & 134 of the Companies Act, 2013.

"Resolved that Mr. Dark, Chief Accountant of the company is hereby charged with the duty of seeing that the requirements of Sections 129 and 134 of the Companies Act, 2013 are duly and fully complied with.

Resolved further that the said Mr. Dark is hereby entrusted with the authority to do such Acts or deeds as may be necessary or expedient for the purpose of discharging his above referred duties."

Consequences of contravention: Section 128(6) provides that if the managing director, the whole-time director in charge of finance, the Chief Financial Officer or any other person of a company charged by the Board with the duty of complying with the provisions of this section, contravenes such provisions, such managing director, whole-time director in charge of finance, Chief Financial officer or such other person of the company shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees or with both.

(ii) Right to carry out the inspection of the books of accounts:

Mr. A has no right to carry out an inspection of the books of accounts of the company despite the fact that he holds 51% of the share capital of the company. According to sections 128 and 206 of the Companies Act, 2013, the following persons have the right to carry out the inspection of the books of accounts of the company.

1. Directors of the Company [Section 128(3)]
2. Registrar of Companies [Section 206]
3. Such officer of Government as may be authorised by the Central Government in this behalf (Section 206).
4. Such officers of SFIO (Serious Fraud Investigation Office) [Section 212].

Since Mr. A is not a director, he is not eligible to carry out the inspection.

Note: According to Regulation 89, of Table F, Companies Act, 2013, a member has right to inspect the books of accounts if he is so authorized by a resolution of the Board of Director or a resolution passed by the company in general meeting.

(b) Rotational Directors and Retirement:

(i) According to section 152(6)(a)(i) of the Companies Act, 2013, unless the articles provide for the retirement of all directors at every annual general meeting, not less than two-thirds of the total number of directors of a public company shall be persons whose period of office is liable to determination by retirement of directors by rotation.

Further, section 152(6)(c) of the Act states that one-third of such of the directors for the time being as are liable to retire by rotation, or if their number is neither three nor a multiple of three, then, the number nearest to one-third, shall retire from office.

From the above provisions, it is clear that the directors who are liable for rotation at every annual general meeting shall be one third of those directors who constitute the two thirds of the total number of directors and who are liable for rotation at every AGM. For example if the number of directors is 14 then the directors liable for rotation at every AGM will be = 14/3*2 = 9 and the directors who will retire will be one third of 9 = 3.

Under section 152(6)(d) the directors to retire by rotation at every annual general meeting shall be those who have been longest in office since their last appointment, but as between persons who became directors on the same day, those who are to retire shall, in default of and subject to any agreement among themselves, be determined by lot. Therefore, the directors who will retire by rotation shall be those who have been in office for the longest term since their appointment. In case of two or more directors who were appointed on the same date at the same AGM, the retiring directors will be mutually agreed by them or in the absence of such agreement, will be determined by lots.

(ii) In terms of section 152(6)(d) of the Companies Act, 2013 if two or more directors have been appointed on the same day at the same AGM, their retirement will be determined either mutually among them or by lot.

(iii) Under section 152(6)(e) of the Companies Act, 2013 the Vacancy caused by the retirement of directors at the AGM may be filled in the same annual general meeting by appointing either the retiring directors or some other person. The annual general meeting may also decide not to fill the vacancy arising from the retirement of one or more directors.

Section 152(7) (a) provides that if the vacancy of the director retiring by rotation, is not so filled-up and the meeting has not expressly resolved not to fill the vacancy, the meeting shall stand adjourned till the same day in the next week, at the same time and place, or if that day is a national holiday, till the next succeeding day which is not a holiday, at the same time and place.

Section 152 (7)(b) further provides that if at the adjourned meeting also, the vacancy of the retiring director is not filled up and that meeting also has not expressly resolved not to fill the vacancy, the retiring director shall be deemed to have been re-appointed at the adjourned meeting, unless:

(i) at that meeting or at the previous meeting a resolution for the re-appointment of such director has been put to the meeting and lost;

(ii) the retiring director has, by a notice in writing addressed to the company or its Board of directors, expressed his unwillingness to be so re-appointed;

(iii) he is not qualified or is disqualified for appointment;

(iv) a resolution, whether special or ordinary, is required for his appointment or re-appointment by virtue of any provisions of this Act; or

(v) section 162 is applicable to the case.

(c) Penalty for default in case of stock brokers: Section 15F of Securities and Exchange Board of India Act, 1992 provides for penalty for default in case of stock brokers. If any person who, is registered, as a stock broker under this Act:

(i) fails to issue contract notes in the form and in the manner specified by the stock exchange of which such broker is a member, he shall be liable to a penalty not exceeding five times the amount for which the contract note was required to be issued by that broker;

(ii) fails to deliver any security or fails to make payment of the amount due to the investor in the manner or within the period specified in the regulations, he shall be liable to a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less;

(iii) charges an amount of brokerage which is in excess of the brokerage specified in the regulations, he shall be liable to a penalty of one lakh rupees or five times the amount of brokerage charged in excess of the specified brokerage, whichever is higher.

Factors for taking into account while action

While adjudging quantum of penalty under section 15J, the adjudicating officer shall have due regard to the following factors:

(i) the **amount of disproportionate gain or unfair advantage**, wherever quantifiable, made as a result of the defaults.

(ii) the **amount of loss to an investor** or group of investors as a result of the default.

(iii) the repetitive nature of the default.

Taking into consideration the above factors, the adjudicating officer may levy a maximum penalty as prescribed in section 15F for default by the concerned stock broker in making the payment to the investor.

(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 other wise 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).

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

2. **(a)** **(i)** Under the proviso to section 196 (3) of the Companies Act, 2013, a person who has attained the age of seventy years may be employed as managing director, whole-time director or manager by the approval of the members by a special resolution passed by the company in the general meeting and the explanatory statement annexed to the notice for such motion shall indicate the justification for appointing such person.

(ii) Under section 197 (7) of the Companies Act, 2013, independent directors may be paid profit related commission as may be approved by the members. However, under section 197 (1) the limit of total managerial remuneration payable by a public company, to its directors, including managing director and whole-time director, and its manager in respect of any financial year shall not exceed eleven per cent of the net profits of that company for that financial year computed in the manner laid down in section 198. Further, the third proviso to section 197 (1) provides that except with the approval of the company in general meeting, the remuneration payable to directors who are neither managing directors or whole-time directors shall not exceed one per cent. of the net profits of the company, if there is a managing or whole-time director or manager; or three per cent of the net profits in any other case Therefore, in the given case, the commission of 4% is beyond the limit specified, and the same should be approved by the members by ordinary resolution.

(iii) If, in any financial year, a company has no profits or its profits are inadequate, the company shall not pay to its directors, including managing or whole time director or manager, any remuneration exclusive of any fees payable to directors except in accordance with the provisions of Schedule V. Section II of Part II of schedule V provides that where in any financial year during the currency of tenure of a managerial person, a company has no profits or its profits are inadequate, it may, without Central Government approval, pay remuneration to the managerial person not exceeding Rs. 42 Lakhs for the year if the effective capital of the company is ranging from5 crore and above to Rs. 100 Crores. In the present case the proposed remuneration can be paid without the approval of Central Government.

(b) (i) Bonus Issue (Chapter IX of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009)

Chapter IX of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 contains the regulations (Regulations 92 to 95) for issue of bonus shares. Royal Ltd. can issue bonus shares in the ratio of 1:1 as follows:

1. **Authorisation by the articles to issue the bonus shares:** The Articles of Royal Ltd. must authorize it to issue the bonus shares and capitalization of reserve. If there is no provision in the Articles authorizing the company, firstly, the Articles shall be amended by passing a special resolution.

2. **Steps for determining** whether any increase in authorised share capital is required:

   (a) Paid up share capital as on 31st March, 2015: Rs. 150 crores.

   (b) Paid up capital (after conversion of Rs. 100 crores fully convertible debentures, assuming that these debentures shall be converted into share capital of Rs. 100 crores) Rs. 250 crores (l50+100).

   (c) Proposed bonus issue - 1 share for every 1 share held.

   (d) Post bonus issue capital: Rs. 500 crores (250+250).

   Since the Authorised share capital of the company is only Rs. 400 crores, it has to take steps to increase the amount to Rs. 500 crores or beyond by complying with the provisions laid down in sections 61and 64 of the Companies Act, 2013.

3. Sources of bonus shares:

   Reserves and surplus (free reserves built out of the genuine profits can be used for issue of bonus issue): Rs. 750 Crores

   Since the source of issue of bonus shares (Rs. 750 crores) is sufficient to issue bonus shares (Rs. 250 crores), the proposed issue can be made.

4. **Other legal requirements** for issue of Bonus shares are as under.

(a) A resolution shall be passed by the Board in a duly convened Board meeting.

(b) The bonus issue shall be made within 15 days of passing the Board resolution.

5. The bonus issue can be made if there is **no default in payment of interest or principal** in respect of fixed deposits and interest on existing debentures or principal on redemption thereof; and payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus, etc.

(ii) Section 223 of the Companies Act, 2013 deals with Inspector's report. The following provisions are applicable in respect of the Inspector's report on investigation:

(a) Submission of interim report and final report [Sub section (1)]: An inspector appointed under this Chapter (Chapter XIV- Inspection, Inquiry and Investigation) may, and if so directed by the Central Government shall, submit interim reports to that Government, and on the conclusion of the investigation, shall submit a final report to the Central Government.

(b) Report to be writing or printed [Sub section (2)]: Every report made under sub section (1) above, shall be in writing or printed as the Central Government may direct.

(c) Obtaining copy or report [Sub section (3)]: A copy of the above report may be obtained by making an application in this regard to the Central Government.

(d) Authentication of report [Sub section (4)]: The report of any inspector appointed under this Chapter shall be authenticated either—

(i) by the seal of the company whose affairs have been investigated; or

(ii) by a certificate of a public officer having the custody of the report, as provided under section 76 of the Indian Evidence Act, 1872, and such report shall be admissible in any legal proceeding as evidence in relation to any matter contained in the report.

(e) Exceptions: Nothing in this section shall apply to the report referred to in section 212 of the Companies Act, 2013.

3. (a) (i) According to Section 161(2) of the Companies Act, 2013, The Board of Directors of a company may, if so authorised by its articles or by a resolution passed by the company in general meeting, appoint a person, not being a person holding any alternate directorship for any other director in the company, to act as an alternate director for a director during his absence for a period of not less than three months from India.

According to section 173(3), a meeting of the Board may be called by giving atleast a 7 days' notice in writing to every director to his registered address with the company and such notice shall be sent by hand delivery or by post or by electronic means.

There is no legal precedence whether the notice of the meeting is to be sent to the original director or the alternate director. But as matter of prudence the notice of the meeting may be served to both the alternate director as well as the original director who is for the time being outside India.

(ii) 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. M 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. M after 31st August, 2015 shall be deemed to be invalid and not binding upon the Company.

(b) (i) An order under section 394 of the Companies Act, 1956 transferring the property, rights and liabilities of one company to another does not automatically transfer contracts of personal service, which are in their nature, incapable of being transferred and no contract of service is thereby created between an employee of the transferor company on the one hand and the transferee company on the other. In *Nokes vs. Doucaster Amalgamated Collieries Ltd. [(1940) 3All 2k 549],* the House of Lords categorically stated that the workers are not furniture and their services cannot be transferred without their consent. Therefore, the workers of ABC Co. Ltd will succeed against XYZ Co. Ltd.

(ii) 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 second case 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.

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

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

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

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

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

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

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

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

(b) (i) (1) The situation as stated in the question relates to the creation of a casual vacancy in the office of an auditor due to resignation of the auditor before the AGM. Under section 139 (8) any casual vacancy in the office of an auditor arising as a result of his resignation, such vacancy can be filled by the Board of Directors within thirty days thereof and in addition the appointment of the new auditor shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

(2) The Companies Act, 2013 categorizes companies into government companies and non government companies and lists down the provisions relating to appointment, removal etc. of auditors as per this classification. Hence, in the given case as the total shareholding of the above two institutions adds upto 22% of the subscribed capital of the company, so it is not a government company and also not a deemed Government company. Hence, the provisions applicable to non government companies in relation to the appointment of auditors shall apply.

(ii) As per section 2(b) of the Competition Act, 2002, an 'agreement' includes any arrangement or understanding or action in concert, -

- Whether or not, such a arrangement or understanding or action is formal or in writing; or
- Whether or not, such an arrangement or understanding or action is intended to be enforceable by legal proceedings.

In the given case the understanding reached among the automobile manufactures not to sell automobile parts below a certain price to the industries, shall amount to an agreement as defined under section 2(b) notwithstanding the fact that arrangement is in writing but not intended to be enforced by legal proceeding.

5. (a) Section 161(1) of the Companies Act, 2013 provides that the articles of association 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 at the general meeting, as an additional director at any time and such director will hold office upto the date of the next annual general meeting or the last date on which such annual general meeting should have been held, whichever is earlier.

(i) M cannot continue as director till the adjourned annual general meeting, since he can hold the office of directorship only 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. Such an additional director shall vacate his office latest on the date on which the annual general meeting could have been held under Section 96 of the Companies Act, 2013. He cannot continue in the office on the ground that the meeting was not held or could not be called within the time prescribed.

(ii) The power to appoint additional directors vests with the Board of Directors and not with the members of the company. The only condition is that the Board must be conferred such power by the articles of the company.

(iii) As a company secretary, I would put the following checks in place in respect of M's appointment as an additional director:

(a) He must have got the Directors Identification Number (DIN);

(b) He must furnish the DIN and a declaration that he is not disqualified to become a director under the Companies Act, 2013;

(c) He must have given his consent to act as director and such consent has been filed with the Registrar within 30 days of his appointment;

(d) His appointment is made by the Board of Directors;

(e) His name is entered in the statutory records as required under the Companies Act, 2013.

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

(a) the instrument constituting or defining the constitution of the company;

(b) the enactments or provisions by or under which the incorporation of the company was effected;

(c) the address in India where the said instrument, enactments or provisions, or copies thereof can be inspected. If the same are not in the English language, a certified translation thereof in the English language should be available for inspection;

(d) the date on which and the country in which the company would be or was incorporated; and

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

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

(ii) **Compensation to shareholders of the acquired bank:** Under section 36AE of the Banking Regulation Act, 1949, the Central Government has power to acquire the undertaking of Banking Companies. When a bank is acquired by the Central Government, a scheme for the acquired bank is made in consultation with the Reserve Bank of India.

Such Scheme also provides for compensation payable to the registered shareholders of the acquired Bank (Section 36AF).

Section 36AG of the Banking Regulation Act, 1949 states that compensation is paid to the registered shareholders in accordance with the principles provided in section 5 of the said Act.

Any shareholder aggrieved with the amount of compensation may request the Central Government to refer the matter to Tribunal to be constituted under section 36AH of the Act. If the number of representation received is not less than one-fourth of the total number of shareholders holding not less than one-fourth of the paid-up share capital of the acquired Bank, the Central Government shall constitute a Tribunal for the purpose. Thus, such matters can be resolved through the Tribunal by the Central Government and the amount of compensation determined by the Tribunal is final and binding on all concerned parties.

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

(ii) Under section 399(1)(a) of the Companies Act, 1956, in the case of a company having share capital, the following member(s) have the right to apply to the Company Law Board under section 397 or 398:

(1) Not less than 100 members of the company or not less than one-tenth of the total number of members, whichever is less; or

(2) Any member or members holding not less than one-tenth of the issued

share capital of the company provided the applicant(s) have paid all the calls and other sums due on the shares.

In the given case, since there are eight shareholders. As per the condition (a) above, 10% of 8 i.e. 1 satisfies the condition. Therefore a single member can present a petition to the Company Law Board (CLB), regardless of the fact that he holds less then one-tenth of the company's share capital.

(b) (i) Director Identification Number (DIN): It is an unique Identification Number allotted to an individual who is an existing director of a company or intends to be appointed as director of a company pursuant to section 153 and 154 of the Companies Act, 2013. Any person intending to apply for DIN shall have to make an application in eForm DIR-3. Following the documents required to be attached with the application-

- High resolution photograph of the applicant.
- PAN is mandatory now. So copy of pan is mandatory for identity, name, father's name and date of birth. Proof of father's name is not required in the case of foreign nationals.
- Copy of passport is mandatory as an id proof in the case of foreign nationals.
- Present Address proof which should not be older than 2 months
- Verification as perform DIR-4 as per the format given on the website.

(ii) "Money laundering" does not mean just siphoning of fund: Money Laundering is a moving of illegally acquired cash through financial systems so that it appears to be legally acquired. Thus, money laundering is not just the siphoning of fund but it is the conversion of money which is illegally obtained.

Prevention of Money Laundering Act, 2002 has been enacted with aim for combating channellising of money into illegal activities.

Significance and Aim of Prevention of Money Laundering Act, 2002: The preamble to the Act provides that it aims to prevent money–laundering and to provide for confiscation of property derived from, or involved in, money–laundering and for matters connected therewith or incidental thereto.

In order to further strengthen the existing legal framework and to effectively combat money laundering, terror financing and cross-border economic offences, an Amendment Act, 2009 was passed. The new law seeks to check use of black money for financing terror activities. Financial intermediaries like full-fledged money changers, money transfer service providers and credit card operators have also been brought under the ambit of The Prevention of Money-Laundering Act. Consequently, these intermediaries, as also casinos, have been brought under the reporting regime of the enforcement authorities.

It also checks the misuse of promissory notes by FIIs, who would now be required to furnish all details of their source. The new law would check misuse of "proceeds of crime" be it from sale of banned narcotic substances or breach of the Unlawful Activities (Prevention) Act. The passage of the Prevention of Money Laundering (Amendment), 2009 have enabled India's entry into Financial Action Task Force (FATF), an inter-governmental body that has the mandate to combat money laundering and terrorist financing.

7. (a) According to section 455(1) of the Companies Act, 2013:

1. A company is 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.
2. Such company or 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.
3. The Registrar shall allow the status of a dormant company to the applicant and issue a certificate after considering of the application.
4. 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 Registrar 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.

(b) Power of Central Government to appoint company prosecutors: This section 443 of the Companies Act, 2013 has come into force with effect from 12th September, 2013. This section lays down the provisions seeking to provide that the Central Government may appoint company prosecutors with the same powers as given under the Cr. PC on Public Prosecutors.

Appointment of company prosecutors: The Central Government may appoint (generally, or for any case, or in any case, or for any specified class of cases in any local area) one or more persons, as company prosecutors for the conduct of prosecutions arising out of this Act; and

(c) False. Section 129(2) of the Companies Act, 2013 provides that at every annual general meeting of a company, the Board of Directors of the company shall lay before such meeting financial statements for the financial year. Further section 134(7) provides that signed copy of every financial statement, including consolidated financial statement, if any, shall be issued, circulated or published along with a copy each of:

(i) any notes annexed to or forming part of such financial statement;

(ii) the auditor's report; and

(iii) the Board's report.

It, therefore, follows that unaudited accounts cannot be sent to members or unaudited accounts cannot be filed with the Registrar of Companies.

(d) **Policy not to be called in question -**Section 45 by the Insurance Laws(Amendment) Act, 2015 in the Insurance Act, 1938 says that no policy of life insurance shall be called in question on any ground whatsoever after the expiry of three years from the date of the policy, i.e., from the date of issuance of the policy or the date of commencement of risk or the date of revival of the policy or the date of the rider to the policy, whichever is later. A policy of life insurance may be called in question at any time within three years from the date of issuance of the policy or the date of commencement of risk or the date of revival of the policy or the date of the rider to the policy, whichever is later, on the ground of fraud. The insurer shall have to communicate in writing to the insured or the legal representatives or nominees or assignees of the insured the grounds and materials on which such decision is based.

(e) The provisions relating to disclaimer of onerous property will arise during the winding up of the company. The liquidator, may, with the leave of the court disclaim any onerous property within 12 months of the commencement of the winding up. If the existence of any disclaimable property does not come to the knowledge of the liquidator, within one month after the commencement of the winding up, he can disclaim at any time within 12 months after he has become aware of it. The Court has, however, the power to extend the time.

An onerous property may consist of (a) land of any tenure burdened with onerous covenants (b) shares or stocks in companies (c) any other property which is unsaleable or not readily saleable (d) unprofitable contracts.

The liquidator's right to disclaim is lost if within 28 days or such extended period as may be allowed by the court, of receiving a demand from any interested person to make his decision, he does not give notice that he intends to apply to the court for leave to disclaim [Section 535(4)].