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 assumptions may be made and disclosed by the candidates.

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

1. (a) High Ltd.'s balance sheet shows an intangible asset at Rs. 72 lakhs as on 01.04.2013, which was acquired for Rs. 96 lakhs on 01.04.2010 and was available for use from the same date. High Ltd. has been following the policy of amortisation of the intangible asset over a period of 12 years on straight line basis. Comment on the accounting treatment of the above with reference to the relevant accounting standard.

   (b) Milton Ltd. is a full tax free enterprise for the first 10 years of its existence and is in the second year of its operations. Depreciation timing difference resulting in a deferred tax liability in years 1 and 2 is Rs. 200 lakhs and 400 lakhs respectively. From the 3rd year onwards, it is expected that the timing difference would reverse each year by Rs. 10 lakhs. Assuming tax rate @ 35%, find out the deferred tax liability at the end of the second year and any charge to the profit and loss account.

   (c) State the treatment of Acquired intangible assets with reference to Indian Accounting Standards and IFRS.

   (d) From the following information compute diluted earnings per share:

Net profit for the year 2013-14	Rs. 12,00,000
Weighted average number of equity shares outstanding during year 2013-14	5,00,000 shares
Average fair value of one equity share during the year 2013-14	Rs. 20
Weighted average number of shares under option during the year 2013-14	1,00,000 shares
Exercise price per share under option during the year 2013-14	Rs. 15

(4 × 5 = 20 Marks)

2. From the following details, prepare a Consolidated Balance Sheet of We Ltd. and its subsidiaries as on 31st March, 2014:

	(Rs. in Lakhs)		
Assets:	We Ltd.	You Ltd.	Me Ltd.
Fixed assets (net)	816	312	126
Investment (at cost)			
7,50,000, Equity shares of You Ltd.	75	-	-
2,40,000 Equity shares of Me Ltd.	24	-	-
4,80,000 Equity shares of Me Ltd.	-	60	-
30,000 Cumulative preference shares of We Ltd.	-	-	30
4,500 Mortgage debentures of We Ltd.	-	-	42
Current assets	1,059	369	336
Profit and loss account	288	108	63
	2,262	849	597
Liabilities:			
Equity share capital (Rs. 10 each fully paid up)	180	144	120
7.5% Cumulative non-convertible preference share capital (Rs. 100 each fully paid)	45	36	30
Capital reserve (revaluation of fixed assets)	360	-	-
General reserve	75	45	30
7,500, 8% Mortgage debenture bonds of Rs. 1,000 each	75	-	-
Secured loans and advances:			
From banks	513	249	165
Unsecured loans:			
From You Ltd.	-	-	36
From Me Ltd.	45	-	-
Current liabilities and provisions:			
Inter-company balances	27	-	-
Other liabilities	942	375	216
	2,262	849	597

Other information are as follows:

(a) You Ltd. subscribed for 2,40,000 shares of Me Ltd. at par at the time of first issue and further acquired 2,40,000 shares from the market at Rs. 15 each, when the Reserve and Surplus account of Me Ltd. stood at Rs. 15 lakhs.

(b) We Ltd. subscribed for shares of You Ltd. and Me Ltd. at par at the time of first issue of shares by both the companies.

(c) Current assets of You Ltd. and Me Ltd. includes Rs. 12 lakhs and Rs. 18 lakhs respectively being current account balance against We Ltd. *(16 Marks)*

3. Following is the Balance Sheet of Momentous Ltd. as on 31st March, 2014:

Liabilities	Rs.	Assets	Rs.
1,00,000 equity shares of Rs. 10 each	10,00,000	Goodwill	5,00,000
10,000, 12% preference shares of Rs. 100 each	10,00,000	Buildings	15,00,000
		Plant	10,00,000
General reserve	6,00,000	Investment in 10% stock	4,80,000
Profit and Loss account	1,80,000	Stock-in-trade	6,00,000
15% Debentures	10,00,000	Debtors	4,00,000
Creditors	8,00,000	Cash	1,00,000
	45,80,000		45,80,000

Additional information are given below:

(a) Nominal value of investment is Rs. 5,00,000 and its market value is Rs. 5,20,000.

(b) Following assets are revalued:

		Rs.
(i)	Building	32,00,000
(ii)	Plant	18,00,000
(iii)	Stock-in-trade	4,50,000
(iv)	Debtors	3,60,000

(c) Average profit before tax of the company is Rs. 12,00,000 and 12.50% of the profit is transferred to general reserve, rate of taxation being 50%.

(d) Normal dividend expected on equity shares is 8% while fair return on closing capital employed is 10%.

(e) Goodwill may be valued at three year's purchase of super profits.

Ascertain the value of an equity share under

(i) Intrinsic value method

(ii) Yield method

(iii) Fair value method. *(16 Marks)*

4. (a) The following information (as of 31-03-2014) is supplied to you by Add-on Ltd.:

			(Rs. in crores)
(i)	Profit after tax (PAT)		205.90
(ii)	Interest		4.85

(iii)	Equity Share Capital	40.00	
	Accumulated surplus	700.00	
	Shareholders fund	740.00	
	Loans (Long term)	37.00	
	Total long term funds		777.00
(iv)	Market capitalization		2,892.00
Additional information:			
(a)	Risk free rate		12.00 percent
(b)	Long Term Market Rate (Based on BSE Sensex)		15.50 percent
(c)	Effective tax rate for the company		25.00 percent
(d)	Beta (β) for last few years		
	Year		
	1	0.48	
	2	0.52	
	3	0.60	
	4	1.10	
	5	0.99	

Using the above data you are requested to calculate the Economic Value Added of Add-on Ltd. as on 31st March, 2014.

(b) (i) Examine classification of term deposit worth Rs. 800 lakhs, having original maturity of 5 years with banks in the Schedule III to the Companies Act, 2013, when its remaining maturity is:

(1) 3 months;

(2) 8 months; or

(3) 2 years.

(ii) An entity has acquired a leasehold land for 30 years. Remaining lease period of that land is 6 months as on the reporting date i.e. 31.3.2014. What will be the classification of the said leasehold land in Schedule III ? *(10 + 6 = 16 Marks)*

5. The summarized Balance Sheet of M Ltd. as on 31st March, 2014 is as follows:

Liabilities	Rs.	Assets	Rs.
Authorised and issued share capital		Goodwill	2,00,000
20,000 Equity shares of Rs.100	20,00,000	Plant & Machinery	18,00,000

each, fully paid			
10,000, 7% Preference shares of Rs.100 each	10,00,000	Stock	3,00,000
Sundry creditors	7,00,000	Debtors	7,50,000
Bank overdraft	3,00,000	Cash	1,50,000
		Profit and Loss A/c	8,00,000
	40,00,000		40,00,000

Additional Information:

Two years' preference share dividend is in arrears. The company had bad time during the last two years and hopes for better business in future, earning profit and paying dividend, provided the capital base is reduced.

An internal reconstruction scheme, agreed to by all concerned, is as follows:

(i) Creditors agreed to forego 50% of their claim.

(ii) Preference shareholders withdrew arrear dividend claim. They also agreed to lower down their capital claim by 20% by reducing nominal value in consideration of 9% dividend effective after reconstruction, in case equity shareholder's loss exceeded 50% on the application of the scheme.

(iii) Bank has agreed to convert overdraft into term loan to the extent required for making current ratio to 2:1.

(iv) Revalued amount for plant and machinery was accepted as Rs. 15,00,000.

(v) Debtors to the extent of Rs. 4,00,000 were considered as good.

(vi) Equity shares shall be exchanged for the same number of equity shares at a revised denomination as required after the reconstruction.

You are required to show the following:

(a) Total loss to be borne by the equity and preference shareholders for the reconstruction

(b) Share of loss to the individual class of shareholders

(c) New structure of share capital after reconstruction

(d) Working capital of the reconstructed company, and

(e) A Performa Balance Sheet after reconstruction. *(16 Marks)*

6. (a) On the basis of the following income statement pertaining to B Ltd., you are required to prepare:

   (i) Gross value added statement; and

   (ii) Statement showing reconciliation of gross value added with Profit Before Taxation.

Profit and Loss Account of B Ltd.
for the year ended 31st March, 2014

	(Rs. in thousands)	(Rs. in thousands)
Income		
Sales less returns		15,27,956
Dividends and interest		130
Miscellaneous income		474
(A)		15,28,560
Expenditure		
Production and operational expenses:		
Decreases in inventory of finished goods	26,054	
Consumption of raw materials	7,40,821	
Power and lighting	1,20,030	
Wages, salaries and bonus	3,81,760	
Staff welfare expenses	26,240	
Excise duty	14,540	
Other manufacturing expenses	32,565	13,42,010
Administrative expenses:		
Directors' remuneration	7,810	
Other administrative expenses	32,640	40,450
Interest on:		
9% Mortgage debentures	14,400	
Long-term loan from financial institution	10,000	
Bank overdraft	100	24,500
Depreciation on fixed assets		50,600
(B)		14,57,560
Profit before Taxation (A) — (B)		71,000
Provision for Income-tax		25,470
Profit after Taxation		45,530
Balance of account as per last Balance Sheet		6,300
		51,830

Transferred to:		
General reserve 40% of Rs. 45,530	18,212	
Proposed dividend @ 22%	22,000	
Tax on distributed profits @ 12.81%	2,818	(43,030)
Surplus carried to Balance Sheet		8,800

(b) A Mutual Fund raised 100 lakh on April 1, 2013 by issue of 10 lakh units of Rs. 10 per unit. The fund invested in several capital market instruments to build a portfolio of Rs. 90 lakhs. The initial expenses amounted to Rs. 7 lakh. During April, 2013, the fund sold certain securities of cost Rs. 38 lakhs for Rs. 40 lakhs and purchased certain other securities for Rs. 28.20 lakhs. The fund management expenses for the month amounted to Rs. 4.50 lakhs of which Rs. 0.25 lakh was in arrears. The dividend earned was Rs. 1.20 lakhs. 75% of the realized earnings were distributed. The market value of the portfolio on 30.04.2013 was Rs. 101.90 lakh. Determine NAV per unit. *(10 + 6 = 16 Marks)*

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

(a) On 1st April, 2014, a company offered 100 shares to each of its 500 employees at Rs. 50 per share. The employees are given a month to decide whether or not to accept the offer. The shares issued under the plan (ESPP) shall be subject to lock-in on transfers for three years from grant date. The market price of shares of the company on the grant date is Rs. 60 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at Rs. 56 per share.

On 30th April, 2014, 400 employees accepted the offer and paid Rs. 30 per share purchased. Nominal value of each share is Rs. 10.

Record the issue of shares in the books of the company under the aforesaid plan.

(b) During the course of the last three years, a company owning and operating Helicopters lost four Helicopters. The company's accountant felt that after the crash, the maintenance provision created in respect of the respective helicopters was no longer required, and proposed to write it back to the Profit and Loss account as a prior period item.

Is the Accountant's proposed accounting treatment correct? Discuss.

(c) F Ltd. borrows a sum of Rs. 20 crore from C Ltd., repayable as a single bullet payment at the end of 5 years. The interest thereon @ 5% p.a. is payable at yearly rests. Since the market rate is 8%, F Ltd. paid an origination fee of Rs. 2.40 crores to C Ltd. to compensate C Ltd. for the lower rate of interest. Apart from the above,

there are no other transactions between the two parties. You are required to show the value at which C Ltd., would recognize the loan and the annual interest thereon.

(d) An asset does not meet the requirements of environment laws which have been recently enacted. Therefore, it has to be destroyed as per the law. The asset is carried in the Balance Sheet at the year end at Rs. 6,00,000. The estimated cost of destroying the asset is Rs. 70,000. How should the asset be accounted for?

(e) Safe Ltd. has taken a Transit Insurance Policy. Suddenly in the year 2013-2014 the percentage of accident has gone up to 7% and the company wants to recognize insurance claim as revenue in 2013-2014 in accordance with the relevant Accounting Standard. Do you agree? Explain in brief, as per the relevant Accounting Standard. *(4 x 4 =16 Marks)*

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SUGGESTED ANSWERS/HINTS

1. (a) As per para 63 of AS 26 "Intangible Assets", the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

High Ltd. has been following the policy of amortisation of intangible asset over a period of 12 years on straight line basis. The period of 12 years is more than the maximum period of 10 years specified under AS 26. Accordingly, High Ltd. would be required to restate the carrying amount of intangible asset as on 1.4.2013 at Rs. 96 lakhs less Rs. 28.8 lakhs [(Rs. 96 lakhs/10 years) × 3 years] = Rs. 67.2 lakhs. If amortisation had been as per AS 26, the carrying amount would have been Rs. 67.2 lakhs only. The difference of Rs. 4.8 lakhs i.e. (Rs. 72 lakhs – Rs. 67.2 lakhs) would be adjusted against the opening balance of revenue reserve. The carrying amount of Rs. 67.2 lakhs would be amortised over 7 (10 less 3) years in future instead of 9 years.

(b) In the case of tax free companies, no deferred tax liability is recognized, in respect of timing differences that originate and reverse in the tax holiday period. Deferred tax liability or asset is created in respect of timing differences that originate in a tax holiday period but are expected to reverse after the tax holiday period. For this purpose, adjustments are done in accordance with the FIFO method.

Of Rs. 200 lakhs, Rs. 80 lakhs will reverse in the tax holiday period. Therefore, Deferred Tax Liability will be created on Rs. 120 lakhs @ 35% i.e. Rs. 42 lakhs.

In the second year, the entire Rs. 400 lakhs will reverse only after the tax holiday period.

Therefore, deferred tax charge in the Profit and Loss Account will be Rs. 400 x 35% = Rs. 140 lakhs and deferred tax liability in the Balance Sheet will be (42+140) = Rs. 182 lakhs.

(c) Treatment under Indian Accounting Standard and IFRS

	Indian Accounting Standards	*IFRS*
Acquired intangible assets	If recognition criteria are satisfied then it can be capitalized. All intangibles are	If recognition criteria are satisfied then it can be capitalized. It is amortized

	amortized over useful life with rebuttable presumption of not exceeding 10 years. Revaluations are not permitted. Intangible assets acquired free of charge or for nominal consideration by way of government grant is recognised **at nominal value or at acquisition cost**, as appropriate, plus any expenditure that is attributable to making the asset ready for intended use.	over useful life. Intangibles assigned an indefinite useful life are not amortized but reviewed at least annually for impairment. Revaluations are permitted in rare circumstances. When intangible assets are acquired free of charge or for nominal consideration by way of government grant an entity should record both the grant and the intangible asset **at fair value.** If an entity chooses not to recognise the asset initially at fair value, the entity may recognise the asset initially **at a nominal amount** plus any expenditure that is directly attributable to preparing the asset for its intended use.

(d) Computation of diluted earnings per share

	Earnings (Rs.)	Shares	Earnings per share (Rs.)
Net profit for the year 2013-14	12,00,000		
Weighted average number of equity shares outstanding during the year 2013-14		5,00,000	
Weighted average number of shares under option		1,00,000	
Number of shares that would have been issued at fair value [(1,00,000 × 15.00)/20.00]	*	(75,000)	
Diluted earnings per share	12,00,000	5,25,000	2.29

*The earnings have not been increased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of computation to have been issued for no consideration (Para 37(b) of AS 20).

2. Consolidated Balance Sheet of We Limited and its subsidiaries as on 31st March, 2014

Particulars	Note No.	(Rs.)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	1,95,00,000
(b) Reserves and Surplus	2	95,81,250
(2) Minority Interest		1,32,18,750
(3) Non-current Liabilities		
Long-term borrowings	3	9,57,00,000
(4) Current Liabilities	4	15,33,00,000
Total		29,13,00,000
II. Assets		
(1) Non-current assets		
Fixed assets		
Tangible assets		12,54,00,000
Intangible assets	5	3,00,000
(2) Current assets	6	16,56,00,000
Total		29,13,00,000

Notes to Accounts

			Rs.
1.	Share Capital		
	18,00,000, Equity Shares of Rs. 10 each	1,80,00,000	
	15,000, 7½% Cumulative Non-convertible Preference shares of Rs. 100 each	15,00,000	1,95,00,000
2.	Reserves and Surplus		
	Capital reserve	3,60,00,000	
	Profit and loss account	(2,64,18,750)	95,81,250
3.	Long Term Borrowings		
	8% Mortgage debentures	30,00,000	
	Secured loan from bank	9,27,00,000	9,57,00,000

4.	Current Liabilities		
	We Ltd.	9,42,00,000	
	You Ltd.	3,75,00,000	
	Me Ltd.	2,16,00,000	15,33,00,000
5.	Intangible assets		
	Goodwill		3,00,000
6.	Current assets		
	Balances of		
	We Ltd.	10,59,00,000	
	You Ltd.	3,69,00,000	
	Me Ltd.	3,36,00,000	
		17,64,00,000	
	Less: Inter-company owing	(81,00,000)	
		16,83,00,000	
	Less: Inter-company balances	(27,00,000)	16,56,00,000

Working Notes:

			In You Ltd.	In Me Ltd.
(1)	**Shareholding Pattern**			
	(i) We Limited		25/48	2/10
	(ii) You Limited			4/10
	(iii) Minority Interest		23/48	4/10
			Capital	Revenue
			Rs.	Rs.
(2)	**Analysis of Profits**			
	(a) Me Limited			
	Balance at acquisition		15,00,000	
	Balance as per P&L A/c	(63,00,000)		
	Less: General reserve	30,00,000		
	Less: Profit on debentures	3,00,000		
	Net loss as on 31.3.2014	(30,00,000)		
	Less: Capital profit	15,00,000		
		(45,00,000)		(45,00,000)

	Minority interest (4/10)		6,00,000	(18,00,000)
	Share of You Limited (4/10)		6,00,000	(18,00,000)
	Share of We Limited (2/10)		3,00,000	(9,00,000)
	(b) **You Limited**			
	P&L A/c as on 31.3.2014			(1,08,00,000)
	General Reserve			45,00,000
				(63,00,000)
	Share of revenue loss in Me Ltd.			(18,00,000)
				(81,00,000)
	Minority Interest (23/48)			(38,81,250)
	We Ltd. (25/48)			(42,18,750)
			You Ltd.	Me Ltd.
(3)	**Goodwill / Capital Reserve**			
	Cost of investment		75,00,000	84,00,000
	Less: Share capital		(75,00,000)	(72,00,000)
	Capital profit		(3,00,000)	(6,00,000)
	Capital reserve/Goodwill		(3,00,000)	6,00,000
	Goodwill Rs. 6,00,000 less Rs. 3,00,000		3,00,000	
(4)	**Minority Interest**			
	Share capital		69,00,000	48,00,000
	Capital profit		-	6,00,000
	Revenue profit		(38,81,250)	(18,00,000)
	Preference shares (36,00,000+30,00,000)		-	66,00,000
			30,18,750	1,02,00,000
	Total			1,32,18,750
(5)	**Profit and Loss Account – We Ltd.**			
	Balance as on 31.03.2014		(2,88,00,000)	
	General reserve		75,00,000	
	Share of Me Limited		(9,00,000)	
	Share of You Limited		(42,18,750)	(2,64,18,750)

3. **(i) Value per Share (Intrinsic Value Method)**

= Rs. 40,82,000 ÷ 1,00,000 = Rs. 40.82

(ii) Value per Share (Yield Method)

Yield on equity shares $= \frac{\text{Profit for Equity Shareholders}}{\text{Equity Capital}} \times 100$

$= \frac{\text{Rs. } 3,83,125}{10,00,000} \times 100 = 38.31\%$

Value per Share (Yield Method) = $\frac{38.31}{8} \times 10$ = Rs. 47.89

Value of equity share under Fair Value Method

$\frac{(\text{Intrinsic Value} + \text{Yield Value})}{2} = \frac{(40.82 + 47.89)}{2}$ = Rs. 44.36 (approx.)

Working Notes:

		Rs.	Rs.
1.	**Capital Employed**		
	Assets:		
	Buildings		32,00,000
	Plant		18,00,000
	Stock		4,50,000
	Debtors		3,60,000
	Cash		1,00,000
			59,10,000
	Less: Liabilities:		
	Creditors	8,00,000	
	Debentures	10,00,000	(18,00,000)
	Capital Employed		41,10,000
2.	**Actual Profit**		
	Average Profit		12,00,000
	Less: Income from investment		(50,000)
			11,50,000
	Less: Income Tax @ 50%		(5,75,000)
	Actual Profit		5,75,000

3.	**Profit for Equity Shareholders**		
	Actual Profit		5,75,000
	Less: Transfer to Reserve @ 12.50%		(71,875)
	Less: Preference Dividend		(1,20,000)
	Profit available to Equity Shareholders		3,83,125
4.	**Normal Profit** = 10% of Capital Employed = 10% of Rs. 41,10,000 = Rs. 4,11,000		
5.	**Super Profit** = Actual profit – Normal profit = Rs. 5,75,000 – Rs. 4,11,000 = Rs. 1,64,000		
6.	**Goodwill** = Rs. 1,64,000 × 3 = Rs. 4,92,000		
7.	**Net Assets for equity shareholders** = Capital Employed + Goodwill + Investment – Preference Share Capital = Rs. (41,10,000 + 4,92,000 + 4,80,000 – 10,00,000) = Rs. 40,82,000		

4. (a) Net Operating Profit After Tax (NOPAT) = Profit After Tax (PAT) + Interest (net of tax)

= 205.90 + 4.85 x (1-0.25) = Rs. 209.54 crores

Debt Capital		Rs. 37 crores
Equity capital (40 + 700)	=	Rs. 740 crores
Capital employed	=	37 + 740 = Rs. 777 crores
Debt to capital employed	=	Rs. 37 crores/Rs. 777 crores = 0.0476
Equity to capital employed	=	Rs. 740 crores /Rs. 777 crores =0.952
Interest cost before Tax		Rs. 4.85 crores
Less: Tax (25% of Rs. 4.85 crores)		(Rs. 1.21 crores)
Interest cost after tax		Rs. 3.64 crores
Cost of debt	=	(Rs. 3.64 crores/ Rs. 37 crores) x 100
	=	9.83%

According to Capital Asset Pricing Model (CAPM), Beta for calculation of EVA should be the highest of the given beta for the last few years. Accordingly,

Cost of Equity Capital = Risk Free Rate + Beta (Market Rate – Risk Free Rate)

= 12% + 1.10 × (15.50% - 12%)

= 12% + 1.10 × 3.5% = 15.85%

Weighted Average Cost of Capital (WACC) = Equity to Capital Employed (CE) x Cost of Equity Capital + Debt to CE x Cost of Debt

= 0.952× 15.85% + 0.0476 × 9.83%

= 15.09% + 0.47% = 15.56%

Cost of Capital Employed (COCE) = WACC × Capital Employed

= 15.56% × Rs. 777 crores = Rs. 120.90 crores

Economic Value Added (E.V.A.) = NOPAT – COCE

= Rs. 209.54 crores – Rs. 120.90 crores = Rs. 88.64 crores

(b) **(i)** Considering definition of cash and cash equivalents under AS 3 "Cash Flow Statements", deposits with original maturity of three months or less can be classified as cash equivalents. Accordingly, term deposit with remaining maturity of three months as on balance sheet date should be included under 'cash and cash equivalents' under 'current assets'.

As per Schedule III to the Companies Act, 2013, the bank deposits with more than 12 months maturity are to be shown separately under cash and cash equivalents. This is in conflict with the provisions of AS 3 as stated above. The solution in this regard has been provided under Guidance Note on Revised Schedule VI* issued by the ICAI, which states that the caption 'cash and cash equivalents' should be changed to 'cash and bank balances' which may have two sub-heading viz 'cash and cash equivalents' and 'other bank balances'.

Accordingly, term deposit (whose remaining period is 8 months) should be shown as "other bank balances" under cash and bank balances. However, the term deposit whose remaining maturity period is two years should be shown as non-current asset as the same is not realizable within 12 months from the balance sheet date.

(ii) All fixed assets (tangible and intangible assets) including leasehold assets will be classified as fixed asset even if its balance estimated useful life is below 12 months as on the reporting date. Only the fixed assets held for sale are classified as a current asset since the intent of the company to sell it is established.

5. (a) **Loss to be borne by Equity and Preference Shareholders**

	Rs.
Profit and loss account (debit balance)	8,00,000
Goodwill	2,00,000
Plant & Machinery	3,00,000
Debtors	3,50,000

* Now Schedule III to the Companies Act, 2013.

Amount to be written off	16,50,000
Less: 50% of Creditors	3,50,000
Recorded loss borne by the share holders	13,00,000
Add: Arrears of preference dividend of 2 years forgone by the preference shareholders	1,40,000
Total sacrifice by the shareholders of M Ltd.	14,40,000

(b) Share of loss to be borne by the equity and preference shareholders

	Rs.	Rs.
Total recorded loss of Rs. 13,00,000		
Preference shareholders' share of loss = 20% of Rs. 10,00,000	2,00,000	
Add: Arrears of preference dividend	1,40,000	3,40,000
Equity shareholders' share of loss (Rs.13,00,000 – Rs. 2,00,000) being more than 51% of equity share capital		11,00,000
		14,40,000

(c) New structure of share capital after reorganisation

Equity shares:	Rs.
20,000 equity shares of Rs. 45 each, fully paid up (Rs. 20,00,000 – Rs. 11,00,000)	9,00,000
Preference shares:	
10,000, 9% preference shares of Rs. 80 each, fully paid up (Rs. 10,00,000 – Rs. 2,00,000)	8,00,000
	17,00,000

(d) Working capital of the reorganized company

Current Assets:	Rs.	Rs.
Stock		3,00,000
Debtors		4,00,000
Cash		1,50,000
		8,50,000
Less: Current liabilities:		
Creditors	3,50,000	

Bank overdraft **	75,000	(4,25,000)
Working capital		4,25,000

(e) **Balance Sheet of M Ltd. (and reduced)**
as on 31st March, 2014

Particulars	Note No.	Rs.
I. Equity and Liabilities		
(1) Shareholder's Funds		
Share Capital	1	17,00,000
(2) Non-current Liabilities		
Long-term borrowings	2	2,25,000
(3) Current Liabilities		
(a) Trade Payables		3,50,000
(b) Other Current Liabilities	3	75,000
Total		23,50,000
II. Assets		
(1) Non-current assets		
Fixed assets		
Tangible Assets	4	15,00,000
(2) Current assets		
(a) Inventories		3,00,000
(b) Trade receivables		4,00,000
(c) Cash and cash equivalents	5	1,50,000
Total		23,50,000

Notes to Accounts

		Rs.	Rs.
1.	Share Capital		
	Equity share capital		
	20,000 Equity shares of Rs.45 each, fully paid up	9,00,000	
	9% Preference share capital		

** Current ratio shall be 2 : 1, i.e. total current liabilities shall be 50% of Rs. 8,50,000 (i.e. Rs. 3,00,000 + 4,00,000 + 1,50,000) = Rs. 4,25,000. Therefore, Bank overdraft = Rs. 75,000 (Rs. 4,25,000 less creditors Rs. 3,50,000).

	10,000 shares of Rs. 80 each	8,00,000	17,00,000
2.	Long Term Borrowings		
	Unsecured:		
	Term loan with Bank		2,25,000
3.	Other Current Liabilities		
	Bank overdraft		75,000
4.	Tangible Assets		
	Plant and machinery		15,00,000
5.	Cash & cash equivalents		
	Cash		1,50,000

6. (a)

B Ltd.

Value Added Statement for the year ended 31st March, 2014

	(Rs. in thousands)	*(Rs. in thousands)*
Sales less returns		15,27,956
Less: Cost of bought in materials and services, as per working note	9,19,470	
Administrative expenses	32,640	
Interest on bank overdraft	100	(9,52,210)
Value added by manufacturing and trading activities		5,75,746
Add: Dividends and interest		130
Miscellaneous income		474
Total value added		5,76,350

Application of value added

	(Rs. in thousands)	*(Rs. in thousands)*	%
To pay Employees:			
Wages, salaries and bonus	3,81,760		
Staff welfare expenses	26,240	4,08,000	70.79
To pay Directors:			
Directors' remuneration		7,810	1.36
To pay Government:			
Excise duty	14,540		

Income tax	25,470		
Tax on distributed profits	2,818	42,828	7.43
To pay providers of capital:			
Interest on 9% debentures	14,400		
Interest on long-term loan from financial institution	10,000		
Dividend to shareholders	22,000	46,400	8.05
To provide for maintenance and expansion of the company:			
Depreciation on Fixed assets	50,600		
Transfer to General reserve	18,212		
Retained profit (8,800-6,300)	2,500	71,312	12.37
		5,76,350	100.00

Statement showing reconciliation of total value added with Profit before taxation

	(Rs. in thousands)	*(Rs. in thousands)*
Profit Before Taxation		71,000
Add back:		
Wages, salaries and bonus	3,81,760	
Staff welfare expenses	26,240	
Excise duty	14,540	
Directors' remuneration	7,810	
Interest on 9% mortgage debentures	14,400	
Interest on long-term loan from financial institution	10,000	
Depreciation on fixed assets	50,600	5,05,350
Total Value Added		5,76,350

Working Note:

Calculation of cost of bought in materials and services:

	(Rs. in thousands)
Decrease in inventory of finished goods	26,054
Consumption of raw materials	7,40,821
Power and lighting	1,20,030

Other manufacturing expenses	32,565
	9,19,470

(b)

	Rs. in lakhs	*Rs. in lakhs*	
Opening bank balance [(100- 90-7) Rs. lakhs]	3.00		
Add: Proceeds from sale of securities	40.00		
Dividend received	1.20	44.20	
Less:			
Cost of securities	28.20		
Fund management expenses [(4.50–0.25) Rs. lakhs]	4.25		
Capital gains distributed [75% of (40.00 – 38.00) Rs. lakhs]	1.50		
Dividends distributed (75% of Rs. 1.20 lakhs)	0.90	(34.85)	
Closing bank balance		9.35	
Closing market value of portfolio		101.90	
		111.25	
Less: Arrears of expenses		0.25	
Closing net assets		111.00	
Number of units			10,00,000
Closing Net Assets Value (NAV)			Rs. 11.10

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

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

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

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

Vesting period = 1 month

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

Journal Entry

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
30.04.2014	Bank A/c (40,000 shares x Rs. 50)	Dr.	20,00,000	

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

(b) The balance amount of maintenance provision written back to profit and loss account, no longer required due to crash of the helicopters, is not a prior period item because there was no error in the preparation of previous periods' financial statements. The term 'prior period items', as defined in AS 5 (revised) "Net Profit or Loss for the Period, Prior Period Items and Changes In Accounting Policies", refer only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

As per para 8 of AS 5, extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived. The amount so written-back (if material) should be disclosed as an extraordinary item as per AS 5.

(c) The fair value of the Loan to C Ltd. is the present value of the interest it will receive over the next 5 years and the present value of repayment at the end of 5th year.

P.V. of interest discounted @ 8% = [(20,00,00,000 × 5%) × 3.9926] = Rs. 3,99,26,000 (A)

P.V. of principal amount = Rs. 20,00,00,000 discounted @ 8%

= Rs. 20,00,00,000 × 0.6806 =13,61,20,000 (B)

Fair Value of Loan (A + B) i.e. Rs. 17,60,46,000 (i.e. approximately Rs. 17,60,00,000 which is loan amount net of origination fee)

Therefore, C Ltd. will recognize the loan at Rs. 17.60 crores only.

C Ltd. will recognize the interest using the effective interest rate method as worked out below:

Year	Amortised Cost (Opening Balance)	Interest income @ 8% to be recognised	Total	Payment received	Amortised Cost (Closing Balance)
	(1)	(2)	(3)	(4)	(5) = (3) – (4)
1	17,60,00,000	1,40,80,000	19,00,80,000	1,00,00,000	18,00,80,000
2	18,00,80,000	1,44,06,400	19,44,86,400	1,00,00,000	18,44,86,400

3	18,44,86,400	1,47,58,912	19,92,45,312	1,00,00,000	18,92,45,312
4	18,92,45,312	1,51,39,625	20,43,84,937	1,00,00,000	19,43,84,937
5	19,43,84,937	1,56,15,063*	21,00,00,000	21,00,00,000	Nil

*Note: The interest in the 5th year has been adjusted in accordance to the value received on closure.

(d) As per AS 28 "Impairment of Assets", impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount, where, recoverable amount is the higher of an asset's net selling price* and its value in use•. In the given case, recoverable amount will be nil [higher of value in use (nil) and net selling price (Rs. 70,000)]. Thus impairment loss will be calculated as Rs. 6,00,000 [carrying amount (Rs. 6,00,000) – recoverable amount (nil)]. Therefore, asset is to be fully impaired and impairment loss of Rs. 6,00,000 has to be recognized as an expense immediately in the Statement of Profit and Loss as per para 58 of AS 28.

(e) As per AS 9 'Revenue Recognition', revenue recognition is mainly concerned with the timing of recognition of revenue in the profit and loss account. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of services, as the case may be even though payments are made in installments. Also, the amount of revenue is usually determined by agreement between the parties to the transaction.

In the given case, Safe Ltd. wants to recognize insurance claim as revenue in advance, because percentage of accidents has increased over the previous year. But, there are uncertainties involved in the settlement of the claim. Also, the claim does not occur in the course of ordinary activity of the company.

Hence, Safe Ltd. is not advised to recognize the insurance claim as revenue.

*Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal. In the given case, Net Selling Price = Selling price – Cost of disposal = Nil – Rs.70,000 = (Rs. 70,000)

• Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. In the given case, value in use is nil.

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 BSE's Market Index is currently trading at 27,000 whose 6 months future's value is trading at 27,810. The Current price of Anand Ltd.'s share listed on BSE is Rs. 1,800. The beta of share is 1.80.

Assuming it is possible to borrow money in the market for transactions in securities at 10% per annum, you are required:

(i) To calculate 6 months future's value and the theoretical minimum price of a 6-months forward purchase of Anand Ltd.'s share; and

(ii) To find arbitrate opportunity, if any possible. *(5 Marks)*

(b) Sun Ltd. is planning to import equipment from Japan at a cost of 3,400 lakh yen. The company may avail loans at 18 percent per annum with which it can import the equipment. The company has also an offer from Osaka branch of an India based bank extending credit of 180 days at 2 percent per annum against opening of an irrecoverable letter of credit.

Additional information:

Present exchange rate	Rs. 100 = 340 yen
180 day's forward rate	Rs. 100 = 345 yen

Commission charges for letter of credit at 2 per cent per 12 months.

Advice the company whether the offer from the foreign branch should be accepted.

(5 Marks)

(c) Assuming lease amortised in 5 years, calculate alternate rental structure from the following:

Investment Outlay	Rs. 100 Lakh
Pre Tax Rate	20%
Scrap Value	Nil

Calculate Lease Rentals as per Schemes, assuming that if rent is payable in year end:

(a) Equal Annual Plan

(b) Stepped Up Plan (15% increase per annum) *(5 Marks)*

(d) Z Co. Ltd. issued commercial paper worth Rs.10 crores as per following details:

Date of issue	:	16th January, 2009
Date of maturity	:	17th April, 2009
No. of days	:	91
Interest rate		12.04% p.a

What was the net amount received by the company on issue of CP? (Charges of intermediary may be ignored). *(5 Marks)*

2. (a) From the following details relating to a project, analyse the sensitivity of the project to changes in initial project cost, annual cash inflow and cost of capital:

Initial Project Cost (Rs.)	1,20,000
Annual Cash Inflow (Rs.)	45,000
Project Life (Years)	4
Cost of Capital	10%

To which of the three factors, the project is most sensitive? (Use annuity factors: for 10% ... 3.169 and 11% ... 3.103). *(10 Marks)*

(b) A Mutual Fund having 300 units has shown its NAV of Rs.8.75 and Rs.9.45 at the beginning and at the end of the year respectively. The Mutual Fund has given two options:

(i) Pay Rs.0.75 per unit as dividend and Rs.0.60 per unit as a capital gain, or

(ii) These distributions are to be reinvested at an average NAV of Rs.8.65 per unit.

What difference it would make in terms of return available and which option is preferable? *(6 Marks)*

3. (a) XY Limited is engaged in large retail business in India. It is contemplating for expansion into a country of Africa by acquiring a group of stores having the same line of operation as that of India.

The exchange rate for the currency of the proposed African country is extremely volatile. Rate of inflation is presently 40% a year. Inflation in India is currently 10% a year. Management of XY Limited expects these rates likely to continue for the foreseeable future.

Estimated projected cash flows, in real terms, in India as well as African country for the first three years of the project are as follows:

	Year – 0	Year – 1	Year – 2	Year - 3
Cashflowsin Indian Rs. (000)	-50,000	-1,500	-2,000	-2,500
Cash flows in African Rands (000)	-2,00,000	+1,80,000	+1,60,000	+1,50,000

It evaluates all investments using nominal cash flows and a nominal discounting rate. The present exchange rate is African Rand 6 to Rs. 1.

You are required to calculate the net present value of the proposed investment considering the following:

(i) African Rand cash flows are converted into rupees and discounted at a risk adjusted rate.

(ii) All cash flows for these projects will be discounted at a rate of 20% to reflect it's high risk.

(iii) Ignore taxation.

	Year - 1	Year - 2	Year - 3
PVIF @ 20%	.833	.694	.579

(8 Marks)

(b) XYZ Ltd. is an export oriented business house based in Mumbai. The Company invoices in customers' currency. Its receipt of US $ 1,00,000 is due on September 1, 2009.

Market information as at June 1, 2009 is:

Exchange Rates US $/Rs.		Currency Futures US $/Rs.	Contract Size Rs.4,72,000
Spot	0.02140	June	0.02126
1 Month Forward	0.02136	September	0.02118
3 Months Forward	0.02127		

	Initial Margin	Interest Rates in India
June	Rs.10,000	7.50%
September	Rs.15,000	8.00%

On September 1, 2009 the spot rate US $/ Rs. is 0.02133 and currency future rate is 0.02134. Comment which of the following methods would be most advantageous for XYZ Ltd.

(a) Using forward contract

(b) Using currency futures

(c) Not hedging currency risks.

It may be assumed that variation in margin would be settled on the maturity of the futures contract. *(8 Marks)*

4. (a) Calculate economic value added (EVA) with the help of the following information of Hypothetical Limited:

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

(6 Marks)

(b) John inherited the following securities on his uncle's death:

Types of Security	Nos.	Annual Coupon %	Maturity Years	Yield %
Bond A (Rs. 1,000)	10	9	3	12
Bond B (Rs. 1,000)	10	10	5	12
Preference shares C (Rs. 100)	100	11	*	13*
Preference shares D (Rs. 100)	100	12	*	13*

*likelihood of being called at a premium over par.

Tax Rate applicable on John is 20% and dividend incomes are tax free. Compute the current value of his uncle's portfolio. *(10 Marks)*

5. (a) MSN Ltd. has total sales of Rs. 4.50 crores and its average collection period is 120 days. The past experience indicates that bad debt losses are 2 percent on sales. The expenditure incurred by the company in administering its receivable collection efforts are Rs. 6,00,000. A Factor is prepared to buy the company's receivables by charging 2 percent commission. The factor will pay advance on receivables to the company at an interest rate of 18 percent per annum after withholding 10 percent as reserve.

You are required to calculate effective cost of factoring to the company. *(10 Marks)*

(b) The market received rumour about ABC corporation's tie-up with a multinational company. This has induced the market price to move up. If the rumour is false, the ABC corporation stock price will probably fall dramatically. To protect from this an investor has bought the call and put options.

He purchased one 3 months call with a striking price of Rs.42 for Rs.2 premium, and paid Re.1 per share premium for a 3 months put with a striking price of Rs.40.

(i) Determine the Investor's position if the tie up offer bids the price of ABC Corporation's stock up to Rs.43 in 3 months.

(ii) Determine the Investor's ending position, if the tie up programme fails and the price of the stocks falls to Rs.36 in 3 months. *(6 Marks)*

6. (a) Following information is provided relating to the acquiring company Mani Ltd. and the target company Ratnam Ltd:

	Mani Ltd.	Ratnam Ltd.
Earnings after tax (Rs. lakhs)	2,000	4,000
No. of shares outstanding (lakhs)	200	1,000
P/E ratio (No. of times)	10	5

Required:

(i) What is the swap ratio based on current market prices?

(ii) What is the EPS of Mani Ltd. after the acquisition?

(iii) What is the expected market price per share of Mani Ltd. after the acquisition, assuming its P/E ratio is adversely affected by 10%?

(iv) Determine the market value of the merged Co.

(v) Calculate gain/loss for the shareholders of the two independent entities, due to the merger. *(10 Marks)*

(b) RST Ltd. has a capital of Rs. 10,00,000 in equity shares of Rs. 100 each. The shares are currently quoted at par. The company proposes to declare a dividend of Rs.10 per share at the end of the current financial year. The capitalization rate for the risk class of which the company belongs is 12%. What will be the market price of the share at the end of the year, if

(i) a dividend is not declared ?

(ii) a dividend is declared ?

(iii) assuming that the company pays the dividend and has net profits of Rs.5,00,000 and makes new investments of Rs.10,00,000 during the period, how many new shares must be issued? Use the MM model. *(6 Marks)*

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

(a) Bower-Herringer-Williamson Method in lease financing

(b) Advantages of Foreign Currency Convertible Bonds (FCCBs)

(c) Uses of Credit Rating

(d) Takeover by Reverse Bid.

(e) Modigliani and Miller (MM) Hypothesis of Dividend *(4 ×4 = 16 Marks)*

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

1. (a) (i) Change in BSE's Market index over six months = [(27,810 – 27,000)/27,000] x 100

= 3.00%

Beta value of Anand Ltd's share = 1.80

Anticipated Change in Share value over six months = 3.00% x 1.80

= 5.40%

Hence, Anand Ltd.'s share's 6 months future's value

= Rs. 1,800(1+0.0540) = Rs. 1,897.20

Calculation of theoretical minimum price of a 6 months forward contract-

Theoretical minimum price = Rs. 1,800 + (Rs. 1,800 x 10/100 x 6/12)

= Rs. 1,890.00

(ii) Arbitrage Opportunity-

The arbitrageur can borrow money @ 10 % for 6 months and buy the shares at Rs. 1,800. At the same time he can sell the shares in the futures market at Rs. 1,897.20. On the expiry date 6 months later, he could deliver the share and collect Rs. 1,897.20, pay off Rs. 1,890.00 and record a profit of Rs. 7.20 (Rs. 1,897.20 – Rs. 1,890.00).

(b)

Option I (To finance the purchases by availing loan at 18% per annum):

Cost of equipment	Rs. in lakhs
3400 lakh yen at Rs.100 = 340 yen	1,000.00
Add: Interest at 18% (on Rs.1000 lakhs) for 6 months	90.00
Total outflow in Rupees	1,090.00

Option II (To accept the offer from foreign branch):

Cost of letter of credit	Rs. in lakhs
At 1 % on 3400 lakhs yen at Rs.100 = 340 yen	10.00
Add: Interest	0.90
(A)	10.90

Payment at the end of 180 days:

Cost	3400.00 lakhs yen
Interest at 2% p.a. [3400 × 2/100 × 180/365]	33.53 lakhs yen
	3433.53 lakhs yen
Conversion at Rs.100 = 345 yen [3433.53 / 345 × 100] (B)	= Rs.995.23
Total Cost: (A) + (B)	= Rs.1006.13 lakhs

Advise: Option 2 is cheaper by (1090.00 – 1006.13) lakh or Rs. 83.87 lakh. Hence, the offer may be accepted.

(c) Scheme (a)

100 = LR × PVIF (20,1) + LR × PVIF (20,2) + LR × PVIF (20,3) + LR × PVIF (20,4) + LR × PVIF (20,5)

100 = LR × PVIFA (20,5)

100 = LR × 2.991

LR = Rs. 33.434 lakhs per year.

Scheme (b)

100 = LR × PVIF (20,1) + (1.15) LR × PVIF (20,2) + $(1.15)^2$ LR × PVIF(20,3) + $(1.15)^3$ LR × PVIF (20,4) + $(1.15)^4$ LR × PVIF(20,5)

LR = Rs.26.09 lakhs in the first year.

(d) The company had issued commercial paper worth Rs.10 crores

No. of days Involves = 91 days

Interest rate applicable = 12.04 % p.a.

Interest for 91 days = 12.04% x [91 days/365 days]

= 3.001%
= or Rs. 10 crores x [3.001/(100+3.001)]
= Rs. 29,13,563
or 29.1356 lacs

∴ Net amount received at the time of issue:-

Rs.10.00 Crores – 0.2913 Crore = Rs. 9.7087 Crores

2. (a) **CALCULATION OF NPV**

	Rs.
PV of cash inflows (Rs. 45,000 x 3.169)	1,42,605
Initial Project Cost	1,20,000

NPV	22,605
If initial project cost is varied adversely by 10%*	
NPV (Revised) (Rs. 1,42,605 - Rs. 1,32,000)	(+) Rs. 10,605
Change in NPV (Rs. 22,605 – Rs. 10,605)/ Rs. 22,605 i.e	53.08%
If annual cash inflow is varied adversely by 10%*	
Revised annual inflow	Rs. 40,500
NPV (Revised) (Rs. 40,500 x 3.169) – (Rs. 1,20,000)	(+) Rs. 8,345
Change in NPV (Rs. 22,605 – Rs. 8,345) / Rs. 22,605	63.08%
If cost of capital is varied adversely by 10%*	
NPV (Revised) (Rs. 45,000 x 3.103) – Rs. 1,20,000	(+) Rs. 19,635
Change in NPV (Rs. 22,605 – Rs. 19,635) / Rs. 22,605	13.14%

Conclusion: Project is most sensitive to 'annual cash inflow'.

*Note: Students may please note that they may assume any other percentage rate other than 10% say 15% , 20% 25% etc.

(b) (i) Returns for the year

(All changes on a Per -Unit Basis)

Change in Price:	Rs.9.45 – Rs.8.75	Re.0.70
Dividends received:		Re. 0.75
Capital gains distribution		Re. 0.60
Total reward		Rs. 2.05

Holding period reward: (Rs. 2.05/Rs. 8.75) x 100 = 23.43%

(ii) When all dividends and capital gains distributions are re-invested into additional units of the fund @ (Rs. 8.65/unit)

Dividend + Capital Gains per unit = Re.0.75 + Re. 0.60 = Rs. 1.35

Total received from 300 units = Rs.1.35 x 300 = Rs.405/-.

Additional Units Acquired = Rs.405/Rs.8.65 = 46.82 Units.

Total No. of Units = 300 units + 46.82 units = 346.82 units.

Value of 346.82 units held at the end of the year

= 346.82 units x Rs.9.45 = Rs.3277.45

Price Paid for 300 Units at the beginning of the year

= 300 units x Rs.8.75 = Rs.2,625.00

Holding Period Reward

Rs. (3277.45 – 2625.00) = Rs.652.45

Holding Period Reward = (Rs. 652.45/Rs. 2625.00) x 100 = 24.85%

Conclusion: Since the holding period reward is more in terms of percentage in option-two i.e., reinvestment of distributions at an average NAV of Rs.8.65 per unit, this option is preferable.

3. (a) **Calculation of NPV**

Year	0	1	2	3
Inflation factor in India	1.00	1.10	1.21	1.331
Inflation factor in Africa	1.00	1.40	1.96	2.744
Exchange Rate (as per IRP)	6.00	7.6364	9.7190	12.3696
Cash Flows in Rs.'000				
Real	-50000	-1500	-2000	-2500
Nominal (1)	-50000	-1650	-2420	-3327.50
Cash Flows in African Rand '000				
Real	-200000	180000	160000	150000
Nominal	-200000	252000	313600	411600
In Indian Rs.'000 (2)	-33333	33000	32267	33275
Net Cash Flow in Rs. '000 (1)+(2)	-83333	31350	29847	29947
PVF@20%	1	0.833	0.694	0.579
PV	-83333	26115	20714	17339

NPV of 3 years = -19165 (Rs. '000)

(b) **Receipts using a forward contract (**1,00,000/0.02127) = Rs.47,01,457

Receipts using currency futures

The number of contracts needed is (1,00,000/0.02118)/4,72,000 = 10

Initial margin payable is 10 x Rs.15,000 = Rs.1,50,000

On September 1 Close at 0.02133

Receipts = US$1,00,000/0.02133 = Rs.46,88,233

Variation Margin = [(0.02134 – 0.02118) x 10 x 472000]/0.02133

OR (0.00016x10x472000)/.02133 = 755.2/0.02133 Rs.35,406

Rs.47,23,639

Less: Interest Cost – 1,50,000 x 0.08 x 3/12 Rs.3,000

Net Receipts Rs.47,20,639

Receipts under different methods of hedging

Forward contract	Rs.47,01,457
Futures	Rs.47,20,639
No Hedge	
US$ 1,00,000/0.02133	Rs.46,88,233

The most advantageous option would have been to hedge with futures.

4. **(a)** Financial Leverage = PBIT/PBT

1.4 = PBIT / (PBIT – Interest)

1.4 = PBIT / (PBIT – 40)

1.4 (PBIT – 40) = PBIT

1.4 PBIT – 56 = PBIT

1.4 PBIT – PBIT = 56

0.4 PBIT = 56

or $PBIT = \frac{56}{0.4} =$ ₹140 lakhs

NOPAT = PBIT – Tax = Rs. 140 lakhs (1 – 0.30) = Rs. 98 lakhs.

Weighted average cost of capital (WACC) = 17.5% × (300 / 700)+ (1 – 0.30) × (10%) × (400 / 700)

= 11.5%

EVA = NOPAT – (WACC × Total Capital)

= Rs. 98 lakhs – 0.115 × Rs. 700 lakhs

= Rs. 17.5 lakhs

(b) Computation of current value of John's portfolio

			Rs.
(i)	<u>10 Nos. Bond A, Rs. 1,000 par value, 9% Bonds maturity 3 years:</u>		
	Current value of interest on bond A		
	1-3 years: Rs. 900(1–0.20) × Cumulative P.V. @ 12% (1-3 years)		
	= Rs. 720 × 2.402		1,729
	Add: Current value of amount received on maturity of Bond A		
	End of 3rd year: Rs. 1,000 × 10 × P.V. @ 12% (3rd year)		
	= Rs. 10,000 × 0.712	<u>7,120</u>	8,849
(ii)	<u>10 Nos. Bond B, Rs. 1,000 par value, 10% Bonds maturity 5 years:</u>		
	Current value of interest on bond B		

1-5 years: Rs. 1,000(1–0.20) × Cumulative P.V. @ 12% (1-5 years)

= Rs. 800 × 3.605 2,884

Add: Current value of amount received on maturity of Bond B

End of 5th year: Rs. 1,000 × 10 × P.V. @ 12% (5th year)

= Rs. 10,000 × 0.567 5,670 8,554

(iii) 100 Preference shares C, Rs. 100 par value, 11% coupon

$= \frac{11\% \times 100 \text{ Nos.} \times \text{Rs. } 100}{13\%}$ 8,462

(iv) 100 Preference shares D, Rs. 100 par value, 12% coupon

$= \frac{12\% \times 100 \text{ Nos.} \times \text{Rs. } 100}{13\%}$ 9,231 17,693

Total Current value of his portfolio [(i) + (ii) + (iii) + (iv)] Rs. 35,096

5. (a) **MSN Ltd.**

Particulars		Rs.
Average level of Receivables	Rs. 4,50,00,000 × 120 / 360	1,50,00,000
Factoring commission	Rs. 1,50,00,000 × 2%	3,00,000
Factoring Reserve	Rs. 1,50,00,000 × 10%	15,00,000
Amount available for advance	Rs. 1,50,00,000 – (3,00,000 + 15,00,000)	1,32,00,000
Factor will deduct interest @ 18%		
Interest (Rs. 1,32,00,000 × 18 × 120) / 100 × 360		7,92,000
Advance to be paid = Rs. 1,32,00,000 – 7,92,000		1,24,08,000
Annual cost of factoring to the firm:		
Factoring commission (Rs. 300000 × 360 / 120)		9,00,000
Interest Charges (Rs. 792,000 × 360 / 120)		23,76,000
		32,76,000
Firms savings on taking factoring service:		
Cost of credit administration saved		6,00,000
Cost of bad debts (Rs. 4,50,00,000 × 2%)		9,00,000
Total savings		15,00,000

Net cost to the firm = Rs. 32,76,000 – Rs. 15,00,000 = Rs. 17,76,000

Effective rate of interest to the firm = Rs. 17,76,000 × 100 / Rs. 1,24,08,000 = 14.31%

Note: The number of days in a year is assumed to be 360 days.

(b) Cost of Call and Put Options

= (Rs.2 per share) x (100 share call) + (Re.1 per share) x (100 share put)

= Rs.2 x 100 + 1 x 100

= Rs.300

(i) Price increases to Rs.43. Since the market price is higher than the strike price of the call, the investor will exercise it.

Ending position = (- Rs.300 cost of 2 option)+(Rs. 1 per share gain on call) x 100

= - Rs.300 + 100

Net Loss = - Rs.200

(ii) The price of the stock falls to Rs.36. Since the market price is lower than the strike price, the investor may not exercise the call option.

Ending Position: = (- Rs.300 cost of 2 options) + (Rs.4 per stock gain on put) x 100

= - Rs.300 + 400

Gain = Rs.100

6. (a) (i) SWAP ratio based on current market prices:

EPS before acquisition:

Mani Ltd. : Rs.2,000 lakhs / 200 lakhs:	Rs. 10
Ratnam Ltd.: Rs.4,000 lakhs / 1,000 lakhs:	Rs. 4

Market price before acquisition:

Mani Ltd.: Rs.10 × 10	Rs. 100
Ratnam Ltd.: Rs.4 × 5	Rs. 20

SWAP ratio: 20/100 or 1/5 i.e. 0.20

(ii) EPS after acquisition:

Rs. [(2,000 + 4,000) lakhs] / [200 + 200] lakhs	Rs. 15.00

(iii) Market Price after acquisition:

EPS after acquisition :	Rs.15.00
P/E ratio after acquisition 10 × 0.9	9
Market price of share (Rs. 15 X 9)	Rs.135.00

(iv) Market value of the merged Co.:

Rs.135 × 400 lakhs shares — Rs. 540.00 Crores

or Rs. 54,000 Lakhs

(v) Gain/loss per share:

		Rs. crore
	Mani Ltd.	Ratnam Ltd.
Total value before Acquisition	200	200
Value after acquisition	270	270
Gain (Total)	70	70
No. of shares (pre-merger) (lakhs)	200	1,000
Gain per share (Rs.)	35	7

(b) As per MM model, the current market price of equity share is:

$$P_0 = \frac{1}{1+k_e} \times (D_1 + P_1)$$

(i) If the dividend is not declared:

$$100 = \frac{1}{1+0.12} \times (0 + P_1)$$

$$100 = \frac{P_1}{1.12}$$

P_1 = Rs. 112

The market price of the equity share at the end of the year would be Rs. 112.

(ii) If the dividend is declared:

$$100 = \frac{1}{1+0.12} \times (10 + P_1)$$

$$100 = \frac{10 + P_1}{1.12}$$

P_1 = Rs. 112 – 10 = Rs. 102

The market price of the equity share at the end of the year would be Rs. 102.

(iii) In case the firm pays dividend of Rs.10 per share out of total profits of Rs. 5,00,000 and plans to make new investment of Rs. 10,00,000, the number of shares to be issued may be found as follows:

Total Earnings	Rs.5,00,000
- Dividends paid	1,00,000
Retained earnings	4,00,000
Total funds required	10,00,000
Fresh funds to be raised	6,00,000
Market price of the share	102

Number of shares to be issued (Rs.6,00,000 / 102) 5,882.35

or, the firm would issue 5,883 shares at the rate of Rs.102

7. **(a)** Bower-Herringer-Williamson Method segregates the financial and tax aspects of lease financing. If the operating advantage of a lease is more than its financial disadvantage or vice-versa lease will be preferred.

The procedure of evaluation is briefly as follows :

1. Compare the present value of debt with the discounted value of lease payments (gross), the rate of discount being the gross cost of debt capital. The net present value is the financial advantage (or disadvantage).
2. Work out the comparative tax benefit during the period and discount it at an appropriate cost of capital. The present value is the operating advantage (or disadvantage) of leasing.
3. If the net result is an advantage, select leasing.

(b) Advantages of Foreign Currency Convertible Bonds (FCCBs)

(i) The convertible bond gives the investor the flexibility to convert the bond into equity at a price or redeem the bond at the end of a specified period, normally three years if the price of the share has not met his expectations.

(ii) Companies prefer bonds as it leads to delayed dilution of equity and allows company to avoid any current dilution in earnings per share that a further issuance of equity would cause.

(iii) FCCBs are easily marketable as investors enjoys option of conversion into equity if resulting to capital appreciation. Further investor is assured of a minimum fixed interest earnings.

(c) Uses of Credit Rating

For users –

(i) Aids in investment decisions.

(ii) Helps in fulfilling regulatory obligations.

(iii) Provides analysts in Mutual Funds to use credit ratings as one of the valuable

inputs to their independent evaluation system.

For issuers –

(i) Requirement of meeting regulatory obligations as per SEBI guidelines.

(ii) Recognition given by prospective investors of providing value to the ratings which helps them to raise debt / equity capital.

The rating process gives a viable market driven system which helps individuals to invest in financial instruments which are productive assets.

(d) Takeover by Reverse Bid: Generally, a big company takes over a small company. When the smaller company gains control of a larger one then it is called "Take-over by reverse bid". In case of reverse take-over, a small company takes over a big company. This concept has been successfully followed for revival of sick industries.

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

(i) The assets of the transferor company are greater than the transferee company;

(ii) Equity capital to be issued by the transferee company pursuant to the acquisition exceeds its original issued capital, and

(iii) The change of control in the transferee company will be through the introduction of minority holder or group of holders.

Reverse takeover takes place in the following cases:

(1) When the acquired company (big company) is a financially weak company

(2) When the acquirer (the small company) already holds a significant proportion of shares of the acquired company (small company)

(3) When the people holding top management positions in the acquirer company want to be relived off of their responsibilities.

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

(e) Modigliani and Miller Hypothesis is in support of the irrelevance of dividends. Modigiliani and Miller argue that firm's dividend policy has no effect on its value of assets and is, therefore of no consequence i.e. dividends are irrelevant to shareholders wealth.

The hypothesis is based on the following assumptions:

- The firm operates in perfect capital markets in which all investors are rational and information is freely available to all.

- There are no taxes. Alternatively, there are no differences in the tax rates applicable to capital gains and dividends.
- The firm has a fixed investment policy.
- There are no floatation or transaction costs.
- Risk of uncertainty does not exist. Investors are able to forecast future prices and dividends with certainty, and one discount rate is appropriate for all securities and all time periods. Thus, $r = k = k_t$ for all t.

Market price of a share after dividend declared on the basis of MM model is shown below:

$$P_o = \frac{P_1 + D_1}{1 + K_e}$$

Where,

Po = The prevailing market price of a share

Ke = The cost of equity capital

D1 = Dividend to be received at the end of period one

P1 = Market price of a share at the end of period one.

If the firm were to finance all investment proposals, the total amount raised through new shares will be ascertained with the help of the following formula:

$$\Delta N = \frac{I - (E - nD_1)}{P_1}$$

Where,

ΔN = Change in the number of shares outstanding during the period

n = Number of shares outstanding at the beginning of the period

I = Total investment amount required for capital budget

E = Earnings of net income of the firm during the period.

The concept of 'home made dividends' supports the argument for irrelevance of dividend policy in shareholder wealth maximization. Due to reduction in the price of a share when it goes 'ex-dividend', the value of a shareholder's wealth is always the same irrespective of the amount of dividend declared. A shareholder can always sell his portion of equity to realize the dividend income.

MOCK TEST PAPER -2

FINAL COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

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

*Answer any **five** from the rest*

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

1. As a Statutory Auditor, how would you deal with the following:

(a) It was decided for the first time that the accounts of the branch office of CL Company Limited be audited by a qualified Chartered Accountant(s) other than the company auditor for the year 2013-14. Accordingly, the Board had appointed branch auditors for the ensuing year. One of the shareholders complained to the Central Government that the appointments made was not valid as the Board of Directors do not have power to appoint auditors, be they Company Auditor or Branch Auditors.

(b) The Managing Director of a Company has committed a "Teeming and Lading" Fraud. However, subsequently, after the year end, the amount involved has been deposited in the company.

(c) SAA Ltd. owns 51% voting power in REY Ltd. It however holds and discloses all the shares as "Stock-in-trade" in its accounts. The shares are held exclusively with a view to their subsequent disposal in the near future. SAA Ltd. represents that while preparing Consolidated Financial Statements, REY Ltd. can be excluded from the consolidation.

(d) Auditor of Future India (P) Ltd. was changed for the accounting year 2013-14. The closing inventory of the company as on 31.3.2013 amounting to Rs. 200 lacs continued as it is and became closing inventory as on 31.3.2014. The auditor of the company propose to exclude from their audit programme the audit of closing inventory of Rs. 200 lacs on the understanding that it pertains to the preceding year which was audited by another auditor. *(5 × 4 = 20 Marks)*

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

(a) CA Sushi, a practicing Chartered Accountant gave 60% of the audit fees received by her to Mr. Sushil, who was not a Chartered Accountant, under the nomenclature of office allowances.

(b) Mr. Rahul, a Chartered Accountant in practice approached Manager of a Nationalised Bank for a loan of Rs. 36 lakhs. He has also informed the Manager that if the loan is sanctioned, the Income Tax return of the Manager and Manager's wife will be filed for free of cost, as quid Pro quo for the loan sanctioned.

(c) Mr. CA, a Chartered Accountant in practice is a partner in 4 firms. On the personal Letter Heads, he mentioned the names and address of all the 4 firms in small fonts.

(d) CA Lazy, a practicing Chartered Accountant, did not complete his work relating to the audit of the accounts of a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirements.

(4 × 4 = 16 Marks)

3. (a) You are appointed to compile financial statements of XY & Co. for tax purposes. During the course of work, you came to know that the inventory is grossly understated. On pointing the same, the partners of XY & Co. tell you that since you are not conducting an audit, the said figures duly certified by the firm should be accepted. Describe, in brief, the procedure you will follow in the above. *(4 Marks)*

(b) CA Ratan has been appointed as an auditor of Ratna Ltd. He was not able to get the confirmation about the existence and value of certain machineries. However, the management gave him a certificate to prove the existence and value of the machinery as appearing in the books of account. The auditor accepted the same without any further procedure and signed the audit report. Whether the approach adopted by CA Ratan tenable? *(4 Marks)*

(c) While auditing a company, you observed certain material financial statement assertions that have been based on estimates made by the management. As the auditor how do you minimise the risk of material misstatements? *(4 Marks)*

(d) Mr. Guilty, a Chartered Accountant, bought a Harley bike financed at Rs. 10,00,000 by Principal Finance Ltd., which is a holding company of Giant Ltd. and Superior Ltd. He has been the statutory auditor of Superior Ltd. and continues to hold office of auditor even after taking the loan. Comment. *(4 Marks)*

4. (a) What are the criteria to be applied for determining the status of various type of credit facilities as Non-Performing Assets in the case of Banks? *(4 Marks)*

(b) State the provisions relating to filling of casual vacancies, in case of government companies as well as non-government companies, as per section 139(8) of the Companies Act, 2013. *(6 Marks)*

(c) Explain in brief the behavioural aspects encountered in the management audit and state the ways to solve them. *(6 Marks)*

5. (a) Briefly mention the matters that an Auditor is required to inquire while performing his duties as per Section 143(1) of the Companies Act, 2013. *(5 Marks)*

(b) What are the steps for the Audit under the State level 'Value Added Tax'? *(6 Marks)*

(c) Parry Industries Ltd. has a paid up capital of Rs. 40 crores divided into equity shares of Rs. 10 each as on 31.03.2013. During the financial year 2013-14 it has issued bonus shares in the ratio 1 : 1. The net profit after tax for the years 31-

03.2013 and 31.3.2014 is Rs. 20 crores and Rs. 30 crores respectively. The Earnings Per Share disclosed in the financial statements for the above two years is Rs. 5.00 and Rs. 3.75 respectively. Is the disclosure correct? *(5 Marks)*

6. (a) While auditing the claims paid in respect of a General Insurance Company, what are the specific areas will you give your attention? *(6 Marks)*

   (b) What are the important aspects to be looked into a due diligence review of Cash flow? *(4 Marks)*

   (c) In the audit of a company, its auditor wants to use CAATs for performing various audit procedures. What procedures can be performed by the auditor using CAATs? *(3 Marks)*

   (d) You have been appointed as an auditor of a NBFC (registered with RBI). How would you proceed to ensure the compliance of Prudential Norms directions by it? *(3 Marks)*

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

   (a) Mark to Market margins

   (b) Advantages of Cost Audit to Government

   (c) Special features involved in the audit of a Co-operative Society.

   (d) Technical, professional and ethical standards as per statement on peer review

   (e) Environmental Audit. *(4 × 4 = 16 Marks)*

MOCK TEST PAPER -2

FINAL COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

SUGGESTED ANSWERS/ HINTS

1. (a) **Appointment of Branch Auditor:** The Companies Act, 2013 leaves it to the company to designate or not to designate any establishment of the company as 'branch office'. Under the Companies Act, 2013, only establishment "described as such by the company" shall be treated as a 'branch office'.

Further, as per Section 143(8) of the Companies Act, 2013, where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139 and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed.

Section 139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

The shareholders in general meeting, instead of appointing branch auditor, may authorize the board of directors to appoint branch auditors.

In the present case, the board of CL Company Limited has appointed branch auditors without obtaining authorization from the shareholders in general meeting. The board had appointed the auditor where it did not have authority to do so. As such, the appointment is invalid. The shareholder's complaint is tenable.

(b) **Fraud Committed by Managing Director:** The Managing Director of the company has committed a "Teeming and Lading" fraud. The fact that the amount involved has been subsequently deposited after the year end is not important because the auditor is required to perform his responsibilities as laid down in SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements". First of all, as per SA 240, the auditor needs to perform procedures whether the financial statements are materially misstated. Because an instance of fraud cannot be considered as an isolated occurrence and it becomes important for the auditor to perform audit procedures and revise the audit risk assessment. Secondly, the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. Thirdly, the auditor should communicate the matter to the Chairman and Board of Directors. Finally, in view of the fact that the fraud has

been committed at the highest level of management, it affects the reliability of audit evidence previously obtained since there is a genuine doubt about representations of management.

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

(c) **Consolidation of Financial Statement:** AS 21 "Consolidated Financial Statements", states that a subsidiary should be excluded from consolidation when:

(i) Control is intended to be temporary because the shares are acquired and held exclusively with a view to its subsequent disposal in the near future or

(ii) Subsidiary operates under severe long term restrictions which significantly impair its ability to transfer funds to the parent.

Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares held as 'stock-in-trade' are acquired and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise would be considered temporary and the investments in such subsidiaries should be accounted for in accordance with AS 13 "Accounting for Investments".

However, as per Section 129(3) of the Companies Act, 2013 read with rule 6 of the Companies (Accounts) Rules, 2014, where a company having subsidiary, which is not required to prepare consolidated financial statements under the Accounting standards, it shall be sufficient if the company complies with the provisions on consolidated financial statements provided in Schedule III to the Act.

In the given case, SAA Ltd's intention is to dispose off the shares of REY Ltd. in the near future as shares are being held as stock in trade and it is quite clear that the control is temporary, however for the compliance of provisions related to consolidation of financial statements given under the Section 129(3) of the Companies Act, 2013 read with Companies (Accounts) Rules, 2014, SAA Ltd. is required to consolidate the financial statements as per the provisions on consolidated financial statements provided in Schedule III to the said Act.

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

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

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

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

General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the balance sheet date. It forms part of normal duties of auditor to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the inventory lying as it is might have deteriorated and the same need to be examined. The auditor of Future India (P) Ltd. is advised not to exclude the audit procedure of closing inventory from his audit programme.

2. (a) **Sharing of Audit Fees with non-member:** As per Clause (2) of Part I of First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services to time in or outside India.

In the instant case, CA Sushi, a practicing Chartered Accountant gave 60% of the audit fees received by her to Mr. Sushil, who was not a Chartered Accountant, under the nomenclature of office allowance. In this case, it is not the nomenclature to a transaction that is material but it is the substance of the transaction, which has to be looked into.

Therefore, CA Sushi will be held guilty of professional misconduct under clause (2) of Part I of First Schedule of Chartered Accountants Act, 1949.

(b) **Disrepute to the Profession:** As per Clause (2) of Part IV of First Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he, in the opinion of the Council, brings disrepute to the profession or to the Institute as a result of his action whether or not related to his professional work.

Accordingly, a Chartered Accountant is also expected to maintain the highest standards and integrity even in his personal affairs and any deviation from these standards calls for disciplinary action.

In the given case, Mr. Rahul, a Chartered Accountant in practice approached Manager of a Nationalised Bank for a loan and offered for filing Income tax Returns without any fees. This approach of Mr. Rahul brings disrepute to the profession of a Chartered Accountant.

Hence, Mr. Rahul will be held guilty of other misconduct under Clause (2) of Part IV of the First Schedule of the Chartered Accountants Act, 1949.

(c) **Advertisement:** As per Clause (7) of Part I of First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he (i) advertises his professional attainments or services or (ii) uses any designation or expressions other than "Chartered Accountant" on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a university established by law in India or recognized by the Central Government or a title indicating membership of the ICAI or of any other institution that has been recognized by the Central Government or may be recognized by the council.

Here there is no prohibition for printing names on the personal letter heads in which a member holding certificate of practice is a partner.

In the given case, Mr. CA mentioned the names and address of all the 4 firms in which he is a partner on the personal letter heads. Therefore, Mr. CA will not be held guilty of any professional misconduct in pursuant to Clause (7) of Part I of First Schedule of the Chartered Accountants Act, 1949.

(d) **Not exercising due diligence:** According to Clause (7) of Part I of Second Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

It is a vital clause which unusually gets attracted whenever it is necessary to judge whether the accountant has honestly and reasonably discharged his duties. The expression negligence covers a wide field and extends from the frontiers of fraud to collateral minor negligence.

Where a Chartered Accountant had not completed his work relating to the audit of the accounts a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirement in this regard, it was held, under a case, that he was guilty of professional misconduct under Clause (7).

In the given case, Mr. Lazy has not completed his audit work in time and consequently could not submit audit report in due time and consequently, company could not comply with the statutory requirements.

Therefore, Mr. Lazy will be held guilty of professional misconduct under Clause (7) of Part I of the Second Schedule of the Chartered Accountants Act, 1949.

3. (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.

In the given case, inventory of XY & Co. is grossly understated. Therefore, XY & Co. should be asked to provide additional information. If the company refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for such withdrawal.

(b) **Validity of Written Representation:** The physical verification of fixed assets is the primary responsibility of the management. The auditor, however, is required to examine the verification programme adopted by the management. He must satisfy himself about the existence, ownership and valuation of fixed assets. In the case of Ratna Ltd., CA Ratan, the auditor has not been able to verify the existence and value of some machinery despite the verification procedure followed in routine audit. He accepted the certificate given to him by the management without making any further enquiry. As per SA 580 "Written Representations", when representation relate to matters which are material to the financial information, then the auditor should seek corroborative audit evidence for other sources inside or outside the entity. He should evaluate whether such representations are reasonable and consistent with other evidences and should consider whether individuals making such representations can be expected to be well informed on the matter. "Written Representations" cannot be a substitute for other audit evidence that the auditor

could reasonably expect to be available. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter, which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter. Therefore, the approach adopted by CA Ratan is not tenable.

(c) **Minimising the risk of material misstatements:** 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 assumptions 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) **Disqualification of an Auditor:** According to section 141(3)(d)(ii) of the Companies Act, 2013, a person is not eligible for appointment as auditor of a company, if he or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees five lakh.

In the given case, Mr. Guilty has been the statutory auditor of Superior Ltd. He also bought a bike and gets it financed by Principal Finance Ltd., which is a holding company of Giant Ltd. and Superior Ltd.

Therefore, he is disqualified to act as an auditor under section 141(3)(d)(ii) of the Companies Act, 2013 as he is indebted to Principal Finance Ltd. for more than Rs. 5,00,000. Also according to Section 141(3)(d)(ii) of the said Act, he cannot act as an auditor of any subsidiary of Principal Finance Ltd. i.e. he is also disqualified to work in Giant Ltd. and Superior Ltd. Therefore he has to vacate his office in Superior Ltd. even though it is a subsidiary of Principal Finance Ltd.

Hence audit work performed by Mr. Guilty as an auditor is invalid, he should vacate his office immediately and such vacation shall be deemed to be a casual vacancy in the office of the Auditor as per Section 141(4) of the Companies Act, 2013. Now, Superior Ltd. must have to appoint any other CA as an auditor of the company.

4. (a) **Classifying Non-performing Assets:** Following are the Criteria applied for determining the classification of various type of credit facilities as Non-Performing Assets in the case of Banks:

(i) Interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan.

(ii) The account remains "out of order" in respect of an Overdraft/Cash Credit (OD/CC).

(iii) The bill remains overdue and unpaid for a period of more than 90 days in the case of bills purchased and discounted.

(iv) The instalments of principal or interest thereon remain overdue for two crop seasons for short duration crops.

(v) The instalment of principal or interest thereon remains overdue for one crop season for long duration crops.

(vi) The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitization dated 1st February, 2006.

(vii) In respect of derivative transactions, the overdue receivables representing positive mark to Market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

(b) **Casual Vacancy:** As per Section 139(8) of the Companies Act, 2013, any casual vacancy in the office of an auditor shall-

(i) **In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Board of Directors within thirty days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he

shall hold the office till the conclusion of the next annual general meeting.

(ii) **In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Comptroller and Auditor-General of India within thirty days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period the Board of Directors shall fill the vacancy within next thirty days.

Casual Vacancy by Resignation: As per section 140(2) of the Companies Act, 2013, the auditor who has resigned from the company shall file within a period of thirty days from the date of resignation, a statement in the prescribed form ADT–3 (as per Rule 8 of Companies (Audit and Auditors) Rules, 2014) with the company and the Registrar, and in case of the companies referred to in section 139(5) i.e. subsequent auditor of Government company, the auditor shall also file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees as per section 140(3) of the said Act.

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

(1) **Staff / Line conflict**: Management auditors are staff people while the members of other departments are line people. Management auditors tend to discount the difficulties the line staff may face, if called on to act on the ideas of management auditors. Management auditors are specialists in their field and they may think their approach and solutions are the only answers.

(2) **Control**: The management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee that the report of the auditor may affect them. There is a fear that the action taken based on the management audit report will affect the line people. It breeds antagonism. The causes are under:

(i) Fear of criticism stemming from adverse audit findings.

(ii) Fear of change in day to day working habits because of changes resulting from audit recommendations.

(iii) Punitive action by superior prompted by reported deficiencies.

(iv) Insensitive audit practices.

(v) Hostile audit style.

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

(i) To demonstrate that audit is part of an overall programme of review for protective and constructive benefit.

(ii) To demonstrate the objective of review is to provide maximum service in all feasible managerial dimensions.

(iii) To demonstrate the review will be with minimum interference with regular operation.

(iv) The responsible officers will be involved in the process of review of the findings and recommendations before the audit report is formally released.

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

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

5. (a) **Audit Inquiry under Section 143(1) of the Companies Act, 2013:** An Auditor is required to make an inquiry and report under Section 143(1) of the Companies Act, 2013 if he is not satisfied in respect of the following matters:

(i) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(ii) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(iii) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(iv) whether loans and advances made by the company have been shown as deposits;

(v) whether personal expenses have been charged to revenue account;

(vi) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

(b) **Major steps required for Tax audit under VAT:** VAT is a tax on the value added to the commodity at each stage in the production and distribution chain. VAT is an indirect Tax on consumption. It is a tax on the value at the retail point of sale which is collected at each stage of sale. The essence of VAT is that it provides credit set off for input tax i.e. tax paid on purchases against the output tax i.e. tax payable on sales. A tax auditor has to make certain preliminary preparations before the actual execution of tax audit under the VAT law. The major steps required to be undertaken for the preparation are as under:

(i) **Knowledge of business:** After accepting the audit assignment the auditor should familiarize himself with the business of the auditee. In this regard, the auditor should refer to the SA 315 - "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment" issued by the Council of the Institute of Chartered Accountants of India. Before starting the audit, the auditor should have a preliminary knowledge of the industry/ business and of the nature of ownership, management etc. More detailed information should be obtained and should be assessed and updated during the course of audit. For this purpose the various sources of information may be tapped. The knowledge of business is important not only to the auditor but also to his staff engaged in the audit. The auditor has to ensure that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to carry out the audit work delegated to them and further they should make effective use of the knowledge about the business and should consider how it affects the tax liability reported in the return. The facts and figures in the returns should be consistent with the auditor's knowledge of the business. The auditor should also make himself familiar with the process of production and the distribution chain. The auditor should also obtain information about whether the auditee is a manufacturer/ importer/ retailer, the details of major customers to whom the sales are effected and the details of sales which are outside the scope of VAT law. Similarly the sources of purchase and the items sold should be listed out. Further it should be ascertained whether the auditee has opted for the composition scheme or not.

(ii) **Obtaining a list of all the accounting records maintained by the auditee:** The auditor should obtain a complete list of all the accounting records relating to sale/purchase of goods, stocks, the various registers, the ledgers etc. maintained, in which the transactions are recorded, the various source

documents in which the entries are recorded in the books of account and the process of their generation.

(iii) **Ascertaining the major accounting policies adopted by the auditee:** The auditor should know the major accounting polices based on which books of account have been recorded. The accounting policy regarding recording of sales, purchases and valuation of inventory must be made known and the auditor should also find out whether there has been any change in those policies during the year covered by audit. If there is any significant change in the accounting policy giving rise to some material effect on the tax liability, the same should be invariably reported.

(iv) **Evaluation of internal control etc.:** Before determining the extent of audit checks to be applied i.e. whether to go in- depth or to do only test check, the auditor should ascertain whether there is an internal check system in operation in the entity. He should particularly find out how the purchases and sales gets initiated. For example, in case of purchase, receipt of indent by the purchase department, determining the need for purchases, initiation of purchase order, receipt of material, preparation of MRN, entries made in the books of accounts etc. should be verified. For sales, receipt of inquiry, acceptance of sales order, execution of sales, preparation of sale invoice and realization of transaction. If the internal control is reliable, the extent of audit may be reduced and should be focused only on those areas where the auditor feels that greater degree of audit risk is involved.

(v) **Knowledge about the VAT law and allied laws:** The auditor and his staff should obtain a thorough knowledge of the State VAT law under which the audit is to be conducted. The auditor should study the VAT law starting from the definition of various terms, the procedure to be adopted, the provisions regarding issue of invoices, claiming of input tax credit, composition schedule in the VAT law, the manner in which the output tax is to be calculated the provisions of audit, the contents of the audit report, the periodicity of the return to be filed, the format of the forms of returns, and the various notifications issued. Further the auditor should know the Central Sales-tax law as he has to comment on the liability under that law also. The auditor should also have some knowledge about the judicial pronouncements made by the Tribunals and the Courts on the various facets of these laws.

(c) Disclosure of Earnings Per Share: AS 20 on Earning Per Share (EPS) prescribes principles for the determination and presentation of EPS. As per AS 20, the earnings per share have to be disclosed as basic and diluted earnings per share on the face of the Statement of Profit and Loss for each class of equity shares that has a different right to share in the net profit for the period. In the instant case, Parry Industries Ltd., both the basic as well as the diluted earnings per share would be the same since there are no dilutive instruments that have been issued by the company. As per AS 20, in the

case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration and thus would lead to increase in number of equity shares without any adjustment to outstanding capital amount. Therefore, the number of equity shares outstanding is increased without an increase in resources. The standard further requires that the number of equity shares outstanding before the event of a bonus issue to be adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. Hence the EPS calculated as on 31-03-2013 would be Adjusted EPS and the same would be disclosed. In view of the above, the EPS will be calculated as under:

As on 31.03.2013 $\dfrac{\text{Profits}}{\text{Adjusted No. of Shares}}$ = Adjusted EPS

$\dfrac{20,00,00,000}{8,00,00,000}$ = Rs. 2.5

As on 31.03.2014 $\dfrac{\text{Profits}}{\text{No. of shares}}$ = EPS

$\dfrac{30,00,00,000}{8,00,00,000}$ = Rs. 3.75

Since the above figures of EPS have not been disclosed, Parry Industries Ltd. has not complied with the provisions of AS 20. Therefore, the auditor would have to qualify his report stating the reasons thereof, in terms of section 143(3)(e) read with section 143(4) of the Companies Act, 2013, for non compliance of financial statements with the accounting standards.

6. (a) **Examination of claims paid:** The auditor may determine the extent of checking of claims paid on the same line as suggested for outstanding claims. Other aspects in respect of claims paid to be examined by the auditors are as follows:

(i) that in case of co-insurance arrangements, claims paid have been booked only in respect of company's share and the balance has been debited to other insurance companies.

(ii) that in case of claims paid on the basis of advices from other insurance companies (where the company is not the leader in co-insurance arrangements), whether share of premium was also received by the company. Such claims which have been communicated after the year-end for losses which occurred prior to the yearend must be accounted for in the year of audit.

(iii) that the claims payments have been duly sanctioned by the authority concerned and the payments of the amounts are duly acknowledged by the claimants;

(iv) that the salvage recovered has been duly accounted for in accordance with the procedure applicable to the company and a letter of subrogation has been obtained in accordance with the laid down procedure;

(v) that the amounts of the nature of pure advances/deposits with Courts, etc., in matters under litigation/arbitration have not been treated as claims paid but are held as assets till final disposal of such claims. In such cases, full provision should be made for outstanding claims;

(vi) that payment made against claims partially settled have been duly vouched. In such cases, the sanctioning authority should be the same as the one which has powers in respect of the total claimed amount;

(vii) that in case of final settlement of claims, the claimant has given an unqualified discharge note, not involving the company in any further liability in respect of the claim; and

(viii) that the figures of claims, wherever communicated for the year by the Division to the Head Office for purposes of reinsurance claims, have been reconciled with the trial balance-figure.

(b) **Due Diligence review of cash flow:**

(i) Review the historical pattern of cash flows of the organization and look for change in trends.

(ii) See whether the company is able to meet its cash requirements from internal generations/accruals or does it seek outside sources from time to time.

(iii) Check whether the company honours its commitments to creditors, Government and other stock holders.

(iv) Verify the ability of the company to turn its stock into Debtors i.e. sale ability of its products.

(v) Ensure that the company follows up with Debtors and that the Debtors collection period is not very large.

(vi) Check the ability of the company to deploy its funds in profitable investment opportunities.

(vii) Look into the investment pattern of the company, whether they give maximum benefits to the company and are easily realizable.

(c) **Auditing procedures using CAATs:** CAATs may be used in performing various auditing procedures, including the following:

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

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

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

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

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

(vi) Re-performing calculations performed by the entity's accounting systems.

(d) Compliance of Prudential Norms by NBFC:

(i) The auditor has to verify the compliance of prudential norms relating to (1) income recognition; (2) Income from investments; (3) Asset classification; (4) Provision for bad and doubtful debts; (5) Capital adequacy norm; (6) Prohibition of granting loans against its own shares; (7) Prohibition on loans and investments for failure to repay public deposits and (8) Norms for concentration of credit etc.

(ii) The auditor shall ensure that Board of the NBFC shall frame a policy for granting demand/call loans and implement the same.

(iii) The auditor should verify the classification of advances and loans as standard/ substandard/ doubtful/ loss and that proper provision has been made in accordance with the directions.

(iv) Auditor should ensure that unrealised income from non-performing assets has not been taken to Statement of Profit and Loss.

(v) The auditor should check all NPAs of the previous years to verify whether during the current year any payments have been received or still they continue to be NPA during the current year also.

7. (a) Mark to Market Margin (MTM): MTM margin is the notional loss, which a stock member or his client would incur, if the net cumulative outstanding positions in all securities were closed out at the closing price of the relevant trading day, which is different from the price at which the transaction had been entered into. For each security, this is worked out by multiplying the difference between the closing price and the price at which the trade was executed by the cumulative buy and sell open position (for buy position the close price being lower than actual trade price and for sell position the close price being higher than actual trade price). The aggregate amount computed across all securities is MTM margin payable by a member. The mark-to-market margin is payable with reference to net position at client's level.

(b) **Advantages of Cost Audit to Government:** Cost auditor's approach is to ensure that the cost accounting plan is in consonance with the objectives set by the organisation and the system of accounting is geared towards the attainment of the objectives. A cost accounting system designed to exercise control over cost may be different from the one if the objective is to fix price. Accordingly, over a period of time particularly in view of administered pricing system the cost accounting becomes quite important. Some of the specific advantages which can be reaped by the Government are:

(i) Where the Government enters into a cost-plus contract, cost audit helps government to fix the price of the contract at a reasonable level.

(ii) Cost audit helps in the fixation of selling prices of essential commodities and thus undue profiteering is checked.

(iii) Cost audit enables the government to focus its attention on inefficient units.

(iv) Cost audit enables the government to decide in favour of giving protection to certain industries.

(v) Cost audit facilitates settlement of trade disputes brought to the government.

(vi) Cost audit and consequent management action can create a healthy competition among the various units in an industry. This imposes an automatic check on inflation.

(c) **Audit of a Co-operative Society:** Special features to be borne in mind in general while conducting the audit of a Co-operative Society are as follows-

(i) Examination of overdue debts.

(ii) Special treatment of overdue interest in the determination of profit.

(iii) Certification of bad debts before being written off.

(iv) Valuation of Assets and Liabilities.

(v) Adherence to co-operative Principles.

(vi) Observations of the Provisions of the Act and Rules.

(vii) Verification of members' Register and examination of their pass books.

(viii) Special report to the registrar on fraud, mismanagement and personal profiteering.

(ix) Audit classification of society based on the audit findings.

(x) Discussion of draft audit report with the managing committee.

(d) **Technical, Professional and Ethical Standards as per statement on peer review:** As per the Statement on Peer Review, Technical, Professional and Ethical Standards means-

(i) Accounting Standards issued by ICAI and /or prescribed and notified by the Central Government of India;

(ii) Standards issued by the Institute of Chartered Accountants of India including

(a) Engagement standards

(b) Statements

(c) Guidance notes

(d) Standards on Internal Audit

(e) Statements on Quality Control

(f) Notifications/ Directions/ Announcements/ Guidelines/ Pronouncements/ Professional standards issued from time to time by the Council or any of its committees.

(iii) Framework for the Preparation and presentation of financial statements, framework of statements and Standard on Auditing, Standard on Assurance Engagements, Standards on Quality Control and Guidance Notes on related services issued, from time to time, by the Institute of Chartered Accountants of India and framework for assurance engagements;

(iv) Provisions of the various relevant statutes and / or regulations which are applicable in the context of the specific engagements being Reviewed including instructions, guidelines, notifications, directions issued by regulatory bodies as covered in the scope of assurance engagements.

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

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

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) Apex Ltd. is having its registered office in the city of Madurai, has its manufacturing plant (Factory) located in the industrial area of the city Mumbai. The Board wants to keep all its books of accounts at Mumbai (Factory) instead of the registered office. Kindly advise as per the provisions of the Companies Act, 2013, can the Board of Directors do so? *(5 Marks)*

   (b) M/s. USD Industries Limited has constituted "Investor Education and Protection Fund" as required under the Companies Act, 1956 but so far no amounts have been deposited into the said account. Explain with reference to the above said enactment, the amounts payable to the credit of the said account. *(5 Marks)*

   (c) The governing body of Jaipur Stock Exchange desires to establish an additional trading floor at Bikaner. Advise, whether additional trading floor can be established by the said stock exchange under the provisions of the Securities Contracts (Regulation) Act, 1956. *(5 Marks)*

   (d) Mr. Ravi, a Director of Anant Limited proceeding on a long foreign tour, appointed Mr. Rajesh as an alternate director to act for him during his absence. The articles of the company provide for appointment of alternate directors. Mr. Ravi claims that he has a right to appoint alternate director. *(5 Marks)*

2. (a) M/s Slow Ltd. proposes to acquire the majority shares of M/s Fast Industries Ltd. by way of Amalgamation. Briefly enumerate the steps that should be taken by the Transferee Company to achieve the objective under the Companies Act, 1956. *(8 Marks)*

   (b) What are contents of the Directors’ Responsibility Statement as per the provisions of the Companies Act, 2013 *(8 Marks)*

3. (a) A complaint was received by the Central Government from some shareholders of a public company that a person had been appointed as the Managing Director of the company without seeking the approval of the Central Government when such approval was required. State as to what action can be taken by the Central Government under the Companies Act, 1956. Also examine the validity of the acts of the Managing Director, if the complaint is found true. *(8 Marks)*

(b) Mr. Amrendra was appointed as a director at the Annual General Meeting of a limited company held on 23rd September, 2013 and he carried on his duties and functions as a director. In the month of August, 2014, it was found out that there were certain irregularities in his appointment and on 31st August, 2014, his appointment was declared invalid. But Mr. Amrendra continued to act as director even after 31st August, 2014.

You are required to state, with reference to the provisions of the Companies Act, 2013, whether the acts done by Mr. Amrendra are valid and binding upon the company ? *(8 Marks)*

4. (a) XYZ Limited, over years, enjoys high reputation and its General Reserve is many times more than the paid up capital of the company. There is apprehension of cornering the shares of the company by some persons likely to result in change in the Board of directors which may be prejudicial to the Public interest.

Advise, as to how can XYZ Limited block the transfer of shares of the company under the provisions of the Companies Act, 1956.

(b) By an order of the Court M/s Meeta Limited was wound up with effect from 15.3.2012. Ms. Vijaya, who ceased to be a member of the Company from 1.6.2011 received a notice from the liquidator to deposit a sum of Rs. 15,000 as her contribution towards the liability on the shares previously held by her. Ms. Vijaya seeks your opinion about her liability. *(8 Marks)*

5. (a) Certain Members of Givo Company Limited having share capital feel that the affairs of the company are being mismanaged by Directors. Members therefore, decide to move the Company Law Board, complaining the mismanagement of company affairs by Directors of the Company. Examine the provisions of the Companies Act, 1956 and state

(i) Whether members are entitled to complain to the Company Law Board.

(ii) Whether the following acts of the Board of Directors amount to mismanagement:

(A) Continuation of Directors in their office after expiry of their tenure and infighting continues among them.

(B) Non-declaration of dividend when it does not lead to devaluation of shares. *(8 Marks)*

(b) State the guidelines issued by SEBI in respect of the "Price and price band" in case of pricing in Public issue. *(8 Marks)*

6. (a) 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? *(8 Marks)*

(b) Explain the provisions regarding 'Prohibition on forward dealings in securities of company by director or key managerial personnel' as covered under the Companies Act, 2013. *(8 Marks)*

7. Attempt any **four:**

(a) During the financial year 2013-14 Mr. Bobby resided in India for a period of 180 days and thereafter went abroad. On 1st April, 2014 Mr. Bobby came back to India as an employee of a business organization. Decide the residential status of Mr. Bobby during the financial year 2013-14 under the provisions of the Foreign Exchange management Act, 1999. *(4 Marks)*

(b) Mr. Alexander was a member of the Competition Commission of India. On the basis of information that he had acquired such financial interest as was likely to affect prejudicially his functions as a member of the Commission, the Central Government appointed an officer to hold an inquiry. On the basis of report of the said officer the Central Government issued an order of removal of Mr. Alexander. Decide whether the action of the Central Government is in order under the provisions of the Competition Act, 2002? *(4 Marks)*

(c) Mr. Zaidi, son of Managing Director of a Public Company, is proposed to be appointed as Chief Executive of the company on a monthly remuneration of Rs. 2,75,000. State the provisions of the Companies Act, 1956 which are required to be complied with by the company in this regard? *(4 Marks)*

(d) In what way are the following terms considered as 'internal aid' in the interpretation of statutes?

(i) Illustrations

(ii) Explanation *(4 Marks)*

(e) How the trials under PMLA are conducted in special courts? Is the offence under PMLA are bailable? *(4 Marks)*

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) **Maintaining the books of accounts at a place other than Registered office of the company:** According to section 128(1) of the Companies Act, 2013, every company shall prepare and keep at its registered office, books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any.

The company may also keep all or any of the books of accounts at any other place in India as the Board of directors may decide. In such a case, the company should file with the Registrar of Companies, a notice in writing giving the full address of that place within 7 days of the Boards' decision.

Thus, in the present case, Apex Ltd. can follow the above procedure and keep its books of accounts at Mumbai instead of the Registered office of the company.

(b) Investor Education & Protection Fund: The Central Government has established a fund, called as Investor Education and Protection Fund. The Fund shall be utilized for promotion of investors' awareness and protection of the interest of investors in accordance with the prescribed rules.

The following amounts shall be credited to the Fund:

(a) amounts in the unpaid dividend accounts of companies;

(b) the application moneys received by companies for allotment of any securities and due for refund;

(c) matured deposits with companies;

(d) matured debentures with companies;

(e) the interest accrued on the amounts referred to in (a) to (d) as above;

(f) grants and donations given to the Fund by the Central Government, State Governments, companies or any other institutions for the purposes of the Fund; and

(g) the interest or other income received out of the investments made from the Fund.

No such amounts referred to in points (a) to (d) shall form part of the Fund unless such amounts have remained unclaimed and unpaid for a period of seven years from the date they became due for payment.

(c) **Additional Trading Floor:** According to Section 13A of the Securities Contracts (Regulation) Act, 1956 a stock exchange may establish additional trading floor with the prior approval of the Securities Exchange Board of India (SEBI) with the terms and conditions stipulated by the said Board.

Additional Trading Floor means a trading ring or trading facility offered by a recognized stock exchange outside its area of operation to enable the investors to buy and sell securities through such trading floor under the regulatory frame work of that stock exchange.

In view of the above, Jaipur Stock Exchange may establish an additional trading floor at Bikaner with prior approval of the SEBI.

(d) Section 313 of the Companies Act, 1956 provides that the Board of directors of a company may, if authorised by its articles or by resolution passed by the company in general meeting, appoint an alternate director to act for a director during his absence for a period of not less than 3 months from the State in which the meetings of the Board are ordinarily held. The alternate director can be appointed only by the Board of directors and only in cases where the Board is authorised by Articles or by the company in general meeting. Hence Mr. Ravi, the director in question, is not competent to appoint alternate director and the appointment of Mr. Rajesh as alternate director is not valid.

2. **(a)** Slow LTD., the transferee company should take the following steps to achieve the objective of acquiring the majority shares of Fast Industries Ltd.:

(i) to check up whether the memorandum of association of the transferee company contains the power of amalgamation. If not, to take steps to alter the objects clauses suitably to acquire the said power.

(ii) to prepare the draft scheme of amalgamation including the exchange ratio and get it approved by a meeting of the Board of directors.

(iii) to apply to the High Court for direction to convene the general meeting by way of Judges' summons as provided in Companies (Court) Rules, 1959.

(iv) to send notice of general meeting to every member along with the details of the scheme of amalgamation.

(v) to hold the general meeting and to pass the resolution approving the draft scheme of amalgamation subject to the confirmation of the High Court. The resolution is to be passed by a majority in number representing 3/4th in value of the members as required by section 391 of the Companies Act, 1956.

(vi) to move the High Court for approval of the scheme.

(vii) on receipt of the court order, to file the certified copy thereof to the Registrar of Companies within 30 days after making the order.

(viii) A copy of the order of the court to be annexed to every copy of the memorandum issuedafter the certified copy of the order has been filed with the Registrar.

(ix) To effect the scheme of amalgamation as per the scheme approved and the directions given by the High Court and to allot shares of the transferee company to the shareholders of transferor company i.e., Fast Industries Ltd.

(b) The Directors' Responsibility Statement shall state that—

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

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

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

(4) the directors had prepared the annual accounts on a going concern basis; and

(5) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

The term "internal financial controls" means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information;

(6) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

3. (a) Improper appointment of Managing Director:

1. According to Section 269(6) of the Companies Act, 1956, if the appointment or re-appointment is not approved by the Central Government the appointee shall

vacate office immediately on communication of the decision by the Central Government, otherwise he shall be punishable with fine up to ₹ 5,000/- for every day during which he fails to vacate such office.

2. According to Section 269(7), on receipt of the complaint, if the Central Government is prima facie, of the opinion that the Managing Director has been appointed without approval of the Central Government, when in fact such approval was necessary, the Central Government may refer the matter to the Company Law Board for decision.

3. According to Section 269(8), the Company Law Board will issue show-cause notice to the Company as well as the concerned Managing Director.

4. According to Section 269(9), the Company Law Board will hear the case, and if it comes to a conclusion that the appointment is in contravention of requirements of Schedule XIII, it will make an order to that effect.

5. On such order, the appointment of the concerned Managing Director shall be deemed to have come to an end. The person so appointed shall in addition to being liable to pay a fine of ₹ 1 lakh, refund to the company the entire remuneration received by him between the date of his appointment and the passing of such an order [Section 269(10)]. But all acts done by him prior to the declaration of invalidity will be valid, if they are otherwise valid [Section 269(12)].

(b) In accordance with the provision of the Companies Act, 2013 as contained in section 176, acts done by a person as a director shall 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:

The Proviso to section 176 of the Companies Act, 2013, further provide that nothing in this section shall be deemed to give validity to acts done by a director after his appointment has been shown to the company to be invalid or to have terminated.

In view of the provision of section 176 of the Companies Act, 2013, the acts done by Mr. Amrendra prior to 31st August, 2014 are to be treated as valid and binding on the Company.

However in view of the Proviso to the said section 176 of the Companies Act, 2013, the acts done by Mr. Amrendra after 31st August, 2013 shall be deemed to be invalid and not binding upon the Company.

4. (a) **Restrictions and Prohibition of transfer of shares or debentures:** As per provisions of section 250(4) of the Companies Act, 1956, where the Company Law Board (referred to as CLB hereinafter) has reasonable grounds to believe that a transfer of shares in a company is likely to take place whereby a change in the composition of the Board of directors of a company is likely to take place and the CLB is of the opinion that any such change would be prejudicial to the public interest, the CLB may, by an order, direct that any transfer of shares in the concerned company during such period not exceeding three years, as may be specified in the order, shall be void.

As per section 250 (1) & (2) of the Companies Act, 1956, if the CLB is of the view that there are good reasons to find out the relevant facts about any shares and the CLB is of the opinion that such facts cannot be found out unless the restrictions are imposed, as an interim measure, it may, by an order, direct that transfer of any such shares shall be void and no voting rights shall be exercised in respect of such shares. However, the CLB is empowered to vary or rescind its order any time.

The facts given in the question squarely fall within the provisions of section 250 of the Companies Act, 1956. The management of XYZ Ltd. may make a complaint to the CLB and convince it that the transfer of shares in favour of the group of unscrupulous persons would change the composition of the Board of directors of the company which shall be prejudicial to the public interest and if the CLB is convinced with the plea of the company, it may pass an order as stated above which would block the transfer of shares as stated in the question.

(b) **Liability of Contributory:** 'Contributory' is a term used in the case of winding up of a company. A Contributory can be past or present member and is liable to contribute to the assets of the company in the event of winding up.

In the instant case, Ms. Vijaya ceased to be a member of the Company when it went into liquidation from 15.3.2012. Thus, Ms. Vijaya will be treated as a past member. She will not be required to contribute to the assets of the company if the following conditions are fulfilled:

(1) If Ms. Vijaya had ceased to be a member of the company for a period of one year or upwards before the commencement of the winding up. In this case, since one year has not elapsed, Ms. Vijaya will be liable to contribute to the assets of the company.

(2) If the debt or liability of the company was contracted or incurred after she ceased to be a member.

(3) If the present members are able to satisfy the contributions required to be made by them under the Act.

In any case, the liability of the past or present member cannot exceed the unpaid amount on the shares and if the shares are fully paid up, no

contribution is required to be made by the members past or present.

5. **(a)** Section 398 of the Companies Act, 1956 provides that a requisite number of members of the company as laid down in section 399 may apply to Company Law Board for appropriate relief on the ground of mismanagement of the company.

   (i) **Conditions Precedent:** Section 398 can be invoked in either of the two circumstances:

   (a) that affairs of the company are being conducted in a manner prejudicial to the interests of the company [Section 398(1)(a)]; or

   (b) that a material change has taken place in the management or control of the company and as a consequence the affairs of the company may be conducted in a manner prejudicial to the public interest or in a manner prejudicial to the interests of the company [Section 398(1)(b)].

   (ii) **Considering the above, the questions as asked can be answered as under:**

   (A) Continuation of directors in their office after the expiry of their term and infighting among them has been held to be the act of mismanagement. (Ranjan Dutta vs. Bhola Nath Paper House Ltd. (1983)).

   (B) Non-declaration of dividend when it does not lead to devaluation of shares is not an act of mismanagement. (V.J. Thomas Vettom vs. Kuttanad Rubber Co. Ltd. (1984)).

   (b) (1) The issuer may mention a price or price band in the draft prospectus (in case of a fixed price issue) and floor price or price band in the red herring prospectus (in case of a book built issue) and determine the price at a later date before registering the prospectus with the Registrar of Companies: Provided that the prospectus registered with the Registrar of companies shall contain only one price or the specific coupon rate, as the case may be.

   (2) The issuer shall announce the floor price or price band at least five working days before the opening of the bid (in case of an initial public offer) and at least one working day before the opening of the bid (in case of a further public offer), in all the newspapers in which the pre issue advertisement was released.

   (3) The announcement referred to in sub-regulation (2) shall contain relevant financial ratios computed for both upper and lower end of the price band and also a statement drawing attention of the investors to the section titled "basis of issue price" in the prospectus.

   (3A) The announcement referred to in sub-regulation (2) and the relevant financial ratios referred to in sub-regulation (3) shall be disclosed on the websites of those stock exchanges where the securities are proposed to be listed and shall also be pre-filled in the application forms available on the websites of the stock

exchanges.

(4) The cap on the price band shall be less than or equal to one hundred and twenty per cent. of the floor price.

(5) The floor price or the final price shall not be less than the face value of the specified securities.

Explanation: For the purposes of sub-regulation (4), the "cap on the price band" includes cap on the coupon rate in case of convertible debt instruments.

6. (a) **Compensation to shareholders of the acquired bank:**

1. 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.

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

3. Section 36AG of the Banking Regulation Act, 1949 states that compensation is paid to the registered shareholders in accordance with the principles as contained in the Fifth Schedule.

4. 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.

5. If the number of representation received is not less than one-fourth of the total number of shareholders holding not less than one-fourth in value 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.

(b) There was no provision under the Companies Act, 1956 for prohibition on forward dealings in securities of company by director or key managerial personnel. A new section 194 of the Companies Act, 2013 which came into force on 12th September, 2013 provides for prohibition on forward dealings in securities of company by director or key managerial personnel.

According to section 194 of the Companies Act, 2013:

(i) No director of a company or any of its key managerial personnel shall buy in the company, or in its holding, subsidiary or associate company—

(a) a right to call for delivery or a right to make delivery at a specified price and within a specified time, of a specified number of relevant shares or a specified amount of relevant debentures; or

(b) a right, as he may elect, to call for delivery or to make delivery at a specified price and within a specified time, of a specified number of relevant shares or a specified amount of relevant debentures.

(ii) If a director or any key managerial personnel of the company contravenes the above provisions, such director or key managerial personnel shall be punishable with imprisonment for a term which may extend to 2 years or with fine which shall not be less than one lakh rupees but which may extend to 5 lakh rupees, or with both.

(iii) Where a director or other key managerial personnel acquires any securities in contravention, he shall along with fine and imprisonment mentioned above, also be liable to surrender the same to the company and the company shall not register the securities so acquired in his name in the register, and if they are in dematerialised form, it shall inform the depository not to record such acquisition and such securities, in both the cases, shall continue to remain in the names of the transferors.

(iv) "relevant shares" and "relevant debentures" mean shares and debentures of the company in which the concerned person is a whole-time director or other key managerial personnel or shares and debentures of its holding and subsidiary companies.

7. (a) **Residential Status under Section 2(v) of Foreign Exchange Management Act, 1999:** In accordance with the provisions of the Foreign Exchange Management Act, 1999, as contained in section 2(v), a person in order to qualify for the purpose of being treated as a 'Person Resident in India" in any financial year, must reside in India for a period of more than 182 days during the preceding financial year.

Mr. Bobby did not reside in India during the year 2013-2014 for more than 182 days and his residential status during the next year, i.e. 2014-2015 is non-resident even though he stayed in India from 1st April, 2014 as an employee. His residential status in 2013-2014 cannot be ascertained as his stay in India during the previous year 2012-2013 is not known.

(b) **Removal of Member of Competition Commission:** Section 11(2)(d) of the Competition Act, 2002 empowers the Central Government to remove, by an order, a member of the Competition Commission of India from his office if such member has acquired such financial interest as is likely to affect prejudicially his functions as a member of the Competition Commission.

However, provisions of Section 11(3) of the said Act put some restrictions on such power of the Central Government. According to this Section, the Central Government has to make a reference to the Supreme Court of India.

The Supreme Court shall hold an enquiry in accordance with the procedure formulated by it and then report that the member in question ought to be removed

from his office on such ground.

Thus, the Central Government can remove a member of the Competition Commission of India only after following the procedure established by Section 11 of the Competition Act, 2002.

In view of the above the action of the Central Government is not in order and removal of Mr. Alexander is not valid.

(c) Under section 314(1B) of the Companies Act, 1956, in case relative of a Director holds office or place of profit under the Company on a monthly remuneration of ₹ 2,50,000 or more, the Company is required to obtain prior consent by special resolution and approval of Central Government. In the present case, the Company is accordingly required to pass a special resolution and obtain approval of the Central Government.

(d) **(i)** **Illustrations:** Illustrations form a part of the statute and considered to be of relevance and value in construing the text of the section. However, illustration can not have the effect of modifying the language of the section and can neither curtail nor expand the ambit of the section.

(ii) **Explanation:** An Explanation may be added to include something or to exclude something from it. Explanation should normally be read as to harmonise with and clear up any ambiguity in the main section. It should be construed as to widen the ambit of the section.

(e) Sections 43 – 47 deals with provision relating to Special Courts. Section 43 empowers the Central Government (in consultation with the Chief Justice of the High Court) for trial of offence of money laundering, to notify one or more Courts of Sessions as Special Court or Special Courts for such area or areas or for such cases or class or group of cases as may be specified in the notification to this effect. Section 44 clearly provides for the offences triable by Special Courts. It overrides the provisions of the Code of Criminal Procedure, 1973 and provides that–

(i) the scheduled offence and the offence punishable under section 4 shall be triable only by the Special Court constituted for the area in which the offence has been committed;

(ii) a Special Court may, upon a complaint made by an authority authorised in this behalf under this Act take cognizance of the offence for which the accused is committed to it for trial. The requirement of police report of the facts which constitute an offence under this Act is no more applicable.