MOCK TEST PAPER – 1

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 by the candidates.

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

1\. (a) Super Fast Construction Ltd. has recognised contract revenue on a contract awarded in the financial year 2013-14. The target period of completion is 5 years. The contract provides for incentives for early completion at the rate of Rs. 1,000 per day subject to a maximum of Rs. 3,00,000. The company has included this amount in contract revenue on the ground that based on the previous experience in similar contracts, it is confident of completing the contract in 4 years. The company's past track record shows that company was able to complete such contracts well in time and earn incentives. Comment on the company's accounting policy for recognition of such incentives.

(b) A company is engaged in the manufacture of electronic products and systems. As per Chief Accountant a prototype system was installed at one of the customer's locations in June 2013 for getting acceptance on the performance of the system. The Chief Accountant has stated that the ownership of the system installed for field trials was vested with the company. Hence, for accounting & control purposes, the prototype system installed at customer's location in 2013 was capitalized in the accounts for the year 2013-14 at its bought-out cost. State whether the accounting treatment adopted by the company is correct or not?

(c) Advise Ltd. (a Public Sector Company) provides consultancy and engineering services to its clients. In the year 2013-14 the Government has set up a commission to decide about the pay revision. The pay will be revised with respect from 1-1-2009 based on the recommendations of the commission. The company makes the provision of Rs. 680 lakhs for pay revision in the financial year 2013-14 on the estimated basis as the report of the commission is yet to come. As per the contracts with the client on cost plus job, the billing is done on the actual payment made to the employees and allocated to jobs based on hours booked by these employees on each job.

The company discloses through notes to accounts:

"Salaries and benefits include the provision of Rs. 680 lakhs in respect of pay revision. The amount chargeable from reimbursable jobs will be billed as per the contract when the actual payment is made".

The accountant feels that the company should also book/recognise the income by Rs. 680 lakhs in Profit and Loss Account as per the terms of the contract. Otherwise, it will be the violation of matching concept & understatement of profit.

(d) On January 1, 2013, S Ltd. sold equipment to B Ltd. for Rs. 6,14,460. The carrying amount of the equipment on that date was Rs. 1,00,000. The sale was a part of the package under which B Ltd. leased the asset to S Ltd. for a ten-year term. The economic life of the asset is estimated at 10 years. The minimum lease rent payable by the lesser has been fixed at Rs. 1,00,000 payable annually beginning December 31, 2013. The incremental borrowing interest rate of S Ltd. is estimated at 10% per annum. Calculate the net effect on the profit and loss account?

(4 × 5 = 20 Marks)

2. (a) At the beginning of year 1, the enterprise grants 100 stock options to each of its 500 employees, conditional upon the employees remaining in the employment of the enterprise during the vesting period. The options will vest at the end of year 1 if the earnings of the enterprise is 18 per cent; at the end of year 2 if the earnings of the enterprise is an average of 13 per cent per year over the two year period; and at the end of year 3 if the earnings of the enterprise is an average of 10 per cent per year over the three year period. The fair value of the options, calculated at the grant date using an option pricing model, is Rs. 30 per option. No dividends are expected to be paid over the three-year period.

By the end of year 1, the earnings of the enterprise was 14 per cent, and 30 employees had left. The enterprise expected that earnings will continue at a similar rate in year 2, and, therefore, expected that the options will vest at the end of year 2. The enterprise expected on the basis of a weighted average probability, that a further 30 employees will leave during the year 2, and, therefore, assumed that options will vest in 440 employees at the end of the year 2.

By the end of year 2, the earnings of the enterprise was only 10 per cent. 28 employees have left during the year. The enterprise expected that a further 25 employees will leave during year 3, and that the earnings of the enterprise will be at least 6 per cent, thereby achieving the average of 10 per cent per year.

By the end of the year 3, 23 employees had left and the earnings of the enterprise had been 8 per cent. You are required to determine the compensation expense to be recognised each year.

(b) Mahindra Finance Ltd. is a non-banking finance company. The extracts of its balance sheet are given below:

Liabilities	*Rs. in lakhs*	*Assets*	*Rs. in lakhs*
Paid-up equity capital	100	Leased out assets	800
Free reserves	500	Investment:	
Loans	400	In shares of subsidiaries and	
Deposits	400	group companies	100
		In debentures of subsidiaries and	
		group companies	100
		Cash and bank balances	200
		Deferred expenditure	200
	1,400		1,400

You are required to compute Tier I' of Mahindra Finance Ltd. as per the NBFC (Deposit Accepting or Holding) Companies Prudential Norms (RBI) Directions 2007.

(10+6=16 Marks)

3. (a) You are given the following information about Add-on Ltd.:

(i) Beta for the year 2013-14 — 1.05

(ii) Risk Free Rate — 12%

(iii) Long term Market Rate (based on BSE Sensex) — 15.14%

(iv) Extracts from the liability side of Balance Sheet as at 31st March, 2014.

	(Rs. in lakhs)
Equity	29,160
Reserves and surplus	43,740
Shareholder's fund	72,900
Loan fund	8,100
Total funds (long-term)	81,000

(v) Profit after tax — Rs. 20,394.16 lakhs

(vi) Interest deducted from profit — Rs. 487.00 lakhs

(viii) Effective tax rate (i.e. (Provision for Tax/PBT) x 100) — 24.45%

Calculate Economic Value Added (EVA) of Add-on Ltd. as on 31st March 2014.

(b) Blue Chip Mutual Fund has invested in 2,00,000 shares of Gain Ltd. No quotation is available for last thirty days prior to the valuation date. The P/E ratio of a comparable company, which is regularly traded, is 12. Earning per share of Gain Ltd. is Rs. 20. The Net Asset Value of Gain Ltd. is Rs. 160 and the comparable

company is Rs. 200. The current market price of comparable equity share is Rs. 240. A policy is taken to give 40% weightage to net assets value and to reduce from comparable P/E ratio for relatively less liquidity of Gain Ltd. stock.

Required:

(a) Explain whether the investment in Gain Ltd. will be classified as 'trade investment' or 'non-trade investment' giving the reason for the stand taken by you.

(b) What do you think, to be the appropriate criteria for selection of comparable stock?

(c) How much discounting should be made from comparable P/E ratio for valuing investment in non- traded scrip?

(d) What should be the value of 2,00,000 equity shares of Gain Ltd.?

(8 + 8 = 16 Marks)

4. NRPL (Nuclear Reactors Private Limited) is engaged in the business of design and construction of nuclear reactors that are supplied exclusively to the Atomic Energy Department. The core component of such reactors is outsourced by NRPL from FIL (Fusion Industrials Ltd.) the sole manufacturer of this item. NRPL wants to gain leadership in this industry and seeks to take over FIL. NRPL estimates that its Goodwill in the industry will increase by a minimum of Rs. 300 crores consequent on the acquisition. NRPL has made the following calculation of the economic benefits presently available and that foreseen as a result of the acquisition.

(i) Projected Cash Flows of NRPL for the next 5 years:

Year	*1*	*2*	*3*	*4*	*5*
Cash flow (Rs. in crores)	1,000	1,500	2,000	2,500	3,000

(ii) Projected Cash Flow of FIL for the next 5 years.

Year	*1*	*2*	*3*	*4*	*5*
Cash flow (Rs. in crores)	400	400	600	800	1,000

(iii) Audited net worth of FIL

	Rs. in Crores
Fixed assets	2,000
Investments (non-trade)	1,000
Current assets	1,000
Total	4,000
Current liabilities	(1,000)
Net worth	3,000

(iv) Other information:

(a) 10% of the fixed assets of FIL will not be required in the event of the acquisition and the same has ready buyers for Rs. 100 crore.

(b) Current Assets include surplus inventory of Rs. 20 crore that can realize Rs. 30 crore.

(c) Investments have a ready marked for Rs. 1,500 crore.

(d) The current liabilities are to be paid off immediately; Rs. 510 crores are payable on account of a compensation claim awarded against FIL, which has been treated as a contingent liability in the accounts on which 20 percent was provided for.

(v) NRPL has estimated the combined cash flows post merger as under:

Year	*1*	*2*	*3*	*4*	*5*
Cash flow (Rs. in crores)	1,500	2,000	2,500	3,000	3,500

You are required to advise NRPL the maximum value it can pay for takeover of FIL; also show the current valuation of FIL as a 'Stands Alone' entity. The Discount rate of 15% is advised appropriate, values for which are given below:

Year	*P.V*
1	0.870
2	0.756
3	0.658
4	0.572
5	0.497

(16 Marks)

5. Alpha Ltd. agreed to acquire the business of Beta Ltd. as on 31st March, 2014. On that date, balance sheet of Beta Ltd. was summarised as follows:

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital (fully paid shares of Rs. 10 each)	3,00,000	Goodwill	50,000
		Land, Buildings and Plant	3,20,000
General Reserve	1,35,000	Inventories	84,000
Profit and Loss Account	55,000	Trade Receivables	18,000
Trade Payables	10,000	Cash and Bank balances	28,000
	5,00,000		5,00,000

The shareholders in Beta Ltd. were to receive Rs. 2.50 in cash per share and 3 shares in Alpha Ltd. for every two shares held - the shares in Alpha Ltd. being considered as worth Rs. 12.50 each.

There were fractions equalling 50 shares of Alpha Ltd. for which cash was paid. The directors of Alpha Ltd. considered the various assets as on 31.3.12 to be valued as follows:

	Rs.
Land	1,00,000
Buildings	2,50,000
Plant	3,50,000
Inventories	80,000
Trade receivables	18,000

The cost of liquidation of Beta Ltd. ultimately was Rs. 5,000. Due to a technical hitch, the transaction could be completed only on 1st October, 2014. Till that date, Beta Ltd. carried on trading which resulted in a profit of Rs. 20,000 (subject to interest) after providing Rs. 15,000 as depreciation. On October 1, 2014, inventory was Rs. 90,000; Trade receivables were Rs. 25,000 and trade payables were Rs. 15,000. There was no addition to or sale of fixed assets. However, for the purpose of amalgamation, stock on October 1, 2014 was taken at Rs. 86,000 only. It was agreed that the profit will belong to Alpha Ltd.

You are required to

(i) Prepare Realisation Account and the Shareholders Account in the books of Beta Ltd., and

(ii) Give journal entries in the books of Alpha Ltd. as on October, 1, 2014. *(16 Marks)*

6. On 31st March, 2014, the abridged Balance Sheets of H Ltd. and S Ltd. stood as follows:

	H Ltd. (Rs. in 000's)	S Ltd. (Rs. in 000's)
Capital and Liabilities		
Equity Share Capital – Authorised	5,000	3,000
Issued and subscribed in Equity Shares of Rs. 10 each fully paid	4,000	2,400
General Reserve	928	690
Profit and Loss Account	1,305	810
Trade payables	611	507
Provision for Taxation	220	180
Other Provisions	65	17
	7,129	4,604

Assets:		
Plant and Machinery	2,541	2,450
Furniture and Fittings	615	298
Investment in the Equity Shares of S Ltd.	1,500	–
Inventory	983	786
Trade receivables	820	778
Cash and Bank Balances	410	102
Sundry Advances	260	190
	7,129	4,604

Following additional information is available:

(a) H Ltd. purchased 90 thousand Equity Shares in S Ltd. on 1st April, 2013 at which date the following balances stood in the books of S Ltd.

General Reserve Rs. 1,500 thousand; Profit and Loss Account Rs. 633 thousand.

(b) On 14th July, 2013, S Ltd. declared a dividend of 20% out of pre-acquisition profits and paid corporate dividend tax (including surcharge) at 11%. H Ltd. credited the dividend received to its Profit and Loss Account.

(c) On 1st November, 2013, S Ltd. issued 3 fully paid Equity Shares of Rs. 10 each, for every 5 shares held as bonus shares out of pre-acquisition General Reserve.

(d) On 31st March, 2014, Inventory of S Ltd. included goods purchased for Rs. 50 thousand from H Ltd., which had made a profit of 25% on cost.

(e) Details of Trade payables and Trade receivables:

	H Ltd. (Rs. in 000's)	S Ltd. (Rs. in 000's)
Trade payables		
Bills Payable	124	80
Sundry creditors	487	427
	611	507
Trade receivables		
Debtors	700	683
Bills Receivables	120	95
	820	778

Prepare a Consolidated Balance Sheet as on 31st March, 2014. *(16 Marks)*

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

(a) XYZ Ltd., with a turnover of Rs. 35 lakhs and borrowings of Rs. 10 lakhs during any time in the previous year, wants to avail the exemptions available in adoption of

Accounting Standards applicable to companies for the year ended 31.3.2014. Advise the management on the exemptions that are available as per the Companies (AS) Rules, 2006.

If XYZ is a partnership firm is there any other exemptions additionally available.

(b) On 30-6-2014, X Limited incurred Rs. 3,00,000 net loss from disposal of a business segment. Also on 31-7-2014, the company paid Rs. 80,000 for property taxes assessed for the calendar year 2014. How should the above transactions be included in determination of net income of X Limited for the six months interim period ended on 30-9-2014?

(c) From the following information, determine the possible value of brand as per potential earning model:

		Rs. in lakhs
(i)	Profit After Tax (PAT)	2,500
(ii)	Tangible fixed assets	10,000
(iii)	Identifiable intangilble other than brand	1,500
(iv)	Weighted average cost of capital (%)	14%
(v)	Expected normal return on tangible assets weighted average cost (14%) + normal spread 4%	18%
(vi)	Appropriate capitalisation factor for intangibles	25%

(d) Write short note on some key differences between IFRS and AS (applicable in India) with respect to 'Accounting Policies, Changes in Accounting Estimates and Errors'.

(e) Huge Ltd. issued Rs. 1,00,00,000 worth of 8% Debentures of face value Rs. 100 each on par value basis on 1st January, 2014. These debentures are redeemable at 12% premium at the end of 2017 or exchangeable for ordinary shares of Huge Ltd. on 1:1 basis. The interest rate for similar debentures that do not carry conversion entitlement is 12%. You are required to calculate the value of the debt portion of the above compound financial instrument. The present value of the rupee at the end of years 1 to 4 at 8% and 12% are supplied to you as:

	8%	*12%*
End of year 1	0.926	0.893
End of year 2	0.857	0.797
End of year 3	0.794	0.712
End of year 4	0.735	0.636

(4 x 4 =16 Marks)

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

SUGGESTED ANSWERS/HINTS

1. **(a)** According to para 14 of AS 7 (Revised), 'Construction Contracts', incentive payments are included in contract revenue only when

- the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and
- the amount of the incentive payment can be measured reliably.

In the given case, the contract is not sufficiently advanced as it is in the first year of construction and its normal time for cnstruction is 4 to 5 years.

Further, the past track record is not the criteria for recognition of incentive payments receivable for early completion of the contract.

Since, the recognition criterias are not met, it is inappropriate to recognise incentive payments in the current year as part of contract revenue. Therefore, Super Fast Construction Ltd.'s accounting policy to recognise incentive payments in the first year of construction as contract revenue, based on past performance, is not in accordance with AS 7 (Revised).

(b) As per para 3 of AS 2 'Valuation of Inventories', inventories mean assets held for sale in the ordinary course of business, or in the process of production for such sale, or for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares.

And as per para 6 of AS 10 'Accounting for Fixed Assets', fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

Accordingly, the system installed by the company at customer's site for his acceptance, based on the field trials of the system, is an item of inventory, and is not a fixed asset. Installation of such prototype system at customers' sites for their acceptance is akin to sale of goods on approval basis. Therefore, the capitalisation of such prototype system at its bought-out-cost is not correct.

At the time of installation of such systems at the customers' site, value of the same should be transferred to a separate account such as 'Goods sent for approval account'.

Since the prototype system does not qualify the definition of fixed asset, no depreciation will be charged on it.

(c) As per para 46 of AS 29, 'Provisions, Contingent Liabilities and Contingent Assets', where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

Accordingly, potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists.

In this case the provision of salary to employees of Rs. 680 lakhs will be ultimately collected from the client as per the terms of the contract. Therefore, the liability of Rs. 680 lakhs is matched by the counter claim from the client. Hence, the provision for salary of employees should be made reducing the claim to be made from the client. It appears that the whole amount of Rs. 680 lakhs is recoverable from client and there is no significant uncertainty about the collection. Hence, the net charge to profit and loss account should be nil.

The opinion of the accountant regarding non-recognition of income of Rs. 680 lakhs is not as per AS 29 and AS 9. However, the concept of prudence will not be followed if Rs. 680 lakhs is simultaneously recognized as income. Rs. 680 lakhs is not the revenue at present but only reimbursement of claim. However the accountant is correct to the extent that non- recognition of Rs. 680 lakhs as income will result in the under statement of profit.

(d) The PV of minimum lease payments at 10% discount rate:

= Rs. 1,00,000 X 6.1446 = Rs. 6,14,460

S Ltd. should recognize the asset and the liability at Rs. 6,14,460.

The excess of sales proceeds over carrying amount

= Rs. 6,14,460 – Rs. 1,00,000 = Rs. 5,14,460

As per para 48 of AS 19 'Leases', if a sale and leaseback transaction results in a finance lease, any excess or deficiency of sale proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

Therefore, assuming that S Ltd. has decided to charge depreciation on straight line basis, AS 19 requires S Ltd. to:

a. Recognize depreciation of Rs. 61,446 per annum for 10 years

b. Allocate excess of Rs. 5,14,460 over the lease term at the rate of Rs. 51,446 p.a.

The net effect is a debit of (Rs. 61,446 – Rs. 51,446) Rs. 10,000 per annum to the profit and loss account for 10 years, as covered under the lease term.

Had there been no sale and lease back transaction, the profit and loss account for each year covered in the lease term would have been charged by (Rs. 1,00,000/10) or Rs. 10,000, towards depreciation. Thus, the sale and lease back transaction has no impact on profit or loss to be reported by the lessee (vendor in the sale transaction) over the lease period.

The deferred income (excess) should be presented as a deduction from the carrying amount of the asset. Thus, the asset should be presented by S Ltd. in its Balance Sheet dated December 31, 2013 as follows:

	Rs.
Gross Block	6,14,460
Less: Accumulated depreciation	(61,446)
Net Block	5,53,014
Less : Deferred Income (5,14,460 – 51,446)	(4,63,014)
Net Block	90,000

In effect, the carrying amount of the equipment does not change with the sale and lease back transaction. In substance, the sale and lease back transaction is a borrowing transaction resulting in recognition of a liability in the balance sheet and recognition of interest expense in the profit and loss account.

2. (a) In the given case, the length of the vesting period varies, depending on when the performance condition is satisfied. In such a situation, as per paragraph 14 of the text of the Guidance Note on 'Accounting for Employee Share Based Payments', the enterprise estimates the length of the expected vesting period, based on the most likely outcome of the performance condition, and revises that estimate, if necessary, if subsequent information indicates that the length of the vesting period is likely to differ from previous estimates.

Statement showing determination of the compensation expense to be recognised each year

Particulars	*Year 1*	*Year 2*	*Year 3*
Vesting condition (earnings)	18%	13% (avg.)	10% (avg.)
Actual earnings	14%	12% (avg.)	10.67% (avg.)
Length of the expected vesting period (at the end of the year)	2 years	3 years	3 years

No. of employees expected to meet vesting conditions	440 employees	417 employees	419 employees
No. of options expected to vest	44,000	41,700	41,900
Fair value of options expected to vest @ Rs. 30 per option (Rs.)	13,20,000	12,51,000	12,57,000
Compensation expense accrued at the end of year (Rs.)	6,60,000 [13,20,000/2]	8,34,000 (12,51,000 × 2/3)	12,57,000
Compensation expense recognised till the end of previous year (Rs.)	Nil	6,60,000	8,34,000
Compensation expense to be recognized for the year (Rs.)	6,60,000	1,74,000	4,23,000

(b) Statement showing computation of 'Tier I Capital'

		Rs. in lakhs
Paid up Equity Capital		100
Free Reserves		500
		600
Less: Deferred expenditure		(200)
Owned Fund	A	400
Investments		
In shares of subsidiaries and group companies		100
In debentures of subsidiaries and group companies		100
	B	200
10% of A i.e. Owned Fund		40
Excess of Investment over 10% of A (200-40)	C	160
Tier I Capital [(A) - (C)] (400-160)		240

3. (a) (i) **NOPAT**

Profit After Tax	Rs. 20,394.16 lakhs
Add: Interest (net of tax) [Rs. 487 lakhs (1-0.2445)]	Rs. 367.93 lakhs
NOPAT	Rs. 20,762.09 lakhs

(ii) **Cost of Equity**

Cost of Equity = Risk free Rate + β [Market Rate – Risk Free Return]

= 12% + 1.05 x (15.14 -12.00) = 12% + 3.30% = 15.30%

(iii) **Cost of Debt**

$$\text{Cost of Debt} = \frac{\text{Interest on Loan Funds (1} - \text{Tax Rate)}}{\text{Loan funds}} \times 100$$

$$\text{Cost of Debt} = \frac{487\text{x}(1-0.2445)}{8{,}100} \times 100 = 4.54\%$$

(iv) Weighted Average Cost of Capital (WACC)

	Amount (Rs. in lakhs)	*Weight*	*Cost*	*WACC %*
Equity	72,900	.90	15.30	13.77
Debt	8,100	.10	4.54	0.454
	81,000	1.00		14.224

(v) Cost of Capital Employed= Rs. 81,000 x 14.224% = Rs. 11,521.44 lakhs

(vi) EVA = NOPAT – Cost of Capital Employed

= Rs. 20,762.09 lakhs – Rs. 11,521.44 lakhs = Rs. 9,240.65 lakhs

(b) (a) A scrip is treated as non-traded, if it is not traded in stock exchange for a period of more than 30 days (Eighth schedule of SEBI (Mutual Funds) Regulations 1996). In the given case, investment in Gain Ltd. will be a 'non-traded investment', as no quotation is available for last thirty days prior the valuation date.

(b) A comparable stock is generally selected from the same industry. It should be of same size and the return of capital employed should be in the same range.

(c) The valuation of investment should be linked both to degree of liquidity and also the level of current net assets value. In case the comparable stock is quoted at a discount to net assets value, the same discount can be used to estimate the applicable discount factor to P/E Ratio.

In the given case, market value of the comparable equity is 20% [i.e. {(240 - 200) / 200} x 100] above the net asset value. So, market value of Gain Ltd.'s share should be Rs. 160 + 20% of Rs. 160 i.e. Rs. 192. Given EPS of Rs. 20, the P/E ratio of Gain Ltd. can be derived as Rs. 192/20 = 9.6, which is 2.4 less than the P/E ratio of 12 of the comparable firm.

(d) Value per equity share of Gain Ltd. = (Rs. 192 + Rs. 160) / 2 = Rs. 176

Total Value = 2,00,000 x Rs. 176 = Rs. 3,52,00,000.

4. **(1)** Calculation of operational synergy expected to arise out of merger

(Rs. in crores)

Year	*1*	*2*	*3*	*4*	*5*
Projected cash flows of NRPL after merger with FIL	1,500	2,000	2,500	3,000	3,500
Less: Projected cash flows of NRPL Ltd. without merger	(1,000)	(1,500)	(2,000)	(2,500)	(3,000)
	500	500	500	500	500

(2) Valuation of FIL in case of merger

Year	*Cash Flows from operations (Rs. in crores)*	*Discount Factor*	*Discounted Cash Flow (Rs. in crores)*
1	500	0.870	435.00
2	500	0.756	378.00
3	500	0.658	329.00
4	500	0.572	286.00
5	500	0.497	248.50
			1,676.50

(3) Maximum value to be quoted

	Rs. in crores	*Rs. in crores*
Value as per discounted cash flows from operations		1,676.50
Add: Increase in goodwill of NRPL on acquisition of FIL		300
		1,976.50
Add: Cash to be collected immediately by disposal of assets:		
Fixed Assets	100	
Investments	1,500	
Inventory	30	1,630.00
		3,606.50
Less: Current liabilities (1,000 – 102) (See Note below)	898	
Compensations claim	510	(1,408.00)
		2,198.50

So, NRPL can quote as high as Rs. 2,198.50 crores for taking over the business of FIL.

(4) Valuation of FIL ignoring merger (as a 'Stand Alone' entity)

Year	Cash Flows (Rs. in crores)	Discount Factor	Discounted Cash Flow (Rs. in crores)
1	400	0.870	348.00
2	400	0.756	302.40
3	600	0.658	394.80
4	800	0.572	457.60
5	1,000	0.497	497.00
			1,999.80

5. (i)

In the books of Beta Ltd.

Realisation Account

2014		Rs.	2014		Rs.
Oct. 1	To Goodwill	50,000	Oct. 1	By Trade Payables	15,000
	To Land, Buildings, Plant, etc.	3,20,000		By Provision for Depreciation	15,000
	To Inventory	90,000		By Alpha Ltd. - consideration (W.N.2)	6,37,500
	To Trade Receivables	25,000			
	To Cash & Bank Balance (W.N.1)	55,000		By Alpha Ltd. (for profit) (W.N.3)	20,000
	To Shareholders - profit	1,47,500			
		6,87,500			6,87,500

Shareholders Account

2014		Rs.	2014		Rs.
Oct. 1	To Cash and Bank A/c	75,625	Oct. 1	By Share Capital A/c	3,00,000
	To Shares in Alpha Ltd.	5,61,875		By General Reserve A/c	1,35,000
				By Profit & Loss A/c	55,000
				By Realisation A/c	1,47,500
		6,37,500			6,37,500

(ii) **Journal of Alpha Ltd.**

2014			Dr. (*Rs.*)	Cr. (*Rs.*)
Oct. 1	Business Purchase Account	Dr.	6,37,500	
	To Liquidator of Beta Ltd.			6,37,500
	(The consideration settled as per agreement dated.... for the purchase of business of Beta Ltd.)			
	Land Account	Dr.	1,00,000	
	Buildings Account	Dr.	2,50,000	
	Plant Account	Dr.	3,50,000	
	Inventory Account	Dr.	86,000	
	Trade Receivables Account	Dr.	25,000	
	Bank Account	Dr.	55,000	
	To Provision for depreciation Account			15,000
	To Profit & Loss Suspense Account			20,000
	To Trade Payables Account			15,000
	To Business Purchase Account			6,37,500
	To Capital Reserve Account			1,78,500
	(Various assets and liabilities taken over from Beta Ltd. and profit up to September 30, 2014 being credited to Profit and Loss Suspense Account)			
	Liquidator of Beta Ltd.	Dr.	6,37,500	
	To Share Capital Account			4,49,500
	To Securities Premium Account			1,12,375
	To Cash and Bank Account			75,625
	(Allotment of shares at a premium and payment of cash in discharge of consideration for the business taken over)			
	Capital Reserve Account	Dr.	5,000	
	To Cash and Bank Account			5,000
	(Expenses of liquidation)			

Working Notes:

(1) Calculation of cash balance as on 1st October, 2014		Rs.	Rs.
Cash and Bank balances as on April 1, 2014			28,000
Add: Profit earned		20,000	
Depreciation (no cash payment)		15,000	
Increase in Trade Payables		5,000	
		40,000	
Less: Increase in Inventory	6,000		
Increase in Trade Receivables	7,000	(13,000)	
Cash profit earned between 1.4.14 to 30.9.14			27,000
Cash balance as on 1st October, 2014			55,000

(2) Calculation of Purchase Consideration	Rs.	Rs.
Cash (Rs. 2.50 x 30,000 shares)		75,000
Shares [Rs.12.50 x (30,000 x 3/2 -50)]		5,61,875
Cash for fractions (Rs.12.50 x 50 shares)		625
		6,37,500

(3) Since, the business of Beta Ltd. is acquired on 31st March, 2014, the profit of Rs. 20,000 for the period of 1st April, 2014 to 30th September, 2014, should be standing to the credit of Alpha Ltd.

6. **Consolidated Balance Sheet of H Ltd. with its subsidiary S Ltd. as on 31st March, 2014**

Particulars	*Note No.*	*(Rs. in 000's)*
I. Equity and Liabilities		
(1) **Shareholder's Funds**		
(a) Share Capital	1	4,000
(b) Reserves and Surplus	2	3,063
(2) **Minority Interest (W.N.6)**		1,560
(3) **Current Liabilities**		
Trade payables	3	1,118
Short term provisions	4	482
Total		10,223
II. Assets		
(1) **Non-current assets**		
Fixed assets		
Tangible assets	5	5,904

(2) **Current assets**		
(a) Inventories	6	1,759
(b) Trade receivables	7	1,598
(c) Cash and cash equivalents	8	512
(d) Short term loans and advances	9	450
Total		10,223

Notes to Accounts

					(Rs. in 000's)	(Rs. in 000's)
1.	**Share Capital**					
	Authorised share capital					
	5 lakhs equity shares of Rs. 10 each					5,000
	Issued, Subscribed and Paid up					
	4 lakhs equity shares of Rs. 10 each fully paid					4,000
2.	**Reserves and surplus**					
	Capital Reserve (Note 5)				660	
	General Reserve (*Rs.* 928+*Rs.* 54)				982	
	Profit and Loss Account:					
		H Ltd.	*Rs.*	1,305		
	Add: Share in	S Ltd	*Rs.*	306		
			Rs.	1,611		
	Less: Dividend wrongly credited		*Rs.*	(180)		
			Rs.	1,431		
	Less: Unrealised profit (50 X 1/5)		*Rs.*	(10)	1,421	3,063
3.	**Trade payables**					
		H Ltd.			611	
		S Ltd.			507	1,118
4.	**Short –term provisions**					
	Provision for Taxation	H Ltd.	*Rs.*	220		
		S Ltd.	*Rs.*	180	400	
	Other Provisions	H Ltd	*Rs.*	65		
		S Ltd.	*Rs.*	17	82	482
5.	**Tangible Assets**					
	Plant and Machinery					
		H Ltd.	*Rs.*	2,541		

	S Ltd.	Rs. 2,450	4,991	
	Furniture and fittings			
	H Ltd.	Rs. 615		
	S Ltd.	Rs. 298	913	5,904
6.	**Inventories**			
	Inventory H Ltd.	Rs. 983		
	S Ltd.	Rs. 786	1,769	
	Less: Unrealised profit (Rs. 50 x 1/5)		(10)	1,759
7.	**Trade receivables**			
	H Ltd.		820	
	S Ltd.		778	1,598
8.	**Cash and cash equivalents**			
	Cash and Bank Balances H Ltd		410	
	S Ltd.		102	512
9.	**Short term loans and advances**			
	Sundry Advances H Ltd.		260	
	S Ltd.		190	450

Working Notes:

Share holding pattern

Particulars	*Number of Shares*	*% of holding*
a. S Ltd.	90,000	
(i) Purchased on 01.04.2013		
(ii) Bonus Issue (90,000/5X3)	54,000	
Total	1,44,000	60 %
b. Minority Interest	96,000	40%

1. S Ltd.'s General Reserve

	(Rs. in 000)		*(Rs. in 000)*
To Bonus to equity shareholders $\left(\frac{2,400 \times 3}{8}\right)$	900	By Balance b/d	1,500
		By Profit and Loss A/c	
To Balance c/d	690	(Balancing figure)	90
	1,590		1,590

2. **S Ltd.'s Profit and Loss Account**

	(Rs. in 000)		*(Rs. in 000)*
To General Reserve	90	By Balance b/d	633
To Dividend paid on 14.7.2013 $\frac{₹1,500 \times 20}{100}$	300	By Net Profit for the year (Balancing figure)	600*
To Corporate Dividend Tax (11% of Rs. 300)	33		
To Balance c/d	810		
	1,233		1,233

* Out of Rs. 6,00,000 profit for the year, Rs. 90,000 has been transferred to reserves by S Ltd.

3. **Distribution of Revenue Profits**

	Rs. in '000
Revenue Profit as above	600
Share of H Ltd. (60%)	360
Share of Minority shareholders (Rs. 600 – Rs. 360)	240

4. **Computation of Capital Profits**

		Rs. in 000	*Rs. in 000*
General Reserve on the date of acquisition			1,500
Less: Bonus issue of shares			(900)
			600
Profit and Loss Account balance on the date of acquisition		633	
Less: Dividends paid	*Rs.* 300		
Corporate tax paid	*Rs.* 33	(333)	300
			900
Share of H Ltd. (60%)			540
Share of Minority shareholders			360

5. **Computation of Capital Reserve**

		Rs. in '000
60% of share capital of S Ltd.		1,440
Add: Share of H Ltd. in the capital profits as in working note (4)		540
		1,980
Less: Investments in S Ltd.	1,500	

Less: Dividends received out of pre- acquisition profits $\frac{₹\ 300 \times 60}{100}$	(180)	(1,320)
		660

6. **Calculation of Minority Interest**

		Rs. in '000
40% of share capital of S Ltd.		960
Add: Share of Revenue Profits (Note 3)		240
Share of Capital Profits (Note 4)		360
		1,560

7. **(a)** The question deals with the issue of Applicability of Accounting Standards for Corporates & Non-corporates.

The companies can be classified under two categories viz SMCs and Non SMCs under the Companies (AS) Rules, 2006.

As per the Companies (AS) Rules, 2006, criteria for above classification as SMCs, are:

"Small and Medium Sized Company" (SMC) means, a company-

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank, financial institution or an insurance company;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Since, XYZ Ltd.'s turnover of Rs. 35 lakhs does not exceed Rs. 50 crores & borrowings of Rs. 10 lakhs is less than Rs. 10 crores, it is a small and medium sized company

Being an SMC, following relaxations and exemptions are available to XYZ Ltd.

1. AS 3 "Cash Flow Statements" is not mandatory.

2. AS 17 "Segment Reporting" is not mandatory.

3. SMCs are exempt from certain paragraphs of AS 19 "Leases" related to disclosures.

4. SMCs are exempt from disclosures of diluted EPS (both including and

excluding extraordinary items).

5. SMCs are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique under AS 28 "Impairment of Assets".
6. SMCs are exempt from disclosure requirements of paragraphs 66 and 67 of AS 29 "Provisions, Contingent Liabilities and Contingent Assets".
7. SMCs are exempt from certain requirements of AS 15 "Employee Benefits".
8. Accounting Standards 21, 23, 27 are not applicable to SMCs.

However, if XYZ is a partnership firm and not a corporate, then its classification will be done on the basis of the classification of non-corporate entities as prescribed by the ICAI. According to ICAI, non-corporate entities can be clasiified under 3 levels viz Level I, Level II (SMEs) and Level III (SMEs).

Since, turnover of M/s. XYZ, a partnership firm is less than Rs. 1 crore & borrowings of Rs. 10 lakhs is less than Rs. 1 crore, therefore, it will be classified as Level III SME. In this case, AS 3, AS 17, AS 18, AS 21, AS 23, AS 24, AS 27 will not be applicable to M/s. XYZ (a partnership firm). Relaxations from certain requirements in respect of AS 15, AS 19, AS 20, AS 25, AS 28 and AS 29 will also be available to M/s. XYZ.

(b) Para 28 of AS 25 "Interim Financial Reporting" states that revenues and gains should be recognised in interim reports on the same basis as used in annual reports. As at September 30, 2014, X Ltd. would report the entire Rs. 3,00,000 loss on the disposal of its business segment since the loss was incurred during the interim period.

A cost charged as an expense in an annual period should be allocated among the interim periods, which are clearly benefited from the expense, through the use of accruals and/or deferrals. Since Rs. 80,000 property tax payment relates to the entire 2014 calendar year, only Rs. 40,000 of the payment would be reported as an expense at September 30, 2014, while out of the remaining Rs. 40,000, Rs. 20,000 for Jan. 2014 to March, 2014 would be shown as payment of the outstanding amount of previous year and another Rs. 20,000 related to quarter October, 2014 to December, 2014, would be reported as a prepaid expense.

(c) Calculation of possible value of brand

	Rs. in lakhs
Profit after Tax	2,500
Less: Profit allocated to tangible assets [18% of *Rs.* 10,000]	(1,800)
Profit allocated to intangible assets including brand	700

Capitalisation factor 25%	
Capitalised value of intangibles including brand $\left[\frac{700}{25}\times 100\right]$	2,800
Less: Identifiable intangibles other than brand	(1,500)
Brand value	1,300

(d)

	AS	*IFRS*
Accounting Policies, Changes in Accounting Estimates and Errors	AS 5 allows change in an accounting policy in case the change is required by the Statute.	IAS 8 does not permit an entity to change an accounting policy even if it is required by the statute.
	This standard is silent that whether a change in accounting policy to be accounted for either retrospectively or prospectively. Any change in an accounting policy, which has a material effect, should be disclosed. Where the effect of such change is not ascertainable wholly or in part, the fact should be indicated.	If an entity changes an accounting policy voluntarily, it needs to apply the change retrospectively. When a change in an accounting policy is applied retrospectively, an entity should adjust the opening balance of each affected component of equity for the earliest prior period presented and disclose the comparative amounts for each prior period presented.
	AS 5 deals with "Prior period items" which basically cover income and expenses only. AS 5 does not consider fraud as an error i.e. errors are unintentional mistakes which may arise due to several reasons.	IAS 8 uses the term "Prior period errors" which covers all items in the financial statements including assets and liabilities. As per IAS 8, errors also include fraud within its scope. Standard says errors may be intentional or unintentional.

	Since AS 5 does not deal with intentional errors, no such disclosures are discussed in it.	IAS 8 requires disclosure if financial statements do not comply with IFRSs i.e. if they contain either material errors or immaterial errors made **intentionally** to achieve a particular presentation of an entity's financial position, financial performance or cash flows.
	Prior period items are included in the Statement of Profit or Loss of the current period i.e. the period in which the error is discovered. Such errors are separately disclosed in the statement of profit and loss in a manner that the impact on current profit or loss can be perceived. There is no requirement of restating the comparatives of the prior periods.	As per IAS 8, material prior period errors shall be corrected retrospectively in the first set of financial statements authorised for issue after their discovery by: (a) Restating the comparative amounts for the prior period(s) presented in which the error occurred; or (b) If the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

(e) Present value of Debentures redeemable in 2017 Rs. 71,23,200

[Rs. 1,00,00,000 x 1.12 x 0.636]

Present value of interest on debentures

[Rs. 8,00,000* x 3.038 (sum of 4 years discount factors @12%)] Rs. 24,30,400

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

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

MOCK TEST PAPER –1

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) BSE 5000

Value of portfolio	Rs. 10,10,000
Risk free interest rate	9% p.a.
Dividend yield on Index	6% p.a.
Beta of portfolio	1.5

We assume that a future contract on the BSE index with four months maturity is used to hedge the value of portfolio over next three months. One future contract is for delivery of 50 times the index.

Based on the above information calculate:

(i) Price of future contract.

(ii) The gain on short futures position if index turns out to be 4,500 in three months.

(5 Marks)

(b) You as a forex dealer have dealing position in your account in London:

Particulars	£
Opening Balance (Oversold)	187,500
Purchase of cheques not credited to the account	164,000
Outstanding Forward Contracts	
Sales	4,096,500
Purchases	3,651,500
DD issued not yet presented for payment	610,040
Bill purchased in hand not due for	1,442,820

What must you do to square up your position? *(5 Marks)*

(c) A company is considering Projects X and Y with following information:

Project	Expected NPV (Rs.)	Standard deviation
X	1,22,000	90,000
Y	2,25,000	1,20,000

(i) Which project will you recommend based on the above data?

(ii) Explain whether your opinion will change, if you use coefficient of variation as a measure of risk.

(iii) Which measure is more appropriate in this situation and why? *(5 Marks)*

(d) M Ltd. has to make a payment on 30th January, 2014 of Rs. 80 lakhs. It has surplus cash today, i.e. 31st October, 2013; and has decided to invest sufficient cash in a bank's Certificate of Deposit scheme offering an yield of 8% p.a. on simple interest basis. What is the amount to be invested now? *(5 Marks)*

2. (a) DEF Ltd has been regularly paying a dividend of Rs. 19,20,000 per annum for several years and it is expected that same dividend would continue at this level in near future. There are 12,00,000 equity shares of Rs. 10 each and the share is traded at par.

The company has an opportunity to invest Rs. 8,00,000 in one year's time as well as further Rs. 8,00,000 in two year's time in a project as it is estimated that the project will generate cash inflow of Rs. 3,00,000 per annum in three year's time and four year's time and Rs. 3,60,000 in five year's time which will continue forever. This investment is possible if dividend is reduced for next two years.

Whether the company should accept the project? Also analyze the effect on the market price of the share, if the company decides to accept the project. *(8 Marks)*

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

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

You are required to:

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

(2) Provide a brief comment on the month end NAV. *(8 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	+50,000	+70,000	+90,000

XY Ltd. assumes the year 3 nominal cash flows will continue to be earned each year indefinitely. 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) Given the following information:

Exchange rate – Canadian dollar 0.665 per DM (spot)

Canadian dollar 0.670 per DM (3 months)

Interest rates – DM 7% p.a.

Canadian Dollar – 9% p.a.

What operations would be carried out to take the possible arbitrage gains? *(8 Marks)*

4. (a) XYZ Ltd.'s bond (Face Value of Rs. 1000) with 4 years maturity is currently trading at Rs. 900 carrying a coupon rate of 15%. Assuming that the reinvestment rate is

16%, you are required to calculate Realized Yield to Maturity of the bond. *(8 Marks)*

(b) Consider the following information on two stocks, A and B :

Year	Return on A (%)	Return on B (%)
2012	10	12
2013	16	18

You are required to determine:

(i) The expected return on a portfolio containing A and B in the proportion of 40% and 60% respectively.

(ii) The Standard Deviation of return from each of the two stocks.

(iii) The covariance of returns from the two stocks.

(iv) Correlation coefficient between the returns of the two stocks.

(v) The risk of a portfolio containing A and B in the proportion of 40% and 60%. *(8 Marks)*

5. (a) A Ltd. has an export sale of Rs. 50 crore of which 20% is paid by importer in advance of dispatch and for balance the average collection period is 60 days. However, it has been observed that these payments have been running late by 18 days. The past experience indicates that bad debt losses are 0.6% on Sales. The expenditure incurred for efforts in receivable collection are Rs. 60,00,000 p.a.

So far A Ltd. had no specific arrangements to deal with export receivables, following two proposals are under consideration:

(i) A non-recourse export factoring agency is ready to buy A Ltd.'s receivables by charging 2% commission. The factor will pay an advance to the firm at an interest rate of MIBOR + 2.00% after withholding 20% as reserve.

(ii) Insu Ltd. an insurance company has offered a comprehensive insurance policy at a premium of 0.45% of the sum insured covering 85% of risk of non-payment. A Ltd. can assign its right to a bank in return of an advance of 75% of the value insured at MIBOR+1.75%.

Assuming that MIBOR is 6% and A Ltd. can borrow from its bank at MIBOR+2.25% by using existing overdraft facility determine the which of the two proposal should be accepted by A Ltd. (1 Year = 360 days). *(10 Marks)*

(b) A company is long on 10 MT of copper @ Rs. 474 per kg (spot) and intends to remain so for the ensuing quarter. The standard deviation of changes of its spot and future prices are 4% and 6% respectively, having correlation coefficient of 0.75.

What is its hedge ratio? What is the amount of the copper future it should short to achieve a perfect hedge? *(6 Marks)*

6. (a) The following information is provided related to the acquiring Firm Mark Limited and the target Firm Mask Limited:

	Firm Mark Limited	Firm Mask Limited
Earning after tax (Rs.)	2,000 lakhs	400 lakhs
Number of shares outstanding	200 lakhs	100 lakhs
P/E ratio (times)	10	5

Required:

(i) What is the Swap Ratio based on current market prices?

(ii) What is the EPS of Mark Limited after acquisition?

(iii) What is the expected market price per share of Mark Limited after acquisition, assuming P/E ratio of Mark Limited remains unchanged?

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

(v) Calculate gain/loss for shareholders of the two independent companies after acquisition. *(8 Marks)*

(b) X Limited, just declared a dividend of Rs. 14.00 per share. Mr. B is planning to purchase the share of X Limited, anticipating increase in growth rate from 8% to 9%, which will continue for three years. He also expects the market price of this share to be Rs. 360.00 after three years.

You are required to determine:

(i) the maximum amount Mr. B should pay for shares, if he requires a rate of return of 13% per annum.

(ii) the maximum price Mr. B will be willing to pay for share, if he is of the opinion that the 9% growth can be maintained indefinitely and require 13% rate of return per annum.

(iii) the price of share at the end of three years, if 9% growth rate is achieved and assuming other conditions remaining same as in (ii) above.

Calculate rupee amount up to two decimal points.

	Year-1	Year-2	Year-3
FVIF @ 9%	1.090	1.188	1.295
FVIF @ 13%	1.130	1.277	1.443
PVIF @ 13%	0.885	0.783	0.693

(8 Marks)

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

(a) Financial and Operating Lease

(b) Euro Convertible Bonds (ECBs)

(c) CAMEL Model in Credit Rating

(d) Random Walk Theory

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

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – I

PAPER – 2: STRATEGIC FINANCIAL MANAGEMENT

SUGGESTED ANSWERS/HINTS

1. (a)

(i) Current future price of the index = 5000 + 5000 (0.09-0.06) $\frac{4}{12}$ = 5000 + 50 = 5,050

$\therefore$ Price of the future contract = Rs. 50 x 5,050 = Rs. 2,52,500

(ii) Hedge ratio = $\frac{1010000}{252500} \times 1.5$ = 6 contracts

Index after three months turns out to be 4500

Future price will be = 4500 + 4500 (0.09-0.06) $\times \frac{1}{3}$ = 4,511.25

Therefore, Gain from the short futures position is = 6 x (5050 – 4511.25) x 50 = Rs. 1,61,625

Note: Alternatively we can also use daily compounding (exponential) formula.

(b)

	Purchases (£)	Sale (£)
Balance (Oversold)		187,500
Cheques purchased	164,000	
Forward Sales		4,096,500
Forward Purchases	3,651,500	
DD issued		610,040
Bill purchased	1,442,820	
	5,258,320	4,894,040
Balance (Overbought)		364,280
	5,258,320	5,258,320

Since dealer has overbought position of £364,280, it will sell this amount (nearest amount £364,000 because it have to buy in interbank market where the deals are available in rounding off.

(c) **(i)** On the basis of standard deviation project X be chosen because it is less risky than Project Y having higher standard deviation.

(ii) $CV_x = \frac{SD}{ENPV} = \frac{90,000}{1,22,000} = 0.738$

$CV_y = \frac{1,20,000}{2,25,000} = 0.533$

On the basis of Co-efficient of Variation (C.V.) Project X appears to be more risky and Y should be accepted.

(iii) However, the NPV method in such conflicting situation is best because the NPV method is in compatibility of the objective of wealth maximisation in terms of time value.

(d) **Calculation of Investment Amount**

Amount required for making payment on 30th January, 2014 = Rs. 80,00,000

Investment in Certificates of Deposit (CDs) on 31st October, 2013

Rate of interest = 8% p.a.

No. of days to maturity = 91 days

Interest on Rs. 1 of 91 days

(Re. 1 × 0.08 × 91/365) = 0.0199452

Amount to be received for Re. 1

(Re.1.00 + Rs. 0.0199452) = 1.0199452

Calculation of amount to be invested now to get Rs. 80 lakhs after 91 days:

$$= \frac{₹\ 80,00,000}{₹\ 1.0199452} = \text{Rs. } 78,43,558.65$$

Or, Rs. 78,43,600 or Rs. 78,44,000 approximately.

2. (a) First we calculate cost of Equity (K_e)/PE Ratio

$$D_1 = \frac{19,20,000}{12,00,000} = \text{Rs. } 1.6$$

P_0 = Rs. 10

$$P/E = \frac{10}{1.6} = 6.25$$

$$K_e = \frac{1}{P/E} = \frac{1}{6.25} = 16\%$$

Now we shall compute NPV of the project

$$NPV = \frac{-800000}{(1+0.16)} + \frac{-800000}{(1+0.16)^2} + \frac{300000}{(1+0.16)^3} + \frac{300000}{(1+0.16)^4} + \frac{360000}{0.16} \times \frac{1}{(1+0.16)^4}$$

= -6,89,655 – 5,94,530 + 1,92,197 + 1,65,687 + 12,42,655

= 3,16,354

As NPV of the project is positive, the value of the firm will increase by Rs. 3,16,354 and spread over the number of shares e.g. 12,00,000, the market price per share will increase by 26 paisa.

(b) (1) Calculation of NAV at the end of month:

Given Annual Return = 15%

Hence Monthly Return = 1.25% (r)

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

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

0.82 = NAV_t - Rs. 64.96

NAV_t = Rs. 65.78

(2) There is no change in NAV.

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	50000	70000	90000
Nominal	-200000	70000	137200	246960
In Indian Rs.'000 (2)	-33333	9167	14117	19965
Net Cash Flow in Rs. '000 (1)+(2)	-83333	7517	11697	16637
PVF@20%	1	0.833	0.694	0.579
PV	-83333	6262	8118	9633

NPV of 3 years = -59320 (Rs. '000)

$$\text{NPV of Terminal Value} = \frac{16637}{0.20} \times 0.579 = 48164 \ (\text{Rs.'000})$$

Total NPV of the Project = -59320 (Rs. '000) + 48164 (Rs.'000) = -11156 (Rs.'000)

(b) In this case, DM is at a premium against the Can$.

Premium = [(0.67 – 0.665) /0.665] x (12/3) x 100 = 3.01 per cent

Interest rate differential = 9% - 7% = 2 per cent.

Since the interest rate differential is smaller than the premium, it will be profitable to place money in Deutschmarks the currency whose 3-months interest is lower.

The following operations are carried out:

(i) Borrow Can$ 1000 at 9 per cent for 3- months;

(ii) Change this sum into DM at the spot rate to obtain DM

= (1000/0.665) = 1503.76

(iii) Place DM 1503.76 in the money market for 3 months to obtain a sum of DM

Principal:	1503.76
Add: Interest @ 7% for 3 months =	26.32
Total	1530.08

(iv) Sell DM at 3-months forward to obtain Can$= (1530.08x0.67) = 1025.15

(v) Refund the debt taken in Can$ with the interest due on it, i.e.,

	Can$
Principal	1000.00
Add: Interest @9% for 3 months	22.50
Total	1022.50

Net arbitrage gain = 1025.15 – 1022.50 = Can$ 2.65

4. (a) We shall compute r* (Realized Yield to Maturity) by using following equation:

$PV (1+r^*)^4$ = Future Value of Benefits and Future Value of Benefits shall be computed as follows:

	0	1	2	3	4
Investment (Rs.)	900				
Annual Interest (Rs.)		150	150	150	150
Compound Factor @ 16%		1.56	1.35	1.16	1.00
Future Value of Intermediate Cash Flows (Rs.)		234.00	202.50	174.00	150

Maturity Value (Rs.)					1000.00
	900	234.00	202.50	174.00	1150.00
				Total of Future Benefits	1760.50

Accordingly,

$900 (1+r^*)^4 = 1760.50$

$(1+r^*)^4 = 1760.50/900$

$(1+r^*)^4 = 1.956$

$(1+r^*) = (1.956)^{1/4}$

$(1+r^*) = (1.1826)$

$r^* = 0.1826$ say 18.26%

(b) (i) Expected return of the portfolio A and B

E (A) = (10 + 16) / 2 = 13%

E (B) = (12 + 18) / 2 = 15%

$$Rp = \sum_{i-l}^{N} X_i R_i = 0.4(13) + 0.6(15) = 14.2\%$$

(ii) Stock A:

Variance = $0.5 (10 - 13)^2 + 0.5 (16 - 13)^2 = 9$

Standard deviation = $\sqrt{9}$ = 3%

Stock B:

Variance = $0.5 (12 - 15)^2 + 0.5 (18 - 15)^2 = 9$

Standard deviation = 3%

(iii) Covariance of stocks A and B

$Cov_{AB} = 0.5 (10 - 13) (12 - 15) + 0.5 (16 - 13) (18 - 15) = 9$

(iv) Correlation of coefficient

$$r_{AB} = \frac{Cov_{AB}}{\sigma_A \sigma_B} = \frac{9}{3 \times 3} = 1$$

(v) Portfolio Risk

$$\sigma_P = \sqrt{X^2{}_A\sigma^2{}_A + X^2{}_B\sigma^2{}_B + 2X_A X_B(\sigma_A\sigma_B\sigma_{AB})}$$

$$= \sqrt{(0.4)^2(3)^2 + (0.6)^2(3)^2 + 2(0.4)(0.6)(3)(3)(1)}$$

$$= \sqrt{1.44 + 3.24 + 4.32} = 3\%$$

5. (a) **Working Notes:**

Total Annual Export Sales	Rs. 50 crore
Cash Received in Advance (20%)	Rs. 10 crore
Balance on 60 days credit (80%)	Rs. 40 crore
Bad Debts 0.6% x Rs. 40 crore	Rs. 0.24 crore
Average Export Debtors Rs. 40 crore x $\frac{78}{360}$	Rs. 8.67 crore

Proposal I – Factoring Services

Due to non-recourse factoring agreement there will be saving of bad debt. A Ltd. can choose one option out of two options:

(i) Using Factoring Services (Debt Collection) only.

(ii) Using Factoring and Finance Services i.e. above services in combination of cash advance.

Since, cash advance rate is lower by 0.25% (2.25% - 2.00%), A Ltd. should take advantage of the same.

Particulars	Amount (Rs.)
Annual Factoring Commission (2% x Rs. 40 crore)	(0.80000 crore)
Saving of Administrative Cost	0.60000 crore
Saving of Bad Debts	0.24000 crore
Interest Saving on 80% of Debtors (8.67 crore x 80% x 0.25%)	0.01734 crore
Net Saving to A Ltd.	0.05734 crore

Proposal II – Insurance of Receivables

Particulars	Amount (Rs.)
Insurance Premium (0.45% x Rs. 40 crore)	(0.18000 crore)
Saving of Bad Debts (85% x Rs. 0.24 crore)	0.20400 crore
Interest Saving on 75% of Debtors (0.5% x 75% x Rs. 8.67 crore)	0.03251 crore
Net Saving to A Ltd.	0.05651 crore

Since saving in Factoring is marginally higher it should be accepted.

(b) The optional hedge ratio to minimize the variance of Hedger's position is given by:

$$H = \rho \frac{\sigma S}{\sigma F}$$

Where

σS= Standard deviation of ΔS

σF=Standard deviation of ΔF

ρ= coefficient of correlation between ΔS and ΔF

H= Hedge Ratio

ΔS = change in Spot price.

ΔF= change in Future price.

Accordingly

$$H = 0.75 \times \frac{0.04}{0.06} = 0.5$$

No. of contract to be short = 10 x 0.5 = 5

Amount = 5000 x Rs. 474 = Rs. 23,70,000

6. (a)

Particulars	Mark Ltd.	Mask Ltd.
EPS	Rs. 2,000 Lakhs/ 200 lakhs	Rs. 400 lakhs / 100 lakhs
	= Rs. 10	Rs. 4
Market Price	Rs. 10 × 10 = Rs. 100	Rs. 4 × 5 = Rs. 20

(i) The Swap ratio based on current market price is

Rs. 20 / Rs. 100 = 0.2 or 1 share of Mark Ltd. for 5 shares of Mask Ltd.

No. of shares to be issued = 100 lakh × 0.2 = 20 lakhs.

(ii) EPS after merger

$$= \frac{\text{Rs. } 2,000 \text{ lakhs} + \text{Rs. } 400 \text{ lakhs}}{200 \text{ lakhs} + 20 \text{ lakhs}} = \text{Rs. } 10.91$$

(iii) Expected market price after merger assuming P / E 10 times.

= Rs. 10.91 × 10 = Rs. 109.10

(iv) Market value of merged firm

= Rs. 109.10 market price × 220 lakhs shares = 240.02 crores

(v) Gain from the merger

Post merger market value of the merged firm	Rs. 240.02 crores

Less: Pre-merger market value

Mark Ltd. 200 Lakhs × Rs. 100 = 200 crores

Mask Ltd. 100 Lakhs × Rs. 20 = 20 crores   <u>Rs. 220.00 crores</u>

Gain from merger   <u>Rs. 20.02 crores</u>

Appropriation of gains from the merger among shareholders:

	Mark Ltd.	*Mask Ltd.*
Post merger value	218.20 crores	21.82 crores
Less: Pre-merger market value	200.00 crores	20.00 crores
Gain to Shareholders	18.20 crores	1.82 crores

(b) (i) **Expected dividend for next 3 years.**

Year 1 (D_1) Rs. 14.00 (1.09) = Rs. 15.26

Year 2 (D_2) Rs. 14.00 $(1.09)^2$ = Rs. 16.63

Year 3 (D_3) Rs. 14.00 $(1.09)^3$ = Rs. 18.13

Required rate of return = 13% (Ke)

Market price of share after 3 years = (P_3) = Rs. 360

The present value of share

$$P_0 = \frac{D_1}{(1+ke)} + \frac{D_2}{(1+ke)^2} + \frac{D_3}{(1+ke)^3} + \frac{P_3}{(1+ke)^3}$$

$$P_0 = \frac{15.26}{(1+0.13)} + \frac{16.63}{(1+0.13)^2} + \frac{18.13}{(1+0.13)^3} + \frac{360}{(1+0.13)^3}$$

P_0 = 15.26(0.885) + 16.63(0.783) +18.13(0.693) + 360(0.693)

P_0 = 13.50 + 13.02 + 12.56 + 249.48

P_0 = Rs. 288.56

(ii) If growth rate 9% is achieved for indefinite period, then maximum price of share should Mr. A willing be to pay is

$$P_0 = \frac{D_1}{(ke-g)} = \frac{\text{Rs. }15.26}{0.13\text{-}0.09} = \frac{\text{Rs.}15.26}{0.04} = \text{Rs. } 381.50$$

(iii) Assuming that conditions mentioned above remain same, the price expected after 3 years will be:

$$P_3 = \frac{D_4}{k_e - g} = \frac{D_3(1.09)}{0.13-0.09} = \frac{18.13 \times 1.09}{0.04} = \frac{19.76}{0.04} = \text{Rs. } 494$$

7. (a) **Salient features of Financial Lease**

(i) It is an intermediate term to long-term arrangement.

(ii) During the primary lease period, the lease cannot be cancelled.

(iii) The lease is more or less fully amortized during the primary lease period.

(iv) The costs of maintenance, taxes, insurance etc., are to be incurred by the lessee unless the contract provides otherwise.

(v) The lessee is required to take the risk of obsolescence.

(vi) The lessor is only the Financier and is not interested in the asset.

Salient features of Operating Lease

(i) The lease term is significantly less than the economic life of the equipment.

(ii) It can be cancelled by the lessee prior to its expiration date.

(iii) The lease rental is generally not sufficient to fully amortize the cost of the asset.

(iv) The cost of maintenance, taxes, insurance are the responsibility of the lessor.

(v) The lessee is protected against the risk of obsolescence.

(vi) The lessor has the option to recover the cost of the asset from another party on cancellation of the lease by leasing out the asset.

(b) **Euro Convertible Bonds**: They are bonds issued by Indian companies in foreign market with the option to convert them into pre-determined number of equity shares of the company. Usually price of equity shares at the time of conversion will fetch premium. The Bonds carry fixed rate of interest.

The issue of bonds may carry two options:

Call option: Under this the issuer can call the bonds for redemption before the date of maturity. Where the issuer's share price has appreciated substantially, i.e., far in excess of the redemption value of bonds, the issuer company can exercise the option. This call option forces the investors to convert the bonds into equity. Usually, such a case arises when the share prices reach a stage near 130% to 150% of the conversion price.

Put option: It enables the buyer of the bond a right to sell his bonds to the issuer company at a pre-determined price and date. The payment of interest and the redemption of the bonds will be made by the issuer-company in US dollars.

(c) **CAMEL Model in Credit Rating**: Camel stands for Capital, Assets, Management, Earnings and Liquidity. The CAMEL model adopted by the rating agencies deserves special attention; it focuses on the following aspects-

(i) *Capital*- Composition of external funds raised and retained earnings, fixed dividends component for preference shares and fluctuating dividends component for equity shares and adequacy of long term funds adjusted to gearing levels, ability of issuer to raise further borrowings.

(ii) *Assets*- Revenue generating capacity of existing/proposed assets, fair values, technological/physical obsolescence, linkage of asset values to turnover, consistency, appropriation of methods of depreciation and adequacy of charge to revenues, size, ageing and recoverability of monetary assets like receivables and its linkage with turnover.

(iii) *Management*- Extent of involvement of management personnel, team-work, authority, timeliness, effectiveness and appropriateness of decision making along with directing management to achieve corporate goals.

(iv) *Earnings*- Absolute levels, trends, stability, adaptability to cyclical fluctuations, ability of the entity to service existing and additional debts proposed.

(v) *Liquidity*- Effectiveness of working capital management, corporate policies for stock and creditors, management and the ability of the corporate to meet their commitment in the short run.

These five aspects form the five core bases for estimating credit worthiness of an issuer which leads to the rating of an instrument. Rating agencies determine the pre-dominance of positive/negative aspects under each of these five categories and these are factored in for making the overall rating decision.

(d) Many investment managers and stock market analysts believe that stock market prices can never be predicted because they are not a result of any underlying factors but are mere statistical ups and downs. This hypothesis is known as Random Walk hypothesis which states that the behaviour of stock market prices is unpredictable and that there is no relationship between the present prices of the shares and their future prices. Proponents of this hypothesis argue that stock market prices are independent. A British statistician, M. G. Kendell, found that changes in security prices behave nearly as if they are generated by a suitably designed roulette wheel for which each outcome is statistically independent of the past history. In other words, the fact that there are peaks and troughs in stock exchange prices is a mere statistical happening – successive peaks and troughs are unconnected. In the layman's language it may be said that prices on the stock exchange behave exactly the way a drunk would behave while walking in a blind lane, i.e., up and down, with an unsteady way going in any direction he likes, bending on the side once and on the other side the second time.

The supporters of this theory put out a simple argument. It follows that:

(i) Prices of shares in stock market can never be predicted. The reason is that the price trends are not the result of any underlying factors, but that they represent a statistical expression of past data.

(ii) There may be periodical ups or downs in share prices, but no connection can be established between two successive peaks (high price of stocks) and troughs (low price of stocks).

(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. According to them, *'Under conditions of perfect capital markets, rational investors, absence of tax discrimination between dividend income and capital appreciation, given the firm's investment policy, its dividend policy may have no influence on the market price of shares'.*

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.

MM Hypothesis is primarily based on the arbitrage argument. Through the arbitrage process, the MM Hypothesis discusses how the value of the firm remains same whether the firm pays dividend or not. It argues that the value depends on the earnings of the firm and is unaffected by the pattern of income distribution. Suppose, a firm which pays dividends will have to raise funds externally to finance its investment plans, MM's argument, that dividend policy does not affect the wealth of the shareholders, implies that when the firm pays dividends, its advantage is offset by external financing. This means that the terminal value of the share declines when dividends are paid. Thus, the wealth of the shareholders - dividends plus terminal price - remains unchanged. As a result, the present value per share after dividends and external financing is equal to the present value per share before the payments of dividends. Thus, the shareholders are indifferent between payment of dividends and retention of earnings.

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,

P_o = The prevailing market price of a share

K_e = The cost of equity capital

D_1 = Dividend to be received at the end of period one

P_1 = 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.

MOCK TEST PAPER -1

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. (a) You are the auditor of Stock Ltd. for the year 2013–14. The inventory as at the end of the year i.e. 31.3.14 was Rs. 1.05 lakhs. Due to unavoidable circumstances, you could not be present at the time of annual physical verification. How would you ensure that the physical verification conducted by the management was in order?

   (b) You have been appointed as an Auditor of a Manufacturing Company, whose year ends on 31st March. An event occurred after the year ended, but before you complete the audit. The audit report issued by you is dated 25th July. The Sales Ledger balance at 31st March was Rs. 1,95,000. By 25th July Rs. 65,000 only had been received against this amount as full and final payment. How would you deal with the situation?

   (c) Wealthy Ltd., holding 65% of the equity shares in Poor Ltd., purchased goods worth Rs. 25,000 from Poor Ltd. during the financial year 2013-14. The Manager of Wealthy Ltd. is of the opinion that it is a normal business activity and in addition the amount of transaction is very minute comparative to the other purchases of the company, therefore there is no need to disclose the same in the final accounts of the Company. Comment.

   (d) Mr. CA, a practicing chartered accountant, has been appointed as an internal auditor of Textile Ltd. He conducted the physical verification of the inventory at the year end and handed over the report of such verification to Mr. AC, the statutory auditor of the Company, for his view and reporting. Can Mr. AC, the statutory auditor of the Company, rely on such report? *(5 × 4 = 20 Marks)*

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

   (a) Mr. A, a practicing Chartered Accountant, took over as the executive chairman of Software Company on 1.4.2014. On 10.4.2014 he applied to the Council for permission.

   (b) CA XY who conducted the audit of a Gujarati daily '21st Century' certified the circulation figures based on Management Information System Report (M.I.S Report) without examining the books of Account.

(c) Mr. A, a practicing Chartered Accountant agreed to prepare, project reports and feasibility studies along with the consideration of tax implications while rendering such services, for and on behalf of a client.

(d) Mr. Superior, a Chartered Accountant in practice, wrote several letters to Government Department, pointing out seniority of his firm, sending his life sketch and stating that he had a glorious record of service to the nation as well as to the organization of accountancy profession with a view to get the audit work.

(4 × 4 = 16 Marks)

3. (a) The first auditors of Healthy and Wealthy Ltd., a Government company, was appointed by the Board of Directors. Comment. *(4 Marks)*

(b) ABC & Associates, a firm of Chartered Accountants, has three partners A, B and C. The firm is already having audit of 45 companies. The firm is offered 20 company audits. Decide and advise whether ABC & Associates will exceed the ceiling prescribed under the Companies Act, 2013 by accepting the above audit assignments? *(4 Marks)*

(c) Outstanding Ltd. appointed CA Premium, as an auditor for the company for the current financial year. Further the company offered him the services of investment banking, rendering of outsourced financial services and management services which was also approved by the Board of Directors. Advise. *(4 Marks)*

(d) Briefly mention the provisions relating to Cost Audit as per the Companies Act, 2013. *(4 Marks)*

4. (a) A limited company has Rs. 65 lakhs of paid up Capital and Rs. 4 crore of average Annual Turnover of past three years preceeding the Financial year under Audit. The company does not have any Internal Audit system because the Management does not think it necessary. As an Auditor how would you react to the given situation.

(4 Marks)

(b) State the matters to be specified in Auditor's Report in terms of provisions of Section 143(3) of the Companies Act, 2013. *(6 Marks)*

(c) Mention the duties of Auditor of Co-operative Societies in regard to the following:

(i) Over-due interest.

(ii) Compliance with provisions of Co-operative Act and Rules there under.

(iii) Special Report to Registrar of Co-operative Societies. *(6 Marks)*

5. (a) Zen Ltd. is intending to acquire Adi Ltd. It hires Bhola & Co., a firm of Chartered Accountants to conduct a due diligence. Bhola & Co., wants to reduce the risk of over valuation of assets in its due diligence exercise. Kindly guide Bhola & Co.

(5 Marks)

(b) CA Mack, a practicing Chartered Accountant, is the Statutory Auditor of an investment company dealing in securities. While performing the audit procedure, the company officials did not provide the investments held by the company at the Balance Sheet date for verification and also did not provide the details for valuation of unlisted shares as on the Balance Sheet date. CA Mack, in his final audit report to the shareholders, reported as follows:

"Subject to the verification of the existence and value of the investments, the Balance Sheet shows a true and fair view."

You are required to guide the Auditor of this Company by discussing the concept of "True and Fair" view in the context of Companies Act, 2013. *(6 Marks)*

(c) DNC Pvt. Ltd. is a private company having paid up share capital of rupees twenty crore but having public borrowing from nationalized banks and financial institutions of rupees fifty crore. The company appointed CA Ram as an auditor in its AGM dated 29th September, 2014.

You are required to state whether provisions related to rotation of auditor are applicable on DNC Pvt. Ltd. If yes than after how many years it will be required to rotate as per section 139 of the Companies Act, 2013. *(5 Marks)*

6. (a) You have been appointed as an auditor of a Hire-Purchase Finance Company. Enumerate the verification procedures in relation to audit of this Non Banking Finance Company (NBFC). *(6 Marks)*

(b) Enumerate some of the areas of concern in an audit of indirect taxes. *(4 Marks)*

(c) State the items contained in the SEBI's check list for auditors in respect of contract notes issued by a Stock Broker. *(3 Marks)*

(d) What are the audit procedures to be followed while verifying the outstanding premium and agents' balances? *(3 Marks)*

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

(a) Vostro and Nostro Accounts

(b) Performance Audit

(c) Objectives of Peer Review

(d) Concurrent Audit

(e) General Steps in the Conduct of Risk- Based Audit. *(4×4 = 16 Marks)*

MOCK TEST PAPER -1

FINAL COURSE: GROUP – I

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

SUGGESTED ANSWERS/ HINTS

1. (a) **Physical verification of Inventory:** SA 500 on "Audit Evidence" requires the auditor to design and perform audit procedures in such a way as to enable him to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. The audit procedures to be performed should be appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

The auditor should perform audit procedures, designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting. If the auditor is unable to be present at the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded. The auditor would also verify the procedure adopted, treatment given for the discrepancies noticed during the physical count. The auditor would also ensure that appropriate cut off procedures were followed by the management. He should also get management's written representation on (1) the completeness of information provided regarding the inventory and (2) assurance with regard to adherence to laid down procedures for physical inventory.

By following the above procedure it will be ensured that the physical verification conducted by the management was in order.

(b) **Consideration of Subsequent Events:** SA 560 on "Subsequent Events" requires that the auditor should consider the effect of subsequent events on the financial statements and the auditor's report. Depending upon the nature of subsequent event, i.e., adjusting event or non-adjusting event, the auditor has to examine the impact on financial statements.

AS 4 "Contingencies and Events Occurring After the Balance Sheet Date" also classifies an adjusting event which provides further evidence of conditions that existed at the balance sheet date after balance sheet date, the effect of such events have to be seen by the auditor on figures contained in the financial statements. The facts indicated in the question clearly reveal that subsequent realisation has been good. Such consideration helps the auditor in assuring the existence of trade receivables as also the realisability aspect. The auditor's duties in respect of trade receivables remaining uncollected at the time of giving audit report involves examination of actual past experience of collections from trade receivables. Further the auditor has to see that

how much provision was assessed in respect of bad and doubtful debts having regard to recovery position, due date, legal cases, cheques dishonoured, etc. as on March 31. Accordingly, the auditor would have to see that in respect of outstanding amount of Rs. 1,30,000, whether the amount of provision needs any revision.

(c) **Related Party Disclosures:** As per definition given in the AS 18 " Related Party Disclosures" parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

Wealthy Ltd. is the holding company of Poor Ltd. as it holds more than 50% of the voting power of Poor Ltd. and thus should be treated as related parties as per AS-18.

According to AS-18, in the case of related party transactions, the reporting enterprise should disclose the following:

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties."

Further, SA 550 on "Related Parties", also prescribes the auditor's responsibilities and audit procedures regarding related party transactions.

In this case, the related party relationship is absolutely clear and accordingly the auditor must examine that the disclosure requirements as laid down in AS 18, "Related Party Disclosures" has been followed.

Since there is related party transaction the contention of Manager of Wealthy Ltd. is not correct and the auditor should insist to make proper disclosure as required by AS-18 and if the management refuses, the auditor should express a qualified opinion.

(d) **Using the Work of Internal Auditor:** As per SA 610 "Using the Work of Internal Auditors", while determining whether the work of the internal auditors is likely to be adequate for the purpose of the audit, the external auditor shall evaluate:

(i) the objectivity of the internal audit function;

(ii) technical competence of the internal auditors;

(iii) whether the work of the internal auditors is likely to be carried out with due professional care; and

(iv) whether there is likely to be effective communication between the internal auditors and the external auditor.

To determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether the internal auditors have adequate technical training and proficiency; work was properly supervised, reviewed and documented; any reports prepared are consistent with the results of the work performed etc.

In the instant case, the statutory auditor should ascertain the internal auditor's scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible he should also test check few items and he can also observe the procedures performed by the internal auditors.

If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order, he has to decide otherwise. The final responsibility to express opinion on the financial statement remains with the statutory auditor.

2. **(a)** As per Clause (11) of Part I of Schedule I of the Chartered Accountant Act, 1949 a Chartered Accountant in practice, will be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

Thus, Mr. A took over as the executive chairman on 01.04.2014 and applied for permission on 10.04.2014, on the basis of these facts he was engaged in other occupation between the period 01.04.2014 and 10.04.2014, without the permission of the Council and is guilty of misconduct in terms of this clause.

(b) As per 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.

In the given case, CA XY certified the circulation figures without examining the books of accounts. To ascertain the number of paid copies; verification of remittances from the agents; credit allowed to the agents for unsold copies returned, examination of books of account is essential. He did not exercise due diligence and is grossly negligent in the conduct of his professional duties.

Further, certification of circulation figures based on statistical information without cross verification with financial records amounts to gross negligence and failure to exercise due diligence.

Thus, CA XY will be held guilty of professional misconduct under Clause (7) of Part I of Second Schedule of Chartered Accountants Act, 1949.

(c) As per Section 2(2)(iv) of the Chartered Accountants Act, 1949, a member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice. Pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services".

The definition of the expression "Management Consultancy and other Services" includes preparing project reports and feasibility studies. Consideration of tax implications while rendering above services will be considered as part of "Management Consultancy and other Services".

Therefore, Mr. A will not be held guilty of professional misconduct in pursuant to the provisions of the Section 2(2)(iv) of the Chartered Accountants Act, 1949 and further resolutions passed in this regard.

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

In the given case, Mr. Superior, a Chartered Accountant in practice, wrote several letters to Government Department pointing out the seniority of his firm and sending his life sketch and stating that he had rendered glorious service to the nation and to the accountancy profession with a view to getting the audit work.

Since these letters were clearly in the nature of advertising professional attainments, Mr. Superior will be held guilty of professional misconduct under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949.

3. **(a)** **Appointment of the First Auditor by the Board of Directors:** Section 139(6) of the Companies Act, 2013 lays down that "the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company". Thus, the first auditor of a company can be appointed by the Board of Directors within 30 days from the date of registration of the company. However, in the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013. This section provides that in the case of a Government company or any other company owned or controlled, directly

or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company. Hence in the case of Healthy and Wealthy Ltd., being a government company, the first auditor shall be appointed by the Comptroller and Auditor General of India.

Thus, the appointment of first auditors made by the Board of Directors of M/s Health and Wealth Ltd., is null and void.

(b) **Ceiling on number of audits:** Before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in section 141(3)(g) of the Companies Act, 2013, which prescribes that a person shall not be eligible for appointment as an auditor of a company who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies.

In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

If Mr. A, B and C do not hold any audits in their personal capacity or as partners of other firms, the total number of company audits that can be accepted by M/s ABC & Associates is 60. But, the firm is already having audit of 45 companies. So the firm can accept the audit of 15 companies only, which is well within the limit, specified by Section 141(3)(g) of the Companies Act, 2013.

(c) **Services not to be Rendered by the Auditor:** Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:

(i) accounting and book keeping services;

(ii) internal audit;

(iii) design and implementation of any financial information system;

(iv) actuarial services;

(v) investment advisory services;

(vi) investment banking services;

(vii) rendering of outsourced financial services;

(viii) management services; and

(ix) any other kind of services as may be prescribed.

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

In the given case, CA Premium was appointed as an auditor of Outstanding Ltd. He was offered additional services of investment banking, rendering of outsourced financial services and management services which was also approved by the Board of Directors. The auditor is advised not to accept the services as these services are specifically covered in the services not to be rendered by him as an auditor as per section 144 of the Companies Act, 2013.

(d) **Cost Audit:** Cost Audit is covered by Section 148 of the Companies Act, 2013. The audit conducted under this section shall be in addition to the audit conducted under section 143 of the Companies Act, 2013.

As per the section 148 the Central Government may by order specify audit of items of cost in respect of certain companies.

Further, the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies.

It is provided that the Central Government shall, before issuing such order in respect of any class of companies regulated under a special Act, consult the regulatory body constituted or established under such special Act.

The audit shall be conducted by a Cost Accountant in Practice who shall be appointed by the Board of such remuneration as may be determined by the members in such manner as may be prescribed.

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

Provided further that the auditor conducting the cost audit shall comply with the cost auditing standards ("cost auditing standards" mean such standards as are issued by the Institute of Cost and Works Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government).

As per rule 14 of the Companies (Audit and Auditors) Rules, 2014

(a) in the case of companies which are required to constitute an audit committee-

(i) the Board shall appoint an individual, who is a cost accountant in practice, or a firm of cost accountants in practice, as cost auditor on the

recommendations of the Audit committee, which shall also recommend remuneration for such cost auditor;

(ii) the remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders;

(b) in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant in practice or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter X of the Companies Act, 2013 shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

It is provided that the report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company.

A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein.

4. **(a) Applicability of Provisions of Internal Audit:** As per section 138 of the Companies Act, 2013 the following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

(a) every listed company;

(b) every unlisted public company having-

(i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(ii) turnover of two hundred crore rupees or more during the preceding financial year; or

(iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(c) every private company having-

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

Thus, any of the condition is required to be satisfied for the applicability of the provision. The internal auditor to be appointed shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies auditor may or may not be an employee of the company.

In the instant case, the company is having paid up capital less than Rs. 50 crore and turnover less than Rs. 200 hundred crore. Further, maximum outstanding loan or borrowing from public financial institution has not been given. Therefore, assuming that outstanding loans or borrowings from banks or public financial institutions are also not exceeding Rs. 100 crore during the previous financial year. Therefore, any of the condition in respect of paid up capital, turnover or outstanding loans is not satisfied. So the company is not liable for internal audit as per section 138 of the Companies Act, 2013.

(b) Matters to be specified in the Auditor's Report: As per sub section 3 of section 143 of the Companies Act, 2013, the auditor's report shall state –

(i) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(ii) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(iii) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(iv) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

(v) whether, in his opinion, the financial statements comply with the accounting standards;

(vi) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(vii) whether any direct is disqualified from being appointed as a director under sub-section (2) of the section 164;

(viii) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(ix) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

(x) such other matters as may be prescribed.

Further, Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditors report. The auditor's report shall also include their views and comments on the following matters, namely:-

(i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

(iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

(c) Duties of Auditor of Co-operative Societies with regard to-

(i) Overdue interest: Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.

(ii) Compliance with provisions of the Act and Rules: An auditor of a co-operative society is required to point out the infringement with the provisions of the relevant Co-operative Act Rules and bye-laws. The auditor of a co-operative society is also required to point out various irregularities, improprieties, and departure from the provision of the Act, rules framed there under and the bye-laws of the society. The financial implications of such infringements should be properly assessed and quantified by the auditor and they should be reported. Some of the State laws contain restrictions on the payment of dividends, which should be noted by the auditor and if dividend is declared in excess of the prescribed percentage, the fact should be reported by the auditor. Auditor should also ensure that various provisions in the Co-operative Societies Act, such as, restriction on borrowings, investment of funds, contribution to education funds, restriction on loans, etc are also complied with.

(iii) Special Report to the Registrar: The auditors are required to report on

number of matters as prescribed in various states. In addition to the main report, the auditors are also required to submit by way of schedules/audit memorandum information on the working of the company as well. During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar, drawing his specific attention to the points. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance a special report may become necessary:

(a) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.

(b) Detection of fraud relating to expenses, purchases, property and stores of the society.

(c) Specific examples of mis-management. Decisions of management against co-operative principles.

(d) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

5. (a) **Due Diligence Exercise in case of Overvalued Assets:** Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any overvalued assets are concerned, this shall form part of such a review. Normally, overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does involve examination from the view point of extraordinary items, analysis of significant deviations, etc. However, in order to reduce the risk of over valuation of assets, the auditor should pay his attention to the following areas:

In the case of overvalued assets, the auditor shall have to specifically examine the following areas:

(i) Uncollected/uncollectable receivables.

(ii) Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with the name of company.

(iii) Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.

(iv) Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.

(v) Litigated assets and property.

(vi) Investments carried at cost though realizable value is much lower.

(vii) Investments carrying a very low rate of income / return.

(viii) Infructuous project expenditure/deferred revenue expenditure etc.

(ix) Group Company balances under reconciliation etc.

(x) Intangibles of no value.

(b) Significance of "True and Fair": The concept of true and fair is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.

This requires that the auditor should examine the accounts with a view to verify that all assets, liabilities, income and expenses are stated as amounts which are in accordance with accounting principles and policies which are relevant and no material amount, item or transaction has been omitted.

(1) As per section 129 of the Companies Act, 2013, the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 of the Companies Act, 2013, (in which the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority) and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III.

Provided that the items contained in such financial statements shall be in accordance with the accounting standards.

Provided further that nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.

(2) At every annual general meeting of a company, the Board of Directors of the company shall lay before such meeting financial statements for the financial year.

(3) Where a company has one or more subsidiaries, it shall, in addition to financial statements provided under sub-section (2), prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own which shall also be laid before the annual

general meeting of the company along with the laying of its financial statement under sub-section (2).

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

Provided further that the Central Government may provide for the consolidation of accounts of companies in such manner as may be prescribed.

Explanation.—For the purposes of this sub-section, the word "subsidiary" shall include associate company and joint venture.

(4) The provisions of this Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, apply to the consolidated financial statements referred to in sub-section (3).

(5) Without prejudice to sub-section (1), where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

(6) The Central Government may, on its own or on an application by a class or classes of companies, by notification, exempt any class or classes of companies from complying with any of the requirements of this section or the rules made there under, if it is considered necessary to grant such exemption in the public interest and any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification.

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

Explanation.—For the purposes of this section, except where the context otherwise requires, any reference to the financial statement shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under this Act.

(c) Rotation of Auditor: The answer of the question requires two parts i.e. applicability of provisions of auditor's rotation and secondly provision of rotation of auditor in case of individual or an audit firm.

1. **Applicability of provisions of Auditor's Rotation** :The provisions related to rotation of auditor are applicable to those companies which are prescribed in Companies (Audit and Auditors) Rules, 2014, which prescribes the following classes of companies excluding one person companies and small companies, namely:-

   (a) all unlisted public companies having paid up share capital of rupees ten crore or more;

   (b) all private limited companies having paid up share capital of rupees twenty crore or more;

   (c) all companies having paid up share capital of below threshold limit mentioned in (a) and (b) above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.

2. **Provision of Rotation of Auditor** :As per Section 139(2) of the Companies Act, 2013, no listed company or a company belonging to such class or classes of companies as mentioned above, shall appoint or re-appoint-

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

   (b) an audit firm as auditor for more than two terms of five consecutive years.

   In the given case, DNC Pvt. Ltd. is a private company having paid up share capital of rupees twenty crore and public borrowings from nationalized banks and financial institutions of rupees fifty crore. The company appointed CA Ram as an auditor in its AGM dated 29th September, 2014.

   The provisions relating to rotation of auditor will be applicable as paid up share capital is Rs. 20 crore and public borrowings from nationalized banks and financial institutions is rupees fifty crore. Therefore, provisions of rotation of auditor will apply. Thus, DNC Pvt. Ltd. shall appoint CA Ram as an auditor of the company for not more than one term of five consecutive years and CA Ram will hold office of Auditor from the conclusion of this meeting upto the conclusion of sixth AGM i.e. AGM to be held in the year 2019.

6. (a) **Verification Procedures in relation to an audit of a Hire Purchase Finance company (HPFC):**

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

   (ii) Verify that the payment for acquiring an asset should be made directly to the

supplier/dealer and that the original invoice has been drawn out in the name of the NBFC.

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

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

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

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

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

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

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

(b) Audit of Indirect Taxes: Some areas of concern in an audit of indirect taxes would be:

(i) Non availment or short / excess availment of export incentives.

(ii) Goods imported duty free or payment at concessional rates without properly complying with conditions.

(iii) Valuation Issues – valuation not in line with customs rules.

(iv) Applicability of the relevant export /excise exemptions.

(v) Valuation of goods not removed in normal course using valuation methods not in line with Central Excise Valuation Rules.

(vi) Ignoring Liability under Service Tax on services provided or availed.

(vii) Procedural non-compliance.

(viii) Passing on of duty suffered on imported goods and of locally manufactured goods in excess of actual.

(ix) Utilisation / Availability of credit of duty/ tax paid on inputs, capital goods of input services.

(c) SEBI's check list for auditors in respect of contract notes issued by a Stock Broker:

(i) Members should issue Contract Notes to his clients for all trades executed by him on their behalf.

(ii) The member should stamp his order sheets/records and the order time should be reflected in the Contract Note along with the time of execution of order.

(iii) The Contract Notes should bear SEBI Registration number of the member. If should be pre printed and issued within 24 hours of trade execution. Appropriate stamps should be affixed on the contract Note. Duplicate copies of the contract note should be maintained.

(iv) The Contract Note should be signed by the member or his constituted attorney.

(v) Contract note issued to the clients should show the brokerage separately.

(vi) In case the broker acts as a principal, the Contract Note should be in Form B.

(vii) Consent of the client should be taken for any trade done by the broker while acting as a principal.

(viii) Brokerage should be within the limits prescribed by the exchange.

(d) Outstanding Premium and Agents' Balances -The following are the audit procedures to be followed for verification of outstanding premium and agents' balances:

(i) Scrutinise and review control account debit balances and their nature should be enquired into.

(ii) Examine inoperative balances and treatment given for old balances with reference to company rules.

(iii) Enquire into the reasons for retaining the old balances

(iv) Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.

(v) Check age-wise, sector-wise analysis of outstanding premium.

(vi) Verify whether outstanding premiums have since been collected.

(vii) Check the availability of adequate bank guarantee or premium deposit for outstanding premium.

7. (a) Vostro and Nostro Accounts: Bank's maintain stocks of foreign currencies in the form of Bank Accounts with their overseas branches/correspondents. Such foreign

currency accounts maintained by Indian banks at other overseas centres is designated by it as "Nostro Account". For example all banks in India would be maintaining a US Dollar Account with their New York office/branch/correspondents, such account would be designated by the Indian office as Nostro Account. "Vostro Account" is the opposite of Nostro accounts. Here a foreign bank in another country maintains stocks of Indian rupees with their Indian branch/correspondent/local bank. Such Indian Rupee Accounts are designated as a Vostro Account. For example a German Bank might maintain a Vostro Account in rupees in terms with Indian Bank. While examining the transaction in foreign exchange, the auditor should also pay attention to reconciliation of Nostro Accounts with the respective minor account. The amount in the Nostro account is stock of foreign currency in the form of bank accounts with the overseas branches and correspondents. Unreconciled Nostro Accounts, on an examination, may reveal unauthorized payments from the foreign currency account, unauthorized withdrawals, and unauthorized debit to minor account. The auditor should also evaluate the internal control with regard to inward/ outward messages. The inward/ outward messages should be properly authenticated and discrepancies noticed, should be properly dealt with, in the books of accounts.

The auditor should also verify whether prescribed procedure in relation to inter bank confirmation in the Vostro account is followed or not. In case balance confirmation certificate have been received but the same have not been reconciled, or where confirmation has not been received the same should be reported, in respect of each Vostro Account.

(b) **Performance Audit:** A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.

Performance audits include economy and efficiency and program audits:

(i) Economy and efficiency audits include determining (1) whether the entity is acquiring, protecting, and using its resources (such as personnel, property, and space) economically and efficiently, (2) the causes of inefficiencies or uneconomical practices, and (3) whether the entity has complied with laws and regulations on matters of economy and efficiency.

(ii) Program audits include determining (1) the extent to which the desired results or benefits established by the legislature or other authorizing body are being achieved, (2) the effectiveness of organizations, programs, activities, or functions, and (3) whether the entity has complied with significant laws and regulations applicable to the program.

(c) **Objectives of Peer Review:** The main objective of Peer Review is to ensure that in carrying out the assurance service assignments, the members of the Institute-

(i) comply with Technical, Professional and Ethical Standards as applicable including other regulatory requirements thereto and

(ii) have in place proper systems including documentation thereof, to amply demonstrate the quality of the assurance services.

Thus the primary objective of peer review is not to find out deficiencies but to improve the quality of services rendered by members of the profession. The Statement of Peer Review also makes it clear that the peer review, "does not seek to redefine the scope and authority of the Technical Standards specified by the Council but seeks to enforce them within the parameters prescribed by the Technical Standards". The peer review is directed towards maintenance as well as enhancement of quality of assurance services and to provide guidance to members to improve their performance and adherence to various statutory and other regulatory requirements. Such an objective of the peer review process makes it amply clear that the reviewer is not going to sit on the judgement of the practice unit while rendering assurance services but to evaluate the procedure followed by the practice unit in rendering such a service.

(d) **Concurrent Audit:** Concurrent audit, as the name suggests, is an audit or verification of transactions or activities of an organisation concurrently as the transaction/activity takes place. It is not a pre-audit. The concept in this audit is to verify the authenticity of the transaction/activity within the shortest possible time after the same takes place.

The concept of concurrent audit in the public as well as the private sector banks has gained acceptance in recent years. It hardly needs to be stressed that the concurrent audit system is to be regarded as part of a bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions at branches. It is, therefore, necessary for the bank's management to bestow serious attention to the implementation of various aspects of the system such as selection of branches/coverage of business operations, appointment of auditors, appropriate reporting procedures, follow-up/rectification processes and utilisation of the feedback from the system for appropriate and quick management decisions.

The bank should once in a year review the effectiveness of the system and take necessary measures to correct the lacunae in the implementation of the programme.

(e) **General Steps in the Conduct of Risk- Based Audit:** Risk- Based Audit consists of four main phases starting with the identification and prioritization of risks, to the

determination of residual risk, reduction of residual risk to acceptable level and the reporting to auditee of audit results. These are achieved through the following:

(i) Understand auditee operations to identify and prioritize risks. This involves processes for reviewing and understanding the audited organization's risk management processes for its strategies, framework of operations etc., in order to identify and prioritize the error and fraud risks that impact the audit of financial statements.

(ii) Assess auditee management strategies and controls to determine residual audit risk. The role of internal audit in promoting a sound accounting system and internal control is recognized, thus the SAI should evaluate the effectiveness of internal audit.

(iii) Manage residual risk to reduce it to acceptable level. This includes the design and execution of necessary audit procedures and substantive testing to obtain evidence in support of transactions and balances.

(iv) Inform auditee of audit results through appropriate report, such as weaknesses in the internal control system, deficiencies in the design and operation of internal controls.

MOCK TEST PAPER 1

FINAL COURSE: GROUP – I

PAPER – 4 : CORPORATE AND ALLIED LAWS

*Question No.**1** is compulsory.*
*Attempt any **five** questions from the remaining **six** Questions.*

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

1. (a) Flora Construction Limited in its General Meeting appointed all its directors by passing one single resolution. No objection was made to the resolution. Examine the validity of appointment of directors explaining the relevant provisions of the Companies Act, 2013. *(5 Marks)*

   (b) The Annual General Meeting of Bhaskar Electronics Limited declared a dividend at the rate of 30 percent payable on paid up equity share capital of the Company as recommended by Board of Directors on 30th April, 2014. But the Company was unable to post the dividend warrant to Mr. Sanjay, an equity shareholder of the Company, up to 30th June, 2014. Mr. Sanjay filed a suit against the Company for the payment of dividend along with interest at the rate of 20 percent per annum for default period. Decide in the light of provisions of the Companies Act, 2013, whether Mr. Sanjay would succeed? *(5 Marks)*

   (c) Impression Ltd. is holding 33% of the paid up equity capital of Thyag Stock Exchange. The company appoints Tilt Ltd. as its proxy who is not a member of the Thyag Stock Exchange, to attend the vote at the meeting of the stock exchange. Examine whether the Thyag Stock Exchange can restrict the appointment of Tilt ltd. as proxy for Impression Ltd. and further restrict, the voting rights of Impression Ltd. in the Thyag Stock Exchange. *(5 Marks)*

   (d) The Articles of Association of a company fixed 3 as the quorum for a meeting of the Board. At a meeting of the Board, all the 5 directors were present. They allotted the shares of the company to 3 of the directors. Is it valid? *(5 Marks)*

2. (a) A scheme of reconstruction of Southern Stone Company Limited was, approved by its shareholders and creditors in their meeting and resolutions to that effect were passed. Afterwards a few shareholders and creditors of the company raised objections against the said arrangements of reconstruction. The entire paid up capital of the company was wiped out by the accumulated losses. Advise the Directors of the said company about the steps to be taken, to give effect to the proposed scheme under the Companies Act, 1956. *(8 Marks)*

(b) With reference to provisions laid down under the Companies Act, 2013, advice on the following:

(i) Which Company is required to constitute CSR (Corporate Social Responsibility) committee?

(ii) Minimum amount of contribution towards CSR?

(iii) Activities which are not considered as CSR activities? *(8 Marks)*

3. (a) A company proposes to appoint a Sole Selling Agent for its products. State the cases in which such appointment requires approval of Central Government. Draft a Board Resolution to appoint a sole selling agent in a case where such appointment does not require approval of Central Government. *(8 Marks)*

(b) Galaxy Medicare Limited was incorporated in the year 2008. The management of the company decides to make donation to recognized political party in the year 2014. Advise the management about the restrictions and the extent up to which such donation can be made under the Companies Act, 2013. Will it make any difference if Galaxy Medicare Limited was incorporated in the year 2012? *(8 Marks)*

4. (a) Mr. A, a Chartered accountant is an auditor of Laxman Ltd. Subsequently, from 1st June, 2014, he has started to render actuarial services to Laxman Ltd. Advice the company keeping in view the provisions of the Companies Act, 2013. *(8 Marks)*

(b) The Directors of Shubra Fabrics Ltd. desire to proceed for voluntary winding up of the company and hence they are required to File 'Declaration of Solvency'. Your advice is sought about the procedure to be followed for the said purpose. *(8 Marks)*

5. (a) The Managing Director of a large public company confessed that he was responsible for manipulation of the accounts and window dressing of the published accounts of the company. In view of this, the Central Government proposes to appoint its nominees as Directors of the company. Explain briefly the powers of the Central Government under the Companies Act, 1956 to appoint its nominees as Directors of a company to prevent oppression or mismanagement and the role of the Central Government with regard to the affairs of such a company. *(8 Marks)*

(b) A company proposes to make a public issue of equity shares for financing its project through book building process. It proposes to fix the floor price of the share at Rs. 500 for a share of Rs. 10. Answer the following with reference to SEBI (ICDR) Regulations.

What is the price band that may be indicated in the red herring prospectus?

If the company wants to lower the floor price during the bidding period in order to increase the response to the issue, state the conditions subject to which such revision can be made. *(8 Marks)*

6. (a) RST Ltd. is a securitization and reconstruction company under SRFAESI Act, 2002.

The certificate of registration granted to it was cancelled. State the authority which can cancel the registration and the right of RST Ltd. against such cancellation.

(8 Marks)

(b) Explain the provisions regarding prohibition on insider trading of securities as covered under the Companies Act, 2013. *(8 Marks)*

7. Attempt any **four:**

(a) The Reserve Bank of India issued certain directions to Dream Construction Limited, an authorised person under the Foreign Exchange Management Act, 1999 to file certain returns. The Company failed to file the said returns. Decide, as to what penal provisions are applicable against the said authorised person under the said Act.

(4 Marks)

(b) Avish Ltd. and Latik Ltd. both dealing in chemicals and fertilizers have entered into an agreement to jointly promote the sale of their products. A complaint has been received by the Competition Commission of India (CCI) stating that the agreement between the two is anti-competitive and against the interests of others in the trade. Examine with reference to the Provisions of the Competition Act, 2002, what are factors the CCI will take into account to determine whether the agreement in question will have any appreciable adverse effect on competition in the market.

(4 Marks)

(c) Kashyap Producer Company Limited was incorporated on 1st April, 2008. At present it has got 200 members and its board consists of 10 Directors. The Board of directors of the company seeks your advice on the following proposals:

(i) Appointment of one expert Director and one Additional Director by the Board for a period of four years.

(ii) Donation of Rs. 10,000 to a Political Party.

Advise the Board of directors explaining the relevant provisions of the Companies Act, 1956. *(4 Marks)*

(d) Does an explanation added to a section widen the ambit of a section? Support your answer with an example from the Companies Act, 1956. *(4 Marks)*

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

MOCK TEST PAPER – 1

FINAL COURSE: GROUP – I

PAPER – 4 : CORPORATE AND ALLIED LAWS
SUGGESTED ANSWERS/HINTS

1. **(a)** Section 162(1) of the Companies Act, 2013, requires that the appointment of every director shall be voted on individually. Thus, two or more directors cannot be appointed by a single resolution. However, an exception has been carried out where under if a resolution has been first passed to the effect that all the directors shall be appointed by a single resolution without any vote being against it.

Any resolution, as per section 162(2) of the Companies Act, 2013, in contravention of the aforesaid provisions shall be void whether or not objection was taken at the time of its being so moved.

Hence, the appointments of all directors by passing one single resolution by Flora Construction Limited in its general meeting are void.

(b) **Liability for failure to pay/post dividend within prescribed time**

According to Section 127 of the Companies Act, 2013, dividend has to be paid within 30 days from the date of its declaration. The posting of dividend warrant by the company within 30 days will be deemed to be payment irrespective of the fact whether the shareholder has encashed it or not. Failure to pay or post dividend warrant within 30 days constitutes an offence under the Act and the company shall be liable to pay simple interest at the rate of eighteen percent per annum during the period for which such default continues.

In the instant case, the Annual General Meeting of Bhaskar Electronics Limited declared a dividend at the rate of 30% payable on paid up equity share capital of the company as recommended by the Board of Directors on 30th April, 2014. But the company was unable to post the dividend warrant to Mr. Sanjay, an equity shareholder of the company, up to 30th June, 2014.

In view of the above provisions, Mr. Sanjay can file a suit against the company for the payment of dividend because failure to pay or post dividend warrant within 30 days constitutes an offence under the Act. Thus, he would succeed but he is entitled for simple interest at the rate of 18% per annum (and not 20% as claimed) during the period for which such default continues.

(c) Section 7A of the Securities (Contracts) Regulation Act, 1956 provides that a recognised stock exchange is empowered to amend rules to provide for all or any of the following matters:

(a) Restriction of voting right to members only.

(b) Regulation of voting rights by specifying that each member is entitled to one vote only irrespective of number of shares held.

(c) Restriction on right of members to appoint proxy and proxy to attend and vote at a meeting of the stock exchange.

As such Thyag Stock Exchange can restrict the appointment of Tilt Ltd., as proxy, if rules of the exchange so provide. If it is not so provided, rules may be amended and after getting approval of the Central Government regarding amendment, it can restrict appointment of proxies.

Thyag Stock Exchange can also restrict the voting rights of Impression Ltd. as proxy if rules of the exchange so provide. If it is not so provided, rules may be amended and after getting approval of Central Government regarding amendment, it can restrict appointment of proxies.

Thyag Stock Exchange can also restrict the voting rights of Impression Ltd.

(d) The provisions in regard to quorum for a Board meeting are contained in section 287 of the Companies Act, 1956. It is provided therein that the quorum for a Board meeting shall be one-third of the total number of directors of a company (any fraction contained in that one-third shall be rounded off as one) or two directors, whichever is higher. It is further provided that where at any time the number of interested directors exceeds or is equal to two thirds of the total strength, the number of disinterested directors present at the meeting being not less than two shall form the quorum. The company is, however, free to fix a higher quorum for the Board meeting.

Viewed in the context of the above provisions, the company has fixed the quorum for a Board meeting at 3. In this case, out of five directors present at the meeting, the number of interested directors is three. As such, the remaining two directors who are not interested do not constitute a quorum and hence the meeting cannot be validly convened. Therefore, the allotment of shares at the aforesaid meeting is not valid.

The proviso to section 287(2) cannot also be availed of as the interested directors, who are three, are not equal to or more than two-thirds of the total strength of directors. The figure representing two-thirds will be 4 by rounding off fraction, if any. Hence, it can be assumed that the allotment made at the Board meeting will not be valid.

2. (a) Scheme of reconstruction: The Company is a sick company and therefore can be considered as a company liable to be wound up with the meaning of section 390 of the Companies Act, 1956. The proposed scheme involves a compromise or arrangement with members and creditors and attracts section 391 of the said Act. An application be submitted before the High Court under section 391 of the said Act. On such application the court may order that a meeting of creditors and/or

members be called and held as per the directions of the court.

The company must send notice of meeting to every creditor/member containing a statement setting forth the terms of compromise explaining its effects. At the meetings convened as per directions of the court majority in number representing atleast ¾ in value of creditors/members present and voting must agree in compromise or arrangements. Thereafter, the company must present a petition to the court for confirmation of the compromise or arrangement.

The notice of application made by the company will be served on the Central Government and the court will take into consideration representation, if any, made by the Central Government (Section 394A). The court will sanction the scheme, if satisfied, after consideration of all relevant matters. Copy of order issued by the court must be filed with the Registrar of Companies and then only the order will come into effect. Copy of the said order must be annexed to memorandum of Association issued thereafter. The scheme sanctioned by the court shall be binding on all members and creditors even on those who were dissenting.

(b) (i) Which Company is required to constitute CSR committee:

(A) Every company including its holding or subsidiary, and a foreign company defined under section 2(42) of the Companies Act, 2013 having its branch office or project office in India, having

(1) net worth of rupees 500 crore or more, or

(2) turnover of rupees 1000 crore or more or

(3) a net profit of rupees 5 crore or more

during any financial year shall constitute a Corporate Social Responsibility Committee of the Board.

(B) The CSR Committee shall institute a transparent monitoring mechanism for implementation of the CSR projects or programs or activities undertaken by the company.

(C) However, the net worth, turnover or net profit of a foreign company shall be computed in accordance with balance sheet and profit and loss account of such company as prepared in accordance with the provisions of section 381(1)(a) and section 198 of the Act.

(ii) Amount of contribution towards CSR:

(A) The Board of every company shall ensure that the company spends, in every financial year, at least two per cent. of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its CSR Policy.

(B) The company shall give preference to the local area and areas around it

where it operates, for spending the amount earmarked for CSR activities.

(C) If the company fails to spend such amount, the Board shall, in its report, specify the reasons for not spending the amount.

(D) Companies may build CSR capacities of their own personnel as well as those of their Implementing agencies through Institutions with established track records of at least three financial years. However, such expenditure shall not exceed five percent. of total CSR expenditure of the company in one financial year.

(iii) Activities which are not considered as CSR activities:

The *Companies (CSR Policy) Rules, 2014* provides for some activities which are not considered as CSR activities:

(A) The CSR projects or programs or activities undertaken outside India.

(B) The CSR projects or programs or activities that benefit only the employees of the company and their families.

(C) Contribution of any amount directly or indirectly to any political party under section 182 of the Act.

3. (a) **Appointment of sole selling agents:** Under Section 294AA of the Companies Act, 1956, in following cases, appointment of sole selling agents will require approval of Central Government:

(i) According to section 294AA(2), an individual firm or body corporate who has a substantial interest in the company cannot be appointed as a sole selling agent without prior approval of Central Government. Substantial interest means shareholding of Rs.5 lakhs or 5% paid up capital of the company, whichever is less. The shareholding may be singly or together with relatives (in the case proposed Sole Selling Agent being an individual), partners and their relatives (in the case of a firm) directors and relatives of directors (in the case of a body corporate as per Explanation (b) to Section 294AA).

(ii) According to section 294AA(3), any company having paid up share capital of Rs.50 lakhs or more cannot appoint sole selling agent without approval in general meeting by a special resolution and also approval of Central Government. These restrictions apply to all Companies i.e. both private and public companies.

Board Resolution: "*Resolved* that pursuant to the provisions of section 294 of the Companies Act, 1956, and subject to the approval of the Company at a general meeting by ordinary resolution, the Board approves the appointment of 'X' as the company's sole selling agent for the sale of ….. in the territory of …. for a period of five years with effect from …… on the terms and conditions set out in the draft agreement produced to this meeting and initiated by the chairman for purposes of

identification or with such modifications (not being less advantageous to the company) as may be mutually agreed by the Board and 'X'."

(b) **Donation to Recognized Political Party**: According to section 182 of the Companies Act, 2013, notwithstanding anything contained in any other provision of this Act, no Government Company and no other company which has been in existence for less than three financial years shall contribute any amount or amounts directly or indirectly to any political party. Any other company may however, contribute any amount directly or indirectly to any political party, provided that the aggregate of the amount so contributed by the company in any financial year shall not exceed 7.5% of the its average net profits during the three immediately preceding financial years.

Thus, Galaxy Medicare Limited in the present case, can contribute to the recognized political party since it is not a Government Company and it is in existence for more than three financial years at the time of making the donation. Further, political donations can be made by Galaxy Medicare Limited only out of its profits.

Further, the political donation is required to be authorized by a resolution passed at a Board of Directors' meeting. The Company, in addition, shall disclose in its profit and loss account any amount or amounts contributed by it to any political party during the financial year to which that account relates, giving particulars of the total amount contributed and the name of the party to which such amount has been contributed.

If Galaxy Medicare Limited was registered in the year 2012, it cannot make political donations because the company has not been in existence for three financial years.

4. (a) **Prohibited services**: An auditor appointed under the Companies Act, 2013 shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be. But such services shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:—

(a) accounting and book keeping services;

(b) internal audit;

(c) design and implementation of any financial information system;

(d) actuarial services;

(e) investment advisory services;

(f) investment banking services;

(g) rendering of outsourced financial services;

(h) management services; and

(i) any other kind of services as may be prescribed.

In the instant case, Mr. A, a chartered accountant is an auditor of Laxman Ltd. and subsequently from 1st June, 2014, he has started to render actuarial services to Laxman Ltd. which falls under the prohibited services as per section 144 of the Companies Act, 2013. Therefore Mr. A is liable for the penalty under section 147 of the Companies Act, 2013.

Penalty for providing prohibited services:

(i) Penalty on company [Section 147(1)]:

If any of the provisions of section 144 is contravened, the company shall be punishable with fine which shall not be less than Rs. 25,000 but which may extend to Rs. 5 Lacs.

(ii) Penalty on officers [Section 147(1)]:

If any of the provisions of section 144 is contravened, every officer of the company who is in default shall be punishable with:

(1) Imprisonment for a term which may extend to 1 year or

(2) With fine which shall not be less than Rs. 10,000 but which may extend to Rs. 1 Lacs; or

(3) Both with imprisonment and fine.

(iii) Penalty on auditor [Section 147(2) & (3)]:

(a) If an auditor of a company contravenes any of the provisions of section 144, the auditor shall be punishable with fine which shall not be less than Rs. 25,000 but which may extend to Rs. 5 Lacs.

(b) If an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with

(1) imprisonment for a term which may extend to 1 year and

(2) fine which shall not be less than Rs. 1 Lac but which may extend to Rs. 25 Lacs.

(c) Further, where an auditor has been convicted as above, he shall be liable to—

(1) refund the remuneration received by him to the company; and

(2) pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.

(b) **Declaration of Solvency:** Chapter III of part VII of the Companies Act, 1956 deals with "Voluntary winding up" of companies and in this relation section 488 of the said Act provides for filing of "declaration of solvency" on the part of the directors of the company when there is proposal for voluntary winding up of the company.

The analysis of Section 488 of the Companies Act, 1956 discloses that a declaration of solvency contains the following features -

1. It is a declaration duly supported by an affidavit, verified by a competent authority.
2. A meeting of Board of Directors is required for the purpose.
3. The declaration is made by the directors or where there are more than two directors, by the majority of the directors that they have made full inquiry into the affairs of the company and
4. That they have formed opinion that the company has no debts or that if it will be able to pay its debt in full within a period not exceeding three years from the date of commencement of winding up as may be specified in the said declaration.
5. In order that the above declaration in valid, it should be made within five weeks immediately preceding the date of passing the resolution for winding up of the company and must be delivered to the Registrar before that date.
6. Further, the said declaration should be accompanied by a copy of the auditors report on the profit and loss account of the company for the period commencing from the date of the last audited accounts upto a date practicable immediately before the date of the declaration and a balance sheet on the last mentioned date and also a statement of company's assets and liabilities as on the date of the declaration made out in accordance with the requirements laid down by clause (2) of section 488 of the Companies Act, 1956.
7. Any director of a company making a declaration under this section without having reasonable grounds for the opinion that the company will be able to pay its debts in full within the period specified in the declaration, shall be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to Rs. 50,000, or with both.
8. If the company is wound-up in pursuance of a resolution passed within the period of five weeks after the making of the declaration but its debts are not paid or provided for in full, within the period specified in the declaration, it shall be presumed, until the contrary is shown, that the director did not have reasonable grounds for his opinion.

5. (a) **Power of Central Government to prevent oppression or mismanagement**: The Central Government is empowered to appoint its nominees as directors of a

company to effectively safeguard the interest of the company or its shareholders or the public interest. If the Central Government wants to appoint its nominees as Directors of such a company then it has to make a reference to the Company Law Board (CLB) and if the CLB is satisfied that the affairs of the company have been conducted in a manner oppressive to any member of the company or in a manner prejudicial to the interests of the company or to public interest, it may pass an order asking the Central Government to appoint directors for a period not exceeding three years on any one occasion. There is no limit as to the number of directors that can be appointed. The CLB may also pass similar orders on an application of not less than 100 members or members holding atleast one tenth of the total voting power. Hence Central Government can appoint its nominees as directors of the company only on an order passed by CLB in this regard and not on its own.

Notwithstanding anything contained in the Companies Act or in any other law for the time being in force, where any person is appointed by the Central Government to hold office as director or additional director, Section 408 (6) of the Companies Act, 1956, empowers the Central Government to issue such directions to the company as it may consider appropriate in regard to its affairs. Such directions may include directions to remove an auditor already appointed and to appoint another auditor in his place or to alter the articles of the company. When such directions are given, the appointment, removal or alteration, as the case may be shall be deemed to have come into effect as if the provisions of the Companies Act in this behalf have been complied without requiring any further act or thing to be done. Though these powers are substantial, yet the same do not empower the Central Government to interfere in the day to day management of the company.

Further, Section 408(7) empowers the Central Government to require the persons appointed as directors to report to the Central Government from time to time with regard to affairs of the company.

(b) The price band is the range within which the price can move. The cap of the price band shall not be more than 20% of the floor price. If the floor price is Rs. 500 the cap of the price shall be Rs. 600 and the company may indicate a price band of Rs. 500 to 600 in the red herring prospectus (Schedule XI, Clause 8(b) SEBI (ICDR) Regulations, 2009.

The price band can be revised during the bidding period in which case the maximum revision on either side shall not exceed 20% i.e. floor of the price band can move up or down to the extent of 20% of the floor price. Hence the revised price band may be Rs. 400 (Rs. 500 less 20%) to Rs. 480 (120% of Rs. 400).

Any revision in the price band shall be widely disseminated by informing the stock exchange, by issuing press releases and also indicating the change on the relevant website and terminals of syndicate members. The bidding period shall be extended for a further period of 3 days subject to the total bidding period not exceeding 10

days. The manner in which the shortfall, if any in the project financing arising on account of lowering of price band will be met shall be disclosed in the red- herring prospectus. It shall also be disclosed that the allotment shall not be made unless the financing is tied up. These are the conditions subject to which the price the price band may be lowered.

6. (a) **Cancellation of Certificate of Registration under SRFAESI Act, 2002:**

The Reserve Bank of India may cancel a certificate of registration granted to a securitisation and reconstruction company for the reasons stated in Section 4 of SRFAESI Act, 2002.

RST Ltd., can prefer an appeal to the Central Government (Secretary, Ministry of Finance, Government of India) within a period of 30 days from the date on which order of cancellation was communicated to it. The Central Government must also give such company a reasonable opportunity of being heard before rejecting the appeal. If RST Ltd., is holding investments of qualified institutional buyers at the time of cancellation of certificate of registration, it shall be deemed to be a securitisation and reconstruction company until it repays the entire investments held by it, together with interest if any, within such period as may be specified by the Reserve Bank.

(b) **Prohibition on insider trading of securities (Section 195 of the Companies Act, 2013)**

There was no provision under the Companies Act, 1956 for prohibition on insider trading of securities. A new section 195 of the Companies Act, 2013 which came into force on 12th September, 2013 provides for prohibition on insider trading of securities. According to section 195 of the Companies Act, 2013:

(i) No person including any director or key managerial personnel of a company shall enter into insider trading. But if any communication is required in the ordinary course of business or profession or employment or under any law, then the above prohibition does not apply.

(ii) "Insider trading" means—

(a) an act of subscribing, buying, selling, dealing or agreeing to subscribe, buy, sell or deal in any securities by any director or key managerial personnel or any other officer of a company either as principal or agent if such director or key managerial personnel or any other officer of the company is reasonably expected to have access to any non-public price sensitive information in respect of securities of company; or

(b) An act of counselling about procuring or communicating directly or indirectly any non-public price-sensitive information to any person.

(iii) "price-sensitive information" means any information which relates, directly or

indirectly, to a company and which if published is likely to materially affect the price of securities of the company.

(iv) If any person contravenes the provisions of this section, he shall be punishable with imprisonment for a term which may extend to five years or with fine which shall not be less than five lakh rupees but which may extend to twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher, or with both.

7. (a) **Penal provisions**: Section 11(3) of the Foreign Exchange Management Act, 1999 states that where any authorized person contravenes any direction given by the Reserve Bank of India under the said Act or fails to file any return as directed by the Reserve Bank of India, the Reserve Bank of India may, after giving reasonable opportunity of being heard impose a penalty which may extend to Rs. 10,000/- and in the case continuing contraventions with an additional penalty which may extend to Rs. 2,000/- for every day during which such contravention continues.

(b) **Factors determining appreciable adverse effect on competition:**

It is not be lawful for any enterprise or association of enterprises or person or association of enterprises or persons or association of persons to 'enter' into an agreement in respect of production, supply, storage, distribution, acquisition or control of goods or provision of service, which causes or is likely to cause an appreciable adverse effect on competition within India. All such agreements entered into in contravention of the aforesaid prohibition shall be void.

According to section 3 of the Competition Act, 2002, any agreement entered into between enterprises or associations of enterprises or persons or associations of persons or between any person and enterprise or practice carried on, or decision taken by, any association of enterprises or association of persons, including cartels, engaged in identical or similar trade of goods or provision of services, shall be presumed to have an appreciable adverse effect on Competition, which—

(a) directly or indirectly determines purchase or sale prices;

(b) limits or controls production, supply, markets, technical development, investment or provision of services;

(c) shares the market or source of production or provision of services by way of allocation of geographical area of market, or type of goods or services, or number of customers in the market or any other similar way;

(d) directly or indirectly results in bid rigging or collusive bidding.

However, any agreement entered into by way of joint ventures, if such agreement increases efficiency in production, supply, distribution, storage, acquisition or control of goods or provision of services, shall not be considered to be an anti-competitive agreement.

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

The number of directors proposed to be co-opted is only 2 and it does not exceed one-fifth of the total number of directors (10*1/5 = 2). They can hold office for the period specified by the Board provided it does not exceed the period specified in the Articles. Hence, the proposed appointment of one expert director and one additional director is in order.

Donation to a Political Party: According to second proviso to section 581ZH, a producer company shall not make directly or indirectly to any political party or for any political purpose to any person any contribution or subscription or make available any facilities including personnel or material. As the donation to a political party is prohibited, the company cannot donate Rs.10,000 to a political party.

(d) Sometimes an explanation is added to a section of an Act for the purpose of explaining the main provisions contained in that section. If there is some ambiguity in the provisions of the main section, the explanation is inserted to harmonise and clear up any ambiguity in the main section. Something may be added to or something may be excluded from the main provision by insertion of an explanation. But the explanation should not be construed to widen the ambit of the section.

For example, section 294AA of the Companies Act, 1956 gives power to the Central Government to prohibit the appointment of Sole Selling Agents of a company in certain cases. An explanation has been added to that section which states that an "appointment" includes "re-appointment". By inclusion of this explanation, the legislature has only clarified the main provisions of that section and has not widened the ambit of the powers of the Central Government.

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

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

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

In order to further strengthen the existing legal framework and to effectively combat money laundering, terror financing and cross-border economic offences, an Amendment Act, 2009 was passed. The new law seeks to check use of black money for financing terror activities. Financial intermediaries like full-fledged money changers, money transfer service providers and credit card operators have also been brought under the ambit of The Prevention of Money-Laundering Act. Consequently, these intermediaries, as also casinos, have been brought under the reporting regime of the enforcement authorities. It also checks the misuse of promissory notes by FIIs, who would now be required to furnish all details of their source. The new law would check misuse of "proceeds of crime" be it from sale of banned narcotic substances or breach of the Unlawful Activities (Prevention) Act. The passage of the Prevention of Money Laundering (Amendment), 2009 have enabled India's entry into Financial Action Task Force (FATF), an inter-governmental body that has the mandate to combat money laundering and terrorist financing.