

## PAPER –1: FINANCIAL REPORTING

### PART – I : RELEVANT AMENDMENTS, NOTIFICATIONS AND ANNOUNCEMENTS

#### A. Applicable for November, 2015 examination

##### 1. Revised Regulatory Framework for NBFCs

RBI vide notification no. DNBR (PD)CC.No. 002/03.10.001/2014-15 dated November 10, 2014 has revised the regulatory provisions relating to the functioning of NBFCs (except primary dealers) in India. The changes introduced to the regulatory framework are delineated below.

##### a. Requirement of Minimum NOF of ₹ 200 lakh

Although the requirement of minimum NOF stands at ₹ 200 lakh, the minimum NOF for companies that were already in existence before April 21, 1999 was retained at ₹ 25 lakh. but the revised regulatory framework has mandated all NBFCs to attain a minimum NOF of ₹ 200 lakh by the end of March 2017, as per the milestones given below:

- ₹ 100 lakh by the end of March 2016
- ₹ 200 lakh by the end of March 2017

##### b. Deposit Acceptance

As per extant NBFCs Acceptance of Public Deposit (Reserve Bank) Directions, 1998, an unrated Asset Finance Company (AFC) having NOF of ₹ 25 lakh or more, complying with all the prudential norms and maintaining capital adequacy ratio of not less than fifteen per cent, is allowed to accept or renew public deposits not exceeding one and half times of its NOF or up to ₹ 10 crore, whichever is lower. AFCs which are rated and complying with all the prudential regulations are allowed to accept deposits up to 4 times of their NOF.

In order to harmonise the deposit acceptance regulations across all deposit taking NBFCs (NBFCs-D), existing unrated AFCs shall have to get themselves rated by March 31, 2016. Those AFCs that do not get an investment grade rating by March 31, 2016, will not be allowed to renew existing or accept fresh deposits thereafter. Further, it has also been decided to harmonise the limit for acceptance of deposits across the sector by reducing the same for rated AFCs from 4 times to 1.5 times of NOF, with effect from the date of this circular.

##### c. Systemic Significance

The threshold for defining systemic significance for NBFCs-ND has been revised in the light of the overall increase in the growth of the NBFC sector with asset size of ₹ 500 crore and above as per the last audited balance sheet.

With this revision in the threshold for systemic significance, NBFCs-ND shall be categorized into two broad categories viz.,

- i. NBFCs-ND (those with assets of less than ₹ 500 crore) and
- ii. BFCs-ND-SI (those with assets of ₹ 500 crore and above).

**d. Multiple NBFCs**

NBFCs that are part of a corporate group or are floated by a common set of promoters will not be viewed on a standalone basis. The total assets of NBFCs in a group including deposit taking NBFCs, if any, will be aggregated to determine if such consolidation falls within the asset sizes of the above two categories.

**e. Prudential Norms**

The regulatory approach in respect of NBFCs-ND with an asset size of less than ₹ 500 crore will be as under:

- (i) They shall not be subjected to any regulation either prudential or conduct of business regulations if they have not accessed any public funds and do not have a customer interface.
- (ii) Those having customer interface will be subjected only to conduct of business regulations if they are not accessing public funds.
- (iii) Those accepting public funds will be subjected to limited prudential regulations but not conduct of business regulations if they have no customer interface.
- (iv) Where both public funds are accepted and customer interface exist, such companies will be subjected both to limited prudential regulations and conduct of business regulations.
- (v) Registration under Section 45 IA of the RBI Act will be mandatory.

All NBFCs-ND with assets of ₹ 500 crore and above, irrespective of whether they have accessed public funds or not, shall comply with prudential regulations as applicable to NBFCs-ND-SI. They shall also comply with conduct of business regulations if customer interface exists.

**Prudential Regulations Applicable to NBFCs-ND with Assets less than ₹ 500 crore**

NBFCs-ND with asset size of less than ₹ 500 crore are exempted from the requirement of maintaining CRAR and complying with Credit Concentration Norms.

A leverage ratio of 7 is being introduced for all such NBFCs-ND to link their asset growth with the capital they hold. For this purpose, leverage ratio is defined as Total Outside Liabilities / Owned Funds.

**Prudential Regulations Applicable to NBFCs-ND-SI (asset of ₹ 500 crore and above) and all NBFCs-D**

**Tier 1 Capital**

All NBFCs-ND which have an asset size of ₹ 500 crore and above, and all NBFCs-D, shall maintain minimum Tier 1 Capital of 10%. The compliance to the revised Tier 1 capital will be phased in as follows:

- 8.5% by end of March 2016.
- 10% by end of March 2017.

**Asset Classification**

In the interest of harmonisation, the asset classification norms for NBFCs-ND-SI and NBFCs-D are being brought in line with that of banks, in a phased manner, as given below.

Lease Rental and Hire-Purchase Assets shall become NPA:

- i. if they become overdue for 9 months (currently 12 months) for the financial year ending March 31, 2016;
- ii. if overdue for 6 months for the financial year ending March 31, 2017; and
- iii. if overdue for 3 months for the financial year ending March 31, 2018 and thereafter.

Assets other than Lease Rental and Hire-Purchase Assets shall become NPA:

- i. if they become overdue for 5 months for the financial year ending March 31, 2016;
- ii. if overdue for 4 months for the financial year ending March 31, 2017; and
- iii. if overdue for 3 months for the financial year ending March 31, 2018 and thereafter.

For all loan and hire-purchase and lease assets, sub-standard asset would mean:

- i. an asset that has been classified as NPA for a period not exceeding 16 months (currently 18 months) for the financial year ending March 31, 2016;
- ii. an asset that has been classified as NPA for a period not exceeding 14 months for the financial year ending March 31, 2017; and
- iii. an asset that has been classified as NPA for a period not exceeding 12 months for the financial year ending March 31, 2018 and thereafter.

For all loan and hire-purchase and lease assets, doubtful asset would mean:

- i. an asset that has remained sub-standard for a period exceeding 16 months (currently 18 months) for the financial year ending March 31, 2016;
- ii. an asset that has remained sub-standard for a period exceeding 14 months for the financial year ending March 31, 2017; and
- iii. an asset that has remained sub-standard for a period exceeding 12 months for the financial year ending March 31, 2018 and thereafter.

For the existing loans, a one-time adjustment of the repayment schedule, which shall not amount to restructuring will, however, be permitted.

#### **Provisioning for Standard Assets**

The provision for standard assets for NBFCs-ND-SI and for all NBFCs-D has being increased to 0.40% (at present 0.25%). The compliance to the revised norm will be phased in as given below:

- 0.30% by the end of March 2016
- 0.35% by the end of March 2017
- 0.40% by the end of March 2018

**Note:** The revisions brought through this circular shall be applicable to NBFCs-MFI and registered Core Investment Companies also except wherever in conflict with the provision of Non-Banking Financial Company- Micro Finance Institutions (Reserve Bank) Directions, 2011 and Core Investment Companies (Reserve Bank) Directions, 2011 respectively, in which case the Directions ibid will be followed.

For a complete text of the circular please refer to the link:  
<http://rbi.org.in/scripts/NotificationUser.aspx?Id=9327&Mode=0>

#### **2. Dividend Distribution Tax**

- (a) With effect from 1<sup>st</sup> Oct, 2014 dividend and income distribution tax is leviable on gross dividend / income and not on the net dividend / income distributed to shareholders and unit holders as per Income- tax Act, 1961.
- (b) The rate of DDT is fifteen per cent (excluding surcharge of 12% plus secondary and higher education cess is (2+1) 3%).

#### **3. Amendment to Schedule VII to the Companies Act, 2013**

The Central Government vide Notification No. G.S.R. 568(E) dated 6<sup>th</sup> August, 2014, made amendments in Schedule VII to the Companies Act, 2013, wherein it has added "slum area development" as one of the avenue for contribution for CSR.

The term 'slum area' shall mean any area declared as such by the Central Government or any State Government or any other competent authority under any law for the time being in force.

Further, MCA vide notification no. G.S.R. 741(E) dated 24th October, 2014 has made further amendments to Schedule VII to the Companies Act, 2013 by notifying two more avenues for incurring eligible expenditure under CSR requirements for companies. According to the said notification, the contributions to the "Swachh Bharat Kosh set up for the promotion of sanitation" and "contributions to the Clean Ganga Fund set up for rejuvenation of river Ganga" will also be considered as eligible expenditure qualifying for CSR.

**4. Securities and Exchange Board of India (Share Based Employee Benefits) Regulations, 2014**

SEBI vide Circular No. LAD-NRO/GN/2014-15/16/1729 dated 28th October, 2014 has formulated the SEBI (Share Based Employee Benefits) Regulations, 2014 which replaces the SEBI (Employees Stock Option Plan) Guidelines, 1999. The said Regulations deal with various provisions relating to employee stock option schemes, employee stock purchase schemes, stock appreciation rights schemes, general employee benefits schemes and retirement benefit schemes formulated by listed companies. The regulations deal with definition of eligible employees, formation of compensation committee, shareholders approvals variation of terms of issue, listing, compliances etc. For the complete text of this notification please refer to the link: [http://www.sebi.gov.in/cms/sebi\\_data/attachdocs/1414568485252.pdf](http://www.sebi.gov.in/cms/sebi_data/attachdocs/1414568485252.pdf)

**5. Amendment to the Rule 6 of the Companies (Accounts) Rules, 2014**

The Central Government vide Notification No. GSR... (E) dated 14<sup>th</sup> October, 2014, has amended the Companies (Accounts) Rules, 2014 by inserting two provisos in its Rule 6. Rule 6 talks about the manner of consolidation for the companies mandated to prepare the consolidated financial statements under section 129(3) of the Companies Act, 2013.

1. According to the first proviso added therein, an intermediate wholly-owned subsidiary company whose immediate parent is a company incorporated in India would not be required to comply with the requirements of the Rule 6 of the Companies (Accounts) Rules, 2014.

However, the intermediate wholly-owned subsidiary company whose immediate parent is a company incorporated outside India is required to comply with the requirements of the Rule 6.

2. According to the second proviso added therein, those companies which do not have any subsidiary but have one or more associates or joint ventures or both, have been exempted from preparing Consolidated Financial Statements for the financial year 2014-15.

**6. Schedule III related disclosures made in the stand-alone financial statements not to be repeated in CFS – Clarification**

Under the Act, the requirements of Schedule III would apply to preparation of stand-alone financial statements as well as to the preparation of Consolidated Financial Statements.

While AS 21, 'Consolidated Financial Statements', inter alia, provides that certain information required under Schedule III to the Companies Act, 2013 given in the notes to the stand-alone financial statements of the parent and/or the subsidiary, need not be included in the Consolidated Financial Statements.

MCA has resolved the conflict between the accounting standards and the Act by providing a clarification in this regard vide Circular No. 39/2014, dated 14<sup>th</sup> October, 2014, after consulting with the ICAI.

The clarification mentions that Schedule III of the Act read with the applicable accounting standards does not envisage a company while preparing its Consolidated Financial Statements to repeat the disclosures made by it under the stand-alone financial statements used for consolidation. In the Consolidated Financial Statements, the company would need to give all disclosures relevant to Consolidated Financial Statements only.

**7. Amendment to the Companies (Corporate Social Responsibility Policy) Rules, 2014**

The Central Government vide Notification No. G.S.R. 644(E) dated 12<sup>th</sup> September, 2014, has amended sub-rule (6) of Rule 4 of the Companies (Corporate Social Responsibility Policy) Rules, 2014.

Earlier sub-rule (6) of Rule 4 states that 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 but such expenditure shall not exceed five percent of total CSR expenditure of the company in one financial year. This sub rule has now been amended and states that such expenditure will include expenditure on administrative overheads also.

**8. Amendment to Schedule II to the Companies Act, 2013**

The Central Government vide Notification No. G.S.R. 627(E) dated 29<sup>th</sup> August, 2014 has amended Schedule II to the Companies Act, 2013 dealing with the useful lives of assets for calculation of depreciation. The said amendments will be voluntary for companies in respect of financial year commencing on or after 1<sup>st</sup> April, 2014 and mandatory for financial statements in respect of financial years commencing on or after 1<sup>st</sup> April, 2015.

**9. Clarification on Accounting Standard 10 - Capitalization of Cost**

MCA, vide general circular no. 35/2014 dated 27<sup>th</sup> August, 2014, has received a number of representations seeking clarifications on capitalization of borrowing costs incurred during extended delay in commercial production for reasons beyond the developer's control and whether capitalization of power plant should be unit wise or project wise.

On consultation with the Accounting Standard Board of the ICAI, MCA has clarified that AS 10 'Accounting for Fixed Assets' and AS 16 'Borrowing Costs' prescribe the principles of capitalization of various costs.

According to AS 10, only such expenditure should be capitalized and form part of the cost of the fixed asset which increase the worth of the asset. Cost incurred during extended delay in commencement of commercial production after the plant is otherwise ready does not increase the worth of the fixed assets. Therefore, such cost cannot be capitalized.

AS 16, inter alia provides guidance with regard to capitalization where some units of a project are complete and ready for commercial production while construction continues for the other units. In such a case, cost should be capitalized in relation to that part once the part is ready for commercial production.

MCA further clarified that AS 10 and AS 16 are applicable irrespective of whether the power projects are 'Cost Plus Projects' or 'Competitive Bid Projects'.

#### **10. Insertion of Paragraph 46 for Entities Other than Companies**

In line with para 46 inserted by the MCA for corporate entities, the Council of the ICAI has also inserted Paragraph 46 in AS 11 for Entities other than Companies in the month of February, 2014, which is as follows:

46(1) In respect of accounting periods commencing on or after 7th December, 2006 (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and should be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long-term asset or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:

Provided that the option exercised by the enterprise should disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

#### **11. Modification of Guidelines on Mortgage Guarantee Companies (MGCs)**

In the wake of representations received from the industry and keeping in view the long – term beneficial impact of development of the Mortgage Guarantee industry, RBI vide Notification No. RBI/2014-15/170 DNBS (PD) CC. No.20/MGC/03.011.001/2014-15, dated August 08, 2014, has decided to make certain modifications to the existing Guidelines on Mortgage Guarantee Companies (MGCs) as under:

(a) *Capital Adequacy*: While calculating the capital adequacy of the MGC, the mortgage guarantees provided by the MGCs may be treated as Contingent Liabilities and the

credit conversion factor applicable to these Contingent Liabilities will be fifty percent as against the present applicable credit conversion factor of hundred percent.

- (b) *Contingency Reserve*
- i. If provision made towards losses exceed 35% of the premium or fee earned during a financial year, the Contingency Reserves could go to a minimum of 24% of the premium or fee earned, such that the aggregate of Provisions made towards Losses and Contingency Reserves is at least 60% of the premium or fee earned during a financial year.
  - ii. A MGC can utilize the Contingency Reserves without the prior approval of RBI for the purpose of meeting and making good the losses suffered by the mortgage guarantee holders. Such a measure can be initiated only after exhausting all other avenues and options to recoup the losses.
- (c) *Classification on Investments*: It has now been decided that investments made by MGCs towards Government securities, quoted or otherwise, government guaranteed securities and bonds not exceeding the MGC's capital may be treated as "Held To Maturity (HTM)" for the purpose of valuation and accounted for accordingly. Investment classified under HTM need not be marked to market and will be carried at acquisition cost, unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity. The book value of the security should continue to be reduced to the extent of the amount amortised during the relevant accounting period. However, if any security out of this HTM category is traded before maturity, the entire lot will be treated as securities held for trade and will have to be marked to market.
- (d) *Provision for Loss on invoked Guarantees*: In case the provisions already held for loss on invoked guarantees are in excess of the contract wise aggregate of 'amount of invocation' (after adjusting the realizable value of the assets held by the company in respect of each housing loan), the excess may be reversed. However, the reversal can be done only after full recovery /closure of the invoked guarantee amount or after the account becomes standard.

## 12. Relevant Section of the Companies Act, 2013

The relevant Sections of the Companies Act, 2013 notified up to 31<sup>st</sup> March 2015 are applicable for November, 2015 Examination.

## 13. Schedule III to the Companies Act, 2013

Students may note that Schedule III to the Companies Act, 2013 gives general instructions for preparation of balance sheet and statement of profit and loss of a company. Schedule III to the Companies Act, 2013, also contains general instructions for preparation of consolidated financial statements, at its end in addition to Part I - Balance Sheet and Part II - Statement of Profit and Loss. Students are advised to go



through complete Schedule III to the Companies Act, 2013 carefully for preparation of financial statements of companies including consolidated financial statements.

*Students may refer Schedule III to the Companies Act, 2013 on the Institute's website [www.icai.org](http://www.icai.org)>>Students>>Bos knowledge portal>>Final Course>>Paper 1 Financial Reporting>>Additional Reading Material>>Schedule III to the Companies Act, 2013.*

#### **14. Buy Back of Securities (Amendment) Regulations, 2013**

In exercise of the powers conferred under section 30 of the Securities and Exchange Board of India Act, 1992, SEBI made Securities and Exchange Board of India (Buy-back of Securities) (Amendment) Regulations, 2013 to amend the Securities and Exchange Board of India (Buy back of Securities) Regulations, 1998.

The important provisions of the new regulations (applicable for listed companies) are:

- (i) No offer of buy-back for fifteen per cent or more of the paid up capital and free reserves of the company shall be made from the open market.
- (ii) A company shall not make any offer of buyback within a period of one year reckoned from the date of closure of the preceding offer of buy-back, if any.
- (iii) The company shall ensure that at least fifty per cent of the amount earmarked for buy-back is utilized for buying back shares or other specified securities.

These new regulations can be downloaded from the link [http://203.199.247.102/cms/sebi\\_data/attach\\_docs/1375961931576.pdf](http://203.199.247.102/cms/sebi_data/attach_docs/1375961931576.pdf)

#### **B. Not applicable for November, 2015 examination**

1. Ind ASs issued by the Ministry of Corporate Affairs would not be applicable for November, 2015 Examination. However, the topic of "Introduction of Indian Accounting Standards (Ind AS); Comparative study of ASs vis-a-vis Ind ASs; Carve outs/ins in Ind ASs vis-à-vis International Financial Reporting Standards (IFRSs)" would be included in the syllabus of Final Paper 1 : Financial Reporting and the same would be applicable from May, 2016 Examination.
2. The topic of "Overview of International Accounting Standards (IAS) / International Financial Reporting Standards (IFRS), Interpretations by International Financial Reporting Interpretation Committee (IFRIC), Significant differences vis-a-vis Indian Accounting Standards; Understanding of US GAAPs, Applications of IFRS and US" would be excluded from the syllabus of Final Paper 1: Financial Reporting and the same would not be applicable from November, 2015 Examination.

**PART – II : QUESTIONS AND ANSWERS**  
**QUESTIONS**

**AS 2**

1. (a) Aman Ltd. is engaged in a manufacturing process of food products. During the year 2014-15, the company introduces 3,00,000 units of raw material @ ₹ 10 per unit. The details of other cost of production are as under:

Item	Amount (₹)	Output (unit)	Market price per unit (₹)	Closing inventory as on 31-03-2015
Wages	16,40,000	Main Product ABC -1,25,000	80	16,000
Fixed overhead	11,60,000	Main Product XYZ -1,00,000	50	4,000
Variable overhead	8,00,000	By-product 32,000	25	
Selling overhead	95,000			

There is a profit of ₹ 90,000 on sale of by-product after incurring separate processing charges of ₹ 80,000 and special packing charges of ₹ 1,20,000. ₹ 60,000 was realised from the sale of scrap.

Calculate the value of closing inventory of MP ABC and MP XYZ as on 31-03-2015.

**AS 3**

- (b) M Ltd. submits the following information pertaining to the year 2014-2015

	(₹ in lakhs)
Additional shares issued	16.50
CAPEX (Capital expenditure)	19.90
Proceeds from assets sold	11.60
Dividends declared	10.50
Amortisation of preliminary expenses	5.00
Gain from disposal of assets	(6.20)
Net income	8.30
Increase in Accounts Receivable	11.50
Redemption of 9% debentures	12.50
Depreciation	5.75

Using the data given above, you are required to prepare Cash Flow Statement as per AS 3 (Revised) by indirect method and find the ending cash and bank balances given an opening figure thereof was ₹ 11.55 lakhs.

**AS 4**

2. (a) A company deals in petroleum products. The sale price of petrol is fixed by the government. After the Balance Sheet date, but before the finalisation of the company's accounts, the government unexpectedly increased the price retrospectively. Can the company account for additional revenue at the close of the year? Discuss.

**AS 5**

- (b) U.P. Rajya Setu Nigam Ltd. was awarded a contract of construction of a bridge for ₹ 100 crores on 1-6-2011. Total contract cost estimated was ₹ 80 crores. The position of the contract on 31-3-2014 and 31-3-2015 was under:-

	As on 31-3-2014	As on 31-3-2015
Contract Price	100	100
Contract cost incurred up to date	25	95 (100% complete)
Estimate contract cost of completion	60	Nil

While closing books of account on 31-3-2015, the chief accountant treated excess cost of ₹ 10 crores incurred as against estimated cost of ₹ 25+60= ₹ 85 crores as on 31-3-2014 as mistakes in estimation of cost, hence classified ₹ 10 crores (95-85) as prior period expenses. Comment on the treatment made by the chief accountant.

**AS 6**

3. (a) The original cost of the machine shown in the books of a company as on 1<sup>st</sup> April, 2012 is ₹ 180 lakhs which they revalued upward by 20% during 2012-13. In the year 2014-15, it appears that a 5% downward revaluation should be made to arrive at the true value of the assets in the changed economic and industry conditions. They charged 15% depreciation on W.D.V of the assets.

Show the value of the asset at which it should appear in the balance sheet dated 31<sup>st</sup> March, 2015 and also show the revaluation reserve account.

**AS 7**

- (b) A firm of contractors obtained a contract work. The following details are available in the records for the year ended 31<sup>st</sup> March, 2015:

	(₹ in lakhs)
Total contract price	800
Work certified	350

Work not certified	75
Estimated further cost to completion	480
Progress payment received	380
Payment to be received	120

Find out the amount of foreseeable loss, contract work-in-progress, contract value recognised as per AS 7 and the amount due or from the customers.

**AS 9**

4. (a) New Spice Ltd. sells male grooming products to various dealers situated in different states in India. It allows normal credit period of 45 days to its dealers to make payment. Interest at the rate of 2% per month is charged on the dealers for delayed payments. The interest recovery on such overdue outstanding amounts from dealers is only 10%, due to various reasons. During the year 2014-15, the company wants to recognize only the interest received and not the balance 90% of interest receivable on overdue outstanding. Do you agree?

**AS 10**

- (b) S Ltd. has constructed a fixed asset and incurred the following expenses on its construction:

	₹
Materials	7,00,000
Direct Expenses	1,80,000
Total Direct Labour (excluding the amount allocated to fixed asset constructed)	18,00,000
(1/10 <sup>th</sup> of the total labour was chargeable to the fixed asset constructed)	
Total Office & Administration Expenses	1,70,000
(5% is chargeable to the fixed asset constructed)	
Total Depreciation	1,90,000
(10% is chargeable to the fixed asset constructed)	

Calculate the cost of the fixed asset constructed as per AS 10.

**AS 11**

5. (a) A company had imported raw material worth US\$ 250,000 on 15<sup>th</sup> January, 2015 when the exchange rate was ₹ 46 per US\$. The company had recorded the transaction at that rate. The payment for imports was made on 15<sup>th</sup> April, 2015 when the exchange rate was ₹ 49 per US\$. However, on 31<sup>st</sup> March, 2015 the rate of

exchange was ₹ 50 per US\$. The company passed an entry on 31<sup>st</sup> March, 2015 adjusting the cost of raw materials consumed for the difference between ₹ 49 and ₹ 46 per US\$. State your views as an accountant.

**AS 12**

- (b) A Ltd. has set up its business in a designated backward area with an investment of ₹ 200 lakhs. The Company is eligible for 25% subsidy and has received ₹ 50 lakhs from the Government.

Explain the treatment for capital subsidy received from the Government in the books of the company.

**AS 13**

6. Naren Garments Manufacturing Company Limited invested in the shares of another company on 1<sup>st</sup> November, 2014 at a cost of ₹ 3,00,000. It also earlier purchased Gold of ₹ 3,50,000 and Silver of ₹ 1,50,000 on 1<sup>st</sup> April, 2014. Market value as on 31<sup>st</sup> March, 2015 of above investments are as follows:

	₹
Shares	2,50,000
Gold	5,00,000
Silver	2,80,000

How will the above investments be shown in the books of accounts of Naren Garments Manufacturing Company Limited for the year ending 31<sup>st</sup> March, 2015 as per the provisions of Accounting Standard 13?

**AS 16**

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

**AS 19**

- (b) XY Ltd. leased a machine to SB Ltd. on the following terms:

	(₹ in lakhs)
Fair value of the machine	4.00
Lease term	5 years

Lease rental per annum	1.00
Guaranteed residual value	0.20
Expected residual value	0.40
Internal rate of return	15%

Depreciation is provided on straight line method at 10% per annum. Ascertain Unearned Finance Income. Also pass necessary journal entries in the books of the Lessee in the first year of lease.

**AS 20**

8. A Ltd. had 8,00,000 equity shares outstanding as on 1<sup>st</sup> April, 2013. The company earned a profit of ₹ 20,00,000 during the year 2014-15. The average fair value per share during 2014-15 was ₹ 40. The company has given share option to its employees of 1,00,000 equity shares at the option price of ₹ 20.

Calculate Basic EPS and Diluted EPS.

**AS 28**

9. Famous Ltd. is in the business of manufacturing and export of its products. The Government put restriction on export of goods exported by Famous Ltd. Due to that restriction the company decide to impair its assets. The company provide you the following information:

- (i) The company acquired the identifiable assets worth ₹ 500 lakhs from Crown Ltd. on 1<sup>st</sup> April, 2011 and paid ₹ 550 lakhs. The excess amount was treated as goodwill.
- (ii) The useful life of acquired identifiable assets was 10 years and depreciation charged on straight line basis.
- (iii) The recoverable amount of assets on 31<sup>st</sup> March, 2015 was determined as ₹ 278 lakhs.
- (iv) The amortisation period of goodwill to be taken as 5 years as per AS 14.

Calculate impairment loss and its treatment in books of accounts as per the provisions of AS 28 and also pass necessary journal entries for adjustment of impairment loss.

**AS 29**

10. Shishir Ltd., a public sector company, provides consultancy and engineering services to its clients. In the year 2014-15, the Government set up a commission to decide about the pay revision. The pay will be revised with respect from 1-1-2012 based on the recommendations of the commission. The company makes the provision of ₹ 1250 lakhs for pay revision in the financial year 2014-15 on the estimated basis as the report of the commission is yet to come. As per the contracts with 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 ₹ 1250 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/recognize the income by ₹ 1250 lakhs in Profit & Loss Account as per the terms of the contract. Otherwise, it will be the violation of matching concept & understatement of profit.

Comment on the opinion of the Accountant with reference to relevant Accounting Standards.

### Corporate Financial Reporting

11. Max & Co. Ltd., had the following items under ‘Reserves & Surplus’ in the Balance Sheet as on 31<sup>st</sup> March, 2015:

Securities Premium	₹ 50 lakhs
Capital Reserve	₹ 30 lakhs
General Reserve	₹ 21 lakhs

The company had accumulated loss of ₹ 120 lakhs, on the same day, which it had disclosed under the head “Statement of Profit and Loss” as an ‘Asset’ in its Balance Sheet.

Comment on the correctness of this treatment in line with Schedule III to the Companies Act, 2013.

### Accounting for Corporate Restructuring

12. The following are the Balance Sheets of A Ltd. & B Ltd. as on 31<sup>st</sup> March, 2015:

<i>Liabilities</i>	<i>A Ltd.</i>	<i>B Ltd.</i>
Share Capital:		
Equity Shares of ₹ 10 each fully paid	45,00,000	10,00,000
8% Preference Shares of ₹ 10 each fully paid	-	5,00,000
General Reserve	3,50,000	3,10,000
Profit and Loss Account	6,34,000	60,000
10% Debentures	-	8,00,000
Current Liabilities	<u>6,00,000</u>	<u>3,80,000</u>
Total	<u>60,84,000</u>	<u>30,50,000</u>

Assets:		
Fixed Assets	30,50,000	7,30,000
30,000 Equity Shares in B Ltd.	3,00,000	-
90,000 Equity Shares in A Ltd.	-	10,00,000
Debtors	12,70,000	4,50,000
Stock	8,40,000	5,50,000
Bank Balance	<u>6,24,000</u>	<u>3,20,000</u>
Total	<u>60,84,000</u>	<u>30,50,000</u>

A Ltd. absorbs B Ltd. on the basis of intrinsic value of both the companies as on 31<sup>st</sup> March, 2015. It is informed that the Preference Shares of B Ltd. do not have priority over payment of capital and dividend. Before absorption, A Ltd. declared dividend of 8%, Dividend tax is 10%.

Prepare Balance sheet of A Ltd., after the absorption of B Ltd. with necessary Notes to accounts.

### Consolidated Financial Statements

13. ZEE Limited is a company carrying on the business of beauty products, acquired 84,000 shares of an herbal products company Dee Limited for ₹ 9,60,000 on 31<sup>st</sup> March, 2010. The Balance Sheet of Dee Limited on that date was as under:

Particulars	₹
Equity and Liabilities	
Shareholders Fund	
1,20,000 equity shares of ₹ 10 each fully paid up	12,00,000
Reserve and surplus	
Capital Reserve	24,000
Profit and Loss Account	48,000
Current Liabilities	
Trade payables	<u>84,000</u>
	<u>13,56,000</u>
Non-Current Assets	
Fixed Assets	8,40,000
Current Assets	<u>5,16,000</u>
	<u>13,56,000</u>



Directors of Dee Limited made bonus issue on 31<sup>st</sup> March, 2015 in the ratio of one equity share of ₹ 10 each fully paid up for every two shares held on that date. It was decided that such bonus shares would be issued out of post-acquisition profits by using revenue reserve.

On 31<sup>st</sup> March, 2015 the summarized Balance Sheets of the two companies were as follows:

<i>Particulars</i>	<i>Zee Limited (₹)</i>	<i>Dee Limited (₹)</i>
Equity and Liabilities		
Shareholders fund		
Equity shares of ₹ 10 each fully paid up (Before bonus issue)	36,00,000	12,00,000
Reserve and Surplus		
Capital Reserve	-	24,000
Securities Premium	7,20,000	-
Revenue Reserve	48,00,000	15,24,000
Profit and Loss Account	12,60,000	3,36,000
Current Liabilities		
Trade payable	<u>4,44,000</u>	<u>1,68,000</u>
	<u>1,08,24,000</u>	<u>32,52,000</u>
Non-current Assets		
Fixed assets	63,36,000	18,48,000
84,000 equity shares in DEE Limited at cost	9,60,000	
Current assets	<u>35,28,000</u>	<u>14,04,000</u>
	<u>1,08,24,000</u>	<u>32,52,000</u>

You are required to calculate as on 31<sup>st</sup> March, 2015 (i) Cost of Control/Capital Reserve (ii) Minority Interest (iii) Consolidated Reserves and Surplus in each of the following cases:

- (i) Before issue of bonus shares.
- (ii) Immediately after issue of bonus shares.

Also, prepare a Consolidated Balance Sheet of the group after the bonus issue alongwith necessary Notes to accounts.

### Financial Instruments

14. (i) Surya Ltd. holds a small number of shares in Supreme Ltd. The shares are classified as 'available for sale'. On 20<sup>th</sup> December 2014, the fair value of the share

is ₹ 240 and the cumulative gain recognised in the Investment Revaluation Reserve Account is ₹ 40. On the same day, Supreme Ltd. was acquired by Simple Ltd. a large entity. As a result, Surya Ltd. receives shares in Simple Ltd. for those it had in Supreme Ltd. of equal fair value.

Should Surya Ltd. recognise the cumulative gain of ₹ 40 recognised in Investment Revaluation Reserve Account in the Statement of Profit and Loss as per the provisions of AS 30?

- (ii) Entity A which owes ₹ 25 lakhs to Entity B agrees to pay ₹ 25 lakhs to Entity C at a future date to assume its obligation to Entity B. Entity B legally releases Entity A from any further obligation under the debt. As desired by Entity C, Entity A agrees to make payment to Entity B on behalf of Entity C.

Examine the status of Entity A with respect to recognition or de-recognition of its liability towards Entity B and Entity C.

### Share Based Payments

15. The following particulars in respect of stock options granted by a company are available:

Grant date	01.04.2012
Number of employees covered	400
Number of options granted per employee	60
Nominal value per share (₹)	100
Exercise price per share (₹)	125

Offer was put in three groups, Group 1 was for 20% of shares offered with vesting period 1 year, Group 2 was for 40% of shares offered with vesting period 2 years. Group 3 was for 40% for shares offered with vesting period three years. Fair value of option per share on grant date was ₹ 10 for Group 1, ₹ 12.50 for Group 2 and ₹ 14 for Group 3.

Position as on 31.03.2013	Position as on 31.03.2014
Number of employees left = 40	Number of employees left = 35
Estimate of number of employees to leave in 2013-14 = 36	Estimate of number of employees to leave in 2014-15 = 30
Estimate of number of employees to leave in 2014-15 = 34	Number of employees exercising options in Group II = 319
Number of employees exercise option in Group 1 = 350	

Position on 31.03.2015

- Number of employees left = 28
- Number of employees at the end of the last vesting period = 297
- Number of employees exercising options in Group III = 295

Options not exercised immediately on vesting, were forfeited. Compute expenses to recognize in each year and show important accounts in the books of the company.

### Mutual Fund

16. The investment portfolio of a mutual fund scheme includes 25,000 shares of Sun Ltd. @ ₹ 20 each and 20,000 shares of Moon Ltd. @ ₹ 30 each acquired on 31.10.2013. The market value of these shares at the end of 2013-14 were ₹ 19 and ₹ 32 respectively. On 31.5.2014, shares of both the companies were disposed off realizing ₹ 18.50 per share of Sun Ltd. and ₹ 33.50 per share of Moon Ltd. Pass important accounting entries in the books of the fund for the accounting years 2013-14 and 2014-15.

### NBFC

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

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

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

### Valuation of Shares

18. Following information from P Ltd. and Q Ltd. are available:

	P Ltd.	Q Ltd.
Earning after Tax	₹ 2,00,00,000	₹ 24,00,000
No. of Equity Shares	10,00,000	4,00,000
P.E Ratio (Times)	12	8

Q Ltd. is taken over by P Ltd.

You are required:

- to calculate market price of shares of P Ltd. and Q Ltd.
- to find out the swap ratio based on market price

- (iii) to compute the EPS of P Ltd. after takeover of Q Ltd.  
 (iv) to find out the market value of shares of the merged company.

**Value Added Statement**

19. From the following Profit & Loss Account of Orange Ltd., prepare a gross value added statement for the year ended 31.3.2015:

Show also the reconciliation between gross value added and profit before taxation.

**Profit and Loss Account for the year ended 31.3.2015**

	Notes	(₹ in lakhs)	(₹ in lakhs)
<b>Income:</b>			
Sales			1,988
Other Income			<u>110</u>
			2,098
<b>Expenditure:</b>			
Production and operational expenses	1	1,390	
Administration expenses (Factory)	2	166	
Interest	3	58	
Depreciation		<u>34</u>	<u>(1,648)</u>
Profit before taxes			450
Provision for tax	4 and 5		<u>(60)</u>
Profit after taxes			390
Balance as per last Balance Sheet			<u>20</u>
			<u>410</u>
Transferred to general reserve		90	
Dividend paid		<u>190</u>	<u>(280)</u>
Surplus carried to Balance Sheet			<u>130</u>

**Notes:**

1. Production & Operation expenses: ₹ in lakhs

Consumption of raw materials	694
Consumption of stores	118
Cess and Local taxes	196
Salaries, wages, gratuities to administrative staff	164
Other manufacturing expenses	<u>218</u>
	<u>1,390</u>

2. Administration expenses include salaries and commission to directors ₹ 18 lakhs and provision for doubtful debts ₹ 12.60 lakhs
3. Interest include: ₹ in lakhs
- |   |           |
|---|-----------|
| (a) Interest on loan from Axis bank for working capital | 18        |
| (b) Interest on loan from Axis bank for Fixed loan      | 20        |
| (c) Interest on loan from ICICI Bank for fixed loan     | 16        |
| (d) Interest on Debentures                              | <u>4</u>  |
|   | <u>58</u> |
4. The charges for taxation include a transfer of ₹ 6 lakhs to the credit of Deferred Tax Account.
5. Cess and local taxes include Excise Duty, which is equal to 1/14 of cost of bought in material and services.

#### Economic Value Added

20. From the following information of Capable Ltd., compute the economic value added:
- |                                     |               |
|-------------------------------------|---------------|
| (i) Share capital                   | ₹ 2,000 lakhs |
| (ii) Reserve and surplus            | ₹ 4,000 lakhs |
| (iii) Long-term debt                | ₹ 400 lakhs   |
| (iv) Tax rate                       | 30%           |
| (v) Risk free rate                  | 9%            |
| (vi) Market rate of return          | 16%           |
| (vii) Interest                      | ₹ 40 lakhs    |
| (viii) Beta factor                  | 1.05          |
| (ix) Profit before interest and tax | ₹ 2,000 lakhs |

#### SUGGESTED ANSWERS / HINTS

1. (a) As per para 10 of AS 2 'Valuation of Inventories', most by-products as well as scrap and waste materials, by their nature, are immaterial. They are often measured at net realizable value and this value is often deducted from the cost of the main product.

#### Determination of value of closing inventory of Main Products

	Main Product ABC	Main Product XYZ
Closing inventory in units	16,000 units	4,000 units

Cost per unit (W.N.3)	₹ 31.68	₹ 19.80
Value of closing inventory	₹ 5,06,880	₹ 79,200

**Working note:**

- (1) Calculation of net realizable value of by-product

	₹
Selling price of by-product (32,000 units x ₹ 25)	8,00,000
Less: Separate processing charges of by-product	(80,000)
Special packing charges	<u>(1,20,000)</u>
Net realizable value of by-product	<u>6,00,000</u>

- (2) Calculation of cost of conversion for allocation between joint product ABC and XYZ

		₹
Raw Material		30,00,000
Wages		16,40,000
Fixed production overhead		11,60,000
Variable overhead		<u>8,00,000</u>
		66,00,000
Less: NRV of by-product	6,00,000	
Sales value of scrap	<u>60,000</u>	<u>(6,60,000)</u>
Joint cost to be allocated between ABC and XYZ		<u>59,40,000</u>

- (3) Determination of basis of allocation and allocation of joint cost to main product ABC and XYZ

	Main Product ABC	Main Product XYZ
Output in units (a)	1,25,000	1,00,000
Sales price per unit (b)	₹ 80	₹ 50
Sales Value (a × b)	₹ 1,00,00,000	₹ 50,00,000
Ratio of allocation	2	1
Joint cost ₹ 59,40,000 allocated in the ratio of 2:1 (c)	₹ 39,60,000	₹ 19,80,000
Cost per unit (c/a)	₹ 31.68	₹ 19.80

(b)

M Ltd.

**Cash Flow Statement for the year ended 31<sup>st</sup> March, 2015**

	₹ in lakhs	₹ in lakhs
<u>Cash Flows from operating activities</u>		
Net Income	8.30	
Add: Depreciation	5.75	
Amortisation of preliminary expenses	5.00	
Loss on sale of asset	6.20	
Less: Increase in account receivables	<u>(11.50)</u>	
Net cash generated from operating activities		13.75
<u>Cash Flows from investing activities</u>		
Capital expenditure	(19.90)	
Proceeds from sale of fixed assets	<u>11.60</u>	
Net cash used in investing activities		(8.30)
<u>Cash Flows from financing activities</u>		
Proceeds from issue of additional shares	16.50	
Dividend declared	(10.50)	
Redemption of 9% debentures	<u>(12.50)</u>	
Net cash generated from financing activities		<u>(6.50)</u>
Net decrease in cash		(1.05)
Cash at the beginning of the period		<u>11.55</u>
Cash at the end of the period (balancing figure)		<u>10.50</u>

2. (a) According to para 8 of AS 4 'Contingencies and Events Occurring After the Balance Sheet Date', the unexpected increase in sale price of petrol by the government after the balance sheet date cannot be regarded as an event occurring after the Balance Sheet date, which requires an adjustment at the Balance Sheet date, since it does not represent a condition present at the balance sheet date. The revenue should be recognized only in the subsequent year with proper disclosure. The retrospective increase in the petrol price should not be considered as a prior period item, as per AS 5, because there was no error in the preparation of previous period's financial statements.
- (b) Cost estimated by U.P. Rajya Setu Nigam Ltd. in 2013-14 ₹ 85 crores  
 Excess Cost incurred in 2014-15 ₹ 10 crores  
 Treatment given by the company Prior period item

As per para 16 of the AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', 'prior period items' refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. Since, the increase in the estimated cost is not an error, so cannot be said as prior-period item.

This increase in the cost is due to change in estimation which involves judgments based on the latest information available. A change in estimate is neither a prior period item nor an extraordinary item. Hence, the treatment given by the company is not correct.

3. (a) (i) **Computation of value of asset at which it should appear in the balance sheet on 31.3.2015**

<i>Particulars</i>	<i>₹ in lakhs</i>
WDV as on 1.4.2012	180.00
Add: Revaluation profit	<u>36.00</u>
Revised WDV	216.00
Less: Depreciation for 2012-13 @ 15%	<u>(32.40)</u>
WDV as on 31.3.2013	183.60
Less: Depreciation for 2013-14 @ 15%	<u>(27.54)</u>
WDV as on 31.3.2014	156.06
Less: Revaluation loss	<u>(7.80)</u>
Revised WDV	148.26
Less: Depreciation for 2014-15 @ 15%	<u>(22.24)</u>
WDV as on 31.3.2015	<u>126.02</u>

- (ii) **Revaluation Reserve A/c for the years 2012-13 to 2014-15**

**Revaluation Reserve A/c**

<i>Date</i>	<i>Particulars</i>	<i>₹ in lakhs</i>	<i>Date</i>	<i>Particulars</i>	<i>₹ in lakhs</i>
31.3.2013	To balance c/d	<u>36.00</u>	1.4.2012	By Machinery A/c	<u>36.00</u>
		<u>36.00</u>			<u>36.00</u>
31.3.2014	To balance c/d	<u>36.00</u>	1.4.2013	By Balance b/d	<u>36.00</u>
		<u>36.00</u>			<u>36.00</u>
2014-15	To Machinery A/c (Revaluation loss)	7.80	1.4.2014	By Balance b/d	36.00
31.3.2015	To Balance c/d	<u>28.20</u>			—
		<u>36.00</u>			<u>36.00</u>



A decrease in net book value arising on revaluation of fixed assets is required to be charged to Profit and Loss A/c. However, as per AS 10, if such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve, the attributable amount is charged against that reserve. Hence, revaluation loss of ₹ 7.80 lakhs has been charged against revaluation reserve.

(b) (i) **Amount of foreseeable loss**

	(₹ in lakhs)
Total cost of construction (350 + 75 + 480)	905
Less: Total contract price	<u>(800)</u>
Total foreseeable loss to be recognized as expense	<u>105</u>

According to para 35 of AS 7 (Revised 2002), when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

(ii) **Contract work-in-progress i.e. cost incurred to date**

	(₹ in lakhs)
Work certified	350
Work not certified	<u>75</u>
	<u>425</u>
This is 46.96% or 47% ( $425/905 \times 100$ ) of total cost of construction	

**Proportion of total contract value recognised as revenue**

47% of ₹ 800 lakhs = ₹ 376 lakhs

- (iii) **Amount due from/to customers** = Contract costs + Recognised profits – Recognised losses – (Progress payments received + Progress payments to be received)
- = [425 + Nil – 105 – (380 + 120)] ₹ in lakhs
- = [425 – 105 + 500] ₹ in lakhs
- Amount due to customers = ₹ 180 lakhs.

4. (a) As per AS 9 on Revenue Recognition, where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g. for escalation of price, export incentive, interest, etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be

appropriate to recognize revenue only when it is reasonable certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

Accordingly, New Spice Ltd. is correct in recognizing the interest on receipt basis i.e. 10% of interest recovered on overdue outstanding.

**(b) Calculation of cost of fixed asset constructed**

	₹
Materials	7,00,000
Direct expenses	1,80,000
Direct labour	2,00,000
Office and administrative expenses (5% of ₹ 1,70,000)	8,500
Depreciation (10% of ₹ 1,90,000)	<u>19,000</u>
Cost of fixed asset	<u>11,07,500</u>

**Working Note:**

**Calculation of direct labour allocated to fixed asset constructed**

	₹
Direct labour (excluding allocation to the fixed asset constructed)	18,00,000
Total direct labour	= 18,00,000 x 10/9 = 20,00,000
Direct labour related to fixed asset constructed	20,00,000 x 1/10 = 2,00,000

5. (a) As per AS11 on "The Effects of Changes in Foreign Exchange Rates", monetary items denominated in a foreign currency should be reported using the closing rate. However, in certain circumstances, the closing rate not reflect with reasonable accuracy the amount in reporting currency that is likely to be realized from or required to disburse, a foreign currency monetary item at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount, which is likely to be realized from, or required to disburse, such item at the balance sheet date.

In the instant case, having regard to the fact that the amount payable for the raw material is a monetary item, the same should be shown in the balance sheet at the rate as on 31<sup>st</sup> March, 2015 i.e. ₹ 50, irrespective of the payment for the same subsequently at a lower rate.

Hence, the treatment given by the company is wrong.

- (b) Subsidy received by A Ltd. is in the nature of promoter's contribution, since, this grant is given with reference to the total investment in an undertaking and by way of contribution towards its total capital outlay and no repayment is ordinarily expected in respect thereof. Therefore, this grant should be treated as capital reserve, which can neither be distributed as dividend nor considered as deferred income.

6. As per AS 13 'Accounting for Investments', for investment in shares - if the investment is purchased with an intention to hold for short-term period then it will be shown at the realizable value of ₹ 2,50,000 as on 31<sup>st</sup> March, 2015.

If equity shares are acquired with an intention to hold for long term period then it will continue to be shown at cost in the Balance Sheet of the company. However, provision for diminution shall be made to recognize a decline, if other than temporary, in the value of the investments.

As per the standard, investment acquired for long term period shall be shown at cost. Gold and silver are generally purchased with an intention to hold it for long term period until and unless given otherwise. Hence, the investment in Gold and Silver (purchased on 1<sup>st</sup> April, 2014) shall continue to be shown at cost as on 31<sup>st</sup> March, 2015 i.e., ₹ 3,50,000 and ₹ 1,50,000 respectively, though their realizable values have been increased.

However, if held as short term investment then it should be valued at lower of cost or fair value (market price) and the resultant profit or loss to be charged to the profit and loss account.

7. (a) Para 10 of the AS 16 'Borrowing Cost' states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. In the given case, the amount of ₹ 150 crores was specifically borrowed for construction of a boiler plant. Therefore, treatment of accountant of Fragrance Ltd. is not correct and the amount of borrowing costs to be capitalised for the financial year 2014-15 should be calculated as follows:

	(₹ in crores)
Interest paid for 2014-15(11% on ₹ 150 crores)	16.50
Less: Income on temporary investment from specific borrowings	<u>(3.50)</u>
Borrowing costs to be capitalised during 2014-15	<u>13.00</u>

(b) **Gross investment** = Minimum lease payments + Unguaranteed residual value  
 = [Total lease rent + Guaranteed residual value (GRV)] +  
 Unguaranteed residual value (URV)  
 = [(₹ 1,00,000 × 5 years) + ₹ 20,000] + ₹ 20,000  
 = ₹ 5,40,000 (a)

Table showing present value of Minimum lease payments (MLP) and Unguaranteed residual value (URV).

Year	M.L.P. inclusive of URV (₹)	Discount factor @ 15%	Present Value (₹)
1	1,00,000	0.8696	86,960
2	1,00,000	0.7561	75,610
3	1,00,000	0.6575	65,750
4	1,00,000	0.5718	57,180
5	1,00,000	0.4972	49,720
	<u>20,000</u> (GRV)	0.4972	<u>9,944</u>
	5,20,000		3,45,164 (i)
	<u>20,000</u> (URV)	0.4972	<u>9,944</u> (ii)
	<u>5,40,000</u>	(i) + (ii)	<u>3,55,108</u> (b)

**Unearned Finance Income** = (a) – (b)  
 = ₹ 5,40,000 – ₹ 3,55,108  
 = ₹ 1,84,892

**Journal Entries in the books of SB Ltd.**

	₹	₹
<i>At the inception of lease</i>		
Machinery account Dr.	3,45,164*	
To XY Ltd.'s account		3,45,164*
(Being lease of machinery recorded at present value of minimum lease payments)		

\* As per para 11 of AS 19, the lessee should recognize the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payments from the standpoint of lessee, the amount recorded should be the present value of these minimum lease payments. Therefore, in this case, as the fair value of ₹ 4,00,000 is more than the present value amounting ₹ 3,45,164, the machinery has been recorded at ₹ 3,45,164 in the books of SB Ltd. (the lessee) at the inception of the lease. According to para 13 of the standard, at the inception of the lease, the asset and liability for the future lease payments are recognised in the balance sheet at the same amounts.

<i>At the end of the first year of lease</i>		
Finance charges account (Refer Working Note) To XY Ltd.'s account (Being the finance charges for first year due)	Dr.	51,775
		51,775
XY Ltd.'s account To Bank account (Being the lease rent paid to the lessor which includes outstanding liability of ₹ 48,225 and finance charge of ₹ 51,775)	Dr.	1,00,000
		1,00,000
Depreciation account <sup>£</sup> To Machinery account (Being the depreciation provided @ 10% p.a. on straight line method)	Dr.	34,516
		34,516
Profit and loss account To Depreciation account To Finance charges account (Being the depreciation and finance charges transferred to profit and loss account)	Dr.	86,291
		34,516
		51,775

**Working Note:**

Table showing apportionment of lease payments by SB Ltd. between the finance charges and the reduction of outstanding liability

Year	Outstanding liability (opening balance)	Minimum lease payments	Finance charges	Reduction in principal amount	Outstanding liability (closing balance)
	₹	₹	₹	₹	₹
1	3,45,164	1,00,000	51,775	48,225	2,96,939
2	2,96,939	1,00,000	44,541	55,459	2,41,480
3	2,41,480	1,00,000	36,222	63,778	1,77,702
4	1,77,702	1,00,000	26,655	73,345	1,04,357
5	1,04,357	1,00,000	15,654	84,346	20,011*

<sup>£</sup>Depreciation has been provided on the basis that the machine has been leased at the beginning of the year.

\*The difference between this figure and guaranteed residual value (₹ 20,000) is due to approximation in computing the interest rate implicit in the lease.

## 8. Computation of Earnings Per Share

	<i>Earnings</i> ₹	<i>Shares</i>	<i>Earnings per share</i> ₹
Net profit for the year 2014-15	20,00,000		
Number of shares outstanding during the year 2014-15		8,00,000	
Basic Earnings Per Share			2.50
$= \frac{20,00,000}{8,00,000}$			
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value (Refer Note)			
[1,00,000 x 20/40]		(50,000)	
Diluted Earnings Per Share			
$= \frac{20,00,000}{8,50,000}$	<u>20,00,000</u>	<u>8,50,000</u>	2.35

**Note:** The earnings have not been increased as the total number of shares has been increased only by the number of shares (50,000) deemed for the purpose of the computation to have been issued for no consideration.

## 9. Calculation and allocation of impairment loss of the identifiable assets

₹ in lakhs

	<i>Goodwill</i>	<i>Assets</i>	<i>Total</i>
Historical cost on 1 <sup>st</sup> April, 2011	50	500	550
Less: Accumulated depreciation (For 2011-12 to 2014-15)		(200)	(200)
Less: Amortization of goodwill (For 2011-12 to 2014-15)	<u>(40)</u>		<u>(40)</u>
	10	300	310
Recoverable amount on 31 <sup>st</sup> March, 2015 was determined as ₹ 278 lakhs			
Impairment of loss = (310-278) = ₹ 32 lakhs			
Impairment loss first allocated to Goodwill and balance to other assets	<u>10</u>	<u>22</u>	<u>32</u>
Carrying amount of the assets after impairment	<u>Nil</u>	<u>278</u>	<u>278</u>

## Journal Entries

₹ in lakhs

Date	Particulars	Dr.	Cr.
31.3.2015	Impairment loss A/c To Assets To Goodwill A/c (Being the entry for accounting of impairment loss)	Dr. 32	22 10
31.3.2015	Profit and loss A/c To Impairment loss A/c (Being the entry to transfer of impairment loss to profit and loss account)	Dr. 32	32

10. As per paras 46 and 47 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 for salary to employees of ₹ 1,250 lakhs will be ultimately collected from the client, as per the terms of the contract. Therefore, the liability of ₹ 1,250 lakhs is matched by the counter claim from the client. Hence, the provision for salary of employees should be matched with the reimbursable asset to be claimed from the client. It appears that the whole amount of ₹ 1,250 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 recognition of income of ₹ 1,250 lakhs is not as per AS 29 and also the concept of prudence will not be followed if ₹ 1,250 lakhs is simultaneously recognized as income. ₹ 1,250 lakhs is not the revenue at present but only reimbursement of claim for which an asset is created. However, the accountant is correct to the extent as that non- recognition of ₹ 1,250 lakhs as income will result in the understatement of profit. To avoid this, in the statement of profit and loss, expense relating to provision may be presented net of the amount (asset) recognized for reimbursement.

11. In accordance with Note 6(B) given under part I of Schedule III to the Companies Act, 2013, the debit balance of Profit and Loss (after all allocations and appropriations), if

any, shall be shown as a negative figure under the head 'Surplus'. Similarly the balance of 'Reserves and Surplus' after adjusting negative balance of surplus, shall be shown under the head 'Reserves and Surplus', even if the resulting figure is in negative.

In this case, the debit balance of ₹ 120 lakhs, exceeds the total of all the reserves i.e. ₹ 101 lakhs. Negative balance of ₹ 19 lakhs of "Reserves and Surplus" after adjusting debit balance of 'Profit and Loss' should be disclosed on the face of Balance Sheet under the sub-heading "Reserves and Surplus" under the heading "Shareholders' Fund". Thus the treatment done by the company is incorrect.

**12. Balance Sheet of A Ltd. (after absorption of B Ltd.) as on 31<sup>st</sup> March, 2015**

<i>Particulars</i>	<i>Note No.</i>	<i>(₹)</i>
<b>I. Equity and Liabilities</b>		
1. <u>Shareholders fund</u>		
a) Share capital	1	49,73,950
b) Reserves and Surplus	2	7,56,040
2. <u>Non-current liabilities</u>		
Long term borrowings		8,00,000
3. <u>Current liabilities</u>		<u>9,80,000</u>
Total		<u>75,09,990</u>
<b>II Assets</b>		
<u>Non-current Assets</u>		
Fixed Assets		
Tangible Assets (₹ 30,50,000 + ₹ 7,30,000)		37,80,000
<u>Current Assets</u>		
a) Inventories		13,90,000
b) Trade receivables		17,20,000
c) Cash and Cash equivalents		<u>6,19,990</u>
		<u>75,09,990</u>

**Notes to Accounts:**

	₹	₹
1. <b><u>Share Capital</u></b>		
4,97,395 Equity Shares of ₹ 10 each fully paid (out of which, 47,395 shares were allotted to vendors for consideration other than cash)		49,73,950



2.	<b>Reserves and surplus</b>		
	General Reserve	4,46,000	
	Profit and loss account (₹ 6,34,000 – ₹ 3,60,000 – ₹ 36,000)	2,38,000	
	Securities premium reserve (47,395 shares x ₹ 1.52)	<u>72,040</u>	7,56,040

**Workings Notes:**

- (1) Computation of Net Assets (excluding inter-company investments)

	A Ltd.	B Ltd.
	₹	₹
<b>Total Assets</b>		
Assets Excluding invest	57,84,000	20,50,000
Dividend receivable	-	<u>72,000</u>
<b>(A)</b>	<u>57,84,000</u>	<u>21,22,000</u>
<b>External Liabilities</b>		
Current Liabilities	6,00,000	3,80,000
Proposed dividend	3,60,000	-
Dividend Distribution tax @ 10%	36,000	-
10% Debentures	-	<u>8,00,000</u>
<b>(B)</b>	<u>9,96,000</u>	<u>11,80,000</u>
<b>Net Assets (A)-(B)</b>	<u>47,88,000</u>	<u>9,42,000</u>

**Note:** (1) Dividend distribution tax has been calculated without grossing up.

- (2) Since the Preference Shares of B Ltd. do not have priority over the payment of capital and dividend, they have to be treated at par with the equity shares. Both types of shares have the same paid up value.
- (2) In view of the above, the proportion of shareholding in B Ltd. is worked out, as follows:

- (a)
- A Ltd. in B. Ltd.**

$$\frac{\text{Number of shares held by B Ltd.}}{\text{Total number of Equity and Preference Shares of B Ltd.}} = \frac{30,000}{1,00,000 + 50,000} = \frac{1}{5}$$

- (b)
- B Ltd. in A Ltd.**

$$\frac{\text{Number of shares held by B Ltd.}}{\text{Total number of Equity and A Ltd.}} = \frac{90,000}{4,50,000} = \frac{1}{5}$$

(3) Calculation of intrinsic value of shares:

Let 'a' be the intrinsic value of shares of A Ltd. and 'b' be the intrinsic value of shares of B Ltd.

$$\text{Now, } a = ₹ 47,88,000 + 1/5 \times b$$

$$b = ₹ 9,42,000 + 1/5 \times a$$

By substituting the value of a in b, we get

$$b = ₹ 9,42,000 + 1/5 (₹ 47,88,000 + 1/5 \times b)$$

$$b = ₹ 9,42,000 + 9,57,600 + b/25$$

$$\frac{24b}{25} = ₹ 18,99,600$$

$$b = \frac{₹ 18,99,600 \times 25}{24}$$

$$b = ₹ 19,78,750$$

$$a = ₹ 47,88,000 + \frac{19,78,750}{5} = ₹ 51,83,750$$

$$\text{Intrinsic value of shares of A. Ltd.} = \frac{₹ 51,83,750}{4,50,000} = 11.52$$

$$\text{Intrinsic value of shares of B. Ltd.} = \frac{₹ 19,78,750}{1,00,000 + 50,000} = ₹ 13.19$$

(4) **Calculation of Purchase Consideration:**

No. of shares held by outside shareholders of B Ltd.

$$= 1,00,000 - 30,000 + 50,000 = 1,20,000$$

Intrinsic value of shares = 1,20,000 x ₹ 13.19 per share

$$= 15,82,800$$

Shares to be issued on the basis of intrinsic value of shares

$$= \frac{₹ 15,82,800}{₹ 11.52} = 1,37,395.83 \text{ shares}$$

Less: Shares already held by A Ltd. = 90,000.00 Shares

Number of shares to be issued = 47,395.83 shares

## (5) Total Purchase price

	₹
Additional shares in A. Ltd. (47,395 shares of ₹ 11.52)	5,45,990
Cash for fractional shares (0.83 x ₹ 11.52)	<u>10</u>
	5,46,000
Value of 30,000 shares already held by A Ltd. (30,000 shares x ₹ 13.19)	<u>3,96,000*</u>
Total	<u>9,42,000</u>

\* Approximate figure has been considered.

## (6) General Reserve

	₹
As per balance sheet	3,50,000
Add: Appreciation in the value of shares held B. Ltd. (₹ 3,96,000 – ₹ 3,00,000)	<u>96,000</u>
Closing balance	<u>4,46,000</u>

## (7) Bank Balance

		A Ltd. ₹	B Ltd. ₹
As per balance sheet		6,24,000	3,20,000
Dividend received		<u>-</u>	<u>72,000</u>
		6,24,000	3,92,000
Less: Dividend payment	3,60,000		
Dividend tax @ 10%	36,000		
Cash for fraction shares	<u>10</u>	<u>(3,96,010)</u>	<u>-</u>
Total bank balance		<u>2,27,990</u>	<u>3,92,000</u>
			<u>6,19,990</u>

## 13. (i) Before issue of bonus shares

		₹	₹
(i) <b>Cost of control</b>			
Investment in DEE Limited			9,60,000
Less: Face Value of investments		8,40,000	

	Capital Profits (W.N.)	<u>50,400</u>	<u>(8,90,400)</u>
	Cost of control		<u>69,600</u>
(ii)	Minority Interest		
	Share capital	3,60,000	
	Capital Profit (W.N.)	21,600	
	Revenue profit (W.N.) (86,400 + 4,57,200)	<u>5,43,600</u>	9,25,200
(iii)	Consolidated Profit and Loss account of ZEE Ltd.		
	Balance	12,60,000	
	<i>Add:</i> Share in post-acquisition profit of DEE Limited (W.N.)	<u>2,01,600</u>	<u>14,61,600</u>
(iv)	Consolidated Revenue reserve account of ZEE Ltd.		
	Balance	48,00,000	
	<i>Add:</i> Post-acquisition share of DEE Limited (W.N.)	<u>10,66,800</u>	<u>58,66,800</u>

**(ii) Immediately after issue of bonus shares**

		₹	₹
(i)	Cost of control		
	Face value of Investment in DEE Limited (8,40,000 + 4,20,000)	12,60,000	
	<i>Add:</i> Capital profits (W.N.)	<u>50,400</u>	
		13,10,400	
	<i>Less:</i> Value of investments	<u>(9,60,000)</u>	
	Cost of control(Capital reserve)		3,50,400
(ii)	Minority Interest		
	Share Capital (3,60,000 + 1,80,000)	5,40,000	
	Pre-acquisition Capital Profit (W.N.)	21,600	
	Post-acquisition Revenue Profit (W.N.)		
	R/R	2,77,200	
	P/L	<u>86,400</u>	
		<u>3,63,600</u>	9,25,200
(iii)	Consolidated Profit and loss account of ZEE Ltd.		
	Balance	12,60,000	
	<i>Add:</i> Share in Post-acquisition profit of DEE Limited (W.N.)	<u>2,01,600</u>	<u>14,61,600</u>

(iv)	Consolidated Revenue reserve account of ZEE Ltd.		
	Balance	48,00,000	
	Add: Post-acquisition share of DEE Limited (W.N.)	<u>6,46,800</u>	<u>54,46,800</u>

**Consolidated Balance Sheet of ZEE Limited and its subsidiary DEE Limited  
as on 31<sup>st</sup> March, 2015**

Particulars	Note No.	₹
<b>Equity and Liabilities</b>		
(1) Shareholders fund		
(a) Equity Share Capital		36,00,000
(b) Reserves and surplus	1	79,78,800
(2) Minority Interest (W.N)		9,25,200
(3) Current Liabilities		
Trade payable	2	<u>6,12,000</u>
		<u>1,31,16,000</u>
<b>Assets</b>		
(1) Non-current Assets		
Fixed assets	3	81,84,000
(2) Current assets	4	<u>49,32,000</u>
		<u>1,31,16,000</u>

**Notes to Accounts:**

		₹	₹
1	Reserves and Surplus		
	Capital Reserve	3,50,400	
	Securities premium reserve	7,20,000	
	Profit and loss account	14,61,600	
	Revenue Reserve	<u>54,46,800</u>	79,78,800
2	Trade Payable		
	Zee Ltd.	4,44,000	
	Dee Ltd.	<u>1,68,000</u>	6,12,000
3.	Fixed assets		
	Zee Ltd.	63,36,000	

4.	Dee Ltd.	<u>18,48,000</u>	81,84,000
	Current assets		
	Zee Ltd.	35,28,000	
	Dee Ltd.	<u>14,04,000</u>	49,32,000

**Working Notes:**

## 1. Shareholding Pattern

	Number of shares	% of holding
Total shares of Dee Ltd. before bonus issue	1,20,000	100%
Total shares of Dee Ltd. after bonus issue	<u>1,80,000</u>	100%
(i) Purchased by Zee Ltd. on 31 <sup>st</sup> March, 2010	84,000	
(ii) Bonus issue (84,000/2)	<u>42,000</u>	
	1,26,000	70%
Minority Interest (36,000 + 18,000)	56,000	30%

## 2. Analysis of profits of DEE Limited

	Capital profit (before and after issue of bonus shares)	Revenue profits (before bonus issue)		Revenue profits (After bonus issue)	
		Revenue Reserve	Profit and Loss A/c	Revenue Reserve	Profit and Loss A/c
Pre-acquisition profits	24,000				
Profit and loss account on 31 <sup>st</sup> March, 2010	<u>48,000</u>				
	72,000				
Revenue Reserve		15,24,000		15,24,000	
Less: Bonus Shares				(6,00,000)	
Add: Profit during the period 1 <sup>st</sup> April, 2010 to 31 <sup>st</sup> March, 2015 (3,36,000-48,000)			<u>2,88,000</u>		<u>2,88,000</u>
	<u>72,000</u>	<u>15,24,000</u>	<u>2,88,000</u>	<u>9,24,000</u>	<u>2,88,000</u>

ZEE Limited's share (70%)	50,400	10,66,800	2,01,600	6,46,800	2,01,600
Minority's share (30%)	21,600	4,57,200	86,400	2,77,200	86,400

14. (i) This transaction qualifies for de-recognition under AS 30. Paragraph 61(b) of AS 30 requires that the cumulative gain or loss that has been recognised in the Investment Revaluation Reserve Account in respect of an "available for sale" financial asset be recognised in the Statement of Profit and Loss when the asset is de-recognized.

In the exchange of shares, Surya Limited disposes of the shares it had in Supreme Limited and receives shares in Simple Limited. Hence the company can recognize the cumulative gain of ₹ 40 in the Statement of Profit and Loss as per the provisions of AS 30.

- (ii) If a debtor agrees to pay a third party in respect of an obligation to a creditor and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payment in the debt to the third party or direct to its original creditor, the debtor recognizes the new debt obligation to the third party.

Here,

Entity A de-recognizes its obligation to pay ₹ 25 lakhs to Entity B and Entity C recognizes a new obligation to pay ₹ 25 lakhs to Entity C.

15. 1. **Computation of Shares/Fair value expected to vest at the end of each Accounting Period**

(a) **Shares Graded Every Year**

Particulars	Options Vesting	Vesting Period
Total shares under ESOP	60	-
Group 1 20% of 60	12	1 Year
Group 2 40% of 60	24	2 Years
Group 3 40% of 60	24	3 Years

(b) **Value of Options Vesting**

Group	Year	No. of Employees expected to qualify		Shares vested per employee	Total No. of Shares expected to vest	Fair value of the Option per share	Fair value of the Option
						₹	₹
I	2012-13	Actual	400-40=360	12	4,320	10.00	43,200
II	2012-13	Expected	400-40-	24	7,776	12.50	97,200

	2013-14	Actual	36=324 400-40-35=325	24	7800	12.50	97,500
III	2012-13	Expected	400-40-36-34=290	24	6960	14.00	97,440
	2013-14	Expected	400-40-35-30=295	24	7080	14.00	99,120
	2014-15	Actual	297	24	7,128	14.00	99,792

No. of Employees = Opening employees – Employees left – Employee expected to leave

**(c) Options forfeited and value to be transferred to General Reserve**

<i>Particulars</i>	<i>Group 1 2012-13</i>	<i>Group 2 2013-14</i>	<i>Group 3 2014-15</i>
Number of employee qualifying	360	325	297
Less: Number of employees actually exercising	<u>(350)</u>	<u>(319)</u>	<u>(295)</u>
Number of employee not exercising (forfeitures)	10	6	2
Number of options per employee	12	24	24
Number of options forfeited	120	144	48
Fair value	₹ 10	₹ 12.50	₹ 14
Total value forfeited and transferred to General Reserve	₹ 1,200	₹ 1,800	₹ 672

**2. Computation of Employee Compensation Expenses to be recognised**

**(a) For Year 2012-13**

<i>Particulars</i>	<i>Group 1 2012-13</i>	<i>Group 2 2013-14</i>	<i>Group 3 2014-15</i>
Total fair value to be recognized as expense	4,320	97,200	97,440
Vesting period	1 year	2 years	3 years
Amount of expense to be recognized (Total value ÷ vesting period)	43,200	48,600 (97,200/2)	32,480 (97,440/3)
		1,24,280	



**(b) For Year 2013-14**

<i>Particulars</i>	<i>Group 2 2013-14</i>	<i>Group 3 2014-15</i>
Total fair value to be recognized as expense	97,500	99,120
Vesting period	2 years	3 years
Cumulative amount of expense to be recognized (Total value ÷ Vesting period × period completed)	97,500 (97,500/2 × 2)	66,080 (99,120/3 × 2)
Less: Amount of expense recognised till 2012-13	(48,600)	(32,480)
Amount of expenses to be recognized in 2013-14	48,900	33,600

Total = ₹ 48,900 + ₹ 33,600 = ₹ 82,500

**(c) For the year 2014-2015**

<i>Particulars</i>	<i>Group 3</i>
Total Fair Value to be recognized as expense	99,792
Less: Amount of Expense Recognised till 2013-14	<u>(66,080)</u>
Amount of Expense to be recognized in 2014-15	<u>33,712</u>

**3. Ledger Accounts****(a) Employees' Compensation Amount**

<i>Year</i>	<i>Particulars</i>	<i>₹</i>		<i>Particulars</i>	<i>₹</i>
2012-13	To ESOP Outstanding A/c	<u>1,24,280</u>	2012-13	By Profit and Loss Account	<u>1,24,280</u>
		<u>1,24,280</u>			<u>1,24,280</u>
2013-14	To ESOP Outstanding A/c	<u>82,500</u>	2013-14	By Profit and Loss Account	<u>82,500</u>
		<u>82,500</u>			<u>82,500</u>
2014-15	To ESOP Outstanding A/c	<u>33,712</u>	2014-15	By Profit and Loss Account	<u>33,712</u>
		<u>33,712</u>			<u>33,712</u>

**(b) ESOP Outstanding A/c**

Year	Particulars	₹		Particulars	₹
2012-13	To General Reserve (120 × ₹ 10)	1,200	2012-13	By Employees' Compensation A/c	1,24,280
	To Share Capital (4,200 × ₹ 100)	4,20,000		By Bank (4,200 × ₹ 125)	5,25,000
	To Securities Premium (4,200 × ₹ 35)	1,47,000			
	To Balance c/d	<u>81,080</u>			
		<u>6,49,280</u>			<u>6,49,280</u>
2013-14	To General Reserve (144 × ₹ 12.50)	1,800	2013-14	By Balance b/d	81,080
	To Share Capital (7,656 × ₹ 100)	7,65,600		By Employees' Compensation A/c	82,500
	To Securities Premium (7,656 × ₹ 37.50)	2,87,100		By Bank (7,656 × ₹ 125)	9,57,000
	To Balance c/d	<u>66,080</u>			-
		<u>11,20,580</u>			<u>11,20,580</u>
2014-15	To General Reserve (48 × ₹ 14)	672	2014-15	By Balance b/d	66,080
	To Share Capital (7,080 × ₹ 100)	7,08,000		By Employees' Compensation A/c	33,712
	To Securities Premium (7,080 × ₹ 39)	<u>2,76,120</u>		By Bank (7,080 × ₹ 125)	<u>8,85,000</u>
		<u>9,84,792</u>			<u>9,84,792</u>

**Working Note:****Calculation of Securities Premium**

Particulars	Group 1 2012-13	Group 3 2013-14	Group 3 2014-15
Excise Price Received per share (Bank)	125.00	125.00	125.00
Add: Value of service received per share	<u>10.00</u>	<u>12.50</u>	<u>14.00</u>
Consideration received per share	135.00	137.50	139.00
Less: Nominal value per share	<u>(100.00)</u>	<u>(100.00)</u>	<u>(100.00)</u>
Securities premium per share	<u>35.00</u>	<u>37.50</u>	<u>39.00</u>

## 16. Books of Mutual Fund Company

<i>Date</i>	<i>Particulars</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
31.10.13	Year 2013-14 Investment in Sun Limited Investment in Moon Limited To Bank A/c (Being purchase of Sun Limited, 25,000 shares @ ₹ 20 each and 20,000 shares of Moon Limited @ ₹ 30 each)	Dr. 5,00,000 6,00,000	11,00,000
31.03.14	Revenue A/c To Provision for depreciation (Being market value of Sun Limited depreciated by Re. 1 each for 25,000 shares)	Dr. 25,000	25,000
31.03.14	Investment in Moon Limited To Unrealised Appreciation Reserve (Being the appreciation in the value of shares of Moon Ltd. by ₹ 2 per share)	Dr. 40,000	40,000
<b>Year 2014-15</b>			
31.05.14	Bank Account Loss on disposal of investment To Investment in Sun Limited (Being Investment of ₹ 5,00,000 in shares of Sun Limited sold for ₹ 4,62,500 and Loss ₹ 37,500 incurred)	Dr. 4,62,500 Dr. 37,500	5,00,000
31.5.14	Provision for depreciation Revenue A/c To Loss on disposal of investment (Earlier depreciation provision provided being reserved on disposal of total shares of Sun Limited and the balance amount debited to revenue account)	Dr. 25,000 Dr. 12,500	37,500
31.05.14	Bank account To Investment in Moon Limited To Profits on disposal of investment (Being 20,000 shares of Moon Limited sold @ ₹ 33.50)	Dr. 6,70,000	6,40,000 30,000

31.05.14	Profit on disposal of investment	Dr.	30,000	70,000
	Unrealized Appreciation Reserve To Revenue A/c (Being profit not booked last year and kept in the reserve now booked to Revenue Account)	Dr.	40,000	

**17. Calculation of provision required on advances as on 31st March, 2015**

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

**18. (i) Calculation of Market Price of shares of P Ltd. and Q Ltd.**

Market price = EPS x P/E ratio

	P Ltd.	Q Ltd.
	₹	₹
Earnings after tax	2,00,00,000	24,00,000
No. of equity shares	10,00,000	4,00,000
EPS	$\frac{2,00,00,000}{10,00,000} = ₹ 20$	$\frac{24,00,000}{4,00,000} = ₹ 6$
P/E ratio	12	8
	$12 \times ₹ 20 = ₹ 240$	$8 \times ₹ 6 = ₹ 48$

**(ii) Calculation of Swap ratio based on Market Price**

$$\begin{aligned} \text{Swap ratio} &= \frac{\text{Market price per share of Q Ltd.}}{\text{Market price per share of P Ltd.}} \\ &= 48/240 \text{ or } 0.2 \end{aligned}$$

Swap ratio = 20 shares of P Ltd. for every 100 shares of Q Ltd.

Or 1 share of P Ltd. for every 5 shares of Q Ltd.

**(iii) Computation of EPS of P Ltd. after takeover of Q Ltd.**

$$\text{Number of shares issued to Q Ltd.} = 4,00,000 \times \frac{20}{100} = 80,000 \text{ shares}$$

$$\begin{aligned} \text{Total number of shares of P. Ltd. after takeover} \\ = 10,00,000 + 80,000 = 10,80,000 \end{aligned}$$

$$\begin{aligned} \text{Total earnings of P Ltd. after takeover of Q Ltd.} \\ = ₹ 2,00,00,000 + ₹ 24,00,000 \\ = ₹ 2,24,00,000 \end{aligned}$$

$$\text{EPS of P Ltd. after takeover of Q Ltd.} = \frac{₹ 2,24,00,000}{10,80,000 \text{ shares}} = ₹ 20.74$$

**(iv) Determination of market value of shares of the merged company**

Market price = PE ratio × EPS

$$\text{P Ltd. after takeover} = 12 \times ₹ 20.74 = ₹ 248.88$$

$$\begin{aligned} \text{Market value of P Ltd.} &= \text{Total No. of shares} \times \text{Market Price per share} \\ &= 10,80,000 \times ₹ 248.88 = ₹ 26,87,90,400 \end{aligned}$$

**Note:** PE ratio of P Ltd. before takeover has been used for calculation of Market Price of Share of P Ltd. after take over

**19. Gross Value Added Statement for the year ended 31<sup>st</sup> March, 2015**

<i>Particular</i>	<i>₹ in lakhs</i>	<i>₹ in lakhs</i>
Sales		1988
<i>Less:</i> Cost of bought in materials and services:		
Production and operational and services expenses (694 + 118 + 218)	1030	
Administration expenses (166-18)	148	
Interest on loan for working capital	18	
Excise duty (W.N.)	<u>92</u>	<u>1288</u>
Value added by manufacturing and trading activities		700
<i>Add:</i> Other income		<u>110</u>
Total value added		<u>810</u>

**Application of value added**

	₹ in lakhs	₹ in lakhs	%
To Employees			
Salaries, wages, gratuities etc.		164	20.25
To Directors			
Salaries and commission		18	2.22
To Government			
Cess and local taxes (196-92)	104		
Income Tax [60-6 (deferred tax)]	<u>54</u>	158	19.51
To Providers of capital			
Interest on Debentures	4		
Interest on fixed loans	36		
Dividends	<u>190</u>	230	28.39
To Provide for maintenance and expansion of the company			
Depreciation	34		
General reserve	90		
Deferred tax	6		
Retained Profit (130-20)	<u>110</u>	<u>240</u>	<u>29.63</u>
		<u>810</u>	<u>100.00</u>

**Note:** Deferred tax account could alternatively be shown as an items to pay to government

**Statement showing reconciliation of Gross Value Added with profit before taxation**

	₹ in lakhs	₹ in lakhs
Profit before taxes		450
<i>Add:</i> Depreciation	34	
Director's remuneration	18	
Salaries, wages, gratuities etc.	164	
Cess and local taxes	104	
Interest on Debentures	4	
Interest on fixed loan	<u>36</u>	<u>360</u>
Total value added		<u>810</u>

**Working Note:**

- (1) Calculation of Excise Duty

Let cost of bought in materials and services is X

So, excise duty is  $1/14^{\text{th}}$  of X = X/14

$$X = 1,030 + 148 + 18 + X/14$$

$$X = 1,196 + X/14$$

$$13X/14 = 1,196$$

$$X = 1,288$$

Hence Excise duty = ₹ 1,288 - 1,196 = ₹ 92 lakhs

20.

**Capable Limited****Computation of Economic Value Added**

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

**Working Notes:**

- (1)
- Cost of Equity**
- = Risk free Rate + Beta Factor (Market Rate – Risk Free Rate)

$$9\% + 1.05 (16 - 9) = 9\% + 7.35\% = 16.35\%$$

- (2)
- Cost of Debt**

Interest ₹ 40 lakhs

Less: Tax (30%) (₹ 12 lakhs)

Interest after Tax ₹ 28 lakhs

$$\text{Cost of Debt} = \frac{28}{400} \times 100 = 7\%$$

- (3)
- Weighted Average Cost of Capital**

Cost of Equity ₹ 6,000 lakhs × 16.35% (W.N.1) ₹ 981 lakhs

Cost of Debt ₹ 400 lakhs × 7% (W.N.2) ₹ 28 lakhs

₹ 1,009 lakhs

$$WACC = \frac{1,009}{6,400} \times 100 = 15.77\% \text{ (approx.)}$$

(4) **Capital Employed**

	<i>₹ in lakhs</i>
Share Capital	2,000
Reserves and Surplus	4,000
Long term debts	<u>400</u>
	<u>6,400</u>

(5) **Net Operating Profit after Tax**

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



## PAPER – 2: STRATEGIC FINANCIAL MANAGEMENT

### QUESTIONS AND ANSWERS

#### QUESTIONS

##### International Capital Budgeting

1. 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
Cash flows in Indian ₹ (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 ₹ 1.

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

- African Rand cash flows are converted into rupees and discounted at a risk adjusted rate.
- All cash flows for these projects will be discounted at a rate of 20% to reflect its high risk.
- Ignore taxation.

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

##### Leasing

2. Khalid Tour Operator Ltd. is considering buying a new car for its fleet for local touring purpose. Purchase Manager has identified Renault Duster model car for acquisition.

Company can acquire it either by borrowing the fund from bank at 12% p.a. or go for leasing option involving yearly payment (in the end) of ₹ 2,70,000 for 5 years.

The new car shall cost ₹ 10,00,000 and would be depreciable at 25% as per WDV method for its owner. The residual value of car is expected to be ₹ 67,000 at the end of 5 years.

The corporate tax rate is 33%. You are required to:

- (a) Calculate which of the two options borrowings or leasing shall be financially more advantageous for the Company.
- (b) Measure the sensitivity of Leasing/ Borrowing Decision in relation to each of the following parameters:
  - (i) Rate of Borrowing
  - (ii) Residual Value
  - (iii) Initial Outlay

Among above which factor is more sensitive.

### Swaps

3. NoBank offers a variety of services to both individuals as well as corporate customers. NoBank generates funds for lending by accepting deposits from customers who are paid interest at PLR which keeps on changing.

NoBank is also in the business of acting as intermediary for interest rate swaps. Since it is difficult to identify matching client, NoBank acts counterparty to any party of swap.

Sleepless approaches NoBank who have already have ₹ 50 crore outstanding and paying interest @PLR+80bp p.a. The duration of loan left is 4 years. Since Sleepless is expecting increase in PLR in coming year, he asked NoBank for arrangement of interest of interest rate swap that will give a fixed rate of interest.

As per the terms of agreement of swap NoBank will borrow ₹50 crore from Sleepless at PLR+80bp per annum and will lend ₹ 50 crore to Sleepless at fixed rate of 10% p.a. The settlement shall be made at the net amount due from each other. For this services NoBank will charge commission @0.2% p.a. if the loan amount. The present PLR is 8.2%.

You as a financial consultant of NoBank have been asked to carry out scenario analysis of this arrangement.

Three possible scenarios of interest rates expected to remain in coming 4 years are as follows:

	Year 1	Year 2	Year 3	Year 4
Scenario 1	10.25	10.50	10.75	11.00
Scenario 2	8.75	8.85	8.85	8.85
Scenario 3	7.20	7.40	7.60	7.70

Assuming that cost of capital is 10%, whether this arrangement should be accepted or not.

### Security Analysis

4. Two companies A Ltd. and B Ltd. paid a dividend of ₹3.50 per share. Both are anticipating that dividend shall grow @ 8%. The beta of A Ltd. and B Ltd. are 0.95 and 1.42 respectively.

The yield on GOI Bond is 7% and it is expected that stock market index shall increase at an annual rate of 13%. You are required to determine:

- Value of share of both companies.
- Why there is a difference in the value of shares of two companies.
- If current market price of share of A Ltd. and B Ltd. are ₹74 and ₹55 respectively. As an investor what course of action should be followed?

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

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

Calculate:

- Stock value of bond.
  - The percentage of downside risk.
  - The conversion premium
  - The conversion parity price of the stock.
6. Delta Ltd.'s current financial year's income statement reports its net income as ₹ 15,00,000. Delta's marginal tax rate is 40% and its interest expense for the year was ₹ 15,00,000. The company has ₹ 1,00,00,000 of invested capital, of which 60% is debt. In addition, Delta Ltd. tries to maintain a Weighted Average Cost of Capital (WACC) of 12.6%.

- (i) Compute the operating income or EBIT earned by Delta Ltd. in the current year.
- (ii) What is Delta Ltd.'s Economic Value Added (EVA) for the current year?
- (iii) Delta Ltd. has 2,50,000 equity shares outstanding. According to the EVA you computed in (ii), how much can Delta pay in dividend per share before the value of the company would start to decrease? If Delta does not pay any dividends, what would you expect to happen to the value of the company?

### Capital Budgeting

7. XY Ltd. has under its consideration a project with an initial investment of ₹ 1,00,000. Three probable cash inflow scenarios with their probabilities of occurrence have been estimated as below:

Annual cash inflow (₹)	20,000	30,000	40,000
Probability	0.1	0.7	0.2

The project life is 5 years and the desired rate of return is 20%. The estimated terminal values for the project assets under the three probability alternatives, respectively, are ₹ 0, 20,000 and 30,000.

You are required to:

- (i) Find the probable NPV;
- (ii) Find the worst-case NPV and the best-case NPV; and
- (iii) State the probability occurrence of the worst case, if the cash flows are perfectly positively correlated over time.

### Indian Capital Market

8. From the following data for Government securities, calculate the forward rates:

Face value (₹)	Interest rate	Maturity (Year)	Current price (₹)
1,00,000	0%	1	91,500
1,00,000	10%	2	98,500
1,00,000	10.5%	3	99,000

9. BSE 5000
- |                         |             |
|-------------------------|-------------|
| Value of portfolio      | ₹ 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.

### Mergers and Acquisitions

10. XY Ltd. has two major operating divisions, furniture manufacturing and real estate, with revenues of ₹ 2600 crore and ₹ 6200 crore respectively. Following financial information is available.

#### Balance Sheet as on 31-3-2015

Liabilities	Amount (₹ Crore)	Assets	Amount (₹ Crore)
Ordinary Shares (₹10 Per Share)	500	Land and Buildings	800
Reserves	1300	Plant and Machinery	1400
Secured Term Loans	600	Current Assets	2500
13% Debenture (₹100 par)	500		
Current Liabilities	1800		
	4700		4700

Summarised cash flow data for XY Ltd. is as follows:

	Amount (₹ Crore)
Sales	8800
Operating expenses	8030
Head Office Expenses	80
Interest	110
Taxation	140
Dividends	150

The company's current share price is ₹ 118.40, and each debenture is trading in market at ₹ 131.

Projected financial data (in ₹ Crore) in real terms (excluding depreciation) of the two divisions is as follows:

Year	1	2	3	4	5	6 Onwards
<b>Furniture Manufacturing</b>						
Operating Profit before Tax	450	480	500	520	570	600
Allocated HO Overheads*	40	40	40	40	40	40
Depreciation	100	80	70	80	80	80
<b>Real Estate</b>						
Operating Profit before Tax	320	400	420	440	460	500
Allocated HO Overheads*	40	30	30	30	30	30
Depreciation	50	50	50	50	50	50

\* Allocated HO Overheads reflect actual cash flows.

Other Information:

- Applicable Corporate tax rate is of 30%, payable in the year, the relevant cash flow arises.
- Inflation is expected to remain at approximately 3% per year.
- The risk free rate is 5.5% and the market return 14%.
- XY Ltd.'s equity beta is 1.15.
- The average equity betas in the Furniture Manufacturing and Realty Sectors are 1.3 and 0.9 respectively and the gearing levels in Furniture Manufacturing and Realty sectors by market values are 70% equity 30% debt and 80% equity 20% debt respectively.
- The current cost of the debentures and long term loan are almost identical.
- The debentures are redeemable at par in 15 years' time.

The company is considering a demerger whereby the two divisions shall be floated separately on the stock market.

#### Terms of Demerger

- (1) The debentures would be serviced by the real estate division and the long term loans by the furniture manufacturing division.
- (2) The existing equity would be split evenly between the divisions, although new ordinary shares would be issued to replace existing shares.
- (3) If a demerger occurs allocated overhead would rise to ₹ 60 crore per year for each company.

- (4) Demerger would involve single one time after tax cost of ₹ 160 crore in the first year which would be shared equally by the two companies. There would be no other significant impact on expected cash flows.

**Required**

Using real cash flows and time horizon of 15 year time and infinite period, evaluates whether or not it is expected to be financially advantageous to the original shareholders of XY Ltd. for the company to separately float the two divisions on the stock market.

**Note:** In any gearing estimates the Furniture Manufacturing division may be assumed to comprise 55% of the market value of equity of XY Ltd, and Real Estate division 45%.

Year	1	2	3	4	5	6 -15
PVAF@10%	0.909	0.821	0.751	0.683	0.621	3.815
PVAF@8.5%	0.922	0.849	0.783	0.722	0.665	4.364

11. Two companies Bull Ltd. and Bear Ltd. recently have been merged. The merger initiative has been taken by Bull Ltd. to achieve a lower risk profile for the combined firm in spite of fact that both companies belong to different industries and disclose a little co-movement in their profit earning streams. Though there is likely to synergy benefits to the tune of ₹ 7 crore from proposed merger. Further both companies are equity financed and other details are as follows:

	Market Capitalization	Beta
Bull Ltd.	₹1000 crore	1.50
Bear Ltd.	₹500 crore	0.60

Expected Market Return and Risk Free Rate of Return are 13% and 8% respectively. Shares of merged entity have been distributed in the ratio of 2:1 i.e. market capitalization just before merger. You are required to:

- (a) Calculate return on shares of both companies before merger and after merger.  
 (b) Calculate the impact of merger on Mr. X, a shareholder holding 4% shares in Bull Ltd. and 2% share of Bear Ltd.

**Portfolio Theory**

12. A study by a Mutual fund has revealed the following data in respect of three securities:

Security	$\sigma$ (%)	Correlation with Index, Pm
A	20	0.60
B	18	0.95
C	12	0.75

The standard deviation of market portfolio (BSE Sensex) is observed to be 15%.

- (i) What is the sensitivity of returns of each stock with respect to the market?
  - (ii) What are the covariances among the various stocks?
  - (iii) What would be the risk of portfolio consisting of all the three stocks equally?
  - (iv) What is the beta of the portfolio consisting of equal investment in each stock?
  - (v) What is the total, systematic and unsystematic risk of the portfolio in (iv)?
13. An investor holds two stocks A and B. An analyst prepared ex-ante probability distribution for the possible economic scenarios and the conditional returns for two stocks and the market index as shown below:

Economic scenario	Probability	Conditional Returns %		
		A	B	Market
Growth	0.40	25	20	18
Stagnation	0.30	10	15	13
Recession	0.30	-5	-8	-3

The risk free rate during the next year is expected to be around 11%. Determine whether the investor should liquidate his holdings in stocks A and B or on the contrary make fresh investments in them. CAPM assumptions are holding true.

#### Money Market Instruments

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

#### Financial Services

15. M/s Atlantic Company Limited with a turnover of ₹ 4.80 crores expecting growth of 25% for forthcoming year. Average credit period is 90 days. The past experience shows that bad debt losses are 1.75% on sales. The Company's administering cost for collecting receivable is ₹ 6,00,000/-.

It has decided to take factoring services of Pacific Factors on terms that factor will be receivable by charging 2% commission and 20% risk with recourse. The Factor will pay advance on receivables to the firm at 16% interest rate per annum after withholding 10% as reserve.

Calculate the effective cost of factoring to the firm. (Assume 360 days in a year).



**Dividend Decisions**

16. Telbel Ltd. is considering undertaking a major expansion an immediate cash outlay of ₹ 150 crore. The Board of Director of company are expecting to generate an additional profit of ₹ 15.30 crore after a period of one year. Further, it is expected that this additional profit shall grow at the rate of 4% for indefinite period in future.

Presently, Telbel Ltd. is completely equity financed and has 50 crore shares of ₹10 each. The current market price of each share is ₹ 22.60 (cum dividend). The company has paid a dividend of ₹ 1.40 per share in last year. For the last few years dividend is increasing at a compound rate of 6% p.a. and it is expected to be continued in future also. This growth rate shall not be affected by expansion project in any way.

Board of Directors are considering following ways of financing the possible expansion:

- (1) A right issue on ratio of 1:5 at price of ₹15 per share.
- (2) A public issue of shares.

In both cases the dividend shall become payable after one year.

You as a Financial Consultant required to:

- (a) Determine whether it is worthwhile to undertake the project or not.
- (b) Calculate ex-dividend market price of share if complete expansion is financed from the right issue.
- (c) Calculate the number of new equity shares to be issued and at what price assuming that new shareholders do not suffer any loss after subscribing new shares.
- (d) Calculate the total benefit from expansion to existing shareholders under each of two financing option.

**Foreign Exchange Risk Management**

17. Nitrogen Ltd, a UK company is in the process of negotiating an order amounting to €4 million with a large German retailer on 6 months credit. If successful, this will be the first time that Nitrogen Ltd has exported goods into the highly competitive German market. The following three alternatives are being considered for managing the transaction risk before the order is finalized.
- (i) Invoice the German firm in Sterling using the current exchange rate to calculate the invoice amount.
  - (ii) Alternative of invoicing the German firm in € and using a forward foreign exchange contract to hedge the transaction risk.
  - (iii) Invoice the German first in € and use sufficient 6 months sterling future contracts (to the nearly whole number) to hedge the transaction risk.

Following data is available:

Spot Rate	€ 1.1750 - €1.1770/£
6 months forward premium	0.60-0.55 Euro Cents
6 months further contract is currently trading at	€1.1760/£
6 months future contract size is	£62500
Spot rate and 6 months future rate	€1.1785/£

Required:

- (a) Calculate to the nearest £ the receipt for Nitrogen Ltd, under each of the three proposals.
- (b) In your opinion, which alternative would you consider to be the most appropriate and the reason thereof.
18. Following information relates to AKC Ltd. which manufactures some parts of an electronics device which are exported to USA, Japan and Europe on 90 days credit terms.

Cost and Sales information:

	Japan	USA	Europe
Variable cost per unit	₹225	₹395	₹510
Export sale price per unit	Yen 650	US\$10.23	Euro 11.99
Receipts from sale due in 90 days	Yen 78,00,000	US\$1,02,300	Euro 95,920

Foreign exchange rate information:

	Yen/₹	US\$/₹	Euro/₹
Spot market	2.417-2.437	0.0214-0.0217	0.0177-0.0180
3 months forward	2.397-2.427	0.0213-0.0216	0.0176-0.0178
3 months spot	2.423-2.459	0.02144-0.02156	0.0177-0.0179

Advice AKC Ltd. by calculating average contribution to sales ratio whether it should hedge it's foreign currency risk or not.

19. AMK Ltd. an Indian based company has subsidiaries in U.S. and U.K.

Forecasts of surplus funds for the next 30 days from two subsidiaries are as below:

U.S.	\$12.5 million
U.K.	£ 6 million

Following exchange rate information is obtained:

	\$/₹	£/₹
Spot	0.0215	0.0149
30 days forward	0.0217	0.0150

Annual borrowing/deposit rates (Simple) are available.

₹	6.4%/6.2%
\$	1.6%/1.5%
£	3.9%/3.7%

The Indian operation is forecasting a cash deficit of ₹500 million.

It is assumed that interest rates are based on a year of 360 days.

- (i) Calculate the cash balance at the end of 30 days period in ₹ for each company under each of the following scenarios ignoring transaction costs and taxes:
    - (a) Each company invests/finances its own cash balances/deficits in local currency independently.
    - (b) Cash balances are pooled immediately in India and the net balances are invested/borrowed for the 30 days period.
  - (ii) Which method do you think is preferable from the parent company's point of view?
20. Write a short note on
- (a) Nostro, Vostro and Loro Accounts
  - (b) Characteristics of Financial Leasing
  - (c) Marking to Market
  - (d) Relevant assumptions of CAPM
  - (e) Exchange Traded Funds

### SUGGESTED ANSWERS / HINTS

1. **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 ₹ '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 ₹ '000 (2)	-33333	9167	14117	19965
Net Cash Flow in ₹ '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 (₹ '000)

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

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

## 2. Working Notes:

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

Year	Opening WDV	Depreciation	Closing WDV	Tax Shield
1	10,00,000	2,50,000	7,50,000	82,500
2	7,50,000	1,87,500	5,62,500	61,875
3	5,62,500	1,40,625	4,21,875	46,406
4	4,21,875	1,05,469	3,16,406	34,805
5	3,16,406	2,49,406*	-	82,304

\* Short Term Capital Loss

(ii) PV of cash outflow under Borrowing Option

Year	Investment/Salvage	Tax Benefit on Dep./STCL	PVF@8.04%	PV
0	(10,00,000)	-	1.00	(10,00,000)
1	-	82,500	0.925	76,313
2	-	61,875	0.857	53,027
3	-	46,406	0.793	36,800
4	-	34,805	0.734	25,547
5	-	82,304	0.679	55,884

5	67,000	-	0.679	45,493
				(7,06,936)

(iii) PV of cash outflow under Leasing Option

Year	Lease Rental after Tax	PVAF@8.04%	PV
1-5	2,70,000(1-0.33) = (1,80,900)	3.988	(7,21,429)

- (a) Since PV of cash outflows is least in case of Borrowing option hence it shall be more advantageous to go for the same.
- (b) (i) Sensitivity to Borrowing Rate can be calculated by determining the rate of borrowing (post tax) at which PV of cash flows shall be equal under both options i.e. IRR.

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

PV of cash outflow under Borrowing Option

Year	Investment/Salvage	Tax Benefit on Dep.	PVF@10%	PV
0	(10,00,000)	-	1.00	(10,00,000)
1	-	82,500	0.909	74,993
2	-	61,875	0.826	51,109
3	-	46,406	0.751	34,851
4	-	34,805	0.683	23,772
5	-	82,304	0.621	51,111
5	67,000	-	0.621	41,607
				(7,22,557)

PV of cash outflow under Leasing Option

Year	Lease Rental after Tax	PVAF@10%	PV
1-5	2,70,000(1-0.33) = (1,80,900)	3.79	(6,85,611)

$$\text{NPV @ 8.04\%} = 7,06,936 - 7,21,429 = -14,493$$

$$\text{NPV @ 10\%} = 7,22,557 - 6,85,611 = 36,946$$

Using IRR Formula:

$$= 8.04 + \frac{-14493}{-14493 - 36946} \times (10 - 8.04)$$

$$= 8.59\%$$

$$\text{Sensitivity of Borrowing Rate} = \frac{8.59 - 8.04}{8.59} \times 100 = 6.40\%$$

## (ii) Sensitivity of Residual Value

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

PV of cash outflow under Borrowing Option

Year	Investment/ Salvage	Tax Benefit	PVF@8.04 %	PV
0	(10,00,000)	-	1.00	(10,00,000)
1	-	82,500	0.925	76,313
2	-	61,875	0.857	53,027
3	-	46,406	0.793	36,800
4	-	34,805	0.734	25,547
5	-	(3,16,406-R) 0.33	0.679	70,897 - 0.224R
5	R	-	0.679	0.679 R
				(7,37,416)+0.455R

$$\text{Accordingly } (7,37,416)+0.455R = (7,21,429)$$

$$R = 35,136$$

$$\text{Sensitivity of Residual Value} = \frac{35,136 - 67,000}{67,000} \times 100 = 47.56\%$$

## (iii) Sensitivity of Initial Outlay

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

$$= I - 2,93,064 \text{ and accordingly}$$

$$I - 2,93,064 = 7,21,429$$

$$I = 10,14,493$$

$$\text{Sensitivity of Initial Investment} = \frac{1014493 - 1000000}{1000000} \times 100 = 1.4493\%$$

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

3. Interest and Commission due from Sleepless = ₹ 50 crore (0.10+0.002) = ₹ 5.10 crore

**Net Sum Due to Sleepless in each of Scenarios**

Scenario 1

Year	PLR	Sum due to Sleepless	Net Sum Due (₹ Crore)		(₹ Crore)
1	10.25	50 (10.25 + 0.8)%= 5.525	5.10 - 5.525 = - 0.425	0.909	-0.38633
2	10.5	50 (10.50 + 0.8)%= 5.650	5.10 - 5.650 = - 0.550	0.826	-0.4543
3	10.75	50 (10.75 + 0.8)%= 5.775	5.10 - 5.775 = - 0.675	0.751	-0.50693
4	11	50 (11.00 + 0.8)%= 5.900	5.10 - 5.900 = - 0.800	0.683	-0.5464
					<b>-1.89395</b>

Scenario 2

Year	PLR	Sum due to Sleepless	Net Sum Due (₹ Crore)		(₹ Crore)
1	8.75	50 (8.75 + 0.8)%= 4.775	5.10 - 4.775 = 0.325	0.909	0.295425
2	8.85	50 (8.85 + 0.8)%= 4.825	5.10 - 4.825 = 0.275	0.826	0.22715
3	8.85	50 (8.85 + 0.8)%= 4.825	5.10 - 4.825 = 0.275	0.751	0.206525
4	8.85	50 (8.85 + 0.8)%= 4.825	5.10 - 4.825 = 0.275	0.683	0.187825
					<b>0.916925</b>

Scenario 3

Year	PLR	Sum due to Sleepless	Net Sum Due (₹ Crore)		(₹ Crore)
1	7.20	50 (7.20 + 0.8)%= 4.00	5.10 - 4.00 = 1.10	0.909	0.9999
2	7.40	50 (7.40 + 0.8)%= 4.10	5.10 - 4.10 = 1.00	0.826	0.826
3	7.60	50 (7.60 + 0.8)%= 4.20	5.10 - 4.20 = 0.90	0.751	0.6759
4	7.70	50 (7.70 + 0.8)%= 4.25	5.10 - 4.25 = 0.85	0.683	0.58055
					<b>3.08235</b>

Decision: Since the NPV of the proposal is positive in Scenario 2 (Best Case) and Scenario 3 (Most likely Case) the proposal of swap can be accepted. However, if management of NoBank is of strong opinion that PLR are likely to be more than 10% in the years to come then it can reconsider its decision.

4. (a) First of all we shall compute Cost of Capital ( $K_e$ ) of these companies using CAPM as follows:

$$K_{e(A)} = 7.00\% + (13\% - 7\%)0.95$$

$$= 7.00\% + 5.70\% = 12.7\%$$

$$K_{e(B)} = 7.00\% + (13\% - 7\%)1.42$$

$$= 7.00\% + 8.52\% = 15.52\%$$

$$P_A = \frac{3.50(1.08)}{0.127 - 0.08} = \frac{3.78}{0.047} = ₹80.43$$

$$P_B = \frac{3.50(1.08)}{0.1552 - 0.08} = \frac{3.78}{0.0752} = ₹50.27$$

- (b) The valuation of share of B Ltd. is higher because if systematic risk is higher though both have same growth rate.
- (c) If the price of share of A Ltd. is ₹74, the share is undervalued and it should be bought. If price of share of B Ltd. is ₹55, it is overvalued and should not be bought.

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

$$12 \times 20 = ₹ 240$$

**(ii) Percentage of the downside risk**

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

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

**(iii) Conversion Premium**

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

$$\frac{₹ 265 - ₹ 240}{₹ 240} \times 100 = 10.42\%$$

**(iv) Conversion Parity Price**

$$\frac{\text{Bond Price}}{\text{No. of Shares on Conversion}}$$

$$\frac{₹ 265}{20} = ₹ 13.25$$

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

**6. (i) Taxable income = Net Income / (1 – 0.40)**

$$\text{or, Taxable income} = ₹ 15,00,000 / (1 - 0.40) = ₹ 25,00,000$$

Again, taxable income = EBIT – Interest



or, EBIT = Taxable Income + Interest  
 = ₹ 25,00,000 + ₹ 15,00,000 = ₹ 40,00,000

(ii) EVA = EBIT (1 – T) – (WACC × Invested capital)  
 = ₹ 40,00,000 (1 – 0.40) – (0.126 × ₹ 1,00,00,000)  
 = ₹ 24,00,000 – ₹ 12,60,000 = ₹ 11,40,000

(iii) EVA Dividend = ₹ 11,40,000/2,50,000 = ₹ 4.56

If Delta Ltd. does not pay a dividend, we would expect the value of the firm to increase because it will achieve higher growth, hence a higher level of EBIT. If EBIT is higher, then all else equal, the value of the firm will increase.

7. The expected cash inflows of the project are as follows:

Year	Pr = 0.1	Pr = 0.7	Pr = 0.2	Total
	₹	₹	₹	₹
1	2,000	21,000	8,000	31,000
2	2,000	21,000	8,000	31,000
3	2,000	21,000	8,000	31,000
4	2,000	21,000	8,000	31,000
5	2,000	21,000	8,000	31,000
5	0	14,000	6,000	20,000

(i) NPV based on expected cash flows would be as follows:

$$= -₹ 1,00,000 + \frac{₹ 31,000}{(1+0.20)^1} + \frac{₹ 31,000}{(1+0.20)^2} + \frac{₹ 31,000}{(1+0.20)^3} + \frac{₹ 31,000}{(1+0.20)^4} + \frac{₹ 31,000}{(1+0.20)^5} + \frac{₹ 20,000}{(1+0.20)^5}$$

$$= -₹ 1,00,000 + ₹ 25,833.33 + ₹ 21,527.78 + ₹ 17,939.81 + ₹ 14,949.85 + ₹ 12,458.20 + ₹ 8,037.55$$

NPV = ₹ 746.52

(ii) For the worst case, the cash flows from the cash flow column farthest on the left are used to calculate NPV

$$= -₹ 100,000 + \frac{₹ 20,000}{(1+0.20)^1} + \frac{₹ 20,000}{(1+0.20)^2} + \frac{₹ 20,000}{(1+0.20)^3} + \frac{₹ 20,000}{(1+0.20)^4} + \frac{₹ 20,000}{(1+0.20)^5}$$

$$= -₹ 100,000 + ₹ 16,666.67 + ₹ 13,888.89 + ₹ 11,574.07 + ₹ 9,645.06 + ₹ 8,037.76$$

NPV = - ₹ 40,187.76

For the best case, the cash flows from the cash flow column farthest on the right are used to calculate NPV

$$= - ₹ 1,00,000 + \frac{₹ 40,000}{(1+0.20)^1} + \frac{₹ 40,000}{(1+0.20)^2} + \frac{₹ 40,000}{(1+0.20)^3} + \frac{₹ 40,000}{(1+0.20)^4} + \frac{₹ 40,000}{(1+0.20)^5} + \frac{₹ 30,000}{(1+0.20)^5}$$

$$= - ₹ 1,00,000 + ₹ 33,333.33 + ₹ 27,777.78 + ₹ 23,148.15 + ₹ 19,290.12 + ₹ 16,075.10 + ₹ 12,056.33$$

$$\text{NPV} = ₹ 31,680.81$$

(iii) If the cash flows are perfectly dependent, then the low cash flow in the first year will mean a low cash flow in every year. Thus the possibility of the worst case occurring is the probability of getting ₹ 20,000 net cash flow in year 1 is 10%.

**8. Consider one-year Treasury bill.**

$$91,500 = \frac{1,00,000}{(1+r_1)}$$

$$1+r_1 = \frac{100,000}{91,500} = 1.092896$$

$$r_1 = 0.0929 \text{ or } 0.093 \text{ say } 9.30\%$$

**Consider two-year Government Security**

$$98,500 = \frac{10,000}{1.093} + \frac{1,10,000}{1.093(1+r_2)}$$

$$98,500 = 9,149.131 + \frac{1,10,000}{1.093(1+r_2)}$$

$$\Rightarrow 89,350.87 = \frac{1,00,640.4}{1+r_2}$$

$$\Rightarrow 1+r_2 = 1.126351$$

$$\Rightarrow r_2 = 0.12635$$

$$\Rightarrow r_2 = 0.1263 \text{ say } 12.63\%$$

**Consider three-year Government Securities:**

$$99,000 = \frac{10,500}{1.093} + \frac{10,500}{1.093 \times 1.1263} + \frac{1,10,500}{1.093 \times 1.1263(1+r_3)}$$

$$\Rightarrow 99,000 = 9,606.587 + 8,529.33 + \frac{89,761.07}{1+r_3}$$

$$\Rightarrow 80,864.083 = \frac{89,761.07}{1+r_3}$$

$$\Rightarrow 1+r_3 = 1.1100240$$

$$\Rightarrow r_3 = 0.1100240 \text{ say } 11.002\%$$

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

∴ Price of the future contract = ₹50 x 5,050 = ₹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 =  $4500 + 4500 (0.09-0.06) \times \frac{1}{12} = 4,511.25$

Therefore, Gain from the short futures position is =  $6 \times (5050 - 4511.25) \times 50$   
= ₹1,61,625

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

10. To decide whether the XY Ltd. should go for the option of demerger i.e. floating two companies for Furniture Manufacturing business and Real Estate we should compare their values.

**Working Notes:**

(i) **Calculation of Discounting Rates**

(a) For Furniture Manufacturing

Market Value of Debt (Secured Loan)	₹ 600.00 crore
Market Value of Equity (Rs.118.40 x 50 crore x 55%)	<u>₹ 3256.00 crore</u>
Total	<u>₹ 3856.00 crore</u>

Gearing Levels

Equity	Debt
$\frac{3256.00}{3856.00} = 84.44\%$	$\frac{600.00}{3856.00} = 15.56\%$

Since this level of gearing differs from the gearing level of industry to find out the beta we must re-gear the asset beta taking into account the current structure. Assuming Debt to be risk free let us de-gear the beta as follows:

$$\beta_U = \frac{\beta_L}{[1 + (1 - T) D / E]}$$

Accordingly,

$$\beta_U = \frac{1.30}{[1 + (1 - 0.30) 30 / 70]} = 1.00$$

Re-gearing

$$\beta_L = \beta_U [1 + (1 - T) D / E]$$

$$\beta_L = 1.00 [1 + (1 - 0.30) 15.56 / 84.44] = 1.129$$

Cost of Equity using CAPM

$$K_e = 5.50\% + 1.129(14\% - 5.50\%) = 15.10\%$$

Cost of Debt using Short Cut Method

$$k_d = \frac{13(1 - 0.30) + \frac{(100 - 131)}{15}}{\frac{100 + 131}{2}} = 0.0609 \text{ i.e. } 6.09\%$$

WACC of Furniture Manufacturing Division

$$15.10\% \times 84.44\% + 6.09\% \times 15.56\% = 13.70\%$$

$$\text{Real WACC} = \frac{(1 + \text{Nominal Rate})}{(1 + \text{Inflation Rate})} - 1 = \frac{(1 + 0.1370)}{(1 + 0.03)} - 1 = 10.39 \text{ say } 10\%$$

(b) For Real Estate

Market Value of Debt (Secured Loan)	₹ 655.00 crore
Market Value of Equity (Rs.118.40 x 50 crore x 45%)	<u>₹ 2,664.00 crore</u>
Total	<u>₹ 3,319.00 crore</u>

Gearing Levels

Equity	Debt
$\frac{2,664.00}{3,319.00} = 80.27\%$	$\frac{655.00}{3,319.00} = 19.73\%$

Since this level of gearing is almost equal to the gearing level of industry the beta of industry shall be the beta of Real Estate Division and Cost of Equity using CAPM will be:

$$K_e = 5.50\% + 0.90(14\% - 5.50\%) = 13.15\%$$

WACC of Real Estate Division

$$13.15\% \times 80.27\% + 6.09\% \times 19.73\% = 11.76\%$$

$$\text{Real WACC} = \frac{(1 + \text{NominalRate})}{(1 + \text{InflationRate})} - 1 = \frac{(1 + 0.1176)}{(1 + 0.03)} - 1 = 0.085 \text{ say } 8.5\%$$

(ii) Calculation of Value of Both Division

(a) Furniture Manufacturing

Year	1	2	3	4	5	6 Onwards
Operating Profit before Tax	450	480	500	520	570	600
Allocated HO Overheads	60	60	60	60	60	60
Depreciation	100	80	70	80	80	80
	290	340	370	380	430	460
Less: Tax@30%	87	102	111	114	129	138
	203	238	259	266	301	322
Add: Depreciation	100	80	70	80	80	80
	303	318	329	346	381	402
Less: One Time Cost	80	-	-	-	-	-
	223	318	329	346	381	402
PVF@10%	0.909	0.826	0.751	0.683	0.621	
PV	202.71	262.67	247.08	236.32	236.60	

$$\text{Terminal Value} = \frac{402}{0.10} \times 0.621 = 2496.42$$

Total Value of Furniture Manufacturing Division (Infinite Period)=₹3681.80 crore

Total Value of Furniture Manufacturing Division (15 years)

$$= ₹1185.38 \text{ crore} + ₹402 \text{ crore} \times 3.815 = ₹2719.01 \text{ crore}$$

(b) Real Estate Business

Year	1	2	3	4	5	6 Onwards
Operating Profit before Tax	320	400	420	440	460	500
Allocated HO Overheads	60	60	60	60	60	60
Depreciation	50	50	50	50	50	50
	210	290	310	330	350	390

Less: Tax@30%	63	87	93	99	105	117
	147	203	217	231	245	273
Add: Depreciation	50	50	50	50	50	50
	197	253	267	281	295	323
Less: One Time Cost	80	-	-	-	-	-
	117	253	267	281	295	323
PVF@8.5%	0.922	0.849	0.783	0.722	0.665	
PV	107.87	214.80	209.06	202.88	196.18	

$$\text{Terminal Value} = \frac{323}{0.085} \times 0.665 = 2527.00$$

Total Value of Furniture Manufacturing Division (Infinite Period) = ₹3457.79 crore

Total Value of Furniture Manufacturing Division (15 years)

$$= ₹930.79 \text{ crore} + ₹323 \text{ crore} \times 4.364 = ₹2340.36 \text{ crore}$$

### Summary

*Total of two divisions (Infinite Period)*

$$= ₹ 3681.80 \text{ crore} + ₹ 3457.79 \text{ crore} - ₹ 1255.00 \text{ crore} = ₹ 5884.59 \text{ crore}$$

*Total of two divisions (15 years horizon)*

$$= ₹ 2719.01 \text{ crore} + ₹ 2340.36 \text{ crore} - ₹ 1255.00 \text{ crore} = ₹ 3804.37 \text{ crore}$$

*Current Market Value of Equity*

$$= \text{Rs.} 118.40 \times 50 \text{ crore} = ₹ 5920.00 \text{ crore}$$

**Decision:** Since the total of the two separate divisions with both time horizons (Infinite and 15 years) is less than the Current Value of Equity demerger is not advisable.

### 11. (a) Expected Return using CAPM

(i) Before Merger

Share of Bull Ltd.	$8\% + 1.50(13\% - 8\%) =$	15.50%
Share of Bear Ltd.	$8\% + 0.60(13\% - 8\%) =$	11.00%

(ii) After Merger

Beta of merged company shall be weighed average of beta of both companies as follows:

$$\frac{2}{3} \times 1.50 + \frac{1}{3} \times 0.60 = 1.20$$

Thus, expected return shall be:

$$8\% + 1.20 (13\% - 8\%) = 14\%$$

**(b) Impact of merger on Mr. X**

After merger his % holding in merged company shall be:

$$\frac{2}{3} \times 4\% + \frac{1}{3} \times 2\% = 3\frac{1}{3}\%$$

The value of Mr. X's holdings before merger was:

Bull Ltd.	4% x ₹1000 crore	₹40 crore
Bear Ltd.	2% x ₹500 crore	₹10 crore
		₹50 crore

To compute the value of holding of Mr. X, after merger first we have to compute the value of merged entity as follows:

Bull Ltd.	15.50% x ₹ 1000 crore	₹ 155 crore
Bear Ltd.	11% x ₹ 500 crore	₹ 55 crore
Synergy Benefits		₹ 7 crore
		₹ 217 crore

$$\text{Market Capitalization of Merged Entity} = \frac{\text{₹ 217 crore}}{0.14} = \text{₹ 1550 crore}$$

$$\text{Value of Mr. X's holding} = \text{₹ 51.67 crore. (₹ 1550 crore} \times 3\frac{1}{3}\%)$$

**12. (i) Sensitivity of each stock with market is given by its beta.**

Standard deviation of market Index = 15%

Variance of market Index = 0.0225

Beta of stocks =  $\sigma_i r / \sigma_m$

$$A = 20 \times 0.60 / 15 = 0.80$$

$$B = 18 \times 0.95 / 15 = 1.14$$

$$C = 12 \times 0.75 / 15 = 0.60$$

**(ii) Covariance between any 2 stocks =  $\beta_1 \beta_2 \sigma_m^2$**

**Covariance matrix**

Stock/Beta	0.80	1.14	0.60
A	400.000	205.200	108.000

<b>B</b>	205.200	324.000	153.900
<b>C</b>	108.000	153.900	144.000

(iii) Total risk of the equally weighted portfolio (Variance) =  $400(1/3)^2 + 324(1/3)^2 + 144(1/3)^2 + 2(205.20)(1/3)^2 + 2(108.0)(1/3)^2 + 2(153.900)(1/3)^2 = 200.244$

(iv)  $\beta$  of equally weighted portfolio =  $\beta_p = \sum \beta_i / N = \frac{0.80 + 1.14 + 0.60}{3} = 0.8467$

(v) Systematic Risk  $\beta_p^2 \sigma_m^2 = (0.8467)^2 (15)^2 = 161.302$

Unsystematic Risk = Total Risk – Systematic Risk  
=  $200.244 - 161.302 = 38.942$

13. Expected Return on stock A =  $E(A) = \sum_{i=G,S,R} P_i A_i$

(G,S&R, denotes Growth, Stagnation and Recession )

$(0.40)(25) + 0.30(10) + 0.30(-5) = 11.5\%$

Expected Return on 'B'

$(0.40 \times 20) + (0.30 \times 15) + 0.30 \times (-8) = 10.1\%$

Expected Return on Market index

$(0.40 \times 18) + (0.30 \times 13) + 0.30 \times (-3) = 10.2\%$

Variance of Market index

$(18-10.2)^2 (0.40) + (13-10.2)^2 (0.30) + (-3-10.2)^2 (0.30)$

$= 24.34 + 2.35 + 52.27 = 78.96\%$

Covariance of stock A and Market Index M

$\text{Cov. (AM)} = \sum_{i=G,S,R} ([A_i - E(A)][M_i - E(M)]P_i)$

$(25 - 11.5) (18 - 10.2)(0.40) + (10 - 11.5) (13 - 10.2) (0.30) + (-5-11.5) (-3-10.2) (0.30)$

$= 42.12 + (-1.26) + 65.34 = 106.20$

Covariance of stock B and Market index M

$(20-10.1) (18-10.2)(0.40) + (15-10.1)(13-10.2)(0.30) + (-8-10.1)(-3-10.2)(0.30) = 30.89 + 4.12 + 71.67 = 106.68$

Beta for stock A =  $\frac{\text{CoV(AM)}}{\text{VAR(M)}} = \frac{106.20}{78.96} = 1.345$



$$\text{Beta for Stock B} = \frac{\text{CoV(BM)}}{\text{Var(M)}} = \frac{106.68}{78.96} = 1.351$$

Required Return for A

$$R(A) = R_f + \beta (M - R_f)$$

$$11\% + 1.345(10.2 - 11)\% = 9.924\%$$

Required Return for B

$$11\% + 1.351(10.2 - 11)\% = 9.92\%$$

Alpha for Stock A

$$E(A) - R(A) \text{ i.e. } 11.5\% - 9.924\% = 1.576\%$$

Alpha for Stock B

$$E(B) - R(B) \text{ i.e. } 10.1\% - 9.92\% = 0.18\%$$

Since stock A and B both have positive Alpha, therefore, they are UNDERPRICED. The investor should make fresh investment in them.

14.

	₹
<i>Issue Price</i>	50,00,000
Less: Interest @ 12.5% for 4 months	2,08,333
Issue Expenses	2,500
Minimum Balance	1,50,000
	46,39,167

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

15. Expected Turnover = ₹ 4.80 crore + 25% i.e. ₹ 1.20 crore = ₹ 6.00 crore

	₹ in Lacs	₹ in Lacs
<i>Advance to be given:</i>		
Debtors ₹ 6.00 crore x 90/360	150.00	
Less: 10% withholding	<u>15.00</u>	135.00
Less: Commission 2%		<u>3.00</u>
Net payment		132.00
Less: Interest @16% for 90 days on ₹ 132 lacs		<u>5.28</u>
		<u>126.72</u>

<i>Calculation of Average Cost:</i>		
Total Commission ₹ 6.00 crore x 2%		<u>12.00</u>
Total Interest ₹ 5.28 lacs x 360/90		<u>21.12</u>
		33.12
Less: Admin. Cost	6.00	
Saving in Bad Debts (₹ 600 lacs x 1.75% x 80%)	<u>8.40</u>	<u>14.40</u>
		<u>18.72</u>
Effective Cost of Factoring $\frac{₹18.72 \text{ lacs}}{₹126.72 \text{ lacs}} \times 100$		14.77%

**16. Working Notes:**

Calculation of Cost of Capital

$$k_e = \frac{D_0(1+g)}{P_0} + g$$

$$D_1 = ₹1.40$$

$$P_0 = ₹22.60 - ₹1.40 = ₹21.20$$

$$k_e = \frac{1.40(1+0.06)}{21.20} + 0.06 = 13\%$$

**(a) NPV of the Project**

This  $k_e$  shall be used to value PV of income stream

$$V = \frac{₹ 15.30 \text{ crore}}{k_e - g} = \frac{₹ 15.30 \text{ crore}}{0.13 - 0.04} = ₹170 \text{ crore}$$

PV of Cash Inflows from Expansion Project	₹ 170 crore
Less: PV of Initial Outlay	₹ 150 crore
NPV	₹ 20 crore

Since NPV is positive we should accept the project.

**(b) By right issue new number of equity shares to be issued shall be:**

$$50 \text{ crore (Existing)} + 10 \text{ crore (Right Issue)} = 60 \text{ crore}$$

Market Value of Company = PV of existing earnings + PV of earnings from Expansion

$$= \frac{₹ 1.40 \times 50 \text{ crore} \times (1 + 0.06)}{0.13 - 0.06} + ₹170 \text{ crore}$$

$$= ₹ 1060 \text{ crore} + ₹ 170 \text{ crore} = ₹ 1230 \text{ crore}$$

$$\text{Price Per Share} = ₹ 1230 \text{ crore} / 60 \text{ crore} = ₹ 20.50$$

- (c) Let  $n$  be the number of new equity shares to be issued then such shares are to be issued at such price that new shareholders should not suffer any immediate loss after subscribing shares. Accordingly,

$$\frac{n}{50 \text{ crore} + n} \times ₹ 1230 \text{ crore} = ₹ 150 \text{ crore}$$

$$1230n = 7500 + 150n$$

$$n = 7500/1080 = 6.9444 \text{ crore}$$

$$\text{Issue Price Per Share} = \frac{₹ 150 \text{ crore}}{6.9444 \text{ crore}} = ₹ 21.60$$

or

$$\text{Ex - Dividend Price Per Share} = \frac{₹ 1230 \text{ crore}}{56.9444 \text{ crore}} = ₹ 21.60$$

- (d) Benefit from expansion

- (i) Right Issue

		₹ Crore
Shareholder's Current Wealth (₹ 22.60 x 50 crore)		1130
Less:	₹ Crore	
Value of 60 crore shares @ ₹ 20.50		1230
Cash Dividend Received @ ₹ 1.40 per share on 50 crore shares		70
Cash paid to subscribe Right Shares (₹15 x 10 crore)	<u>(150)</u>	<u>1150</u>
Net Gain		<u>20</u>

or

		₹ Crore
Shareholder's Current Wealth (₹21.20 x 50 crore)		1060
Less:	₹ Crore	
Value of 60 crore shares @ ₹ 20.50		1230
Cash paid to subscribe Right Shares (₹ 15 x 10 crore)	<u>(150)</u>	<u>1080</u>
Net Gain		<u>20</u>

(ii) Fresh Issue

	₹ Crore
Shareholder's Current Wealth (₹22.60 x 50 crore)	1130
Less:	₹ Crore
Value of existing 50 crore shares @ ₹21.60	1080
Cash Dividend Received @ ₹1.40 per share on 50 crore shares	<u>70</u> <u>1150</u>
Net Gain	<u>20</u>
or	
	₹ Crore
Shareholder's Current Wealth (₹21.20 x 50 crore)	1060
Value of existing 50 crore shares @ ₹21.60	<u>1080</u>
Net Gain	<u>20</u>

**17. (i) Receipt under three proposals**

(a) Invoicing in Sterling

$$\text{Invoicing in } \text{£} \text{ will produce} = \frac{\text{€ 4 million}}{1.1770} = \text{£}3398471$$

(b) Use of Forward Contract

$$\text{Forward Rate} = \text{€}1.1770 + 0.0055 = 1.1825$$

$$\text{Using Forward Market hedge Sterling receipt would be } \frac{\text{€ 4 million}}{1.1825} = \text{£} 3382664$$

(c) Use of Future Contract

$$\begin{aligned} &\text{The equivalent sterling of the order placed based on future price (€1.1760)} \\ &= \frac{\text{€ 4.00 million}}{1.1760} = \text{£} 3401360 \end{aligned}$$

$$\text{Number of Contracts} = \frac{\text{£}3401360}{62,500} = 54 \text{ Contracts (to the nearest whole number)}$$

$$\text{Thus, € amount hedged by future contract will be} = 54 \times \text{£}62,500 = \text{£}3375000$$

$$\text{Buy Future at} \quad \quad \quad \text{€}1.1760$$

$$\text{Sell Future at} \quad \quad \quad \underline{\text{€}1.1785}$$

$$\underline{\text{€}0.0025}$$

$$\text{Total profit on Future Contracts} = 54 \times \text{£}62,500 \times \text{€}0.0025 = \text{€}8438$$

After 6 months

Amount Received € 4000000

Add: Profit on Future Contracts € 8438

€ 4008438

Sterling Receipts

On sale of € at spot =  $\frac{€ 4008438}{1.1785} = €3401305$

- (ii) Proposal of option (c) is preferable because the option (a) & (b) produces least receipts.

**Alternative solution:**

Assuming that 6 month forward premium is considered as discount, because generally premium is mentioned in ascending order and discount is mentioned in descending order.

**(i) Receipt under three proposals**

- (a) Invoicing in Sterling

Invoicing in £ will produce =  $\frac{€ 4 \text{ million}}{1.1770} = £3398471$

- (b) Use of Forward Contract

Forward Rate =  $€1.1770 - 0.0055 = 1.1715$

Using Forward Market hedge Sterling receipt would be  $\frac{€ 4 \text{ million}}{1.1715} = £ 3414426$

- (c) Use of Future Contract

The equivalent sterling of the order placed based on future price (€1.1760) =  $\frac{€ 4.00 \text{ million}}{1.1760} = £ 3401360$

Number of Contracts =  $\frac{£3401360}{62,500} = 54$  Contracts (to the nearest whole number)

Thus, € amount hedged by future contract will be =  $54 \times £62,500 = £3375000$

Buy Future at €1.1760

Sell Future at €1.1785

€0.0025

Total profit on Future Contracts =  $54 \times £62,500 \times €0.0025 = €8438$

After 6 months	
Amount Received	€ 4000000
Add: Profit on Future Contracts	€ <u>8438</u>
	€ <u>4008438</u>

Sterling Receipts

$$\text{On sale of € at spot} = \frac{€ 4008438}{1.1785} = €3401305$$

- (ii) Proposal of option (b) is preferable because the option (a) & (c) produces least receipts.

**18. If foreign exchange risk is hedged**

				Total (₹)
Sum due	Yen 78,00,000	US\$1,02,300	Euro 95,920	
Unit input price	Yen 650	US\$10.23	Euro 11.99	
Unit sold	12000	10000	8000	
Variable cost per unit	₹225/-	₹395	₹510	
Variable cost	₹27,00,000	₹39,50,000	₹40,80,000	₹1,07,30,000
Three months forward rate for selling	2.427	0.0216	0.0178	
Rupee value of receipts	₹32,13,844	₹47,36,111	₹53,88,764	₹1,33,38,719
Contribution	₹5,13,844	₹7,86,111	₹13,08,764	₹26,08,719
Average contribution to sale ratio				19.56%
<b>If risk is not hedged</b>				
Rupee value of receipt	₹31,72,021	₹47,44,898	₹53,58,659	₹1,32,75,578
Total contribution				₹25,45,578
Average contribution to sale ratio				19.17%

AKC Ltd. Is advised to hedge its foreign currency exchange risk.

**19. Cash Balances:**

(‘000)

Acting independently

	Capital	Interest	₹ in 30 days
India	-5,00,000	-2,666.67	-5,02,667

U.S.	12,500	15.63	5,76,757
U.K.	6,000	18.50	<u>4,01,233</u>
			<u>4,75,323</u>

**Cash Balances:***Immediate Cash pooling*

	₹('000)
India	-5,00,000
U.S.	$\frac{12.50 \text{ Million}}{0.0215} = 5,81,395$
U.K.	$\frac{6.00 \text{ Million}}{0.0149} = \underline{4,02,685}$
	<u>4,84,080</u>

Immediate cash pooling is preferable as it maximizes interest earnings

20. (a) In interbank transactions, foreign exchange is transferred from one account to another account and from one centre to another centre. Therefore, the banks maintain three types of current accounts in order to facilitate quick transfer of funds in different currencies. These accounts are Nostro, Vostro and Loro accounts meaning "our", "your" and "their". A bank's foreign currency account maintained by the bank in a foreign country and in the home currency of that country is known as Nostro Account or "our account with you". For example, An Indian bank's Swiss franc account with a bank in Switzerland. Vostro account is the local currency account maintained by a foreign bank/branch. It is also called "your account with us". For example, Indian rupee account maintained by a bank in Switzerland with a bank in India. The Loro account is an account wherein a bank remits funds in foreign currency to another bank for credit to an account of a third bank.
- (b) Salient features of Financial Lease
- It is an intermediate term to long-term arrangement.
  - During the primary lease period, the lease cannot be cancelled.
  - The lease is more or less fully amortized during the primary lease period.
  - The costs of maintenance, taxes, insurance etc., are to be incurred by the lessee unless the contract provides otherwise.
  - The lessee is required to take the risk of obsolescence.
  - The lessor is only the Financier and is not interested in the asset.
- (c) It implies the process of recording the investments in traded securities (shares, debt-instruments, etc.) at a value, which reflects the market value of securities on

the reporting date. In the context of derivatives trading, the futures contracts are marked to market on periodic (or daily) basis. Marking to market essentially means that at the end of a trading session, all outstanding contracts are repriced at the settlement price of that session. Unlike the forward contracts, the future contracts are repriced every day. Any loss or profit resulting from repricing would be debited or credited to the margin account of the broker. It, therefore, provides an opportunity to calculate the extent of liability on the basis of repricing. Thus, the futures contracts provide better risk management measure as compared to forward contracts.

Suppose on 1<sup>st</sup> day we take a long position, say at a price of ₹ 100 to be matured on 7<sup>th</sup> day. Now on 2<sup>nd</sup> day if the price goes up to ₹ 105, the contract will be repriced at ₹ 105 at the end of the trading session and profit of ₹ 5 will be credited to the account of the buyer. This profit of ₹ 5 may be drawn and thus cash flow also increases. This marking to market will result in three things – one, you will get a cash profit of ₹ 5; second, the existing contract at a price of ₹ 100 would stand cancelled; and third you will receive a new futures contract at ₹ 105. In essence, the marking to market feature implies that the value of the futures contract is set to zero at the end of each trading day.

**(d) Relevant Assumptions of CAPM**

- (i) The investor's objective is to maximize the utility of terminal wealth;
- (ii) Investors make choices on the basis of risk and return;
- (iii) Investors have identical time horizon;
- (iv) Investors have homogeneous expectations of risk and return;
- (v) Information is freely and simultaneously available to investors;
- (vi) There is risk-free asset, and investor can borrow and lend unlimited amounts at the risk-free rate;
- (vii) There are no taxes, transaction costs, restrictions on short rates or other market imperfections;
- (viii) Total asset quantity is fixed, and all assets are marketable and divisible.

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

ETF can be bought and sold like any other stock on stock exchange. In other words, they can be bought or sold any time during the market hours at prices that are expected to be closer to the NAV at the end of the day. NAV of an ETF is the value



of the underlying component of the benchmark index held by the ETF plus all accrued dividends less accrued management fees.

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

Some other important features of ETF are as follows:

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

## PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

### PART – I : ACADEMIC UPDATE

#### (Legislative Amendments as per the Companies Act, 2013 and Rules made thereunder)

1. **Reporting under Companies (Auditor's Report) Order, 2015 [CARO, 2015]:** The Central Government, after consultation with the Institute of Chartered Accountants of India, has issued the Companies (Auditor's Report) Order, 2015, (CARO, 2015) under section 143(11) of the Companies Act, 2013, dated 10<sup>th</sup> April, 2015. The requirements of the Order are supplemental to the existing provisions of section 143 of the Act regarding the auditor's report.

The Order is not intended to limit the duties and responsibilities of auditors but only requires a statement to be included in the audit report in respect of the matters specified therein. For example, examination of the system of internal control is one of the basic audit procedures employed by the auditor. The fact that the Order requires a statement regarding the internal control system applicable to purchases of inventory and fixed assets, and sale of goods and services only is no justification for the auditor to conclude that an examination of internal control regarding the other areas of a company's business is not important or not required.

**Applicability of the Order:** The CARO, 2015 is an additional reporting requirement Order. The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013.

However, the Order specifically **exempts** the following class of companies-

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;
- (ii) an insurance company as defined under the Insurance Act, 1938;
- (iii) a company licensed to operate under section 8 of the Companies Act;
- (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act;
- (v) a small company as defined under clause (85) of section 2 of the Companies Act; and
- (vi) a private limited company with a paid up capital and reserves not more than ₹ 50 lakh and which does not have loan outstanding exceeding ₹ 25 lakh from any bank or financial institution and does not have a turnover exceeding ₹ 5 crore at any point of time during the financial year.

**Matters to be included in the Auditor's Report:** Paragraph 3 of the Order requires the auditor to include a statement in the auditor's report on the following matters, namely-

- (i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;

- (b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account.
- (ii) (a) whether physical verification of inventory has been conducted at reasonable intervals by the management;
- (b) are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business. If not, the inadequacies in such procedures should be reported;
- (c) whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account.
- (iii) whether the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 189 of the Companies Act. If so,
  - (a) whether receipt of the principal amount and interest are also regular; and
  - (b) if overdue amount is more than rupees one lakh, whether reasonable steps have been taken by the company for recovery of the principal and interest.
- (iv) is there an adequate internal control system commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods and services. Whether there is a continuing failure to correct major weaknesses in internal control system.
- (v) in case the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act and the rules framed there under, where applicable, have been complied with? If not, the nature of contraventions should be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?
- (vi) where maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act, whether such accounts and records have been made and maintained.
- (vii) (a) is the company regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, wealth tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year

concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

- (b) in case dues of income tax or sales tax or wealth tax or service tax or duty of customs or duty of excise or value added tax or cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not constitute a dispute).
- (c) whether the amount required to be transferred to investor education and protection fund in accordance with the relevant provisions of the Companies Act, 1956 and rules made thereunder has been transferred to such fund within time.
- (viii) whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year.
- (ix) whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported.
- (x) whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company.
- (xi) whether term loans were applied for the purpose for which the loans were obtained.
- (xii) whether any fraud on or by the company has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

**Reasons to be Stated for Unfavourable or Qualified Answers:** Where the answer to any of the questions referred to in paragraph 3 of the Order is unfavourable or qualified, in the auditor's report, the auditor shall also state the reasons for such unfavourable or qualified answer, as the case may be.

Further, where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give an answer to such question.

**Consequential Amendment to the Format of the Auditor's Report of a Company:**

The Auditing and Assurance Standards Board has issued illustrative formats of the auditor's report on financial statements of a company under the Companies Act, 2013. While reporting on the requirements of CARO, 2015, a reference thereto also needs to be added in the main audit report under the "Report on Legal and Other Regulatory Matters" paragraph as follows:

*"Report on Other Legal and Regulatory Requirements*

*As required by the Companies (Auditor's Report) Order, 2015 ("the Order"), issued by the Central Government of India in terms of sub-section (11) of section 143 of the*

*Companies Act, 2013, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.*

*As required by Section 143(3) of the Act, we report that:*

.....  
 .....”

2. **Companies (Cost Records and Audit) Rules, 2014:** The Central Government has amended the Companies (Cost Records and Audit) Rules, 2014 dated 31<sup>st</sup> December, 2014 which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

**Maintenance of Cost Records:** Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, required to include cost records in their books of account. These companies include Foreign Companies defined in sub-section (42) of section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise including as per the turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006.

The said rule has divided the list of companies into regulated sectors and non-regulated sectors. Some of the companies/industry/sector/product/service prescribed under the said rule are given below:

**(A) Regulated Sectors-**

- (i) Telecommunication services made available to users by means of any transmission or reception of signs, signals, images etc. (other than broadcasting services) and regulated by the Telecom Regulatory Authority of India.
- (ii) Generation, transmission, distribution and supply of electricity regulated by the relevant regulatory body or authority under the Electricity Act, 2003, other than for captive generation.
- (iii) Petroleum products regulated by the Petroleum and Natural Gas Regulatory Board.
- (iv) Drugs and Pharmaceutical.
- (v) Sugar and industrial alcohol.

**(B) Non-Regulated Sectors-**

- (i) Machinery and mechanical appliances used in defence, space and atomic energy sectors excluding any ancillary item or items.
- (ii) Turbo jets and turbo propellers.
- (iii) Tyres and Tubes.
- (iv) Steel; Cement.

- (v) Production, import and supply or trading of following medical devices, such as heart valves; orthopaedic implants; pacemaker (temporary and permanent), etc. The rule excludes the foreign companies having only liaison offices.

As per Rule 5 of the Companies (Cost Records and Audit) Rules, 2014, every company under these rules including all units and branches thereof, shall, in respect of each of its financial year, is required to maintain cost records in **Form CRA-1**. The cost records shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.

Additionally, as per clause (vi) to Paragraph 3 of the CARO, 2015, where maintenance of cost records has been specified by the Government under section 148(1) of the Companies Act, 2013, the auditor has to report whether such accounts and records have been made and maintained.

**Applicability of Cost Audit:** Rule 4 of the Companies (Cost Records and Audit) Rules, 2014 states the provisions related to the applicability of cost audit depending on the turnover of the company as follows-

- (i) Classes of companies specified under item (A) "Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 50 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 25 crore or more.
- (ii) Classes of companies specified under item (B) "Non-Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 100 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 35 crore or more.

**Casual Vacancy in the Office of a Cost Auditor:** Any casual vacancy in the office of a Cost Auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors within 30 days of occurrence of such vacancy and the company shall inform the central government in **Form CRA-2** within 30 days of such appointment of cost auditor.

3. **General Features of Cost Records:** The following general features of the cost records to be maintained in the books of accounts as per Form CRA-1 pursuant to rule 5(1) of the Companies (Cost Records and Audit) Rules, 2014 have been amended by the Central Government *vide* notification dated 31st December, 2014-

- (i) **Material Costs-** Proper records shall be maintained showing separately all receipts, issues and balances both in quantities and cost of each item of raw material required for the production of goods or rendering of services under reference.

The material receipt shall be valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited by the taxing authorities) that can be quantified with reasonable accuracy at the time of acquisition. Finance costs incurred in connection with the acquisition of Material shall not form part of material cost.

Spares which are specific to an item of equipment shall not be taken to inventory, but shall be capitalized with the cost of the specific equipment. Cost of capital spares or insurance spares, whether procured with the equipment or subsequently, shall be amortised over a period, not exceeding the useful life of the equipment.

Normal loss or spoilage of material prior to reaching the factory or at places where the services are provided shall be absorbed in the cost of balance materials net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal. Where materials are accounted at standard cost, the price variances related to materials shall be treated as part of material cost.

The material cost of normal scrap or defectives which are rejects shall be included in the material cost of goods manufactured. The material cost of actual scrap or defectives, not exceeding the normal shall be adjusted in the material cost of good production. Material Cost of abnormal scrap or objectives shall not be included in material cost but treated as loss after giving credit to the realisable value of such scrap or defectives.

Material costs shall be directly traced to a cost object to the extent it is economically feasible or shall be assigned to the cost object on the basis of material quantity consumed or similar identifiable measure and valued as per above principles. Where the material costs are not directly traceable to the cost object, the same shall be assigned on a suitable basis like technical estimates.

Where a material is processed or part manufactured by a third party according to specifications provided by the buyer, the processing or manufacturing charges payable to the third party shall be treated as part of the material cost.

**(ii) Employee Cost-** Proper records shall be maintained in respect of employee costs in whole such a manner as to enable the company to book these expenses cost centre wise or department wise with reference to goods or services under reference and to furnish necessary particulars. Where the employees work in such a manner that it is not possible to identify them with any specific cost centre or service centre or department, the employees cost shall be apportioned to the cost centre or service centres or departments on equitable and reasonable basis and applied consistently.

Employee cost shall be ascertained taking into account the gross pay including all allowances payable along with the cost to the employer of all the benefits.

Bonus whether payable as a statutory minimum or on a sharing of surplus shall be treated as part of employee cost. Ex-gratia payable in lieu of or in addition to bonus shall also be treated as part of the employee cost.

Remuneration payable to Managerial Personnel including Executive Directors on the Board and other officers of a corporate body under a statute shall be considered as part of the employee cost of the year under reference whether the whole or part of the remuneration is computed as a percentage of profits. Remuneration paid to non-executive directors shall not form part of employee cost but shall form part of administrative overheads.

Where employee cost is accounted at standard cost, variances due to normal reasons related to employee cost shall be treated as part of employee cost. Variances due to abnormal reasons shall be treated as part of abnormal cost.

Any recovery from the employee towards any benefit provided, namely, housing shall be reduced from the employee cost. Any change in the cost accounting principles applied for the determination of the employee cost shall be made only if it is required by law or a change would result in a more appropriate preparation or presentation of cost statements of an enterprise.

Where the employee services are traceable to a cost object, such employees' cost shall be assigned to the cost object on the basis such as time consumed or number of employees engaged or other related basis or similar identifiable measure. While determining whether a particular employee cost is chargeable to a separate cost object, the principle of materiality shall be adhered to.

Overtime premium shall be assigned directly to the cost object or treated as overheads depending on the economic feasibility and the specific circumstance requiring such overtime. Idle time cost shall be assigned direct to the cost object or treated as overheads depending on the economic feasibility and the specific circumstances causing such idle time.

**(iii) Utilities-** Proper records shall be maintained showing the quantity and cost of each major utility such as power, water, steam, effluent treatment and other related utilities produced and consumed by the different cost centres in such detail as to have particulars for each utility separately.

Cost of utilities purchased shall be measured at cost of purchase including duties and taxes, transportation cost, insurance and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited) that can be quantified with reasonable accuracy at the time of acquisition.

Cost of self-generated utilities for own consumption shall comprise direct material cost, direct employee cost, direct expenses and factory overheads. In case of utilities generated for the purpose of inter unit transfers, the distribution cost incurred for such transfers shall be added to the cost of utilities determined as above. Cost of utilities generated for the intercompany transfers shall comprise direct material cost, direct employee cost, direct expenses, factory overheads, distribution cost and share of administrative overheads.



Where cost of utilities is accounted at standard cost, the price variances related to utilities shall be treated as part of cost of utilities and the portion of usage variances due to normal reasons shall be treated as part of cost of utilities. Usage variances due to abnormal reasons shall be treated as part of abnormal cost.

Any subsidy or grant or incentive or any such payment received or receivable with respect to any cost of utilities shall be reduced for ascertainment of the cost to which such amounts are related.

**(iv) Direct Expenses-** Proper records shall be maintained in respect of direct expenses in such a manner as to enable the company to book these expenses cost centre wise or cost object or department wise with reference to goods or services under reference and to furnish necessary particulars.

Direct expenses incurred for the use of bought out resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of trade discounts, rebates, taxes and duties refundable or to be credited. Other direct expenses shall be determined on the basis of amount incurred on connection therewith.

**(v) Repairs and Maintenance-** Proper records showing the expenditure incurred by the workshop, tool room and on repairs and maintenance in the various cost centres or departments shall be maintained under different heads.

Repairs and maintenance cost shall be the aggregate of direct and indirect cost relating to repairs and maintenance activity. Direct cost shall include the cost of materials, consumable stores, spares, manpower, equipment usage, utilities and other identifiable resources consumed in such activity. Indirect cost shall include the cost of resources common to various repairs and maintenance activities such as manpower, equipment usage and other costs allocable to such activities.

Cost of in-house repairs and maintenance activity shall include cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources used in such activity.

Cost of repairs and maintenance activity carried out by outside contractors inside the entity shall include charges payable to the contractor and cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other costs incurred by the entity for such jobs.

Each type of repairs and maintenance shall be treated as a distinct activity, in material and identifiable. Cost of repairs and maintenance activity shall be measured for each major asset category separately.

Cost of spares replaced which do not enhance the future economic benefits from the existing asset beyond its previously assessed standard of performance shall be included under repairs and maintenance cost.

Where the repairs and maintenance cost is not directly traceable to cost object, it shall be assigned based on either of the following the principles of (1) Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost and (2) Benefits received - overheads are to be apportioned to the various cost objects in proportion to the benefits received by them. If the repairs and maintenance cost (including the share of the cost of reciprocal exchange of services) is shared by several cost objects, the related cost shall be measured as an aggregate and distributed among the cost objects.

**(vi) Fixed Assets and depreciation-** Proper and adequate records shall be maintained for assets used for production of goods or rendering of services under reference n respect of which depreciation has to be provided for. These records shall, *inter-alia*, indicate grouping of assets under each good or service, the cost of acquisition of each item of asset including installation charges, date of acquisition and rate of depreciation.

The minimum amount of depreciation to be provided shall not be less than the amount calculated as per principles and methods as prescribed by any law or regulations applicable to the entity and followed by it.

Spare purchased specifically for a particular asset, or class of assets, and which would become redundant if that asset or class of asset was retired or use of that asset was discontinued, shall form part of that asset. The depreciable amount of such spares shall be allocated over the useful life of the asset.

Cost of small assets shall be written off in the period in which they were purchased as per the accounting policy of the entity.

**(vii) Overheads-** Overheads representing procurement of resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discounts), taxes and duties refundable or to be credited.

Overheads other than those referred to above shall be determined on the basis of cost incurred in connection therewith. Any abnormal cost where it is material and quantifiable shall not form part of the overheads.

Finance costs incurred in connection with procured or self-generated resources shall not form part of overheads. Marketing overheads that can be identified to a product or service shall be assigned to that product or service.

**(viii) Administrative Overheads-** Administrative overheads shall be the aggregate of cost of resources consumed in activities relating to general management and administration of an organisation.

In case of leased assets, if the lease is an operating lease, the entire rentals shall be included in the administrative overheads. If the lease is a financial lease, the finance cost portion shall be segregated and treated as part of finance costs.

The cost of software (developed in house, purchased, licensed or customised), including up-gradation cost shall be amortised over its estimated useful life.

The cost of administrative services procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited.

Any subsidy or grant or incentive or any amount of similar nature received or receivable with respect to any administrative overheads shall be reduced for ascertainment of the cost of the cost object to which such amounts are related. Administrative overheads shall not include any abnormal administrative cost.

Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the administrative overheads.

**(ix) Transportation Cost-** Proper records shall be maintained for recording the actual cost of transportation showing each element of cost such as freight, cartage, transit insurance and others after adjustment for recovery or transportation cost. Abnormal costs relating to transportation, if any, are to be identified and recorded for exclusion of computation of average transportation cost.

In case of a manufacturer having his own transport fleet, proper records shall be maintained to determine the actual operating cost of vehicles showing details of various elements of cost, such as salaries and wages of driver, cleaners and others, cost of fuel, lubricant grease, amortized cost of tyres and battery, repairs and maintenance, depreciation of the vehicles, distance covered and trips made, goods hauled and transported to the depot.

In case of hired transport charges incurred for despatch of goods, complete details shall be recorded as to date of despatch, type of transport used, description of the goods, destination of buyer, name of consignee, challan number, quantity of goods in terms of weight or volume, distance involved, amount paid and other related details.

**(x) Royalty and Technical Know-how-** Adequate records shall be maintained showing royalty or technical know-how fee including other recurring or non-recurring payments of similar nature, if any, made for the goods or services under reference to collaborators or technology suppliers in terms of agreements entered into with them.

Royalty and technical know-how fee paid or incurred in lump-sum or which are in the nature of 'one-time' payment, shall be amortised on the basis of the estimated output or benefit to be derived from the related asset. Amortisation of the amount of royalty or technical know-how fee paid for which the benefit is ensued in the current or future periods shall be determined based on the production or service volumes estimated for the period over which the asset is expected to benefit the entity.

Amount of the royalty and technical know-how fee shall not include finance costs and imputed costs. Any subsidy or grant or incentive or any such payment received or

receivable with respect to amount of royalty and technical know-how fee shall be reduced to measure the amount of royalty and technical know-how fee.

**(xi) Research and Development Expenses-** Research and development costs shall include all the costs that are directly traceable to research or development activities or that can be assigned to research and development activities strictly on the basis of (a) cause and effect or (b) benefits received.

**(xii) Quality control expenses-** Adequate records shall be maintained to indicate the expenses incurred in respect of quality control department or cost centre or service centre for goods or services under reference. Where these services are also utilized for other goods or services of the company, the basis of apportionment to goods or services under reference and to other goods or services shall be on equitable and reasonable basis and applied consistently.

**(xiii) Pollution control expenses-** Adequate records shall be maintained to indicate the expenses incurred in respect of pollution control. The basis of apportionment to goods or services under reference and to other goods or services shall be on equitable and reasonable basis and applied consistently.

Pollution control costs shall be the aggregate of direct and indirect cost relating to pollution control activity. Direct cost shall include the cost of materials, consumable stores, spares, manpower, equipment usage, utilities, resources for testing and certification and other identifiable resources consumed in activities such as waste processing, disposal, remediation and others. Indirect cost shall include the cost of resources common to various pollution control activities such as pollution control registration and such like expenses.

**(xiv) Service department expenses-** Proper records shall be maintained in respect of service departments, that is, cost centres which primarily provide auxiliary services across the enterprise, to indicate expenses incurred in respect of each such service cost centre like engineering, work shop, designing, laboratory, safety, transport, computer cell, welfare and other related centres.

Each identifiable service cost centre shall be treated as a distinct cost object for measurement of the cost of services subject to the principle of materiality.

Cost of service cost centre shall be the aggregate of direct and indirect cost attributable to services being rendered by such cost centre. Cost of in-house services shall include cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources used in such service. Cost of other resources shall include related overheads. Cost of services rendered by contractors within the facilities of the entity shall include charges payable to the contractor and cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources provided to the contractors for such services.

**(xv) Packing expenses-** Proper records shall be maintained separately for domestic and export packing showing the quantity and cost of various packing materials and other expenses incurred on primary or secondary packing indicating the basis of valuation.

The packing material receipts shall be valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited) that can be quantified at the time of acquisition.

Finance costs directly incurred in connection with the acquisition of packing material shall not form part of packing material cost.

Self manufactured packing materials shall be valued including direct material cost, direct employee cost, direct expenses, job charges, factory overheads including share of administrative overheads comprising factory management and administration and share of research and development cost incurred for development and improvement of existing process or product.

**(xvi) Interest and financing charges-** Interest and financing charges are costs incurred by an enterprise in connection with the borrowing of fund or other costs which in effect represent payment for the use of non-equity fund.

Interest and financing charges incurred shall be identified for-

- (I) acquisition or construction or production of qualifying assets including fixed assets; and
- (II) other finance costs for production of goods or operations or services rendered which cannot be classified as qualifying assets.

Interest and financing charges directly attributable to the acquisition or construction or production of a qualifying asset shall be included in the cost of the asset. The charges shall not include imputed costs.

Subsidy or grant or incentive or amount of similar nature received or receivable with respect to interest and financing Charges, if any, shall be reduced to ascertain the net interest and financing charges.

**(xvii) Any other item of cost-** Proper records shall be maintained for any other item of cost being indispensable and considered necessary for inclusion in cost records for calculating cost of production of goods or rendering of services, cost of sales, margin in total and per unit of the goods or services under reference.

**(xviii) Capacity determination-** Capacity shall be determined in terms of units of production or equivalent machine or man hours.

Installed capacity is determined based on-

- (I) manufacturers' technical specifications;
- (II) capacities of individual or interrelated production centres;

- (III) operational constraints or capacity of critical machines; or
- (IV) number of shifts.

In case manufacturers' technical specifications are not available, the estimates by technical experts on capacity under ideal conditions shall be considered for determination of installed capacity. In case any production facility is added or discarded the installed capacity shall be reassessed from the date of such addition or discard. In case the same is reassessed as per direction of the Government, it shall be in accordance with the principles laid down in the said directives. In case of improvement in the production process, the installed capacity shall be reassessed from the date of such improvement.

Normal capacity shall be determined *vis-a-vis* installed capacity after carrying out adjustments for-

- (I) holidays, normal shut down days and normal idle time;
- (II) normal time lost in batch change over;
- (III) time lost due to preventive maintenance and normal break downs of equipments;
- (IV) losing efficiency due to ageing of the equipment; or
- (V) number of shifts;

Capacity utilization is actual production measured as a percentage of installed capacity.

**(xix) Work-in-progress and finished stock-** The method followed for determining the cost of work-in-progress and finished stock of the goods and for services under delivery or in-process shall be appropriate and shall be indicated in the cost records so as to reveal the cost element that have been taken into account in such computation. All conversion costs incurred in bringing the inventories to their present location and condition shall be taken into account while computing the cost of work-in-progress and finished stock. The method adopted for determining the cost of work in progress and finished goods shall be followed consistently.

**(xx) Captive consumption-** If the goods or services under reference are used for captive consumption, proper records shall be maintained showing the quantity and cost of each such goods or services transferred to other departments or cost centres or units of the company for self-consumption and sold to outside parties separately.

**(xxi) By-Products and Joint Products-** Proper records shall be maintained for each item of by-product, if any, produced showing the receipt, issues and balances, both in quantity and value. The basis adopted for valuation of by-product for giving credit to the respective process shall be equitable and consistent and shall be indicated in cost records. Records showing the expenses incurred on further processing, if any, and actual sales realisation of by-product shall be maintained. The proper records shall be maintained in respect of credits or recoveries from the disposal of by-products.

Proper records shall be maintained the cost up to the point of separation of products or services shall be apportioned to joint products or services on reasonable and equitable basis and shall be applied consistently. The basis on which such joint costs are apportioned to different products or services arising from the process shall be indicated in the cost records. Proper records shall be maintained in respect credits or recoveries from the disposal of joint products or services.

**(xxii) Adjustment of cost variances-** Where the company maintains cost records on any basis other than actual such as standard costing, the records shall indicate the procedure followed by the company in working out the cost of the goods or services under such system. The cost variances shall be shown against separate heads and analyzed into material, labour, overheads and further segregated into quantity, price and efficiency variances. The method followed for adjusting the cost variances in determining the actual cost of the goods or services shall be indicated clearly in the cost records. The reasons for the variances shall be duly explained in the cost records and statements.

**(xxiii) Reconciliation of cost and financial accounts-** The cost statements shall be reconciled with the financial statements for the financial year specifically indicating the expenses or incomes not considered in the cost records or statements so as to ensure accuracy and to adjust the profit of the goods or services under reference with the overall profit of the Company. The variations, if any, shall be clearly indicated and explained.

**(xxiv) Related party transactions-** Related Party means related party as defined under clause (76) of section 2 of the Companies Act 2013.

'Normal' price means price charged for comparable and similar products in the ordinary course of trade and commerce where the price charged in the sole consideration of sale and such sale is not made to a related party. Normal price can be construed to be a price at which two unrelated and non-desperate parties would agree to a transaction and where such transaction is not clouded due to the proximity of the parties to the transaction and free from influence though the parties may have shared interest.

In respect of related party transactions or supplies made or services rendered by a company to a company termed 'related party relationship' and vice-a-versa, records shall be maintained showing contracts entered into, agreements or understanding reached in respect of-

- (I) purchase and sale of raw materials, finished goods, rendering of services, process materials and rejected goods including scraps and other related materials;
- (II) utilisation of plant facilities and technical know-how;
- (III) supply of utilities and any other services;
- (IV) administrative, technical, managerial or any other consultancy services;
- (V) purchase and sale of capital goods including plant and machinery; and
- (VI) any other payment related to the production of goods or rendering of services under reference.

**(xxv) Expenses or incentives on exports-** Proper records showing the expenses incurred on the export sales, if any, of the goods or services under reference shall be separately maintained so that the cost of export sales can be determined correctly. Separate cost statements shall be prepared for goods or services exported giving details of export expenses incurred or incentive earned.

Proper records shall be maintained giving the details of export commitments license-wise and the fulfillment of these commitments giving the reasons for non-compliance, if any. In case, duty free imports are made, the cost statements shall reflect this fact. If the duty free imports have been made after actual production, the statement shall reflect this fact also.

**(xxvi) Production Records-** Quantitative records of all finished goods (packed or unpacked) or services rendered showing production, issues for sales and balances of different type of the goods or services under reference, shall be maintained. The quantitative details of production of goods or services rendered shall be maintained separately for self-produced, third party on job work, loan license basis etc.

**(xxvii) Sales records-** Separate details of sales shall be maintained for domestic sales at control price, domestic sales at market price, export sales under advance license, export sales under other obligations, export sales at market price, and sales to related party or inter unit transfer. In case of services details of domestic delivery or sales at control price, domestic delivery or sales at market price, export delivery or sales under advance license, export delivery or sales under other obligations, export delivery or sales at market price, and delivery or sales to related party or inter unit transfer. Such details shall be maintained separately for each plant or unit wise or service center wise for total as well as per unit sales realization.

**(xxviii) Cost statements-** Cost statements (monthly, quarterly and annually) showing quantitative information in respect of each good or service under reference shall be prepared showing details of available capacity, actual production, production as per excise records, capacity utilization (in-house), stock purchased for trading, stock and other adjustments, quantity available for sale, wastage and actual sale during current financial year and previous year.

Such statements shall also include details in respect of all major items of costs constituting cost of production of goods or services, cost of sales of goods or services and margin in total as well as per unit of the goods or services. The goods or services emerging from a process, which forms raw material or an input material or service for a subsequent process, shall be valued at the cost of production or cost of service up to the previous stage.

Cost Statements in respect of reconciliation of indirect taxes showing details of total clearances of goods or services, assessable value, duties or taxes paid, CENVAT or VAT or Service Tax credit utilized, duties or taxes recovered and interest or penalty paid.



If the company is operating more than one plant, factory or service centre, separate cost statements as specified above shall be prepared in respect of each plant, factory or service centre.

**(xxix) Statistical Records-** The records regarding available machine hours or direct labour hours in different production departments and actually utilized shall be maintained for production of goods or rendering of services under reference and shortfall suitably analyzed. Suitable records for computation of idle time of machines or labour shall also be maintained and analyzed.

Proper records shall be maintained to enable the company to identify the capital employed, net fixed assets and working capital separately for the production of goods or rendering of services under reference and other goods or services to the extent such elements are separately identifiable. Non-identifiable items shall be allocated on a suitable and reasonable basis to different goods or services. Fresh investments on fixed assets for production of goods or rendering of services under reference that have not contributed to the production of goods or rendering of services during the relevant period or year shall be indicated in the cost records. The records shall, in addition, show assets added as replacement and those added for increasing existing capacity.

**(xxx) Records of Physical Verification-** Records of physical verification may be maintained in respect of all items held in the stock such as raw materials, process materials, packing materials, consumables stores, machinery spares, chemicals, fuels, finished goods and fixed assets etc. Reasons for shortages or surplus arising out of such verifications and the method followed for adjusting the same in the cost of the goods or services shall be indicated in the records.

## PART – II : QUESTIONS AND ANSWERS

### QUESTIONS

#### Standards on Auditing, Statements and Guidance Notes

- (a) CA Jack, a recently qualified practicing Chartered Accountant got his first audit assignment of Futura (P) Ltd. for the financial year 2014-15. He obtained all the relevant appropriate audit evidence for the items related to Statement of Profit and Loss. However, while auditing the Balance Sheet items, CA Jack left out obtaining appropriate audit evidence, say, confirmations, from the outstanding Accounts Receivable amounting ₹ 150 lakhs, continued as it is from the last year, on the affirmation of the management that there is no receipts and further credits during the year. CA Jack, therefore, excluded from the audit programme, the audit of accounts receivable on the understanding that it pertains to the preceding year which was already audited by predecessor auditor. Comment.

(b) M/s Sureshchandra & Co. has been appointed as an auditor of SC Ltd. for the financial year 2014-15. CA Suresh, one of the partners of M/s Sureshchandra &

Co., completed entire routine audit work by 29<sup>th</sup> May, 2015. Unfortunately, on the very next morning, while roving towards office of SC Ltd. to sign final audit report, he met with a road accident and died. CA Chandra, another partner of M/s Sureshchandra & Co., therefore, signed the accounts of SC Ltd., without reviewing the work performed by CA Suresh. State with reasons whether CA Chandra is right in expressing an opinion on financial statements the audit of which is performed by another auditor.

2. (a) Ferry Ltd. is a leading employee friendly company operating in India. The company outsourced the most critical function of its HR Department i.e. the actuarial services to Ms. Preeti, a renowned practicing actuary, for ascertaining its employee cost, gratuity and leave encashment liabilities.

As the auditor of Ferry Ltd., you would like to use the report submitted by the actuary as an audit evidence. How would you evaluate the work of the actuary?

- (b) CA Amboj, 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 CA Kishor, the statutory auditor of the Company, for his view and reporting. Can CA Kishor rely on such report?

#### **Audit Strategy, Planning and Programming**

3. xLoud, a movie theater complex, is the foremost theater located in Delhi. Along with the sale of tickets over the counter and online booking, the major proportion of income is from the cafe shops, pubs etc. located in the complex. Its 'other income' includes advertisements exhibited within/outside the premises such as hoarding, banners, slides, short films etc. The facility for parking of vehicles is also provided in the basement of the premises.

xLoud appointed your firm as the auditor of the entity. Being the head of the audit team, you are therefore required to draw an audit programme initially in respect of its revenue and expenditure considering the above mentioned facts along with other relevant points related to a complex.

#### **Risk Assessment and Internal Control**

4. (a) You are the auditor of Max Ltd., a distributor of automotive components, and have been provided with the following description of the sales order processing system.

##### **Order entry**

Sales orders are taken over the telephone and entered into the computer by a sales order clerk *via* a terminal in the sales office while the customer is on the line. On entry the order details are read back to the customer for confirmation. The computer checks that there are sufficient inventories to meet the order and that the customer's credit limit is not exceeded.

If the goods are unavailable, the customer is asked if he wants the order to be

recorded as a 'backorder' which will be fulfilled when there is sufficient inventory. Once accepted, the order is automatically given an order number which is relayed to the customer.

Orders which take a customer over his credit limit are referred to the credit controller who decides, in consultation with the chief accountants, whether or not the customer should be allowed to exceed the credit limit or have the credit limit raised. Any adjustments in respect of overrides of, or increase in, credit limits are input *via* a terminal in the accounts department by the credit controller. Printouts of these amendments are not generated and no other review of credit limits is undertaken.

New customers are referred to the credit controller who obtains credit ratings and references and on the oral authority of the chief accountant, enters the customer account details on to the sales.

#### **Dispatch of goods**

Sequentially-numbered packing notes in respect of accepted orders are printed out in the warehouse and the goods are selected, packed and checked by warehouse staff. Confirmations of packing and any notifications of short falls are entered into the computer *via* a terminal in the warehouse by the warehouse supervisor. Two copies of the sequentially numbered delivery advice are printed in the warehouse and sent with the goods to the customer who is required to sign a copy which is returned by the driver to the accounts department. All dispatches are checked at the gate house to ensure that they are accompanied by the appropriate documentation. The packing notes are filed in numerical order in the warehouse and the sequence is checked for completeness on a daily basis by the warehouse supervisor.

The system does not automatically generate purchase orders with manufacturers when a customer's order cannot be fulfilled.

#### **Computer system**

All users of the system are required to log on using identification codes and individual passwords which control their level of access to the system. All passwords are changed every 90 days and when employees leave. System's support is provided by a supplier where the service agreement provides for availability of a back-up system within 72 hours of a systems failure.

#### **Requirements**

- (i) Identify the objectives of exercising internal controls over sales order processing ignoring sales invoicing or ledger processing. For each objective discuss the extent to which the procedures exercised by Max Ltd. achieve the objective.
- (ii) Set out, in a manner suitable for inclusion in a report to management, any weaknesses in the system described above. For each weakness you should

include the possible consequence of the weakness and a recommendation to remedy the weakness.

- (b) "Corporate accountability and civil and criminal penalties for white collar crimes." Comment on the major provisions of Sarbanes Oxley Act.

#### **Audit under CIS Environment**

5. Techno Ltd., for the first time, is considering computerizing its manner of maintaining documentation. This change will have a significant effect on the organization control, flow of document information processing and so on. This will also require the auditor of the company to gain knowledge about computer environment (Hardware, software etc.) and keep pace with rapidly changing technology even to the extent of using sophisticated Audit software.

You, being an expert of audit under CIS environment are required to guide the auditor of the company by explaining -

- (a) The risks and internal control characteristics in an audit conducted in Computer Information Systems (CIS) environment.
- (b) Whether the use of audit software would increase the probability of detecting frauds.

#### **The Company Audit & Audit Report**

6. (a) CA Adroit was indebted to Anfractuious (P) Ltd. for a sum of ₹ 6,00,000 as on 01.04.2015. However, CA Adroit having come to know that he might be appointed as auditor of the company, he squared up the amount on 10.7.2015. Later on, he was appointed as an auditor of the company for the year ended 31.3.2016 at the Annual General Meeting held on 16.07.2015.

Subsequently, one of the shareholders complains that the appointment of CA Adroit as an auditor is invalid because he incurred disqualification under section 141 of the Companies Act, 2013. Comment.

- (b) While auditing Y Ltd., CA Max, the statutory auditor of Y Ltd. encounters exceptional circumstances that bring into question his ability to continue performing the audit. Considering it appropriate, CA Max resigned from the office of auditor of Y Ltd. Due to the resignation of the existing auditor, the Board of Directors of Y Ltd. itself appointed CA Mini, a practicing Chartered Accountant, as the statutory auditor till the conclusion of 6<sup>th</sup> meeting.

You are required to state the provisions related to filling of casual vacancy as per the Companies Act, 2013 and comment upon the validity of appointment made by the Board.

- (c) Malta Pvt. Ltd., a newly incorporated company dated 01.07.2015 is engaged in the manufacturing business of Cotton Shirts. On 30.07.2015, the Managing Director of Malta Pvt. Ltd. himself appointed CA Rajnath, his daughter's husband, as the first auditor of the company.

You are required to –

- (i) state the provisions of the Companies Act, 2013 relating to appointment of first auditor.
  - (ii) comment on the action of the Managing Director.
- (d) Carroty Ltd. appointed M/s CROSS as the sole statutory auditor for financial year 2015-16 where till last year M/s WORD was also one of the joint auditors along with M/s CROSS. Mention the steps that should be taken by M/s CROSS before commencing the audit work.
7. Comment on the following situations:
- (a) The Board of Directors of Polite Ltd. made an aggregate of online contribution of ₹ 37.5 lakhs to a National Defence Fund for the financial year ending on 31<sup>st</sup> March, 2016. All the contribution of the fund is used for the welfare of the members of the Armed Forces and their dependents. The average net profit of the company during the three immediately preceding financial years was ₹ 476 lakhs.
- The manager of the company is of the view that the maximum contribution that can be made to a National Defence Fund is ₹ 35.7 lakhs and, therefore, the company is violating the provisions of the Companies Act, 2013.
- (b) Pirana Ltd. issued 10,000 shares of face value of ₹ 10 each at a premium of ₹ 490 each in May, 2015. The company received the stated minimum amount in the prospectus and transferred a sum equal to the aggregate amount of the premium received on shares (i.e. ₹ 49 lakhs) to the 'Securities Premium Account'.
- Unfortunately, in the month of July, the godown of the company caught fire and stock worth ₹ 45 lakhs burnt to ashes.
- Now, the management desires to adjust the loss due to fire against the said premium account.
- (c) Axel Ltd., a newly incorporated company in India, commenced its business from 1<sup>st</sup> April, 2014. The Company purchased a machinery costing ₹ 4,000 lakhs on 01.04.2014 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in 4 annual equal installments. Exchange rates were 1 Dollar = ₹ 40.00 and ₹ 43.00 as on 01-04-2014 and 31-03-2015 respectively. The company worked out foreign exchange loss as per AS 11 at ₹ 300 Lakhs and expensed the entire amount in the statement of profit and loss. The Managing Director of the company was worried about this heavy revenue loss and asked the accountant not to follow AS 11 issued by the ICAI for this particular transaction. The accountant of the company followed the instruction of the Managing Director and removed exchange loss from the statement of profit and loss but then he added the entire exchange loss to the value of machinery and computed the depreciation thereon.
- (d) Forex Pvt. Ltd. started stock broking activities in May, 2014. For this purpose, it acquired membership of a stock exchange for ₹ 150 lakhs. While finalizing the

accounts for the financial year ending March, 2015, the company disclosed the above amount under the Fixed Assets Schedule as "Stock Exchange Membership Rights". The company also did not write off any amount thinking that the rights would enable the company to perpetually carry on its business.

8. (a) E-Tech Pvt. Ltd., which has an aggregate outstanding loan of ₹ 20 lakhs from Banks and ₹ 30 lakhs from Financial Institutions, defaulted in repayment thereof to the extent of 50%. The company holds that it being a private limited company, the Companies (Auditor's Report) Order, 2015 is not applicable.

You are required to state the list of companies to which CARO is applicable and state how would you deal with the given situation as an auditor of the company.

- (b) Zig Pvt. Ltd. has granted a loan of ₹ 20 crores to its associate Zag Pvt. Ltd. at the beginning of the financial year and it remain outstanding at the year end. How the auditor should report the fact?
- (c) During the course of audit of Visionary Ltd. it is noticed that out of ₹ 12 lakhs of provident fund contribution accounted in the books, only ₹ 5 lakhs has been remitted to the authorities during the year. On enquiry, the Chief Accountant informed that due to financial problems they have not remitted but will remit the same as and when the position improves. As a Statutory Auditor, how would you deal?
- (d) You have been appointed as an auditor of Giant Ltd. The company closed one of its main manufacturing units and sold all its fixed assets during the financial year ended 31st March, 2015. However, it intends to continue its operations as a trading company. In respect of other fixed assets, the company carried out a physical verification as at the end of 31st March, 2015 and found a material discrepancy to the tune of ₹ 80,000, which was written off and is disclosed separately in the Statement of Profit and Loss. How are you supposed to incorporate the above in your audit report?

#### Liabilities of Auditor

9. (a) Cloud Ltd. appointed an auditor for the financial year 2015-16. While going through the audit procedure, the auditor observed that the management has entered into certain transactions which are irregular in nature and the management is personally benefited from such transactions.

Explain briefly the duties and responsibilities of an auditor in case of material misstatement resulting from Management Fraud.

- (b) Explain the liability of the auditor under section 35 of the Companies Act, 2013, for making an untrue statement in the report (as an expert forming a part of the prospectus).

#### Audit Committee and Corporate Governance

10. (a) A leading corporate in India approached Mr. Watson, a renowned and experienced

Chartered Accountant at international level, to join its Board and also as a Chairman of its Audit Committee for reviewing the annual financial statements of the entity. Mr. Watson expressed his consternation that he is not having the requisite experience regarding the responsibilities of an Audit Committee.

Mr. Watson seeks your advice on the responsibility of Audit Committee *vis-a-vis* the review of Financial Statements.

- (b) State the main features of the Qualified and Independent Audit Committee set up under clause 49 of the listing agreement.

#### **Audit of Consolidated Financial Statements**

11. Hold Ltd. has two subsidiaries and one associate. While doing the audit of Consolidated Financial Statements (CFS) of Hold Ltd., you have come to know that the associate entity had made a provision for proposed dividend in its financial statements. Hold Ltd. computed its share of the results of operations of the associate after taking into account the proposed dividend. Comment.

#### **Audit of Banks**

12. (a) Your firm has been appointed as central statutory auditors of Rustic Bank, a nationalised bank of India. In the course of audit, you observed that the accountant has classified an advance as NPA due to non-receipt of latest stock statement. You further observed that there are many other wrong classification of assets to NPA without considering RBI norms issued in this perspective.
- You are therefore required to guide him by stating the exceptions to the general rule of treating advances as Non-performing Assets (NPAs).
- (b) As the concurrent auditor of Unity Bank, you are requested by its management to draft an internal control policy in respect of loans and advances. What factors would you consider as important while drafting such a policy?

#### **Audit of General Insurance Companies**

13. While auditing Secure Insurance Ltd., you observed that the major proportion of expense of the company is the remuneration/commission paid to its insurance agents. As the auditor of the company, what audit procedure would you adopt for verification of such expense?

#### **Audit under Fiscal Laws**

14. (a) Ploy Ltd., engaged in the leasing of goods carriage, appointed you as the tax auditor for the financial year 2015-16. How would you deal with the following matters in your tax audit report:
- (i) Payments of 6 invoices of ₹ 5,000 each made in cash to Mr. X on 4<sup>th</sup> July, 2015.
- (ii) Payments of 2 invoices of ₹ 18,000 each made in cash to Mr. Y on

5<sup>th</sup> July, 2015 and 6<sup>th</sup> July, 2015 respectively.

(iii) Payment of ₹ 40,000 made in cash to Mr. Z on 7<sup>th</sup> July, 2015 against an invoice for expenses booked in 2014-15.

- (b) Beam Ltd., having principal place of business in Gujarat, is engaged in the generation, transmission, distribution and supply of electricity throughout the India. The management of the company came to know that the provisions related to maintenance of cost records and cost audit are applicable to the company. The company, therefore, appointed a cost auditor for the financial year 2015-16.

The cost auditor reported certain disqualifications in Form CRA-3 of the cost audit report to which the management of the company disagreed.

The management of Beam Ltd. ingeniously instructed its tax auditor not to reveal any of the disqualifications related to the cost audit while filling particulars to be furnished in Form No. 3CD contending that the disqualifications are not relevant and there is no correlation between tax audit and cost audit as well.

As a tax auditor, how would you deal with the matter?

- (c) Nadir India (P) Ltd. appointed a tax auditor under the value added tax system to conduct its VAT audit for the financial year 2015-16. You are required to state the approach to be adopted and the major areas to be tested by the tax auditor while conducting the tax audit under VAT laws.

### Cost Audit

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

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

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

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

### Audit of Public Sector Undertakings

16. (a) While planning a performance audit, the auditor should define the audit's objectives and the scope and methodology to achieve those objectives. What are the other



factors the auditor needs to consider while planning such audit?

- (b) What is a comprehensive audit of public enterprises? Discuss some of the areas to be examined therein.

#### **Internal Audit, Management and Operational Audit**

17. (a) UV Ltd. appointed CA Manan, a recently qualified CA, for conducting internal audit for the financial year 2015-16. CA Manan seeks your advice in drafting a good quality internal audit report. You are, therefore, required to guide him by elaborating essential features of a good internal audit report.
- (b) Operational Auditing is a systematic process involving logical, structured and organized series of procedures. It concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented.

In this perspective, state the following -

- (i) Need of operational auditing.
- (ii) Major differences between Financial and Operational Auditing.

#### **Investigation and Due Diligence**

18. (a) A departmental store has a very large turnover in cash sales of all kinds of items such as groceries, foodstuffs, sweets, chocolates, and other related items. One day, the accountant of the store stole all the cash receipts and cleverly misguided the management about the embezzlement.

The management appointed you to investigate the suspected embezzlement of cash receipts in the departmental store. What are the steps you would take in this regard?

- (b) A nationalised bank received an application from a limited company seeking sanction of a term loan to expand its existing business. In this connection, the Loan Manager of the Bank approaches you to conduct a thorough investigation of the Balance Sheet of this limited company and submit a confidential report based on which he will decide whether to sanction this loan or not.

List out the major steps an investing accountant would involve in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank.

#### **Professional Ethics**

19. Comment on the following with reference to the Chartered Accountants Act, 1949, and Schedules thereto:
- (a) CA Brilliant is a leading income tax practitioner and consultant for derivative products. He resides in Mumbai near to the XYZ commodity stock exchange and does trading in commodity derivatives. Every day he invests most of his time to

settle the commodity transactions though he has not obtained any permission from the Institute for conducting such business.

- (b) CA Intelligent, a Chartered Accountant in practice, provides part-time tutorship under the coaching organization of the Institute. On 30<sup>th</sup> June, 2015, he was awarded 'Best Faculty of the year' as gratitude from the Institute. Later on, CA Intelligent posted his framed photograph on his website wherein he was receiving the said award from the Institute.
- (c) Mr. Hopeful, an aspiring student of ICAI, approached Mr. Witty, a practicing Chartered Accountant, for the purpose of articleship. Mr. Witty, the principal, offered him stipend at the rate of ₹ 2,000 per month to be paid every sixth month along with interest at the rate of 10% per annum compounded monthly to compensate such late payment on plea that cycle of professional receipts from clients is six months. Mr. Hopeful agreed for such late payment in the hope of getting extra stipend in the form of interest.

Mr. Witty, however, used to disburse salary to all of his employees on time.

- (d) MNC Pvt. Ltd. appointed CA Posh for some professional assignments like company's ROC work, preparation of minutes, statutory register etc. For this, CA Posh charged his fees depending on the complexity and the time spent by him on each assignment.

Later on, MNC Pvt. Ltd. filed a complaint against CA Posh to the Institute of Chartered Accountants of India (ICAI) that he has charged excessive fees for the assignments comparative to the scale of fees recommended by the Committee as well as duly considered by the Council of ICAI.

#### Other Miscellaneous Chapters

20. Write short notes on the following:

- (a) Focus of a Peer review.
- (b) Statistical and Non-Statistical Sampling.
- (c) Purpose of appointing Inspecting officer of a Depository.
- (d) Restrictions on investments of funds of a central co-operative society.
- (e) Special points that may be covered in the audit of equipment leasing finance company.

#### SUGGESTED ANSWERS / HINTS

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

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

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

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

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

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

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

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

- (b) **Relying on Work Performed by Another Auditor:** As per SA 220 "Quality Control for an Audit of Financial Statements", an engagement partner taking over an audit during the engagement may apply the review procedures such as the work has been performed in accordance with professional standards and regulatory and legal requirements; significant matters have been raised for further consideration; appropriate consultations have taken place and the resulting conclusions have been documented and implemented; there is a need to revise the nature, timing and extent of work performed; the work performed supports the conclusions reached and is appropriately documented; the evidence obtained is sufficient and appropriate to support the auditor's report; and the objectives of the engagement procedures have been achieved.

Further, one of the basic principles, which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried, is that when the auditor delegates work to assistants or uses work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. This is the fundamental principle which is ethically required as per Code of Ethics.

However, the auditor should carefully direct, supervise and review work delegated. He should obtain reasonable assurance that work performed by other auditors/experts and assistants is adequate for his purpose.

In the given case, all the auditing procedures before the moment of signing of final report have been performed by CA Suresh. However, the report could not be signed by him due to his unfortunate death. Later on, CA Chandra signed the report relying on the work performed by CA Suresh. Here, CA Chandra is allowed to sign the audit report, though, will be responsible for expressing the opinion. He may rely on the work performed by CA Suresh provided he further exercises adequate skill and due care and review the work performed by him.

2. (a) **Evaluating the Work of Management's Expert:** As per SA 500 "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes,-
- (i) Evaluate the competence, capabilities and objectivity of that expert;
  - (ii) Obtain an understanding of the work of that expert; and
  - (iii) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

The auditor may obtain information regarding the competence, capabilities and objectivity of a management's expert from a variety of sources, such as personal experience with previous work of that expert; discussions with that expert;

discussions with others who are familiar with that expert's work; knowledge of that expert's qualifications; published papers or books written by that expert.

Aspects of the management's expert's field relevant to the auditor's understanding may include what assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.

The auditor may also consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion:

- (i) The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- (ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
- (iii) If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

**(b) 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, CA Kishor 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.

**3. Audit Programme of a Complex:**

- (i) Peruse the Memorandum of Association and Articles of Association of the entity.
- (ii) Ensure the object clause permits the entity to engage in this type of business.
- (iii) In the case of income from sale of tickets:
  - (1) Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly accounted.
  - (2) Verify the system of relating to online booking of various shows and the system of realization of money.
  - (3) Check that there is overall system of reconciliation of collections with the number of seats available for different shows on a day.
- (iv) Verify the internal control system and its effectiveness relating to the income from cafe shops, pubs etc., located within the multiplex.
- (v) Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.
- (vi) Verify the system of collection from the parking areas in respect of the vehicles parked by the customers.
- (vii) In the case of payment to the distributors verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement any payment of advance made to the distributor is also adjusted against the amount due.
- (viii) Verify the system of payment of salaries and other benefits to the employees and ensure that statutory requirements are complied with.
- (ix) Verify the payments effected in respect of the maintenance of the building and ensure the same is in order.

**4. (a) (i) Internal Controls over Sales Order Processing**

Objectives	Extent to which achieved by Max Ltd's procedures
➤ To ensure that goods are available for all orders accepted.	<ul style="list-style-type: none"> <li>➤ The availability of inventories is checked on the computer system while the customer is on the line.</li> <li>➤ This will be effective only where the system is continuously updated for new orders and deliveries of inventories.</li> </ul>
➤ To ensure that existing customers are within	➤ The computer system automatically checks that the

their credit limits (including the current order being taken).	customer is within his current credit limit. ➤ Adjustments to credit limits are carried out by the credit controller but no review of any amendments is carried out.
➤ To ensure that new customers are credit worthy before	➤ The credit controller carries out credit checks but details are amended on the terminal in the accounts department only after oral authority from the chief accountant, and no subsequent review of new customers is performed.
➤ To ensure that changes to credit limits are valid.	➤ As above.
➤ To ensure that the correct goods are dispatched to each customer.	➤ Order details are read back to the customer to confirm their accuracy. ➤ Packing notes are produced in the warehouse giving the details of the order. However, there is no responsibility assigned in respect of dealing with shortfalls of inventories and ensuring that the customer ultimately receives all of the goods ordered.
➤ To ensure that goods are dispatched for all orders accepted	➤ Packing notes are sequentially numbered and a completeness check is carried out on a daily basis.
➤ To ensure that all goods leaving the premises are in respect of valid orders.	➤ All goods leaving the warehouse are checked at the gate house to ensure that they are accompanied by a valid delivery advice.
➤ To ensure that back orders are fulfilled when inventories become available.	➤ There are no procedures in place to ensure that, one goods are received by Max Ltd., back orders are fulfilled.

## (ii) Points for inclusion in a report to management

Weakness	Consequence	Recommendation
<ul style="list-style-type: none"> <li>➤ There is no review of amendments to credit limits once these have been processed on the system.</li> </ul>	<ul style="list-style-type: none"> <li>➤ Invalid amendments could be made, leading to supply of goods to non-credit worthy customers.</li> </ul>	<ul style="list-style-type: none"> <li>➤ An exception report should be produced on a weekly basis detailing all changes made to credit limits. This should be reviewed by the chief accountant, and evidenced by his signature, to ensure that all amendments are for valid business reasons.</li> </ul>
<ul style="list-style-type: none"> <li>➤ Authority to enter new customers on to the system is only given orally with no review of the credit ratings and references obtained.</li> </ul>	<ul style="list-style-type: none"> <li>➤ Invalid entries of new customers could be made without detection until non-payment of invoices arises.</li> </ul>	<ul style="list-style-type: none"> <li>➤ The chief accountant should review the credit ratings and references obtained before giving authority to accept the new customer.</li> </ul>
<ul style="list-style-type: none"> <li>➤ There is no responsibility assigned for dealing with shortfalls in orders when they are being selected in the warehouse.</li> </ul>	<ul style="list-style-type: none"> <li>➤ Delivery of part-complete orders and non-delivery of parts of orders will lead to loss of customer goodwill and subsequent loss of revenue.</li> </ul>	<ul style="list-style-type: none"> <li>➤ A daily printout of unprocessed orders should be produced and followed up by the warehouse supervisor.</li> </ul>
<ul style="list-style-type: none"> <li>➤ There are no procedures to ensure that back orders are fulfilled when the goods become available.</li> </ul>	<ul style="list-style-type: none"> <li>➤ Delay in fulfilling customer orders will again lead to loss of customer goodwill.</li> </ul>	<ul style="list-style-type: none"> <li>➤ The system should produce a daily list of items that have come into inventory for which there are current backorders. The sales ledger clerk should contact</li> </ul>



		the customer to ensure that the goods are still required and then process the order in the normal manner.
➤ When back orders are accepted the goods which are unavailable are not immediately reordered.	➤ There may be significant delays in fulfilling these orders.	➤ The computer should automatically generate purchase requisitions on a daily basis for items which have been requested but are unavailable. A supervisor should review these purchase requisitions and raise a purchase order where the goods have not already been ordered.

**Additional notes:**

- Credit control procedures do not take the age of the debt into consideration; this could result in goods being dispatched to slow payers.
- In respect of the failure to review credit limits on a regular basis, limits may be unrealistically low for customers with a good payment history, resulting in loss of business.
- Response time in respect of systems support is too slow; this could result in delayed and lost orders.

**(b) Major Provisions of Sarbanes Oxley Act:** The Sarbanes Oxley Act of 2002 established corporate accountability and civil and criminal penalties for white – collar crimes. This Act also known as the Public Company Accounting Reform and Investor Protection Act of 2002 and commonly called SOX or Sarbox; is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. These scandals resulted in a decline of public trust in accounting and reporting practices.

This Act provides regulatory bodies and courts to take various actions – civil and criminal proceedings in connection of misstatements amounting to accounting scandals and fraudulent financial reports, other frauds on securities matters, obstruction of justice and retaliating against corporate whistleblowers. The Act also enforces tougher civil and criminal penalties for fraud and accounting scandals, securities fraud and certain other forms of obstruction of justice. The Act further protects employer against corporate whistle blowers (person who provides evidence of fraud in the company).

Some of the major provisions of Sarbanes-Oxley Act of 2002 are:

- (i) Creation of the Public Company Accounting Oversight Board (PCAOB);
- (ii) A requirement that public companies evaluate and disclose the effectiveness of their internal controls as they relate to financial reporting, and that independent auditors for such companies "attest" (i.e., agree, or qualify) to such disclosure;
- (iii) Certification of financial reports by chief executive officers and chief financial officers;
- (iv) Auditor independence, including outright bans on certain types of work for audit clients and pre-certification by the company's Audit Committee of all other non-audit work;
- (v) Ban on most personal loans to any executive officer or director;
- (vi) Accelerated reporting of insider trading;
- (vii) Prohibition on insider trades during pension fund blackout periods;
- (viii) Enhanced criminal and civil penalties for violations of securities law;
- (ix) A requirement that companies listed on stock exchanges have fully independent audit committees that oversee the relationship between the company and its auditor;
- (x) Additional disclosure;
- (xi) Significantly longer maximum jail sentences and larger fines for corporate executives who knowingly and willfully misstate financial statements, although maximum sentences are largely irrelevant because judges generally follow the Federal Sentencing Guidelines in setting actual sentences;
- (xii) Employee protections allowing those corporate fraud whistleblowers who file complaints with OSHA within 90 days to win reinstatement, back pay and benefits, compensatory damages, and congressional page abatement orders, and reasonable attorney fees and costs.

5. (a) **The Risks and Internal Control Characteristics in CIS Environment include the following:**

- (i) **Lack of transaction trails:** Some computer information systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form. Where a complex application system performs a large number of processing steps, there may not be a complete trail. Accordingly, errors embedded in an application's program logic may be difficult to detect on a timely basis by manual (user) procedures.
- (ii) **Uniform processing of transactions:** Computer processing uniformly processes like transactions with the same processing instructions. Thus, the clerical errors ordinarily associated with manual processing are virtually eliminated. Conversely, programming errors (or other systemic errors in hardware or software) will ordinarily result in all transactions being processed incorrectly.
- (iii) **Lack of segregation of functions:** Many control procedures that would ordinarily be performed by separate individuals in manual systems may become concentrated in a CIS environment. Thus, an individual who has access to computer programs, processing or data may be in a position to perform incompatible functions.
- (iv) **Potential for errors and irregularities:** The potential for human error in the development, maintenance and execution of computer information systems may be greater than in manual systems, partially because of the level of detail inherent in these activities. Also, the potential for individuals to gain unauthorised access to data or to alter data without visible evidence may be greater in CIS than in manual systems.

In addition, decreased human involvement in handling transactions processed by computer information systems can reduce the potential for observing errors and irregularities. Errors or irregularities occurring during the design or modification of application programs or systems software can remain undetected for long periods of time.

- (v) **Initiation or execution of transactions:** Computer information systems may include the capability to initiate or cause the execution of certain types of transactions, automatically. The authorisation of these transactions or procedures may not be documented in the same way as that in a manual system, and management's authorisation of these transactions may be implicit in its acceptance of the design of the computer information systems and subsequent modification.
- (vi) **Dependence of other controls over computer processing:** Computer processing may produce reports and other output that are used in performing manual control procedures. The effectiveness of these manual control

procedures can be dependent on the effectiveness of controls over the completeness and accuracy of computer processing. In turn, the effectiveness and consistent operation of transaction processing controls in computer applications is often dependent on the effectiveness of general computer information systems controls.

- (vii) **Potential for increased management supervision:** Computer information systems can offer management a variety of analytical tools that may be used to review and supervise the operations of the entity. The availability of these analytical tools, if used, may serve to enhance the entire internal control structure.
  - (viii) **Potential for the use of computer-assisted audit techniques:** The case of processing and analysing large quantities of data using computers may require the auditor to apply general or specialised computer audit techniques and tools in the execution of audit tests.
- (b) **Use of Audit Software:** CAATs allow the auditor to give access to data without dependence on the client, test the reliability of client software and perform audit tests more efficiently. CAATs are used to perform various audit procedures like-
- (i) Tests of details of transactions and balances e.g. use of audits software to test all or a few transactions in a computer file.
  - (ii) Analytical review procedures e.g. use of audit software to identify unusual fluctuations or items.
  - (iii) Compliance tests of IT application controls e.g. use of test data to test the functioning of a programmed procedure.

However, the methods of applying audit procedures to gather evidence may be influenced by the methods of computer processing. Sometimes, in some accounting systems that use of computer for processing significant applications, it may difficult or impossible for an auditor to obtain certain data for inspection, inquiry or confirmation without computer assistance.

**CAAT in Fraud Detection:** In a CIS Environment, the Auditor is required to plan his work by exercising reasonable care and skill in such a manner that there is reasonable expectation of detecting material misstatements in the financial information resulting from fraud or error.

Use of the CAAT/ audit software systems will help the auditor to identify errors and frauds in the accounting and internal control system.

**Conclusion:** Frauds are intentional. Auditing through the computer with adequate knowledge of computer systems may highlight some frauds, but there is no empirical evidence to prove the assertion that the use of audit software systems has unearthed well concealed frauds.

Thus, it cannot be conclusively said that use of audit software systems increases the probability of detection of fraud.

6. (a) **Indebtness to the Company:** According to the section 141(3)(d)(ii) of the Companies Act, 2013, a person who is indebted to the company for an amount exceeding ₹ 5,00,000 shall be disqualified to act as an auditor of such company and further under section 141(4) he shall vacate his office of auditor when he incurs this disqualification subsequent to his appointment.

However, where the person has liquidated his debt before the appointment date, there is no disqualification to be construed for such appointment.

In the given case, CA Adroit was indebted to Anfractuous (P) Ltd. for a sum of ₹ 6,00,000 as on 01.04.2015. He was appointed as an auditor of the company for the year ended 31.03.2016 at the Annual General Meeting held on 16.07.2015. He also repaid the loan amount fully to the company on 10.7.2015 i.e. before the date of his appointment.

Hence, the appointment of CA Adroit as an auditor is valid and the shareholder's complaint is not acceptable.

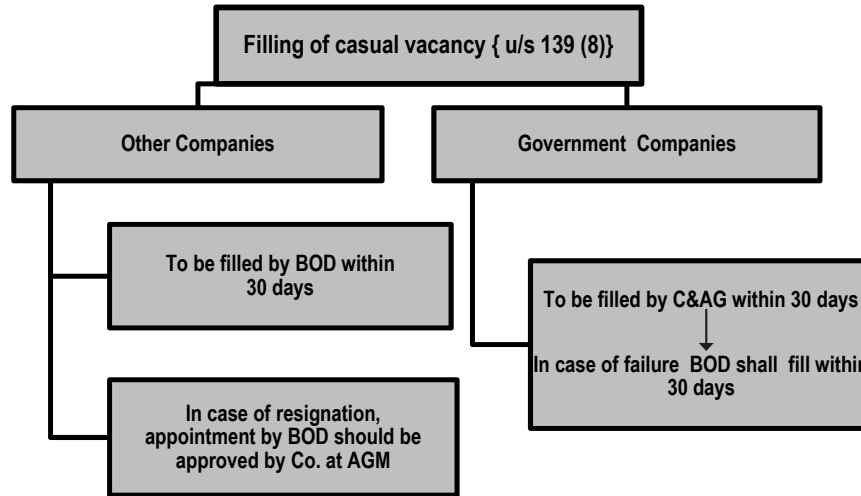
- (b) **Filling of Casual Vacancy:** According to section 139(8) of the Companies Act, 2013, any casual vacancy in the office of an auditor shall-

- (i) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within 3 months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

- (ii) In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within 30 days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within he said period the Board of Directors shall fill the vacancy within next 30 days.



In the given case, CA Max, the statutory auditor of Y Ltd. has resigned from the office of auditor. Therefore, such casual vacancy can be filled by the Board of Directors subject to approval by the company at a general meeting convened within 3 months of the recommendation of the Board.

Thus, the appointment of CA Mini made by the Board of Directors without the approval of the company at a general meeting is invalid.

Further, if appointment is approved by the company, CA Mini cannot hold the office of auditor till the conclusion of 6<sup>th</sup> meeting i.e. the appointment cannot be made for five years. The auditor can hold office only till the conclusion of the next AGM.

(c) (i) **Appointment of First Auditor:** Provisions of the Companies Act, 2013 relating to appointment of first auditor are stated below-

**(1) Appointment of First Auditor in the case of a company, other than a Government Company-** As per Section 139(6), the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

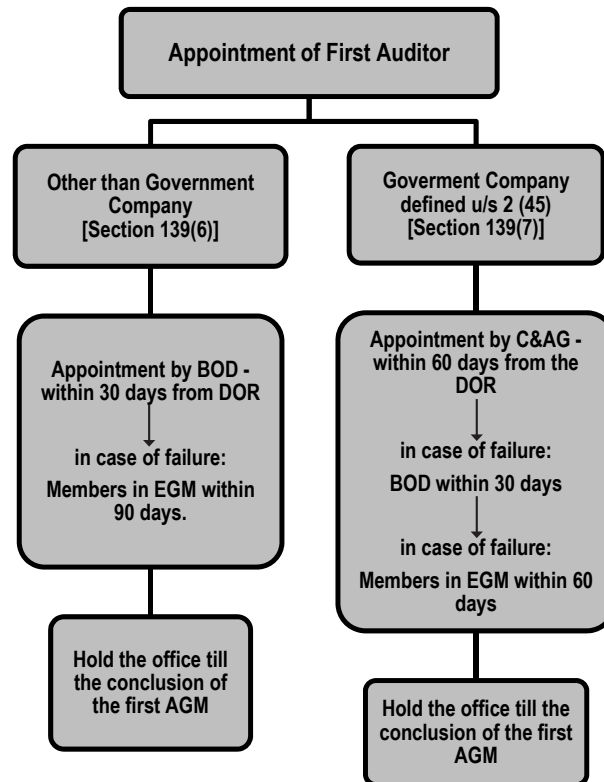
In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

**(2) Appointment of First Auditor in the case of Government Company-** Section 139(7) 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.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.



(ii) **Appointment of First Auditor by the Managing Director:** Apparently, there are two issues arising out of the situation given in the question, viz., first one relates to appointment of first auditor by the Managing Director; and second pertains to relation of such an auditor with the Managing Director. Regarding the first issue relating to appointment of auditor, particularly, in this case relating to appointment of first auditor, it may be noted that as per the provisions of section 139(6) of the Companies Act, 2013, the first auditor of a

company shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

As per the facts given in the case, the appointment of CA Rajnath as first auditor by the Managing Director of Malta Pvt. Ltd. by himself is in violation of section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company within one month of registration of the company.

Thus, the appointment of CA Rajnath is not valid. Under the circumstances, the second issue relating to relationship of auditor with Managing Director becomes redundant.

- (d) **Steps before commencing the Audit Work:** When one of the joint auditors of the previous year is considered for ratification by the members as the sole auditor for the next year, it is similar to non re-appointment of one of the retiring joint auditors. The provisions of section 140 of the Companies Act, 2013 (hereinafter referred as the Act) relating to non-reappointment of the retiring auditor need to be considered. As per sub-section 4 of section 140 of the Act, special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or, as the case may be, ten years, as provided under sub-section (2) of section 139 of the Act.

The following steps should be taken care of by M/s CROSS before commencing the audit:

- (i) Ascertain that special notice under section 140(4) of the Act was duly received by the company from such number of members holding not less than one percent of total voting power or holding shares on which an aggregate sum of not less than five lakh rupees has been paid up on the date of the notice, not earlier than three months but at least 14 days before the AGM date as per section 115 of the Act read with the Companies (Management and Administration) Rules, 2014.
- (ii) Check whether the said notice has been sent to all the members at least 7 days before the date of the AGM as per section 115 of the Act.
- (iii) Verify the notice contains an express intention of a member for proposing the resolution for appointing a sole auditor in place of both the joint auditors who retire at the meeting but are eligible for re-appointment.
- (iv) Verify that the said notice is also sent to the retiring auditor as per section 140(4)(ii) of the Act.
- (v) Verify whether any representation received from the retiring auditor was sent to the members of the company to whom notice of the meeting was sent as per section 140(4)(iii) of the Act.



- (vi) Verify from the minutes book whether the representation received from the retiring joint auditor was considered at the AGM.
- (vii) Examine that proposed resolution was properly passed.

Further, Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949 provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant without first communicating with him in writing. Moreover, Clause (9) of Part I of the same Schedule provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Sections 224 and 225 of the Companies Act, 1956 (now Section 139 and 140 read with section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Therefore, M/s CROSS is required to comply with all the above mentioned provisions provided under Companies Act and Chartered Accountants Act before commencing the audit.

7. (a) **Contribution to National Defence Fund:** Section 183 of the Companies Act, 2013 deals with the power of Board and other persons to make contributions to National Defence Fund, etc. This section permits the Board and other person to make contributions to the National Defence Fund or any other Fund approved by the Central Government for the purpose of National Defence to any extent as it thinks fit.

In the given case, the board of Polite Ltd. has made an aggregate of online contribution of ₹ 37.5 lakhs to a National Defence Fund. However, according to the manager of Polite Ltd., the maximum contribution that can be made to the Fund is ₹ 35.7 lakhs.

In this context, it may be noted that there is no such restriction imposed on contributions to National Defence Fund. The board is free to contribute such amount as it thinks fit.

Therefore, the view of the manager of Polite Ltd. is not appropriate and, thus, there is no such violation of the provisions of section 183 of the Companies Act, 2013. The data on average net profit of the company given in question is of no relevance here.

- (b) **Application of Securities Premium Account:** Section 52 of the Companies Act, 2013 (herein after referred as the Act) deals with the application of premium received on issue of shares. The said section provides that where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to an account called "Securities Premium Account" and the provisions of this Act relating to reduction of share capital of a company except as provided in this section

shall apply as if the securities premium account was the paid up share capital of the company.

However, as per section 52, the securities premium account may be applied for the following purposes:

- (i) towards the issue of fully paid bonus shares;
- (ii) in writing off the preliminary expenses;
- (iii) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures;
- (iv) in providing for the premium payable on the redemption of any redeemable preference shares or debentures; or
- (v) for the purchase of its own shares or other securities under section 68 of the Companies Act, 2013.

In the given case, the management of Pirana Ltd. desires to adjust the loss due to fire against the securities premium account.

In view of the above provisions of the Companies Act, 2013, it may be noted that the company is not permitted to adjust its loss against the securities premium account.

- (c) **Treatment of Changes in Foreign Exchange Rates:** As per Para 46A(1) of Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates", the exchange differences arising on reporting of long-term foreign currency monetary items in so far as they relate to the acquisition of a depreciable capital asset, in respect of accounting periods commencing on or after the 1st April, 2011, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, it can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods.

In the given case, the accountant of Axel Ltd. has added the exchange loss to the value of machinery and computed the depreciation thereon.

In this context, it may be noted that Axel Ltd. has the choice to avail this option. However, the company should disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized.

- (d) **Stock Exchange Membership Rights:** Forex Pvt. Ltd. has paid ₹ 150 lakhs for acquiring membership of stock exchange. Such membership rights provide exclusive right to Forex Pvt. Ltd. for carrying out stock broking activities. Thus, Stock Exchange Membership Rights are controlled by Forex Pvt. Ltd. and provide the basis for generating economic benefits to it. All these criteria appear to meet

the definition of intangible assets as laid down in AS 26 "Intangible Assets". The Standard requires an entity to recognize an intangible asset if it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise and the cost of the asset can be measured reliably.

In the instant case, membership rights of stock exchange acquired by Forex Pvt. Ltd. meet the criteria of identifiability, control and arising of future benefits as well as reliability of the amount of cost. Thus, recognizing the membership rights as Fixed Assets is proper.

However, the fact that the company did not write-off any amount since it would enable the company to perpetually carry on its business is not proper since AS 26 requires that all Intangible Assets to be amortised. For this purpose, a rebuttable presumption of 10 years is to be considered. Hence, in the instant case, the company should have amortised such rights over 10 years. Since the company has not amortised any amount, the auditor will have to qualify his report and state the fact of non-compliance with AS 26.

8. (a) **Applicability of Companies (Auditor's Report) Order, 2015 [CARO, 2015]:** The CARO, 2015 is an additional reporting requirement Order which has been issued by the Central Government in consultation with the Institute of Chartered Accountants of India under section 143(11) of the Companies Act, 2013.

The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013. However, the Order specifically exempts the following class of companies-

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;
- (ii) an insurance company as defined under the Insurance Act, 1938;
- (iii) a company licensed to operate under section 8 of the Companies Act;
- (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act;
- (v) a small company as defined under clause (85) of section 2 of the Companies Act; and
- (vi) a private limited company with a paid up capital and reserves not more than ₹ 50 lakh and which does not have loan outstanding exceeding ₹ 25 lakh from any bank or financial institution and does not have a turnover exceeding ₹ 5 crore at any point of time during the financial year.

In the given case, E-Tech Pvt. Ltd. has outstanding loan of ₹ 50 lakhs (₹ 20 lakhs + ₹ 30 lakhs) from Banks and Financial Institutions together, which is exceeding the limit prescribed under Order for applicability of exemption.

Therefore, CARO, 2015 will be applicable to E-Tech Pvt. Ltd. Thus, the period and amount of default need to be reported for default in repayment of dues to bank or financial institution under clause (ix) of Para 3 of CARO, 2015.

**(b) Reporting of "Loan to Related Party":** As per AS 18 "Related Party Disclosures", related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged. According to this AS, 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.

Additionally, the auditor is required to report on certain matters specified in Para 3 of CARO, 2015 under section 143(11) of the Companies Act, 2013. As per clause (iii) of Para 3 of CARO, 2015, if the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 189 of the Companies Act, 2013, the auditor is required to report-

- (a) whether receipt of the principal amount and interest are also regular; and
- (b) if overdue amount is more than ₹ 1 lakh, whether reasonable steps have been taken by the company for recovery of the principal and interest.

In the instant case, Zig Pvt. Ltd. has granted a loan of ₹ 20 crores to its associate Zag Pvt. Ltd. and it remain outstanding at the year end. The case is squarely covered by AS 18.

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

Therefore, the auditor should insist to make proper disclosure as per the AS and report as per CARO, 2015. If management refuses, the auditor shall have to modify his report.

- (c) **Non-Compliance of Laws and Regulations & Reporting Requirements:** As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", it is the responsibility of management with the oversight of those charged with governance to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected even though the audit is properly planned and performed in accordance with the SAs.

If the auditor concludes that the non-compliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

Further, as per section 128 of the Companies Act, 2013, a company has to maintain proper books of account on accrual basis and according to the double entry system of accounting.

Additionally, as per Section 43B of the Income Tax Act, 1961, there are certain expenses, which includes any sum payable by the assessee as an employer by way of contribution to any provident fund, which are allowed only on its actual payment.

The auditor is, therefore, required to report under clause (vii)(a) of Para 3 of CARO, 2015 whether the company is regular in depositing undisputed statutory dues including provident fund with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

In the instant case, out of ₹ 12 lakhs of provident fund contribution accounted in the books, only ₹ 5 lakhs has been remitted to the authorities due to financial problems during the year. Hence, even though accrual principles have been followed, disclosure of non-payment is necessary. The auditor should disclose the fact of non-payment of ₹ 7 lakhs in his report.

- (d) **Disclosure in Audit Report:** As per SA 570 "Going Concern", when the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements-
- (i) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's

plans to deal with these events or conditions; and

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

The auditor is further required to specifically include certain matters as per CARO, 2015 under section 143(11) of the Companies Act, 2013. According to clause (i)(b) of Para 3 of CARO, the auditor has to comment whether the fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account.

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

**Para in the Audit Report-**

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

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

9. (a) **Duties & Responsibilities of an Auditor in case of Material Misstatement resulting from Management Fraud:** As per SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", fraud can be committed by management overriding controls using such techniques as engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.

The primary responsibility for the prevention and detection of fraud rests with those charged with the governance and the management of the entity.

Further, an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the

inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

The risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees

Auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, hence in an audit, the auditor does not guarantee that material misstatements will be detected.

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

The auditor is also required to report as per clause (xii) of Paragraph 3 of CARO, 2015, if there is any fraud on or by the company has been noticed or reported during the year. The nature and the amount involved are to be indicated.

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

- (i) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
- (ii) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and
- (iii) If the auditor withdraws:
  - (1) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
  - (2) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

**(b) Liability of Auditor under section 35 of the Companies Act, 2013:** Under section 35 of the Companies Act, 2013, where a person has subscribed for

securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who-

- (i) is a director of the company at the time of the issue of the prospectus;
- (ii) has authorized himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;
- (iii) is a promoter of the company;
- (iv) has authorised the issue of the prospectus; and
- (v) is an expert referred to in sub-section (5) of section 26,

shall, without prejudice to any punishment to which any person may be liable under section 36, be liable to pay compensation to every person who has sustained such loss or damage.

No person shall be liable under sub-section (1) of section 35, if he proves—  
(i) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent; or (ii) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.

It may be noted that anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) of section 35 shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.

**10. (a) Responsibility of Audit Committee *vis-a-vis* review of Financial Statements:**

The responsibility of the audit committee while reviewing the annual financial statements with management before submission to the Board, focuses primarily on-

- (i) Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (c) of sub-section 3 of section 134 of the Companies Act, 2013.
- (ii) Changes, if any, in accounting policies and practices and reasons for the same.
- (iii) Major accounting entries involving estimates based on the exercise of judgment by management.
- (iv) Significant adjustments made in the financial statements arising out of audit findings.



- (v) Compliance with listing and other legal requirements relating to financial statements.
- (vi) Disclosure of any related party transactions.
- (vii) Qualifications in the draft audit report.

**(b) Features of Qualified and Independent Audit Committee:** The main features of a qualified and independent audit committee to be set up under clause 49 of listing agreement are as follows-

- (1) The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors;
- (2) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise;

**Explanation (i):** The term “financially literate” means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

**Explanation (ii):** A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

- (3) The Chairman of the Audit Committee shall be an independent director;
- (4) The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;
- (5) The Audit Committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;
- (6) The Company Secretary shall act as the secretary to the committee.

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

share of the investor in the revalued amount, the corresponding amount of revaluation reserve is shown in the consolidated balance sheet.

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

Applying the above provisions to the given problem, Hold Ltd. should have computed its share of the results of operations of the associate without taking into consideration the proposed dividend. Therefore, treatment made by Hold Ltd. is not correct.

12. (a) **Non-Performing Assets:** RBI has laid down norms for classification of assets and provisioning norms for NPAs. However, certain exceptions to these norms are discussed below-
- (i) **Temporary Deficiencies**, e.g., non availability of current drawing power due to non-receipt of latest stock statement, temporary delay in renewals of limits on due date, etc.
  - (ii) **Natural Calamities:** Where, in the wake of natural calamities, short-term agricultural loans are converted into term loans or there is rescheduling of repayment period or fresh short-term loans are sanctioned, the term loan as well as fresh short term loan may be treated as current dues and need not be classified as NPA.
  - (iii) **Facilities backed by Central Government Guarantees:** Credit facilities backed by guarantee of the Central Government though overdue should be treated as NPA only when the government repudiates its guarantee when invoked (this exemption is only for the purpose of asset classification and provisioning and not for the purpose of recognition of income).
  - (iv) **Advances to "On Lending" arrangements** are also exempted under this category.
- (b) **Drafting of Internal Control Policy for Loans and Advances:** The following are the important factors to be considered while drafting internal control policy in respect of loans and advances of Unity Bank-
- (i) The bank should make advances only after satisfying itself as to the creditworthiness of the borrowers and after obtaining sanction from the proper authorities of the bank.
  - (ii) All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
  - (iii) Sufficient margin should be kept against securities taken so as to cover any decline in the value thereof and also to comply with Reserve Bank directives. Such margins should be determined by the proper authorities of the bank as a general policy or for particular accounts.

- (iv) All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers.
- (v) All securities requiring registration should be registered in the name of the bank or otherwise accompanied by the documents sufficient to give title of the bank.
- (vi) In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipts. The godowns should be regularly and frequently inspected by a responsible officer of the branch concerned, in addition by the inspectors of the bank.
- (vii) Surprise checks should be made in respect of hypothecated goods not in the possession of the bank.
- (viii) Market value of goods should be checked by officers of the bank by personal enquiry in addition to the invoice value given by the borrowers.
- (ix) As soon as any increase or decrease takes place in the value of securities proper entries should be made in the Drawing Power Book and Daily Balance Book. These entries should be checked by an officer.
- (x) All accounts should be kept within both the drawing power and the sanctioned limit at all times.
- (xi) All the accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly.
- (xii) The operation in each advance should be reviewed at least once every year.
- (xiii) Post disbursement supervision and follow-up should be proper, such as receipt of stock statements, instalments, renewal of limits, etc.
- (xiv) There should not be any mis-utilisation of the loans and instances indicative of diversion of funds should be checked.
- (xv) Letters of credit issued by the branch should be within the delegated power and should be for genuine trade transactions.
- (xvi) Bank guarantees issued, should be properly worded and recorded in the register of the bank. They should be promptly renewed on the due dates.
- (xvii) Proper follow-up should be made for overdue bills of exchange.
- (xviii) The classification of advances should be done as per RBI guidelines.
- (xix) The submission of claims to DICGC and ECGC should be on time.
- (xx) Instances of exceeding delegated powers should be promptly reported to controlling/Head Office by the branch and should be got confirmed or ratified at the required level.

**13. Commission Paid to Insurance Agents:** It is a well-known fact that insurance business is solicited by insurance agents. The remuneration of an agent is paid by way of commission which is calculated by applying a percentage to the premium collected by him. Commission is payable to the agents for the business procured through them and is debited to Commission on Direct Business Account. There is a separate head for commission on reinsurance accepted which usually arise in case of Head Office. It may be noted that under section 40 of Insurance Act, 1938, no commission can be paid to a person who is not an agent or intermediary of the insurance company.

The auditor should, *inter alia*, do the following for verification of commission-

- (i) Vouch disbursement entries with reference to the disbursement vouchers with copies of commission bills and commission statements.
- (ii) Check whether the vouchers are authorised by the officers-in-charge as per rules in force and income tax is deducted at source, as applicable.
- (iii) Test check correctness of amounts of commission allowed.
- (iv) Scrutinise agents' ledger and the balances, examine accounts having debit balances, if any, and obtain information on the same. Necessary rectification of accounts and other remedial actions have to be considered.
- (v) Check whether commission outgo for the period under audit been duly accounted.

**14. (a) Reporting of Payments Exceeding ₹ 35,000 in Cash:** Disallowance under section 40A(3) of the Income Tax Act, 1961 is attracted if the assessee incurs any expenses in respect of which payment or aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on bank or account payee draft, exceeds ₹ 20,000. However, in case of payment made for plying, hiring or leasing of goods carriage, limit is ₹ 35,000 instead of ₹ 20,000.

Further, as per section 40A(3A) of the Income Tax Act, 1961, where an allowance has been made in the assessment for any year in respect of any liability incurred by the assessee for any expenditure and subsequently during any previous year the assessee makes payment in respect thereof, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, the payment so made shall be deemed to be the profits and gains of business or profession and accordingly chargeable to income-tax as income of the subsequent year if the payments made to a person in a day, exceeds ₹ 20,000 (₹ 35,000 in case of plying, hiring or leasing of goods carriages).

However, exemption is provided under Rule 6DD having regard to nature and extent of banking facilities available and other relevant factors.

Subsequently, under clause 21(d)(A) and 21(d)(B) of Form 3CD, the tax auditor has to scrutinize on the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) and 40A(3A) respectively read with rule 6DD were made by account payee cheque

drawn on a bank or account payee bank draft. If not, the same has to be reported under abovementioned clauses.

Therefore, as per the provisions and explanations discussed above, the given cases are dealt as under-

- (i) Payments of 6 invoices of ₹ 5,000 each aggregating ₹ 30,000 made in cash on 4<sup>th</sup> July, 2015 need not be reported as the aggregate of payments do not exceed ₹ 35,000.
- (ii) Payments of 2 invoices of ₹ 18,000 each made in cash on 5<sup>th</sup> July, 2015 and 6<sup>th</sup> July, 2015 respectively aggregating ₹ 36,000 need not be reported as the payment do not exceed ₹ 35,000 in a day.
- (iii) Payment of ₹ 40,000 made in cash against an invoice for expenses booked in 2014-15 is likely to be deemed to be the profits and gains of business or profession under section 40A(3A) of the Income Tax Act, 1961. Thus, the details of such amount needs to be furnished under clause 21(d)(B) of Form 3CD.

- (b) Reporting Requirement for Disqualifications in Cost Audit Report:** A tax auditor is required to ascertain under Clause (37) of Form 3CD whether cost audit was carried out and if yes, provide the details of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the cost auditor.

The tax auditor should obtain the copy of cost audit from the assessee. Even though the tax auditor is not required to make any detailed study of such report, he has to take note of the details of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the cost auditor. The tax auditor need not express any opinion in a case where such audit has been ordered but the same has not been carried out.

In the given case, the cost auditor of Beam Ltd. has reported certain disqualifications in Form CRA-3 of the cost audit report.

Therefore, the tax auditor of Beam Ltd. is required to provide the details of disqualifications reported by the cost auditor under Clause (37) of the Form 3CD. Thus, the contention of the management of Beam Ltd. not to reveal any of the disqualifications related to the cost audit on the belief that there is no correlation between tax audit and cost audit is not acceptable.

- (c) Approach to Tax Audit under VAT Law:** The audit approach of the tax auditor under the value added tax system will be more or less similar to the approach, which is adopted by the auditor while conducting the tax audit under the provisions of section 44AB of the Income-tax Act, 1961. However, the reporting requirements vary to a considerable extent.

While the auditor has to apply the basic principles of audit he has to keep in mind that the requirements of VAT audit are different and accordingly he should design his audit programme.

While designing the audit program the auditor has to ensure that the program includes the performance of such audit checks as would generate the information which would enable him to ensure the following and also to draw his audit reports.

The auditor has to take a judgement of his own regarding the adequacy and appropriateness of the audit checks to be applied and the areas where the tests are to be applied, so as to give him all the information needed to form a view not only on the authenticity of the books of account, correctness of the returns filed but also in the quantification of tax liability.

**Major areas to be tested:** The following are only the major areas which are to be tested by the auditor while conducting the tax audit under VAT laws-

- (i) The turnover of sales/purchases of goods has been properly determined keeping in view not only the generally accepted accounting policies but the definition of turnover of sales in the relevant VAT law. The sales turnover arrived at by applying the generally accepted accounting policies may not be the same as required under the VAT law. To take an example, the sale proceeds of a fixed asset will not form a part of turnover or sales as per the generally accepted accounting policies but will form a part of turnover or sales for the purpose of VAT law. Similarly the price of goods returned is deducted from the turnover or sales even if the returns are from the sales effected in the previous years, while under VAT law, the goods returned are to be deducted only if they are made within the prescribed time, say six months from the date of sale. Thus, the results of the audit procedure adopted by the auditor should be such as will give him a reasonable assurance regarding the figures of sales reported in the returns. Not only that, he should also be able to get the exact quantum of the sales under reported or over reported duly classified for different tax rates and its impact on overall tax liability. The sales as per the financial statements may include the turnover or sales effected by all the branches, but for the purposes of VAT law the turnover or sales of only those branches will be included which are included in one registration certificate.
- (ii) The turnover of purchases should be tested by applying audit checks as will enable the auditor to get the purchases eligible for grant of input tax credit segregated from other purchases. Further, the purchases on which the input tax credit is available in full and the purchases on which it is available partially should also be ascertained correctly. Thereafter, the auditor should get the exact amount of input tax credit available; compare the same with the credit claimed in the returns and report on the excess/short claim of the credit in the returns filed.

- (iii) The auditor is also required to comment on the timely filing of the returns under the VAT law. For this purpose the auditor is expected to list out the due dates of filing of returns and find out the reasons for delay in filing the returns if any.
- (iv) The auditor is also required to give his report on the composition scheme. He should apply such compliance tests as will be enable him to ascertain that the auditee is eligible for composition, it has paid the requisite composition fee and all the procedural formalities in relation thereto have been complied with.
- (v) The auditor has to give his report on the TDS. Therefore, such tests are to be applied as will enable him to report on the applicability of TDS provisions, the accuracy of the amount deducted and paid, timely issue of TDS certificate and filing of TDS returns.
- (vi) The auditor is also expected to check the consolidation of the returns filed for all the periods covered in the year under audit, both under the State-Level VAT law and the Central Sales-tax Act. These returns are to be compared with the books of account and the documentary evidences available. The auditor is expected to apply such substantive steps as would enable him to judge whether all the transactions relating to sale and purchase are entered in the books of account and have been taken into consideration while filing the returns. In case of any inconsistency, a proper reconciliation of book figures and the returned figures should be made and also the correct quantification of tax liability is to be done.

**15. Applicability of Provisions related to Cost Records and Audit:** The provisions relating to cost records and audit are governed by section 148 of the Companies Act, 2013 read with the Companies (Cost Records and Audit) Rules, 2014. The audit conducted under this section shall be in addition to the audit conducted under section 143.

Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, required to include cost records in their books of account. The said rule has divided the list of companies into regulated sectors and non-regulated sectors. Company belonging to sugar industry is one of the types of companies prescribed under the regulated sectors.

However, the requirement for cost audit under these rules shall not be applicable to a company which is covered under Rule 3, and,

- (1) whose revenue from exports, in foreign exchange, exceeds 75 per cent of its total revenue; or
- (2) which is operating from a special economic zone.

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

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

16. (a) **Factors to be considered while planning the Performance Audit:** While planning a performance audit, the auditors should take care of certain factors which are listed below-

- (i) to consider significance and the needs of potential users of the audit report.
- (ii) to obtain an understanding of the program to be audited.
- (iii) to consider legal and regulatory requirements.
- (iv) to consider management controls.
- (v) to identify criteria needed to evaluate matters subject to audit.
- (vi) to identify significant findings and recommendations from previous audits that could affect the current audit objectives. Auditors should determine if management has corrected the conditions causing those findings and implemented those recommendations.
- (vii) to identify potential sources of data that could be used as audit evidence and consider the validity and reliability of these data, including data collected by the audited entity, data generated by the auditors, or data provided by third parties.
- (viii) to consider whether the work of other auditors and experts may be used to satisfy some of the auditors' objectives.
- (ix) to provide sufficient staff and other resources to do the audit.
- (x) to prepare a written audit plan.

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

The starting point of a comprehensive audit of a public enterprise, which covers aspects of economy, efficiency and effectiveness, is the preparation of an audit programme based on the study of decisions relating to the setting up of the enterprise, its objectives, the areas of operation, organisation, financial and operational details available in the annual reports and accounts, capital and operational budgets, deliberations of the board of directors, material in the earlier



audit inspection reports on the enterprise and other relevant available papers. These audit programmes (or guidelines) identify the areas/aspects which require further detailed audit analysis and criteria, the data required for such analysis and the sources of such data, the extent of the audit analysis including the test checks to be applied and the instructions to the audit parties assigned to the work.

**Areas to be examined:** The areas covered by comprehensive audit are those of investment decisions, project formulation and management, organisation, delegation of powers and management information systems, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, development of complementary ancillary small scale industries, materials management, sales and credit control, budgetary and internal control systems, etc. The areas covered in comprehensive audit will naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations. Some of the broad areas are listed below-

- ◆ Comparison of overall capital cost of the project with the approved planned costs.
- ◆ Production or operational outputs *vis-à-vis* under-utilisation of the installed capacity.
- ◆ Systems of project formulation and implementation.
- ◆ Planned rate of return.
- ◆ Cost control measures.
- ◆ Research and development programmes.
- ◆ System of repairs and maintenance.
- ◆ adequate purchase policies.
- ◆ Effective and economical procedures.
- ◆ Project planning.
- ◆ Undue waste, unproductive time for men and machines, wasteful utilisation or even non-utilisation of resources.

17. (a) **Essential Features of a Good Internal Audit Report:** The contents of an internal audit report are influenced by various factors such as the nature of internal auditing function in the organisation, level of reporting, degree of management support and capabilities of internal audit staff. However, for preparing a good internal audit report, the following general rules may be observed-

- (i) **Objectivity** - To maintain the credibility of internal audit function the comments and opinions expressed in the report should be as objective and unbiased as possible.
- (ii) **Clarity** - The language used should be simple and straight-forward. As far as practicable, use of technical terms and jargon should be avoided. Each draft of

the report should be reviewed by a senior who should attempt to read it from the point of view of the users of the report.

- (iii) **Accuracy** - The information contained in the report, whether quantified or otherwise, should be accurate. Where approximation or assumptions have been made the fact should be clearly stated along with reasons, if material.
- (iv) **Conciseness** - Brevity is vital subject, of course, to the condition that important information should not be omitted.
- (v) **Constructiveness** - Destructive criticism should carefully be avoided in the report. The report should clearly demonstrate that the internal auditor is trying to assist the auditor in an effective discharge of his responsibilities.
- (vi) **Readability** - The reader's interest should be captured and retained throughout. For this, appropriate paragraph heading may be used.
- (vii) **Timeliness** - The report should be submitted promptly because if the time lag between the occurrence of an event and its reporting is considerable, the opportunity for taking action may be lost or a wrong decision may be taken in the absence of the information.
- (viii) **Findings and conclusions** - These may be given either department-wise or in the order of importance. All the facts and data pertaining to the situation should be assembled, classified and analysed. Each conclusion and opinion should normally follow the findings. Tables or graphs may be used for the presentation of statistical data in appendices.
- (ix) **Recommendations** - An internal audit report usually includes recommendations for potential improvements. In order to enable the management to accept and implement the recommendations, the internal auditor should be able to convince the management that the conclusions are logical and valid and the recommendations represent effective and feasible ways of taking action.
- (x) **Auditee's views** - The auditee's views about audit conclusions or recommendations may also be included in the audit report in appropriate circumstances.
- (xi) **Summary** - A summary of conclusions and recommendations may be given at the end. This is particularly useful in long reports.
- (xii) **Supporting information** - The internal auditor should supplement his report by such documents and data which adequately and convincingly support the conclusions. Supporting information may include the relevant standards or regulations.
- (xiii) **Draft Report** - Before writing the final report, the internal auditor should prepare a draft report. This would help him in finding out the most effective manner of presenting his reports. It would also indicate whether there is any superfluous information or a gap in reasoning.

(xiv) **Writing and issuing the Final Report** - The final report should be written only when the auditor is completely satisfied with the draft report. The head of the internal auditing department may review and approve the final report. Before issuing the final report, the auditor should discuss conclusions and recommendations at appropriate levels of management. The report should be duly signed.

- (b) (i) **Need of Operational Auditing:** The need for operational auditing has arisen due to the inadequacy of traditional sources of information for an effective management of the company where the management is at a distance from actual operations due to layers of delegation of responsibility, separating it from actualities in the organisation. Specifically, operational auditing arose from the need of managers responsible for areas beyond their direct observation to be fully, objectively and currently informed about conditions in the units under control.

Operational audit is considered as a specialised management information tool to fill the void that conventional information sources fail to fill. Conventional sources of management information are departmental managers, routine performance report, internal audit reports, and periodic special investigation and survey. These conventional sources fail to provide information for the best direction of the departments all of whose activities do not come under direct observation of managers.

- (ii) **Difference between Financial and Operational Auditing:** The major differences between financial and operational auditing can be described as follows -

- (1) **Purpose** - The financial auditing is basically concerned with the opinion that whether the historical information recorded is correct or not, whereas the operational auditing emphasizes on effectiveness and efficiency of operations for future performance.
- (2) **Area** - Financial audits are restricted to the matters directly affecting the appropriateness of the presented financial statements but the operational auditing covers all the activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organization.
- (3) **Reporting** - The financial audit report is sent to all stock holders, bankers and other persons having stake in the Organisation. However the operational audit report is primarily for the management.
- (4) **End Task** - The financial audit has reporting the findings to the persons getting the report as its end objective, however, the operational auditing is not limited to reporting only but includes suggestions for improvement also.

The main objective of operational auditing is to verify the fulfillment of plans, and sound business requirements. Operational auditing is considered as

specialized management information tool. Operational auditing is essentially a function of internal auditing staff. Operational auditing is a systematic process of evaluating an organisation's effectiveness, efficiency and economy of operations under management control and reporting to appropriate persons, the result of the evaluation along with recommendations for improvements. Operational audit concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented. It does not end with the reporting of the findings but also recommends the steps for improvements in future. Operational auditing is not different from internal auditing; it is merely an extension of internal auditing into operational areas.

While in financial auditing, the concentration is more in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are minimized or removed. In financial auditing, an auditor is called upon to review the financial statements of an enterprise to ascertain whether they reflect true and fair view of its state of affairs and of its working results. He may analyse the operations of an enterprise to appraise their cost effectiveness and also he may seek evidence to review the managerial performances.

- 18. (a) Investigation of Suspected Embezzlement of Cash Receipts:** While doing investigation of suspected embezzlement of cash receipts of a departmental store, an investigating accountant would like to take below mentioned steps-
- (i) Before proceeding to investigate a suspected embezzlement, the investigating accountant should ascertain the exact duties of the person concerned who is suspected to have committed a fraud; his relationship to the general routine of the office, and the circumstances in which any known instances of defalcation have come to light. Such an enquiry would give a clue to promising avenues of investigation. Greater the authority of the individual suspected of a fraud, wider would be the field which would have to be covered by the investigation.
  - (ii) He should also examine the line of responsibility between the various members of the staff.
  - (iii) He should have a look at the system of internal control in operation for spotting out the weaknesses, if any, that may exist in it. Relying on the above study, he should direct his enquiry towards those aspects of the business where there has been excessive control in the hands of single persons, without any supervision by any other person or any other inherent weakness that may be in existence in the system.
  - (iv) On the assumption that cash may have been diverted before being entered in the books, evidence as regards income received from different sources should be scrutinised, e.g., inventory, sales summaries, rental registers, correspondence with customers, advices of travelling salesmen and counterfoils or receipts.
  - (v) Carbon copies of receipts marked 'duplicate', should be scrutinised to confirm that they are in fact copies of receipts issued earlier.

- (vi) By recalling paying-in-slips from the bank the details of cash deposited on each day should be compared with those shown in the Cash Book.
  - (vii) The record of sales of scrap of waste paper, that of collection of rents from labourers temporarily accommodated in the company's quarters, that of refunds of amounts deposited with the electric supply co., and other Government authorities should be examined for finding out if any of these amounts have been misappropriated.
  - (viii) Cash sales should be vouched in detail. Recoveries from customers and sundry parties should be checked with the copies of receipts issued to them; deductions made on account of cash discounts should be reviewed.
  - (ix) All withdrawals from the bank should be checked by reference to corresponding entries in the bank pass book.
- (b) **Steps involved in the verification of Assets and Liabilities included in the Balance Sheet of the borrower company:** The investigating accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below-
- (i) **Fixed assets** - A full description of each item, its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.
  - (ii) **Inventory** - The value of different types of inventories held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued.  
  
Details as regards the nature and composition of finished goods should be disclosed. Slow-moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of inventory subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered.  
  
If any inventory has been pledged as a security for a loan the amount of loan should be disclosed.
  - (iii) **Trade Receivables, including bills receivable** - Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.

Further, the total amount outstanding at the close of the period should be segregated as follows:

- (1) debts due in respect of which the period of credit has not expired;
- (2) debts due within six months; and
- (3) debts due but not recovered for over six months.

If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated. Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed. The recoveries out of various debts subsequent to the date of the Balance sheet should be stated.

- (iv) **Investments** - The schedule of investments should be prepared. It should disclose the date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.
- (v) **Secured Loans** - Debentures and other loans should be included together in a separate schedule. Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re-payment of a liability should be disclosed.
- (vi) **Provision of Taxation** - The previous years up to which taxes have been assessed should be ascertained. If provision for taxes not assessed appears in be inadequate, the fact should be stated along with the extent of the shortfall.
- (vii) **Other Liabilities** - It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade payables should be given to show that the company has been meeting its obligations in time and has not been depending on trade credit for its working capital requirements.
- (viii) **Insurance** - A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets, together with a report as to whether or not the insurance-cover appears to be adequate, having regard to the value of assets.
- (ix) **Contingent Liabilities** - By making direct enquiries from the borrower company, from members of its staff, perusal of the files of parties to whom any loan has been advanced those of machinery suppliers and the legal adviser, for example, the investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed. In case, there are any, these should be included in a schedule and attached to the report.

- (x) The impact on economic position of the company by economic, political and social changes those are likely to take place during the period of loan.

Finally, the investigating accountant should ascertain whether any application for loan to another bank or any other party has been made. If so, the result thereof should be examined.

- 19 (a) Engaging into a Business:** As per clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

However, the Council has granted general permission to the members to engage in certain specific occupation. In respect of all other occupations specific permission of the Institute is necessary.

In this case, CA Brilliant is engaged in the occupation of trading in commodity derivatives which is not covered under the general permission. Further, he has not even obtained any permission from the Institute for conducting such business.

Hence, he will be deemed to be guilty of professional misconduct under clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949.

- (b) Posting Photograph on Website:** A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct under clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, 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, CA Intelligent shared his framed photograph on website wherein he was receiving 'Best Faculty of the year' award from the Institute.

In this context, it may be noted that according to the guidelines approved by the Council of the Institute of Chartered Accountants of India, no photographs of any sort are permitted. Only display of passport size photograph is permitted.

Therefore, CA Intelligent is guilty of professional misconduct under clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

- (c) Contravening Provisions of the Act:** A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct under clause (1) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, if he contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council.

In the given case, Mr. Witty has failed to make the payments of stipend to articulated assistant every month in accordance with Regulation 48. The fact that the articulated assistant will be compensated with extra sum in the form of interest on late payment is not relevant and the plea that cycle of professional receipts from clients is six

months is not acceptable as Mr. Witty has disbursed salary to all of his employees on time.

Therefore, Mr. Witty is guilty of professional misconduct under clause (1) of Part II of the Second Schedule to the Chartered Accountants Act, 1949 as he has contravened Regulation 48 by not making the payment every month.

- (d) **Charging Excess Fees:** The prescribed scale of fees for the professional assignments done by the chartered accountants is recommendatory in nature. Charging an excessive fee for a professional assignment does not constitute any misconduct in the context of the provisions of the Chartered Accountants Act, 1949 and regulation made thereunder since the matter of fixation of actual fee charged in individual cases depends upon the mutual agreement and understanding between the member and the client.

In the given case, CA Posh has charged excess fees comparative to the scale of fees recommended by the Committee as well as duly considered by the Council of ICAI. In this context, it may be noted that the scale of fees is the minimum prescribed scale of fees.

From the above facts and provisions, it may be concluded that CA Posh is not liable for any misconduct under the Chartered Accountants Act, 1949. Therefore, the contention of MNC Pvt. Ltd. is not tenable.

20. (a) **Focus of a Peer review:** As per the Statement of Peer Review issued by the Institute of Chartered Accountants of India, Peer Review - means an examination and Review of the systems and procedures to determine whether the same have been put in place by the Practice Unit for ensuring the quality of assurance services as envisaged by the Technical, Professional and Ethical Standards and whether the same were consistently applied in the period under review.

The Review shall cover:

- (i) Compliance with Technical, Professional and Ethical Standards.
- (ii) Quality of reporting.
- (iii) Systems and procedures for carrying out assurance services.
- (iv) Training programmes for staff (including articled and audit assistants) concerned with assurance functions, including availability of appropriate infrastructure.
- (v) Compliance with directions and / or guidelines issued by the Council to the Members, including Fees to be charged, Number of audits undertaken, register for Assurance Engagements conducted during the year and such other related records.
- (vi) Compliance with directions and / or guidelines issued by the Council in relating to article assistants and / or audit assistants, including attendance register, work diaries, stipend payments, and such other related records.



- (b) **Statistical and Non-statistical Sampling:** Audit sampling means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

As per SA 530, "Audit Sampling", the auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

There are two major methods in which the size of the sample and the selection of individual items of the sample are determined. These methods are statistical and non-statistical sampling.

- (i) **Statistical sampling:** This is a method of audit testing which is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.
- (ii) **Non-statistical sampling:** Under this method, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor. This method has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. For example, March, June & September may be selected in year one and different months would be selected in the next year. An attempt would be made to avoid establishing a pattern of selection year after year to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.
- (c) **Purpose of Appointing Inspecting Officer of a Depository:** The SEBI may appoint one or more persons as inspecting officer to undertake the inspection of the books of account, records, documents and infrastructure, systems and procedures or to investigate the affairs of a mutual fund, the trustees and asset Management Company for any of the following purposes, namely-
- (i) To ensure that the books of accounts are maintained in the names specified in the regulations;
- (ii) To look into the complaints received from depositors' participant, beneficial owners or other persons;

- (iii) To ascertain whether the provisions of the Act, bye-laws agreements and these regulations are being complied;
- (iv) To ascertain whether the systems, procedures and safeguards are being followed in the interests and to secure the market;
- (v) To ensure that the affairs are being conducted in the interest of the Investors / Securities markets.

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

- (i) In the Central or State Co-operative Bank.
- (ii) In any of the securities specified in Section 20 of the Indian Trusts Act, 1882.
- (iii) In the shares, securities, bonds or debentures of any other society with limited liability.
- (iv) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.
- (v) In any other moneys permitted by the Central or State Government.

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

**(e) Special Points in the Audit of Equipment Leasing Finance Company:** The auditor should-

- (i) Ascertain whether the Non Banking Financial Companies (NBFC) has an adequate appraisal system for extending equipment leasing finance.
- (ii) Verify whether there is an adequate system in place for ensuring installation of assets and their periodical physical verification. In some major transactions, arrange for physical verification of the leased assets so as to dispel any doubts that equipment leasing finance was not extended without the corresponding assets being created.
- (iii) Ascertain that the NBFC has an adequate system for monitoring whether the assets have been adequately insured against and regular maintenance of the leased asset is being carried out by the lessee.
- (iv) Verify the lease agreement entered into with the lessee in respect of the equipment given on lease.
- (v) Verify whether the Accounting Standard issued by the Institute of Chartered Accountants of India in respect of "Accounting for Lease" has been compulsorily followed.

## PAPER – 4: CORPORATE AND ALLIED LAWS

### PART – I: RELEVANT AMENDMENTS APPLICABLE FOR NOVEMBER, 2015

#### Applicability of relevant Amendments/Circulars/Notifications/Regulations etc.

#### (A) Applicability of Relevant Amendments/ Circulars/ Notifications/ Regulations etc.

The Study material (October 2014 edition) of Corporate and Allied Laws is relevant for November 2015 examinations. It contains all relevant Amendments/ Circulars/ Notifications etc. in the Companies Act, 2013 and the Allied Laws up to 30<sup>th</sup> September, 2014. Below are the further Amendments/ Circulars/ Notifications etc. issued between 1<sup>st</sup> October, 2014 to 30<sup>th</sup> April, 2015 which are also applicable for the said examinations:

SL.No.	Heading of Amendments	Gist
<b>Section –A: Company Law</b>		
1.	The Companies (Audit and Auditors) Amendment Rules, 2014	<b>Vide Notification G.S.R. 722(E) dated 14<sup>th</sup> October 2014</b> , the Central Government amended the Companies (Audit and Auditors) Rules, 2014. According to it, in the Companies (Audit and Auditors) Rules, 2014, after rule 10, the new section 10A has been inserted. “10A. For the purposes of clause (i) of sub-section (3) of section 143, for the financial years commencing on or after 1st April, 2015, the report of the auditor shall state about existence of adequate internal financial controls system and its operating effectiveness.”
2.	The Companies (Accounts) Amendment Rules, 2014.	<b>Vide Notification G.S.R. 723(E), dated 14<sup>th</sup> October, 2014</b> , the Central Government amended the Companies (Accounts) Rules, 2014. In the Companies (Accounts) Rules, 2014, in rule 6, after the existing proviso, the following provisos have been inserted- “Provided further that nothing in

		<p>this rule shall apply in respect of preparation of consolidated financial statement by an intermediate wholly-owned subsidiary, other than a wholly-owned subsidiary whose immediate parent is a company incorporated outside India:</p> <p>Provided also that nothing contained in this rule shall, subject to any other law or regulation, apply for the financial year commencing from the 1st day of April, 2014 and ending on the 31st March, 2015, in case of a company which does not have a subsidiary or subsidiaries but has one or more associate companies or joint ventures or both, for the consolidation of financial statement in respect of associate companies or joint ventures or both, as the case may be.”</p>
3.	Clarification on matters relating to Consolidated Financial statements	<p><b>Vide General Circular No, 39/2014, dated 14<sup>th</sup> October, 2014</b>, clarifications has been issued on the manner of presentation of notes in Consolidated Financial Statement (CFS) to be prepared .Circular clarified that Schedule III to the Act read with the applicable Accounting Standards does not envisage that a company while preparing its CFS merely repeats the disclosures made by it under stand-alone accounts being consolidated. In the CFS, the company would need to give all disclosures relevant for CFS only.</p>
4.	Right of persons other than retiring director to stand for directorship -	<p><b>Vide General Circular 38/2014, dated 14<sup>th</sup> October 2014</b>, clarity</p>

	Refund of deposit under section 160 of the Companies Act, 2013 in certain cases.	<p>has been bought by companies registered under section 8 of the Companies Act, 2013 about the manner in which the amount of deposit of rupees one lakh received by them under section 160(1) of the Companies Act, 2013 is to be handled if the depositor fails to secure more than twenty five have per cent of the total valid votes.</p> <p>It has been clarified that in such cases, the Board of directors of a section 8 company is to decide as to whether the deposit made by or on behalf of the person failing to secure more than twenty-five percent of the valid votes is to be forfeited or refunded.</p>
5.	Amendments to Schedule VII	<p><b>Vide Notification G.S.R. 741(E) dated 24th October, 2014</b>, the Central Government hereby made further amendments to Schedule VII of the Companies Act, 2013.</p> <p>(a) In item (i), after the words “and sanitation”, the words “including contribution to the Swachh Bharat Kosh set-up by the Central Government for the promotion of sanitation” shall be inserted;</p> <p>(b) In item (iv), after the words “and water”, the words “including contribution to the Clean Ganga Fund setup by the Central Government for rejuvenation of river Ganga;” shall be inserted.</p>
6.	The Companies (Accounts) Amendment Rules, 2015.	<p><b>Vide Notification G.S.R. 37(E) dated 16<sup>th</sup> January 2015</b> the Central Government amended the Companies (Accounts) Rules, 2014.</p>

		<p>In the Companies (Accounts) Rules, 2014,-</p> <p>(i) after rule 2, new rule 2A dealing with "Notice of address at which books of account are to be maintained" has been inserted.</p> <p>(ii) in rule 6, after the third proviso, the following proviso has been inserted-</p>
		<p>"Provided also that nothing in this rule (rule 6) shall apply in respect of consolidation of financial statement by a company having subsidiary or subsidiaries incorporated outside India only for the financial year commencing on or after 1st April, 2014.</p> <p>(iii) the Annexure, after Form AOC-4, the Form no. AOC-5 (Notice of address at which books of account are to be maintained have been inserted.</p>
7.	The Companies (Appointment and Qualification of Directors) Amendment Rules, 2015	<p><b>Vide Notification G.S.R. 42(E) dated 19<sup>th</sup> January 2015</b> the Central Government further amended the Companies (Appointment and Qualification of Directors) Rules, 2014.</p> <p>In the Companies (Appointment and Qualification of Directors) Rules, 2014, in rule 16, following proviso has been inserted-</p> <p>"Provided that in case a company has already filed Form DIR-12 with the Registrar under rule 15, a foreign director of such company resigning from his office may authorise in writing a practicing chartered accountant or cost accountant in practice or company secretary in practice or any other</p>

		resident director of the company to sign Form DIR-11 and file the same on his behalf intimating the reasons for the resignation.”
8.	The Companies (Corporate Social Responsibility Policy) Amendment Rules, 2015	<p><b>Vide Notification G.S.R. 43 (E) dated 19<sup>th</sup> January 2015</b>, Central Government amended the Companies (Corporate Social Responsibility Policy) Rules, 2014.</p> <p>In the Companies (Corporate Social Responsibility Policy) Rules, 2014, in rule 4, in sub-rule (2),—</p> <p>(i) for the words “established by the company or its holding or subsidiary or associate company under section 8 of the Act or otherwise”, the words “established under section 8 of the Act by the company, either singly or along with its holding or subsidiary or associate company, or along with any other company or holding or subsidiary or associate company of such other company, or otherwise” shall be substituted;</p> <p>(ii) in the proviso, in clause (i), for the words “not established by the company or its holding or subsidiary or associate company, it”, the words “not established by the company, either singly or along with its holding or subsidiary or associate company, or along with any other company or holding or subsidiary or associate company of such other company” shall be substituted.</p>
9.	The Companies (Registration Offices and Fees) Amendment Rules, 2015	<p><b>Vide Notification G.S.R. 122(E) dated 24<sup>th</sup> February, 2015</b>, the Central Government amended the Companies (Registration Offices and Fees) Rules, 2014.</p>

		<p>In the Companies (Registration Offices and Fees) Rules, 2014,—</p> <p>(a) in rule 10, after sub-rule (6), the following sub-rule shall be inserted, namely:—</p> <p>“7. Any further information or documents called for, in respect of application or e-form or document, filed electronically with the Ministry of Corporate Affairs shall be furnished in Form No. GNL-4 as an addendum”.</p> <p>(b) in the Annexure, after Form No. GNL-3, Form no. GNL-4 has been inserted pursuant to Rule 10(7) of the Companies(Registration offices and Fee) Rules, 2014 for filing addendum for rectification of defects or incompleteness.</p>
10.	The Companies (Removal of Difficulties) Order, 2015	<p><b>Vide Order S.O. 504(E) dated 13 February 2015</b>, the Central Government issued an order to remove the difficulties having arisen in giving effect to the provisions contained under sections 2(85) and 186(11)(b) of the Companies Act, 2013.</p> <p>In the Companies Act, 2013-</p> <p>(a) in section 2, in clause (85), in sub-clause (i), for the word “or” occurring at the end, the word “and” shall be substituted; and</p> <p>(b) in section 186 sub-section (11), in clause (b), after item (iii), the following item shall be inserted, namely :—</p> <p>“(iv) made by a banking company or an insurance company or a housing finance company, making acquisition of securities in the ordinary course of its business.”</p>



11.	Clarification with regard to section 185 and 186 of the Companies Act 2013 - loans and advances to employees.	<p><b>Vide General Circular No, 04/2015, dated 10/3/2015</b> clarification has been issued on the applicability of provisions of section 186 of the Companies Act, 2013 relating to grant of loans and advances by Companies to their employees.</p> <p>It has been clarified that loans and/or advances made by the companies to their employees, other than the managing or whole time directors (which is governed by section 185) are not governed by the requirements of section 186 of the Companies Act, 2013.</p> <p>This clarification will, however, be applicable if such loans/advances to employees are in accordance with the conditions of service applicable to employees and are also in accordance with the remuneration policy, in cases where such policy is required to be formulated.</p>
12.	The Companies (Meetings of Board and its Powers) Amendment Rules,2015.	<p><b>Vide Notification G.S.R. 206 (E) dated 18<sup>th</sup> March, 2015,</b> the Central Government hereby makes the following rules further to amend the Companies (Meetings of Board and its Powers) Rules, 2014.</p> <p>Item no. 3, 5, 6, 7, 8, and 9 of Rule 8 prescribing powers of Board which shall be exercised by the Board of Directors only by means of resolutions passed at meetings of the Board shall be omitted.</p>
13.	Remuneration to managerial person under Schedule XIII of the Companies Act, 1956 - Clarification with regard to payment for period	<p><b>Vide General Circular 07/2015 dated 10<sup>th</sup> April, 2015,</b> it has been clarified that a managerial person who has been appointed in</p>

		accordance with provisions of Schedule XIII of the Companies Act, 1956, may continue to receive remuneration for his remaining term in accordance with terms and conditions approved by company as per relevant provisions of Schedule XIII of 1956 Act even if the part of his/her tenure falls after 1st April, 2014.
14.	The Companies (Auditor's Report) Order, 2015.	<b>Vide Order S.O. 990(E) dated 10<sup>th</sup> April 2015</b> , the Central Government, after consultation with the Institute of Chartered Accountants of India, issued the Companies (Auditor's Report) Order, 2015 in exercise of the powers conferred by section 143(11) of the Companies Act, 2013 and in supersession of the Companies (Auditor's Report) Order, 2003.
<b>Section B: Allied Laws</b>		
15.	SEBI (Issue of Capital and Disclosure Requirement) Regulations, 2009	SEBI <b>Vide Notification dated 24<sup>th</sup> March, 2015</b> has issued SEBI (Issue of Capital and Disclosure Requirements)(Amendment) Regulations, 2015.  The amendments have been carried out in regulation 4 and 54 of SEBI (ICDR) Regulations, 2009. Regulation 4 deals with general conditions for public issues and right issues. Under point (3) of this regulation further clause(c) and (d) have been inserted.  Regulation 54 deals with letter of offer, abridged letter of offer, pricing and period of subscription. In the proviso under the point (7) after the word "Investors" following line is inserted "part payment on

		application shall not be less than 25% of the issue price”.
16.	The Insurance Act, 1938 and the Insurance Regulatory and Development Authority Act, 1999	<p><b>Vide Notification dated 23<sup>rd</sup> March, 2015</b>, Ministry of Law and Justice further amended the Insurance Act, 1938 and the Insurance Regulatory and Development Authority Act, 1999 by enacting the Insurance Laws (Amendment) Act, 2015. It shall be deemed to have come into force on the 26th day of December, 2014.</p> <p><b>Students please Note:</b></p> <p>The reading material in relation to the Insurance Act, 1938 as amended by the Insurance (Amendment) Act, 2015 is given at the end of this RTP. Students are advised read the revised material in place of the existing matter given in the Chapter 23 – Para 23.10 to 23.21 of Module 2 of Final Course Study Material, Paper 4 – Corporate and Allied Laws.</p>

**(B) Non-Applicability of the following Chapters / Amendments for the said examinations:**

S.No.	Subject Matter
(i)	Chapter 9 of the study material (October, 2014 edition) covering provisions relating to Revival and Rehabilitation of Sick-Industrial Companies.
(ii)	Chapter 15 of the study material (October, 2014 edition) covering provisions relating to the National Company Law Tribunal and Appellate Tribunal.
(iii)	The Companies (Amendment) Act, 2015

**PART – II: QUESTIONS AND ANSWERS****QUESTIONS****SECTION – A: COMPANY LAW****Dividend**

1. (a) Examine the validity of given situations as per the Companies Act, 2013:
  - (i) A company wants to transfer more percentage of profits to reserves than it had transferred in the previous year.
  - (ii) A company wants to declare dividends out of past reserves instead of current year profits.
- (b) ABC Limited in the Annual General Meeting 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, 2015. But the Company failed to post the dividend warrant to Mr. S, an equity shareholder of the Company, up to 30th June, 2015. Mr. S, filed a suit against the ABC Ltd. 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. S would succeed? Also state the directors' liability in this regard under the Act.

**Accounts and Audit**

2. (a) XYZ , a refinery company controlled by the Central Government, incorporated on 30th June, 2015. The XYZ company decided to appoint Mr. Ramaswamy as a first auditor. The Board of Directors of XYZ Company appointed him as an auditor in first annual general meeting. M, a member of the company raised its objection on the appointment of the Mr. Ramaswamy as a first auditor of XYZ company stating that Board is not authorized for the appointment. Examining the provisions of the Companies Act, 2013, state whether the contention of M is tenable.
  - (b) The Board of Directors of X company undertakes to make contribution under the discharge of its social responsibilities for promotion of sanitation facilities and to make available clean and safe drinking ganga water in nearby villages. State in the light of the Companies Act, 2013, whether the company can undertake such a responsibility and contribute towards the achievement of such social responsibility?
3. (a) P Limited did not prepare its Balance Sheet and the Profit and Loss Account for the year in conformity with some of the mandatory Accounting Standards issued by the Institute of Chartered Accountants of India. State with reference to the provisions of the Companies Act, 2013, the responsibilities of directors of the company in this regard.

- (b) The Board of Directors of Sunrise Ltd. want to circulate unaudited accounts before the Annual General Meeting of the shareholders of the Company. Examine the validity of the act of the Board of Directors under the provisions of the Companies Act, 2013

#### **Appointment and qualification of Directors**

4. (a) The Articles of Association of Surya Private Co. provided that the maximum number of Directors in the company shall be 15. Presently, the company is having 12 directors. The Board of Directors of the said company desired to increase the number of directors to 16. Advise whether under the provisions of the Companies Act, 2013 the Board of Directors can do so.
- (b) M/s. Bharat Pharma Limited is a company listed with Bombay Stock Exchange. The company were having 500 small shareholders in the said company, so they wanted to appoint Mr. A as a Director as their representative on the Board of Directors of the said company. Mr. A is holding 1000 equity shares of ₹ 10 each in the said company. State in the light of the Companies Act, 2013 whether the proposal to appoint Mr. A as a Small Shareholders' Director can be adopted by the company. Examine, if Mr. A is already holding a position of small shareholders' director in more than two companies.
5. Annual general meeting of Amba Ltd. is scheduled to be held in compliance with the provisions of the Companies Act, 2013. Please advise the company in relation to the retirement of Directors.
- (i) Which of the existing directors shall be retiring by rotation and be eligible for re-election?
- (ii) In case of vacancies caused by retirement and the meeting could not decide how such vacancies to be dealt with. What shall be further course of action?

#### **Appointment and Remuneration of Managerial Personnel**

6. (a) The Board of Directors of a listed company have decided to fix payment of sitting fee for each Meeting of Directors subject to maximum of ₹ 30,000. In view of increased responsibilities of women directors of the company, the company proposes to increase the sitting fee to ₹ 45,000 per meeting. State whether the company can accept such a proposal to increase the sitting fees for women directors keeping in view the provisions of the Companies Act, 2013.
- (b) X, a Director of PQR Ltd., was appointed on 1st April, 2013, one of the terms of appointment was that in the absence of adequacy of profits or if the company had no profits in a particular year, he will be paid remuneration in accordance with Schedule V. For the financial year ended 31st March, 2015, the company suffered heavy losses. The company was not in a position to pay any remuneration but he (X) was paid ₹ 50 lacs for the year, as paid to other directors. The effective capital

of the company is ₹ 150 crores. Referring to the provisions of the Companies Act, 2013, as contained in Schedule V, examine the validity of the above payment of remuneration to X.

7. (a) Mr. Pawan is proposed to be appointed as Manager for life by the Article of Association of Sri Ram private company incorporated on 1<sup>st</sup> June, 2015. Examine in the light of the Companies Act, 2013, whether such an appointment is valid.
- (b) M, a Managing Director of Super tech Pvt. Ltd. was removed during the tenure of office and certain compensation was paid to him. Later found that during the tenure of his office that he was guilty of corrupt practices and the company felt that no compensation should have been paid to him and therefore wants to recover the compensation so paid to him. Explaining the law given under the Companies Act, 2013, can the company succeed to recover the compensation paid to M?

#### **Meetings of Board and its powers**

8. State the legal requirements to be complied with by a public company in respect of a Board Meeting. Examine with reference to the provisions of the Companies Act, 2013 whether notice of a Board Meeting is required to be sent to the following persons:
- (i) An interested Director;
  - (ii) A Director who has expressed his inability to attend a particular Board Meeting;
  - (iii) A Director who has gone abroad (for less than 3 months).
9. (a) State whether the acts done by the Board meeting be invalid if it was found afterwards that there was some defect in the appointment of directors or any person acting as a director?
- (b) M/s Aravalli Ltd. had power under its memorandum to sell its undertaking to another company having similar objects. The Articles of the company contained a provision by which directors were empowered to sell or otherwise deal with the property of the company. The Shareholders passed an ordinary resolution for the sale of its assets on certain terms and required the directors to carry out the sale. The Directors refused to comply with the wishes of the shareholders where upon it was contended on behalf of the shareholders that they were the principal and directors being their agents were bound to give effect to their decision. Based on the above facts, decide the following issues, having regard to the provisions of the Companies Act, 2013.
- (i) Whether the contention of shareholders against the non-compliance of their wishes by the directors is tenable.
  - (ii) Can shareholders takeover the powers which by the articles are vested in the directors by passing a resolution in the general meeting?

#### **Inspection, Inquiry and Investigation**

10. A majority of the Board of Directors of M/s Esteem Ltd. have realised that some of the business activities carried out in the name of the company are not in the interest of either the company or its members. They want that the company should make an application to the Central Government to appoint an Inspector to carry out investigation and find out the whole truth. Explain the relevant law that should be taken to achieve the purpose.

### **Compromise, Arrangements and Amalgamations**

11. (a) A scheme of reconstruction of Company 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.
- (b) Answer the following with reference to a scheme of amalgamation of companies explaining the relevant provisions of the Companies Act, 1956:
- (i) Whether companies being amalgamated must be companies registered in India.
  - (ii) What is the majority required for approving the scheme of amalgamation in a meeting of members of a company called as per directions of the court? Is the scheme to be approved by preference shareholders?
  - (iii) When will the court order dissolution of the transferor company?

### **Prevention of Oppression and Mismanagement**

12. What is meant by 'oppression'? State whether the aggrieved party would succeed in obtaining relief from Company Law Board on the ground of oppression in the following cases:
- (i) The majority of the Board of directors override the minority directors and the minority directors apply to Company Law Board complaining oppression by majority directors.
  - (ii) A petition by majority shareholders complaining oppression by minority shareholders.

Give your answer according to the provisions of the Companies Act, 1956.

### **Winding Up**

13. (a) By an order of the Court, X company was wound up with effect from 15.3.2015. Mr. G, who ceased to be a member of the Company from 1.6.2014 received a notice from the liquidator to deposit a sum of ₹ 15,000 as his contribution towards the liability on the shares previously held by him. Mr. G seeks your opinion about his liability under the Companies Act, 1956.

- (b) H Limited has its subsidiary company S Ltd, which is formed to carry out some of the objectives of H Limited. H Ltd suspends one of its several businesses, by passing a resolution at the company's extraordinary general meeting, with effect from 1st January 2015. The business continued to be suspended till March 2015. On 1st April 2015, a group of shareholders of H Ltd file a petition in the court for winding of the company on the ground of suspension of business by the company.

Referring to the provisions of the Companies Act, 1956, decide:

- (1) Whether the shareholders' contention shall be tenable?
- (2) What would be your answer in case H Ltd suspends all its business?
- (3) Can shareholders of S Ltd. file a petition in the court for winding up of their company (S Ltd) on the ground that the holding company viz., H Ltd has suspended its entire business, though S Ltd. has not suspended business?

#### **Producer Companies**

14. (i) A two year old Producer Company registered under Section 581C of the Companies Act, 1956 wants to donate some amount. The Chief Executive of the Producer Company has approached you to advise him as to how and for what purposes the donation can be made by such company. Also state the monetary restrictions, if any, laid down in the Companies Act, 1956 on making donations by a Producer Company. You are informed that as per the Profit & Loss account of the Producer Company for its last accounting year, net profit was ₹ 20.00 lacs.
- (ii) Mr. Farmer is an expert in modern agriculture practices. He intended to lend his services as a director in Krishna Cotton Producer Company Ltd. which was registered under Section 581C of the Companies Act, 1956. Advise Mr. Farmer as to how he can be appointed as a director including (1) The total number of directors that can be appointed (2) The tenure of the directors (3) The time limit within which the appointment should be made (4) the co-option of directors and (5) the voting powers of such co-opted directors.

#### **Companies Incorporated outside India**

15. Aster Ltd., is a company incorporated outside India. 50% of its preference share capital and 20% of its equity share capital is held by companies incorporated in India. It issued prospectus inviting subscriptions in India for its shares but did not state the country in which it is incorporated.

Examine

- (i) Is the prospectus of the company valid?
- (ii) What other disclosures in the prospectus are required to be made by a foreign company?

#### **Offences and Penalties/E-Governance/Special Courts**



16. State the functioning of the Mediation and Conciliation Panel as per Section 442 of the Companies Act, 2013?
17. Which offences are deemed to be Non- cognizable under the Companies Act, 2013? Enumerate the relevant provisions.

**Miscellaneous provisions**

18. (i) Mr. Atharva, a director of National highway Tolls Private Limited, authorised by board of directors to prepare and file return, report or other documents to registrar on the behalf of the company. He timely filed all the required documents to Registrar; however, subsequently it is found that the filed documents are false in respect to material particulars (knowing it to be false) submitted to registrar. Explain the penal provision under the Companies Act, 2013.  
(ii) It is apprehended by the Directors of a Public Company that they are likely to be prosecuted for an offence under the Companies Act, 2013 which is not compoundable. Explain the provisions of the Companies Act, 2013 under which the Directors can seek relief from the liability for offence. What will be the position in case prosecution has already been launched?
19. (i) The Board of Directors of Humble Limited decided to pass a resolution to purchase certain equity shares of Pioneer Limited at a meeting. Draft a specimen Board Resolution to be passed at the said meeting.  
(ii) Kitply Woods Limited decide to appoint Mr. W as its Managing Director for a period of 5 years with effect from 1st May, 2015. Mr. W fulfils all the conditions as specified under Schedule V to the Companies Act, 2013.

The terms of appointment are as under:

- (i) Salary ₹ 1 lakh per month;
- (ii) Commission, as may be decided by the Board of Directors of the company;
- (iii) Perquisites;

Free Housing,

Medical reimbursement upto ₹ 10,000 per month,

Leave Travel Concession for the family,

Club membership fee,

Personal Accident Insurance ₹ 10 lakh,

Gratuity, and

Provident Fund as per Company's policy.

You being the Secretary of the said Company, are required to draft a resolution to give effect to the above, assuming that Mr. W is already the Managing Director in a public limited company.

### SECTION – B: ALLIED LAWS

#### The Securities and Exchange Board of India (SEBI)

20. (i) On the complaint of Mr. X, SEBI after enquiry finds that Mr. Y a Chief Executive Officer of the Company, on the basis of unpublished price sensitive information, has indulged in the trading of the securities of that company. Explain, on the basis of the said finding, what action SEBI can take against Mr. Y under the Securities and Exchange Board of India Act, 1992.
- (ii) Gauri Chemicals Limited, a listed company, having a paid-up equity share capital of ₹ 80 crore and net worth of ₹ 120 crores as on 31<sup>st</sup> March, 2015 proposes to raise funds to finance its expansion programme by issue of equity shares under the "Qualified Institutions Placement Scheme."

Answer the following with reference to the provisions of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009:

- (i) What are the conditions to be satisfied by the company so that it can make Qualified Institutions Placement?
- (ii) What is the maximum amount that can be raised by the company under the proposed issue of shares?
- (iii) What are the restrictions, if any, with regard to pricing of issue and transferability of shares by qualified institution buyers?

#### The Securities Contracts (Regulation) Act, 1956

21. (a) The Securities and Exchange Board of India received serious complaints against Mr. S, a member of Bombay Stock Exchange. State as to what powers can be exercised by the Securities and Exchange Board of India to make enquiries and to take action in this matter, under the provisions of the Securities Contracts (Regulation) Act, 1956?
- (b) State how a recognised stock exchange may delist the securities and how an appeal may be filed by an aggrieved investor against the decision of stock exchange for delisting of securities.

#### The Foreign Exchange Management Act, 1999

22. (a) Mr. Sekhar resided for a period of 150 days in India during the Financial year 2013-2014 and thereafter went abroad. He came back to India on 1<sup>st</sup> April, 2014 as an employee of a business organization. What would be his residential status during the financial year 2014-2015?

- (b) State in the light of FEMA, 1999, the residential status of the following corporations whether they are “Person resident in India” or “Person resident outside India”.
- (i) MKP Limited, an Indian company having its Registered Office at Mumbai, India established a branch at New York U.S.A. on 1<sup>st</sup> April, 2015.
  - (ii) WIP Ltd., a company incorporated and registered in London established a branch at Chandigarh in India on 1<sup>st</sup> April, 2015.
  - (iii) WIP Ltd.’s Singapore branch which is controlled by its Chandigarh branch.

### **The Competition Act, 2002**

23. (a) Examine with reference to the relevant provisions of the Competition Act, 2002 the following:
- (i) Whether a Government Department supplying water for irrigation to the Agriculturists after levying charges for water supplied (and not a water tax) can be considered as an ‘Enterprise’.
  - (ii) Whether a person purchasing goods not for personal use, but for resale can be considered as a ‘consumer.’
- (b) ABC Ltd. made an initial public offer of certain number of equity shares. Examine whether these shares can be considered as ‘Goods’ under the Competition Act, 2002 before allotment.

### **The Banking Regulation Act, 1949, The Insurance Act, 1938, The Insurance Regulatory and Development Authority Act, 1999, The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002**

24. (a) The Board of Directors of VDV Ltd., a banking company incorporated in India, for the accounting year ended 31-3-2015 transferred 15% of its net profit to its Reserve Fund. Certain shareholders of the company object to the above act of the Board of Directors on the ground that it is violative of the provisions, of the Banking Regulation Act, 1949. Examine the provision of Banking Act and decide:
- (i) Whether contention of the Shareholders is tenable.
  - (ii) Would your answer be still the same in case the Board of Directors transfer 30% of the company’s net profits to Reserve Fund.
- (b) M, wants to nominate Mr. S, his 10 years old son, as a nominee for his life insurance policy. Advise him under the provisions of the Insurance Act, 1938.

### **The Prevention of Money Laundering Act, 2002 & Interpretation of Statutes, Deeds and Documents**

25. (a) Explain the meaning of the term “Money Laundering”. Z, a known smuggler was caught in transfer of funds illegally exporting narcotic drugs from India to some countries in Africa. State the maximum punishment that can be awarded to him

under Prevention of the Money Laundering Act, 2002.

- (b) (i) What is the effect of proviso? Does it qualify the main provisions of an Enactment?
- (ii) Does an explanation added to a section widen the ambit of a section?
- (iii) What do you understand by the term 'Preamble' and how does it help in interpretation of a statute?

### SUGGESTED ANSWERS / HINTS

1. (a) Section 123 of the Companies Act, 2013 deals with the provision related to the declaration of dividend.

- (i) The first proviso to 123 (1) of the Companies Act, 2013 provides that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company.

Therefore, under the Companies Act, 2013 the amount transferred to reserves out of profits for a financial year has been left at the discretion of the company acting vide its Board of Directors. Therefore, the company is free to transfer any part of its profits to reserves as it deems fit.

- (ii) The second proviso to section 123 (1) of the Companies Act, 2013 permits a company to declare dividend out of the accumulated profits earned by it in previous years and transferred by the company to the reserves subject to the rules prescribed in this behalf. Rule 3 of the Companies (Declaration and Payment of Dividend) Rules, 2014 provides for the declaration of dividend out of reserves as under:

- (1) The rate of dividend declared does not exceed the average of the rates at which dividend was declared by it in the 3 years immediately preceding that year.

However, this rule will not apply if a company has not declared any dividend in each of the three preceding financial year.

- (2) The total amount to be drawn from the accumulated profits earned in previous years and transferred to the reserves does not exceed an amount equal to 1/10th of the sum of its paid-up capital and free reserves as appearing in the latest audited financial statement.
- (3) The amount so drawn must first be utilized to set off losses incurred in the financial year before any dividend in respect of equity shares is declared.

- (4) The balance of reserves after such drawal shall not fall below 15% of its paid-up share capital as appearing in the latest audited financial statement.
  - (5) No company shall declare dividend unless carried over previous losses and depreciation not provided in previous year or years are set off against profit of the company of the current year.
- (b) Section 127 of the Companies Act, 2013 lays down the penalty for non payment of dividend within the prescribed time period. Under section 127 where a dividend has been declared by a company but has not been paid or the warrant in respect thereof has not been posted within thirty days from the date of declaration to any shareholder entitled to the payment of the dividend:
- a. every director of the company shall, if he is knowingly a party to the default, be punishable with imprisonment which may extend to two years and with fine which shall not be less than one thousand rupees for every day during which such default continues; and
  - b. 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.

Therefore, in the given case Mr. S will not succeed in his claim for 20% interest as the limit under section 127 is 18% per annum.

2. (a) According to Section 139(7) of the Companies Act, 2013, 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 sixty days from the date of registration of the company and in case the Comptroller and Auditor-General of India does not appoint such auditor within the said period, the Board of Directors of the company shall appoint such auditor within the next thirty days; and in the case of failure of the Board to appoint such auditor within the next thirty days, it shall inform the members of the company who shall appoint such auditor within the sixty days at an extraordinary general meeting, who shall hold office till the conclusion of the first annual general meeting.

In the given case, XYZ is directly controlled Central Government company, incorporated on 30<sup>th</sup> June, 2015. Mr. Ramawamy was appointed as first Auditor in the first Annual general meeting. As per the above provision, the first auditor shall be appointed by the Comptroller and Auditor-General of India within sixty days from the date of registration of the company and in case the Comptroller and Auditor-General of India does not appoint such auditor within the said period, the Board of Directors of the company shall appoint such auditor within the next thirty days.

Thus, M objection on the appointment of the Ramaswamy as auditor, is correct. As per the above provision, Comptroller and Auditor-General of India is authorized to appoint him as auditor, in case of his failure to appoint within the prescribed period, then the Board may appoint such auditor of the company.

- (b) Section 135 of the Companies Act, 2013 deals with the provisions related to the Corporate Social Responsibility. According to which it is mandatory for every company with specified criteria to spend a prescribed percentage of their profits on certain specified areas of social upliftment in discharge of their social responsibilities. The Companies (CSR Policy) Rules, 2014 provides that the CSR may include:-
- (i) Projects or programs relating to activities specified in Schedule VII to the Act; or
  - (ii) Projects or programs relating to activities undertaken by the board of directors of a company (Board) in pursuance of recommendations of the CSR Committee of the Board as per declared CSR Policy of the company subject to the condition that such policy will cover subjects enumerated in Schedule VII of the Act.

The MCA vide Notification No. G.S.R. 741(E) dated 24th October, 2014, has amended Schedule VII to the Companies Act, 2013, whereby, contribution to the Swach Bharat Kosh set-up by the Central Government for the promotion of sanitation and contribution to the Clean Ganga Fund setup by the Central Government for rejuvenation of river Ganga have also been included in the activities which may be included by companies in their Corporate Social Responsibility policies.

Accordingly, in the given case, X company can take such responsibility and contribute for the promotion of sanitation facilities and rejuvenation of river Ganga for supply of safe drinking water in nearby villages where it operates.

3. (a) Section 129(1) of the Companies Act, 2013 states that financial statement of the company shall comply with the accounting standards notified under section 133. Further section 129(5) says that where the Financial Statements of the company do not comply with the accounting standards, such companies shall disclose in its financial statements, the following, namely:
- (a) the deviation from the accounting standards;
  - (b) the reasons for such deviation; and
  - (c) the financial effect, if any, arising due to such deviation.

Also section 129(7) provides that if a company contravenes the provisions of section 129 (which requires compliance with accounting standards), the managing director, whole-time director in charge of finance, the Chief Financial Officer or any other

person charged by the Board with the duty of complying with the requirements of this section and in the absence of any of the officers mentioned above, all the directors shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

Moreover, the Board of Directors is also required under section 134(5) of the Companies Act, 2013 to include a Directors Responsibility Statement indicating therein that in the preparation of the financial statements the applicable accounting standards had been followed along with proper explanation relating to material departures, if any. If such person (as above referred) fails to take all reasonable steps to secure compliance by the company, as respects any accounts laid before the company in general meeting, with the provisions of this section and with the other requirements of this Act as to the matters to be stated in the accounts, he shall, be punishable with imprisonment for a term which may extend to 1 year, or with fine not less than ₹ 50,000 but which may extend to ₹ 5,00,000 or with both.

- (b) Section 129(2) of the Companies Act, 2013 provides that at every annual general meeting of a company, the Board of Directors of the company shall lay financial statements for the financial year. Further section 134(7) provides that signed copy of every financial statement, including consolidated financial statement, if any, shall be issued, circulated or published along with a copy each of:
- (a) any notes annexed to or forming part of such financial statement;
  - (b) the auditor's report; and
  - (c) the Board's report.

It, therefore, follows that unaudited accounts cannot be sent to members or unaudited accounts cannot be filed with the Registrar of Companies. So the act of the Board of Directors of sunrise limited is not valid.

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

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

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

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

- (i) Alter its Articles of Association under section 14 of the Act;
  - (ii) Authorise the maximum number of directors to 16 by means of a special resolution of members passed at a duly convened general meeting of the company.
- (b) Section 151 of the Companies Act, 2013 provides that a listed company may have one director elected by such small shareholders in such manner and with such terms and conditions as may be prescribed. Further, the explanation to section 151 clarifies that for the purposes of this section “small shareholders” means a shareholder holding shares of nominal value of not more than twenty thousand rupees or such other sum as may be prescribed.

The Companies (Appointment & Qualifications of Directors) Rules, 2014 clearly provides that a listed company, may upon notice of not less than one thousand small shareholders or one-tenth of the total number of such shareholders, whichever is lower, have a small shareholders’ director elected by the small shareholders.

In the given case, the company is a listed one, hence the provisions of section 151 will apply. Therefore, the number of small shareholders who can send the notice for the appointment of a small shareholders director must not be less than 1,000 or one tenth of the total number of small shareholders i.e., 50 small shareholders may propose a person as a candidate for the post of small shareholders. They must give 14 days notice to the company under their signatures specifying the name, address, shares held and folio number of the person whose name is being proposed for the post of director and of the small shareholders who are proposing such person for the office of director.

Thus, as per the above provision, Company may appoint Mr. A as small shareholders’ director in the company. Also, that Mr. A shall not hold the position of small shareholders’ director in more than two companies at the same time. Provided that the second company in which he has been appointed shall not be in a business which is competing or is in conflict with the business of the first company

#### 5. Rotational Directors and Retirement:

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



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

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

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

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

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

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

- (a) at that meeting or at the previous meeting a resolution for the re-appointment of such director has been put to the meeting and lost;
- (b) the retiring director has, by a notice in writing addressed to the company or its Board of directors, expressed his unwillingness to be so re-appointed;
- (c) he is not qualified or is disqualified for appointment;
- (d) a resolution, whether special or ordinary, is required for his appointment or re-appointment by virtue of any provisions of this Act; or
- (e) section 162 is applicable to the case.

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

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

- (b) Under Part II of Schedule V to the Companies Act, 2013, the remuneration payable to a managerial personnel is linked to the effective capital of the company. Where in any financial year during the currency of tenure of a managerial person, a company has no profits or its profits are inadequate, it may, without Central Government approval, pay remuneration to the managerial person not exceeding ₹ 60 Lakhs in the year in case the effective capital of the company is between ₹ 100 crores to 250 crores. The limit will be doubled if approved by the members by special resolution and further if the appointment is for a part of the financial year the remuneration will be pro rated.

From the foregoing provisions contained in schedule V to the Companies Act, 2013 the payment of ₹ 50 Lacs in the year as remuneration to Mr. X is valid in case he accepts it as under the said schedule he is entitled to a remuneration of ₹ 60 Lakhs in the year and his terms of appointment provide for payment of the remuneration as per schedule V.

7. (a) Section 196(2) of the Companies Act, 2013 lays down that no company shall appoint or re-appoint any person as its managing director, whole-time director or manager for a term exceeding five years at a time. No concession or exception is allowed by the Act to private companies.

Hence, the proposal to appoint Mr. Pawan as Manager for life in a private company is not valid.

Further, section 196(4) of the Companies Act, 2013 provides that a managing director, whole-time director or manager shall be appointed and the terms and conditions of such appointment and remuneration payable be approved by the Board of Directors at a meeting which shall be subject to approval by a resolution at the next general meeting of the company and by the Central Government in case such appointment is at variance to the conditions specified in Schedule V of the Act.

From the above, it is clear that Mr. Pawan cannot legally appoint anyone including Mr. Angad to succeed him as the Manager of the company and consequently Mr. Angad cannot succeed Mr. Pawan as Manager of the company after the death of 'L'.

- (b) The Companies Act, 2013 does not provide for the refund of any compensation paid by the company to its Managing Director, Whole Time Director or Manager. It only lays down the situations given under Section 202(2) of the Companies Act, 2013 under which no compensation is payable for loss of office and one such situation is the commitment of fraud or breach of trust by the director.

Moreover, in *Bell vs. Lever Brothers, (1932)*, Lever Brothers removed their managing director of a subsidiary by paying him compensation. It was afterwards discovered that during his tenure of office he had been guilty of so many breaches of duty and corrupt practices that he could have been removed without compensation. An action was then commenced to recover back the compensation money. It was held that Bell was not bound to refund the compensation money and to disclose any breach of his fiduciary obligation so as to give the company an opportunity to dismiss him. Thus, M is not bound to refund the compensation. Hence, the company cannot succeed to recover the compensation from M.

#### 8. Legal requirements to be complied with by a public company in respect of a Board Meeting:

- (a) **Frequency of meeting:** According to Section 173(1) of the Companies Act, 2013, every company shall hold its first Board Meeting within 30 days of the date of incorporation. Further, for subsequent meetings, at least four Board Meetings will be held in a year in such a manner that not more than one hundred and twenty days shall elapse between two Board Meetings.
- (b) **Notice of meeting:** Under section 173(3) a meeting of the Board shall be called by giving not less than 7 days' notice in writing to every director at his address registered with the company and such notice shall be sent by hand delivery or by post or by electronic means.

The proviso to section 173 (3) further provides that a meeting of the Board may be called at shorter notice to transact urgent business subject to the condition that at least one independent director, if any, shall be present at the meeting.

- (c) **Quorum for meetings:** According to Section 174(1) of the Act, the quorum for a meeting of the Board of Directors of a company shall be one-third of its total strength (any fraction contained in that one-third being rounded off as one), or two directors, whichever is higher. The directors participating by video conferencing or any other audio visual means shall be counted for the purposes of determining the quorum
- (d) **Adjourned meeting:** According to Section 174(4) of the Act, if a meeting of the Board could not be held for want of quorum, then, unless the articles otherwise

provide, the meeting shall automatically stand adjourned till the same day in the next week, at the same time and place, or if that day is a national holiday, till the next succeeding day which is not a national holiday, at the same time and place.

#### **Notice of Board meeting**

(i) Section 173(3) of the Companies Act, 2013 makes it mandatory for every director to be given proper notice of every Board Meeting. It is immaterial whether a director is interested or not.

An Interested Director: Notice must be given to a director even though he is precluded from voting at the meeting on the business to be transacted

(ii) A Director who has expressed his inability to attend a particular Board Meeting: In terms of section 173(3) even if a director states that he will not be able to attend the next Board meeting; notice must be given to that director

(iii) A director who has gone abroad: A director who has gone abroad is still a director. Therefore, he is entitled to receive notice of board meetings during his stay abroad. The Companies Act, 2013, allows delivery of notice of meeting by electronic means also. This is important because the Companies Act, 2013 permits a director to participate in a meeting by video conferencing or any other audio visual means.

9. (a) Under section 176 of the Companies Act, 2013 no act done by a person as a director shall be deemed to be invalid, notwithstanding that it was subsequently noticed that his appointment was invalid by reason of any defect or disqualification or had terminated by virtue of any provision contained in this Act or in the articles of the company.

Provided that nothing in this section shall be deemed to give validity to any act done by the director after his appointment has been noticed by the company to be invalid or to have terminated.

Therefore, from the above provisions of law, all acts done by the Board meeting or by its committee meeting or by any person acting as a director shall be as valid as if every such director or such person had been duly appointed and was qualified to be a director. The validity of all such acts done is not affected even if it discovered later on that there was some defect in the appointment of any one or more of such directors or of any person acting as a director.

However, once the defect in appointment is noticed by the company, no such acts of the director will be valid.

- (b) According to section 179(1), the Board of Directors of a company shall be entitled to exercise all such powers, and to do all such acts and things, as the company is authorised to exercise and do:

Provided that in exercising such power or doing such act or thing, the Board shall be subject to the provisions contained in that behalf in this Act, or in the memorandum or articles, or in any regulations not inconsistent therewith and duly made thereunder, including regulations made by the company in general meeting:

Provided further that the Board shall not exercise any power or do any act or thing which is directed or required, whether under this Act or by the memorandum or articles of the company or otherwise, to be exercised or done by the company in general meeting.

The Companies Act, 2013 vide section 180 (1) lays down the powers of the Board of Directors of a company which can be exercised only with the consent of the company by a special resolution. Clause (a) of section 180(1) defines one such power as the power to sell, lease or otherwise dispose of the whole or substantially the whole of the undertaking of the company or where the company owns more than one undertaking, of the whole or substantially the whole of any of such undertakings.

Therefore, the sale of the undertaking of a company can be made by the Board of Directors only with the consent of the members of the company accorded vide a special resolution.

Even if the power is given to the Board by the memorandum and articles of the company, the sale of the undertaking must be approved by the shareholders by a special resolution.

Therefore, the correct procedure to be followed is for the Board to approve the sale of the undertaking clearly specifying the terms of such sale and then convene a general meeting of the members to have the proposal approved by a special resolution.

In the given case therefore, the procedure followed is completely incorrect. The shareholders cannot on their own make out a proposal of sale and pass an ordinary resolution to implement it through the directors.

- (i) Therefore, the contention of the shareholders is incorrect in the first place as it is not within their authority to approve a proposal independently of the Board of Directors. It is for the Board to approve a proposal of sale of the undertaking and then get the members to approve it by a special resolution.
- (ii) Further, in exercising their powers the directors do not act as agent for the majority members or even all the members. The members therefore cannot by resolution passed by a majority or even unanimously supersede the powers of directors or instruct them how they shall exercise their powers.

- 10. Investigation into affairs of Company:** (1) According to section 210 (1) of the Companies Act, 2013 the Central Government may order an investigation into the affairs of the company, if it is of the opinion that it is necessary to do so:

- (a) on the receipt of a report of the Registrar or inspector under section 208;
  - (b) on intimation of a special resolution passed by a company that the affairs of the company ought to be investigated;
  - (c) in public interest.
- (2) According to section 210(3) of the Companies Act, 2013, the Central Government may appoint one or more persons as inspectors to investigate into the affairs of the company and to report thereon in such manner as the Central Government may direct.

In the given case, the majority of directors are already of the view that the affairs of the company are not conducted in a manner beneficial either to the company or to the members and want to make an application to the Central Government to appoint an inspector. Therefore, the steps to be carried out for the purpose will be as under:

- (a) Convene an Extraordinary General Meeting of members for passing the required special resolution. The provisions for convening the meeting should be complied with and the explanatory statement with the notice of the meeting must provide full details of the proposed special resolution.
  - (b) Once the special resolution is passed, a copy of it along with the copy of the notice should be filed with the Registrar;
  - (c) An application should be made under section 210 (1) to the Central Government requesting it to appoint an inspector to investigate the affairs of the company.
  - (d) The Central Government on receipt of such notice will ask for information, documents and other supporting evidence and may order an investigation only if it is of the opinion that an investigation is warranted. It may appoint one or more inspectors to investigate into the affairs of the company and to report thereon in such manner as it may direct.
11. (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  $\frac{3}{4}$  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) A scheme of compromise or arrangement may provide for amalgamation of companies under section 394 of the Companies Act, 1956. Section 394(4)(b) defines the 'transferee' and 'transferor' companies. While the 'transferee company' does not include any company other than a company within the meaning of the Companies Act, 1956, the transferor company includes any body corporate whether a company within the meaning of the Companies Act or not. Hence the scheme of amalgamation may provide for transfer of foreign companies to Indian companies.

- (ii) Majority in number representing three-fourths in value of members or class of members, as the case may be, present and voting either in person or by proxy, where proxies are allowed under the rules made under section 643 must approve the scheme or arrangement providing for amalgamation of companies [Section 391(2)]. Any member who though present at the meeting, does not vote for or against, but remains neutral, is not to be taken into consideration.

As the expression used is 'member', not only holders of equity shares but also preference shareholders will have to be taken into account and the value of their shares be included or, if the meeting of holders of preference shares and equity shares are ordered by the court to be held separately, the three-fourths majority of each class will have to be ascertained separately.

- (iii) The scheme may provide for the dissolution, without winding up, of any transferor company [Section 394(1)]. The Court shall not order dissolution of any transferor company unless the official liquidator has, on scrutiny of the books and papers of the company, made a report to the court that the affairs of the company have not been conducted in a manner prejudicial to the interests of its members or to public interest [Second proviso to Section 394(2)].

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

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

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

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

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

In the instant case, Mr. G ceased to be a member of the Company when it went into liquidation from 15.3.2015. Thus, Mr. G will be treated as a past member. He will not be required to contribute to the assets of the company if the following conditions are fulfilled:

- (1) If Mr. G had ceased to be a member of the company for a period of one year or upwards before the commencement of the winding up. In this case, since one year has not elapsed, Mr. G will be liable to contribute to the assets of the company.
- (2) If the debt or liability of the company was contracted or incurred after he ceased to be a member.



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

In any case, the liability of the past or present member cannot exceed the unpaid amount on the shares and if the shares are fully paid up, no contribution is required to be made by the members past or present.

- (b) The problem relates to suspension of business by a company. Section 433 of the Companies Act, 1956 provides that if a company does not commence its business within a year from its incorporation or suspends its business for a whole year, it may be wound up by the court. The contention of the shareholders of H Ltd that the company is liable to be wound up on the ground of suspensions of business, is not tenable for the following reasons:

- (1) A company may be wound up by court if a company suspends its business for a whole year. Here the business was suspended only on 1.1.2015. Hence on 1<sup>st</sup> April, 2015 the business has not been suspended for the whole year to attract Section 433(c).
- (2) Where a company having much business discontinues one of them, it cannot be said to have suspended business within the meaning of Section 433(c).
- (3) Where a company ceases to do any business but is a holding company of subsidiaries engaged in the pursuit of the business, which it was previously doing, it cannot be said that the company has suspended its business (*Ref; Eastern Telegraph Company Ltd*).

14. (i) As per provisions of section 581 ZH of the Companies Act, 1956, a Producer Company may, by special resolution, make donation or subscription to any institution or individual for the following purposes:-

- (a) For promoting the social and economic welfare of Producer Members or Producers or general public; or
- (b) For promoting the mutual assistance principles.

Thus as per the above stated provisions of the Companies Act, 1956, a Producer Company may make a donation by passing a special resolution and for the above mentioned purposes.

The 1<sup>st</sup> Proviso to the said section 581ZH lays down the monetary limit for making the donation by a Producer Company. According to the said proviso the aggregate amount of all such donation and subscription in any financial year shall not exceed three per cent of the net profit of the Producer Company in the financial year immediately preceding the financial year in which the donation or subscription was made.

Since the net profit of the Producer Company as per its last profit & loss account was ₹ 20.00 lacs, it can make a total donation of ₹ 60,000/- in this year being three percent thereof.

(ii) According to section 581P of the Companies Act, 1956 the members who sign the memorandum and the articles may designate (not less than five) as first directors and who shall govern the affairs of the company until the directors are appointed at the Annual General Meeting.

- (1) According to section 581-O every producer company shall have at least five and not more than fifteen directors.
- (2) The period of office of director shall be not less than one year and not exceeding 5 years as may be specified in the articles.
- (3) The election of directors shall be conducted within 90 days from the date of registration of the producer company. In the case of Inter-state co-operative society the election shall be held within a period of 360 days.
- (4) The directors are normally elected and appointed by the members in the Annual General Meeting. The Board may also co-opt one or more expert directors as an additional director. Such directors cannot exceed 1/5<sup>th</sup> of the total number of directors.
- (5) The expert directors shall not have the right to vote in the election of Chairman but shall be eligible to be elected as Chairman if it is provided by the articles. The maximum period for which such experts are appointed as directors will be as provided in the articles of association and it cannot exceed 5 years.

Thus Mr. Farmar can be appointed as expert director but he will not have any voting right in the election of chairman of the Board of directors. His tenure of office can be between one to five years.

**15. Under section 379 of the Companies Act, 2013 where**

- a. Not less than 50% of the paid-up share capital,
- b. whether equity or preference or partly equity and partly preference, of a foreign company
- c. is held either singly or in the aggregate by one or more citizens of India or by one or more companies or bodies corporate incorporated in India,
- d. such company shall comply with this Chapter (XXII) and
- e. such other provisions of this Act as may be prescribed
- f. with regard to the business carried on by it in India
- g. as if it were a company incorporated in India.

It may further be added that the chapter XXII which governs the foreign companies is spread from section 379 to section 393.

From the above provisions, it is clear that Aster Ltd. will fall within the purview of section 379 as more than 50% (50% preference share capital + 20% equity share capital = 70%) is held by companies incorporated in India.

Further, section 387 (1) (a) (iv) requires for the prospectus of a foreign company to include the date on which and the country in which the company would be or was incorporated.

(i) In view of the above provisions, the prospectus issued by Aster Ltd. is a non compliant prospectus. Thus, according to Section 387 the prospectus is not valid

Further, according to section 393 which states that any failure by a company to comply with the provisions of this Chapter shall not affect the validity of any contract, dealing or transaction entered into by the company or its liability to be sued in respect thereof, but the company shall not be entitled to bring any suit, claim any set-off, make any counter-claim or institute any legal proceeding in respect of any such contract, dealing or transaction, until the company has complied with the provisions of this Act applicable to it. Therefore, it may be concluded that the non disclosure of the country in which it was incorporated will not invalidate the validity of any contract, dealing or transaction entered into by Aster Ltd.

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

- a. the instrument constituting or defining the constitution of the company;
- b. the enactments or provisions by or under which the incorporation of the company was effected;
- c. the address in India where the said instrument, enactments or provisions, or copies thereof can be inspected. If the same are not in the English language, a certified translation thereof in the English language should be available for inspection;
- d. the date on which and the country in which the company would be or was incorporated; and
- e. whether the company has established a place of business in India and , if so, the address of its principal office in India, and the matters specified under section 26 (so far as they are applicable) which lays down the matters to be included in a prospectus issued by an Indian Company.

**16. Mediation and Conciliation Panel:** In common parlance, Mediation means intervention of some third party in a dispute with the intention to resolve the dispute.

Conciliation means the process of adjusting or settling disputes in a friendly manner through extra judicial means. This new provision introduced by the Companies Act, 2013 has come into force with effect from 1<sup>st</sup> April, 2014 vide notification dated 26<sup>th</sup> of March, 2014. Section 442 of the Companies Act, 2013 deals with the constitution and functioning of the mediation and conciliation panel in order to dispose the matter.

Section 442 lays the following law with respect to the functioning of the Mediation and Conciliation Panel:

- (1) **Central Government to maintain the Panel of Mediators:** The Central Government shall maintain a panel of experts to be known as Mediation and conciliation panel for mediation between the parties during the pendency of any proceedings before the Central Government or the Tribunal or the Appellate Tribunal under this Act.

Hence, it is important that the case should be pending before the Central Government or the Tribunal or the Appellate Tribunal under this Act.

- (2) **Panel consisting of experts:** The panel shall consist of such number of experts having such qualification as may be prescribed.
  
- (3) **Filing of application:** Application for mediation and conciliation can be made by:
  - (i) any parties to the proceedings. (It shall be accompanied with such fees and in such form as may be prescribed.)
  - (ii) The Central Government or the Tribunal or the Appellate Tribunal before which any proceeding is pending may, *suo motu* refer any matter pertaining to such proceeding to such number of experts as it may deem fit.
- (4) **Appointment of expert/s from panel:** The Central Government or the Tribunal or the Appellate Tribunal before which any proceeding is pending may appoint one or more experts from the Panel as may be deemed fit.
- (5) **Fees, terms and conditions of the experts:** The fee and other terms and conditions of experts of the Mediation and Conciliation Panel shall be such as may be prescribed.
- (6) **Procedure for the disposal of matter:** In order to dispose the matter, the Mediation and Conciliation Panel shall follow such procedure as may be prescribed.
- (7) **Period for the disposal of matter:** The Mediation and Conciliation Panel shall dispose of the matter referred to it within a period of three months from the date of such reference and forward its recommendations to the Central Government or the Tribunal or the Appellate Tribunal, as the case may be.

- (8) **Filing of objection on the recommendation of the panel:** Any party aggrieved by the recommendation of the Mediation and Conciliation Panel may file objections to the Central Government or the Tribunal or the Appellate Tribunal, as the case may be.
17. **Offences to be non-cognizable:** A new section 439 of the Companies Act, 2013 provides for offences to be non-cognizable. According to this section:
- (i) Every offence under this Act except the offences referred to in sub-section (6) of section 212 shall be deemed to be non-cognizable within the meaning of the said Code.
  - (ii) No court shall take cognizance of any offence under this Act which is alleged to have been committed by any company or any officer thereof, except on the complaint in writing of the Registrar, a shareholder of the company, or of a person authorised by the Central Government in that behalf.
  - (iii) The court may take cognizance of offences relating to issue and transfer of securities and non-payment of dividend, on a complaint in writing, by a person authorised by the Securities and Exchange Board of India.
  - (iv) Nothing in this sub-section shall apply to a prosecution by a company of any of its officers.
  - (v) Where the complainant is the Registrar or a person authorised by the Central Government, the presence of such officer before the Court trying the offences shall not be necessary unless the court requires his personal attendance at the trial.
  - (vi) The above provisions shall not apply to any action taken by the liquidator of a company in respect of any offence alleged to have been committed in respect of any of the matters in Chapter XX or in any other provision of this Act relating to winding up of companies.
  - (vii) The liquidator of a company shall not be deemed to be an officer of the company.
18. (i) According to section 448 of the Companies Act, 2013, if any person makes a statement which is false in any material particulars, knowing it to be false or omits any material facts, knowing it to be material, such person shall be liable under section 447. As per Section 447, any person who is found to be guilty under this section shall be punishable with imprisonment for a term which shall not be less than 6 months but which may extend to 10 years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to 3 times the amount involved in the fraud. Provided that, where the fraud involves public interest, the term of imprisonment shall not be less than 3 years.
- Hence, Mr. Atharva, a director of National highway Tolls Private Limited shall be punishable with imprisonment and fine prescribed as aforesaid.
- (ii) **Relief under Section 463:** Under section 463(1) of the Companies Act, 2013 if in any proceeding for negligence, default, breach of duty, misfeasance or breach of trust against an officer of a company, it appears to the court hearing the case he is

or may be liable in respect of the negligence, default, breach of duty, misfeasance or breach of trust, but that he has acted honestly and reasonably, and that having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused, the court may relieve him, either wholly or partly, from his liability on such terms, as it may think fit.

Provided that in a criminal proceeding under this sub-section, the court shall have no power to grant relief from any civil liability which may attach to an officer in respect of such negligence, default, breach of duty, misfeasance or breach of trust.

In the given case, the offence is not compoundable i.e. it carries imprisonment as a punishment either alone or with a fine. In either case, it would indicate that a criminal liability is indicated. Hence, the court will not have the power to grant relief under section 463. However, the nature of the offence will have to be examined.

**19. (i) Specimen Board Resolution: Purchase of Equity Shares**

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

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

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

Sd/-

Board of Directors

Humble Limited

**(ii) Draft Board Resolution**

“Resolved that consent of all the directors present at the meeting be and is hereby accorded to the appointment of Mr. W, who is already the Managing Director of another limited company, and fulfils the conditions as specified in Schedule V of the Companies Act, 2013, as the Managing Director of the company for a period of 5 years effective from 1<sup>st</sup> May, 2015 subject to approval by a resolution of shareholders in a general meeting and that Mr. W may be paid remuneration as follows:

- (i) Salary of ₹ 1 Lakh per month
- (ii) Commission
- (iii) Perquisites: Free Housing, Medical reimbursement upto ₹ 10,000, Leave Travel Concession for the family, Club membership fee, Personal Accident Insurance of ₹ 10 Lakhs, Gratuity, Provident Fund etc.

Resolved further that in the event of loss or inadequacy of profits, the salary payable to him shall be subject to the limits specified in Schedule V.

Resolved further that the Secretary of the company be and is hereby authorize to prepare and file with the Registrar of Companies necessary forms and returns in respect of the above appointment.”

Sd/

Board of Directors

Kitply Woods Limited

(Note: Since in the given case Mr. W fulfils all the conditions for appointment of Managing Director as specified in Schedule V, approval of Central Government is not required)

20. (i) Section 15G of the Securities and Exchange Board of India (SEBI) Act, 1992 deals with penalty for Insider Trading. According to this, if any insider -

- (a) either on his own behalf or on behalf of any other person, deals in securities of a body corporate on any stock exchange on the basis of any unpublished price sensitive information; or
- (b) communicates any unpublished price sensitive information to any person, with or without his request for such information except as required in the ordinary cause of business or under any law, or
- (c) counsels or procures for, any other person to deal in any securities of any body corporate on the basis of unpublished price sensitive information,

shall be liable to a penalty of twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher. As such SEBI can, after following the prescribed procedure, impose a penalty on Mr. Y. The maximum penalty that SEBI can impose is Rupees twenty-five crores or three times the amount of profits made out of insider trading, whichever is higher.

(ii) (1) **Conditions for qualified institutions placement [Chapter VIII of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009]:** Gauri Chemicals Limited, a listed company may make qualified institutions placement if it satisfies the following conditions:

- (a) a special resolution approving the qualified institutions placement has been passed by its shareholders;
- (b) the equity shares of the same class, which are proposed to be allotted through qualified institutions placement or pursuant to conversion or exchange of eligible securities offered through qualified institutions placement, have been listed on a recognised stock exchange having nation wide trading terminal for a period of at least one year prior to the

date of issuance of notice to its shareholders for convening the meeting to pass the special resolution:

- (c) it is in compliance with the requirement of minimum public shareholding specified in the Securities Contracts (Regulation) Rules, 1957;
  - (d) In the special resolution, it shall be, among other relevant matters, specified that the allotment is proposed to be made through qualified institutions placement and the relevant date referred in the regulations shall also be specified.
- (2) **Restrictions on amount raised:** The aggregate of the proposed qualified institutions placement and all previous qualified institutions placements made by the issuer in the same financial year shall not exceed five times the net worth of the issuer as per the audited balance sheet of the previous financial year.

In the instant case, the net worth of Gauri Chemicals Limited is ₹ 120 crore. Therefore, the maximum amount that can be raised by the company under the proposed issue of shares is ₹ 600 crore (5\*120).

- (3) **Restrictions on Pricing of issue and transferability of shares:**

**Pricing of issue:** The qualified institutions placement shall be made at a price not less than the average of the weekly high and low of the closing prices of the equity shares of the same class quoted on the stock exchange during the two weeks preceding the relevant date.

**Transferability of shares:** The eligible securities allotted under qualified institutions placement shall not be sold by the allottee for a period of one year from the date of allotment, except on a recognised stock exchange.

21. (a) **Disciplinary action against members of Stock Exchange:** SEBI can exercise the following powers under Securities Contracts (Regulation) Act, 1956 on receipt of serious complaints against the affairs of Mr. S, a member of Bombay Stock Exchange.
- (i) SEBI may, if it is satisfied that it is in the interest of the trade or in the public interest, by order in writing call upon the member of the stock exchange to furnish in writing information or explanation in respect of the matter under inquiry [Section 6(3)(a)].
  - (ii) SEBI instead of calling for information, may either appoint one or more persons to make an enquiry or direct the governing body of stock exchange to make inquiry and submit its report to SEBI [Section 6(3)(b)].



In case of adverse findings, SEBI can direct Bombay Stock Exchange to take disciplinary action against Mr. S, such as fine, expulsion from membership, suspension from membership for a specified period and any other penalty of a like nature not involving the payment of money. Bye-laws of the stock exchange usually provide for such punishment [Section 9(3)(b)]. Bombay Stock Exchange is under obligation to take the action as directed.

(b) According to section 21A of the Securities Contracts (Regulation) Act, 1956 the delisting of securities may take place in the following manner-

(1) A recognised stock exchange may delist the securities, after recording the reasons therefor, from any recognised stock exchange on any of the ground or grounds as may be prescribed under this Act:

Provided that the securities of a company shall not be delisted unless the company concerned has been given a reasonable opportunity of being heard.

(2) A listed company or an aggrieved investor may file an appeal before the Securities Appellate Tribunal against the decision of the recognised stock exchange delisting the securities within fifteen days from the date of the decision of the recognised stock exchange delisting the securities and the provisions of sections 22B to 22E of this Act, shall apply, as far as may be, to such appeals:

Provided that the Securities Appellate Tribunal may, if it is satisfied that the company was prevented by sufficient cause from filing the appeal within the said period, allow it to be filed within a further period not exceeding one month.

22. (a) According to the provisions of section 2(v) of the Foreign Exchange Management Act, 1999, a person in order to qualify for the purpose of being treated as a "Person Resident in India" in any financial year, must reside in India for a period of more than 182 days during the preceding financial year. In the given case, Mr. Sekhar has resided in India for a period of only 150 days, i.e., less than 182 days, during the financial year 2013-2014. Hence he cannot be considered as a "Person Resident in India" during the financial year 2014-2015 irrespective of the purpose or duration of his stay.

(b) (i) As per the provisions of section 2(v)(ii) of the Foreign Exchange Management Act, 1999 (FEMA) any person or body corporate registered or incorporated in India is a "Person resident in India". As per section 2(v) of the said Act the term "person" includes a company. Section 2(v)(iv) of the said Act states that an office, branch or agency outside India owned or controlled by a person resident in India is a "Person resident in India".

In the light of the above provisions of FEMA, the residential status of the New York branch of MKP Ltd is that of a "Person resident in India" from the date of its establishment since it is owned by a person, i.e., a company, resident in India.

- (ii) As per provisions of section 2(v)(iii) of the Foreign Exchange Management Act, 1999 (FEMA) an office, branch or agency in India owned or controlled by a person resident outside India is a "Person resident in India". Section 2(w) of the said Act states that a person who is not resident in India is a "Person resident outside India".

On application of the above provisions of FEMA, it can be concluded that WIP Ltd. is a "Person resident outside India" and since it owns a branch in Chandigarh, India, the residential status of the said Chandigarh branch is that of a "Person resident in India" from the date of its establishment.

- (iii) As per provisions of section 2(v)(iv) of the Foreign Exchange Management Act, 1999 (FEMA) an office, branch or agency outside India owned or controlled by a person resident in India is a "Person resident in India". Here, the Singapore branch of WIP Ltd. is controlled by its Chandigarh branch which is a "Person resident in India". Therefore, the residential status of the Singapore branch of WIP Ltd. shall be that of a "Person resident in India".

23. (a) (i) **Enterprise:** The term 'enterprise' is defined in section 2(h) of the Competition Act, 2002. Accordingly 'enterprise' means a person or a department of the Government, who or which is engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or the provision of services of any kind. But the term does not include any activity of the Government relating to sovereign functions of the Government including all activities carried on by the departments of the Central Government dealing with atomic energy, currency, defence and space.

Certain specific activities of Government departments like dealing with atomic energy, etc. and sovereign functions of the Government (like police, defence, etc.) are excluded from the purview of the said terms. Hence, a Government department engaged in the activity of providing service in the form of supply of water for irrigation to the agriculturists after levying charges can be considered as an 'enterprise' within the meaning of section 2(h) of the Competition Act, 2002.

- (ii) **Consumer:** The term 'consumer' is defined in section 2(f) of the Competition Act, 2002. Accordingly 'consumer' means any person who buys any goods for a consideration, which has been paid or promised or partly paid and partly promised, whether such purchase of goods is for resale or for any commercial purpose or for personal use.

Hence, it is not necessary that a person must purchase the goods for personal use in order to be considered as a 'consumer' under the Competition Act, 2002. Even a person purchasing goods for resale or for any commercial purpose will also be considered as a 'consumer' within the meaning of Section 2(f) of the Competition Act, 2002.

(b) Section 2(i) of the Competition Act, 2002 defines 'goods' as follows:

'Goods' means goods as defined in the Sale of Goods Act, 1930 and includes –

- (a) products manufactured, processed or mined;
- (b) debentures, stock and shares after allotment
- (c) in relation to goods supplied, distributed or controlled in India, goods imported into India.

Hence, debentures and shares can be considered as 'goods' within the meaning of section 2(i) of the Competition Act, 2002 only after allotment and not before allotment.

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

- 1 when the amount in the reserve fund and the share premium account are equal to the paid-up share capital of the banking company.
2. when the Central Govt. feels that its paid-up share capital and reserves are adequate to safeguard the interest of the depositors.

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

Therefore, applying the above provisions:

- (i). Contention of share holders shall be tenable since the 15% of transfer of profits to Reserve Fund is lower than statutory limits, as provided in the Act.
- (ii). In the second case the contention of shareholders shall not be tenable, since 30% is more than the minimum statutory limit of 20% of the net profits.

(b) Section 39 of the Insurance Act, 1938 deals with the nomination by policy holder. According to which, the holder of a policy of life insurance on his own life may, when effecting the policy or at any time before the policy matures for payment, nominate the person or persons to whom the money secured by the policy shall be paid in the event of his death.

Provided that, where any nominee is a minor, it shall be lawful for the policyholder to appoint any person in the manner laid down by the insurer, to receive the money secured by the policy in the event of his death during the minority of the nominee.

The given problem is based on above provision i.e. minor as a nominee. Here, Mr. M wants to nominate S his minor son as a nominee for his life insurance policy. He can do so after fulfilling the requirement of the above provision.

25. (a) **Money Laundering:** Whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of offence of money laundering. [Section 3 of the Prevention of Money Laundering Act, 2002]

Paragraph 2 of Part A of the Schedule to the Prevention of Money Laundering Act, 2002, covers offences under the Narcotic Drugs and Psychotropic Substances Act, 1985. Whereby, illegal import into India, export from India or transshipment of narcotic drugs and psychotropic substances (section 23) is covered under paragraph 2 of Part A.

**Punishment:** Section 4 of the said Act provides for the punishment for Money-Laundering. Whoever commits the offence of money-laundering shall be punishable with rigorous imprisonment for a term which shall not be less than 3 years but which may extend to 7 years and shall also be liable to fine. But where the proceeds of crime involved in money-laundering relate to any offence specified under paragraph 2 of Part A of the Schedule, the maximum punishment may extend to 10 years instead of 7 years.

- (b) (i) Normally a Proviso is added to a section of an Act to except something or qualify something stated in that particular section to which it is added. A proviso should not be, ordinarily, interpreted as a general rule. A proviso to a particular section carves out an exception to the main provision to which it has been enacted as a Proviso and to no other provision. [*Ram Narian Sons Ltd. Vs. Commissioner of Sales Tax AIR (1955) S.C. 765*]
- (ii) 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 and ambiguity in the main section. Something may added be 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.
- (iii) The "Preamble" expresses the scope, object and purpose of the Act. It may recite the ground and the cause making a statue and the evil, which is sought to be remedied by it. It is a part of the statute and can legitimately be used for construing it. However, it does not over-ride the plain provisions of the Act, but if the wording of the statute gives rise to the doubts as to its proper construction, e.g., where the words or phrase have more than one meaning and a doubt arises as to which of the two meanings is intended in the Act, then the Preamble can and ought to be referred to in order to arrive at the proper construction.

**Applicability of Pronouncements/Legislative Amendments/Circulars etc.  
for November, 2015 – Final Examination**

**Paper 1: Financial Reporting**

- I. Framework for the Preparation and Presentation of Financial Statements.**
- II. Accounting Standards**

<i>AS No.</i>	<i>AS Title</i>
1	Disclosure of Accounting Policies
2	Valuation of Inventories
3	Cash Flow Statements
4	Contingencies and Events Occurring after the Balance Sheet Date
5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
6	Depreciation Accounting
7	Construction Contracts (Revised 2002)
9	Revenue Recognition
10	Accounting for Fixed Assets
11	The Effects of Changes in Foreign Exchange Rates (Revised 2003)
12	Accounting for Government Grants
13	Accounting for Investments
14	Accounting for Amalgamations
15	Employee Benefits
16	Borrowing Costs
17	Segment Reporting
18	Related Party Disclosures
19	Leases
20	Earnings Per Share
21	Consolidated Financial Statements
22	Accounting for Taxes on Income
23	Accounting for Investment in Associates in Consolidated Financial Statements
24	Discontinuing Operations

25	Interim Financial Reporting
26	Intangible Assets
27	Financial Reporting of Interests in Joint Ventures
28	Impairment of Assets
29	Provisions, Contingent Liabilities and Contingent Assets
30	Financial Instruments: Recognition and Measurement
31	Financial Instruments: Presentation
32	Financial Instruments: Disclosure

### III. Guidance Notes on Accounting Aspects

1. Guidance Note on Accrual Basis of Accounting.
2. Guidance Note on Accounting Treatment for Excise Duty.
3. Guidance Note on Terms Used in Financial Statements.
4. Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares.
5. Guidance Note on Accounting Treatment for MODVAT/CENVAT.
6. Guidance Note on Accounting for Corporate Dividend Tax.
7. Guidance Note on Accounting for Employee Share-based Payments.
8. Guidance Note on Accounting for Credit Available in respect of Minimum Alternate Tax under the Income Tax Act, 1961.
9. Guidance Note on Measurement of Income Tax for Interim Financial Reporting in the \_\_\_\_\_ context \_\_\_\_\_ of AS 25.
10. Guidance Note on Applicability of Accounting Standard (AS) 20, Earnings per Share.
11. Guidance Note on Remuneration paid to key management personnel – whether a related party transaction.
12. Guidance Note on Applicability of AS 25 to Interim Financial Results.
13. Guidance Note on Turnover in case of Contractors.
14. Guidance Note on the Revised Schedule VI to the Companies Act, 1956\*

[\*Schedule III to the Companies Act, 2013.]

### IV. Applicability of the Companies Act, 2013 and other Legislative Amendments

The relevant notified Sections of the Companies Act, 2013 up to 31<sup>st</sup> March, 2015 and other legislative amendments including relevant Notifications / Circulars / Rules /

Guidelines issued by Regulating Authority up to 30th April, 2015.

**Non-Applicability of Ind ASs:**

The Ministry of Corporate Affairs has notified Roadmap for applicability of Indian Accounting Standards (Ind AS) vide Notification No. G.S.R.....(E) dated 16 February, 2015, for compliance by the class of companies specified in the said roadmap. The notification has been uploaded on [www.mca.gov.in](http://www.mca.gov.in) along with the thirty nine (39) Indian Accounting Standards (Ind AS). **Students may note that these Ind ASs are not applicable for November, 2015 Examination.**

**Paper 3: Advanced Auditing and Professional Ethics**

**I. Statements and Standards**

1. Statement on Reporting under Section 227(1A) of the Companies Act, 1956 (Section 143 of the Companies Act, 2013).
2. Framework for Assurance Engagements.

**II. Engagements and Quality Control Standards on Auditing**

S.No	SA	Title of Standard on Auditing
1	SQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements
2	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
3	SA 210	Agreeing the Terms of Audit Engagements
4	SA 220	Quality Control for Audit of Financial Statements
5	SA 230	Audit Documentation
6	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements
7	SA 250	Consideration of Laws and Regulations in An Audit of Financial Statements
8	SA 260	Communication with Those Charged with Governance
9	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
10	SA 299	Responsibility of Joint Auditors
11	SA 300	Planning an Audit of Financial Statements
12	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment

13	SA 320	Materiality in Planning and Performing an Audit
14	SA 330	The Auditor's Responses to Assessed Risks
15	SA 402	Audit Considerations Relating to an Entity Using a Service Organization
16	SA 450	Evaluation of Misstatements Identified during the Audits
17	SA 500	Audit Evidence
18	SA 501	Audit Evidence - Specific Considerations for Selected Items
19	SA 505	External Confirmations
20	SA 510	Initial Audit Engagements-Opening Balances
21	SA 520	Analytical Procedures
22	SA 530	Audit Sampling
23	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
24	SA 550	Related Parties
25	SA 560	Subsequent Events
26	SA 570	Going Concern
27	SA 580	Written Representations
28	SA 600	Using the Work of Another Auditor
29	SA 610	Using the Work of Internal Auditors
30	SA 620	Using the Work of an Auditor's Expert
31	SA 700	Forming an Opinion and Reporting on Financial Statements
32	SA 705	Modifications to the Opinion in the Independent Auditor's Report
33	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
34	SA 710	Comparative Information – Corresponding Figures and Comparative Financial Statements
35	SA 720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements
36	SA 800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework
37	SA 805	Special Considerations-Audits of Single Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
38	SA 810	Engagements to Report on Summary Financial Statements



39	SRE 2400	Engagements to Review Financial Statements
40	SRE 2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity
41	SAE 3400	The Examination of Prospective Financial Information
42	SAE 3402	Assurance Reports on Controls At a Service Organisation
43	SRS 4400	Engagements to Perform Agreed Upon Procedures Regarding Financial Information
44	SRS 4410	Engagements to Compile Financial Information

### III. Guidance Notes and other publications

1. Code of Ethics
2. Guidance Note on Independence of Auditors.
3. Guidance Note on Audit Reports and Certificates for Special Purposes.
4. Guidance Note on Audit under Section 44AB of the Income-tax Act (Revised in view of Latest Form 3CA, 3CB and 3CD notified on 25<sup>th</sup> July).
5. Guidance Note on Audit of Inventories.
6. Guidance Note on Audit of Debtors, Loans and Advances.
7. Guidance Note on Audit of Investments.
8. Guidance Note on Audit of Cash and Bank Balances.
9. Guidance Note on Audit of Liabilities.
10. Guidance Note on Audit of Revenue.
11. Guidance Note on Audit of Expenses.
12. Guidance Note on Computer Assisted Audit Techniques (CAATs).
13. Guidance Note on Audit of Payment of Dividend.
14. Guidance Note on Audit of Capital and Reserves.

### IV Applicability of the Companies Act, 2013 and Other Legislative Amendments:

- (i) The relevant notified Sections of the Companies Act, 2013 up to 31<sup>st</sup> March, 2015 alongwith other legislative amendments including relevant Notifications / Circulars / Rules / Guidelines issued by Regulating Authorities cut-off date will be 30<sup>th</sup> April, 2015.
- (ii) Companies (Auditor's Report) Order, 2015 [CARO] issued by Ministry of Corporate Affairs on 10<sup>th</sup> April, 2015 is applicable for November 2015 Examination.

**Paper 4: Corporate and Allied Laws**

**Applicability of the Companies Act, 2013 and other legislative amendments**

The relevant sections of the Companies Act, 2013, notified up to 31<sup>st</sup> March, 2015 along with other relevant Rules/ Notifications/ Circulars/ Clarification/ Orders issued by the Ministry of Corporate Affairs upto 30<sup>th</sup> April, 2015.

**SEBI (Issue of Capital and Disclosure Requirement) Regulations, 2009**

SEBI vide Notification dated 24<sup>th</sup> March, 2015 has issued SEBI (Issue of Capital and Disclosure Requirements) (Amendment) Regulations, 2015.

**The Insurance Act, 1938 and the Insurance Regulatory and Development Authority Act, 1999**

Vide Notification dated 23<sup>rd</sup> March, 2015, Ministry of Law and Justice further amended the Insurance Act, 1938 and the Insurance Regulatory and Development Authority Act, 1999 by enacting the Insurance Laws (Amendment) Act, 2015.

**Non-Applicability of the following Chapters/Amendments/Circulars/Notifications**

S.No.	Subject Matter
1.	Chapter 9 of the study material (October, 2014 edition) covering provisions relating to Revival and Rehabilitation of Sick-Industrial Companies.
2.	Chapter 15 of the study material (October, 2014 edition) covering provisions relating to the National Company Law Tribunal and Appellate Tribunal.
3.	The Companies(Amendment)Act, 2015

# The Insurance Act, 1938

## As Amended by the Insurance Laws (Amendment) Act, 2015

### 23.10 Introduction

#### (Highlights of the Amendment Act, 2015)<sup>1</sup>

The Insurance Laws (Amendment) Bill, 2015 was passed by the Lok Sabha on 4th March, 2015 and by the Rajya Sabha yesterday i.e. on 12th March, 2015. The passage of the Bill thus paved the way for major reform related amendments in the Insurance Act, 1938, the General Insurance Business (Nationalization) Act, 1972 and the Insurance Regulatory and Development Authority (IRDA) Act, 1999. The Insurance Laws (Amendment) Act 2015 deemed to *come into force on 26th December 2014*. The amendment Act paved way for removing archaic and redundant provisions in the legislations and incorporates certain provisions to provide Insurance Regulatory and Development Authority of India (IRDAI) with the flexibility to discharge its functions more effectively and efficiently. It also provides for enhancement of the foreign investment cap in an Indian Insurance Company from 26% to an explicitly composite limit of 49% with the safeguard of Indian ownership and control.

In addition to the provisions for enhanced foreign equity, the amended law will *enable capital raising* through new and innovative instruments under the regulatory supervision of IRDAI. Greater availability of capital for the capital intensive insurance sector would lead to greater distribution reach to under / un-served areas, more innovative product formulations to meet diverse insurance needs of citizens, efficient service delivery through improved distribution technology and enhanced customer service standards. The Rules to operationalize the new provisions in the Law related to foreign equity investors have already been notified on 19th February 2015 under powers accorded by the Ordinance.

The four public sector general insurance companies, presently required as per the General Insurance Business (Nationalisation) Act, 1972 (GIBNA, 1972) to be 100% government owned, are now allowed to raise capital, keeping in view the need for expansion of the business in the rural and social sectors, meeting the solvency margin for this purpose and achieving enhanced competitiveness subject to the Government equity not being less than 51% at any point of time.

Further, the amendments to the laws will enable the *interests of consumers to be better served* through provisions like those enabling penalties on intermediaries / insurance companies for misconduct and disallowing multilevel marketing of insurance products in order to curtail the practice of mis-selling. The amended Law has several provisions for levying higher penalties ranging from up to ₹ 1 Crore to ₹ 25 Crore for various violations including mis-selling and misrepresentation by agents / insurance companies. With a view to serve the interest of the policy holders better, the period during which a policy can be repudiated on any

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<sup>1</sup> Press Information Bureau, Ministry of Finance, Govt. of India, dt. 13<sup>th</sup> March, 2015

ground, including mis-statement of facts etc., will be confined to three years from the commencement of the policy and no policy would be called in question on any ground after three years. The amendments provide for an easier process for payment to the nominee of the policy holder, as the insurer would be discharged of its legal liabilities once the payment is made to the nominee. It is now obligatory in the law for insurance companies to underwrite third party motor vehicle insurance as per IRDAI regulations. Rural and Social sector obligations for insurers are retained in the amended laws.

The Act will entrust responsibility of appointing insurance agents to insurers and provides for IRDAI to regulate their eligibility, qualifications and other aspects. It enables agents to work more broadly across companies in various business categories; with the safeguard that conflict of interest would not be allowed by IRDAI through suitable regulations. *IRDAI is empowered* to regulate key aspects of Insurance Company operations in areas like solvency, investments, expenses and commissions and to formulate regulations for payment of commission and control of management expenses. It empowers the Authority to regulate the functions, code of conduct, etc., of surveyors and loss assessors. It also expands the scope of insurance intermediaries to include insurance brokers, re- insurance brokers, insurance consultants, corporate agents, third party administrators, surveyors and loss assessors and such other entities, as may be notified by the Authority from time to time. Further, properties in India can now be insured with a foreign insurer with prior permission of IRDAI; which was earlier to be done with the approval of the Central Government.

The amendment Act *defines 'health insurance business'* inclusive of travel and personal accident cover and discourages non-serious players by retaining capital requirements for health insurers at the level of ₹ 100 Crore, thereby paving the way for promotion of health insurance as a separate vertical.

The amended law enables *foreign reinsurers to set up branches in India* and *defines 're-insurance'* to mean "the insurance of part of one insurer's risk by another insurer who accepts the risk for a mutually acceptable premium", and thereby excludes the possibility of 100% ceding of risk to a re-insurer, which could lead to companies acting as front companies for other insurers. Further, it enables Lloyds and its members to operate in India through setting up of branches for the purpose of reinsurance business or as investors in an Indian Insurance Company within the 49% cap.

The Life Insurance Council and General Insurance Council have now been made *self-regulating bodies* by empowering them to frame bye-laws for elections, meetings and levy and collect fees etc. from its members. Inclusion of representatives of self-help groups and insurance cooperative societies in insurance councils has also been enabled to broad base the representation on these Councils.

Appeals against the orders of IRDAI are to be preferred to SAT as the amended Law provides for any insurer or insurance intermediary aggrieved by any order made by IRDAI to prefer an appeal to the Securities Appellate Tribunal (SAT).

### 23.11 Important Definitions (Section 2)

(1) "*Actuary*" means an actuary as defined in clause (a) of sub-section (1) of section 2 of the Actuaries Act, 2006.

(1A) "*Authority*" means the Insurance Regulatory and Development Authority of India established under sub-section (1) of section 3 of the Insurance Regulatory and Development Authority Act, 1999

(6C) "*Health insurance business*" means the effecting of contracts which provide for sickness benefits or medical, surgical or hospital expense benefits, whether in-patient or out-patient travel cover and personal accident cover.

(7A) "*Indian insurance company*" means any insurer, being a company which is limited by shares, and, (a) which is formed and registered under the Companies Act, 2013 as a public company or is converted into such a company within one year of the commencement of the Insurance Laws (Amendment) Act, 2015; (b) in which the aggregate holdings of equity shares by foreign investors, including portfolio investors, do not exceed forty-nine per cent of the paid up equity capital of such Indian insurance company, which is Indian owned and controlled, in such manner as may be prescribed. The expression "control" shall include the right to appoint a majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreements; (c) whose sole purpose is to carry on life insurance business or general insurance business or re-insurance business or health insurance business.

(9) "*Insurer*" means (a) an Indian Insurance Company, or (b) a statutory body established by an Act of Parliament to carry on insurance business, or (c) an insurance co-operative society, or (d) a foreign company engaged in re-insurance business through a branch established in India. The expression "foreign company" shall mean a company or body established or incorporated under a law of any country outside India and includes Lloyd's established under the Lloyd's Act, 1871 (United Kingdom) or any of its Members.

(16B) "*Re-insurance*" means the insurance of part of one insurer's risk by another insurer who accepts the risk for a mutually acceptable premium.

### 23.12 Provisions Related To Insurance

#### (a) Indian properties not to be insured with foreign insurers (section 2CB)

Without the permission of the IRDA, no person shall take out or renew any policy of insurance in respect of any property in India or any ship or other vessel or aircraft registered in India with an insurer whose principal place of business is outside India.

#### (b) Requirements as to Capital (Section 6)

Type of Insurance Business	Minimum Paid-up equity capital required (with a provision for further enhancement & Paid-up equity excludes preliminary expenses incurred during formation and registration)
Life insurance or general insurance	₹ 100 crore

Health insurance (exclusively)	₹ 100 crore
Re-insurer (exclusively)	₹ 200 crore (besides re-insurer shall not be registered unless he has net owned funds of not less than ₹ 5,000 crore)

**(c) Further Conditions (Section 6A)**

To carry on the business of life or general or health or re-insurance the following further requirements are to be satisfied by such companies:

- that the capital of the company shall consist of equity shares each having a single face value and such other form of capital, as may be specified by the regulations;
- that the voting rights of shareholders are restricted to equity shares;
- that, except during any period not exceeding one year allowed by the company for payment of calls on shares, the paid-up amount is the same for all shares, whether existing or new.
- The aforesaid conditions shall not apply to a public company which before the commencement of the Insurance (Amendment) Act, 1950, has issued any shares other than ordinary shares each of which has a single face value or shares, the paid-up amount whereof is not the same for all them for a period of three years from such commencement.

**(d) Audit of accounts of insurance companies (Section 12)& Submission of returns (Section 15)**

Unless subject to audit under the Companies Act, 2013, the balance sheet, profit and loss account, revenue account and profit and loss appropriation account of every insurer, in respect of all insurance business transacted by him, shall be audited annually by an auditor, and the auditor shall in the audit of all such accounts have the powers of, exercise the functions vested in, and discharge the duties and be subject to the liabilities and penalties imposed on, auditors of companies by section 147 of the Companies Act, 2013.

The audited accounts and statements and the abstract and statement referred to in section 13 shall be printed, and four copies thereof shall be furnished as returns to the Authority within six months from the end of the period to which they refer. Of the four copies so furnished, one shall be signed in the case of a company by the chairman and two directors and by the principal officer of the company and, if the company has a managing director by that managing director and one shall be signed by the auditor who made the audit or the actuary who made the valuation, as the case may be.

**(e) Actuarial Valuation/Report (section 13)**

At least once a year, every insurer carrying on life insurance business shall cause an investigation of the life insurance business carried on by him including a valuation of his liabilities in respect thereto and shall cause an abstract of the report of such actuary to be made in accordance with the regulations. The Authority may, having regard to the

circumstances of any particular insurer, allow him to have the investigation made as at a date not later than two years from the date as at which the previous investigation was made. If the investigation is made annually by any insurer, the statement need not be appended every year but shall be appended at least once in every three years.

**(f) Record of Policies and claims (Section 14)**

Every insurer, in respect of all business transacted by him, shall maintain

1. a record of policies, in which shall be entered, in respect of every policy issued by the insurer, the name and address of the policyholder, the date when the policy was effected and a record of any transfer, assignment or nomination of which the insurer has notice;
2. a record of claims, every claim made together with the date of the claim, the name and address of the claimant and the date on which the claim was discharged, or, in the case of a claim which is rejected, the date of rejection and the grounds thereof;
3. a record of policies and claims may be maintained in any such form, including electronic mode, as may be specified by the regulations made under this Act;
4. Every insurer shall, in respect of all business transacted by him, endeavour to issue policies above a specified threshold in terms of sum assured and premium in electronic form, in the manner and form to be specified by the regulations made under this Act.

**(g) Investment of Assets (Section 27)**

Every insurer shall invest and at all times keep invested assets equivalent to not less than the sum of the amount of his liabilities to holders of life insurance policies in India on account of matured claims, and the amount required to meet the liability on policies of life insurance maturing for payment in India, less the amount of premiums which have fallen due to the insurer on such policies but have not been paid and the days of grace for payment of which have not expired, and any amount due to the insurer for loans granted on and within the surrender values of policies of life insurance maturing for payment in India issued by him or by an insurer whose business he has acquired and in respect of which he has assumed liability in the following manner namely:-

1. 25% of the said sum in Government securities, a further sum equal to not less than twenty-five per cent of the said sum in Government securities or other approved securities; and
2. the balance in any of the approved investments as may be specified by the regulations subject to the limitations, conditions and restrictions specified therein.

In the case of an insurer carrying on general insurance business, 25% of the assets in Government Securities, a further sum equal to not less than ten per cent of the assets in Government Securities or other approved securities and the balance in any other investment in accordance with the regulations of the Authority and subject to such limitations, conditions and restrictions as may be specified by the Authority in this regard.

No insurer carrying on life insurance business shall invest or keep invested any part of his controlled fund and no insurer carrying on general business shall invest or keep invested any part of his assets otherwise than in any of the approved investments as may be specified by the regulations subject to such limitations, conditions and restrictions therein. (Section 27A)

All assets of an insurer carrying on general insurance business shall subject to such conditions, if any, as may be prescribed, be deemed to be assets invested or kept invested in approved investments specified in section 27. (Section 27B)

An insurer may invest not more than five per cent in aggregate of his controlled fund or assets in the companies belonging to the promoters, subject to such conditions as may be specified by the regulations. (Section 27C)

**(h) Prohibition of loans (Section 29)**

No insurer shall grant loans or temporary advances either on hypothecation of property or on personal security or otherwise, except loans on life insurance policies issued by him within their surrender value, to any director, manager, actuary, auditor or officer of the insurer, if a company or to any other company or firm in which any such director, manager, actuary or officer holds the position of a director, manager, actuary, officer or partner. This shall not apply to such loans made by an insurer to a banking company, as may be specified by the Authority. Further this shall not be applicable from granting such loans or advances to a subsidiary company or to any other company of which the company granting the loan or advance is a subsidiary company if the previous approval of the Authority is obtained for such loan or advance. The provisions of section 185 of the Companies Act, 2013 shall not apply to a loan granted to a director of an insurer being a company, if the loan is one granted on the security of a policy on which the insurer bears the risk and the policy was issued to the director on his own life, and the loan is within the surrender value of the policy.

**(i) Liability of directors for contravention (Section 30)**

If by reason of a contravention of any of the provisions of section 27, 27A, 27B, 27C, 27D or section 29, any loss is sustained by the insurer or by the policy holders, every director, manager or officer who is knowingly a party to such contravention shall, without prejudice to any other penalty to which he may be liable under this Act, be jointly and severally liable to make good the amount of such loss.

**(j) Obligations of Insurers in respect of third party risks of motor vehicles (Section 32D)**

Every insurer carrying on general insurance business shall, after the commencement of the Insurance Laws (Amendment) Act, 2015, underwrite such minimum percentage of insurance business in third party risks of motor vehicles as may be specified by the regulations: The Authority may, by regulations, exempt any insurer who is primarily engaged in the business of health, re-insurance, agriculture, export credit guarantee, from the application of this section. 105B. If an insurer fails to comply with the provisions



of section 32B, section 32C and section 32D, he shall be liable to a penalty not exceeding twenty-five crore rupees. (Section 105B)

**(k) Power of investigation and inspection by authority (Section 33)**

The Authority may, at any time, if it considers expedient to do so by order in writing, direct any person ("Investigating Officer") specified in the order to investigate the affairs of any insurer or intermediary or insurance intermediary, as the case may be, and to report to the Authority on any investigation made by such Investigating Officer: The Investigating Officer may, wherever necessary, employ any auditor or actuary or both for the purpose of assisting him in any investigation under this section. Notwithstanding anything to the contrary contained in section 210 of the Companies Act, 2013, the Investigating Officer may, at any time, and shall, on being directed so to do by the Authority, cause an inspection to be made by one or more of his officers of the books of account of any insurer or intermediary or insurance intermediary, as the case may be, and the Investigating Officer shall supply to the insurer or intermediary or insurance intermediary, as the case may be, a copy of the report on such inspection.

It shall be the duty of every manager, managing director or other officer of the insurer including a service provider, contractor of an insurer where services are outsourced by the insurer, or intermediary or insurance intermediary, as the case may be, to produce before the Investigating Officer directed to make the investigation or inspection, all such books of account, registers, other documents and the database in his custody or power and to furnish him with any statement and information relating to the affairs of the insurer or intermediary or insurance intermediary, as the case may be, as the Investigating Officer may require of him within such time as the said Investigating Officer may specify. The Investigating officer shall make a report to the Authority on such inspection and the Authority may after giving such opportunity to the insurer or intermediary to make a representation. All expenses incidental to any investigation shall be defrayed by the insurer or intermediary or insurance intermediary and shall have priority over the debts due from the insurer and shall be recoverable as an arrear of land revenue.

**(l) Prohibition of payment by way of commission or otherwise for procuring business (Section 40)**

No person shall, pay or contract to pay any remuneration or reward whether by way of commission or otherwise for soliciting or procuring insurance business in India to any person except an insurance agent or an intermediary or insurance intermediary in such manner as may be specified by the regulations. No insurance agent or intermediary or insurance intermediary shall receive or contract to receive commission or remuneration in any form in respect of policies issued in India, by an insurer in any form in respect of policies issued in India, by an insurer except in accordance with the regulations specified in this regard.

**(m) Appointment of insurance agents (Section 42)**

An insurer may appoint any person to act as insurance agent for the purpose of soliciting and procuring insurance business. Such person should not suffer from any of the

disqualifications. Further no person shall act as an insurance agent for more than one life insurer, one general insurer, one health insurer and one of each of the other mono-line insurers: The Authority shall, while framing regulations, ensure that no conflict of interest is allowed to arise for any agent in representing two or more insurers for whom he may be an agent.

**(n) Prohibition of insurance business through principal agent, special agent and multilevel marketing (Section 42A)**

No insurer shall, on or after the commencement of the Insurance Laws (Amendment) Act, 2015, appoint any principal agent, chief agent, and special agent and transact any insurance business in India through them. No person shall allow or offer to allow, either directly or indirectly, as an inducement to any person to take out or renew or continue an insurance policy through multilevel marketing scheme. The Authority may, through an officer authorised in this behalf, make a complaint to the appropriate police authorities against the entity or persons involved in the multilevel marketing scheme. "multilevel marketing scheme" means any scheme or programme or arrangement or plan (by whatever name called) for the purpose of soliciting and procuring insurance business through persons not authorised for the said purpose with or without consideration of whole or part of commission or remuneration earned through such solicitation and procurement and includes enrolment of persons into a multilevel chain for the said purpose either directly or indirectly.

**(o) Policy not to be called in question after three years (Section 45)**

No policy of life insurance shall be called in question on any ground whatsoever after the expiry of three years from the date of the policy, i.e., from the date of issuance of the policy or the date of commencement of risk or the date of revival of the policy or the date of the rider to the policy, whichever is later. A policy of life insurance may be called in question at any time within three years from the date of issuance of the policy or the date of commencement of risk or the date of revival of the policy or the date of the rider to the policy, whichever is later, on the ground of fraud. The insurer shall have to communicate in writing to the insured or the legal representatives or nominees or assignees of the insured the grounds and materials on which such decision is based.

**(p) Agent/intermediary not to be a director (Section 48A)**

No insurance agent or intermediary or insurance intermediary shall be eligible to be or remain a director in insurance company. Any director holding office at the commencement of the Insurance Laws (Amendment) Act, 2015 shall not become ineligible to remain a director by reason of this section until the expiry of six months from the date of commencement of the said Act. The Authority may permit an agent or intermediary or insurance intermediary to be on the Board of an insurance company subject to such conditions or restrictions as it may impose to protect the interest of policyholders or to avoid conflict of interest.

**(q) Prohibition of business on dividing business (Section 52)**

No insurer shall commence any business upon the dividing principle, that is to say, on the principle that the benefit secured by a policy is not fixed but depends either wholly or partly on the result of a distribution of certain sums amongst policies becoming claims within certain time-limits, or on the principle that the premiums payable by a policyholder depend wholly or partly on the number of policies becoming claims within certain time-limits: This does not deemed to prevent an insurer from allocating bonuses to holders of policies of life insurance as a result of a periodical actuarial valuation either as reversionary additions to the sums insured or as immediate cash bonuses or otherwise.

**(r) Councils of Life and General Insurance (Section 64C)**

On and from the date of commencement of this Act, the existing Life Insurance Council, a representative body of the insurers, who carry on the life insurance business in India; and the existing General Insurance Council, a representative body of insurers, who carry on general, health insurance business and re-insurance in India, shall be deemed to have been constituted as the respective Councils under this Act.

**(s) Surveyors or loss assessors (Section 64UM)**

No person shall act as a surveyor or loss assessor in respect of general insurance business after the expiry of a period of one year from the commencement of the Insurance Laws (Amendment) Act, 2015, unless he possesses such academic qualifications as may be specified by the regulations made under this Act; and is a member of a professional body of surveyors and loss assessors, namely, the Indian Institute of Insurance Surveyors and Loss Assessors. In the case of a firm or company, all the partners or directors or other persons, who may be called upon to make a survey or assess a loss reported, as the case may be, shall fulfil the same requirements. Every surveyor and loss assessor shall comply with the code of conduct in respect of his duties, responsibilities and other professional requirements, as may be specified by the regulations made under the Act.

**(t) Assets and liabilities how to be valued (Section 64V)**

Assets shall be valued at value not exceeding their market or realizable value and certain assets may be excluded by the Authority in the manner as may be specified by the regulations made in this behalf. A proper value shall be placed on every item of liability of the insurer in the manner as may be specified by the regulations made in this behalf. Every insurer shall furnish to the Authority along with the returns required to be filed under this Act, a statement, certified by an Auditor, approved by the Authority in respect of general insurance business or an actuary approved by the Authority in respect of life insurance business, as the case may be, of his assets and liabilities assessed in the manner required by this section as on the 31st day of March of each year within such time as may be specified by the regulations.

**(u) Sufficiency of assets (Section 64V)**

Every insurer and re-insurer shall at all times maintain an excess of value of assets over the amount of liabilities of, not less than fifty per cent of the amount of minimum capital as stated under section 6 and arrived at in the manner specified by the regulations. An insurer or re-insurer, as the case may be, who does not comply with shall be deemed to be insolvent and may be wound-up by the court on an application made by the Authority. The Authority shall by way of regulation made for the purpose, specify a level of solvency margin known as control level of solvency on the breach of which the Authority shall act in accordance with without prejudice to taking of any other remedial measures as deemed fit.

Thus, the amendments incorporate enhancements in the Insurance Laws in keeping with the evolving insurance sector scenario and regulatory practices across the globe. The amendments will enable the Regulator to create an operational framework for greater innovation, competition and transparency, to meet the insurance needs of citizens in a more complete and subscriber friendly manner. *The amendments are expected to enable the sector to achieve its full growth potential and contribute towards the overall growth of the economy and job creation.*