

## SAP 1

## FINAL (NEW) GROUP - I

## PAPER-2: STRATEGIC FINANCIAL MANAGEMENT

(Time Allowed - 90 Minutes)

Maximum Marks - 50

Answer all the Questions.

- 1) (A) M/s. Parker & Co. is contemplating to borrow an amount of `60 crores for a Period of 3 months in the coming 6 months' time from now. The current rate of interest is 9% p.a., but it may go up in 6 months' time. The company wants to hedge itself against the likely increase in interest rate.

The Company's Bankers quoted an FRA (Forward Rate Agreement) at 9.30% p.a.

What will be the Final settlement amount, if the actual rate of interest after 6 months happens to be (i) 9.60% p.a. and (ii) 8.80% p.a.?

(6 Marks)

2. Final settlement amount shall be computed by using formula:

$$= \frac{(N)(RR - FR)(dtm/DY)}{[1 + RR(dt/DY)]}$$

Where,

N = the notional principal amount of the agreement;

RR = Reference Rate for the maturity specified by the contract prevailing on the contract settlement date;

FR = Agreed-upon Forward Rate; and

dtm = maturity of the forward rate, specified in days (FRA Days)

DY = Day count basis applicable to money market transactions which could be 360 or 365 days.

Accordingly,

If actual rate of interest after 6 months happens to be 9.60%

$$= \frac{(\text{₹ } 60 \text{ crore})(0.096 - 0.093)(3/12)}{[1 + 0.096(3/12)]}$$

$$= \frac{(\text{₹ } 60 \text{ crore})(0.00075)}{1.024} = \text{₹ } 4,39,453$$

Thus banker will pay Parker & Co. a sum of ₹ 4,39,453

If actual rate of interest after 6 months happens to be 8.80%

$$= \frac{(\text{₹ } 60 \text{ crore})(0.088 - 0.093)(3/12)}{[1 + 0.088(3/12)]}$$

$$= \frac{(\text{₹ } 60 \text{ crore})(-0.00125)}{1.022} = - \text{₹ } 7,33,855$$

Thus Parker & Co. will pay banker a sum of ₹ 7,33,855

**Note:** It might be possible that students may solve the question on basis of days instead of months (as considered in above calculations). Further there may be also possibility that the FRA days and Day Count convention may be taken in various plausible combinations such as 90 days/360 days, 90 days/ 365 days, 91 days/360 days or 91 days/365days.

- 1) (B) Followings are the spot exchange rates quoted at three different forex markets:
- |         |                    |
|---------|--------------------|
| USD/INR | 48.30 in Mumbai    |
| GBP/INR | 77.52 in London    |
| GBP/USD | 1.6231 in New York |

The arbitrageur has USD 1,00,00,000. Assuming that there are no transaction costs, explain whether there is any arbitrage gain possible from the quoted spot exchange rates.

(5 Marks)

8. The arbitrageur can proceed as stated below to realize arbitrage gains.
- (i) Buy ₹ from USD 10,000,000 at Mumbai  $48.30 \times 10,000,000 = ₹483,000,000$
  - (ii) Convert these ₹ to GBP at London  $(\frac{₹ 483,000,000}{Rs. 77.52}) = GBP 6,230,650.155$
  - (iii) Convert GBP to USD at New York  $GBP 6,230,650.155 \times 1.6231 = USD 10,112,968.26$
- There is net gain of USD 10,112,968.26 less USD 10,000,000 i.e. USD 112,968.26

1) (C) Derivative Bank entered into a plain vanilla swap through on OIS (Overnight Index Swap) on a principal of Rs.10 crores and agreed to receive MIBOR overnight floating rate for a fixed payment on the principal. The swap was entered into on Monday, 2<sup>nd</sup> August, 2010 and was to commence on 3<sup>rd</sup> August, 2010 and run for a period of 7 days. Respective MIBOR rates for Tuesday to Monday were: 7.75%, 8.15%, 8.12%, 7.95%, 7.98%, 8.15%.

If Derivative Bank received Rs.317 net on settlement, calculate Fixed rate and interest under both legs. Notes:

- (i) Sunday is Holiday.
- (ii) Work in rounded rupees and avoid decimal working

(4 Marks)

1.

Day	Principal (₹)	MIBOR (%)	Interest (₹)
Tuesday	10,00,00,000	7.75	21,233
Wednesday	10,00,21,233	8.15	22,334
Thursday	10,00,43,567	8.12	22,256
Friday	10,00,65,823	7.95	21,795
Saturday & Sunday (*)	10,00,87,618	7.98	43,764
Monday	10,01,31,382	8.15	<u>22,358</u>
Total Interest @ Floating			1,53,740
Less: Net Received			<u>317</u>
Expected Interest @ fixed			<u>1,53,423</u>
Thus Fixed Rate of Interest			0.07999914
Approx.			8%

(\*) i.e. interest for two days.

**Note:** Alternatively, answer can also be calculated on the basis of 360 days in a year.

- 2) (A) DEF Ltd. has imported goods to the extent of US\$ 1 crore. The payment terms are 60 days interest-free credit. For additional credit of 30 days, interest at the rate of 7.75% p.a. will be charged.

The banker of DEF Ltd. has offered a 30 days loan at the rate of 9.5% p.a. Their quote for the foreign exchange is as follows:

Spot rate INR/US\$	62.50
60 days forward rate INR/US\$	63.15
90 days forward rate INR/US\$	63.45

Which one of the following options would be better?

- (i) Pay the supplier on 60<sup>th</sup> day and avail bank loan for 30 days.  
(ii) Avail the supplier's offer of 90 days credit.

(6 Marks)

**Answer**

**(i) Pay the supplier in 60 days**

If the payment is made to supplier in 60 days the applicable forward rate for 1 USD	₹ 63.15
Payment Due	USD 1 crore
Outflow in Rupees (USD 1 crore × ₹ 63.15)	₹ 63.15 crore

Add: Interest on loan for 30 days@9.5% p.a.	₹ 0.50 crore
Total Outflow in ₹	₹ 63.65 crore

**(ii) Availing supplier's offer of 90 days credit**

Amount Payable	USD 1.00000 crore
Add: Interest on credit period for 30 days@7.75% p.a.	USD 0.00646 crore
Total Outflow in USD	USD 1.00646 crore
Applicable forward rate for 1 USD	₹ 63.45
Total Outflow in ₹ (USD 1.00646 crore × ₹ 63.45)	₹ 63.86 crore

Alternative 1 is better as it entails lower cash outflow.

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

Contracted Rate – US\$ 1 = Rs.42.32

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

Spot – 41.5000/41.5200

3 months' Premium -0.87% /0.93%

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

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

(5Marks)

**Answer**

- (i) The contract is to be cancelled on 30-10-2010 at the spot buying rate of US\$ 1  
 = ₹ 41.5000  
 Less: Margin Money 0.075% = ₹ 0.0311  
 = ₹ 41.4689 or ₹ 41.47  
 US\$ 20,000 @ ₹ 41.47 = ₹ 8,29,400  
 US\$ 20,000 @ ₹ 42.32 = ₹ 8,46,400  
 The difference in favour of the Bank/Cost to the importer ₹ 17,000
- (ii) The Rate of New Forward Contract  
 Spot Selling Rate US\$ 1 = ₹ 41.5200  
 Add: Premium @ 0.93% = ₹ 0.3861  
 = ₹ 41.9061  
 Add: Margin Money 0.20% = ₹ 0.0838  
 = ₹ 41.9899 or ₹ 41.99

2) (C) What is the impact of GDRs on Indian Capital Market?

(4 Marks)

- **Impact of GDRs on Indian Capital Market**

Since the inception of GDRs a remarkable change in Indian capital market has been observed as follows:

- (i) Indian stock market to some extent is shifting from Bombay to Luxemburg.
- (ii) There is arbitrage possibility in GDR issues.
- (iii) Indian stock market is no longer independent from the rest of the world. This puts additional strain on the investors as they now need to keep updated with world wide economic events.
- (iv) Indian retail investors are completely sidelined. GDRs/Foreign Institutional Investors' placements + free pricing implies that retail investors can no longer expect to make easy money on heavily discounted rights/public issues.

As a result of introduction of GDRs a considerable foreign investment has flown into India.

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

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

Calculate the NPV of the project using foreign currency approach. Required rate of return on this project is 14%.

(8 Marks)

$$10. (1 + 0.12) (1 + \text{Risk Premium}) = (1 + 0.14)$$

$$\text{Or, } 1 + \text{Risk Premium} = 1.14/1.12 = 1.0179$$

$$\text{Therefore, Risk adjusted dollar rate is } = 1.0179 \times 1.08 = 1.099 - 1 = 0.099$$

Calculation of NPV

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

$$\text{Therefore, Rupee NPV of the project is } = ₹ (48 \times 1.013) \text{ Million}$$

$$= ₹48.624 \text{ Million}$$

- 3) (B) X Ltd. is interested in expanding its operation and planning to install manufacturing plant at US. For the proposed project it requires a fund of \$ 10 million (net of issue expenses/ floatation cost). The estimated floatation cost is 2%. To finance this project, it proposes to issue GDRs.

You as financial consultant is required to compute the number of GDRs to be issued and cost of the GD R with the help of following additional information.

1. Expected market price of share at the time of issue of GDR is Rs.250 (Face Value Rs.100)
2. Shares shall underly each GDR and shall be priced at 10% discount to market price.
3. Expected exchange rate Rs.60/\$.
4. Dividend expected to be paid is 20% with growth rate 12%.

(8 Marks)

### Solution

Net Issue Size = \$10 million

$$\text{Gross Issue} = \frac{\$10 \text{ million}}{0.98} = \$ 10.204 \text{ million}$$

Issue Price per GDR in ₹ (200 x 2 x 90%)	₹ 450
Issue Price per GDR in \$ (₹ 450/ ₹ 60)	\$ 7.50
Dividend Per GDR (D <sub>1</sub> ) (₹ 20 x 2)	₹ 40
Net Proceeds Per GDR (₹ 450 x 0.98)	₹ 441.00

(a) Number of GDR to be issued

$$\frac{\$10.204 \text{ million}}{\$7.50} = 1.3605 \text{ million}$$

(b) Cost of GDR to Odessa Ltd.

$$k_e = \frac{60.00}{441.00} + 0.12 = 21.07\%$$

3) (C) Briefly discuss the concept of Purchasing Power Parity

(4 Marks)

**(b) Purchasing Power Parity (PPP):** Purchasing Power Parity theory focuses on the 'inflation – exchange rate' relationship. There are two forms of PPP theory:-

The ABSOLUTE FORM, also called the 'Law of One Price' suggests that "prices of similar products of two different countries should be equal when measured in a common currency". If a discrepancy in prices as measured by a common currency exists, the demand should shift so that these prices should converge.

The RELATIVE FORM is an alternative version that accounts for the possibility of market imperfections such as transportation costs, tariffs, and quotas. It suggests that 'because of these market imperfections, prices of similar products of different countries will not necessarily be the same when measured in a common currency.' However, it states that the rate of change in the prices of products should be somewhat similar when measured in a common currency, as long as the transportation costs and trade barriers are unchanged.

The formula for computing the forward rate using the inflation rates in domestic and foreign countries is as follows:

$$F = S \frac{(1 + i_D)}{(1 + i_F)}$$

Where F= Forward Rate of Foreign Currency and S= Spot Rate

i<sub>D</sub> = Domestic Inflation Rate and i<sub>F</sub> = Inflation Rate in foreign country

Thus PPP theory states that the exchange rate between two countries reflects the relative purchasing power of the two countries i.e. the price at which a basket of goods can be bought in the two countries.

(OR)

Explain Euro Convertible Bonds[ECB]?

**(4 Marks)**

## **2.4 Euro-Convertible Bonds (ECBs)**

A convertible bond is a debt instrument which gives the holders of the bond an option to convert the bond into a predetermined number of equity shares of the company. Usually, the price of the equity shares at the time of conversion will have a premium element. The bonds carry a fixed rate of interest. If the issuer company desires, the issue of such bonds may carry two options viz.

(i) Call Options: (Issuer's option) - where the terms of issue of the bonds contain a provision for call option, the issuer company has the option of calling (buying) the bonds for redemption before the date of maturity of the bonds. Where the issuer's share price has appreciated substantially, i.e. far in excess of the redemption value of the bonds, the issuer company can exercise the option. This call option forces the investors to convert the bonds into equity. Usually, such a case arises when the share prices reach a stage near 130% to 150% of the conversion price.

(ii) Put options - A provision of put option gives the holder of the bonds a right to put (sell) his bonds back to the issuer company at a pre-determined price and date. In case of Euro-convertible bonds, the payment of interest on and the redemption of the bonds will be made by the issuer company in US dollars.

## SAP 1

## FINAL (NEW) GROUP I

## PAPER-3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

(Time Allowed - 45 Minutes)

Maximum Marks - 25

## Division A: Multiple Choice Questions - 8 Marks

1. KJ Private Ltd is engaged in the business of e-commerce wherein most of the operations are automated. The company has SAP at its ERP package and is planning to upgrade the SAP version. Currently, the version of SAP being used is fine but the higher version would lead to increased efficiencies and hence the company is considering this plan which will also involve a huge outlay. KPP & Associates, were appointed as the statutory auditors of this company for the year ended 31 March 2019 and the statutory audit firm has been working in this industry for long but most of the work which the firm did was more of risk advisory or internal audit. For the first time, this audit will be conducted and that's why the audit team started obtaining understanding of the operations of the company which included understanding of the SAP system of the company. However, the management of the company was not comfortable with this approach of the audit team particularly because audit team was spending good time on understanding of the IT systems of the company. The management suggested that the auditors should limit their understanding and should perform audit procedures rather than getting into business/ operations. But the auditors have a different view on this matter and because of which work has got stuck. In the given situation, please suggest what should be the course of action.
  - (a) The approach of audit team to obtain detailed understanding of the company before starting with the audit procedures is absolutely fine. If the auditors don't understand the systems properly the audit procedures may not be appropriate.
  - (b) The management's concern regarding the approach of the auditors seems reasonable. The auditors are spending time on understanding of the systems/ business and not performing their audit procedures.
  - (c) This being a private company and that too into the business of e-commerce, the auditors should have knowledge about the operations of the company through their understanding of the industry and hence should not get into this process of obtaining detailed understanding at the client place.
  - (d) The audit team could have planned their work differently. They should involve IT experts who would have knowledge of the systems of the company and hence lot of time can be saved. Further in case of such type of industry, involvement of IT experts is anyways required mandatorily as per the legal requirements.

**(2 Marks)**
2. What types of engagements are not included in the scope of the quality assurance review program?
  - (a) Financial statement audit - listed entities (minimum requirement)

- (b) Financial statement audit - audit of other than listed entities
- (c) Other services (e.g., review, compilation)
- (d) Insolvency

**(1 Mark)**

3. Shivam & Co LLP is a large firm of Chartered Accountants based out of Delhi-NCR. During the financial year ended 31 March 2019, the firm Shivam & Co LLP got an intimation for the peer review on 1 July 2018. The process of peer review got started and completed on 15 September 2018 which included the on-site review from 1 August 2018 to 16 August 2018. Shivam & Co LLP objected to the time taken by the Peer Reviewer on-site, however, as per Peer Reviewer, the entire review process got completed within 90 days from the date of notifying the firm about its selection for review.

- (a) The time for complete review should be completed within 120 days.
- (b) The time for on-site review should not have extended beyond 10 working days.
- (c) The time for complete review should be completed within 60 days.
- (d) The time for on-site review should not have extended beyond 7 working days.

**(1 Mark)**

4. VKPL & Associates, a firm of Chartered Accountants, have been operating for the last 5 years having its office in Gurgaon. The firm has staff of around 25 persons with 3 Partners. The firm has been offering statutory audit, risk advisory and tax services to its various clients. The major work of the firm is for taxation services. The audit partners also discussed that the firm needs to work significantly to improve the quality of the services they offer and that would also help the firm to grow in its business. Considering this objective, the firm started training programmes for the staff which were made mandatory to be attended. During one of the training programmes on quality, a topic was discussed regarding the information that should be obtained by the firm before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. It was explained that the following points may assist the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate (as per SA 220):

- (i) The integrity of the principal owners, key management and those charged with governance of the entity;
- (ii) The qualification of all the employees of the entity;
- (iii) Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- (iv) The remuneration offered by the entity to its various consultants;
- (v) Whether the firm and the engagement team can comply with relevant ethical requirements; and
- (vi) Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship. We would like to

understand from you which of the above mentioned points are relevant for the topic under discussion?

- (a) i, ii, iv and v.
- (b) ii, iv, v and vi.
- (c) iii, iv, v and vi.
- (d) i, iii, v and vi.

**(2 Marks)**

5. AR Private Limited is a medium-sized company engaged in the business of trading of electronic equipments. The company has various warehouses where all of these equipments are kept and has an inventory levels of generally 2-3 months. The internal environment of the company is driven by various processes some of them are manual and some automated. Accordingly, the management has also set up various controls both manual and automated and is comfortable with their design and operating effectiveness. During the course of audit of the financial statements for the year ended 31 March 2019, the auditors raised various queries regarding various processes where the controls were operating effectively. This was because of the fact that auditor was considering either only manual controls or only automated controls in a process. As per the auditor, the management should have adopted the same approach and hence he would like to increase the substantive audit procedures because they had a view that as per the current approach of the management, controls should be considered as ineffective irrespective of the fact that the testing which the audit team had performed resulted in the controls being effective. Currently, the concern was regarding the approach on which management was also stuck on their point. You are required to provide your inputs to resolve this matter.

- (a) The approach of the management doesn't seem to be correct because of the nature of the operations of the company. The current approach which the management has followed can be accepted only in case of manufacturing industry.
- (b) The management should have discussed their approach with the auditors before appointing them. The Companies Act 2013 provide specific guidance on these matters wherein the management of the company can follow such approach by taking pre-approval from their auditors and in such a case, the report of the auditors is always clean.
- (c) The approach of the management is completely fine. The auditors need to correct their understanding of the internal controls and the application of internal controls. A process cannot be limited to have either only manual control or automated control.
- (d) Considering the size of the company, such matters should be ignored by the auditors. Even if the approach of the management is not correct, it would not have any impact on the work of the auditors because all such matters get resolved at the time when auditors perform final analytical procedures.

**(2 Marks)**

1	A	2	D	3	D
4	D	5	C		

**Division B: Descriptive Questions - 17 Marks**

**Question no 1 is Compulsory. Answer any three questions from the rest.**

1) (A) What are the Consideration of Automated Environment at each phase of audit cycle?

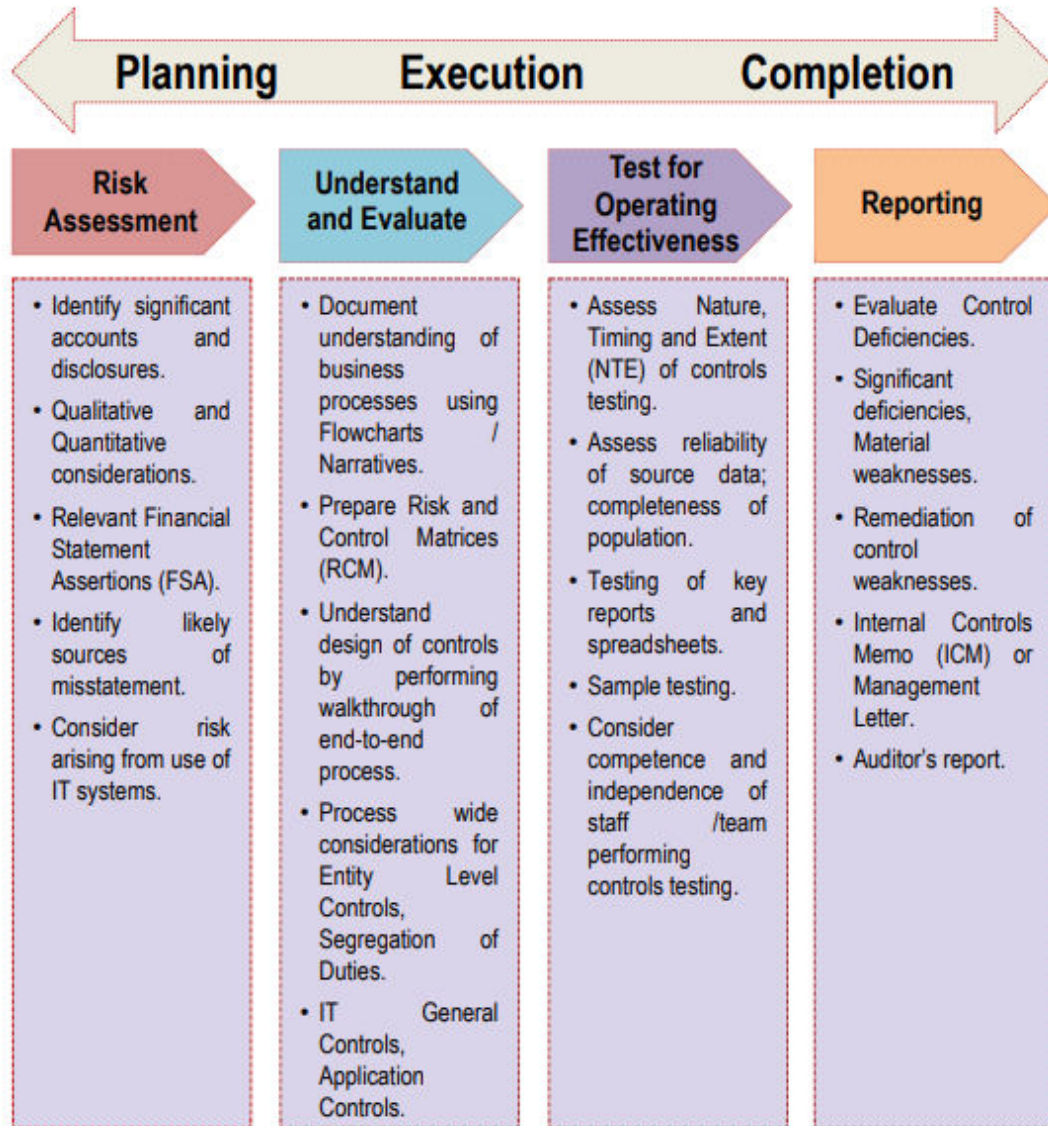
**(3 Marks)**



**4. CONSIDERATION OF AUTOMATED ENVIRONMENT AT EACH PHASE OF AUDIT CYCLE**

In a controls-based audit, the audit approach can be classified into three broad phases comprising of planning, execution, and completion. In this approach, the considerations of automated environment will be relevant at every phase as given below:

- during risk assessment, the auditor should consider risk arising from the use of IT systems at the company;
- when obtaining an understanding of the business process and performing walkthroughs the use of IT systems and applications should be considered;
- while assessing the entity level controls the aspects related to IT governance need to be understood and reviewed;
- pervasive controls including segregation of duties, general IT controls and applications should be considered and reviewed;
- during testing phase, the results of general IT controls would impact the nature, timing and extent of testing;
- when testing of reports and information produced by the entity (IPE) generated through IT systems and applications;
- at completion stage, evaluation of control deficiencies may require using data analytics and CAATs.



1) (B) In an automated environment, the data stored and processed in systems can be used to get various insights into the way business operates. This data can be useful for preparation of management information system (MIS) reports and electronic dashboards that give a high-level snapshot of business performance. In view of above you are required to briefly discuss the meaning of data analytics and example of circumstances when auditing in an automated environment, auditors can apply the concepts of data analytics

(2 Marks)

**14. Data Analytics:** Generating and preparing meaningful information from raw system data using processes, tools, and techniques is known as Data Analytics. The data analytics methods used in an audit are known as Computer Assisted Auditing Techniques or CAATs. When auditing in an automated environment, auditors can apply the concepts of data analytics for several aspects of an audit including the following:

- preliminary analytics;
- risk assessment;
- control testing;
- non-standard journal analysis;
- evaluation of deficiencies;
- Fraud risk assessment.

2) R & M Co. wants to be alert on the possibility of non-compliance with Laws and Regulations during the course of audit of SRS Ltd. R & M Co. seeks your guidance for identifying the indications of non-compliance with Laws and Regulations.

(4 Marks)

**(b) As per SA 250, "Consideration of Laws and Regulations, the auditor shall perform the audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements by inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.**

**However, when the auditor becomes aware of the existence of, or information about, the following matters, it may also be an indication of non-compliance with laws and regulations:**

- **Investigations by regulatory organisations and government departments or payment of fines or penalties.**
- **Payments for unspecified services or loans to consultants, related parties, employees or government employees.**
- **Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.**
- **Purchasing at prices significantly above or below market price.**
- **Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.**

- ***Unusual payments towards legal and retainership fees.***
- ***Unusual transactions with companies registered in tax havens.***
- ***Payments for goods or services made other than to the country from which the goods or services originated.***
- ***Payments without proper exchange control documentation.***
- ***Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.***
- ***Unauthorised transactions or improperly recorded transactions.***
- ***Adverse media comment.***

- 3) R & Co, a firm of Chartered Accountants have not revised the terms of engagements and obtained confirmation from the clients, for last 5 years despite changes in business and professional environment. Please elucidate the circumstances that may warrant the revision in terms of engagement.

**(4 Marks)**

- (d) As per SA 210 on “Agreeing the Terms of Audit Engagements”, the auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the

audit engagement or to remind the entity of existing terms:

- (i) Any indication that the entity misunderstands the objective and scope of the audit.
- (ii) Any revised or special terms of the audit engagement.
- (iii) A recent change of senior management.
- (iv) A significant change in ownership.
- (v) A significant change in nature or size of the entity's business.
- (vi) A change in legal or regulatory requirements.
- (vii) A change in the financial reporting framework adopted in the preparation of the financial statements.
- (viii) A change in other reporting requirements.

- 4) Write a short note on the Various Stages involved in the Conduct of the Quality Review Assignments.

**(4 Marks)**

**(b) Various Stages involved in the Conduct of the Quality Review Assignments are:**

- ✍ Selection of Audit Firm and Technical Reviewer to conduct Quality Review and sending Offer Letter of Engagement to the Technical Reviewer.
- ✍ Technical Reviewer to convey his acceptance of Letter of Engagement by sending necessary declarations for meeting eligibility conditions and furnishing statement of confidentiality by the Technical Reviewer and his assistant/s, if any.
- ✍ Intimation to the Audit Firm about the proposed Quality Review and acceptance of the assignment by the Technical Reviewer. Also marking a copy of the intimation to the Technical Reviewer.
- ✍ Technical Reviewer to send the specified Quality Review Program General Questionnaire to the Audit firm for filling-up and call for additional information from the Audit Firm, if required.
- ✍ Technical Reviewer to carry out the Quality Review by visiting the office of the Audit Firm by fixing the date as per mutual consent.
- ✍ Technical Reviewer to send the preliminary report to Audit firm.
- ✍ Audit firm to submit representation on the preliminary report to the Technical Reviewer.
- ✍ Technical Reviewer to submit final report alongwith a copy of Annual report of the company/entity for the year, to the Board in the specified format, on their (individual) letterhead, duly signed and dated within 45 days from the date of acceptance of the assignment.
- ✍ Technical Reviewer should also send a copy of their final report to the Statutory Auditor/Audit firm, requesting the firm to send their submissions thereon to the Board within 7 days of receipt of the final report with a copy to Technical Reviewer. Upon receipt of their final submission, Technical Reviewer shall submit within next 7 days a summary of their findings, reply of the audit firm thereon alongwith their final comments in the specified format.
- ✍ Quality Review Group to consider the report of the Technical Reviewer and responses of the Audit firm and make recommendations to Quality Review Board.
- ✍ Quality Review Board to consider the report of the Quality Review Group and decide the final course of action.

- 5) During the audit of FMP Ltd, a listed company, Engagement Partner (EP) completed his reviews and also ensured compliance with independence requirements that apply to the audit engagement. The engagement files were also reviewed by the Engagement Quality Control Reviewer (EQCR) except the independence assessment documentation. Engagement Partner was of the view that matters related to independence assessment are the responsibility of the Engagement Partner and not Engagement Quality Control Reviewer. Engagement Quality Control Reviewer objected to this and refused to sign off the documentation. Please advise as per SA 220.

(4 Marks)

- (c) As per SA 220, Engagement Partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, Engagement Partner shall:

- Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
- Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

Engagement Partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.

As per SA 220, "Quality Control for Audit of Financial Statements", for audits of financial statements of listed entities, Engagement Quality Control Reviewer (EQCR), on performing an engagement quality control review, shall also consider the engagement team's evaluation of the firm's independence in relation to the audit engagement.

In the given case, Engagement Partner is not right. The independence assessment documentation should also be given to Engagement Quality Control Reviewer for his review.

**SAP 1 - CORPORATE AND ECONOMIC LAWS (Answer Key)****FINAL (NEW) GROUP II****PAPER-4: CORPORATE AND ECONOMIC LAWS****(Time Allowed - 45 Minutes)****Maximum Marks - 25****Division A: Multiple Choice Questions (7 Marks)**

1. (c)
2. (c)
3. (c)
4. (c)
5. (c)
6. (d)
7. (d)

**Division B: Descriptive Questions (18 Marks)**

1. The Articles of Association of XBL Limited provided of maximum number of Directors 12. Presently, the company is having 10 directors. Since XBL Limited was expanding its business, so it's Board of directors was desiring to increase the number of directors to 16.

During the time, out of the 10 directors in its board, two of the directors have retired by rotation at an Annual General Meeting. The place of retiring directors was not so filled up and the meeting has also not expressly resolved 'not to fill the vacancy'. Due to some reasons, the AGM was adjourned to a later date. At this adjourned meeting also, the place of retiring directors could not be filled up, and the meeting has also not expressly resolved 'not to fill the vacancy'.

Referring to the provisions of the Companies Act, 2013, decide:

- a) Whether the Board of Directors can increase the number of directors to 16 though specified maximum to 12, in the Article of Association.
- b) What will be the consequences if at the adjourned meeting also, the place of retiring directors could not be filled up, and the meeting has also not expressly resolved 'not to fill the vacancy'.
- c) What if, at the adjourned meeting, a Retiring director has given a notice in writing addressed to the company and the Board of Directors expressing his desire not to be re-elected.

**Answer**

(i) Under section 149(1) of the Companies Act, 2013 every company shall have a Board of Directors consisting of individuals as directors and shall have a minimum number of 3 directors in the case of a public company. The maximum number of directors shall be 15.

However, the proviso to section 149(1) states that a company may appoint more than 15 directors after passing a special resolution.

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:

(1) Alter its Articles of Association under section 14 of the Act, so as to increase the number of directors in the Articles from 12 to 16;

(2) Approval shall also be taken to be authorised to increase 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.

(ii) In accordance with the provision of the Companies Act, 2013, as contained in section 152(7)(a) which provides that if at the annual general meeting at which a director retires and the vacancy is not so filled up and the meeting has not expressly resolved not to fill the vacancy, the meeting shall stand adjourned to same day in the next week, at the same time and place.

Section 152(7)(b) further provides that if at the adjourned meeting also, the place of the retiring 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.

Accordingly, as per the above provisions, the retiring director shall be deemed to have been re-appointed at the adjourned meeting.

(iii) Section 152(7)(b) further marks the restrictions that, if at the adjourned meeting or at the previous meeting a resolution for the re-appointment of such directors was put and lost or he has given a notice in writing addressed to the company and the Board of Directors expressing his desire not to be re-elected or he is disqualified, the retiring director shall not be deemed to have been re-appointed at the adjourned meeting

(6 Marks)

2. State the legal position in the given situations:

- a) Can Mr. Khan appointed as an Independent Director in the Board of a company, be appointed in its subsidiary or its holding or its associate company.
- b) Mr. D, proposes his candidature as a director in X Ltd. along with the deposit of 1 lac rupees. Later Mr. D failed to be appointed but received 30% of total votes. Mr. D asked X Ltd. to refund the deposit but the company denied to pay as he failed to be elected.

**Answer**

(i) As per the definition of the independent director given under section 149 of the Companies Act, 2013, an independent director means a director other than a managing director or a whole time director or a nominee director and who fulfills the criteria laid out under section 149(6).

Therefore, if ID meets the above qualifications, then the same person can be appointed as an ID in the company or its holding, subsidiary or associate company. So Mr. Khan can be appointed.

(ii) As per section 160 of the Companies Act, 2013, a company shall refund amount deposited along with the candidature of a person who has been elected as a director or who has received more than 25% of total votes. Since in the given case, Mr. D though failed to be appointed but acquired 30% of the total votes, so he is eligible for the refund of the deposit amount of 1 lac rupees.

(4 Marks)

3. Raman garments manufacturer entered into an arbitration agreement with its regular customers on the supply of dress material on demand in advance. At the same time, also hold the term that in case of disputes they may refer to the arbitration for the settlement of the matter. Raman garments manufacturer fail to make delivery of supply of dress material to Mr. X, a regular customer. MR. X already made Raman garments manufacturer aware of this important order in advance. Since Raman garments manufacturer was not able to meet the said the order well in time, he took the plea of theft and setting of fire to the property in the manufacturing unit. The said matter was referred to the arbitration. State the validity as to the submission of the said dispute to the arbitration in the light of the Arbitration and Conciliation Act, 1996.

**Answer**

As per the arbitration agreement, the disputes submitted/ proposed to be submitted to arbitration must be arbitrable. In other words that law must permit arbitration in that matter only which are capable of arbitration. There are certain disputes that the law retains exclusively for the court, and the same cannot be submitted for arbitration. The rationale is that given the nature of disputes, the courts are the only appropriate forum for adjudicating the matter. In the given matter, it clearly reveals of non-performance of the duties of the Raman garments manufacturer within the specified timelines. To safeguard himself from the non-performance of the contract, took the cause of theft and setting of fires in the manufacturing unit. Accordingly in the given situation, the submitted disputes before arbitration is not arbitrable as they are the offences of criminal natures. Such types of disputes is to be tried by the court of proper jurisdiction. Therefore the submission of the dispute in the situation to arbitration is invalid.

(4 Marks)

4. The Board of directors of XYZ Ltd. filled up a casual vacancy caused by the death of Mr. P by appointing Mr. C as a director on 3<sup>rd</sup> April, 2019 which was subsequently approved by the members in the immediate next general meeting. Unfortunately Mr. C expired on 15<sup>th</sup> May, 2019 after working about 40 days as a director. The Board now wishes to fill up the casual vacancy by appointing Mrs. C in the forthcoming meeting of the Board. Advise the Board in this regard keeping in view the provisions of the Companies Act, 2013.

### Answer

Section 161(4) of the Companies Act, 2013 provides that if the office of any director appointed by the company in general meeting is vacated before his term of office expires in the normal course, the resulting casual vacancy may, in default of and subject to any regulations in the articles of the company, be filled by the Board of Directors at a meeting of the Board which shall be subsequently approved by members in the immediate next general meeting.

Further, any person so appointed shall hold office only up to the date up to which the director in whose place he is appointed would have held office if it had not been vacated.

In view of the above provisions, in the given case, the appointment of Mr. C in place of the deceased director Mr. P was in order. In normal course, Mr. C could have held his office as director up to the date to which Mr. P would have held the same.

However, Mr. C expired on 15<sup>th</sup> May, 2018 and again a vacancy has arisen in the office of director owing to death of Mr. C who was appointed by the board and approved by members to fill up the casual vacancy resulting from P's demise. Vacancy arising on the Board due to vacation of office by the director appointed to fill a casual vacancy in the first place, does not create another casual vacancy as section 161 (4) clearly mentions that such vacancy is created by the vacation of office by any director appointed by the company in general meeting. Hence, the Board cannot fill the vacancy arising from the death of Mr. C who was appointed to fill a casual vacancy.

The Board may however appoint Mrs. C as an additional director under section 161 (1) of the Companies Act, 2013 provided the articles of association authorise the board to do so, in which case Mrs. C will hold the office up to the date of the next annual general meeting or the last date on which the annual general meeting should have been held, whichever is earlier.

(or)

Excel limited is a listed company with a turnover of Rs. 60 crore in the FY 2016-2017. The company appoints Ms. R as the women director on 1<sup>st</sup> March 2017. Ms. R is already a director in twelve companies including ten public companies. Evaluate in the light of the given facts, the following situations with reference to the provisions of the Companies Act, 2013 The validity of an appointment of Ms. R in Excel Limited.

**Answer**

Number of directorships: As per section 165(1) of the Companies Act, 2013, no person shall hold office as director, including any alternate directorship, in more than 20 companies at the same time.

Out of the limit of 20, the maximum number of public companies in which a person can be appointed as a director shall not exceed 10. [Proviso to section 165(1)]

Private companies that is either holding or subsidiary company of a public company shall be included in reckoning the limit of public companies in which a person can be appointed as a director.

In the instant case, Ms. R was appointed as a women director on 1st March, 2017 in Excel Limited. She was already holding directorship in twelve companies including ten public companies.

As Ms. R was already a director in ten public companies, her appointment in Excel Limited is not valid as it will lead to her directorship in 11 public companies.

In this case, either she can choose between the companies in which she wishes to continue to hold the office of director or resign her office as director in the other remaining companies to maintain the limit of holding of directorship.

(4 Marks)

**SAP 1 - CA FINAL (NEW SYLLABUS) - STRATEGIC COST MANAGEMENT AND  
PERFORMANCE EVALUATION**

**Answer all the Questions**

- 1) (A) WDG is a family owned business. The family owns 80% of the shares. The remaining 20% is owned by six non-family shareholders. It manufactures Cardboard Boxes for customers which are mainly manufacturers of shoes, cloths, crackers etc. Now, the board is considering to join the Paper Tubes market as well. Paper Tubes, also known as Cardboard Tubes, are cylinder-shaped components that are made with Cardboard. Paper Tubes can be used for a wide range of functions. Paper Tubes are usually ordered in bulk by many industries that rely Paper Tubes include food processing, shipping and the postal service, automotive manufacturing, material handling, textile, pulp and paper, packaging, and art etc. The Paper Tubes cost approximately 1% - 3% of the total cost of the customer's finished goods. The information about Paper Tubes is as follows:
- (i) The Paper Tubes are made in machines of different size. The lowest cost machine is of Rs. 1,89,000 including GST @ 5% and only one operator is required to run this machine. Two days training program is required to enable untrained person to run such a machine efficiently and effectively. A special paper is used in making Paper Tubes and this paper remains in short supply.
  - (ii) Presently, five major manufacturers of Paper Tubes have a total market share of 75%, offer product ranges which are similar in size and quality. The market leader currently has 24% share and the four remaining competitors hold on average 12.75% share. The annual market growth is 3% per annum during recent years.
  - (iii) A current report "Insight on Global Activities of Foreign Based MNCs" released the news that now MNC's are planning to expand their packaging operations in overseas market by installing automated machines to produce Paper Tubes of any size.
  - (iv) Another company, HEG manufactures a small, however increasing, range of Plastic Tubes which are capable of housing small products such as foils and paper-based products. Currently, these tubes are on an average 15% more costly than the equivalent sized Paper Tubes.

**Required**

ASSESS whether WDG should join the Paper Tubes market as a performance improvement strategy?

**(5 Marks)**

### Solution

To assess the feasibility of joining Paper Tubes market, Michael Porter's 'five forces model' can be used. It analyses the competitive environment of an industry. It is an important tool for understanding the competitive structure of a particular industry. This complete analysis includes five forces: buyer's bargaining power, supplier's bargaining power, the threat of substitute products, the threat of new entrants and the intra industry competition.

While applying this model to the above case, it can be observed that the low cost of the machine along with the fact that an untrained person will only need two day's training as to be able to operate a machine, will form comparatively low costs of entry to the market. Therefore, WDG may reasonably consider *high threat of new entrants*.

Customer's (buyer) power could be high since customers buy Paper Tubes in bulk along with the fact that there is insignificant difference between the products of alternative suppliers. Paper Tubes cost approximately 1% - 3% of the total cost of the customer's finished goods also indicates that *customer's power is high*.

The fact that the special paper from which the tubes are made remain in short supply, signals

*high threat from suppliers*. Hence, suppliers may raise their prices that would result in reduction of profit.

Five major players with 75% market share, offer product ranges which are similar in size and quality, besides, the market is a slow growing i.e. annual growth of 3% p.a., indicate *high rivalry among competitors*.

*A little real threat from a substitute product* exist since HEG manufactures a narrow range of Plastic Tubes. This threat might go up if the product range of HEG is expanded or the price of Plastic Tubes goes down sharply.

*Major threat from potential new entrants* can be seen, as foreign-based MNCs are planning to joining this market and it seems that these giant corporations might be able to gain economies of scale from automated machines and large production lines with manufacturing flexibility.

WDG might enter this market due to low capital investment but this would also lead to other potential entrants. The easy entry, threat of substitute, the existence of established competitors in the market, the possible entry of a MNCs, and competitors struggling due to slow growth market are putting the potential of WDG into the question to achieve any sort of competitive advantage.

Joining this market might be a good move, if WDG would be able manufacture Paper Tubes at lowest cost within the industry. To assess feasibility, WDG must take into consideration *all possible synergies* between its existing operations of Card Boxes and the proposed operations of Paper Tubes.

From the available information, joining the market for Paper Tubes does not seem to be attractive. Thus, WDG should go for other alternative performance improvement strategy.

- (B) CIMZ is a new banking company which is about to open its first branch in INDIA. CIMZ believes that in order to win customers from the market, it needs to offer potential customers a new banking experience. Other banking companies are focusing on interest rates and bank charges, whereas CIMZ believes that quality and timely availability of service is an important factor to attract customers.

**Required**

EXPLAIN how Total Quality Management would enable CIMZ to gain competitive advantage in the banking sector.

(5Marks)

1. Total Quality Management is a management philosophy. It concerns itself with managing the processes and people to make sure that the customer is satisfied at each and every stage. This means *making the needs of the customer the priority, expanding the relationship beyond traditional services and incorporating the customer's needs in the company's business plan and corporate strategy*. In TQM, the concept of "quality" is perceived exclusively from the frame of reference of the customer. These customers can be internal, such as, those working in another department and there can be external customers who are the end recipients of the product or services. The organisation should attempt for continuous improvement in the quality that it delivers with the ultimate aim of achieving zero defects in this quality.

TQM should be view as an investment rather than as a cost that should be minimised. There are many ways in which investment can be made in TQM.:

- fine-tuning the product mix,
- fine-tuning of the processes of ensuring quality,
- introducing employee development programmes with the nature of an academic course,
- empowering the employees professionally and personally,
- improving the top management commitment to quality,
- monitoring of the performances and proper rewarding based on achievements,
- ensuring the customer satisfaction etc.

CIMZ could provide its employees with *training* in the technical aspects of banking practice as well as in customer care. Customers would thus get a better service not only technically but also from a customer care perspective. This should lead to smaller customer complaints and greater customer satisfaction. It could also motivate customers to recommend others to use this bank.

TQM also requires CIMZ to respond to its customer's requirements immediately for example by providing more staff to reduce the lengths of queues in festive/ seasonal/ busy time. If Bank could also be opened for longer hours to allow customers to complete their bank related requirements and have meetings with bank employees at a time that is more convenient for the customer, this would lead to more satisfaction to customers.

In long run, if bank continue to follow TQM, the bank would have higher profits and competitive advantage in banking sector despite incurring additional expenditure to improve quality.

**2) About Aditya Group**

Aditya Group was established in 1975, manufactures and sells electronic personal grooming and beauty products. The group has two 100% subsidiaries AUS Ltd. and ANZ Ltd. AUS Ltd. manufactures luxury products that cater to niche customers who prefer specialized personal grooming and beauty care. ANZ Ltd. caters to regular daily beauty and grooming requirements that has a wide reach within the market. Factories of both companies are located within India. The products are sold to wholesalers, who supply these products to the retail market.

Aditya Group purchases its raw material requirements from both domestic and overseas markets. Additionally, certain products manufactured by AUS Ltd. can be enhanced based on the products manufactured by ANZ Ltd. Therefore, as per production requirements, AUS Ltd. sources some product components from ANZ Ltd.

Aditya Group has a centralized decision making set-up. Basic policy decisions for functions such as production planning, sales and client relationship, finance and human resources are handled at the group level. Individual units AUS Ltd. and ANZ Ltd. concentrate on the manufacturing alone.

**About You**

You are an Assistant Manager in Finance and Accounts department of Aditya Group, headed by Director- Finance Ms. Elsea. You assist and report to Ms. Fiona, Manager of your department. Sometime you also assist Director Finance in analysing financial and non- financial information, drafting reports for board meetings, preparation of presentation and staff trainings.

**Business Situation- 1****Yesterday, 5.15 P.M.**

You got an email from Ms. Elsea, with Cc to Ms. Fiona. Ms. Elsea, asked you to prepare a cost statement for making a quotation to a new customer. She has also informed you that the customer can also maintain a long- term business relation with us. You have been requested to gather information related to the specification from Sales Manager.

**Yesterday, 5.25 P.M.**

You have been called by Ms. Fiona, and provided the product specification received from Sales- Manager for which quotation has to be quoted. Ms. Fiona has also requested you to gather relevant information to prepare cost statement. Due to the expected long term business relationship that AUS Ltd. wants to have with the customer, the sales manager wants to quote the lowest possible price. AUS Ltd. currently has some spare capacity that can be utilized to cater to this entire order.

Therefore, only the relevant cost to AUS Ltd. has to be considered to arrive at the quote.

After meeting with your reporting officer, you mailed to various concerned department and requested for data.

The following information has been obtained in relation to the contract:

Today, 10.05 A.M.

You got an e-mail from Production Manager, it has been informed that 40 tonnes of material Dx would be required. This material is in regular use by AUS and has a current purchase price of Rs.380 per tonne. Currently, there are 5 tonnes in inventory which cost Rs.350 per tonne. The resale value of the material in inventory is Rs.240 per tonne.

Further, with regards to components, it has been informed that 4,000 components would be required. These could be bought externally for Rs.15 each or alternatively they could be supplied by ANZ Ltd. The variable cost of the component if it were manufactured by ANZ Ltd. would be Rs.8 per unit. ANZ Ltd. has sufficient capacity to produce 2,500 components without affecting its ability to satisfy its own external customers. However, in order to make the extra 1,500 components required by AUS Ltd., ANZ Ltd. would have to forgo other external sales of Rs.50,000 which have a contribution to sales ratio of 40%. To have uniformity in the quality of the component, it is assumed that AUS Ltd. would procure its entire requirement of 4,000 components either externally or from ANZ Ltd. The transfer pricing policy of Aditya Group for sales between units aims at goal congruence. The unit selling the goods would be allowed to charge any opportunity cost on account of catering to internal demand, while the purchasing unit should ensure that the company is not at a loss.

Today, 10.45 A.M.

You got an e-mail from Personnel Manager, it has been informed that 2,000 high skilled labour hours would be required. The grade of labour required is currently paid Rs.5 per hour. Highly skilled labour is in short supply and cannot be increased significantly in the short-term. This labour is presently engaged in meeting the demand for product 'G', which requires 4 hours of highly skilled labour. The contribution from the sale of one unit of product L is Rs.24.

It has also been informed that the contract would require a specialist machine. The machine could be hired for Rs.15,000 or it could be bought for Rs.50,000. At the end of the contract if the machine were bought, it could be sold for Rs.30,000. Alternatively, it could be modified at a cost of Rs.5,000 and then used on other contracts instead of buying another essential machine that would cost Rs.45,000. The operating costs of the machine are payable by AUS whether it hires or buys the machine. These costs

would total Rs.12,000 in respect of the new contract.

#### Supervisor

The contract would be supervised by an existing manager who is paid an annual salary of

Rs.50,000 and has sufficient capacity to carry out this supervision. The manager would receive a bonus of Rs.5,000 for the additional work.

#### Development Time

15 hours of development time at a cost of Rs.30,000 have already been worked in determining the resource requirements of the contract.

#### Fixed Overhead Absorption Rate

AUS uses an absorption rate of Rs.20 per direct labour hour to recover its general fixed overhead costs. This includes Rs.5 per hour for depreciation.

**Today, 11.15 A.M:** Ms. Fiona called you in her place as asked you the following:

#### Required

(i) CALCULATE the relevant cost of the contract to AUS. You must present your answer in a schedule that clearly shows the relevant cost value for each of the items identified above. You should also EXPLAIN each relevant cost value you have included in your schedule and why any values you have excluded are not relevant. Ignore taxation and the time value of money.

(ii) DISCUSS two problems that can arise as a result of setting prices using relevant costing.

#### Business Situation- 2

**Today, 5.26 P.M:** A memo from Managing Director of the group has been circulated to all officers of the group which stated "My objective for the forthcoming year is to reduce our quality costs in each of the primary activities in our value chain". The company is keen to build a reputation for quality and gives a five-year guarantee with all of its products.

**Today, 5.37 P.M:** Ms. Fiona, called you in her place and asked the following:

#### Required

(iii) EXPLAIN, by giving examples, how each of the four types of quality cost could be reduced. You should also IDENTIFY in which primary activity each one of your examples would occur in Aditya Group's value chain.

**(10Marks)**

## 6. (i) Statement Showing Relevant Cost

Type of Cost	Explanation	Amount (₹)
Material Dx (40 tonnes × ₹380)	1	15,200
Components	2	52,000
Direct labour (2,000 hrs. × ₹11)	3	22,000
Specialist machine	4	10,000
Machine operating cost	5	12,000
Supervision	6	5,000
Development time	7	Nil
General fixed overhead	8	Nil
Total relevant cost		1,16,200

**Explanation**

1. Material Dx is in regular use by AUS Ltd. and must be replaced. Consequently, its relevant value is its replacement cost. The historical cost is not relevant because it is a past cost and the resale value is not relevant because AUS Ltd. is not going to sell it because the material is in regular use.
2. AUS Ltd. would like to procure 4,000 components either from ANZ Ltd. or externally from the market. At the current production level, ANZ Ltd. (seller) has available capacity to accommodate part of AUS Ltd's request to the extent of 2,500 components. At this point, ANZ Ltd. would be operating at its maximum capacity.

To cater to the remaining demand of 1,500 units from AUS Ltd., ANZ Ltd. has to forego external sales of ₹50,000 to its own customers. Given that the contribution to sales ratio is 40%. Therefore, ANZ Ltd. has to forego contribution of ₹20,000 (40% of external sales foregone ₹50,000) in order to cater to AUS Ltd.'s request. Fixed cost at ANZ Ltd. is irrelevant, since it would be incurred irrespective of whether AUS Ltd.'s order to catered to or not.

Therefore, in spirit of goal congruence, the transfer price that ANZ Ltd. would charge AUS Ltd. would be the variable cost of ₹8 per unit and ₹20,000 towards lost contribution as explained above. Therefore, the transfer price

$$\begin{aligned}
 &= (\text{₹8 per unit} \times 4,000 \text{ components}) + \text{₹20,000} \\
 &= \text{₹32,000} + \text{₹20,000} \\
 &= \text{₹52,000 for 4,000 components}
 \end{aligned}$$

Therefore, per component, the price charged would be ₹52,000 / 4,000 = ₹13 per component. This is lower than the external market price of ₹15 per unit. Therefore, in the interest of goal congruence the cheaper option is preferred. AUS Ltd. should source its components from ANZ Ltd, for a total procurement cost of ₹52,000.

3. Skilled labour is in short supply and can only be obtained by reducing the production of product 'G', resulting in a loss of contribution of ₹24 (given) or ₹6 per hour of skilled labour. Hence the relevant labour cost will be ₹6 (contribution lost per hour) + ₹5 (hourly rate of skilled labour) i.e. ₹11 per hour.
4. AUS Ltd. has a number of options: (a) If the machine were to be hired it would have a cost of ₹15,000; (b) if the machine were bought and then sold at the end of the work it would have a net cost of ₹20,000; or (c) if the machine were bought and then modified to avoid the need to buy the other machine it would have a net cost of ₹10,000 (₹50,000 plus ₹5,000 modifications less ₹45,000 cost of another machine). Thus, the most economic approach is buy the machine and then modify it so the relevant cost is ₹10,000.
5. The machine operating costs are future costs of doing the work and therefore are relevant.
6. The supervisor's salary is irrelevant, but the bonus needs to be included because it is dependent on this work and therefore is relevant.
7. The development time has already been incurred. Therefore, it is a past cost and not relevant.
8. General fixed overhead costs and their absorption are not relevant because they will be incurred whether the work goes ahead or not. Depreciation is also not relevant because it is an accounting entry based on the historical purchase of assets. It is not affected by the work being considered.

**(ii) Two main issues arise when pricing work based on relevant costs:**

- Profit reporting; and
- Pricing of future work.

With regard to profit reporting, the decision as to whether to proceed with the work will have been based on the use of relevant costs, but the routine reporting of the profit from the work will be based on the company's normal accounting system. Since this system will be based on total cost, it is probable that the costs of the work reported will be greater than its relevant cost. Consequently, the amount of profit reported to have been made on this order will be lower than expected and may even be a loss. This may cause difficulties for the manager who accepted the work as an explanation will be required of the reasons why there is such a difference in profit.

With regard to the pricing of future work the difficulty lies in increasing the price for similar items for the same customer in future. Once a price is set, customers tend to expect that any future items will be priced similarly. However, where a special price has been offered based on relevant cost because of the existence of spare capacity the supplier would not be able to continue to price on that basis as it does not recover its long term total costs. There may also be difficulties created by this method of pricing as other customers are being charged on a full cost basis and if they were to discover that a lower price was offered to a new customer they would feel that their loyalty was being penalised.

**(iii) Prevention**

Operations: Preventative maintenance and checking of the calibration of machinery. This would reduce the number of potentially faulty products being produced and therefore reduce guarantee claims.

**Appraisal**

Inbound Logistics: Reduce costs of incoming inspections by building close links with suppliers and getting them to adopt TQM. If suppliers can guarantee their quality, then inbound inspections could be eliminated.

**Internal Failure**

Operations: Reduce costs of re-works by training employees on a continual basis e.g. quality circles. This would reduce failure costs and also improve quality.

**External Failure**

Service: Design quality into the product to try to prevent guarantee claims and therefore the cost of servicing/repairing the product.

**3) (A) Examine the Validity of following statements along with the reasons:**

- (i) The concepts, tools and techniques of value chain analysis apply only to all those organizations which produce and sell a product.
- (ii) Procurement activities are included in the Primary activities as classified by Porter under value chain analysis concept.
- (iii) Value chain analysis in the strategic framework consists of single cost driver concept.

**(3Marks)**

4. (i) **Invalid:** The concepts, tools and techniques of value chain analysis apply to organizations which produce and sell a product and also to organizations which provide a service.
- (ii) **Invalid:** Procurement activities are included in the support activities rather than primary activities.
- (iii) **Invalid:** Value chain analysis in the strategic framework consists of multiple cost drivers concept. In value chain analysis, a set of unique cost drivers is identified for each value activity instead of single cost driver application at the overall firm level. Multiple cost drivers may be classified into Structural drivers and Executional drivers.

- 3) (B) 7 Star Sports Co. (7SSC) is engaged in the manufacture of cricket bats. Following table shows the budgeted figures for the coming year:

Particulars	Rs. per unit
Selling Price	4,800
Less: Components (1 Set)	1,200
Assembling Costs	2,000
Delivery Cost	800
Contribution	800

Components like willow, rubber grip and handle bar in a set, are bought in and an assembling process carried out to transform them into a single bat. Market is intensely competitive where 7SSC currently holds 30% market share. Annual demand of these bats is 1,00,000 units.

On reviewing previous performance, it is revealed that 3% of the bats supplied to customers were returned for free replacement because of faults. Defective components, which are initially bought in to assembling process, are held responsible for this. These returned bats cannot be repaired and have no scrap value. Supply of faulty bats to customers could be eliminated by implementing an inspection process immediately before the goods are delivered. This would improve customer perception thus resulting in an increase of 5% in current market share (making in all a total share of 35%).

- (i) Calculate the quality non-conformance cost for the coming year, based on the budgeted figures and sales returns rate.
- (ii) Calculate the impact on profitability due to implementation of inspection process for the bats

(7 Marks)


1. (i) **Calculation of Quality Non- Conformance Cost**

Annual Sales	=	1,00,000 × 30%	
	=	30,000 units	
Number of returned bats which are replaced <i>free of cost</i>	=	30,000 units × $\frac{3}{97}$	
	=	928 units	
Cost of 928 units that are replaced <i>free of charge</i>	=	928 × ₹4,000	
	=	₹37,12,000	(A)
Contribution Lost (Market Share) due to <i>faulty bats</i>	=	₹35,04,000	(B)
So, Total Quality Non-Conformance Cost [(A) + (B)]	=	₹72,16,000	

**Statement Showing Contribution Lost (Market Share) due to *faulty bats***

Particulars	₹ '000
Sales (5,000 units × ₹4,800)	24,000
Less: Variable Cost [(₹1,200 units + ₹2,000 + ₹800) × 5,000 units]	20,000
Less: Relevant Cost of <i>faulty bats</i> [155 units × (₹2,000 + ₹1,200)]	496
Contribution	3,504

$$\text{No. of Faulty Bats} = 155 \left( 5,000 \text{ units} \times \frac{3\%}{97\%} \right)$$

 **Quality Non-Conformance Costs** are costs that are incurred by a firm as an outcome of quality failures that have occurred.

(ii) **Impact on Profitability due to *implementation of inspection process***

Implementing *inspection process* before delivery to the customer would eliminate risk of supplying faulty bat to the customer. This would lead to improvement in customer perception, thus increasing market share to 35%.

Additional Contribution due to <i>increase in market share</i>	=	₹35,04,000	(C)
Saving in the Delivery Cost on 928 faulty bats	=	928 units × ₹800	
	=	₹ 7,42,400	(D)
Total Increase in Profit [(C) + (D)]	=	₹ 42,46,400	

- 4) A company produces and sells a single product. The cost data per unit for the year 2019 is predicted as below:

<b>Rs. per unit</b>	
Direct Material	35
Direct Labour	25
Variable Overheads	15
Selling Price	90

The company has forecast that demand for the product during the year 2019 will be 28,000 units. However, to satisfy this level of demand, production quantity will be increased?

There are no opening stock and closing stock of the product.

The stock level of material remains unchanged throughout the period.

The following additional information regarding costs and revenue are given:

- 12.5% of the items delivered to customers will be rejected due to specification failure and will require free replacement. The cost of delivering the replacement item is Rs.5 per unit.
- 20% of the items produced will be discovered faulty at the inspection stage before they are delivered to customers.
- 10% of the direct material will be scrapped due to damage while in storage. Due to above, total quality costs for the year is expected to be Rs.10,75,556.

The company is now considering the following proposal:

1. To introduce training programmes for the workers which, the management of the company believes, will reduce the level of faulty production to 10%. This training programme will cost Rs.4,50,000 per annum.
2. To avail the services of quality control consultant at an annual charges of Rs.50,000 which would reduce the percentage of faulty items delivered to customers to 9.5%.

**Required**

- (i) PREPARE a statement of expected quality costs the company would incur if it accepts the proposal. Costs are to be calculated using the four recognised quality costs heads.
- (ii) Would you RECOMMEND the proposal? Give financial and non-financial reasons.

(8Marks)

4. (i) **Statement of 'Expected Quality Costs'**

Particulars	Current Situation (₹)	Proposed Situation (₹)
Prevention Costs	---	4,50,000
Appraisal Costs	---	50,000
External Failure Costs	3,20,000	2,35,120
Internal Failure Costs	7,55,556	3,91,538
Total Quality Costs	10,75,556	11,26,658

**Workings****External Failure Cost**

Particulars	Current Situation	Proposed Situation
Customer's Demand ... (A)	28,000 units	28,000 units
Number of units Dispatched to Customers ... (B) $\left( \frac{28,000 \text{ units}}{87.5\%} \right); \left( \frac{28,000 \text{ units}}{90.5\%} \right)$	32,000 units	30,939 units
Number of units Replaced ... (B) – (A)	4,000 units	2,939 units
External Failure Cost {4,000 units × ₹(35+25+15+5)}; {2,939 units × ₹(35+25+15+5)}	₹3,20,000	₹2,35,120

**Internal Failure Cost**

Particulars	Current Situation	Proposed Situation
Number of units Dispatched to Customers ... (A)	32,000 units	30,939 units
Number of units Produced & Rejected ... (B) $\left(\frac{32,000 \text{ units}}{80\%}\right); \left(\frac{30,939 \text{ units}}{90\%}\right)$	40,000 units	34,377 units
Number of units Discovered Faulty ... (B) – (A)	8,000 units	3,438 units
Cost of Faulty Production ... (D) {8,000 units × ₹(35+25+15)}; {3,438 units × ₹(35+25+15)}	₹6,00,000	₹2,57,850
Material Scrapped $\left(\frac{40,000 \text{ units}}{90\%} \times 10\%\right); \left(\frac{34,377 \text{ units}}{90\%} \times 10\%\right)$	4,444.44 units	3,819.67 units
Cost of Material Scrapped ... (E) {4,444.44 units × ₹35}; {3,819.67 units × ₹35}	₹1,55,556	₹1,33,688
Internal Failure Cost ... (D)+(E)	₹7,55,556	₹3,91,538

**(ii) Recommendation**

On purely *financial grounds* the company should not accept the proposal because there is an increase of ₹51,102 in quality costs. However there may be *other factors* to consider as the company may enhance its reputation as a company that cares about quality products and this may increase the company's market share.

On balance the company should accept the proposal to improve its *long-term* performance.

- 5) Catalyst Ltd. Makes a single product with the following details:

Description	Current Situation	Proposed Change
Selling Price (Rs./unit)	10	
Direct Costs (Rs./unit)	5	
Present number of setups per production period, (before each production run, setup is done)	42	
Cost per set up (Rs.)	450	Decrease by Rs.90
Production units per run	960	1,008

Engineering hours for production period	500	422
Cost per engineering hour (Rs.)	10	

The company has begun Activity Based Costing of fixed costs and has presently identified two cost drivers, viz. production runs and engineering hours. Of the total fixed costs presently at Rs.96,000, after the above, Rs.72,100 remains to be analyzed. There are changes as proposed above for the next production period for the same volume of output.

### Required

- (i) COMPUTE units and production runs Catalyst Ltd. should produce in the changed scenario for break-even.
- (ii) ADVISE whether Catalyst Ltd. should continue to break up the remaining fixed costs into activity based costs.

(4Marks)

### Required

- (i) COMPUTE units and production runs Catalyst Ltd. should produce in the changed scenario for break-even.
- (ii) ADVISE whether Catalyst Ltd. should continue to break up the remaining fixed costs into activity based costs.

### Solution

### Workings

Statement Showing 'Non-unit Level Overhead Costs'

Particulars	Current Situation	Proposed Situation
No. of Production Runs/ Setups	42	40 $\left( \frac{960 \text{ runs} \times 42 \text{ setup}}{1,008 \text{ units}} \right)$
Cost per Setup	₹450	₹360
Production Units per run	960 units	1,008 units
Production Units	40,320 (960 units × 42)	40,320
Engineering Hrs.	500	422
Engineering Cost per hour	₹10	₹10

**Requirement of Question****(i) Break Even Point (Changed Scenario)**

Break Even Point

$$= \frac{\text{Fixed Cost} + (\text{Setup Cost} \times \text{No. of Setups}) + (\text{Engineering Costs} \times \text{No. of Engineering Hrs.})}{(\text{Price} - \text{Unit Variable Cost})}$$

$$= \frac{\text{₹ } 72,100 + (\text{₹ } 360 \times 40 \text{ Setups}) + (\text{₹ } 10 \times 422 \text{ hrs.})}{(\text{₹ } 10 - \text{₹ } 5)}$$

$$= 18,144 \text{ units}$$

Break Even Point (No of Production Runs)

$$= \frac{\text{Break Even (units)}}{\text{Production (units per run)}}$$

$$= \frac{18,144 \text{ units}}{1,008 \text{ units}}$$

$$= 18 \text{ Runs}$$

- (ii) A company should adopt Activity Based Costing (ABC) system for *accurate product costing*, as traditional volume based costing system does not take into account the *Non-unit Level Overhead Costs* such as Setup Cost, Inspection Cost, and Material Handling Cost etc. Cost Analysis under ABC system showed that while these costs are largely fixed with respect to sales volume, but they are not fixed to other appropriate cost drivers. If break up the remaining ₹ 72,100 fixed costs consist of only a small portion of these costs, ABC need not be applied.

However, it may also be noted that the primary study has resulted in cost savings. If the savings in cost are expected to exceed the cost of study and implementing ABC, it may be justified. Further it is pertinent to mention that ABC offers no increase in product-costing accuracy for single-product setting.

- 6) N2 Co. is the manufacturer and supplier of firefighting and safety equipment for industrial use and follows the international quality standards and uses the high grade raw material. It is a fast-growing brand that protects millions of people across the India, every single day. N2 has been offered a bid on a prospective export contract for 20,000 commercial fire extinguishers with following specification from USA buyer and the delivery terms is FOB.

“two-gallon cylinder holding 10 pounds of multi-purpose dry chemical at 380 PSI”

N2 is exporting first time. The price computation per fire extinguisher is as follows:

	Rs.	Rs.
Direct Material		
Circle Part Cost	620	
Necking Part	30	
Bottom Part	50	
Fire Extinguisher Powder	590	
Heat Process	50	
Nozzle	60	
Meter	20	
Pipe	50	
Nitrogen	30	1,500
Direct Labor (2 hrs. × Rs.40)		80
Leakage Testing		50
Variable Overheads (including packing)		214
Export Clearance Charges on FOB term		36
Fixed Overhead		100
Total		1,980
Add: Markup @ 10%		198
Price		2,178
USD to INR		67
<b>Price in USD</b>		<b>32.51</b>

After quotation of USD 32.51, the buyer is negotiating the price and ready to pay only USD 28.50.

**Required**

ADVISE whether it is worth accepting at USD 28.50 considering other factors.

**(8 Marks)**

## 7. Workings

### Statement Showing Benefit from Prospective Export Contract

	₹
Direct Material	1,500
Direct Labor (2 hrs. × ₹40)	80
Leakage Testing	50
Variable Overheads (including packing)	214
Export Clearance Charges on FOB term	36
Total Relevant Cost	1,880
USD to INR	₹67
Relevant Cost	\$28.06
Price Offered by Customer	\$28.50
Benefit <i>per extinguisher</i>	\$0.44
No. of Extinguishers	20,000
Total Benefit	\$8,800

#### Advise

From financial perspective, it will be profitable for N2 to accept the contract because of gain of \$8,800 (₹5,89,600) along with export incentives of drawback. Besides this, following consideration should also be taken into consideration while exporting fire extinguishers:

#### Statutory Compliances

Before exporting to a foreign country or even agreeing to sell to a new customer in a foreign country, N2 should be aware of foreign laws that might affect the sale. Export documentation is important as it plays a significant role in regulating the flow and movement of goods in international markets. Each country has its own prescribed statutory documents to be complied by exporters and importers. Thus, N2 should consider about the documentation and inspection compliances part of new buyer. It may include third party audit, commercial invoice and packaging list requirements, certificate requirements like- no child labour certificate, inspection certificate, reach compliance certificate etc. If any compliance requirement is not met, what will be the consequences? There may be stiff penalty has to be paid owing to non-compliance or failure to accurately comply with the export obligation.

#### Buyer Creditworthiness

It is necessary that before shipment the exporter to carry out its own credit check on the importer to determine creditworthiness. Thus, N2 should make a proper assessment of the creditworthiness of the foreign buyer and spend sufficient time in cross checking the credit worthiness of his counterpart to avoid any kind of unforeseen situation in future. Such information can be easily availed through contracts or through ECGC. Private agencies also provide information on paid service basis. However, this risk can be covered by asking for LC payment terms or 100% advance or opting for post shipment insurance for goods being exported.

***Industry Analysis***

Industry analysis involves such things as assessing the competition in the industry; the interplay of supply and demand in the industry; how the industry holds up against other industries that are emerging and providing competitions; the likely future of the industry, especially in light of technological developments; how credit works in the industry; and the exact extent of the impact that external factors have on the industry.

For N2, it is worthwhile to know the current and future demand of fire extinguisher and factors influencing the growth of global fire extinguisher market. N2 can perform industry analysis through three main ways i.e. the Competitive Forces Model (also known as Porter's 5 Forces); the broad factors analysis, also known as PEST analysis; and SWOT Analysis. It may also arrange industry report from trusted sources.

***Additional Terms***

Ensure that the all terms are clear and suit the business purpose. For instance, delivery terms should provide date of shipment or means of determining the date. In some circumstances, a late delivery penalty may be incurred where goods are not supplied by a specific delivery date. Therefore, N2 should evaluate whether shipment date is attainable or not. If the target shipment date could not be met, what will be the charges? Further, N2 must also check whether the foreign bank charges are subject to beneficiary account. If yes, then the same must be considered in the quotation.

**Overall**, N2 should accept the proposed contract only after due and careful consideration of above factors.

## SAP 1

## FINAL (NEW) GROUP II

## PAPER-7: DIRECT TAX LAWS

(Time Allowed – 45 Minutes)

Maximum Marks – 25

**Division A: Multiple Choice Questions - 5 Marks**

1. Mr. Anjan, a property dealer, sold a flat in Mumbai, the stamp duty of which is Rs.2 crores for Rs.1.80 crores to his friend Mr. Ashwin, a college lecturer. Mr. Anjan had purchased the flat one year back for Rs.1.50 crores and the stamp duty value on that date was also Rs.1.50 crores. What are the tax implications of such sale?

- (a)Rs.50 lakhs would be taxable as short-term capital gains in the hands of Mr. Anjan. There would be no tax implication in the hands of Mr. Ashwin
- (b)Rs.50 lakhs would be taxable as business income in the hands of Mr. Anjan. There would be no tax implication in the hands of Mr. Ashwin
- (c)Rs.50 lakhs would be taxable as business income in the hands of Mr. Anjan and Rs.20 lakhs would be taxable as income from other sources in the hands of Mr. Ashwin.
- (d)Rs.50 lakhs would be taxable as short-term capital gains in the hands of Mr. Anjan and Rs.20 lakhs would be taxable as income from other sources in the hands of Mr. Ashwin

**(1 Mark)**

2. P is a salaried employee. On 01.06.2019, he gets a gift of house property situated in Mumbai (stamp duty value Rs.80,00,000) from Q. On 02.08.2019, P gets a gift of house property in Pune (Stamp duty value Rs. 50,000) from R. On 03.09.2019, P also gets a gift of house property in Delhi from R, the stamp duty value of which is Rs.1,00,000. What will be the tax implications in the hands of P, Q and R.

- (a)Rs.81,00,000 shall be chargeable to tax in the hands of P as income from other sources and capital gains shall arise in the hands of Q and R respectively on account of transfer of capital asset.
- (b)Rs.81,50,000 shall be chargeable to tax in the hands of P as income from other sources and capital gains shall arise in the hands of Q and R respectively on account of transfer of capital asset.
- (c)Rs.81,00,000 shall be chargeable to tax in the hands of P as income from other sources and no capital gains shall arise in the hands of Q and R respectively as gift does not constitutes "transfer".
- (d)Rs.81,50,000 shall be chargeable to tax in the hands of P as income from other sources and no capital gains shall arise in the hands of Q and R respectively as gift does not constitutes "transfer".

**(2 Marks)**

3. Rental income earned from the business of letting out of properties is –
- (a) always taxable as income from house property
- (b) always taxable as business income
- (c) taxable as business income or income from house property, at the option of the assessee. However, the practice should be followed consistently.
- (d) taxable as business income only if the entire or substantial income of the assessee was from letting out of property. Otherwise, the same would be taxable as income from house property.

(1 Mark)

4. Mr. Arjun's, aged 40 years, total income comprises of long-term capital gains on sale of land Rs.5 lakhs; short-term capital gains on sale of STT paid listed equity shares Rs.2 lakhs; income from lottery Rs.1 lakh and savings bank interest Rs.30,000. He invests Rs.1.50 lakhs in PPF. His tax liability for A.Y.2020-21 is –

- (a) Rs.1,64,800
- (b) Rs.1,66,400
- (c) Rs.1,14,400
- (d) Rs.1,13,300

(1 Mark)

1	C	2	C
3	D	4	C

### Division B: Descriptive Questions - 20 Marks

#### Answer all the questions

1. X Limited has transferred its Unit N to Y Limited by way of slump sale on November 30, 2019. The summarised Balance Sheet of X Limited as on that date is given below:

Liabilities	Rs.(in lakhs)	Assets	Rs.(in lakhs)
Paid up capital	1,700	Fixed Assets :	
Reserve & surplus	620	Unit L	150
Liabilities:		Unit M	150
Unit L	40	Unit N	550
Unit M	110	Other Assets:	
Unit N	90	Unit L	520
		Unit M	800

		Unit N	390
<b>Total</b>	<b>2,560</b>	<b>Total</b>	<b>2,560</b>

Using the further information given below, compute the capital gain arising from slump sale of Unit N and tax on such capital gain.

- (i) Lump sum consideration on transfer of Unit N is Rs.880 lakhs.
- (ii) Fixed assets of Unit N include land which was purchased at Rs.60 lakhs in August 2007 and revalued at Rs.90 lakhs as on March 31, 2019.
- (iii) Other fixed assets are reflected at Rs.460 lakhs (i.e. Rs.550 lakhs less value of land) which represents written down value of those assets as per books. The written down value of these assets under section 43(6) of the Income-tax Act, 1961 is Rs.410 lakhs.
- (iv) Unit N was set up by X Limited in July, 2007.
- (v) Cost inflation index for financial year 2007-08 and financial year 2019-20 are 129 and 289, respectively.

**(8 Marks)**

**Answer****Computation of capital gain on slump sale of Unit N under section 50B**

Particulars	₹ (in lacs)
Sale consideration for the slump sale of Unit N	880
<b>Less:</b> Net worth of Unit N (Refer Note 1 below)	770
<b>Long term capital gain arising on slump sale</b>	<b>110</b>

**Computation of tax liability of X Ltd. on slump sale of Unit N**

Particulars	₹ (in lacs)
Tax on capital gains@20%	22.00
Add: Surcharge@7%	1.54
	23.54
Add: Health and Education cess @4%	0.94
<b>Total tax liability on capital gain arising on slump sale of Unit N</b>	<b>24.48</b>

**Notes:**

- The net worth of an undertaking transferred by way of slump sale shall be deemed to the cost of acquisition and cost of improvement for the purposes of section 48 and 49 [Section 50B(2)].

**Computation of net worth of Unit N**

Particulars	₹ (in lacs)
(A) Book value of non-depreciable assets:	
(i) Land (Revaluation is to be ignored for computing net worth)	60
(ii) Other assets	390
(B) Written down value of depreciable assets under section 43(6)	410
Aggregate value of total assets	860
Less: Value of liabilities of Unit N	90
<b>Net worth of Unit N</b>	<b>770</b>

- Since Unit N is held for more than 36 months, the capital gains of ₹ 110 lacs arising on transfer of such unit would be a long term capital gain taxable under section 112. However, indexation benefit is not available in the case of a slump sale.
- Following are the details of income provided by Mr. Singh, the assessee for the financial year ended 31<sup>st</sup> March, 2020:

- (i) Rental income from property at Bangalore - Rs.3 lakhs, Standard Rent - Rs.2,50,000, Fair Rent - Rs.2,80,000.
- (ii) Municipal and water tax paid during 2019-20: Current year Rs.35,000, Arrears - Rs.1,50,000.
- (iii) Interest on loan borrowed towards major repairs to the property: Rs.1,50,000.
- (iv) Arrears of rent of Rs.30,000 received during the year, which was not charged to tax in earlier years.

Further, the assessee furnished following additional information regarding sale of property at Chennai:

- (i) Mr. Singh's father acquired a residential house in April 2006 for Rs.1,25,000 and thereafter gifted this property to the assessee, Mr. Singh on 1<sup>st</sup> March, 2007.
- (ii) The property, so gifted, was sold by Mr. Singh on 10<sup>th</sup> June 2019. The consideration received was Rs.25,00,000.
- (iii) Stamp duty charges paid by the purchaser at the time of registration @ 13% (as per statutory guidelines) was Rs.3,90,000.
- (iv) Out of the sale consideration received:
  - (a) On 02/01/2020, the assessee had purchased two adjacent flats, in the same building, and made suitable modification to make it as one unit. The investment was made by separate sale deeds, amount being Rs.8,00,000 and Rs.7,00,000, respectively.
  - (b) On 10/10/2019, Rs.10 lakhs was invested in bonds issued by National Highways Authority of India, but the allotment of the bonds was made on 1.2.2020.

Compute Mr. Singh's taxable income for assessment year 2020-21. Cost inflation index: F.Y. 2006-07: 122; F.Y. 2019-20: 289

**(8 Marks)**

## Answer

## Computation of taxable income of Mr. Singh for A.Y.2020-21

Particulars	₹	₹
<b>Income from house property</b>		
Gross Annual Value [Higher of Expected Rent & Actual Rent]		3,00,000
Expected Rent [lower of Fair Rent and Standard Rent]	2,50,000	
Actual Rent	3,00,000	
Less: Municipal taxes paid by Mr. Singh during the year (including arrears) [₹ 35,000 + ₹1,50,000]		1,85,000
Net Annual Value (NAV)		1,15,000
Less: Deductions under section 24		
(a) 30% of NAV	34,500	
(b) Interest on loan borrowed for major repairs	1,50,000	1,84,500
		(69,500)
Arrears of rent taxable under section 25A	30,000	
Less: Deduction@30%	9,000	21,000
		(48,500)
<b>Capital Gains</b>		
Full value of consideration		30,00,000
As per section 50C, the full value of consideration would be the higher of -		
Actual Consideration	25,00,000	
Stamp Duty Value [₹ 3,90,000/13%]	30,00,000	
Since stamp duty value > 105% of actual consideration		
Less: <b>Indexed cost of acquisition</b> [₹ 1,25,000 × 289/122]		
As per section 49(1), cost of acquisition of the residential house gifted by Mr. Singh's father to Mr. Singh would be the cost for which Mr. Singh's father acquired the asset		2,96,107
		27,03,893
Less: <b>Exemption under section 54</b> (₹ 8,00,000 + ₹ 7,00,000)		
Purchase of residential house within the stipulated time (within one year before or two years after the date of sale) [Where the flats are situated side by side and the builder had effected the necessary		

<p>modification to make it as one house, the assessee would be entitled to exemption under section 54 in respect of investment in both the flats, despite the fact that they were purchased by separate sale deeds]  <i>[CIT v. Ananda Basappa (2009) 331 ITR 211 (Kar.)]</i></p> <p><b>Note:</b> Since two adjacent flats are treated as one residential house, Mr. Singh can defer availing exemption under section 54 in respect of two residential houses (where capital gains does not exceed ` 2 crores) to a later assessment year.</p> <p><b>Exemption under section 54EC</b></p> <p>Investment in bonds of NHAI within six months from the date of transfer. Where the payment for bonds has been made within the six month period, exemption under section 54EC would be available even if the allotment of bonds was made after the expiry of the six months  <i>[Hindustan Unilever Ltd. v. DCIT (2010) 325 ITR 102 (Bom.)]</i></p> <p><b>Long-term capital gains</b></p> <p><b>Total Income</b></p>	<p>15,00,000</p> <p>10,00,000</p>	<p>25,00,000</p> <p>2,03,893</p> <p><b>1,55,393</b></p>
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3. Can exemption under section 54EC be denied on account of the bonds being issued after six months of the date of transfer even though the payment for the bonds was made by the assessee within the six month period?

14. **Can exemption under section 54EC be denied on account of the bonds being issued after six months of the date of transfer even though the payment for the bonds was made by the assessee within the six month period?**

***Hindustan Unilever Ltd. v. DCIT (2010) 325 ITR 102 (Bom.)***

**High Court's Observations:** In this case, the Bombay High Court observed that in order to avail the exemption under section 54EC, the capital gains have to be invested in a long-term specified asset within a period of six months from the date of transfer. Where the assessee has made the payment within the six month period, and the same is reflected in the bank account and a receipt has been issued as on that date, the exemption under section 54EC cannot be denied merely because the bond was issued after the expiry of the

six month period or the date of allotment specified therein was after the expiry of the six month period.

**High Court's Decision:** For the purpose of the provisions of section 54EC, the date of investment by the assessee must be regarded as the date on which payment is made. The High Court, therefore, held that if such payment is within a period of six months from the date of transfer, the assessee would be eligible to claim exemption under section 54EC.

(OR)

Would income from letting out of properties by a company, whose main object as per its memorandum of association is to acquire and let out properties, be taxable as its business income or income from house property, considering the fact that the entire income of the company as per its return of income was only from letting out of properties?

2. **Would income from letting out of properties by a company, whose main object as per its memorandum of association is to acquire and let out properties, be taxable as its business income or income from house property, considering the fact that the entire income of the company as per its return of income was only from letting out of properties?**

***Chennai Properties and Investments Ltd. v. CIT (2015) 373 ITR 673 (SC)***

**Facts of the Case:** The assessee-company was incorporated under the Companies Act, 1956. Its main objective, as stated in the memorandum of association, is to acquire properties in the city of Madras and let out those properties. The company had rented out such properties and the rental income was shown as its business income in the return filed by the assessee.

The Assessing Officer, however, assessed the rental income under the head "Income from house property". On appeal, the Commissioner (Appeals) concurred with the assessee's view that the rental income, in this case, was the company's business income. The Appellate Tribunal also supported the view of the Commissioner (Appeals).

**High Court's Opinion:** The High Court allowed the Department's appeal holding that income derived from letting out of properties has to be assessed as income from house property. It held so on the basis of the Supreme Court ruling in *East India Housing and Land Development Trust Ltd. v. CIT (1961) 42 ITR 9*, wherein it was decided that income from letting out of shops and stalls was to be assessed as income from house property, in the case of a company whose main object of was buying and developing landed properties and promoting and developing markets.

**Supreme Court's Observations:** The Supreme Court observed that the High Court had pronounced its ruling on the basis of the decision of the Apex Court in *East India Housing and Land Development Trust Ltd.'s* case, wherein the letting out of property was not the object of the company at all. Therefore, in that case, the Apex Court was of the opinion that the character of the income which was from house property had not changed merely because it was received by the company formed with the object of developing and setting up properties.

The Supreme Court further observed the law laid down authoritatively and succinctly by it in *Karanpura Development Co. Ltd. v. CIT [1962] 44 ITR 362*. In that case, the assessee-

company was formed with the object of, *inter alia*, acquiring and disposing of the underground coal mining rights in certain coal fields and it had restricted its activities to acquiring coal mining leases over large areas, developing them as coal fields and then sub-letting them to collieries and other companies. Thus, in that case, the leasing out of the coal fields to the collieries and other companies was the business of the assessee. The income which was received from letting out of those mining leases was shown as business income. Department took the position that the same was to be treated as income from the house property. Thus, in similar circumstances, an identical issue arose before the Apex Court. The Apex Court pointed out that the deciding factor as to the head under which the income was to be assessed is not the ownership of land or leases but the nature of the activity of the assessee and the nature of the operations in relation to them. It was highlighted and stressed that the objects of the company must also be kept in view to interpret the activities. In support of the aforesaid proposition, a number of judgments of other jurisdictions, i.e., Privy Council, House of Lords in England and the US Courts were taken note of.

After applying the aforesaid principle to the facts, the Apex Court had arrived at the conclusion that such income had to be treated as income from business and not as income from house property.

**Supreme Court's Decision:** The Supreme Court opined that the aforesaid judgment in *Karanpura Development Co. Ltd.*'s case squarely applied to the facts of the present case, where letting of the properties is in fact the business of the assessee. The main objective of the company as per its memorandum of association is to acquire and hold properties in Chennai and let out these properties. Therefore, holding of the properties and earning income by letting out these properties is the main objective of the company. Further, in the return of income filed by the company and accepted by the Assessing Officer, the entire income of the company comprised of income from letting out of such properties. The Supreme Court, accordingly, held that the assessee had rightly disclosed the income derived from letting out of such properties under the head "Profits and gains of business or profession".

(4 Marks)

**SAP 1**  
**CA FINAL (NEW) GROUP II**  
**PAPER-8 INDIRECT TAX LAWS**  
**Division A - Multiple choice questions - 7 Marks**

1. M/s. Jolly Electronics (P) Ltd., is an authorized dealer of M/s. GG Micro Ltd., located and registered in Lucknow, Uttar Pradesh. It has sold following items to Mr. Alla Rakha (a consumer):

<b>Product</b>	<b>Amount (Rs.)</b>
Refrigerator (500 liters) taxable @18%	40,000/-
Stabilizer for refrigerator taxable @12%	5,000/-
LED television (42 inches) taxable @12%	30,000/-
Split air conditioner (2 Tons) taxable@28%	35,000/-
Stabilizer for air conditioner taxable@ 12%	5,000/-
<b>Total Value</b>	<b>1,15,000/-</b>

Jolly Electronics (P) Ltd. has given a single invoice, indicating price of each item separately to Mr. Alla Rakha. Mr. Alla Rakha, has given a single cheque of Rs. 1,00,000/-for all the items as a composite discounted price. State the type of supply and the tax rate applicable on the same.

- (a) Composite supply; Highest tax rate applicable to split air conditioner, i.e. 28%
- (b) Mixed supply; Highest tax rate applicable to split air conditioner, i.e. 28%
- (c) Supply other than composite and mixed supply; Highest tax rate applicable to split air conditioner i.e. 28%
- (d) Supply other than composite and mixed supply; respective tax rate applicable to each item

**(1 Mark)**

2. Where any agent supplies goods on behalf of his principal:

- (a)Such agent shall be jointly and severally liable to pay the GST payable on such goods.
- (b)The principal shall be jointly and severally liable to pay the GST payable on such goods.
- (c)Both (a) and (b)
- (d)None of the above.

**(1 Mark)**

3. Which of the following transactions does not qualify as supply under GST law?

- (a) Disposal of car without consideration and where the supplier has not claimed input tax credit on such car.
- (b) When a principal makes supplies to his agent who is also registered and is situated within the same State.
- (c) When the Head Office makes a supply of services to its own branch outside the State.
- (d) When a person imports services without consideration for the purposes of his business from his elder son living outside India.

**(1 Mark)**

4. Which of the following is not considered as a supply under the CGST Act, 2017?

- (a) Importation of architectural services for Rs.1,00,000/-for construction of residential property used for personal purposes from unrelated person.
- (b) Importation of architectural services free of cost for construction of office used for business purposes from related person.
- (c) Importation of architectural services free of cost for construction of office used for business purposes from unrelated person.
- (d)Both (a) and (c)

**(1 Mark)**

5. Which of the following is not a supply under the CGST Act, 2017?

- (a) Food supplied free of cost by Mr. A (Owner of a Restaurant) to his agent for further supply to customer at Rs.500/-.
- (b) Importation of accounting services free of cost from a dependent father residing in US.
- (c) A Rolex watch gifted to an employee for Rs. 50,000/-.
- (d) A machinery given free of cost to an employee on which input tax credit was availed by the employer.

**(1 Mark)**

6. M/s. Vishu Megamart, operating a store located and registered in Rajasthan, has come out with big discount offers at the time of Diwali on various gift items. In order to attract more customers, it has decided to supply a gift pack containing 5 packets of Haldiram's Namkeen (200 gram each) taxable @ 12%, 1 packet of Roasted Smoked Almonds (100 gram) taxable @ 18%, 1 packet of Bournville Chocolate (50 mg) taxable @ 28% and 1 bottle of Real Fresh Juice

(1 litre) taxable @ 18% in a single basket for a single price of Rs. 1,000/-. State the type of supply and the tax rate applicable on the same.

- (a) Composite supply; Tax rate of the principal item, i.e. Namkeen @18%
- (b) Composite supply; Highest tax rate out of all items, i.e. 28% applicable to chocolates
- (c) Mixed supply; Tax rate of principal item, i.e. Namkeen @18%
- (d) Mixed supply; Highest tax rate out of all items, i.e. 28% applicable to chocolates

**(1 Mark)**

7. Which of the following supplies are naturally bundled?

- (a) Rent deed executed for renting of two different floors of a building-one for residential and another for commercial purpose to same person
- (b) Pack of watch, tie and belt
- (c) Package of canned food such as burger, chocolates, sweets, cake etc.
- (d) None of the above.

**(1 Mark)**

<b>1</b>	<b>D</b>	<b>2</b>	<b>C</b>	<b>3</b>	<b>A</b>
<b>4</b>	<b>C</b>	<b>5</b>	<b>C</b>	<b>6</b>	<b>D</b>
<b>7</b>	<b>D</b>				

**Division B: Descriptive Questions (18 Marks)**

**Question No 1 is compulsory. Answer any 3 from the rest.**

1. Examine whether the following activities would amount to supply under Section 7 of the CGST Act, 2017.
  - (i) Hitkari charitable trust a trust engaged in providing medical relief free of cost, donated books and stationery to children living in slum areas.
  - (ii) Karishma manufacturers have a factory in Jaipur and a depot in Delhi. Both these establishments are registered in respective states. Finished goods are sent from the factory to the depot without consideration so that same can be sold.
  - (iii) Manan is an Electronic Commerce Operator in Delhi. His father who is settled in London is a well-known lawyer. Manan has taken legal consultancy from his free of cost with regard to his family dispute.  
Would your answer be different if in the above case, Manan has taken advise in respect of his business unit in Delhi.

**(6 Marks)**

*Ans:*

(1) Section 7 of the CGST Act, provides that supply must be made for a consideration except the activities specified in Schedule I and in course or furtherance of business. Since, both these elements are missing, donation of books and stationery to children living in slum area would not amount to supply under Section 7 of the CGST Act.

(2) Schedule I of CGST Act, provides that supply of goods or services or both between related persons or between distinct persons as specified in Section 25, is supply even without consideration **provided it is made in the course or furtherance of business.**

According to Section 25(5) of the CGST Act, 2017, where a person who has obtained or is required to obtain registration in a State in respect of an establishment, has an establishment in another State, then such establishments shall be treated as establishments of distinct persons for the purposes of this Act. In view of the same, factory and depot of Karishma Manufacturers are establishments of two distinct persons. Therefore, supply of goods from factory to depot without consideration, but in course of or in furtherance of business, is supply under Section 7 of the CGST Act.

(3) Schedule I of CGST Act, provides that import of services by person from a related person located outside India, without consideration is treated as supply if it is provided in the course or furtherance of business. In the given case, Manan has received legal consultancy from his father free of cost in a personal matter and not in course or furtherance of business. Hence, services provided by Manan's father to him would not be treated as supply under Section 7 of the CGST Act.

In the above case, if Manan has taken advice with regard to his business unit, services provided by Manan's father to him would be treated as supply under Section 7 of the CGST Act as the same are provided in course or furtherance of business though received from a related person.

2. State person liable to pay GST in the following independent cases provided recipient is located in the taxable territory:

- (a) Services provided by an arbitral tribunal to any business entity.
- (b) Sponsorship services provided by a company to an individual.
- (c) Renting of immovable property service provided by the Central Government to a registered business entity.

**(4 Marks)**

1.
  - (a) Since GST on services provided or agreed to be provided by an arbitral tribunal to any business entity located in the taxable territory is payable under reverse charge, in the given case, GST is payable by the recipient - business entity.
  - (b) GST on sponsorship services provided by any person to any body corporate or partnership firm located in the taxable territory is payable under reverse charge. Since in the given case, services have been provided to an individual, reverse charge provisions will not be attracted. GST is payable under forward charge by the supplier – company.
  - (c) GST on services supplied by Central Government, State Government, Union territory/ local authority by way of renting of immovable property to a person registered under CGST Act, 2017 is payable under reverse charge. Therefore, in the given case, GST is payable under reverse charge by the recipient – registered business entity.
  
3. Mr X, a manufacturer in Rajasthan has supplied goods valued Rs.1,00,000 to Mr A a dealer in Rajasthan. Mr.A supplied the said goods to Mr.B in Madhya Pradesh after making value addition of 20%. Mr.B further supplied the goods to Mr.C of Madhya Pradesh after making value addition of 20%. You are required to determine the tax payable by Mr.X, Mr.A and Mr.B in respect of the said transaction assuming the rate of GST is 18%. Also determine revenue earned by Central and State Government.  

**(4 Marks)**

**Solution:** In case of local supply of goods, the supplier would charge dual GST i.e., CGST and SGST at specified rates on the supply. Thus, the tax to be levied by Mr. A on supply of goods to Mr. B will be as under:

**(i) Supply of goods by Mr. A to Mr. B:**

	(amount in ₹)
Value charged for supply of goods	1,00,000
Add: CGST @ 9%	9,000
Add: SGST @ 9%	9,000
<b>Total price charged by Mr. A from Mr. B for local supply of goods</b>	<b>1,18,000</b>

The CGST & SGST charged from Mr. B for supply of goods will be remitted by Mr. A to the appropriate account of the Central and State Government's respectively.

A is the first stage supplier of goods and hence, does not have credit of CGST, SGST or IGST.

**(ii) Supply of goods by Mr. B to Mr. C - Value addition @ 20% :** Mr. B will avail credit of CGST and SGST paid by him on the purchase of goods and will utilise such credit for being set off against the CGST and SGST payable on the supply of goods made by him to Mr. C. :

	(amount in ₹)
Value charged for supply of goods (₹ 1,00,000 × 120%)	1,20,000
Add: CGST @ 9%	10,800
Add: SGST @ 9%	10,800
<b>Total price charged by Mr. B from Mr. C for local supply of goods</b>	<b>1,41,600</b>

**Computation of CGST, SGST payable by Mr. B to Government :**

	(amount in ₹)
CGST payable	10,800
Less: Credit of CGST	9,000
<b>CGST payable to Central Government</b>	<b>1,800</b>
SGST payable	10,800
Less: Credit of SGST	9,000
<b>SGST payable to State Government</b>	<b>1,800</b>

**Statement of revenue earned by Central and State Government :**

	(amount in ₹)	
Transaction	Revenue to Central Government	Revenue to State Government
Supply of goods by Mr. A to Mr. B	9,000	9,000
Supply of goods by Mr. B to Mr. C	1,800	1,800
<b>Total</b>	<b>10,800</b>	<b>10,800</b>

4. What are the conditions for availing concessional rate of tax under Notification No 2/2019- Central tax rate?

(4 Marks)



### Conditions to be fulfilled

*The conditions for availing the concessional rate of tax under Notification No. 2/2019 CT (R) are primarily same as the conditions for availing the composition scheme with few exceptions. The same have been elaborated as under:*

1. **Supplies are made by a registered person who is:**
  - not engaged in making any supply which is not leviable to tax under the said Act. Under composition scheme, restriction is only on supply of goods not leviable to tax.*
  - not engaged in making any inter-State outward supply – neither of goods nor of services. This condition is a divergence from the composition scheme where the restriction is only on making inter-State outward supply of goods and not on inter-State outward supply of services.*
  - neither a casual taxable person nor a non-resident taxable person.*
  - not engaged in making any supply through an electronic commerce operator who is required to collect tax at source under section 52.*
  - not engaged in making supplies of notified goods, namely, ice cream and other edible ice, whether or not containing cocoa [2105 00 00], Pan masala [2106 90 20] and all goods of Chapter 24, i.e. Tobacco and manufactured tobacco substitutes. Under composition scheme, condition is that the supplier should not be engaged in manufacture of notified goods.*
2. *The registered person shall not collect any tax from the recipient on supplies made by him nor shall he be entitled to any credit of input tax.*
3. *The registered person shall issue a bill of supply\*\* instead of tax invoice. Such bill of supply will have the following words at its top - 'taxable person paying tax in terms of Notification No. 2/2019 CT (R) dated 07.03.2019, not eligible to collect tax on supplies'.*

**\*\*Order No. 3/2019 CT dated 08.03.2019 has clarified that provisions of section 31(3)(c) of the CGST Act, 2017 [containing provisions relating to Bill of Supply] shall also apply to a person paying tax under this notification<sup>23</sup>.**

5. Discuss how GST resolved the double taxation dichotomy under previous indirect tax laws.

(4 Marks)

Under the earlier indirect tax regime, despite the introduction of the principle of taxation of value added in India – at the Central level in the form of CENVAT and at the State level in the form of State VAT - its application always remained piecemeal and fragmented on account of the following reasons:

- 📖 Double taxation of a transaction as both goods and services as the distinction between goods and services was often blurred, e.g. software was liable to both VAT and service tax.
- 📖 CENVAT did not include chain of value addition in the distributive trade below the stage of production. Similarly, in the State-level VAT, CENVAT load on the goods was not removed leading to the cascading of taxes. To illustrate, when the goods were manufactured and sold, both central excise duty (CENVAT) and State-Level VAT were levied.
- 📖 Though CENVAT and State-Level VAT were essentially value added taxes, set off of one against the credit of another was not possible as CENVAT was a central levy and State-Level VAT was a State levy.
- 📖 There were several taxes in the States, such as, Luxury Tax, Entertainment Tax, etc. which were not subsumed in the VAT.
- 📖 VAT on goods was not integrated with tax on services, at the State level, to remove the cascading effect of service tax. With service sector being the fastest growing sector in the economy, the exclusion of services from the tax base of the States potentially eroded their tax- buoyancy.
- 📖 CST was another source of distortion in terms of its cascading nature since it was non-VATABLE. Being an origin based tax, CST was also against one of the basic principles of consumption taxes that tax should accrue to the jurisdiction where consumption takes place.

- 📖 A comprehensive tax structure covering both goods and services viz. Goods and Services Tax (GST) addresses the above-mentioned problems. Simultaneous introduction of GST at both Centre and State levels has integrated taxes on goods and services for the purpose of set-off relief and ensures that both the cascading effects of CENVAT and service tax are removed and a continuous chain of set-off from the original producer's point/ service provider's point upto the retailer's level/ consumer's level is established.



- 📖 In the GST regime, the major indirect taxes have been subsumed in the ambit of GST. The erstwhile concepts of manufacture or sale of goods or rendering of services are no longer applicable since the tax is now levied on "Supply of Goods and/or services".