The Institute of Chartered Accountants of Nepal
Revision Test Paper December 2016

ADVANCE FINANCIAL REPORTING

Questions based on Holding Company

Question No.1
As on 30th June 2015, the balance sheets of three companies showed the following positions:

Fig Ltd.

	Rs.		Rs.
Share Capital	2,00,000	Land & Buildings	40,000
Capital Reserve	20,000	Plant & Machinery	80,000
Revenue Reserve	60,000	Share in Run Ltd. at cost	1,15,000
Current Liabilities:		Shares in Trot Ltd. at cost	70,000
Provision for Taxes	50,000	Stock in Hand	57,000
Proposed dividend	1,00,000	Sundry debtors	83,000
Creditors	40,000	Balance at Bank	25,000
	4,70,000		4,70,000

Run Ltd.

	Rs.		Rs.
Share Capital (Rs.10 each)	80,000	Land & Buildings	1,00,000
Capital Reserve	40,000	Plant & Machinery	35,000
Revenue Reserve	42,000	Current Assets:	
Current Liabilities:		Stock in Hand	65,000
Creditors	40,000	Debtors	40,000
Proposed Dividend	80,000	Bank Balance	60,000
Provision for Taxes	18,000		
	3,00,000		3,00,000

Trot Ltd.

	Rs.		Rs.
Share Capital (Rs.10 each)	1,00,000	Land & Buildings	65,000
Capital Reserve	----	Plant & Machinery	25,000
Revenue Reserve	32,000	Current Assets:	
Current Liabilities:		Stock in Hand	60,000
Creditors	23,000	Debtors	40,000
Proposed Dividend	10,000	Bank Balance	10,000
Provision for tax	35,000		
	2,00,000		2,00,000

You are also given the following information:

1. Fig Ltd acquired 5,000 shares in Run Ltd in 2010, when the balance on capital reserve had been Rs.20,000 and on revenue reserve Rs.16,000. A further 1,000 shares were purchased in 2012 when the balance in capital reserve and revenue reserve had been Rs.40,000 and Rs.24,000 respectively.
2. Fig Ltd had purchased 7,500 shares in Trot Ltd in 2011 when there had been adverse balance on revenue reserve of Rs.6,000.

3. The proposed dividend from subsidiary companies have been included in the figure for debtors in the accounts of the parent company.

You are required to prepare the consolidated balance sheet of Fig Ltd and its subsidiaries as on 30th June 2015 together with your consolidated schedules.

Answer/Hints

Consolidated Balance Sheet of Fig Ltd and its subsidiary Trot Ltd and Run Ltd as on 30th June 2015

Liabilities	Rs.	Assets	Rs.
Share Capital	200,000	Goodwill	24,000
Revenue Reserve	107,000	Land & Building	205,000
Capital Reserve	32,500	Plant & Machinery	140,000
Creditors	103,000	Stock	182,000
Tax	103,000	Debtors	95,500
Proposed dividend	122,500	Bank	95,000
Minority Interest	73,500		
	741,500		741,500

Working Note:

1. Analysis of profit of Trot Ltd

	Pre-acquisition	Post		
Revenue reserve	(6,000)	38,000		
	Fig (75%)	M	Fig (75%)	M
	(4,500)	(1,500)	28,500	9,500

2. Analysis of profit of Run Ltd

	Capital Reserve		revenue Reserve		
	40,000		42,000		
	Fig (75%)	M	Fig (75%)		M
\	30,000	10,000	31,500		10,500
	Pre	Post	Pre	Post	
	(20,000 × 5/8)		(16,000× 5/8)		
	(40,000× 1/8)		(24,000× 1/8)		
	= 17,500	12,500	= 13,000	18,500	

3. Cost of Control

	Cost of Investment (115,000 + 70,000)	185,000	
Less:	Paid up Capital	135,000	
	Share in pre-acquisition profit (Trot)	(4,500)	
	Share jn pre-acquisition profit (Run)	30,500	161,000
Goodwill			24,000

4. Minority Interest

Share in paid up capital	45,000
Share in capital profit	10,000
Share in revenue profit	10,500
Share in profit of Trot (9,500-1,500)	8,000
Total	73,500

5. Revenue reserve

Of Fig	60,000

Share in Trot		28,500
Share in Run		18,500
Total	107,000	

6. Capital reserve

Of Fig	20,000
Share in Run	12,500
Total	32,500

7. Proposed Dividend

Of Fig	100,000
Of Run	80,000
Of Trot	10,000
Share in Run Mutual	(60,000)
Share in Trot Mutual	(7,500)
Consolidated	122,500

8. Debtors

Total	163,000
Proposed dividend Mutual	(67,500)
Consolidated	95,500

Question No.2

The following summarized balance sheet as on December 31, 2015 as given:

	A Ltd.	B Ltd.
Share Capital (fully paid shares of Rs.100 each)	20,00,000	5,00,000
Reserve & surplus	6,00,000	2,40,000
Loans from B Ltd. (including interest)	2,25,000	---
Bank Overdraft	----	1,50,000
Sundry Creditors	2,40,000	2,10,000
	30,65,000	11,00,000
Fixed Assets	16,00,000	5,00,000
Investments:		
(i) In B Ltd.	4,72,500	
(ii) Other	5,70,000	
Loans to A Ltd	---	2,00,000
Cash at Bank	1,20,000	12,000
Other Current Assets (including interest receivable)	3,02,500	3,84,000
	30,65,000	11,00,000

The following other information are available:

a. The Reserve of the companies as on January 1, 2015 were: A Ltd. Rs.4,30,000 and B Ltd. Rs.2,50,000.
b. B Ltd. has advanced the loan to A Ltd on January 1, 2015.
c. On July 1, 2015 B Ltd issued fully paid bonus shares at the rate of one shares for every four held. On the same date, a dividend of 10 percent was paid for 2014.
d. A Ltd has purchased 3,500 shares in B Ltd on April 1, 2015 but had disposed of 375 shares on October 31, 2015 at Rs.140 the sale proceeds of being credited to the concerned investment account which so far has only this entry in addition to that made on the acquisition of the shares.

Prepare consolidated balance sheet.

Answer/Hints

Consolidated Balance Sheet of A Ltd and Its Subsidiary B Ltd

Liabilities	Rs.	Assets	Rs.
Share Capital	2,000,000	Fixed Assets	2,100,000
Reserve and Surplus	653,500	Other Investments	570,000
Bank overdraft	150,000	Other Current Assets	661,500
Sundry Creditors	450,000	Bank	136,000
Minority Interest	148,000		
Capital Reserve	66,000		
	3,467,500		3,467,500

Working Note:

1. Analysis of profit of B Ltd as on 31.12. 2015

		Pre-acquisition (upto 1.4)	Post –acquisition (1.4 – 31.12)
Reserve	250,000		
Less: Bonus	(100,000)		
Less: Dividend	(40,000)	110,000	
Profit of current year (130,000 in 3:9)		32,500	97,500
Total		142,500	97,500

H (80%)	M	H	M
114,000	28,500	78,000	19,500

2. Minority Interest

Share in paid up capital	100,000
Share in pre-acquisition profit	28,500
Share in post-acquisition profit	19,500
Total	148,000

3. Cost of control

Cost of investment			480,000
Less:	share in paid up capital	400,000	
	Pre-acquisition dividend	32,000	
	Pre-acquisition profit	114,000	546,000
Goodwill			66,000

4. Reserve & Surplus

Of A Ltd	600,000	
Post-acquisition profit		78,000
Pre-acquisition dividend	(35,000)	
Profit on sale of shares	10,500	
Consolidated	653,500	

Question No.3

The following are the balance sheets of A Ltd, B Ltd and C Ltd as at 31st December 2015: (Prepare consolidated Balance Sheet)

	A Ltd. Rs.	B Ltd Rs.	C Ltd. Rs.
Shares Capital (Rs.10 each)	10,00,000	5,00,000	2,00,000
General Reserve	2,00,000	36,000	---

Profit & Loss A/c	1,70,000	1,19,000	---
Liabilities	1,60,000	3,75,000	1,40,000
	15,30,000	10,30,000	3,40,000
4,000 shares in B Ltd.	6,00,000	--	---
500 shares in C Ltd.	25,000	---	--
1,500 shares in C Ltd	--	90,000	---
Profit & loss A/c	---	---	80,000
Other Assets	9,05,000	9,40,000	2,60,000
	15,30,000	10,30,000	3,40,000

The following information are available:

1. A Ltd acquired its investment in B Ltd on 1st January 2015 on which date the amounts standing to the credit of general reserve and profit and loss account in B Ltd was Rs.35,000 and 65,000 respectively.
2. A Ltd acquired its investment in C Ltd on 1st January 2015 when the debit balance in the profit and loss account in C Ltd.'s book was Rs.60,000.
3. B Ltd acquired its investment in C Ltd on 1st January 2013 when the debit balance in the profit & loss account in C Ltd.'s book was Rs.20,000.

Answer/Hints

Consolidated Balance Sheet

Liabilities	Rs.	Assets	Rs.
Share Capital	1,000,000	Goodwill	89,000
General reserve	200,800	Other assets	2,105,000
Profit & Loss Account	196,200		
Liabilities	675,000		
Minority Interest	122,000		
	2,194,000		2,194,000

1. Analysis of profit of C Ltd

P & L A/c
(80,000)

A Ltd (20,000)		B Ltd (60,000)	
Pre (60,000 ×25%) = (15,000)	Post (5,000)	Pre (20,000 × 75%) = (15,000)	Post (45,000)

2. Profit of B Ltd on different dates

	1.1.2015	31.12.2015
a. General Reserve of B	35,000	36,000
Consolidated	35,000	36,000
b. Profit & Loss Account		
Profit of B's own	65,000	119,000
Share of B in C's post acquisition	(30,000)	(45,000)
Consolidated	35,000	74,000

3. Analysis of profit of B Ltd

Pre-acquisition		Post Acquisition			
		GR		PL	
35,000		1,000			
35,000				39,000	
H	M	H	M	H	M

	56,000	14,000	800	200	31,200	7,800

4. Minority Interest

Share Capital	100,000
Share in pre-acquistion profit	14,000
Share in post acquisition profit	8,000
Total	122,000

5. Cost of Control

Cost of Investment			715,000
Less:			
Share capital			600,000
Pre-acquisition profit	B		56,000
Pre-acquisition in C		(30,000)	626,000
Goodwill			89,000

Questions Based on Valuation of Goodwill, Shares and Business

Question No. 4

Negotiation is going on for transfer of X Ltd. on the basis of the balance sheet and the additional information as given below:

Balance Sheet of X Ltd as on 31st March 2016

	Rs.		Rs.
Share capital (Rs.10 fully Paid up share)	10,00,000	Goodwill	1,00,000
Reserves and Surplus	4,00,000	Land and Buildings	3,00,000
Sundry Creditors	3,00,000	Plant and Machinery	8,00,000
		Investments	1,00,000
		Stock	2,00,000
		Debtors	1,50,000
		Cash and Bank	50,000
	17,00,000		17,00,000

Profit before tax for 2015-16 amounted to Rs.6,00,000 including Rs.10,000 as interest on investment. However, and additional amount of Rs.50,000 p.a. shall be required to be spent for smooth running of the business.

Market values of land and buildings and plant and machinery are estimated at Rs.9,00,000 and Rs.10,00,000 respectively. In order to match the above figures further depreciation to the extent of Rs.40,000 should be taken into consideration. Income-tax rate may be taken at 50%. Return on capital at the rate of 20% before tax may be considered normal for this business at the rate present stage.

For the purposes of determining the rate of return, profit for this year after the aforesaid adjustments may be taken as expected average profit. Similarly, average trading capital employed is also to be considered on the basis of the position in this year.

It has been agreed that 4 years' purchase of super profit shall be taken as value of goodwill for the purpose of the deal. Value the goodwill.

Answer/Hints

1. Closing Capital Employed

	Rs.
Land & Building	900,000
Plant & Machinery	1,000,000

	Stock	200,000
	Debtors	150,000
	Cash and Bank	50,000
	Investments	100,000
Less:	Creditors	(300,000)
Closing Capital Employed		2,100,000

2. Average Capital Employed
= Closing Capital Employed + Dividend – ½ profit after tax
= 2,100,000+ 0 – ½ of 300,000
= 1,950,000

3. Normal profit
= Average Capital × normal rate of return
= 1,950,000 × 10% (after tax)
= 195,000

4. Future Maintainable Profit

Profit	600,000
Less: Additional Expenses	(50,000)
Less: Additional depreciation	(40,000)
Profit before tax	510,000
Less: Tax (50%)	(255,000)
Profit after tax	255,000

5. Super Profit
= 255,000 – 195,000
= 60,000

6. Goodwill
= Super Profit ×4 years
= 60,000 × 4
= Rs.240,000

Question No. 5

A Ltd and its subsidiary B Ltd get their supply of some essential raw materials from C Ltd. To coordinate their production on a more profitable basis. A Ltd and C Ltd agreed between themselves each to acquire a quarter of shares in the other's authorized capital by means of exchange of shares. The terms are as follows:

1. A Ltd.'s shares are quoted at Rs.14, but for the purpose of exchange the value is to be taken at the higher of two values (a) quoted and (b) on the basis of the balance sheet valuation.
2. C Ltd.'s share which are unquoted are to be taken at the higher of the values as on (a) yield basis and (b) the balance sheet basis. The future profits are estimated at Rs.1,05,000 subject to one-third to be retained for development purposes. Shares of similar companies yield 8 percent.
3. Freehold properties of C Ltd are to be taken at Rs.4,30,000.
4. No Cash is to pass and the balance due on settlement is to be treated as loan between the two companies.

The summarized balance sheet of the companies at the relevant date stood as follows:

	A Ltd	B Ltd	C Ltd
	Rs.	Rs.	Rs.
Authorised share capital equity shares of Rs.10 each	12,00,000	5,00,000	10,00,000

Issued and fully paid	8,00,000	5,00,000	7,50,000
Share premium	80,000		
7% Debentures	3,00,000		
Profit and Loss Account	2,30,000	2,10,000	2,00,000
Current Liabilities	2,80,000	1,80,000	2,10,000
Proposed dividend	1,00,000	50,000	
	17,90,000	9,40,000	11,60,000
Freehold property	6,60,000	2,90,000	3,30,000
Plant and machinery etc.	4,50,000	4,10,000	4,40,000
Investments 40,000 shares in B Ltd	4,70,000		
Current Assets	2,10,000	2,40,000	3,90,000
	17,90,000	9,40,000	11,60,000

You are required to compute the value of the shares according to the terms of the agreement and to present the final settlement showing all the necessary workings.

Answer/Hints

1. Determination of issue price of shares of C Ltd.

a. Intrinsic value of shares of C Ltd

	Rs.
Freehold property	430,000
Plant and Machinery	440,000
Current Assets	390,000
Less: Current Liabilities	(210,000)
Net Assets	1,050,000
No of shares	75,000
Intrinsic value	14

b. Yield value of shares of C Ltd

Maximum possible dividend(105,000 – 1/3 of 105,000)	70,000
Maximum possible dividend rate (70,000/750,000)	9.33
Yield value (9.33 × 10/8)	11.66

So C Ltd will issue 25,000 shares at rate of Rs.14 per share.

2. Determination of issue price of shares of A Ltd

a. Intrinsic value (ex- dividend)

Total assets	1,790,000
Add: Increase in investment value	138,000
Less: debentures	(300,000)
Less: Current Liabilities	(280,000)
Less: Proposed Dividend	(100,000)
Net Assets	1,248,000
Intrinsic value (1248,000/80,000)	Rs.15.60

b. Quoted price Rs.14

So A Ltd will issue 30,000 shares at Rs.15.60 per shares.

Journal Entry of A Ltd

Investment A/c	Dr. (25,000 × 14)	350,000	
Loan A/c	Dr. (B.F.)	118,000	
To Equity Share Capital (30,000 × 10)			300,000
To Share Premium A/c (30,000 × 5.6)			168,000

Journal Entry of B Ltd

Investment A/c	Dr. (30,000 × 15.6)	468,000	
To Equity Share Capital (25,000 × 10)			250,000
To Share Premium (25,000 × 4)			100,000
To Loan A/c	(BF)		118,000

Question No.6

The following is the balance sheet of Star and Co. Ltd as at 31st December 2015:

Liabilities	Rs.	Assets	Rs.
Equity share of Rs.100 each	10,00,000	Goodwill	1,00,000
Less: Calls in arrear		Machinery	5,00,000
(Rs.20 for final call)	1,00,000	Factory shed	5,50,000
	9,00,000	Vehicles	1,50,000
10% Preference shares of		Furniture	50,000
Rs.10 each fully paid	4,00,000	Investments	2,00,000
Reserves and surplus:		*Current Assets:*	
General Reserve	4,00,000	Stock in trade	4,00,000
Profit and Loss A/c	3,00,000	Sundry debtors	7,00,000
Current Liabilities:		Cash at Bank	1,00,000
Bank Loan	2,00,000	*Misc. Expenditure:*	
Creditors	6,00,000	Preliminary Expenditure	50,000
	28,00,000		28,00,000

Additional Information are as follows:

1. Fixed assets are worth 20 percent above their book value. Depreciation on appreciated value of fixed assets not to be considered for valuation of goodwill.
2. Of the investment, 60 percent in non-trading and the balance is trade. All trade investments are to be valued at 25 percent above cost. A uniform rate of dividend @ 15 percent is earned on all investment.
3. For the purpose of valuation of shares, goodwill is to be considered on the basis of 4 years' purchase of the super profits based on average profit (after tax) of the last three years.
   Profit after tax are as follows:
   2013 Rs.4,00,000
   2014 Rs.4,30,000
   2015 Rs.4,50,000
   In a similar business, return on capital employed is 15 percent (after tax). Tax 50 percent.
4. In 2013 new machinery costing Rs.20,000 was purchased but wrongly charged to revenue (no effect has yet been given for rectifying the same)
   Depreciation charged on machinery is @ 10 percent on reducing balance method.

Find out the value of each fully paid and partly paid equity share on net assets basis.

Answer/Hints

1. Analysis of Investment

Total	Rs.200,000
Non- Trade (60%)	Rs.120,000
Trade	Rs.80,000
Current Value of Investment (80,000× 125%)	Rs.100,000

Interest on non-trade investment	Rs.18,000
Less: Tax 50%	Rs.9,000

Interest income after tax Rs.9,000

2. Future maintainable profit

Year	2013	2014	2015
Profit after tax	400,000	430,000	450,000
Machinery (after tax)	10,000		
Depreciation on Machine	(1,000)	(900)	(810)
None trade investment	(9,000)	(9,000)	(9,000)
	400,000	420,100	440,190

Average profit = (400,000 × 1 + 420,100 × 2 + 440,190 × 3)/6
= 426,795

3. Normal Profit

Machinery	(500,000 + 14,580) × 1.2	617,496
Factory Shed		660,000
Vehicles		180,000
Furniture		600,000
Trade Investment		100,000
Stock		400,000
Debtors		700,000
Cash		100,000
Less: Bank Loan		(200,000)
Creditors		(600,000)
Closing capital employed		2,017,496
Normal rate of return		15%
Normal profit (2,017,496 × 15%)		302,624.40

4. Valuation of Goodwill

Super Profit = Future maintainable profit – Normal Profit
= 426,725 – 302,624.40
= 124,170.60
Goodwill = Super Profit × 4 years
= 124,170.60 × 4
= 496,683

Note: Balance in profit & loss account is lower than current year post tax profit so normal profit is calculated on closing capital employed.

Questions based on business Reconstruction

Question No.7

Balance sheets of X Ltd and Y Ltd as on 31.12.2015 are given below:

	X	Y		X	Y
Share capital (Rs.10)	4,00,000	2,00,000	Assets	6,00,000	3,40,000
9% Debentures		1,00,000	5,000 shares of X Ltd.		50,000
Reserve	1,00,000	40,000			
Creditors	1,00,000	50,000			
	6,00,000	3,90,000		6,00,000	3,90,000

X Ltd to take over Y Ltd on the following terms (a) For each share of Y Ltd, X Ltd will issue its one share of Rs.10 at Rs.11 and pay cash 50 paisa, (b) X Ltd to issue such an amount of fully paid 10 percent

debentures at 90 as it sufficient to discharge 9 percent debentures of Y Ltd at a premium of 8 percent. Give journal entries of X. Also give realization account and shareholders account in the books of Y Ltd.

Answer/Hints

Books of X Ltd

Business Purchase	Dr.	175,000	
To Liquidator of Y Ltd			175,000
(PC Due)			
Liquidator of Y Ltd.	Dr.	175,000	
To Cash			10,000
To Share Capital (15,000 × 10)			150,000
To Share Premium (15,000 × 1)			15,000
(PC Discharged)			
Sundry Assets	Dr.	340,000	
To Liability for Debentures			108,000
To Liability for Creditors			50,000
To Business Purchase			175,000
To Capital Reserve			7,000
(Take over of assets and liabilities)			
Liability for debenture	Dr.	108,000	
Discount on issue of debenture	Dr.	12,000	
To 10% Debenture			120,000
(Discharge of debenture by issue of new debentures)			

Books of Y Ltd

Realisation Account

Particulars	Rs.	Particular	Rs.
To Sundry Assets	340,000	By Debentures	100,000
To 5,000 shares in X Ltd	50,000	By Creditors	50,000
		By X Ltd (PC)	175,000
		By Shareholders (Shares in X)	55,000
		By Shareholders (Loss0	10,000
	390,000		390,000

Shareholders Account

Particulars	Rs.	Particular	Rs.
To Realisation (5,000 × 11)	55,000	By Share Capital	200,000
To Cash	10,000	By Reserve	40,000
To Shares in X Ltd.	165,000		
To Realisation (Loss)	10,000		
	240,000		240,000

Working Note:

1. **Calculation of purchase consideration**

Value of business of Y Ltd	
- Share (20,000 × 11)	220,000
- Cash (20,000 × 0.5)	10,000
	230,000
Less: Value of shares not taken by X Ltd (5,000 × 11)	55,000
Purchase consideration	175,000

Question No.8

A Ltd has acquired, as current asset, 60,000 shares in B Ltd for Rs.60,000 on 1st November 2014. On 1st January 2016 it agreed to absorb B Ltd. The consideration being:

i. The assumption of its liabilities.
ii. The discharge of the Rs.40,000 debentures held outside the company at a premium of 10 percent by the issue of 6 ½ percent. Debentures in A Ltd carrying a full six months interest payable 1st July 2016.
iii. A payment in cash of Re.0.50 per share in B Ltd; and
iv. The issue of shares of Re.1 each in A Ltd credited as fully paid to the members of B Ltd on the basis of:
   Two equity shares (valued at Rs.1.60 each) and one 7 ½ cumulative preference share (valued at Rs.1.10) for every five shares in B Ltd.

The summarized balance sheet of B Ltd as on 31st December 2015 was as follows:

	Rs.			Rs.
Share capital:		Fixed assets		73,000
1,60,000 shares of Re.1		Stocks		85,800
each Re.0.75 paid	1,20,000	Debtors		45,000
General reserve	75,000	Investments:		
Profit & Loss A/c	21,550	on account of		
Insurance Fund*	10,000	Insurance Fund	10,000	
5% Debentures	45,000	5% Debentures		
Creditors	17,800	in B Ltd	4,800	14,800
		Bank Balance		50,750
		Goodwill		20,000
	2,89,350			2,89,350

* The company had been carrying its own insurance risk crediting amounts equivalent to premium to the fund and charging losses thereof.

It was agreed that for absorption purposes, 5 percent should be written off stocks and provision of 2 ½ percent made for doubtful debts. The remaining assets, other than goodwill, are considered to be properly valued for the purpose of absorption.

Before passing entries in respect of the absorption, A Ltd decided to revalue shares in B Ltd on the same basis as that of the absorption.

The absorption was completed on 1st March 2016 by the issue of necessary shares and debentures in A Ltd and payment of cash B Ltd was thereupon wound be. Expenses amounted to Rs.750 and were paid by A Ltd. Prepare Ledger of B and Journal of A.

Answer/Hints

Books of A

Investment	Dr.	21,600	
To Capital reserve			21,600
(Revaluation of investment)			
Business purchase	Dr.	217,600	
To Liquidator of B			217,600
(PC due)			
Liquidator of B	Dr.	217,600	
To Cash			50,000
To Equity share capital			40,000
To Preference share capital			20,000
To Share premium			26,000
To Investment			81,600
(PC discharged)			
Fixed Assets	Dr.	73,000	

Stock	Dr.	81,510		
Debtors	Dr.	45,000		
Investment	Dr.	10,000		
Bank Balance	Dr.	50,750		
Goodwill (BF)	Dr.	20,265		
To Creditors				17,800
To Provision for bad debts			1,125	
To Liability for debentures			44,000	
To Business Purchase				217,600
(Take over of assets and liabilities)				
Goodwill	Dr.	750		
To Bank			750	
(Realization expenses)				
Liability for Debentures	Dr.	44,000		
To Debentures			44,000	

Books of B

Realisation Account

Particulars	Rs.	Particulars	Rs.
To Fixed Assets	73,000	By Creditors	17,800
To Stocks	85,800	By Debentures	45,000
To Debtors	45,000	By A Ltd (PC)	217,600
To Investment	14,800	By Shareholders (Loss0	8,950
To Bank	50,750		
To Goodwill	20,000		
	289,350		289,350

A Account

Particulars	Rs.	Particulars	Rs.
To Realisation	217,600	By shareholders	81,600
		By Equity Share	64,000
		By Preference share	22,000
		By cash	50,000
	217,600		217,600

Equityshareholders Account

Particulars	Rs.	Particulars	Rs.
To Realisation (loss0	8,950	By Equity Share	120,000
To A Ltd	81,600	By General Reserve	75,000
To Cash	50,000	BY Profit & Loss Account	21,550
To Equity Share	64,000	By Insurance Fund	10,000
To Preference share	22,000		
	226,550		226,550

Working Note:

Calculation of purchase consideration

Particulars	Payable				Receivable	Net Pc
Cash	(160,000	×	0.5)	=	(60,000 ×0.5) = 30,000	50,000
	80,000					
Equity Share	(64,000	×	1.6)	=	(24,000 × 1.6) = 38,400	64,000
	102,400					

Preference \share	(32,000 × 1.1) = 35,200	(12,000 × 1.1) = 13,200	22,000
Total	217,600	81,600	136,000

Question No.9

Gloria and Swanson Ltd had to pass the hands of a receiver for debenture holders who held charge on all assets except uncalled capital. The following is the positions prepared by the receiver:

	Rs.
Share Capital:	
20,000 shares of Rs.50 each fully paid up	10,00,000
1,00,000 shares of Rs.50 each, Rs.25 per share paid up	25,00,000
First debentures	25,00,000
Second debentures	50,00,000
Unsecured Creditors	40,00,000
Bank Balance	30,00,000
Building, Plant and Machinery (estimated to realize Rs.15,00,000)	40,00,000

The following is the interest of Gloria and Swanson in the company:

	Gloria Rs.	Swanson Rs.
First Debentures	20,00,000	5,00,000
Second debentures	30,00,000	20,00,000
Unsecured Creditors	6,00,000	9,00,000
	56,00,000	34,00,000
Share Capital:		
Fully paid shares	5,00,000	5,00,000
Partly paid shares	10,00,000	10,00,000

The following scheme of reconstruction is proposed:

1. Gloria is to cancel Rs.31,00,000 of his total debt, pay cash Rs.5,00,000 and he would be issued Rs.30,00,000 first debentures in lieu of first and second debentures to be cancelled.
2. (a) Swanson is to cancel his total debt by accepting Rs.5,00,000 in cash and Rs.5,00,000 in first debentures.
   (b) Swanson is to surrender for cancellation Rs.5,00,000 worth of fully paid up shares.
3. Unsecured creditors, other than Gloria and Swanson, agree to reduce their debt by 20 percent and accept in lieu thereof 1,00,000 shares of rs.10 each fully paid and the balance in cash payable five equal annual instilments.
4. Uncalled capital is to be called up in full and Rs.40 per share to be cancelled, thus making all shares of Rs.10 each.

Assuming the scheme is duly approved by all parties concerned and by the court, show the reconstructed Balance Sheet and the journal entries in the books of the company.

Answer/Hints

Journal Entries

First debentures	Dr.	2,000,000	
Second debentures	Dr.	3,000,000	
Unsecured creditors	Dr.	600,000	
Bank	Dr.	500,000	
To First Debenture (new)			3,000,000

To Capital Reduction			3,100,000
(Interest of Gloria)			
First Debentures	Dr.	500,000	
Second debentures	Dr.	2,000,000	
Unsecured creditors	Dr.	900,000	
To Bank			500,000
To First Debenture (new)			500,000
To Capital reduction			2,400,000
(Interest of Swanson)			
Equity share capital	Dr.	500,000	
To Capital reduction			500,000
(Equity of Swanson)			
Unsecured Creditors	Dr.	2,500,000	
To Capital reduction			500,000
To Equity share capital (100,000 of Rs.10)			1,000,000
To Loan payable in installments			1,000,000
(Creditors other than Gloria and Swanson)			
Share Final Call	Dr.	2,500,000	
To Equity Share Capital			2,500,000
(Final call on shares)			
Bank	Dr.	2,500,000	
To Share Final Call			2,500,000
(Final call received)			
Equity Share Capital	Dr.	5,500,000	
To Equity of Rs.10			1,100,000
To Capital reduction			4,400,000
(Share of Rs.50 reduced to Rs.10)			
Capital reduction	Dr.	10,500,000	
To Profit & Loss Account			8,000,000
To Fixed Assets			2,500,000
(Loss in p& l account and reduction in fixed assets written off)			
Capital reduction	Dr.	400,000	
To Capital Reserve			400,000
(Balance of capital reduction transferred to capital reserve)			

Balance sheet after reconstruction

Liabilities	Rs.	Assets	Rs.
210,000 shares of Rs.10	2,100,000	Building , Plant etc.	1,500,000
Capital reserve	400,000	Bank Balance	5,500,000
First Debentures	3,500,000		
Loan payable in installments	1,000,000		
	7,000,000		7,000,000

Working Note:

Balance sheet before reconstruction

Liabilities	Rs.	Assets	Rs.
Share capital of Rs.50 paid	1,000,000	Bank Balance	3,000,000
Share Capital of Rs.25 paid	2,500,000	Building, Plant etc	4,000,000
First Debentures	2,500,000	Profit & Loss account (BF)	8,000,000
Second debentures	5,000,000		
Unsecured creditors	4,000,000		

	15,000,000				15,000,000

Question No.10

The balance sheet of X Ltd and Y Ltd as on 31.3.2015 are as below:

Liabilities	X	Y	Assets	X	Y
Equity Shares Capital (Rs.10)	5,00,000	3,00,000	Fixed Assets other than goodwill	3,00,000	2,00,000
Reserve	40,000	20,000	Stock	80,000	60,000
P&L A/c	60,000	40,000	Debtors	1,40,000	90,000
Sundry Creditors	50,000	30,000	Cash at Bank	1,20,000	35,000
			Preliminary Expenses	10,000	5,000
	6,50,000	3,90,000		6,50,000	3,90,000

Y Ltd is taken over by X Ltd as on 1.7.2015. No balance sheet of Y Ltd is prepared as on 1.7.2015. But it is estimated that Rs.20,000 profit has been earned in these three months after charging 10 percent depreciation p.a. on fixed assets. Profit earned by X Ltd over these three months is estimated at Rs.40,000 after charging 10 percent depreciation p.a.

Both the companies have declared and paid 10 percent dividend in the meantime. Purchase consideration is to be satisfied by X Ltd at par neglecting actual value of its share. Goodwill of Y Ltd is valued at Rs.20,000 and fixed assets are valued Rs.10,000 above the estimated book value. Balance Sheet of X Ltd after absorption?

Answer/Hints

Balance Sheet of X Ltd as on 1.7.2015 (after take over)

Liabilities	Rs.	Assets	Rs.
Equity Share Capital	875,000	Goodwill	20,000
Reserve	40,000	Fixed Assets	497,500
Profit & Loss Account	50,000	Preliminary Expenses	10,000
		Net Working Capital	437,500
	965,000		965,000

Working Note:

Balance sheet as on 1.7.2015 (Before absorption)

Liabilities	X	Y	Assets	X	Y
Equity	500,000	300,000	Fixed Assets	292,500	195,000
Reserve	40,000	20,000	Preliminary Expenses	10,000	5,000
Profit & Loss account	50,000	30,000	Net working Capital (BF)	287,500	150,000
	590,000	350,000		590,000	350,000

Purchase Consideration

Goodwill	20,000
Fixed Assets	205,000
Net working capital	150,000
	375,000

Journal Entries in the Books of X Ltd

Business Purchase A/c	Dr.	375,000	
To Liquidator of Y Ltd			375,000

(Purchase consideration due)

Liquidator of Y Ltd	Dr.	375,000	
To Equity Share Capital			375,000

(PC discharged)

Goodwill	Dr.	20,000	
Fixed Assets	Dr.	205,000	
Net Working Capital	Dr.	150,000	
To Business purchase			375,000

Questions based on NAS/NFRS

Question No.11

X limited, a departmental store, deals in 5,000 items. It find difficult to determine cost of each and every inventory items separately and therefore wants to apply retail method. At the year end, it has classified the goods into four categories in accordance with gross profit rate as follows:

Categories	Estimated sales amount (Rs. In million)	Gross Profit %
I	380	15
II	1,120	10
III	2,000	5
IV (15% discount sale category)	3,000	2

What should be the cost of inventory under retail method?

Answer/hints:

Category	Estimated selling price (Rs. in million)	Gross Profit %		Cost (Rs. in million)
I	380	15%	380 × 100/115	330.43
II	1120	10%	1120 ×100/110	1018.18
III	2000	5%	2000 ×100/105	1904.76
IV (15% discount sale category	3000	2%	3000 × 100/102	2941.18
Total cost of Inventory				

Question No.12

AB limited has the following production data and overhead:

Year	Production (units)	Fixed overheads (Rs.)	Variable overheads (Rs.)
2006	1,200,000	11,000,000	5,000,000
2007	1,500,000	13,000,000	6,170,000
2008	1,000,000	14,500,000	4,400,000

Direct labour cost for 2008 = Rs.57,000,000

There was low production in 2008 because of market recession. Can the company include actual fixed overhead for the determination of cost of conversion? Find out conversion cost in accordance with NAS 02.

Answer/hints:

The company had achieved production growth in 2007 and there is a production decline in 2008 because of market recession. So normal capacity can not be linked to 2007 level. The company can derive normal capacity level covering 2006 and if it feels appropriate it can use 2005 or 2004 data as well. A five yearly average production data could be good approximation. However, increase in capacity level should be taken into account. If the company has increased production capacity since 2005, then 2004 data would be irrelevant.

Normal capacity = average capacity = 1,233,333 units

Determination of conversion cost

Direct labour	Rs.57,000,000
Variable overheads	Rs.4,400,000
Fixed overheads (14,500,000 × 1,000,000/1,233,333)	Rs.11,756,759
Total	Rs.73,156,759

Balance of fixed overheads of Rs.2,743,241 (Rs.14,500,000 – Rs.11,756,759) is to be expensed.

Question No.13

AD Limited manufactures three different products X, Y and Z. The joint costs incurred was Rs.18,000. The products did not require any further processing costs after split off point. The output and selling price per unit of each product are:

Products	Selling price per unit	Output in Units
X	Rs.12	200
Y	Rs.8	600
Z	Rs.4	700

Required: Apportion the joint costs.

Answer/hints:

Product	X	Y	Z
Output (units)	200	600	700
Sales value (Rs.)	2,400	4,800	2,800
Joint Cost apportioned (Rs.) (Rs.18,000 in 24: 48 : 28)	4,320	8,640	5,040

Question No.14

ABC Limited was making provision for non-moving stocks based on no issue for the last 12 months upto 31.3.2014.

The company wants to provide during the year ending 31.3.2003 based on technical evaluation:

Total value of stock	100 lakhs
Provision required based on 12 months issue	3.5 lakhs
Provision based on technical evaluation	2.5 lakhs

Does this amount to change in accounting policy? Can the company change the method of provision?

Answer/hints:

The decision of making provision for non-moving stocks on the basis of technical evaluation does not amount to change in accounting policy. The method of estimating the amount of provision may be changed in case a more prudent estimate can be made.

In the given case, considering the total value of stock, the change in the amount of required provision of non-moving stock from Rs.3.5 lakhs to Rs.2.5 lakhs is also not material. The disclosure can be

made for such changes in the following lines by way of notes to the accounts in the annual accounts of ABC Limited for the year 2014-2015:
'The company has provided for non-moving stock on the basis of technical evaluation unlike preceding years. Had the same method followed as in the previous year, the profit for the year and the corresponding effect on the year end net assets would have been higher by Rs.1 lakh.'

Question No.15
How would you deal with the following in the annual accounts of a company for the year ended 31st March 2016?
The company has to pay delayed cotton clearing charges over and above the negotiated price for taking delayed delivery of cotton from the supplier's godown. Up to 2014-15, the company has regularly included such charges in the valuation of closing stock. This being in the nature of interest, the company has decided to exclude it from closing stock valuation for the year 2015-16. This would result into decrease in profit by Rs.7.60 lakhs.
Answer/hints:
As per NAS 08 'Accounting policies, changes in estimates and errors' an entity shall change an accounting policy only if the change is required by a standard; or result in the financial statements provided reliable and more relevant information about the effects of the transactions, other events or conditions on the entity's financial position, financial performance or cash flows. Therefore the changes in the method of stock valuation is justified in view of the fact that the change is on the line with the recommendation of NAS 02 'Inventories' and would result in more appropriate preparation of financial statements.
Also, appropriate disclosure of the changes and the amount by which any item in the financial statement is affected by such change is necessary. Therefore, the under mentioned note should be given the financial statements.
'In compliance of the Nepal Accounting Standard, delayed cotton clearing charges which are in the nature of interest have been excluded from the valuation of closing stock unlike preceding years. Had the company continued the accounting policy followed earlier, the value of closing stock as well as profit before tax for the year would have been higher by Rs.7.60 lakhs'.

Question No.16
A limited company closed its accounting year on 30.06.1998 and the accounts for that period were considered and approved by the board of directors on 20th August, 1998. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on 01.09.1998 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of Rs.80 lakhs. You are required to state with the reasons, how the event would be dealt with in the financial statements for the year ended 30.06.1998.
Answer/hints
NAS 10 'Events after the reporting period' prescribes the accounting treatment or disclosure of events after the balance sheet date, favourable and unfavourable, that occur between the balance sheet date and the date when the financial statements are authorized for issue.
In the given case the incidence, which was expected to push up cost became evident after the date of approval of the accounts. So that was not an event after the reporting period. So it does not any treatment in the financial statements of the period ended on 30.06.1998.
However, this may be mentioned in the Director's Report.

Question No.17
While preparing its final accounts for the year ended 31st March 2015 a company made a provision for bad debts @ 5% of the total debtors. In the last week of February, 2015 a debtor for Rs.2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by insurance policy. In April 2015, the

debtor became bankrupt. Can the company provide for the full loss arising out of insolvency of the debtor in the final accounts for the year ended 31st March 2015?

Answer/hints

As per NAS 10 'Events after the reporting period', assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist estimation of amounts relating to conditions existing at the balance sheet date.

So full provision for bad debts amounting to Rs.2 lakhs should be made to cover the loss arising due to the insolvency in the final accounts for the year ended 31st March 2015. It is because earthquake took place before the balance sheet date.

Had the earthquake taken place after 31st March 2015, then the disclosure in notes to accounts would have been sufficient.

Question No.18

AC Limited purchased a truck for Rs.4,000,000 on 1st January 2009. The management estimates that the following rental charges can be collected during the life of five years:

Year ending	Rental Charges
31st December 2009	Rs.1,500,000
31st December 2010	Rs.1,200,000
31st December 2011	Rs.1,210,000
31st December 2012	Rs.1,000,000
31st December 2013	Rs.650,000

The truck can be sold on 31st December 2013 for Rs.1,200,000.

You are required to calculate entity specific value for AC Limited. (Assume discount rate of 10%)

Answer/hints

Entity specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life. In this case, specific value is Rs.5,096,180.72

$\{1,500,000/ (1+ 0.10)^1 + 1,200,000/ (1+ 0.10)^2 + 1,210,000/ (1+ 0.10)^3 +1,000,000/ (1+ 0.10)^4 + 650,000/ (1+ 0.10)^5 + 1,200,000/ (1+ 0.10)^5\}$

Question No.19

X Limited begun construction of a new building on 1st January 2012. It obtained Rs.1 lakh special loan to finance the construction of the building on 1st January 2012 at an interest rate of 10%. The company's other outstanding two non-specific loans were:

Amount	Rate of Interest
Rs.500,000	11%
Rs.900,000	13%

The expenditure that were made on the building project were as follows:

Date	Amount
January 2012	Rs.200,000
April 2012	Rs.250,000
July 2012	Rs.450,000
December 2012	Rs.120,000

Building was completed by 31st December 2012. Following the principles prescribed in NAS 08 "Borrowing Costs", calculate the amount of interest to be capitalized and pass one Journal Entry for capitalizing the cost and borrowing cost in respect of the building.

Answer/Hints

1. *Calculation of amount eligible for capitalization of borrowing cost*

Rs.200,000 × 12/12	=	Rs.200,000
Rs.250,000 × 9/12	=	Rs.187,500
Rs.450,000 × 6/12	=	Rs.225,000
Rs.120,000 × 1/12	=	Rs.10,000
Total		Rs.622,500

2. *Calculation of weighted average rate of interest on general borrowings*

Amount of Loan	Rate of Interest	Amount of Interest
Rs.500,000	11%	55,000
Rs.900,000	13%	117,000
Rs.1,400,000		172,000

Weighted average rate of interest = $\frac{172,000}{1,400,000}$

= 12.285% (Appx)

3. *Calculation of interest eligible for capitalization*

Specific borrowings (Rs.100,000 × 10%)	=	Rs.10,000
General borrowings (Rs.522,500 × 12.285%)	=	Rs.64,189
Total	=	Rs.74,189

4. *Total amount to be capitalized for building*

Cost of building (Rs.200,000 + Rs.250,000 Rs.450,000 + Rs.120,000)	=	Rs.1,020,000
Amount of interest	=	Rs.74,189
Total	=	Rs.1,094,189

5. *Journal Entry*

Building Account	Dr.	1,094,189	
To Bank Account			1,094,189

Question No.20

31st December 2009 is closing date of AB Limited. It purchased inventory costing US $ 10,000 on 15.4.2009 (when the rate was Rs.75 per US $). The rate of exchange on 31st December 2009 is Rs.76 per US $. And net realizable value of the inventory on 31st December 2009 was US $ 10,200. Find out the value of inventories to be included in financial statements as on 31st December 2009. (Assume functional currency is Rs.)

Answer/Hints

As per NAS 11, carrying amount of non-monetary asset is first determined applying appropriate standards then the provision of NAS 11 applies.

Inventories are valued at lower of cost and net realizable value i.e. at cost of US $ 10,000. The inventories are then translated into rupees applying the rate when the cost was determined i.e. Rs.75. so the value of closing inventories will be Rs.750,000.

Question No.21

AD Limited has taken a plant under operating lease agreement for five years. The lessee will pay Rs.2,500,000 p.a. for first three years and Rs.1,500,000 for remaining two years. How should the lessee account for lease payments applying straight line basis? (Assume that the incremental borrowing cost of the lessee is 10%).

Answer/Hints

1. Determination of annual equated lease payments

Year	Lease Payments	Discount Factor (10%)	Discounted Cash Flow

1	2,500,000	0.9091	2,272,727
2	2,500,000	0.8264	2,066,116
3	2,500,000	0.7513	1,878,287
4	1,500,000	0.6830	1,024,520
5	1,500,000	0.6209	931,382
Total	10,500,000	3.790787	8,173,032
Annual Equated Payments (8,173,032/3.790878)			2,156,025

2. Accounting for operating lease payments

Year	Lease Payments	Charge in Income Statement	Prepaid Lease	Finance Income	Cumulative balance of prepaid lease
1	2,500,000	2,156,025	343,975	0	343,975
2	2,500,000	2,156,025	343,975	34,397	722,347
3	2,500,000	2,156,025	343,975	72,235	1,138,557
4	1,500,000	2,156,025	(656,025)	113,856	596,388
5	1,500,000	2,156,025	(656,025)	59,637	0

3. Accounting entries

Year 1

Operating Lease Charges	Dr.	2,156,025	
Prepaid Lease	Dr.	343,975	
To Bank			2,500,000

Year 2

Operating Lease Charges	Dr.	2,156,025	
Prepaid Lease	Dr.	378,372	
To Bank			2,500,000
To Finance Income			34,397

Year 3

Same way as year 2

Year 4

Operating Lease Charges	Dr.	2,156,025	
To Bank			1,500,000
To Finance Income			113,856
To Prepaid Lease			542,169

Year 5

Same way as year 4.

Question No.22

ABC Limited had 5,000,000 equity shares on 01.01.2001. Net profit for the year is Rs.10,000,000. It had 12% 100,000 convertible debentures of Rs.100 each to be converted into five equity shares. Tax rate is 30%. Calculate (i) Basic Earning per share and (ii) Diluted Earning per share.

Answer:

Calculation of basic earning per share

$$= \frac{\text{Earnings of 2001}}{\text{Weighted average number of shares}}$$

$$= \frac{\text{Rs.10,000,000}}{\text{5,000,000 shares}}$$

= Rs.2.00

Calculation of Diluted Earning per share

Adjusted Earnings = Net Profit + Debenture Interest – Tax on Interest

= 10,000,000 + 12% of 10,000,000 – Tax on Interest

= 10,000,000 + 1,200,000 – 30% of 1,200,000

= 10,840,000

Weighted average number of shares

= Equity shares + Potential Equity shares

= 5,000,000 + 100,000 × 10

= 6,000,000

Diluted earning per share

$$= \frac{\text{Adjusted Earnings of 2001}}{\text{Adjusted Weighted average number of shares}}$$

$$= \frac{\text{Rs.10,840,000}}{\text{6,000,000 shares}}$$

= Rs.1.81

Question No.23

A Limited has a working capital loan of Rs.1,000,000. The working capital loan has been renewed every year in a routine manner. Suggest the company whether to show it as a long term liability or current liability.

Answer/Hints

Working capital loan, which is granted for a period of twelve months, is renewable at the option of the lender and not at the option of borrower. Therefore it is classified as current liability.

Question No.24

Should a bonus issue shall be classified as equity transactions?

Answer/Hints

Yes. The issuer assumes an obligation to distribute additional equity shares by making adjustment to another component of equity say retained earnings. Thus issue of bonus shares results in an equity transactions.

Question No.25

Entity AB has granted 120 stock options to each of its 1,000 employees subject to the condition that they should work for three years from the grant date. Grant date is 1.1.2004. The entity closes its account at the end of December. Fair value of each option is Rs.24. Based upon past experience, the entity expects that 70% of the employees will complete the vesting condition. In 2005, it revises this estimate to 80%. Finally 78% of the employees were found eligible. Show journal entries. Face value of each equity shares of the entity is Rs.10.

Answer/Hints

Journal entries

Date	Particulars		Dr. Rs.	Cr. Rs.
2004	Employees Benefits	Dr.	672,000	
	To Share Suspense A/c			672,000
	(Total charge = (120 × 1000× 70% ×24)/3. Expected no of shares to be vested 84,000 so total charges to equity is Rs.2,016,000 over 3 years)			

2005	Employee Benefits Dr.	816,000	
	To Share Suspense A/c		816,000
	(Revised value of the option Rs.2,304,000 (120 ×1000×80%×24). No. of shares 96,000. Amount charges in 2004 Rs.672,000. Balance of 1,632,000 (2,304,000-672,000) to be charged over 2 years)		
2006	Employee Benefits Dr.	758,400	
	To Share Suspense A/c		758,400
	(Revised value of option Rs.2,246,000 (120 ×1000×78%×24). No of shares 93,600. Amount charged in 2004 Rs.672,000 and charged in 2005 Rs.816,000. Balance to be charged in 2005 Rs.758,400 (2246,000 – 672,000 – 816,000)		

Miscellaneous

Question No.26

The Balance Sheet of Tee Ltd as on 31st December 2015 was as follows:

Liabilities	Rs.	Assets		Rs.
6% Redeemable Preference		Land & Building		2,00,000
share capital (fully paid		Plant & Machinery		6,80,000
shares of Rs.100 each)	2,00,000	Patents		1,00,000
Equity Share Capital (fully		Trade Investments		2,50,000
paid shares of Rs.100 each)	5,00,000	Investment in Govt. Securities		
Capital Redemption Reserve	1,00,000	as current assets (highly liquid)		70,000
Revenue Reserve	2,50,000	Stock in Trade		1,20,000
7% Debentures	2,50,000	Book debts	1,70,000	
Liabilities for goods	1,70,000	Less: Provision	10,000	1,60,000
Provision for:		Cash		1,10,000
Income Tax	1,80,000	Preliminary Expenses		10,000
Equity Dividend	50,000			
	17,00,000			17,00,000

The company has prepared the following (summarized) projected profit and loss account for 2016:

	Rs.		Rs.
To Opening Stock	1,20,000	By Sales	24,00,000
To Purchases	15,00,000	By Closing Stock	1,80,000
To Wages	2,60,000	By Income from trade Invest.	9,000
To Salaries & Other Exp.	2,62,500	By Profit on sale of Machine	6,000
To Interest on debentures	17,500	By Saving in provision for	
To Provision for Depreciation	97,000	income tax for 2015	15,000
To Provision for Income Tax	1,90,000		
To Preference dividend	12,000		
To Proposed Equity dividend	60,000		
To Preliminary Expenses	5,000		
To Balance of profit	86,000		
	26,10,000		26,10,000

You are given the under mentioned further information:

(a) Provision for depreciation as on 31.12.2015 was Rs.2,30,000 against plant and machinery and Rs.20,000 against land and building. Of the amount provided against depreciation Rs.5,000 is for building.
(b) At the end of 2016, the redeemable preference shares are to be redeemed.
(c) New machinery costing Rs.1,50,000 will be installed towards the end of 2016. The machine which will be disposed of cost Rs.40,000 against which Rs.30,000 has been provided as depreciation till 31.12.2015. The sale will take place early in 2016.
(d) The 7% debentures were to be redeemed at the end of 2016. Half of them agree to take new 10% debentures ; others agree to take equity shares.
(e) The Company allows one month's credit to its customers and receives 1 ½ month's credit from its suppliers. Wages Rs.45,000 will be paid in January 2017.
(f) Unclaimed Dividends for 2015 Rs.5,000.

Prepare a statement showing the cash flows in 2016. Assume that to the necessary extent Government securities will be sold at book value and no bank overdraft will be raised. Also give Projected Balance Sheet.

Answer/Hints

Projected Cash Flow Statement for the year 2016

	Rs.	Rs.
1. Operating Activities		
Net profit	86,000	
Adjustment for:		
Interest on debentures	17,500	
Depreciation	97,000	
Tax Provision	190,000	
Preference Dividend	12,000	
Proposed Dividend	60,000	
Preliminary Expenses	5,000	
Income from trade investment	(9,000)	
Profit on sale of machine	(6,000)	
Saving in tax provision	(15,000)	
Adjusted profit	437,500	
Changes in working Capital:		
Increase in stock	(60,000)	
Increase in debtors	(30,000)	
Increase in creditors	17,500	
Increase in o/s wages	45,000	
	410,000	
Less: tax paid	(165,000)	
Cash flow from operating activities		245,000
2. Investing activities		
Purchase of machine	(150,000)	
Sale of Machine	16,000	
Income from investment	9,000	
Cash flow from investing activities		(125,000)
3. Financing Activities		
Interest on debentures	(17,500)	
Preference dividend	(12,000)	
Equity dividend	(50,000)	

Preference redeemed	(200,000)	
Cash flow from financing activities		(279,500)
Cash flow during the year (1 + 2 + 3)		(159,500)
Add: Opening cash and Cash Equivalent (110,000 + 70,000)		180,000
Closing cash and cash equivalent		20,500

Projected Balance Sheet at the end of 2016

Liabilities	Rs.	Assets	Rs.
Equity Share Capital	625,000	Land & Building (220,000 – 25,000)	195,000
Capital redemption reserve	300,000	Plant & Machinery (910,000 -40,000 + 150,000 – 292,000)	728,000
Revenue reserve	50,000	Patents	100,000
Profit & Loss Account	86,000	Investment others	250,000
10% debentures	125,000	Investment Govt	20,500
Creditors	187,500	Stock	180,000
O/s Wages	45,000	Book debts	190,000
Unclaimed Dividend	5,000	Preliminary Expenses	5,000
Provision for tax	190,000	Unclaimed Dividend – Bank	5,000
Proposed dividend	60,000		
	1,673,500		1,673,500

CAP III
REVISION TEST PAPER
ADVANCE FINANCIAL MANAGEMENT

Question No. 1

Assume today is 1 April 2000. KUBL is a bank located and listed in Nepal. Today's exchange rate for the Nepalese Rupee (NPR) is GBP/NPR 76.9231 (that is, GBP 1 = NPR 76.9231).

In recent years, KUBL has experienced a fall in profits as a result of the credit crunch which has weakened the capital base of the bank. Although revenue has risen by 6.3% in the past year, operating profits have fallen by 19% and earnings per share by 9%. In the past KUBL has paid regular quarterly dividends.

Due to the credit crunch and the downturn in the global economy, the Nepalese banking regulator (together with banking regulators around the world) is in the process of introducing higher capital and liquidity requirements for all banks, which will be a legal requirement in twelve months' time. Currently, KUBL would not satisfy these new capital and liquidity requirements.

The board of KUBL has recently met to discuss how best to improve capital and liquidity in order to be able to meet the new requirements. The following two suggestions were made by Board members regarding the next quarterly dividend:

- Director A has suggested that no dividend should be paid.
- Director B has suggested that the normal cash dividend be replaced with a scrip dividend (that is, a bonus issue of shares).

Under the proposed scrip dividend, KUBL would issue shareholders with the right to subscribe for ordinary shares at zero cost in the proportion of 1 new bonus share for every 50 shares held. The rights to receive bonus shares would be issued on 15 May 2000, with the new shares being issued on 31 May 2000. A shareholder would have to choose between the following actions:

1. Sell the rights in the open market for cash at the latest market price for the rights between the dates 15 May 2000 and 31 May 2000.
2. Hold onto the rights until 31 May 2000 and receive new shares in the proportion 1 share for every 50 held on that date.

KUBL has 4,300 million NPR 100 (nominal) ordinary shares in issue. The market price for selling the rights is expected to be in the order of NPR 7 per existing share under the rights. Assume that a typical shareholder in KUBL holds 1,000 ordinary shares of nominal value NPR 100 each and that today's share price is NPR 396.

Required:

a. Discuss the likely impacts on KUBL's share price of an announcement that no dividend will be paid, as suggested by Director A.
b. Evaluate which of the following actions would be more beneficial to a typical shareholder if Director B's suggestion is implemented:
   i. Accepting the shares offered under the scrip dividend.
   ii. Selling the rights under the scrip dividend in the market.
   iii. Your answer should include an estimate of the change in shareholder value in each case based upon today's share price.
c. Recommend which, if either, of the strategies suggested by Director A and Director B, KUBL should adopt.
d. Identify alternative financial strategies (other than changing the dividend policy) that could help improve KUBL's liquidity position.

Question No. 2

Assume today is 1 April 2012.

CBA is a manufacturing company, operating in the United Kingdom (UK), whose shares are listed on the main UK stock exchange. The board needs to raise GBP 250 million to fund a number of planned new investments and is considering issuing either a convertible bond or additional shares.

CBA currently has 280 million GBP 1 ordinary shares in issue and today's share price is GBP 3.60 per share. It also has GBP 195 million (nominal) of undated 6% preference shares. The preference shares each have a nominal value of GBP 1 and are currently quoted at GBP 1.05 per share. CBA currently has no debt.

Financial position prior to new investment or new financing
Earnings per share for the last financial year ended 31 March 2012 are 45 pence per share and the dividend pay-out ratio has been maintained as close as possible to 50% of earnings. Assume that the dividend for the year ended 31 March 2012 has just been paid and was based on 50% of estimated earnings for the year.

The convertible bond would be issued at a 7% discount to its nominal value and carry a coupon rate of 3% per annum. The bond would be convertible into ordinary shares in 4 years' time at the ratio of 23 ordinary shares per GBP 100 nominal of the bond.

Forecast position after issuing the convertible bond and making the new investments Assuming the new investments are undertaken and financed by convertible debt, CBA expects its earnings to grow by 5% per annum for the foreseeable future and to maintain its dividend pay-out ratio at 50%. The share price is expected to rise by 6% per year over the next four year period.

Other information
- CBA pays corporate income tax at a rate of 30% on taxable profits and tax is payable at the end of the year in which the taxable profit arises.
- CBA has sufficient taxable profits to benefit from any tax relief available.

Required:

(a) Calculate the following values assuming that the proposed convertible bond is issued on 1 April 2012:
   i. The forecast conversion value for the convertible bond in four years' time.
   ii. The post-tax cost of debt for the convertible bond based on its yield over the next four years up to and including conversion.
   iii. CBA's post-tax weighted average cost of capital (WACC). For the purpose of this calculation, assume no change in the market value of the ordinary and preference shares as a result of the convertible bond issue.

(b) Advise on the benefits and limitations to CBA of issuing a convertible bond rather than new equity.
(c) Explain the role of CBA's treasury department in evaluating and implementing the convertible bond issue.

Question No. 3
Country T is a small landlocked European country which is outside the euro zone. Its currency is T$ which currently exchanges at GBP/T$ 1.5000 and EUR/T$ 1.2500, (that is, GBP 1 = T$ 1.5000 and EUR 1 = T$ 1.2500).
Unlike many other countries, Country T has a nationalised railway system known as T Railways.T Railways, via its division TPTS, operates cafes in approximately 50% of its 200 stations. The cafes sell

hot and cold drinks and light refreshments to take away or consume on the premises.The Board of T Railways is keen to outsource the operation of some or all of the cafes since theyhave never made large profits. Indeed, some of the cafes in smaller stations have been making losses after having been allocated a share of the station overheads. The Board has been approached by Mr C who is interested in operating the station cafes in five railway stations (which are situated within a 20 mile radius of each other) within a newly formed company, CCC. CCC would pay rent in return for the use of the premises and permission to take over the cafe business and all associated revenues and costs. T Railways estimates that the rent received from CCC when operating these five station cafes would be greater than the head office overheads that are currently re-allocated to those cafes.

The contract to operate the five cafes would be for an initial period of three years starting on 1 January 2014. CCC would be given the option to extend its operations to twenty additional railway stations at the end of the third year and the remainder by the end of 2023, subject to high customer satisfaction scores in relation to the quality of food and drink, standard of décor and level of service provided.

Investment appraisal

Mr C has drawn up estimates of forecast operating cash inflows for a single cafe in the first three years of the project. These are shown below:

Year to 31 December	2014	2015	2016
Number of passengers per station per day	3,600	3,700	3,800
Proportion of passengers using the cafe	9%	12%	15%
Average spend per customer	T$ 3.0	T$ 3.4	T$ 3.6

The railway operates 360 days a year.

Additional information collated by Mr C:

- Operating cash outflows can be divided into:
  - Variable costs per cafe, estimated to be 70% of cash inflows.
  - Fixed costs per cafe, including rent and advertising costs, forecast to be, on average, T$ 90,000 in 2014 and then increase by 7% a year thereafter.

- Staff costs have been included in operating cash outflows but no provision has been made to pay Mr C a salary as he only intends to claim a nominal salary, allowing profits to be retained in the business or paid out as dividends. Due to the amount of time that Mr C would need to spend running the station cafes, he would not also have time to run his existing cafe business and so would need to employ a manager to run this for him at a salary of T$ 50,000 a year in 2014, increasing by 7% a year thereafter.

- An investment of T$ 200,000 per cafe in fixtures and fittings would be required on 1 January 2014, with an estimated residual value of T$ 100,000 per cafe on 31 December 2016.
- Tax depreciation allowances would be available on the investment in fixtures and fittings at a rate of 25% per annum on a reducing balance basis.
- Corporate income tax would be charged at 30% of taxable profits and would be payable at the end of the year in which the taxable profit arises.
- All revenues and costs should be assumed to be cash flows and arise at the end of the year unless otherwise stated.
- The risk free rate is 3% and the market premium is 5%.A national chain of cafes that is 100% equity financed has a published equity beta of 1.28.
- Mr C intends to use this information to calculate a cost of equity for CCC.

Financing the project

Mr C is planning to finance the project 50% from his own savings and 50% from a fixed term bank loan. He estimates that a bank would charge interest of 5.7% a year on a loan, implying a debt beta for CCC of 0.54. However, Mr C has not yet applied to the bank for a loan. If the bank is not willing to provide funding, Mr C has sufficient personal resources to be able to finance the initial stage, that is, the investment in the first five cafes.

Required:
Assume you are a management consultant reporting to Mr C. Write a report in which you:

i. Calculate the following measures in respect of the proposed investment by CCC in five cafes for the initial three year contract as at 1 January 2014:
   - Net Present Value (NPV)
   - Internal Rate of Return (IRR)
   - Payback

   Your answer to this section should assume that bank finance is available and should ignore real options.

ii. Evaluate the potential financial benefit of the project to Mr C. Your answer should consider your results in (b)(i), real options and other relevant factors.(12 marks)

iii. Advise Mr C on the challenges that CCC might face in obtaining a bank loan to finance the project.

Question No. 4
Company MV owns a number of motor vehicle retail showrooms in its home country, Country H. It has grown rapidly in recent years, largely by acquiring land and building new showrooms. The directors of MV are currently considering a number of possible sites for development to achieve further expansion. One or more of these sites may be developed up to a maximum overall capital budget of H$ 100 million. One of the sites being considered is located in a neighboring country, Country J. If selected, this would be the first showroom to be opened in a foreign country. Four possible sites have been identified, each of which would support a certain size of showroom. It would not be possible to change the plans so that only part of a site is developed.
Each possible site has been allocated a project name as shown below. Single period capital rationing is to be applied when selecting projects.

Project data is given below:

Project	Initial investment	Forecast after tax net cash inflow each year for a 10 year period	Risk adjustment (to be added to the H$ WACC)	Project net present value (NPV)	Undiscounted payback period	Profitability index
	H$ million	H$ million	%	H$ million	Years	
Project A	50	12	2.5	33.9	4.2	0.678
Project B	100	20	2.0	49.1	5.0	0.491
Project C	75	15	1.5	39.7	5.0	0.529
	J$ million	J$ million	%	J$ million	Years	
Project D	80	20	2.5	To be calculated	To be calculated	To be calculated

Note that projects A, B and C are located in MV's home country (Country H) and project D is located in neighboring Country J.

Additional data:

- Based on its target gearing, MV has an after tax Weighted Average Cost of Capital (WACC) of 9.5%.
- The risk free rate is 2% in Country H and 4% in Country J.
- The spot rate is currently H$/J$ 2.2900 (that is, H$ 1 = J$ 2.2900).
- Each project has a 10 year term.
- The residual value of each project at the end of its 10 year term should be assumed to be equal to the value of the initial investment.

A separate decision has yet to be made about to best finance the selected project or projects.

Question No. 5

(a) Briefly describe the meaning of the term Efficient Market Hypothesis.

(b) Kinsale PLC a quoted company on The Stock Exchange has 5,000,000 shares in issue. Their current market price is €4 per share. Bantry PLC another Irish quoted company has 4,000,000 shares in issue currently trading at €10 each. This may be taken as the situation on day 0.

On day 3 the Board of Bantry PLC decide at a private meeting to make a takeover bid for Kinsale PLC. At the Board meeting Bantry PLC's Financial Director informs her fellow board members that a detailed assessment of the synergistic benefits of the takeover is estimated at having a Net Present Value of 10,000,000. The Board agrees to propose a cash offer to shareholders in Kinsale PLC of 6 per share. There will be no paper consideration.

On day 6 the board of Bantry PLC publicly announce the terms of their offer. They do not release details as to the potential synergistic benefits.

On day 10 Bantry PLC's Board announce publicly details of the potential synergistic benefits.

Required:

Ignoring tax and the time value of money between day 0 and 10, and assuming that no other factors have influenced the share price of both Bantry PLC and Kinsale PLC, determine the:

Day 0

Day 3

Day 6

Day 10

share price of both companies if, The Stock Exchange is considered to display:

(a) Semi-strong Form Efficiency

(b) Strong Form Efficiency

Question No. 6

A client company, Dunnycove PLC, is planning to purchase a Polish subsidiary, Wisla Limited. The target company will operate in Poland and its assets will be denominated in the local currency, the Polish Zloty. The most recent Balance Sheet of the target company is condensed as follows:

Wisla Limited

Summary Balance Sheet as at 31st March 2008

	Zloty (millions)
Non-Current Assets	200
Current Assets	40
Current Liabilities -	60
Non-Current Liabilities -	30
Total Net Assets to be acquired	150

The Management of Wisla Limited have indicated that a price of 150 million Polish Zloty would be acceptable to them.
Due diligence auditors have encountered a number of significant unresolved problems relating to the legal title of Wisla Limited's property assets. They have indicated that their final report is expected to be issued in one month's time. Given this unexpected delay it is likely that the completion of the proposed takeover will take six months.
You have researched the foreign exchange rates between the Polish Zloty and the €Euro. Relevant details are:

- today's spot rate is 3.5 zloty – 3.8 zloty to the € euro
- annual interest rates in the euro zone stand at 3% depositing and 6% borrowing
- annual interest rates in Poland stand at 4% depositing and 8% borrowing

As the Polish government is considering carefully whether to enter the euro-zone there is significant concern about the stability of the Polish Zloty.

REQUIRED:

a. Calculate today's euro cost of the purchase of Wisla Limited in six month's time if the foreign exchange risk associated with the payment of 150 Million Zloty is hedged using the money markets.
b. Advises your client as to the nature and suitability of buying a foreign currency option for the proposed purchase of Wisla Limited.
c. Explains the meaning of foreign currency translation risk, and
d. How (without illustrations) foreign currency translation risk could be avoided in the event that Dunnycove PLC acquires Wisla Limited?

Question No. 7
Write a brief note outlining the meaning and significance of the following terms:

- The stages in an effective foreign exchange transaction risk strategy.
- Adjusted Present Value.
- The Benefits of Centralised Treasury Management.
- The Residual Theory of Dividends.
- Financial Risk.
- Business Risk.
- Co-efficient of Correlation of an Investment Portfolio.

Question No. 8
Your client, Rajaram Bhandari, provides back packers with cheap overnight accommodation in Thamel and Nagarkot. Rajaram has been considering growing the business, but is of the view that the current market is saturated. A friend recently asked Rajaram if he is interested in buying a hostel located in Bandipur. Rajaram is excited at this proposal and has researched the opportunity, which he has summarised as follows:

The hostel has twelve family rooms, twenty twin rooms and thirty single rooms. Each family room is expected to be occupied by three guests, whilst twin rooms will always be occupied by two guests. Rajaram estimates that he will be able to charge NRs.100 per family room per night, NRs.70 per twin room per night and NRs.50 per single room per night. It is anticipated that these room rates will remain at the above level for two years and that they will increase by 10% per annum thereafter.

The hostel will be open for 300 nights per year. Rajaram expects the following occupancy rates to be achieved over the next three years:

% Occupancy Rates

Year/Room Type	Family	Twin	Single
Year 1 - 2011	60	50	70
Year 2 - 2012	50	60	75
Year 3 - 2013	70	70	80

The present staffing level of the hostel is as follows:

Details	Number of Staff	Annual Salary
Security Staff	4	NRs.25,000
Housekeeping Staff	2	NRs.21,000
Cleaning Staff	3	NRs.19,000
Reception Staff	4	NRs.36,000
Maintenance Staff	1	NRs.41,000
Management Staff	1	NRs.42,000

Rajaram is of the opinion that security staff and reception staff numbers could be reduced by 50%. Each member of staff made redundant would be paid a full year's wages payable immediately.
Employees will receive a pay increase of 4% effective from year 2 followed by a further 10% uplift each year thereafter.
The annual running costs are as follows:

- Rates of NRs.40,000 in year one, expected to increase by 15% per annum thereafter.
- Light & Heat – A fixed annual charge of NRs.10,000. The annual charge is expected to decrease by NRs.1,000 per annum commencing in year 2.
- Gas – A variable cost of NRs.5 per night per room occupied. This cost is expected to increase by 5% per year commencing in year 3.
- Laundry will cost NRs.2 per night per guest. This charge is not expected to increase for the next three years.
- Depreciation of NRs.20,000 will be charged on sundry items of equipment.

Rajaram has yet to meet the vendors of the hostel to agree an acceptable price. Rajaram's cost of capital is 10%. Rajaram has made it abundantly clear to you that he will only invest in a hostel which delivers a discounted payback of three years or less.

Required:

a) Determine the maximum amount payable for the Bandipur Hostel if it must achieve a discounted payback after three years (ignore taxation).
b) Consider five qualitative factors that Rajaram should consider before deciding whether or not to purchase the Bandipur Hostel.

Question No. 9

Specify the MBOs reasons for success (compared to 3rd party acquisition)

Question No. 10

S PLC has recently been approached by R PLC, who has expressed an interest in buying the company for a cash consideration. You have been asked to advise the Senior Management of R PLC in relation to placing an indicative value on the business. Thus far you have discerned the following information:

- S PLC pays corporation tax at an effective rate of 20%.
- S PLC's annual average post-tax profits for the last four years was €440 million.

The company's most recent audited Statement of Financial Position reads as follows:

S PLC
Statement of Financial Position as at 31st March 2011

	Amount in Millions
Non-Current Assets at NBV	
Land & Buildings	4,200
Other Assets	425
Total Non-Current Assets	4,625
Current Assets	
Inventories	650
Trade Receivables	875
Cash & Cash Equivalents	0
Total Current Assets	1,525
Total Assets	6,150
Equity & Liabilities	
Equity Attributable to Equity Holders	
Ordinary Shares @ €1 each	2,000
8% Preference Shares at €2 each	800
Other Reserves	590
Total Shareholder's Equity	3,390
Non-Current Liabilities	
4% Debentures redeemable 30/8/2015	2,000
Current Liabilities	
Trade Payables	250
Short Term Borrowings	390
Current portion of Long Term Borrowings	120
Total Current Liabilities	760
Total Liabilities	6,150

Notes:

i. R PLC intends to take over all non-current assets. The Land and Building assets have recently been independently valued at 5,500 million.
ii. R PLC will immediately on acquisition, pay off the debentures at 60% to par.
iii. S PLC was last subject to a revenue audit in 2000.
iv. R PLC will sell off the healthcare division on acquisition for an estimated 600 million. This division has net assets of 300 million and delivers average annual profits before tax of 90 million.
v. R PLC plans to close the natural gas division of S PLC due to average annual pre-tax losses of 20 million. The cost of closure is estimated at 10 million which is tax deductible.
vi. S PLC's pension fund was last subject to actuarial valuation in 2005. The Directors of the company estimate that the scheme is underfunded by 150 million, which could be funded by increased employer contributions of 5 million per annum for the foreseeable future. Pension contributions are tax deductible.
vii. S PLC's Statement of Financial Position includes damaged stocks estimated at 4 million and a probable bad debt of 10 million.
viii. R PLC's most recent EPS was 36 per ordinary share. Its ordinary shares are trading at 288 ex div.
ix. S PLC has agreed to the commencement of the due diligence audit.

Required:
(a) Provide the Senior Management Team of R PLC, in the context of the potential purchase of S PLC, estimates of the valuation of S PLC using the following methodologies:
(i) Net Assets Basis.
(ii) Earning Basis.

Question No. 11
NATAK PVT. LTD. is a company that stages theatrical events throughout Nepal. The company is contemplating producing a movie of one of its most popular productions, Pashupati Prasad. The company's Development team has to date, spent NRs.80,000 researching the commercial elements and costs associated with producing and marketing the proposed film. Their findings were as follows:

Box - Office Projections

Year	Year 2	Year 3	Year 4
Viewers	100,000	50,000	20,000

The company will receive 3 per cinema viewer throughout the three years. This will reduce to NRs.2.75 in any year that the movie is viewed by in excess of 75,000 viewers.
The movie will be made in year 1 of the proposal and released for viewing/sale/download for a three year period commencing in year 2.
The company also forecasts that 10,000 DVDs of the movie will be sold in each of the three years of release at an initial price of NRs.10 in year 2, reducing by NRs.2 per year thereafter in order to prolong sales.
In addition, it is anticipated that the movie may be downloaded at a cost to the purchaser of NRs.5 per download. The hosting website "E-Tunes" commission schedule is as follows:

E - Tunes - Commission Schedule

Downloads	1-10,000	10,001-20,000	20,001 +
Commission %	20%	30%	40%

NATAK PVT. LTD. expects that the following number of downloads will be sold in each year.

Projected Downloads

Year	Year 2	Year 3	Year 4
Number	18,000	50,000	5,000

The movie will incur the following promotional costs:

Projected Promotional Costs

Year/Cost	Year 2	Year 3	Year 4
Print Media	50,000	20,000	20,000
Premier Event	20,000	n/a	n/a
DVD Posters	10,000	10,000	0
Internet Adverts	5,000	5,000	5,000

The cost of producing this movie will be as follows:

A producer has been selected. This producer will be paid NRs.40,000 immediately and a commission of 5% of allgross revenues accruing to NATAK PVT. LTD.. This commission is to be paid one year after the revenues accrue to NATAK PVT. LTD..
The cost of the movie cast will be:

Forecast Acting Costs

Particulars	Cost Units	Cost per Actor
Lead	2	50,000

Support	8	20,000
Extras	400	50

Equipment costing NRs.100,000 will be purchased at the outset of the production. It will be resold when the movie is completed at the end of year 1 for estimated sales proceeds of NRs.50,000.

NATAK PVT. LTD.'s Financial Director has asked you to use the company's Weighted Average Cost of Capital (WACC) for the purpose of determining the project's Net Present Value. You have discerned the following information in relation to the company's various sources of finance:

NATAK PVT. LTD. - Financial Structure

Source of Finance	Nominal Value (NRs. MIllions)
NRs.200 Ordinary Shares	15
NRs.100 20% Preference Shares	5
8% Irredeemable Loan Stock	4

The ordinary shares are trading at NRs.350 ex dividend, whilst the preference shares are trading at NRs.240. The recently confirmed preference dividend of NRs.20 per share has not been paid as yet. The loan stock is trading at par ex int.

The most recent dividend paid on NATAK PVT. LTD.'s ordinary shares was NRs. 40 cent per share. The average annual rate of growth in ordinary shares is 8%, which is likely to continue for some years to come.

NATAK PVT. LTD. pays Corporation Tax at an effective rate of 19%.

REQUIREMENT:

(a) Advise NATAK PVT. LTD., based on strictly net present value criteria, whether or not it should embark on the production of the proposed movie.

(b) Discuss four qualitative factors that should be considered when deciding whether or not to produce the movie.

Question No. 12

Write a brief note outlining the meaning and significance of the following terms:

(i) Money Market Hedge.
(ii) Bonus/Scrip Dividends.
(iii) Deep Discount Bonds.
(iv) Co-efficient of Correlation (between investments).
(v) Management Buyouts (MBOs).
(vi) Contents of a Business Plan.
(vii) Income-based business valuations.

Question No. 13

For a number of years Daikon Co has been using forward rate agreements to manage its exposure to interest rate fluctuations. Recently its chief executive officer (CEO) attended a talk on using exchange-traded derivative products to manage risks. She wants to find out by how much the extra cost of the borrowing detailed below can be reduced, when using interest rate futures, options on interest rate futures, and a collar on the options, to manage the interest rate risk. She asks that detailed calculations for each of the three derivative products be provided and a reasoned recommendation to be made.

Daikon Co is expecting to borrow $34,000,000 in five months' time. It expects to make a full repayment of the borrowed amount in 11 months' time. Assume it is 1 June 2015 today. Daikon Co can borrow funds at LIBOR plus 70 basis points. LIBOR is currently 3·6%, but Daikon Co expects that interest rates may increase by as much as 80 basis points in five months' time.

The following information and quotes from an appropriate exchange are provided on LIBOR-based $ futures and options.
Three-month $ December futures are currently quoted at 95·84. The contract size is $1,000,000, the tick size is 0·01% and the tick value is $25.
Options on three-month $ futures, $1,000,000 contract, tick size 0·01% and tick value $25. Option premiums are in annual %.

December calls	**Strike price**	**December puts**
0·541	95·50	0·304
0·223	96·00	0·508

Initial assumptions
It can be assumed that settlement for both the futures and options contracts is at the end of the month; that basis diminishes to zero at a constant rate until the contract matures and time intervals can be counted in months; that margin requirements may be ignored; and that if the options are in-the-money, they will exercised at the end of the hedge instead of being sold.
expiry. Instead, they more likely to be sold and the positions closed.

Required:
Based on the three hedging choices available to Daikon Co and the initial assumptions given above, draft a response to the chief executive officer's (CEO) request made in the first paragraph of the question.

Question No. 14
Further assume in Q 13 that:
In the talk, the CEO was informed of the following issues:
(i) Futures contracts will be marked-to-market daily. The CEO wondered what the impact of this would be if 50 futures contracts were bought at 95·84 on 1 June and 30 futures contracts were sold at 95·61 on 3 June, based on the $ December futures contract given above. The closing settlement prices are given below for four days:

Date	Settlement price
1 June	95·84
2 June	95·76
3 June	95·66
4 June	95·74

(ii) Daikon Co will need to deposit funds into a margin account with a broker for each contract they have opened, and this margin will need to be adjusted when the contracts are marked-to-market daily.
(iii) It is unlikely that option contracts will be exercised at the end of the hedge period unless they have reached
Discuss the impact on Daikon Co of each of the three further issues given above. As part of the discussion, include the calculations of the daily impact of the mark-to-market closing prices on the transactions specified by the CEO.

Question No. 15
K Plc is a quoted company which operates in the oil exploration industry. Over the last year, the company has achieved a significant increase in sales while experiencing a worsening cash position. Management decided to sell plant assets to shore up the worsening cash position and now are particularly concerned about this continuing trend of cash depletion. A summary of K Plc's recent Income Statement reveals the following:
K Plc
Income Statement Extracts
Year ended 31 December 2012 M's
Turnover 4,500

Cost of sales	-2,300
Gross profit	2,200
Expenses	-1,100
Taxation	-200
Net profit	900

K Plc wishes to raise a further 50 million using asset-backed lending at an interest rate of 6% per annum. The company pays corporation tax at an effective rate of 10%

Notes:
1. K Plc's 5 million ordinary shares in issue are presently trading at 77.5 cum-div. 10% growth is expected in ordinary dividend each year.
2. Preference shares have an ex-div market value of 115

Compute K Plc's proposed WACC (based on 31/12/2012 information) if the 50 million loan is obtained as planned.

Question No. 16
Assume a 3-period Cox-Ross-Rubinstein model. The annual interest rate with continuous compounding is r = 0:06. The volatility of the stock is ¾ = 0:2 with a price of S(0) = 100. Furthermore, there exists an American Put with maturity date T = 1 und strike K = 90.
(a) Calculate the risk-neutral probability and the stock prices at each node in the binomial tree (correct up to 2 decimal places after the decimal point).
(b) Calculate the value of the American Put for all nodes in the tree.
(c) What is the optimal stopping time? Justify your answer.

Question No. 17
To finance capital investment in its domestic market, the Chaudhary Company raised 150 million through the issue of 12-year floating rate notes at 120 basis points over LIBOR, interest payable at six month intervals. Following a review of the current yield curve, the company's Chief Financial Officer has become concerned about the potential impact of rising LIBOR on the firm's future cash flows. The loan now has 10 years to maturity. The CFO asks you, his deputy, to examine the choices that are now available to the firm and to recommend the best course of action. She comments that a swap is an obvious choice but that she would appreciate a briefing on the advantages and disadvantages of the alternative approaches to managing the company's interest rate risk and an estimate of the six monthly Value at Risk (VaR) if nothing is done.

As part of your investigation you note that 10-year swap rates are quoted at 5·25–5·40.

In estimating the VaR you note that the firm has a policy of 95% confidence level on its exposure to non-core risk and that the annual volatility of LIBOR is currently 150 basis points.
Required:

i. Evaluate the alternative choices the company has for managing its interest rate exposure and recommend, with justification, the course of action the company should follow.
ii. Estimate the six-monthly interest rate and the effective annual rate payable if a vanilla interest rate swap is agreed.
iii. Estimate the six monthly Value at Risk on the interest rate exposure associated with this borrowing and comment upon the interpretation of the result.

Question No. 18

Asteroid Systems is a German-based company with a subsidiary in Switzerland. The company's financial manager expects the Swiss business will remit the equivalent of Euros 1·5 million in two months. Her expectations of the future remittance are based upon the current SFr/Euro forward rate.
The current spot and forward rates for Swiss francs against the Euro are extracted from the Financial Times and are shown in the table below.

	Closing mid-point	Change on day	Bid/offer spread	Days mid high	low	One month Rate	Annual %	Three month Rate	Annual %
SFr/€	1·6242	0·0107	239–244	1·6261	1·6147	1·6223	1·4	1·6176	1·6

In the Euro money market the company can make fixed interest deposits at LIBOR and can borrow at LIBOR plus 20 basis points for terms of greater than one month but up to six months. The company can borrow at fixed rates in the Swiss money market. LIBOR rates, as quoted in the Financial Times, are as follows:

	EUR	**CHF**
spot	3·56688	2·06000
1 week	3·57300	2·06000
2 week	3·58438	2·07000
1 month	3·60900	2·08000
2 month	3·72538	2·17000
3 month	3·78238	2·20000

The company's financial manager is keen to eliminate transaction risk. However, because of the margin requirements and their impact upon the firm's cash flow, she would prefer not to use exchange traded derivatives. Swiss franc borrowing or lending rates would need to be negotiated with the bank.
Required:
(a) Estimate the lowest acceptable Swiss borrowing or lending rate for a money market hedge maturing in two
months.
(b) Discuss the relative advantages and disadvantages of the use of a money market hedge compared with using exchange traded derivatives for hedging a foreign exchange exposure.
(c) Discuss the extent to which currency hedging can reduce a firm's cost of capital.

Question No. 19
Neptune is a listed company in the telecommunications business. You are a senior financial management advisor employed by the company to review its capital investment appraisal procedures and to provide advice on the acceptability of a significant new capital project – the Galileo.

The project is a domestic project entailing immediate capital expenditure of 800 million at 1 July 2008 and with projected revenues over five years as follows:

Year ended	**30 June 2009**	**30 June 2010**	**30 June 2011**	**30 June 2012**	**30 June 2013**
Revenue (million)	680·00	900·00	900·00	750·00	320·00

Direct costs are 60% of revenues and indirect, activity based costs are 140 million for the first year of operations, growing at 5% per annum over the life of the project. In the first two years of operations, acceptance of this project will mean that other work making a net contribution before indirect costs of 150 million for each of the first two years will not be able to proceed. The capital expenditure of 800 million is to be paid immediately and the equipment will have a residual value after five years' operation of 40 million. The company depreciates plant and equipment on a straight-line basis and, in this case, the annual charge will be allocated to the project as a further indirect charge.

Preconstruction design and contracting costs incurred over the previous three years total $50 million and will be charged to the project in the first year of operation.
The company pays tax at 30% on its taxable profits and can claim a 50% first year allowance on qualifying capital expenditure followed by a writing down allowance of 40% applied on a reducing balance basis. Given the timing of the company's tax payments, tax credits and charges will be paid or received twelve months after they arise. The company has sufficient other profits to absorb any capital allowances derived from this project.
The company currently has 7,500 million of equity and 2,500 million of debt in issue quoted at current market values. The current cost of its debt finance is LIBOR plus 180 basis points. LIBOR is currently 5·40%, which is 40 basis points above the one month Treasury bill rate. The equity risk premium is 3·5% and the company's beta is 1·40. The company wishes to raise the additional finance for this project by a new bond issue. Its advisors do not believe that this will alter the company's bond rating. The new issue will incur transaction costs of 2% of the issue value at the date of issue.
Required:
(a) Estimate the adjusted present value of the project resulting from the new investment and from the refinancing proposal and justify the use of this technique.
(b) Estimate the modified internal rate of return generated by the project cash flows, excluding the effects of refinancing.

Question No. 20
Small Company, a UK company, has an opportunity to invest in Nepal for three years, by setting up and operating an operations centre on behalf of the Nepal government. The cost of establishing the centre will be 3 million Rupees. At the end of the three years, Nepal government will pay 6 million Rupees to purchase the centre from Small Company and take over the operations. During the three years that Small Company will operate the centre, the Nepalese government will pay an annual fee of 2,000,000 Rupees. The entire operation will be free from tax.
The current exchange rate is £1 = 90.00 Rupees spot. There is no forward market in Nepal. Economic conditions in Nepal are unstable, and the expected inflation rate in the country over the next three years could be anywhere between 10% and 50%.
Inflation is expected to be negligible in the UK.

A bank in Nepal has identified a Nepalese company that would be interested in entering a currency swap with Small Company. The swap would involve the exchange of 3 million Rupees at the current spot rate, at the beginning and the end of the swap. An opportunity for credit arbitrage exists, because the rates at which Small company and the Nepalese swap counterparty can borrow directly for three years are as follows.

	Sterling	Nepalese Rupee
Small Company	6.5%	NIBOR + 2%
Nepalese counterparty	8.5%	NIBOR + 1.5%

NIBOR is the Nepalese inter-bank offered rate, which is usually set very close to the inflation rate in Nepal.

The bank would take an annual fee of 0.5% in sterling for arranging the swap, and Small Company would receive 75% of the net arbitrage benefit from the swap.
Required
(a) Suggest how a currency swap might be arranged between the counterparties, and indicate whether Small Company would arrange the swap if it decides to invest in the project.

(b) Making whatever assumptions you consider necessary and using a discount rate of 15%, recommend whether Small Company should undertake the project.

Question No. 21

X ltd. & Y ltd. are two fast growing companies in the IT industry. They're close competitors and their asset composition, capital structure & profitability records have been similar for several years. The primary difference is dividend policy only. Their recent EPS, DPS & MPS are as follows:

	X Ltd.			Y Ltd.		
Year	EPS	DPS	MPS Range	EPS	DPS	MPS Range
1	9.3	2	75 - 90	9.50	1.90	60 - 80
2	7.4	2	55 - 80	7.00	1.40	25 - 65
3	10.5	2	70 -110	10.50	2.10	35 - 80
4	12.75	2.25	85 - 135	12.25	2.45	80 - 120
5	20	2.5	135 - 200	20.25	4.05	110 - 125
6	16	2.5	150 - 190	17.00	3.40	140 - 180
7	19	2.5	155 - 210	20.00	4.00	180 - 190

Calculate:

Use average price where the following calculations require use of market price

i. Determine Dividend payout & PE ratio for both the company for all the years
ii. Determine the average D/P & PE ratios
iii. The management of Y ltd. is puzzled as to why it's share price is quoted below X Ltd.'s though its earnings are higher than that of X Ltd's.
iv. Determine the return on equity for each of the given years for both companies. (assume the companies issued each of these shares at par value of NRs. 100 on year zero)

Question No. 22

Kenduri Co is a large multinational company based in the UK with a number of subsidiary companies around the world. Currently, foreign exchange exposure as a result of transactions between Kenduri Co and its subsidiary companies is managed by each company individually. Kenduri Co is considering whether or not to manage the foreign exchange exposure using multilateral netting from the UK, with the Sterling Pound (£) as the base currency. If multilateral netting is undertaken, spot mid-rates would be used.

The following cash flows are due in three months between Kenduri Co and three of its subsidiary companies. The subsidiary companies are Lakama Co, based in the United States (currency US$), Jaia Co, based in Canada (currency CAD) and Gochiso Co, based in Japan (currency JPY).

Owed by	Owed to	Amount
Kenduri Co	Lakama Co	US$ 4·5 million
Kenduri Co	Jaia Co	CAD 1·1 million
Gochiso Co	Jaia Co	CAD 3·2 million
Gochiso Co	Lakama Co	US$ 1·4 million
Jaia Co	Lakama Co	US$ 1·5 million
Jaia Co	Kenduri Co	CAD 3·4 million
Lakama Co	Gochiso Co	JPY 320 million

Lakama Co Kenduri Co US$ 2·1 million

Exchange rates available to Kenduri Co
US$/£1 CAD/£1 JPY/£1
Spot 1·5938–1·5962 1·5690–1·5710 131·91–133·59
3-month forward 1·5996–1·6037 1·5652–1·5678 129·15–131·05
Currency options available to Kenduri Co
Contract size £62,500, Exercise price quotation: US$/£1, Premium: cents per £1

Exercise price	Call Options		Put Options	
	3-month expiry	6 month expiry	3-month expiry	6 month expiry
1.60	1.55	2.25	2.08	2.23
1.62	0.98	1.58	3.42	3.73

It can be assumed that option contracts expire at the end of the relevant month
Annual interest rates available to Kenduri Co and subsidiaries

Country	Borrowing rate	Investing rate
UK	4·0%	2·8%
United States	4·8%	3·1%
Canada	3·4%	2·1%
Japan	2·2%	0·5%

Required:
Advise Kenduri Co on, and recommend, an appropriate hedging strategy for the US$ cash flows it is due to receive or pay in three months, from Lakama Co. Show all relevant calculations to support the advice given.

Question No. 23
Your client J Limited expects to win a tender for a contract to supply tables for South African schools. The tender will be for the supply of 40,000 tables in three months time and a further 60,000 tables in nine months time. The tender price was quoted at 750 South African Rand (ZAR) per table. If J Limited wins the tender, the South African schools department will pay for the tables in South African Rand three months after the receipt of each batch of tables.
J Limited has sourced the tables in Australia. If they are successful in winning the tender their Australian supplier will charge $100 (Australian) per table. All tables will be dispatched directly to South Africa. The Australian supplier has agreed that full payment (for all tables) will be made by J Limited in 12 month's time.
You have researched the relevant exchange rate information which is summarised in the following table:

Exchanges Rates	**ZAR/€**		**Aus $/€**	
Spot	**12.5**	**13**	**1.9**	**1.95**
3 Month Forward	30 cent premium	32 cent premium	10 cent discount	15 cent discount
6 Month Forward	40 cent premium	44 cent premium	12 cent discount	16 cent discount
9 Month Forward	60 cent premium	68 cent premium	14 cent discount	18 cent discount
12 Month Forward	80 cent premium	90 cent premium	18 cent discount	20 cent discount

Your bank has quoted the following standardised currency options rates;

Option Type	Exercise Price	6 Month Premium	9 Month Premium	12 Month Premium	Contract Size
ZAR Put	12	0.25	0.4	0.55	500,000 ZAR
Aus $ Call	2	0.4	0.6	0.8	100,000 Aus $

Each premium is quoted in €s per 100 units of the relevant foreign currency.

Required:

a) If J Limited is successful in winning the tender, advise on the profit it will secure if the foreign exchange risk is hedged using the forward exchange market. (Ignore the time value of money, taxation and transaction charges).
b) Advise on the appropriateness of a Forward Exchange Contract hedge for these related South African and Australian transactions.
c) Determine the profit on the contract if the foreign currency transaction risk relating to all potential transactions is hedged using standardised currency options.
d) Set out three limitations of using Currency Options as a method of hedging foreign currency transaction risk.

Answer Hint

Answer to Q. No. 1

a) If an announcement is made that no dividend is to be paid, there are two aspects to be considered. Firstly, the speed of any reaction and secondly, how the market will react.

- The speed of reaction of the market will be dependent upon its efficiency level. If the market is only weak form efficient then the share price is unlikely to react straight away (because in such a market the share price reacts very slowly to any new information released about a company). If however the market is semi-strong form efficient then the market will react instantly to the announcement of a zero dividend (because, by definition, semi-strong form means that there will be an instant reaction to any new information). If the market is strong form efficient then the market will in effect have already reacted to the news about a zero dividend prior to it being realised and hence there would be no further share price impact. Markets are generally found to be semi- strong form efficient and therefore we would expect the market to react straight away to the announcement.

- In relation to whether the share price will go up, down or stay the same there are a number of considerations to bear in mind:
  - Dividends simply move cash from cash owned by the shareholders in the company to the shareholders' own pockets. Theoretically therefore the value of the company does not change and therefore, all things being equal the share price should not change.
- From a behavioral finance standpoint, it is known that investors prefer dividends, if they are paid, to be stable or increasing. In most developed markets dividend payments are often seen to signal the health of a company and there is an expectation that for most companies the markets expect to see a stable dividend policy. Therefore if KUBL, having previously paid a substantial dividend, announces that it will not pay a dividend this year, it is likely that the market will react unfavourably and hence the share price will fall (possibly quite significantly) as investors sell shares.
- However, markets are a little more sophisticated than that and it's possible that given the credit crunch, drop in profits and the expectation of stricter funding requirements for banks in the future, the market may have already built in an expectation of either a zero dividend or a vastly reduced dividend. If this is the case then the drop in share price would be reduced if indeed it drops at all

(some investors may even perceive the lack of a dividend as evidence of sound management in such an economic climate which could in fact bolster the market.)

(b)

(i) Shareholder who accepts the shares

A typical shareholder with 1000 shares will receive an entitlement to one new share for every 50 held. That is, the right to acquire 20 new shares (where 20 = 1,000/50). This may give the shareholder the illusion of increased "value" as he now holds 1,020 shares. However, the company itself has not changed in value and so the total value that those shares represent is unchanged.

The share price can be expected to fall to the extent that the 1,020 shares will have exactly the same value as the original 1,000, that is NPR 396,000.This implies a fall in the share price to NPR 388.24 (= NPR 396,000/1,020).

(ii) Shareholder who sells the rights

If the rights are sold, a typical shareholder should receive NPR 7,000 in total (where NPR 7,000 = 1,000 x NPR 7).

If the remaining 1,000 share are worth NPR 388.24 each, the shareholder's total worth can be estimated to be NPR 395,240 (= NPR 388,240 + NPR 7,000).

This is marginally less than in (i) above, indicating that it is better for the shareholder to accept the new shares rather than sell the rights. Note, however, that it is likely that arbitrage activity in the market will close out any discrepancy between (i) and (ii) and so the shareholder should be largely indifferent between the two options.

Again, there is an impression of increased "value" as a result of the NPR 7,000 receipt, but this is largely illusory due to the likely corresponding fall in the share price.

(c)

In theory, shareholders should be indifferent between a zero dividend and a scrip dividend and the decision should have no impact on company value. However, it is important for the board of KUBL to fully understand how the market is likely to react to the news.

Assuming that the market is already anticipating some change in the dividend policy because of the economic environment (as discussed already in part (a)) then it's possible that it will react better to Director B's suggestion of a scrip dividend rather than no dividend at all, as at least investors feel that they are getting something. However, the larger and more sophisticated the investor the more they will understand that the scrip dividend has no bearing on the overall value of their investment.

Indeed, there are a number of disadvantages with the scrip dividend from KUBL's point of view. Firstly, a scrip dividend will incur significant administrative costs whilst a zero dividend will not. Secondly, a greater number of shares in circulation may increase the pressure for dividend payouts in the future as the dividend per share would be lower for the same total dividend payment. Thirdly, a scrip dividend has the effect of moving reserves from distributable to non-distributable by increasing share capital. This reduces the reserves available for distribution as dividends at a future date.

However, despite the drawbacks associated with a scrip dividend, in practice many companies, including banks, have chosen the scrip dividend route in recent years in order to give the impression that they are giving a payout to investors.

(d)

Alternatives to a zero dividend or a scrip dividend to improve liquidity include:

i. Raising additional equity via a rights issue or a new issue. The success of this though will be very dependent upon the state of the market and the enlarged share capital would require higher dividends in future years in order to maintain the current level of dividend per share.
ii. Issuing new debt via a bond issue. This might be better than an equity issue, depending on investor risk appetite.
iii. Reduce costs – for example, make staff redundant
iv. Sell assets – for example, close branches of the bank
v. Raise interest rates offered on investments to encourage more deposits.

Answer to Q. No. 2

Part (ai)

Premium on conversion:

Share price now GBP 3.60

Share price in 4 years' time GBP 4.54 (GBP3.60 x 1.06^4)

Forecast conversion value GBP 104.42 (23 x GBP4.54)

Part (aii)

Year	Particulars	Cash Flow	DF@7%	DCF	DF@5%	DCF
0	Loan capital	-93.00	1.000	-93.00	1.000	-93.00
1 - 4	Annual Interest	3.00	3.387	7.11	3.546	7.45
4	Capital Redemption	104.42	0.763	79.67	0.823	85.94
Totals				6.22		0.39

Post tax Kd by interpolation = 5% + 2% [0.39/(0.39+6.22)] = 5.12%

Note: the result will be slightly different depending on the two rates chosen. Here, the NPV at 5% is fairly close to zero so in practice no further calculations would be necessary.

Part (aiii)

Calculation of WACC

$$WACC = \left[k_{eg} \times \frac{E}{D+E+P}\right] + \left[k_d(1-t) \times \frac{E}{D+E+P}\right] + \left[k_p \times \frac{E}{D+E+P}\right]$$

Which can be calculated as follows:

Particulars	**Market value GBP m (MV)**	**Cost of Capital (k)**	**MV x k GBP m**
Ordinary Shares	1,008	11.56%	116.52
Preference Shares	205	5.71%	11.71
Debt	250	5.12	12.80
Total	1,463		141.03

So WACC is 141.03m/1,463m = 9.64%

Workings for cost of capital:

Calculation of ke

Formula for cost of equity for a company with constant growth and recently paid dividend is

Ke = (D1/po) +g

D1 = (GBP 0.45 x 50% x 1.05) = GBP 0.23625 per share

Ke = (GBP 0.23625 / GBP 3.60) + 0.05 = 0.1156 ie: 11.56%
Calculation of kp
Kp = (GBP 0.06 / GBP 1.05) = 0.0571, ie: 5.71%
Kd was calculated earlier.

Part (b)
Benefits (to CBA) of convertible bond over equity

- All forms of debt would normally be cheaper than equity for the company because interest carries tax relief, dividends do not. Also, debt is (usually) less risky than equity for the providers of finance and therefore the return required by a debt provider will be less than that for an equity provider.
- There is no immediate dilution of earnings if debt is issued, although debt interest has to be paid before equity dividends are declared and paid. Dilution would occur on conversion but the logic of a convertible bond would be that the money invested would increase earnings to the level where there would be sufficient to pay old and new shareholders without reducing EPS or DPS.
- Costs of issue are likely to be lower with convertible debt than a new issue of equity.
- It is also likely to be quicker to arrange, although convertible debt might take longer than straight debt.

Assuming preference shares are classed with debt, gearing is currently low at 17% prior to the issue of the convertible debt. CBA is thus taking no advantage of the tax relief available on any interest payments. In addition given that gearing is so low it is likely that the WACC calculated in part (a) will be lower than the WACC prior to the investments and new finance. This is because it is likely that the effect of the lower cost of debt will outweigh the impact of any increase in the cost of equity as a result of adding debt into the capital structure.

Disadvantages of convertible debt over equity

- Interest has to be paid otherwise the company could be put into liquidation. This is the risk of all forms of debt over equity.
- At high levels of debt the gearing level might rise to an unacceptable level for equity holders, increasing the cost of equity and the overall WACC. This does not seem to be an issue for CBA as gearing is relatively low at present at 17%. If debt is issued this would rise to 31%, still not unreasonable. This gearing would reduce once conversion started to take place, all other things being equal.

Overall evaluation
There is insufficient information in the scenario about economic and market factors and the business risk of CBA to make a full evaluation and recommendation. However, CBA is fairly lowly geared at present and an issue of debt would be unlikely to significantly increase the cost of equity. Assuming investor reaction to an issue of convertible debt is positive then this would appear the most attractive option.

Part (c)
Treasury is likely to be involved in:

- Determining conversion ratio(s) and coupon interest rate on the instrument.
- Managing the relationship with the investment bank or issuing house supporting the bond issue.
- Calculating costs of capital and ensuring that new debt will not adversely affect the value of the company. Ensuring earnings are sufficient to cover interest payments and maintain dividend levels to preference and ordinary shareholders.
- Preparing all paperwork and a timetable for the issue.

Answer to Q. No. 3

NPV and IRR calculations:

Cash flows	0 T$'000	1 T$'000	2 T$'000	3 T$'000
Operating cash inflows (W1)		1,749.6	2,717.3	3,693.6
Operating cash outflows (70% of inflows)		(1,224.7)	(1,902.1)	(2,585.5)
Fixed operating costs (7% uplift)		(450.0)	(481.5)	(515.2)
Manager's salary(7% uplift)		(50.0)	(53.5)	(57.3)
Sub total	0.0	24.9	280.2	535.6
Tax at 30%		(7.5)	(84.1)	(160.7)
Tax relief on tax WDA (W2)	75.0	56.3	18.8	
Fixtures & fittings	(1,000.0)			500.0
Net operating cash flow	(1,000.0)	92.4	252.4	893.7
Discount at 8%	1.000	0.926	0.857	0.794
PV at 8% (in T$'000)	(1,000.0)	85.6	216.3	709.6
NPV (in T$'000)		**11.5**		
Discount at 10%	1.000	0.909	0.826	0.751
PV at 10% (in T$'000)	(1,000.0)	84.0	208.5	671.2
NPV (in T$'000)		**(36.3)**		

IRR: 8.48% = 8% + 2% x (11.5/(11.5 + 36.3))

Working W1: Revenue per café

Number of passengers per day	3,600	3,700	3,800
Percentage of passengers using the cafe	9%	12%	15%
Average daily spend per passenger (T$)	3.0	3.4	3.6
Days in year that trains operate	360	360	360
Total revenue (T$) per café	349,920	543,456	738,720
Revenue for five cafes (T$)	1,749,600	2,717,280	3,693,600

Working W2: Tax written down allowances

Particulars	Amount	Tax relief at 30%
Fixtures & fittings	1,000.0	
25% WDA in year 1	(250.0)	75.0
C/f to year 2	750.0	
25% WDA in year 2	(187.5)	56.3
C/f to year 3	562.5	
Final value	(500.0)	
Balancing allowance 62.5	18.8	

Payback calculation:

Particulars	0	1	2	3
	T$'000	T$'000	T$'000	T$'000
Net operating cash flow		92.4	252.4	893.7
Balance of investment	1,000.0	907.6	655.2	(238.5)

Hence payback occurs during year 3, at approximately 2 years 8.8 months
(where 8.8 = 655.2/893.7 x 12 months).

(b) (ii)
Potential benefit
The results in (b)(i) show that the project is expected to generate positive wealth for shareholders. It has:

- A NPV result of T$ 11,500 at a WACC of 8%.
- An internal rate of return of 8.48%, which is slightly higher than the WACC but lower than the geared cost of equity of 11.99%.
- Payback is achieved approximately 8.8 months into year 3.

Evaluation of results
The results in (b)(i) are highly sensitive to a number of input variables such as the cost of capital and estimates of growth, passenger numbers, variable cost relationships and residual value. Mr C therefore needs to consider how reliable these estimates are. Three of these (customer numbers, residual value and the cost of capital) will be examined in more detail below.

The estimated growth in customer numbers gives a figure of 570 customers a day (or 47 customers per hour in a 12 hour day) by year 3. There needs to be a 'reality check' here to ensure that such numbers appear to be realistic given the size of the cafe premises and the extent of takeaway business. Indeed, for smaller premises these numbers may exceed reasonable capacity and lower growth figures may need to be applied.

The residual value of fixtures and fittings is particularly important. If, say, the RV of the 5 cafes fell 5% to T$ 475,000, the NPV of the project would be - T$2,430 (see workings below). This demonstrates that the residual value would not need to fall much to make the initial project not worthwhile.

Workings (in T$'000):
Tax written down allowance becomes 26.25 (= 30% x (562.5 – 475.0))
So cash flows decrease by 17.55 (= (500.0 + 18.8) - (475.00 + 26.25))
So NPV decreases by 13.93 (= 0.794 x 17.55)
To -2.43 (= 11.5 – 13.93)

Perhaps of greater importance here though is the impact of the financing of the project on the NPV. If Mr C is unable to secure the debt funding then the initial acquisition will need to be funded from 100% equity which will impact on the cost of capital. An appropriate all equity cost of capital would be 9.4% (= 3% + 5% x 1.28). Given that the IRR of the project is 8.48%, then this shows how important it is for Mr C to secure bank funding to finance the project. If not, the initial project will not be financially viable. Similar sensitivity exercises could be carried out for each of the other underlying assumptions.

Real options
The profitability of the cafes is forecast to increase significantly year on year during the three year period due to forecast increase in the number of passengers using the cafes, together with a forecast increase in average spend. Before tax adjustments, forecast net operating cash flows increased ten-fold between year 1 and year 2, increasing from T$24,900 to T$280,200 in that year and almost doubled again in year 3.

However, as already commented above, these figures need to be reviewed to see if they are reasonable. The customer numbers predicted at the end of year 3 appear to be close to maximum capacity (or possibly exceed maximum capacity already, depending on the size of the cafes) and this would restrict or eliminate the possibility of future growth. Space constraints need to be taken into account when valuing 'follow on' options.

The 'follow on' option to expand the number of cafes operated within the next three to ten years is, however, still potentially very valuable, even assuming zero growth in customer numbers beyond year 3. However, expanding from 5 to up to 100 cafes would greatly change the nature of the business. CCC would need to develop a more complex management structure and acquire extensive additional finance to be able to expand in this manner.

It is not stated that there is an option to 'abandon' the first five cafes, that is, whether there is a break clause in the rental agreement. Even with a break clause, abandonment is likely to create a large loss given the large upfront investment required to fit out the cafes at the beginning.

There is unlikely to be any possibility of 'delay' to the start of the project. It is likely that T Railways could find other interested parties and Mr C could lose out. No contract has yet been signed. It appears that Mr C has sufficient personal resources to be able to proceed without finance from the bank if the bank refuses to provide a loan.

Conclusion

In conclusion, the project does appear to be worthwhile pursuing assuming that the growth in passenger numbers and of the number of passengers making use of the café is considered to be reliable. The potential profits in the longer term are sufficient to make the experimental run with five cafes to be worthwhile as long as Mr C has sufficient personal financial resources to be able to withstand a possible loss.

Answer to Q. No. 4

(a) Calculation of an appropriate J$ based discount rate for project D:

H$ WACC is: 9.5%
So adjusted H$ WACC is: 12% (= 9.5% + 2.5%)
So J$ WACC: 14% (where 0.14 = ((1 + 12%) x (1 + 4%) / (1 + 2%)) - 1)

NPV: J$ 45.9 million (= - 80 + (20 x 5.216) + (80 x 0.270))
that is, H$ 20.0 million (= J$ 45.9 million / 2.29) converted at spot
Payback: J$ 80 million / J$ 20 million = 4 years
PI: 0.574 = J$ 45.9 million / J$ 80 million (= NPV/initial investment)

(b) (i)

The initial investment for project D is H$35 million (= J$80 million / 2.29)
Limit H$ 100 million:

Projects	Investment	NPV	Payback
B	H$ 100 m	H$ 49.1 m	5.0 years
A + D	H$ 85 m	H$ 53.9 m	between 4.0 and 4.2 years
C	H$ 75 m	H$ 39.7 m	5.0 years

Therefore the best combination of projects is A and D as this maximizes shareholder wealth.

(b) (ii)

Competitive position.

If a site is left undeveloped there a risk that a competitor would develop it and make it very difficult to develop in that locality in the future.

Option to delay
The likelihood that the site would still be available for development in a year's time when further investment funds may be available needs to be considered. An option might be available to purchase that gives MV the right to acquire the land in a year's time.

Follow on options
Each project has been appraised over a 10 year period. However it's possible that each site will ultimately have a different life span. Therefore the possibility of follow on opportunities should be included in the analysis (and not just as a broad assumption on residual value). E.g. if successful in country J, potentially this could open up new opportunities for MV to expand in that country.

Possible interdependence of projects
There might be correlation or interdependency between the four sites. E.g., if project B is not developed, this might lead to an increase in sales at site A (project A) if B's potential customers were likely to travel to site A instead.

Accuracy of the estimates used
Whilst each project is being appraised over the same 10 year time span, there could be significant issues with regard to how accurate are the estimates of future cash flow and residual value in particular. It would appear that management appear to have tried to take this into account by applying a different risk premium to the WACC when appraising the projects, however it might be prudent to also consider probability analysis as well. Also, no growth has been factored into the analysis and the cash flows identified appear to be very simplistic.

Accuracy of the discount rate
Management have sought to adjust the discount rate to make it specific to each project – however we do not know if this has been done on a reasonable basis. The overseas project will by definition be riskier than the home projects, yet it has the same risk premium as one of the other projects. Before making a decision management need to consider the basis of their adjustments to ensure that they are appropriate.

Risks of operating in a foreign country
Project D involves setting up a show room overseas and therefore MV needs to ensure that it considers issues such as:

- Availability of staff in the location who are appropriately qualified.
- Any language issues.
- Practical issues of integrating accounting systems and managing the showroom.
- Any remittance issues that might arise.
- The acceptability of the motor vehicles that MV sells being accepted and popular in Country J.

(c) Choice of currency
For 'home' projects, H$ is the optimum choice of currency. Any other currency, unless swapped back into H$, would create currency risk.
For project D in country J, there is a strong argument for borrowing in J$ in order to reduce currency exposure. J$ denominated project income can be matched against J$ denominated financing costs and the J$ value of the premises can be matched against the J$ value of the underpinning borrowing.

Source

J$ debt could be raised in either country H or country J using P plc's creditworthiness. Alternatively, MV may wish to raise the project finance as part of a larger debt issue and simply swap part of the proceeds into J$.

Answer to Q. No. 5
Efficient Market Hypothesis
The efficiency of a capital market relates to the ability of the market to price securities quickly and fairly in order to reflect all the relevant publicly available information in respect to each security. The Efficient Market Hypothesis indicate three levels of processing efficiency namely:

Weak form – Prices reflect all past information.
Semi strong form – Prices reflect all past information and publicly available information.
Strong form - Prices reflect all past information, publicly available information and inside information.

There has been considerable research carried out on the topic of measuring market efficiency with varying findings. However, it is considered that capital markets today tend to display semi-strong form efficiency.

Semi Strong Form Efficiency

Day	Note	BANTRY PLC Price per share	KINSALE PLC Price per share
1	1	10	4
3	2	10	4
6	3	7.5	6
10	4	12.5	6

Strong Form Efficiency

Day	Note	BANTRY PLC Price per share	KINSALE PLC Price per share
1	1	10	4
3	4	12.5	6
6	4	12.5	6
10	4	12.5	6

Note 1) As the proposal was discussed on day 3, the day 1 price of each share price of each company will remain unchanged.

Note 2) As the proposal was discussed in private on day 3 and the Irish Stock Market is considered to display semi-strong form efficiency, the day 3 share price of each company will remain unchanged as the detail discussed is not publicly available.

Note 3) Day 6 value of Bantry PLC Euros

Intrinsic value of Bantry PLC (4m shares at 10 each)	40000000
Intrinsic value of Kinsale PLC (5m shares at 4 each)	20000000
Less:Cash Payment to Kinsale PLC Shareholders (5m shares @ 6)	30000000

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INDICATIVE DAY 6 VALUE OF BANTRY PLC	30000000
Divided by:Bantry PLC shares in issue	4000000
INDICATIVE DAY 6 VALUE OF EACH BANTRY PLC SHARE	7.5

Note 4) Day 10 value of Bantry PLC Euros

INDICATIVE DAY 6 VALUE OF BANTRY PLC (per note 3)	30000000
Add: Synergistic benefits of combination	20000000
INDICATIVE DAY 10 VALUE OF BANTRY PLC	50000000
Divided by: Bantry PLC shares in issue	4000000
INDICATIVE DAY 10 VALUE OF EACH BANTRY PLC SHARE	12.5

Answer to Q. No. 6

Cost of Purchase – Money Market Hedge

If you insist on hedging against the foreign currency risk using a money market hedge it will cost you €42,016,807 today. The transaction can be summarized as follows:

Money Market Hedge

Deposit 147058824 zloty (150m/(1 + (.04%/2)) today 147058824

Purchase these zlotys at today's spot rate (3.5 zloty to €1) 42016807

If these funds are borrowed, cost in three months would total €43,277,311 / €42,016,807 x [1+(.0612)]

Foreign Currency Option

Given the problems being encountered by the due diligence auditors I would be concerned about hedging the risk using the money markets. This is because if the takeover does not go ahead you will be still be locked into significant Polish zloty related transactions.

A preferable option would be to take out a foreign currency option to buy 150Million Polish zloty any time between say, three months and one year from now. This would enable Dunnycove PLC to hedge against the foreign currency risk associated with the volatile Polish Zloty. The option also provides the flexibility to let the option lapse in the event that the takeover does not occur.

Foreign Currency Translation Risk

Where a company owns investments in foreign economies with a currency different from its domestic currency itwill have to include the value of such investments in its year end balance sheet. For the purposes of inclusion itwill convert the value of the foreign investment into its domestic currency at the exchange rate prevailing at eachbalance sheet date. Where such investments are held for more than one year there is a risk that the value of theinvestment (for inclusion in Balance Sheet) may suffer a diminution in value if the foreign currency has weakenedviz the domestic currency between year end dates. This in known as foreign currency translation risk.

Management of Currency Translation Risk

The most effective way for Dunnycove PLC to eliminate the potential for such translation risk is to match the foreign investment with a liability denominated in that foreign currency. This would involve borrowing the 150 million Polish zloty required to purchase Wisla Limited in the Polish currency. As this loan would also have to be translated at Dunnycove PLC's Balance Sheet date it would increase or decrease as the Polish zloty strengthens or weakens. The effect on the Balance Sheet of Dunnycove PLC would be to cancel out the changes in the value of the net assets of the subsidiary.

Answer to Q. No. 7

Steps in an effective foreign exchange risk management policy
1. Establish the net transaction risk exposure for each currency and endeavour in the first place to minimize this net exposure using internal hedging mechanisms
2. If internal hedging mechanisms cannot be used then external mechanisms may be used subject to adherence to a clear policy on the risk management mechanisms that can be employed
3. Implement the hedges according to the external hedging policy
4. At all times controls should be in place to ensure that an organisation is not risk exposed as a result of speculative positions.

Adjusted Present Value
Adjusted Present Value (APV) is an alternative approach to the Net Present Value (NPV) approach to investment appraisal. The valuation approach taken by APV is to separate the operational and financial effects of a proposed capital investment. It firstly discounts the investment at a base-line cost of capital, as if it was fully equity financed in order to arrive at a base cost net present value. As a separate and subsequent step the cash flow consequences of the alternative financing options are discounted and added to the base cost present value to arrive at the APV. The NPV technique allows for the financing effects by adjusting the discount rate to be applied for the purpose of the NPV calculation.

Benefits of Centralised Treasury Management
Centralised treasury management involves the corporate handling of all financial matters including, the generation of external and internal funds for business, the management of currencies and cash flows. The benefits of doing so centrally include;
• Economies of scale
• Expertise more affordable
• More effective treasury management e.g. forex netting
• Cheaper hedging e.g. forex matching
• Enables divisional management to concentrate on the core business by removing a potential distraction

Residual Theory of Dividends
There are many contrasting theories as to how dividend policy does or does not impact on shareholder wealth e.g. Modigliani and Miller's dividend irrelevance theory. The residual theory of dividends argues that in order to maximise shareholder wealth that management should continue to invest profits in investments that deliver a positive NPV at the company's cost of capital. In an efficient capital market the NPV delivered will increase share value. It is only after all such investments are exhausted that the company should pay dividends to shareholders.

Financial Risk
The risk that an investment strategy/organisation is too highly geared i.e. funded by debt capital. A highly geared investment will increase the risk of illiquidity i.e. the ability to service the debt and make capital repayments as expected. Providers of equity capital will require a higher return for the increased financial risk they suffer as a company becomes more highly geared.

Business Risk
This is the inherent investment risk that is specific to an industry. Some investments/sectors e.g. commercial property (in the current economic climate) are considered to be more risky than others. The business risk of a proposed investment will consider the track record and experience of operating within a specific industry.

Co-efficient of Correlation of an Investment Portfolio
A measure of the relationship between two (or more) investments in a portfolio. It is measured using a score between -1 (perfect negative correlation) to 0 (no correlation) to +1 (perfect positive correlation).

To reduce overall portfolio risk through diversification the relationship between the investments in the portfolio should be of an inverse (negative) nature. Thus, the fortunes of one investment will be the opposite of the other.

Answer to Q. N. 8

Financial Review

The maximum payable for the hostel in order to achieve a discounted payback over three years is NRs.742,589. This was calculated as follows:

Bandipur Hostel Proposal Evaluation (NPV)

Details	**Note**	**Year 0**	**Year 1**	**Year 2**	**Year 3**
Redundancy Payment		-122,000			
Income	1,2,3		741,000	769,500	996,600
Rates		-40,000	-46,000	-52,900	
Wages Costs	4		-304,000	-316,160	-347,776
Light & Heat			-10,000	-9,000	-8,000
Gas	5	-57,300	-60,750	-73,080	
Laundry	6		-37,560	-38,700	-46,320
Total Annual Cashflow		-122,000	292,140	298,890	468,524
Discount Factor		1	0.9091	0.8264	0.7513
Present Value		-122,000	265,584	247,003	352,002
Net Present Value					742,589

Note 1

Details	**Family**	**Twin**	**Single**	**Total**
Capacity	12	20	30	
Occupancy	0.6	0.5	0.7	
Annual Nights	300	300	300	
Total Nights	2,160	3,000	6,300	11,460
Guests per Room	3	2	1	
Total Guests	6,480	6,000	6,300	18,780
Charge Per Night	100	70	50	
Total Income	**216,000**	**210,000**	**315,000**	**741,000**

Note 2

Details	**Family**	**Twin**	**Single**	**Total**
Capacity	12	20	30	
Occupancy	0.5	0.6	0.75	
Annual Nights	300	300	300	
Total Nights	1800	3600	6750	12150
Guests per Room	3	2	1	
Total Guests	5400	7200	6750	19350
Charge Per Night	100	70	50	
Total Income	**180000**	**252000**	**337500**	**769500**

Note 3

Details	**Family**	**Twin**	**Single**	**Total**
Capacity	12	20	30	
Occupancy	0.7	0.7	0.8	
Annual Nights	300	300	300	
Total Nights	2,520	4,200	7,200	13,920
Guests per Room	3	2	1	
Total Guests	7,560	8,400	7,200	23,160
Charge Per Night	110	77	55	
Total Income	**277,200**	**323,400**	**396,000**	**996,600**

Note 4

Details	**Number**	**Cost**	**Total**
Security	2	25000	50000
Housekeeping	2	21000	42000
Cleaning	3	19000	57000
Reception	2	36000	72000
Maintenance	1	41000	41000
Management	1	42000	42000

Total Year 1	304000
Total Year 2	316160
Total Year 3	347776

Note 5

Details	**Year 1**	**Year 2**	**Year 3**
Total Rooms	11460	12150	13920
Gas cost per room	5	5	5.25
Total Gas Cost	57300	60750	73080

Note 6

Details	**Year 1**	**Year 2**	**Year 3**
Total Guests	18780	19350	23160
Laundry cost per guest	2	2	2
Total	37560	38700	46320

Qualitative Factors
- Impact of redundancy on service levels.
- Impact of redundancy on staff morale.
- Will his organisation be overstretched?
- Will it impact adversely on Bandipur Hostel occupancy rates?
- Will customer goodwill continue?

Answer to Q. No. 9
MBOs Reasons for success (compared to 3rd party acquisition):

i. Higher levels of motivation. Given the financial an time commitment that members of the MBO team will have invested in the acquisition.
ii. Knowledge of business e.g. Lifestyle Sports. As the management team will have many years of experience working in the industry and for the organisation.
iii. Ability to concentrate on core competence. The management team will not be distracted by the running of the remainder of the organisation.
iv. Quicker decision making. As the management hierarchy is likely to involver fewer layers and administrative bureaucracy.
v. Savings in overheads, such as the running of the head office and all of its necessary functions.
vi. Strong customer and supplier relationships that will have been built up over the management team's time working in the industry
vii. Retention of key personnel if the management team can persuade them to play a part in the future of the business.

Answer to Q. No. 10

S PLC - Asset Based Valuation

Detail	**Amount**	**Explanation**
Land & Buildings	5,500	Market Value
Other Assets	425	
Inventories	646	Deduct Damaged Stock
Trade receivables	865	Deduct Bad Debts
Debentures	-1,200	60% of Par
Trade Payables	-250	
ST Borrowings	-390	
Current Portion LT Borrowings	-120	
Underfunded Pension Scheme	-150	
Healthcare Increase in Value	300	(600m - 300m)
Net Asset Valuation	5,626	

S PLC - Earnings Based Valuation

Detail	**Amount**	**Explanation**
Annual Recurrent Earnings	440	
Adjustments		
Debenture Interest Saved	64	80 Million at 80%
Pension Fund Contribution	-4	
Healthcare Division Profits	-72	90 Million at 80%
Natural Gas Savings	16	20 Million at 80%
Annual Recurrent Earnings	444	
Price Earnings Multiple	8	288/36
Capitalized Value	3,552	
Less: Closure Costs	-8	10 Million at 80%
Earnings Valuation	3,544	

Answer to Q. No. 11

Details	**Yr 0**	**Yr1**	**Yr 2**	**Yr 3**	**Yr 4**	**Yr 5**
Producer Payment	-40,000			-21,900	-19,000	-7,000

Acting Costs		-280,000				
Downloading Income			63,000	150,000	20,000	
DVD Income			100,000	80,000	60,000	
Box Office Income			275,000	150,000	60,000	
Promotional costs			-85,000	-35,000	-25,000	
Equipment	-100,000					50,000
Net Annual Cash Flows	-140,000	-230,000	353,000	323,100	96,000	-7,000
Discount Factor @ 16%	1	0.8621	0.7432	0.6407	0.5523	0.4761
Present Values	-140,000	-198,283	262,350	207,010	53,021	-3,333
Net Present Value						180,765

Capital Component	**Note**	**MV %**	**Cost %**	**Weight**	**Weighted**
Ordinary Shares (ex div)	1	26,250,000	20.34%	63.64%	12.95%
Preference Shares (ex div)	2	11,000,000	9.09%	26.67%	2.42%
Irredeemable Loan Stock	3	4,000,000	6.48%	9.70%	0.63%
Weighted Average Cost of Capital		41250000		100.00%	16.00%

Note 1) Cost of Equity (Gordon's Growth Model)
[.40*(1+.08)/(3.5)] +.08 = 20.34%
Note 2) Cost of Preference Shares
Dividend Payable/Ex Div. Market value
= 20/220 * 100 = 9.09%
Note 3) Cost of ILS
Interest Payable/Ex INT. Market value
= (320*[1-.19])/4000 * 100 = 6.48%
Other Factors to Consider

- How reliable is the market research in relation to the potential sales of the firm?
- Will the firm raise the profile of the company as a whole?
- How will theatre goers react to the company 'straying' into film production? Will their reaction be positive or negative?
- Will these initial film open doors into the lucrative world of cinema?
- Could the experience gained from the film production benefit the theatrical productions?
- How skilled are the staff at movie production?

Answer to Q. No. 12
Money Market Hedge
Due to the relationship between forward exchange contracts and interest rates in two currencies it is possible to 'manufacture' a forward rate by using spot exchange rates and money market lending or borrowing. For example, if a company purchased an item in a foreign currency for settlement into the future it could guarantee to cost of the transaction by money market hedging. In this case it would involve depositing in the foreign currency by buying this currency at the spot rate. The foreign currency deposited plus the interest accrued thereon would be sufficient to discharge the foreign currency liability for the cost of the item.

Bonus/Scrip Dividends
This is where dividends are paid in the form of shares rather than cash. Effectively, it converts revenue reserves into issued share capital. Scrip issues would be used where a company is concerned about its liquidity position and wishes to retain funds within the business. As a result of scrip dividends there will

be no relative dilution of shareholding as each shareholder will receive shares in accordance with their percentage shareholding.

Deep Discount Bonds
A deep discount bond is a bond that is issued at a price which is significantly lower than its par/redemption value. The attraction to the issuer is that the bond will carry a lower coupon rate compared to other debt instruments. This may be particularly attractive to start-up companies as there may be increased uncertain as to cash flow availability at the early stages of development. The attraction to the investor is that the initial capital outlay is significantly reduced. There may also be tax advantages as the return to the investor takes the form of capital gain rather than an income tax assessed interest receipt.

Co-efficient of Correlation (between investments)
This measures the relationship between two (or more) investments in a portfolio. In this case the property development and construction industries are closely related as they have an 'r' score of +.8. This indicates that the financial fortunes of both industries are likely to follow similar trends. To further reduce overall portfolio risk through diversification the relationship between the new investments in the portfolio should be of an inverse (negative) nature. Thus the fortunes of one industry will be the opposite of the other.

Management Buyouts (MBOs)
When an organisation decides to divest itself of part of its business for whatever reason (cash absorber, lack of strategic fit etc.) it may receive offers from many parties. Occasionally, the management of the part of the business being sold may decide to mount a bid for the purchase. This is known as a management buyout. Research has shown than MBOs tend to be more successful than 3rd party acquisitions. This is for many reasons including: knowledge of the industry and the specific business being bought increased levels of motivation to make the business a success. Often with MBOs the most difficult challenge is to raise sufficient finance.

Contents of a Business Plan
• Executive Summary
• Description of the business opportunity/plan
• Articulation of the objectives of the business plan
• Identification of and briefing on key individuals involved in managing the proposal/plan
• Identification of strengths and risks associated with the proposal/plan
• Time line of key milestones and events
• Description of funding available and the funding required
• Forecast Income Statements, Cash Flow Forecasts and Balance Sheets
• Conclusion

Income-based business valuations
This method identifies the annual expected recurrent earnings to be derived from the business that is subject to the proposed purchase/takeover. These earnings are multiplied by an agreed price earnings (P/E) ratio to determine the valuation of the business i.e. Indicative Value = EPS * P/E Ratio
There are a number of difficulties associated with the earnings based valuation. These include:
Difficulties associated with determining an appropriate P/E ratio

- A single year's P/E ratio may not be representative of potential performance. Averaged annual earnings will typically be used to
- Deciding on the quality of the earnings e.g. Recurrent contractual income vs. Casual earnings
- Allowing for future expected economic and trading conditions
- When valuing an unquoted company namely;
- Finding a similar quoted company to benchmark the p/e ratio against

- Deciding on a reduction in the quoted p/e ration of similar public companies to allow for the increase risk
- Associated with an unquoted company
- If employing this valuation method one must consider the any additional financial impact of the proposed
- Acquisition. This might include;
- Any synergistic benefits arising as a result of the combination
- Any cost savings to be delivered from the combination
- The one off costs of planned post acquisition changes e.g. rationalisation schemes, redundancies etc.

Answer to Q. No. 13

(a) Borrowing period is 6 months (11 months – 5 months)
Current borrowing cost = $34,000,000 x 6 months/12 months x 4·3% = $731,000
Borrowing cost if interest rates increase by 80 basis points (0·8%) = $34,000,000 x 6/12 x 5·1% = $867,000
Additional cost = $136,000 [$34,000,000 x 6/12 x 0·8%]

Using futures to hedge

Need to hedge against a rise in interest rates, therefore go short in the futures market.
Borrowing period is 6 months
No. of contracts needed = $34,000,000/ $1,000,000 x 6 months/3 months = 68 contracts.
Basis
Current price (on 1 June 2015) – futures price = total basis
(100 – 3·6) – 95·84 = 0·56
Unexpired basis (at beginning of November) = 2/7 x 0·56 = 0·16
Assume that interest rates increase by 0·8% (80 basis points) to 4·4%
Expected futures price = 100 – 4·4 – 0·16 = 95·44
Gain on the futures market = (95·84 – 95·44) x $25 x 68 = $68,000
Net additional cost = ($136,000 – $68,000) $68,000

Using options on futures to hedge

Need to hedge against a rise in interest rates, therefore buy put options. As before, 68 put option contracts are needed ($34,000,000/$1,000,000 x 6 months/3 months)
Assume that interest rates increase by 0·8% (80 basis points) to 4·4%

Exercise price	95·50	96·00
Futures price	95·44	95·44
Exercise?	Yes	Yes
Gain in basis points 6	56	
Gain on options 6 x $25 x 68 = $10,200	56 x $25 x 68 = $95,200	
Premium	30·4 x $25 x 68 = $51,680	50·8 x $25 x 68 = $86,360
Option benefit/(cost)	$(41,480)	$8,840
Net additional cost	($136,000 + $41,480) $177,480	($ 136,000 – $8,840) $127,160

Using a collar on options to hedge

Buy put options at 95·50 for 0·304 and sell call at 96·00 for 0·223

Net premium payable = 0·081
Assume that interest rates increase by 0·8% (80 basis points) to 4·4%

Buy put Sell call

Exercise price 95·50 96·00

Futures price 95·44 95·44
Exercise? * Yes No
(*The put option is exercised, since by exercising the option, the option holder has the right to sell the instrument at 95·50 instead of the market price of 95·44 and gain 6 basis points per contract. The call option is not exercised, since by not exercising the option, the option holder can buy the instrument at a lower market price of 95·44 instead of the higher option exercise price of 96·00)
Gain on options 6 x $25 x 68 = $10,200
Premium payable 8·1 x $25 x 68 $13,770
Net cost of the collar $3,570
Net additional cost ($136,000 + $3,570) $139,570
Based on the assumption that interest rates increase by 80 basis points in the next five months, the futures hedge would lower the additional cost by the greatest amount and is significantly better than either of the options hedge or the collar hedge.
In addition to this, futures fix the amount which Daikon Co is likely to pay, assuming that there is no basis risk. The benefits accruing from the options are lower, with the 95·50 option and the collar option actually increasing the overall cost. In each case, this is due to the high premium costs. However, if interest rates do not increase and actually reduce, then the options (and to some extent the collar) provide more flexibility because they do not have to be exercised when interest rates move in the company's favour. But the movement will need to be significant before the cost of the premium is covered.
On that basis, on balance, it is recommended that hedging using futures is the best choice as they will probably provide the most benefit to Daikon Co.

Answer to Q. No. 14
Mark-to-market: Daily settlements
2 June: 8 basis points (95·76 – 95·84) x $25 x 50 contracts = $10,000 loss
3 June: 10 basis points (95·66 – 95·76) x $25 x 50 contracts + 5 basis points (95·61 – 95·66) x $25 x 30 contracts =$16,250 loss
[Alternatively: 15 basis points (95·61 – 95·76) x $25 x 30 contracts + 10 basis points (95·66 – 95·76) x $25 x 20 contracts = $16,250 loss]
4 June: 8 basis points (95·74 – 95·66) x $25 x 20 contracts = $4,000 profit
Both mark-to-market and margins are used by markets to reduce (eliminate) the risk of non-payment by purchasers of the derivative products if prices move against them.
Mark-to-market closes all the open deals at the end of each day at that day's settlement price, and opens them again at the start of the following day. The notional profit or loss on the deals is then calculated and the margin account is adjusted accordingly on a daily basis. The impact on Daikon Co is that if losses are made, then the company may have to deposit extra funds with its broker if the margin account falls below the maintenance margin level. This may affect the company's ability to plan adequately and ensure it has enough funds for other activities. On the other hand, extra cash accruing from the notional profits can be withdrawn from the broker account if needed.

Answer to Q. No. 15
K PLC's cost of capital of 19.8% is calculated as follows:

WACC	**Note**	**MV(MS) NRs.**	**% Cost**	**Weight**	**Weighted**
Ordinary Shares (ex div)	1	337.5	26.3%	337.5/502.5 = 67.2%	17.67%
Preference Shares (ex div)	2	115	6.96%	115/502.5 = 22.9%	1.59%
Long Term Loan	3	50	5.4%	50/502.5 = 9.9%	.54%
Weighted Average Cost of		502.5		100.00%	19.8%

Capital

Note 1) Cost of Equity (Gordon's Growth Model)
[100*(1+.1)/(77.5- 10)] +.1 = 26.3%

Note 2) Cost of Preference Shares
Dividend Payable/Ex Div. Market value = 8/115 * 100 = 6.96%

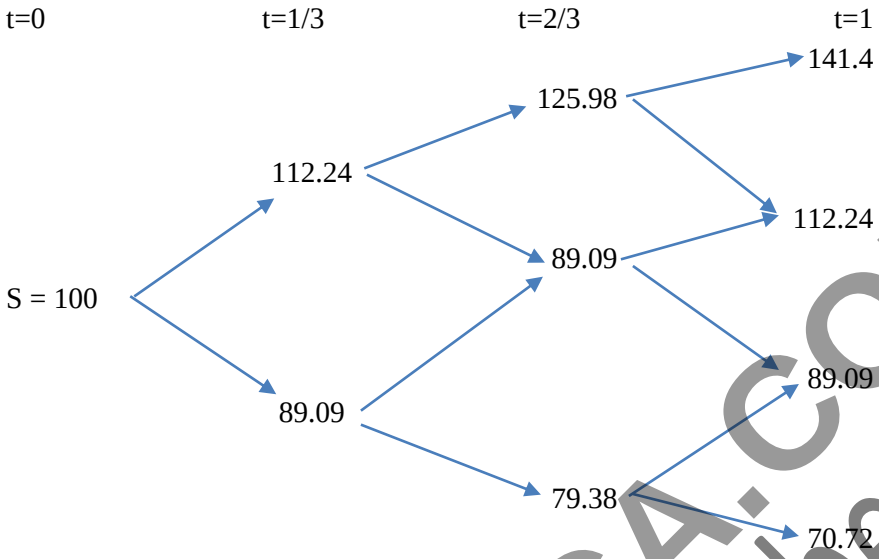
Note 3) Cost of Debt
Cost of debt = Interest 8 (1-Tax rate) = 6*(1-.10) = 5.4%

Answer to Q. No. 16
Solution:

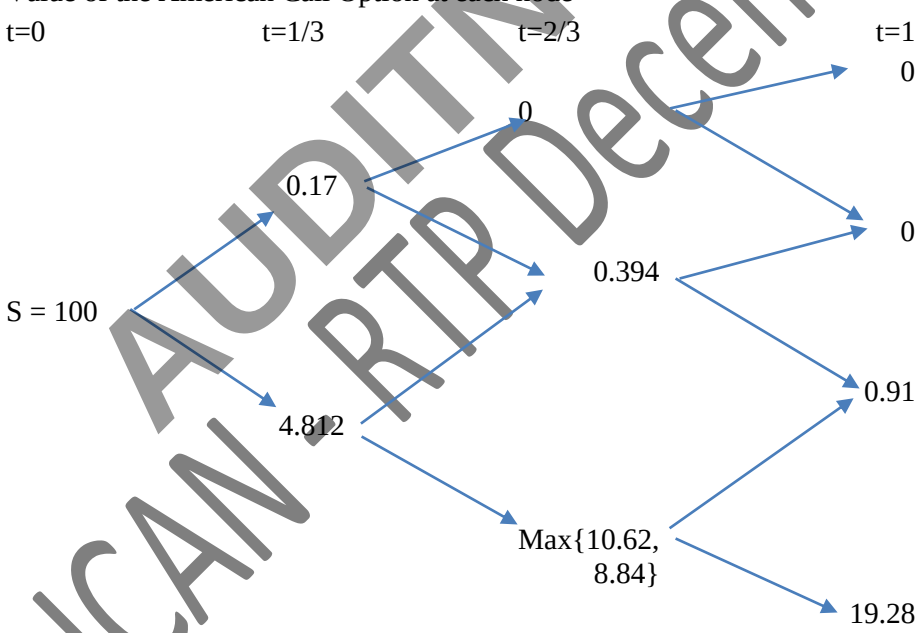
a. The parameter values are

$\Delta = \frac{1}{3}$; $1 + r_d = e^{r\Delta} = 1.0202, 1 + u = e^{\sigma\sqrt{\Delta}} = 1.1224$; $1 = d = e^{-\sigma\sqrt{\Delta}} = 0.8909$
For the risk neutral probability, we get
$p = \frac{r_d - d}{u - d}$ = 0.5584

The tree with the stock prices is



Value of the American Call Option at each node



Let Ω={u,d}^{3} . The optimal exercise date is:

$$\tau(\omega) = \begin{cases} n = 2 (for\ \omega\ \epsilon\ \{ddu, ddd\}) \\ \quad n = 3 (Otherwise) \end{cases}$$

For $\omega\ \epsilon\ \{ddu, ddd\}$, we have $\frac{1}{1+r_d}\mathbb{E}[p \times f_{32} + (1-p) \times f_{33}] < K - S_0(1+d)^2$

Here f_{ij} denotes the price of the claim in period i with j-down movement

Answer to Q. No. 17

(a) Possible strategies available to the Chaudhary company may include:

(i) Do nothing: with this strategy the company is taking a gamble on the yield curve that future interest rates will remain unchanged or indeed may fall. Much would depend on the degree of interest rate diversification the company may have on overseas debt and on the magnitude of any interest payable.

(ii) Retire and reissue fixed rate debt: with this strategy the company will issue fixed rate bonds and use the proceeds to retire the floating rate notes. This will eliminate any downside risk associated with increasing interest rates but will be an expensive option to pursue as commissions, arrangement fees and underwriting costs can be between 2–3% of the value of the loan.

(iii) Enter a fixed for variable interest rate swap: with this strategy the company will enter into a swap agreement with a market maker for the term of the loan. Normally this will entail swapping the liability for the LIBOR component of the swap for a fixed rate. The advantage of a swap agreement is that it is easy to establish through the highly organised OTC swap market. The disadvantage is that the company will be committed for the term of the swap which means that the company would have to reverse out of the swap if it found itself in a position to retire the loan notes earlier than planned.

Moving from variable to fixed interest rates is unlikely to have a significant impact upon the company's weighted average cost of capital or its value but it will stabilise the firm's financing flows which should make forward planning and budgeting easier.

Therefore, in deciding between the three alternatives the directors should assess whether taking risk of this sort is a part of its core business or whether managing interest rate volatility in the budgeting process is a diversionary activity. Either (ii) or (iii) will reduce managerial and labour risk exposure by reducing the volatility of the surplus from which their remuneration and other compensation is drawn.

From an equity investor point of view therefore, given the costs of hedging, (i) may be the preferred strategy.

From the perspective of other stakeholders (iii) is likely to be the least costly alternative for achieving stability in future financing flows. From a managerial perspective (iii) is the recommended course of action.

(b) The six monthly interest rate under a vanilla swap given the quoted spread would be as follows:

Payments LIBOR/2 + 0·6%

Receipt under a vanilla swap LIBOR/2

Payment on fixed leg 5·4%/2 = 2·7%

Net payment 3·30%

The six-monthly rate is therefore 3·30% or an effective annual rate:

EAR = (1·0332 – 1) = 6·71%

(c) Given that the annual interest rate volatility is 1·5%, the standard deviation of six-monthly rates is:

The Value at Risk (VAR) is given by:

$$\sigma_6 = \sigma_a \times \sqrt{\frac{1}{2}} = 1.5\% \times 0.7071 = 1.061$$

VAR = Loan × σ_6 × CL = 150 million × 1·061% × 1·645 = 2·62 million

Where the confidence level of 95% is taken from the normal tables and is, assuming a single tail, 1·645 standard deviations away from the mean.

VAR is defined (Jorion, 2007) as the 'worst loss over a target horizon such that there is a low, prespecified probability that the actual loss will be larger'. Currently the six-monthly interest rate is LIBOR plus 120 basis points. Let us assume for the moment that LIBOR is 5% per annum. The six-monthly interest on this loan will be 3·1% or 4·65 million. There is a 5% chance that the actual interest paid would be greater than (4·65 million + 2·.62 million) 7·27 million or, to put it another way, there is a 95% likelihood that the actual interest payable will be less than this figure. A number of assumptions constrain our interpretation of VAR. The first is that interest rates are assumed to follow a 'random walk' in that the current rate is the mean of the distribution of future possible rates, second that the volatility of future rates remains unchanged and third, that the distribution of rates is normal. In practice, although the 'normality' assumption may be useful in simplifying the mathematics of VAR, calculation shows that actual rate distributions exhibit significant skew and that the likelihood of extreme outcomes is somewhat higher than would be expected. However, VAR does simplify the representation of risk by placing a monetary value on the exposure arising from different sources.

Answer to Q. No. 18

Currency hedging.

The objective is to fix (Euro/SFr) currency exchange rates for two months for an expected remittance of SFr 2·4299 million. This is achieved with a money market hedge for the two month exposure.

(a) Hedging the two month Swiss franc exposure

Forward contracts in the money market are the most straightforward way of eliminating transaction risk. The exposure to movements in the Swiss Franc can be eliminated by entering into a forward contract to purchase the currency at Euro SFr 1·6199 (see note 1). Alternatively, given access to fixed rate finance in the Swiss market a reverse money market hedge can be established by borrowing in SFr and depositing in Euros. Given that the interest rates can be locked in this would offer a better forward rate at two months at any borrowing rate less than SFr LIBOR + 7 (note 2).

Supporting notes

Note (1)

The current expectation of remittances is based upon an estimate of the two month forward rate of (1·6223 + 1·6176)/2 = 1·6199 for the Swiss Franc

Swiss Francs = 1·6199 × 1·5m = SFr 2·4299 million in two months using the forward rate above.

Note (2)

The money market hedge is based upon interest rate parity and using the IRP formula we can calculate the maximum rate of interest that can be borne for the money market hedge to be worthwhile.

The technique for a reverse money market hedge is identical to that for a conventional hedge except that the counter currency is borrowed in the foreign market, converted at spot and deposited in the domestic market. However, for a money market hedge to work, the company must be able to secure short term money market finance in both the base and the counter currency area. With the SFr exposure it is possible to borrow at fixed in the Swiss market. Using the no arbitrage condition of the interest rate parity formula we can determine the maximum rate of interest the company should agree in creating a money market hedge. The interest rate in the base currency to use is the best rate for depositing in the Euro market:

$$1.6199 = 1.6244 \times \frac{1+i\times\frac{2}{12}}{1+0.03725\times\frac{2}{12}}$$

If the company can borrow at less than spot Swiss 2·13% in the Swiss market then the money market hedge will be preferred to a forward sale of SFr 1·5 million.

(b) The relative advantages and disadvantages of the use of a money market hedge versus exchange traded derivatives A money market hedge is a mechanism for the delivery of foreign currency, at a future

date, at a specified rate without recourse to the forward FOREX market. If a company is able to achieve preferential access to the short term money markets in the base and counter currency zones then it can be a cost effective substitute for a forward agreement. However, it is difficult to reverse quickly and is cumbersome to establish as it requires borrowing/lending agreements to be established denominated in the two currencies.

Exchange traded derivatives such as futures and foreign exchange options offer a rapid way of creating a hedge and are easily closed out. For example, currency futures are normally closed out and the profit/loss on the derivative position used to offset the gain or loss in the underlying. The fixed contract sizes for exchange traded products mean that it is often impossible to achieve a perfect hedge and some gain or loss on the unhedged element of the underlying or the derivative will be carried. Also, given that exchange traded derivatives are priced in a separate market to the underlying there may be discrepancies in the movements of each and the observed delta may not equal one. This basis risk is minimised by choosing short maturity derivatives but cannot be completely eliminated unless maturity coincides exactly with the end of the exposure. Furthermore less than perfectly hedged positions require disclosure under IFRS 39. Although rapid to establish, currency hedging using the derivatives market may also involve significant cash flows in meeting and maintaining the margin requirements of the exchange. Unlike futures, currency options will entail the payment of a premium which may be an expensive way of eliminating the risk of an adverse currency movement.

With relatively small amounts, the OTC market represents the most convenient means of locking in exchange rates. Where cross border flows are common and business is well diversified across different currency areas then currency hedging is of questionable benefit. Where, as in this case, relatively infrequent flows occur then the simplest solution is to engage in the forward market for hedging risk. The use of a money market hedge as described may generate a more favorable forward rate than direct recourse to the forex market. However the administrative and management costs in setting up the necessary loans and deposits are a significant consideration.
(c) The only risk which will impact on a firm's cost of capital is that risk which is priced in either the equity or the debt markets.
Considering these two markets in turn:
Currency risk forms part of a firm's exposure to market risk and will impact on a firm's cost of capital through its beta value and, as a result, its equity cost of capital. The extent to which this is significant depends on the exposed volume of currency transactions conducted in a given period, the average duration of the exposure and the correlation of the currency with the market. If a given currency has the same correlation with the market as the company, removing currency risk will have no impact on the firm's overall exposure to market risk and as a result no impact on the firm's cost of capital. The greater the difference in the relative correlations the higher the potential improvement in shareholder value from hedging. The impact on the cost of debt is more complex. The most significant impact is through the firm's exposure to default risk. If currency transactions are significant and the foreign currency is highly correlated with the domestic currency then the impact is unlikely to be significant and the gains from hedging modest. Where the degree of correlation is low or indeed negative then eliminating currency risk may significantly alter the firm's default risk. However, unlike market risk default risk is related to the overall volatility of a firm's underlying value and its ability to finance its debt. The elimination of currency risk is therefore likely to have at least some impact on the volatility of the firm's cash flows and therefore its cost of capital.

Answer to Q. No. 19
Answer:

(a) The adjusted present value technique separates the value created by the Galileo project into two components: (a) the value of the project cash flows at the firm's pure rate of equity (i.e., the unlevered WACC), and (b) the gain or loss of value associated with the costs and benefits of the new finance.

The adjusted present value method is only appropriate where the project does not affect the firm's exposure to business risk.
With the Galileo project we can estimate the alteration to the firm's cash flows as a whole if the project were to proceed. This adjustment entails a substantial tax benefit because of writing down allowances but also a delayed tax charge attributable to the increase in the firm's taxable earnings generated by the project.

The project cash flows exclude all non-relevant costs but include the opportunity costs associated with the redeployment of labour. The projected relevant cash flows and the calculation on the eventual profit on the sale of the capital equipment are as follows:

	0	1	2	3	4	5
Sales revenue		680·00	900·00	900·00	750·00	320·00
Direct costs		–408·00	–540·00	–540·00	–450·00	–192·00
Redeployment of labour		–150·00	–150·00			
operating cash flow		122·00	210·00	360·00	300·00	128·00
capital payments and receipts	–800·00					40·00
less written down value						31·00
profit on sale of equipment						8·90

On the basis of this the net of tax operating cash flows and the tax savings attributable to the write-off for tax purposes of the capital equipment are:

	0	1	2	3	4	5	6
operating cash flow		122·00	210·00	360·00	300·00	128·00	
tax on operating cash flows			–36·00	–63·00	–108·00	–90·00	–38·40
		122·00	173·40	297·00	192·00	38·00	–38·40
capital cash flow	–800·00					40·00	
capital allowance saving		120·00	48·00	28·80	17·28	10·37	6·22
sale of capital equipment							–2·67
nominal project cash flow	–800·00	242·00	221·40	325·80	209·28	88·37	–34·85

The valuation of this future cash flow involves the firm's cost of capital on the basis that it is ungeared (the pure equity rate). The calculation of the ungeared rate is shown in note 1.
Using the ungeared rate of 8·97% to discount the project cash flows and LIBOR plus the firm's credit spread (7·2%) to discount the tax benefit associated with the project an adjusted present value is estimated at 100·69 million as follows:

	0	**1**	**2**	**3**	**4**	**5**	**6**
nominal project cash flow	–800·00	242·00	221·40	325·80	209·28	88·37	–34·85
discount at pure equity rate	–800·00	222·07	186·44	251·76	148·41	57·50	–20·81
Net present value of post tax operating flow	45·38						
new capital introduced	–816·32						
tax saving on annual interest		17·63	17·63	17·63	17·63	17·63	
discounted value of tax shield on		71·63	15·87	15·06	14·29	13·56	12·86

interest

Cost of financing	–16·32
Adjusted present value	100·69

Note: it is assumed that there is no tax relief on debt.

This suggests that the new project will add substantial value to the firm although $71·63 million is attributable to the tax benefit associated with the new financing less 2% transaction cost associated with the new debt finance. With this project the clear advice on the basis of the financial analysis is to proceed although it is worth bearing in mind that more marginal projects may be solely justified through the financing effect.

The modified internal rate of return (MIRR) is calculated using the rate of return required to discount those cash flows as follows:
One procedure for calculating the MIRR is to calculate the terminal value of the cash flows from the recovery phase of the project using the company's cost of capital of 8·97%.

	0	**1**	**2**	**3**	**4**	**5**	**6**
nominal project cash flow	–800·00	242·00	221·40	325·80	209·28	88·37	–34·85
compound factor using 8·97%		1·5365	1·4100	1·2940	1·1874	1·0897	1·0000
terminal cash flow		371·83	312·18	421·57	248·51	96·29	–34·85
future value of recovery cash flows	1,415·54						

The modified internal rate of return is found by calculating the internal rate of return of the modified project cash flow:
$-800+1\ 415\ 54/(1+MIRR)^6=0$

$1+MIRR1 = \sqrt[6]{\frac{1415.54}{800}} - 1$

Therefore MIRR = 9.98%

Answer to Q. No. 20
(a) Small company will want to borrow 3 million Rupees, but can borrow in sterling at a rate that is 2% lower than the rate that the Nepalese counterparty can obtain. The Nepalese counterparty presumably wants to borrow in sterling (the equivalent of 3 million Rupees), but can can borrow in Rupees at a rate that is 0.5% lower than the rate that Small Company can obtain.
This provides an opportunity for credit arbitrage of 2% + 0.5% = 2.5%.
The bank would take 0.5% in fees, leaving 2% of net credit arbitrage for the swap counterparties to share. Small Company would have three-quarters of this amount, which is 1.5%.
The swap arrangement might therefore be as follows:

	Small Company	Nepalese counterparty
	%	%
Borrow direct	(6.5)	(NIBOR + 1.5)
Swap		
Pay	NIBOR	6.5
Receive	6.0	NIBOR
Net cost	NIBOR + 0.5%	8.00%

Small company would pay 1.5% less than by borrowing direct (at NIBOR + 2%) and the Nepalese counterparty would borrow at 0.5% less than by borrowing sterling direct at 8.5%.

(b)
It is assumed that 15% is the appropriate discount rate for evaluating the project's cash flows in sterling. (A DCF rate of 15% would be very low for evaluating the cash flows in Rupees, considering the expected high rate of inflation in Nepal.)
It is also assumed that the swap will be undertaken, and in Year 0 Small Company will spend £333,333 (30 million Rupees at the spot rate of 90.00). At the end of Year 3, it is assumed that Small Company will receive the same amount (£333,333) on the termination of the currency swap, and a further 30,000,000 Rupees for the remainder of the sale price of the operations centre.
The project cash flows will therefore be as follows:

Year	Amount	Rate
0	£(333,333)	
1	2,000,000 Rupees	at the end of Year 1 spot rate
2	2,000,000 Rupees	at the end of Year 2 spot rate
3	2,000,000 Rupees	at the end of Year 3 spot rate
3	30,000,000 Rupees	at the end of Year 3 spot rate
3	30,000,000 Rupees	at the swap rate of 90.00, therefore £333,333.

Year	Spot rate	
	Best case	Worst case
	10% inflation	50% inflation
0	90.00	90.00
1	99.00	135.00
2	108.90	202.50
3	119.80	303.80

Year	Cash flow Rupees	DCF @ 15%	Best case (£)		Worst case (£)	
			Cash flow	PV	Cash flow	PV
0		1.000	(333,333)	(333,333)	(333,333)	(333,333)
1	2,000,000	0.870	20,202	17,576	14,815	12,889
2	2,000,000	0.756	18,365	13,884	9,877	7,467
3	32,000,000	0.658	267,112	175,760	105,332	69,308
3	30,000,000	0.658	333,333	219,333	333,333	219,333

NPV	**+ 93,220**	**(24,336)**

(Note: As the company will enter into a currency swap, the 30,00,000 component of terminal refund is converted to £ at NRs. 90/£. The rest of the refund component is translated using expected spot rates as calculated in the above table)

Conclusion

On the basis of the assumptions used, the project would have a positive NPV if inflation in Nepal exceeds inflation in the UK by 10% per year, but will have a negative NPV if inflation in Nepal exceeds inflation in the UK by 50% per year.

There is consequently an element of risk in the project due to uncertainty about the spot exchange rate, and this risk element should be assessed more closely before a decision is taken about the investment.

Answer to Q.No. 21

	X Ltd.			Y Ltd.		
Year	Dividend payout Ratio = DPS/EPS	Average price(MPS) = (Low+High)/2	P/E ratio = MPS/EPS	Dividend payout Ratio = DPS/EPS	Average price(MPS) = (Low+High)/2	P/E ratio = MPS/EPS
1	21.51%	82.5	8.87	20%	70	7.37
2	27.03%	67.5	9.12	20%	45	6.43
3	19.05%	90	8.57	20%	57.5	5.48
4	17.65%	110	8.63	20%	100	8.16
5	12.50%	167.5	8.38	20%	117.5	5.80
6	15.63%	170	10.63	20%	160	9.41
7	13.16%	182.5	9.61	20%	185	9.25
Average	18.07%	124.29	9.11	20.00%	105	7.41

Though the earnings are higher, Y ltd. follows a constant dividend rate policy thereby giving a doubt on the shareholders as to the amount of dividend that will be received. Whereas in case of X Ltd., it is following a constant dividend policy (i.e. fixed amount as dividend) & that has been increasing in intervals (without decline) therefore giving more confidence to the shareholders on the dividend amount & these expectations thereby fueling increased share price of X ltd.

Calculation of ROE,

We have, ROE = Dividend yield + Capital gains Yield

For Company X

Year	Dividend	Average price	Dividend Yield = DPS/MPS	Capital Gain Yield = (Closing Price - Opening Price) / Opening price	ROE
1		82.50	2.42%	-17.50%	-15.08%
2	2	67.50	2.96%	-18.18%	-15.22%
3	2	90.00	2.22%	33.33%	35.56%
4	2.25	110.00	2.05%	22.22%	24.27%
5	2.5	167.50	1.49%	52.27%	53.77%
6	2.5	170.00	1.47%	1.49%	2.96%
7	2.5	182.50	1.37%	7.35%	8.72%

For Y Ltd.

Year	Dividend	Average price	Dividend Yield = DPS/MPS	Capital Gain Yield = (Closing Price - Opening Price) / Opening price	ROE
1	1.90	70	2.71%	-30.00%	-27.29%
2	1.40	45	3.11%	-35.71%	-32.60%
3	2.10	57.5	3.65%	27.78%	31.43%
4	2.45	100	2.45%	73.91%	76.36%
5	4.05	117.5	3.45%	17.50%	20.95%
6	3.40	160	2.13%	36.17%	38.30%
7	4.00	185	2.16%	15.63%	17.79%

Answer to Q.No. 22

Only the transactions resulting in cash flows between Kenduri Co and Lakama Co are considered for hedging. Other transactions are not considered.

Net flow in US$:
US$4·5m payment – US$2·1m receipt = US$2·4m payment

Hedge the US$ exposure using the forward market, the money market and options.

Forward market

US$ hedge: 2,400,000/1·5996 = £1,500,375 payment

Money market

US$ hedge

Invest in US$: 2,400,000/(1 + 0·031/4)	= US$2,381,543
Convert into £ at spot: US$2,381,543/1·5938	= £1,494,255
Borrow in £: £1,494,255 x (1 + 0·040/4)	= £1,509,198

The forward market is preferred due to lower payment costs.

Options

Kenduri Co would purchase Sterling three-month put options to protect itself against a strengthening US$ to £.

Exercise price: $1·60/£1

£ payment	= 2,400,000/1·60 = 1,500,000 or 24 contracts
24 put options purchased	
Premium payable	= 24 x 0·0208 x 62,500 = US$31,200
Premium in £	= 31,200/1·5938 = £19,576
Total payments	= £1,500,000 + £19,576 = £1,519,576

Exercise price: $1·62/£1

£ payment	= 2,400,000/1·62 = 1,481,481 or 23·7 contracts
23 put options purchased	
£ payment	= 23 x 62,500 = £1,437,500
Premium payable	= 23 x 0·0342 x 62,500 = US$49,163

Premium in £	= 49,163/1·5938 = £30,846
Amount not hedged	= US$2,400,000 – (23 x 62,500 x 1·62) = US$71,250
Use forwards to hedge amount not hedged	= US$71,250/1·5996 = £44,542
Total payments	= 1,437,500 + 30,846 + 44,542 = £1,512,888

Both these hedges are worse than the hedge using forward or money markets. This is due to the premiums payable to let the option lapse if the prices move in Kenduri Co's favour . Options have an advantage over forwards and money markets because the prices are not fixed and the option buyer can let the option lapse if the rates move favourably. Hence options have an unlimited upside but a limited downside. With forwards and money markets, Kenduri Co cannot take advantage of the US$ weakening against the £.

Conclusion

The forward market minimises the payment and is therefore recommended over the money market. However ,options give Kenduri Co the choice of an unlimited upside, although the cost is higher . Therefore the choice between the forward market and the option market depends on the risk preference of the company.

Answer to Q. No.23

1) The profit on the tender (if J Limited is successful in winning) is calculated as follows:

Details	Amount	Forward Rate	€ Value
Receipt 1	300,000,000 ZAR (40,000*750)	12.56 (13.00 - .44)	2,388,535
Receipt 2	450,000,000 ZAR (60,000*750)	12.1 (13.00 - .9)	3,719,008
Payment	10,000,000 AD (100,000*100)	2.08 (1.9 + .18)	-4,807,692
Profit On Contract			**1,299,851**

2) The use of FECs to hedge the foreign currency risk would be inappropriate for transactions of this nature.

This is primarily because whilst J Limited may not even win the contract it will have committed itself to the execution of three FECs.

If they are unsuccessful in winning the tender it will be obliged to sell ZAR and buy Australian Dollars at spot on the dates on which the FECs must be executed. This will create foreign exchange transaction risk and incur significant transaction charges/commissions.

Given the inherent uncertainty of the ZAR receipts and Australian Dollar payments J Limited would be best advised to hedge the foreign currency transaction risk using internal methods (if possible) and if not possible by using more flexible external methods e.g. currency options or a money market hedge.

3)

Currency & Exercise Date	Amount of Foreign Currency	Exercise Price	Options Purchased	€ Value	Commission	Final € Receipt/Cost
6 M ZAR Put	300,000,000 ZAR	12	60	2,500,000	-75,000	2,425,000
12 M ZAR Put	450,000,000 ZAR	12	90	3,750,000	-247,500	3,502,500
12 M AD Call	10,000,000 AD	2	100	-5,000,000	-80,000	-5,080,000

Profit On Tender 847,000

4) Limitations of using Currency Options as a method of hedging foreign currency transaction risk.

a) They can be expensive (perhaps prohibitively so), particularly OTC options
b) The premium must be paid immediately and whether or not the option is ultimately exercised
c) Standardised (exchange traded) options may not achieve a perfect hedge for a transaction (if not exactly divisible by the standardised option size) resulting in some residual foreign exchange risk
Standardised (exchange traded) options are not available in all world currencies

REVISION TEST PAPER
AUDIT AND ASSURANCE
DECEMBER 2016

1. You are an audit manager in Dhakal & Co, Chartered Accountants responsible for the audit of listed pharmaceutical company- "Nagarik Pharmaceuticals Ltd". You are planning the audit of the financial statements for the year ending 31 Ashad 31 2073, and the audit partner, Sunil Joshi, has sent you this email:

To: Audit manager
From: Sunil Joshi, Audit partner
Subject: Audit planning – Nagarik Pharmaceuticals Ltd.

Hello

I would like you to start planning the audit of Nagarik Pharmaceuticals. The company's finance director, Hareram, has sent to me this morning some key financial information discussed at the latest board meeting. I have also provided you with minutes of a meeting I had with Hareram last week and some background information about the company. Using this information I would like you to prepare briefing notes for my use in which you:

a) Evaluate the business risks faced by Nagarik Pharmaceuticals;
b) Identify and explain FOUR risks of material misstatement to be considered in planning the audit;
c) Recommend the principal audit procedures to be performed in respect of the acquired 'Cold Comforts' brand name; and
d) Discuss the ethical issues relevant to the audit firm, and recommend appropriate actions to be taken.

Thank you.

Background information
Nagarik Pharmaceuticals is a company, developing drugs to be licensed for use around the world. Products include medicines such as tablets and medical gels and creams. Some drugs are sold over the counter at pharmacy stores, while others can only be prescribed for use by a doctor. Products are heavily advertised to support the company's brand names. In some countries television advertising is not allowed for prescription drugs.
The market is very competitive, encouraging rapid product innovation. New products are continually in development and improvements are made to existing formulations. Four new drugs are in the research and development phase. Drugs have to meet very stringent regulatory requirements prior to being licensed for production and sale. Research and development involves human clinical trials, the results of which are scrutinised by the licensing authorities.
It is common in the industry for patents to be acquired for new drugs and patent rights are rigorously defended, sometimes resulting in legal action against potential infringement.

Minutes from Sunil's meeting with Hareram
Nagarik Pharmaceuticals has approached its bank to extend its borrowing facilities. An extension of NRs. 10 million is being sought to its existing loan to support the on-going development of new drugs. Our firm has been asked by the bank to provide a guarantee in respect of this loan extension.
In addition, the company has asked the bank to make cash of NRs. 3 million available in the event that an existing court case against the company is successful. The court case is being brought by an individual who suffered severe and debilitating side effects when participating in a clinical trial in 2071-72.

In Shrawan 2072, Nagarik Pharmaceuticals began to sell into a new market – that of animal health. This has been very successful, and the sales of veterinary pharmaceuticals and grooming products for livestock and pets amount to approximately 15% of total revenue for 2072-73.
Another success during the year 2072-73 was the acquisition of the 'Cold Comforts' brand from a rival company. Products to alleviate the symptoms of coughs and colds are sold under this brand. The brand cost NRs. 5 million and is being amortised over an estimated useful life of 15 years.

Nagarik Pharmaceutical's accounting and management information systems are out of date. This is not considered to create any significant control deficiencies, but the company would like to develop and implement new systems next year. Management has asked our firm to give advice on the new systems as they have little specialist in-house knowledge in this area.

Key financial information

NRs.'000

	2072-73 (unaudited)	**2071-72 (Audited)**
Revenue	40,000	38,000
Operating profit	8,100	9,085
Operating margin	20%	24%
Earnings per share	25c	29c
Net cash flow	(1,200)	6,000
Research and development cash outflow in the year	(3,000)	(2,800)
Total development intangible asset recognised at the year end	50,000	48,000
Total assets	200,000	195,000
Gearing ratio (debt/equity)	0.8	0.9

Required:
Respond to the email from the audit partner.

2. You are a manager in the audit department of Sharma & Co, Chartered Accountants and you are reviewing the audit working papers in relation to the Explore Group (the Group), whose financial year ended on 31 Ashad 2073. Your firm audits all components of the Group, which consists of a parent company and three subsidiaries – Ishara Co, Tishara Co and Basera Co.

The Group manufactures engines which are then supplied to the car industry. The draft consolidated financial statements recognise profit for the year to 31 Ashad 2073 of NRs.23 million (2071-72 – NRs.33 million) and total assets of NRs.450 million (2071-72 – NRs.455 million).

Information in respect of three issues has been highlighted for your attention during the file review.

a) An 80% equity shareholding in Basera Co was acquired on Magh 1, 2072. Goodwill on the acquisition of NRs. 27 million was calculated at that date and remains recognised as an intangible asset at that value at the year end. The goodwill calculation performed by the Group's management is shown below:

NRs.'000

Purchase consideration	75000
Fair value of 20% non-controlling interest	13000
	88000
Less: Fair value of Basera Co's identifiable net assets at acquisition	61000)
Goodwill	27000

In determining the fair value of identifiable net assets at acquisition, an upwards fair value adjustment of NRs. 300,000 was made to the book value of a property recognised in Basera Co's financial statements at a carrying value of NRs. 600,000.
A loan of NRs. 60 million was taken out on Magh 1, 2072 to help finance the acquisition. The loan carries an annual interest rate of 6%, with interest payments made annually in arrears. The loan will be repaid in 20 years at a premium of NRs.5 million.

b) In Falgun 2072, a natural disaster caused severe damage to the property complex housing the Group's head office and main manufacturing site. For health and safety reasons, a decision was made to demolish the property complex. The demolition took place three weeks after the damage was caused. The property had a carrying value of NRs. 16 million at 31 Ashad 2073.
A contingent asset of NRs. 18 million has been recognised as a current asset and as deferred income in the Group statement of financial position at 31 Ashad 2073, representing the amount claimed under the Group's insurance policy in respect of the disaster.

c) Ishara Co supplies some of the components used by Tishara Co in its manufacturing process. At the year end, an intercompany receivable of NRs. 20 million is recognised in Ishara Co's financial statements. Tishara Co's financial statements include a corresponding intercompany payables balance of NRs. 20 million and inventory supplied from Ishara Co valued at NRs. 50 million.

Required:
Comment on the matters to be considered, and explain the audit evidence you should expect to find during your review of the audit working papers in respect of each of the issues described above.

3. Soma Air Pvt. Ltd. is a new audit client of Joshi & Co. You are responsible for the audit of the financial statements for the year ended 31 Ashad 2073. The draft financial statements recognise revenue of NRs. 150 million and total assets of NRs. 250 million.
During the year, the Co purchased several large plots of land located near major airports at a cost of NRs. 12.5 million. The land is currently rented out and is classified as investment property, which is recognised in the draft financial statements at a fair value of NRs. 14.5 million.

Required:
In respect of the land recognised as investment property, explain the additional information which you require to plan the audit of the land

4. Soma Air Pvt. Ltd. is a new audit client of Joshi & Co. You are responsible for the audit of the financial statements for the year ended 31 Ashad 2073. The draft financial statements recognise revenue of NRs.150 million and total assets of NRs. 250 million. During the year, the Co purchased several large plots of land located near major airports at a cost of NRs. 12.5 million. The land is currently rented out and is classified as investment property, which is recognised in the draft financial statements at a fair value of NRs. 14.5 million. The audit partner has suggested the use of an auditor's expert to obtain evidence in respect of the fair value of the land.

Explain the matters to be considered in assessing the reliance which can be placed on the work of an auditor's expert.

5. Promote Pokhara Pvt. Ltd. is a long-standing audit client of your firm. Aashis Pokharel has acted as audit engagement partner for seven years and understands that a new audit partner needs to be appointed to take his place. Aashis is hoping to stay in contact with the client and act as the engagement quality control reviewer in forthcoming audits of Promote Pokhara.

Required:
Explain the ethical threats raised by the long association of senior audit personnel with an audit client and the relevant safeguards to be applied.

6. The audit of Ambu Steel Co.'s financial statements for the year ended 31 Ashad 2073 is nearly complete, and the audit report is due to be issued next week. Ambu Steel Co. operates steel processing plants at 5 locations and sells its output to manufacturers and engineering companies. You are performing an engagement quality control review on the audit of Ambu Steel Co, as it is a significant new client of your firm. The financial statements recognise revenue of NRs. 2.5 million, and total assets of NRs. 35 million.

The audit senior who has been working on the audit of Ambu Steel Co made the following comment when discussing the completion of the audit with you:
'We received the final version of the financial statements and the chairman's statement to be published with the financial statements yesterday. I have quickly looked at the financial statements but the audit manager said I need not perform a detailed review on the financial statements as the audit was relatively low risk. The manager also said that he had discussed the chairman's statement with the finance director so no further work on it is needed.'

Required:
Explain the quality control and other professional issues raised by the audit senior's comment in relation to the completion of the audit.

7. The audit of Ambu Steel Co.'s financial statements for the year ended 31 August 2014 is nearly complete, and the audit report is due to be issued next week. The financial statements recognise revenue of NRs. 2.5 million, and total assets of NRs. 35 million.

The schedule of proposed adjustments to uncorrected misstatements included in Ambu Steel Co's audit working papers is shown below, including notes to explain each matter included in the schedule. The audit partner is holding a meeting with management tomorrow, at which the uncorrected misstatements will be discussed.

NRs.

Proposed adjustments to uncorrected misstatements	**Statement of Profit or Loss**		**Statement of Financial Position**	
	Debit	**Credit**	**Debit**	**Credit**
Share based payment scheme	300,000			300,000

Restructuring provision		50,000	50,000	
Additional allowance required for slow-moving inventory	10,000			10,000
Total	**10,000**	**50,000**	**50,000**	**10,000**

A share-based payment scheme was established in January 2014. Management has not recognised any amount in the financial statements in relation to the scheme, arguing that due to the decline in Ambu Steel Co's share price, the share options granted are unlikely to be exercised. The audit conclusion is that an expense and related equity figure should be included in the financial statements.

A provision has been recognised in respect of a restructuring involving the closure of one of the steel processing plants. Management approved the closure at a board meeting in August 2014, but announced the closure to employees in September 2014. The audit conclusion is that the provision should not be recognised.

The estimate relates to slow-moving inventory in respect of a particular type of steel alloy for which demand has fallen. Management has already recognised a provision of NRs. 35,000, which is considered insufficient by the auditor.

Required:

(i) Explain the matters which should be discussed with management in relation to each of the uncorrected misstatements; and

(ii) Assuming that management does not adjust the misstatements, justify an appropriate audit opinion and explain the impact on the auditor's report.

8. Discuss two problems that may be faced in implementing quality control procedures in a small firm of Chartered Accountants, and recommend how these problems may be overcome.

9. Define
   a. Forensic accounting
   b. Forensic Investigation
   c. Forensic Auditing

10. Following statement is made by the internal auditor to the board of directors of Woodland Furniture Pvt. Ltd.

    'I think that someone is taking items from the warehouse. A physical inventory count is performed every three months, and it has become apparent that about 200 boxes of flat-packed chairs and tables are disappearing from the warehouse every month. We should get someone to investigate what has happened and quantify the value of the loss.'

    Explain the relevance of forensic accounting to the statement made by the internal auditor.

11. Discuss the statement - Financial statements often contain material balances recognised at fair value. For auditors, this leads to additional audit risk.

12. Compare and contrast the responsibilities of management, and of auditors, in relation to the assessment of going concern. You should include a description of the procedures used in this assessment where relevant.

13. Discuss why the identification of related parties, and material related party transactions, can be difficult for auditors.

14. You are the manager responsible for the audit of Axis Management Co., a listed company, for the year ended 31 March 2008. Your firm was appointed as auditors of Axis Management Co. in September 2007. The audit work has been completed, and you are reviewing the working papers in order to draft a report to those charged with governance. The statement of financial position (balance sheet) shows total assets of NRs. 78 million (2007 – NRs. 66 million). The main business activity of Axis Management Co. is the manufacture of farm machinery.
During the audit of property, plant and equipment it was discovered that controls over capital expenditure transactions had deteriorated during the year. Authorisation had not been gained for the purchase of office equipment with a cost of NRs. 225,000. No material errors in the financial statements were revealed by audit procedures performed on property, plant and equipment.

An internally generated brand name has been included in the statement of financial position (balance sheet) at a fair value of NRs. 10 million. Audit working papers show that the matter was discussed with the financial controller, who stated that the NRs. 10 million represents the present value of future cash flows estimated to be generated by the brand name. The member of the audit team who completed the work programme on intangible assets has noted that this treatment appears to be in breach of IAS 38 Intangible Assets, and that the management refuses to derecognise the asset.

Problems were experienced in the audit of inventories. Due to an oversight by the internal auditors of Axis Management Co., the external audit team did not receive a copy of inventory counting procedures prior to attending the count. This caused a delay at the beginning of the inventory count, when the audit team had to quickly familiarise themselves with the procedures. In addition, on the final audit, when the audit senior requested documentation to support the final inventory valuation, it took two weeks for the information to be received because the accountant who had prepared the schedules had mislaid them.

a) Identify the main purpose of including 'findings from the audit' (management letter points) in a report to those charged with governance.
b) From the information provided above, recommend the matters which should be included as 'findings from the audit' in your report to those charged with governance, and explain the reason for their inclusion.

15. Explain and differentiate between the terms 'overall audit strategy' and 'audit plan'.

16. Explain the auditor's responsibility in relation to subsequent events.

17. You are the manager responsible for the audit of Lychee Co, a manufacturing company with a year ended 30 September 2009. The audit work has been completed and reviewed and you are due to issue the audit report in three days. The draft audit opinion is unmodified. The financial statements show revenue for the year ended 30 September 2009 of NRs. 15 million, net profit of NRs. 3 million, and total assets at the year-end are NRs. 80 million.
The finance director of Lychee Co telephoned you this morning to tell you about the announcement yesterday, of a significant restructuring of Lychee Co, which will take place over the next six months. The restructuring will involve the closure of a factory, and its relocation to another part of the country. There

will be some redundancies and the estimated cost of closure is NRs. 250,000. The financial statements have not been amended in respect of this matter.

Required:
In respect of the announcement of the restructuring:
(i) Comment on the financial reporting implications, and advise the further audit procedures to be performed; and
(ii) Recommend the actions to be taken by the auditor if the financial statements are not amended.

18. M/s Rely More Cooperative Limited with a paid up share capital of NRs. 20,00,000 has earned surplus after tax in the financial year 2067/68 to the tune of NRs. 7,50,000. The management of the Cooperative Limited wants to distribute the profit to various funds as follows:
i) General Reserve NRs. 100,000
ii) Dividend to members NRs. 500,000
iii) Appropriation in various funds NRs. 150,000
The above appropriation of surplus to various funds has also been approved by the Board of Directors of the Cooperative. You are required to verify, as an auditor, the validity of above appropriations in the light of the Cooperatives Act, 2048.

19. You are a manager of a four partner firm. The directors of Surya Group., a listed company, wish to dismiss their auditors. The directors of Surya Group have approached your firm to act as auditors and have stated that they are prepared to pay NRs. 100,000 as an audit fee, plus a bonus of 1% of the profit after taxation.
The directors of the company have a poor reputation as regards employee welfare and there is a high turnover of employees. The company's business practices have previously been investigated by the authorities but no action was taken against the directors or the company.

Required
Comment on the ethical and other professional issues you would take into account before deciding whether or not your firm should indicate its willingness to accept nomination as auditors of Surya Group.

20. Difference between hot review & cold review

21. Described below are situations which have arisen in two unrelated audits and which are considered material

a) Although you are satisfied that closing inventories this year are fairly stated, the audit report on the previous year's financial statements was modified due to a restriction on the scope of the audit work in respect of the closing inventory figure. This led to a qualified opinion.
b) The financial statements disclose the fact that a provision may be required to reduce inventories to their net realisable value if a contract with a major customer, representing 60% of the company's revenue, is not renewed. A decision on this by the customer is not expected until after the accounts are due to be signed.

Required
a) State what is meant by, and explain the relationship between, the concepts of materiality and true & fair.
b) State, with reasons, the effect on the audit reports of the situations described above.

22. Malika construction is a company engaged in demolition, construction & removals. In the year ended 31 Ashad 2073 the company made a trading profit of NRs. 5,000,000. You are the manager in charge of the audit. The following issues have been arisen:

i) A customer is suing the company for NRs. 1,500,000 for damage caused to antique furniture. The company is defending the claim and believes that the furniture was reproduction as opposed to antique and therefore worth only NRs. 650,000.
ii) The company has recently invested in three new heavy vehicles and is currently carrying out extensive refurbishment of its premises. As a result of this expenditure the company has reached its overdraft limit of NRs. 3,500,000.

Required

For each of the above issues

a) State with reasons the audit work that you would expect to find in undertaking your review of the audit working papers for the year ended 31 Ashad 2073.
b) Draft the relevant sections dealing with these issues of the management representation letter you would wish the directors to sign.

1. Solution

Briefing notes

To: Audit partner
From: Audit manager
Subject: Audit planning for Nagarik Pharmaceuticals, year ending 31 Ashad 2073

Introduction
These briefing notes are prepared to assist in planning the audit of Nagarik Pharmaceuticals, our client operating in the pharmaceutical industry. Specifically, the briefing notes will evaluate the business risks facing our client, identify and explain four risks of material misstatement, recommend audit procedures in relation to a new brand acquired during the year, and finally explain ethical threats to our firm.

a) Business risks

Licensing of products
A significant regulatory risk relates to the highly regulated nature of the industry in which the company operates. If any of Nagarik Pharmaceuticals's products fail to be licensed for development and sale, it would mean that costs already incurred are wasted. Research and development costs are significant. For example, in 2072-73 the cash outflow in relation to research and development amounted to 7.5% of revenue, and the failure to obtain the necessary licences is a major threat to the company's business objectives.

Patent infringements
In developing new products and improving existing products, Nagarik Pharmaceuticals must be careful not to breach any competitor's existing patent. In the event of this occurring, significant legal costs could be incurred in defending the company's legal position. Time and effort must be spent monitoring product developments to ensure legal compliance with existing patents. Similarly, while patents serve to protect Nagarik Pharmaceuticals's products, if a competitor were found to be in breach of one of the company's patents, costs of bringing legal action against that company could be substantial.

Advertising regulations
The company risks running inappropriate advertising campaigns, and failing to comply with local variations in regulatory requirements. For example, if television campaigns to promote products occurred in countries where this is not allowed, the company could face fines and reputational damage, with consequences for cash flow and revenue streams.

Skilled personnel
The nature of Nagarik Pharmaceuticals's operations demands a skilled workforce with the necessary scientific knowledge to be able to develop new drugs. Loss of personnel, especially to competitors in the industry, would be a drain on the remaining resources and in the worst case scenario it could delay the development and launch of new products. It may be difficult to attract and retain skilled staff given the pending court case and potential reputational damage to the company.

Diversification and rapid growth
During the year Nagarik Pharmaceuticals has acquired a new brand name and range of products, and has also diversified into a new market, that of animal health products. While diversification

has commercial and strategic advantages, it can bring risks. Management may struggle to deal with the increased number of operations which they need to monitor and control, or they may focus so much on ensuring the success of the new business segments that existing activities are neglected. There may also be additional costs associated with the diversification which puts pressure on cash and on the margins of the enlarged business. This may be the reason for the fall in operating profit of 10.8% and for the decline in operating margin from 24% to 20%.

Cash flow and liquidity issues

Nagarik Pharmaceuticals seems to be struggling to maintain its cash position, as this year its cash flow is negative by NRs. 1.2 million. Contributing factors to this will include the costs of acquiring the 'Cold Comforts' brand name, expenditure to launch the new animal-related product line, and the cash outflow in relation to on-going research and development, which has increased by 7.1% in the year. The first two of these are one-off issues and may not create a cause for concern over long-term cash management issues, but the company must be careful to maintain a positive cash inflow from its operating activities to provide a sound foundation for future activities.

Companies operating in this industry must be careful to manage cash flows due to the nature of the product lifecycle, meaning that large amounts have to be expended long before any revenue is generated, in some cases the time lag may be many years before any cash inflow is derived from expenditure on research activities.

The fact that the company has approached its bank to make cash available in the event of damages of NRs. 3 million having to be paid out indicates that the company is not very liquid, and is relying to some degree on external finance. If the bank refuses to extend existing borrowing facilities, the company may have to find finance from other sources, for example, from an alternative external provider of funds or from an issue of equity shares, which may be difficult to achieve and expensive. The company has relatively high gearing, which may deter potential providers of finance or discourage potential equity investors. If finance is refused, the company may not be able to pay liabilities as they fall due, and other operational problems may arise, for example, an inability to continue to fund in-progress research and development projects. Ultimately this would result in a going concern problem, though much more information is needed to assess if this is a risk at this yearend.

Court case and bad publicity

The court case against the company will create reputational damage, and publicity over people suffering side effects while participating in clinical trials will undoubtedly lead to bad publicity, affecting market share especially if competitors take advantage of the situation. It is also likely that the bad publicity will lead to increased scrutiny of the company's activities making it more vulnerable should further problems arise.

Risk of overtrading

The fall in operating margin and earnings per share is a worrying sign for shareholders, though for the reasons explained above this may not be the start of a long-term trend as several events in this year have put one-off pressure on margins.

However, there could be a risk of overtrading, as the company's revenue has increased by 5.2%.

b) Risks of material misstatement

Inherent risk of management bias

Nagarik Pharmaceuticals's management is attempting to raise finance, and the bank will use its financial statements as part of their lending decision. There is therefore pressure on management to present a favourable position. This may lead to bias in how balances and transactions are measured and presented. For example, there is a risk that earnings management techniques are used to overstate revenue and understate expenses in order to maximise the profit recognised. Estimates

included in the financial statements are also subject to higher risk. ISA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures states that auditors shall review the judgements and decisions made by management in the making of accounting estimates to identify whether there are indicators of management bias.

Research and development costs – recognition

There is a significant risk that the requirements of IAS 38 Intangible Assets have not been followed. Research costs must be expensed and strict criteria must be applied to development expenditure to determine whether it should be capitalised and recognised as an intangible asset. Development costs are capitalised only after technical and commercial feasibility of the asset for sale or use have been established, and Nagarik Pharmaceuticals must demonstrate an intention and ability to complete the development and that it will generate future economic benefits. The risk is that research costs have been inappropriately classified as development costs and then capitalised, overstating assets and understating expenses.

A specific risk relates to the drug which was being developed but in relation to which there have been side effects during the clinical trials. It is unlikely that the costs in relation to this product development continue to meet the criteria for capitalisation, so there is a risk that they have not been written off, overstating assets and profit.

Development costs – amortisation

When an intangible asset has a finite useful life, it should be amortised systematically over that life. For a development asset, the amortisation should correspond with the pattern of economic benefits generated from the sale of associated goods. The risk is that the amortisation period has not been appropriately assessed. For example, if a competitor introduces a successful rival product which reduces the period over which Nagarik Pharmaceuticals's product will generate economic benefit, this should be reflected in a reduction in the period over which that product is amortised, resulting in an increased amortisation charge. The risk if this does not happen is that assets are overstated and expenses are understated.

Patents – recognition and amortisation

The cost of acquiring patents for products should be capitalised and recognised as an intangible asset as the patent provides protection over the economic benefit to be derived. If patent costs have been expensed rather than capitalised, this would understate assets and overstate expenses. Once recognised, patents should be amortised over the period of their duration, and non-amortisation will overstate assets and understate expenses.

Court case – provisions and contingent liabilities

The court case which has been brought against Nagarik Pharmaceuticals may give rise to a present obligation as a result of a past event, and if there is a probable outflow of economic benefit which can be measured reliably, then a provision should be recognised.

The clinical trial took place in 2071-72, so the obligating event has occurred. Depending on the assessment of probability of the case going against Nagarik Pharmaceuticals, it may be that instead of a provision, a contingent liability exists. This would be the case if there is a possible, rather than probable, outflow of economic benefit. The risk is that either a necessary provision is not recognised, understating liabilities and expenses, or that a contingent liability is not appropriately disclosed in the notes to the financial statements, in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

Legal fees relating to the court case should also be accrued if they have been incurred before the year end, and failure to do so will understate current liabilities and understate expenses.

Segmental reporting

The diversification into the new product area relating to animal health may warrant separate disclosure according to IFRS 8 Operating Segments. This requires listed companies to disclose in a note to the financial statements the performance of the company disaggregated over its operating or geographical segments, as the information is viewed by management. As the new product area has been successful and contributes 15% to revenue, it could be seen as a significant operating segment, and disclosure of its revenue, profit and other figures may be required. The risk is non-disclosure or incomplete disclosure of the necessary information.

c) Recommended audit procedures

- Review board minutes for evidence of discussion of the purchase of the acquired brand, and for its approval.
- Agree the cost of NRs. 5 million to the company's cash book and bank statement.
- Obtain the purchase agreement and confirm the rights of Nagarik Pharmaceuticals in respect of the brand.
- Discuss with management the estimated useful life of the brand of 15 years and obtain an understanding of how 15 years has been determined as appropriate.
- If the 15-year useful life is a period stipulated in the purchase document, confirm to the terms of the agreement.
- If the 15-year useful life is based on the life expectancy of the product, obtain an understanding of the basis for this, for example, by reviewing a cash flow forecast of sales of the product.
- Obtain any market research or customer satisfaction surveys to confirm the existence of a revenue stream.
- Consider whether there are any indicators of potential impairment at the yearend by obtaining pre year-end sales information and reviewing terms of contracts to supply the products to pharmacies.
- Recalculate the amortisation expense for the year and agree the charge to the financial statements, and confirm adequacy of disclosure in the notes to the financial statements.

d) Ethical threats

There are two ethical threats relevant to the audit firm.

First, the bank has asked our firm to provide a guarantee in respect of the bank loan which may be advanced to our client. The provision of such a guarantee represents a financial interest in an audit client, and creates a self-interest threat because the audit firm has an interest in the financial position of the client, causing loss of objectivity when auditing the financial statements.

According to Code of Ethics for Professional Accountants (the Code), if an audit firm guarantees a loan to an audit client, the self-interest threat created would be so significant that no safeguards could reduce the threat to an acceptable level unless the loan or guarantee is immaterial to both the audit firm and the client. In this case the loan would be material as it represents 5% of Nagarik Pharmaceuticals's total assets, and would also be considered material in nature because of the company's need for the additional finance.

The second threat relates to Nagarik Pharmaceuticals's request for our firm to provide advice on the new accounting and management information systems to be implemented next year. If the advice were given, it would constitute the provision of a non-assurance service to an audit client. The Code has detailed guidance in this area and specific requirements in the case of a public interest entity such as Nagarik Pharmaceuticals which is a listed entity.

The Code states that services related to IT systems including the design or implementation of hardware or software systems may create a self-review threat. This is because when auditing the financial statements the auditor would assess the systems which they had recommended, and an objective assessment would be difficult to achieve. There is also a risk of assuming the

responsibility of management, especially as Nagarik Pharmaceuticals has little experience in this area, so would rely on the auditor's suggestions and be less inclined to make their own decision.

In the case of an audit client which is a public interest entity, the Code states that an audit firm shall not provide services involving the design or implementation of IT systems which form a significant part of the internal control over financial reporting or which generate information which is significant to the client's accounting records or financial statements on which the firm will express an opinion.

Therefore the audit firm should not provide a service to give advice on the accounting systems. With further clarification on the nature of the management information systems and the update required to them, it may be possible for the audit firm to provide a service to Nagarik Pharmaceuticals, as long as those systems are outside of the financial reporting system. However, it may be prudent for the audit firm to decline offering any advice on systems to the client.

These ethical issues should be discussed with those charged with governance of Nagarik Pharmaceuticals, with an explanation provided as to why the audit firm cannot guarantee the loan or provide the non-audit service to the company.

Conclusion

Nagarik Pharmaceuticals faces a variety of business risks, some of which are generic to the industry in which it operates, while others are more entity-specific. A number of risks of material misstatement have been discussed, and the audit planning must ensure that appropriate responses are designed for each of them. The purchase of a new brand will necessitate detailed audit testing.

Two ethical issues have been raised by requests from the client for our firm to provide a loan guarantee and to provide advice on systems, both of which create significant threats to independence and objectivity, and the matters must be discussed with the client before advising that we are unable to provide the guarantee or to provide the systems advice.

2. Solution

a) Measurement of goodwill on acquisition

The goodwill arising on the acquisition of Basera Co is material to the Group financial statements, representing 6% of total assets.

The goodwill should be recognised as an intangible asset and measured according to IAS 38 Intangible Assets and IFRS 3 Business Combinations. The purchase consideration should reflect the fair value of total consideration paid and payable, and there is a risk that the amount shown in the calculation is not complete, for example, if any deferred or contingent consideration has not been included.

The non-controlling interest has been measured at fair value. This is permitted by IFRS 3, and the decision to measure at fair value can be made on an investment by investment basis. The important issue is the basis for measurement of fair value. If Basera Co is a listed company, then the market value of its shares at the date of acquisition can be used and this is a reliable measurement. If Basera Co is not listed, then management should have used estimation techniques according to the fair value hierarchy of inputs contained in IFRS 13 Fair Value Measurement. This would introduce subjectivity into the measurement of non-controlling interest and goodwill and the method of determining fair value must be clearly understood by the auditor.

The net assets acquired should be all identifiable assets and liabilities at the date of acquisition. For such a significant acquisition some form of due diligence investigation should have been performed, and one of the objectives of this would be to determine the existence of assets and liabilities, even those not recognised in Basera Co's individual financial statements. There is a risk that not all acquired assets and liabilities have been identified, or that they have not been appropriately measured at fair value, which would lead to over or understatement of goodwill and incomplete recording of assets and liabilities in the consolidated financial statements.

The fair value adjustment of NRs. 300,000 made in relation to Basera Co's property is not material to the Group accounts, representing less than 1% of total assets. However, the auditor should confirm that additional depreciation is being charged at Group level in respect of the fair value uplift. Though the value of the depreciation would not be material to the consolidated financial statements, for completeness and accuracy the adjustment should be made.

The auditor should also consider if any further adjustments need to be made to Basera Co's net assets to ensure that Group accounting policies have been applied. IFRS 3 requires consistency in accounting policies across Group members, so if the necessary adjustments have not been made, the assets and liabilities will be over or understated on consolidation.

Impairment

IAS 38 requires that goodwill is tested annually for impairment regardless of whether indicators of potential impairment exist. The goodwill in relation to Basera Co is recognised at the same amount at the year-end as it was at acquisition, indicating that no impairment has been recognised. It could be that management has performed an impairment review and has concluded that there is no impairment, or that no impairment review has been performed at all.

However, Group profit has declined by 30·3% over the year, which in itself is an indicator of potential impairment of the Group's assets, so it is unlikely that no impairment exists unless the fall in revenue relates to parts of the Group's activities which are unrelated to Basera Co. There is a risk that Group assets are overstated and profit overstated if any necessary impairment has not been recognised.

Loan

The loan is material, representing 13.3% of the Group's total assets.

The loan taken out to finance the acquisition should be accounted for under IFRS 9 Financial Instruments. It should be initially measured at fair value, and classified according to whether it is subsequently measured at amortised cost or at fair value. As the loan is not held for trading, it should be measured at amortised cost unless Group management decides to use the fair value option.

Assuming subsequent measurement is based on amortised cost, an effective interest rate should be calculated to allocate the premium to be paid on maturity over the 20-year life of the loan, meaning that the annual finance charge will be more than just the actual interest paid. There is a risk that the finance charge does not include an element relating to the premium, in which case both the finance charge and the liability are understated.

Evidence:

- Agreement of the purchase consideration to the legal documentation pertaining to the acquisition, and a review of the documents to ensure that the figures included in the goodwill calculation are complete.
- Agreement of the NRs. 75 million to the bank statement and cash book of the acquiring company (presumably the parent company of the Group).
- Review of board minutes for discussions relating to the acquisition, and for the relevant minute of board approval.
- A review of the purchase documentation and a register of significant shareholders of Basera Co to confirm the 20% non-controlling interest.
- If Basera Co's shares are not listed, a discussion with management as to how the fair value of the non-controlling interest has been determined and evaluation of the appropriateness of the method used.
- If Basera Co's shares are listed, confirmation that the fair value of the non-controlling interest has been calculated based on an externally available share price at the date of acquisition.
- A copy of any due diligence report relevant to the acquisition, reviewed for confirmation of acquired assets and liabilities and their fair values.

- An evaluation of the methods used to determine the fair value of acquired assets, including the property, and liabilities to confirm compliance with IFRS 3 and IFRS 13.
- Review of depreciation calculations, and recalculation, to confirm that additional depreciation is being charged on the fair value uplift.
- A review of the calculation of net assets acquired to confirm that Group accounting policies have been applied.
- Discussion with management regarding the potential impairment of Group assets and confirmation as to whether an impairment review has been performed.
- A copy of any impairment review performed by management, with scrutiny of the assumptions used, and re-performance of calculations.
- Re-performance of management's calculation of the finance charge in relation to the loan, to ensure that the loan premium has been correctly accrued.
- Agreement of the loan receipt and interest payment to bank statement and cash book.
- Review of board minutes for approval of the loan to be taken out.
- A copy of the loan agreement, reviewed to confirm terms including the maturity date, premium to be paid on maturity and annual interest payments.
- A copy of the note to the financial statements which discusses the loan to ensure all requirements of IFRSs 7 and 13 have been met.

b) Property complex

The carrying value of the property complex is material to the Group financial statements, representing 3.6% of total assets.

The natural disaster is a subsequent event, and its accounting treatment should be in accordance with IAS 10 Events after the Reporting Period. IAS 10 distinguishes between adjusting and non-adjusting events, the classification being dependent on whether the event provides additional information about conditions already existing at the year end. The natural disaster is a non-adjusting event as it indicates a condition which arose after the year end.

Disclosure is necessary in a note to the financial statements to describe the impact of the natural disaster, and quantify the effect which it will have on next year's financial statements.

The demolition of the property complex should be explained in the note to the financial statements and reference made to the monetary amounts involved. Consideration should be made of any other costs which will be incurred, e.g. if there is inventory to be written off, and the costs of the demolition itself.

The contingent asset of NRs.18 million should not have been recognised. Even if the amount were virtually certain to be received, the fact that it relates to the non-adjusting event after the reporting period means that it cannot be recognised as an asset and deferred income at the year end.

The financial statements should be adjusted to remove the contingent asset and the deferred income. The amount is material at 4% of total assets. There would be no profit impact of this adjustment as the NRs. 18 million has not been recognised in the statement of profit or loss.

Evidence:

- A copy of any press release made by the Group after the natural disaster, and relevant media reports of the natural disaster, in particular focusing on its impact on the property complex.
- Photographic evidence of the site after the natural disaster, and of the demolished site.
- A copy of the note to the financial statements describing the event, reviewed for completeness and accuracy.
- A schedule of the costs of the demolition, with a sample agreed to supporting documentation, e.g. invoices for work performed and confirmation that this is included in the costs described in the note to the financial statements.

- A schedule showing the value of inventories and items such as fixtures and fittings at the time of the disaster, and confirmation that this is included in the costs described in the note to the financial statements.
- A copy of the insurance claim and correspondence with the Group's insurers to confirm that the property is insured.
- Confirmation that an adjustment has been made to reverse out the contingent asset and deferred income which has been recognised.

c) Intercompany trading

The intercompany receivables and payables represent 4.4% of Group assets and are material to the consolidated statement of financial position. The inventory is also material, at 11% of Group assets.

On consolidation, the intercompany receivables and payables balances should be eliminated, leaving only balances between the Group and external parties recognised at Group level. There is a risk that during the consolidation process the elimination has not happened, overstating Group assets and liabilities by the same amount.

If the intercompany transaction included a profit element, then the inventory needs to be reduced in value by an adjustment for unrealised profit. This means that the profit made by Ishara Co on the sale of any inventory still remaining in the Group at the year-end is eliminated. If the adjustment has not been made, then inventory and Group profit will be overstated.

Evidence:

- Review of consolidation working papers to confirm that the intercompany balances have been eliminated.
- A copy of the terms of sale between Ishara Co and Tishara Co, scrutinised to find out if a profit margin or mark-up is part of the sales price.
- A reconciliation of the intercompany balances between Tishara Co and Ishara Co to confirm that there are no other reconciling items to be adjusted, e.g. cash in transit or goods in transit.
- Copies of inventory movement reports for the goods sold from Ishara Co to Tishara Co, to determine the quantity of goods transferred.
- Details of the inventory count held at Tishara Co at the year end, reviewed to confirm that no other intercompany goods are held at the year end.

3. Solution

Additional information needed to plan the audit of land includes the following:

- Details of the reason for the purchase, to understand the business rationale, e.g. is the land held for capital appreciation?
- Does management have any specific plans for how Faster Jets Co may make use of the land in the future, e.g. are there plans to construct buildings and if so what will be their purpose?
- The date of purchase to ascertain how long it has taken for the land to increase in value by NRs. 2 million and whether this seems reasonable.
- Whether the land was purchased for cash or if finance was taken out to raise the NRs. 12.5 million paid.
- Who is renting the land? This could establish whether the arrangement is with a related party.
- The type of rental arrangement and whether it constitutes a finance or operating lease.
- What is the land being used for? As the legal owner, Faster Jets Co should be aware of its use and any associated risks, e.g. activities close to airports may convey security risks, e.g. terrorism.
- The location of the purchased land – this is necessary to plan the logistics of the audit.
- Does the company hold any other investment property, and if so, is that also held at fair value? The accounting treatment should be consistent for all investment property.

- What is management's rationale for the accounting policy choice to measure the land at fair value? It will result in profit for the year including the NRs.2 million fair value increase.
- Establish who holds the title deeds to the land as this may need to be inspected.

4. Solution

Matters to consider before placing reliance on the work of the auditor's expert

ISA 620 Using the Work of an Auditor's Expert contains requirements relating to the objectivity and capabilities of the auditor's expert, the scope and objectives of their work, and assessing their work.

Objectivity

According to ISA 620, the auditor shall evaluate whether the auditor's expert has the necessary objectivity and that this should include inquiry regarding interests and relationships which may create a threat to the expert's objectivity. The audit firm will need to ensure that the expert has no connection to Soma Air, for example, that they are not a related party of the company or any person in a position of influence over the financial statements. If the expert's objectivity is threatened, less reliance can be placed on their work.

Competence

ISA 620 also requires the competence of the expert to be considered; this should include considering the expert's membership of appropriate professional bodies. Any doubts over the competence of the expert will reduce the reliability of audit evidence obtained. The expert should in this case have experience in valuing land, and be familiar with the framework for measuring fair value in accordance with IAS 40 Investment Property and IFRS 13 Fair Value Measurement.

Scope of work

ISA 620 requires the auditor to agree the scope of work with the expert. This may include agreement of the objectives of the work, how the expert's work will be used by the auditor and the methodology and key assumptions to be used.

In assessing the work performed by the expert, the auditor should confirm that the scope of the work is as agreed at the start of the engagement. If the expert has deviated from the agreed scope of work, it is likely to be less relevant and reliable.

Relevance of conclusions

ISA 620 states that the auditor shall evaluate the relevance and adequacy of the expert's findings or conclusions. This will involve consideration of the source data which was used, the appropriateness of assumptions and the reasons for any changes in methodology or assumptions. The conclusion should be consistent with other relevant audit findings and with the auditor's general understanding of the business. Any inconsistencies should be investigated as they may indicate evidence which is not reliable.

5. Solution

Ethical threats created by long association of senior audit personnel and relevant safeguards

When a senior auditor acts for an audit client for a long period, several ethical problems can arise. First, the professional scepticism of the auditor can be diminished. This happens because the auditor becomes too accepting of the client's methods and explanations, so stops approaching the audit with a questioning mind.

Familiarity and self-interest threats are created by using the same senior personnel on an audit engagement over a long period of time. The familiarity threat is linked to the issues relating to the loss of professional scepticism discussed above, and is due to the senior auditor forming a close relationship with the client's personnel over a long period of time.

As with any ethical threat, the significance of the threat should be evaluated and safeguards which reduce the threat to an acceptable level put in place. Matters which should be considered in evaluating the significance of the ethical threat could include the seniority of the auditor involved, the length of time they have acted for the client, the nature, frequency and extent of the individual's interactions with the client's management or those charged with governance and whether the client's management team has changed.

Examples of safeguards which can be used include:

- Rotating the senior personnel off the audit team;
- Having a professional accountant who was not a member of the audit team review the work of the senior personnel; or
- Regular independent internal or external quality control reviews of the engagement.

6. Solution

Quality control, ethical and other issues raised

It is a requirement of ISA 520 Analytical Procedures that analytical procedures are performed at the overall review stage of the audit. An objective of ISA 520 is that the auditor should design and perform analytical procedures near the end of the audit which assist the auditor when forming their opinion as to whether the financial statements are consistent with the auditor's understanding of the entity.

It is unlikely that the audit senior's 'quick look' at Ambu Steel Co's financial statements is adequate to meet the requirements of ISA 520 and audit documentation would seem to be inadequate. Therefore if the audit senior, or another auditor, does not perform a detailed analytical review on Ambu Steel Co.'s financial statements as part of the completion of the audit, there is a breach of ISA 520. Failing to perform the final analytical review could mean that further errors are not found, and the auditor will not be able to check that the presentation of the financial statements conforms to the requirements of the applicable financial reporting framework. It is also doubtful whether a full check on the presentation and disclosure in the financial statements has been made. The firm should evidence this through the use of a disclosure checklist.

The lack of final analytical review increases audit risk. Because Ambu Steel Co. is a new audit client, it is particularly important that the analytical review is performed as detection risk is higher than for longer-standing audit engagements where the auditor has developed a cumulative knowledge of the audit client.

The fact that the audit manager suggested that a detailed review was not necessary shows a lack of knowledge and understanding of ISA requirements. An audit client being assessed as low risk does not negate the need for analytical review to be performed, which the audit manager should know. Alternatively, the audit manager may have known that analytical review should have been performed, but regardless of this still instructed the audit senior not to perform the review, maybe due to time pressure. The audit manager should be asked about the reason for his instruction and given further training if necessary.

The manager is not providing proper direction and supervision of the audit senior, which goes against the principles of ISA 220 Quality Control for an Audit of Financial Statements, and ISQC1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements and other Assurance and Related Services Engagements. Both of these discuss the importance of the audit team having proper direction and supervision as part of ensuring a good quality of audit engagement performance.

The second issue relates to the chairman's statement. ISA 720 The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements requires that the auditor shall read the other information to identify material inconsistencies, if any, with the audited financial statements.

The audit manager has discussed the chairman's statement but this does not necessarily mean that the manager had read it for the purpose of identifying potential misstatements, and it might not have been read at all. Even if the manager has read the chairman's statement, there may not be any audit documentation to show that this has been done or the conclusion of the work. The manager needs to be asked exactly what work has been done, and what documentation exists. As the work performed does not comply with the ISA 720 requirements, then the necessary procedures must be performed before the audit report is issued.

Again, the situation could indicate the audit manager's lack of knowledge of ISA requirements, or that a short-cut is being taken. In either case the quality of the audit is in jeopardy.

7. Solution

i. Evaluation of Uncorrected Misstatements

During the completion stage of the audit, the effect of uncorrected misstatements must be evaluated by the auditor, as required by ISA 450 Evaluation of Misstatements Identified during the Audit. In the event that management refuses to correct some or all of the misstatements communicated by the auditor, ISA 450 requires that the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. Therefore a discussion with management is essential in helping the auditor to form an audit opinion.

ISA 450 also requires that the auditor shall communicate with those charged with governance about uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report.

Each of the matters included in the schedule of uncorrected misstatements will be discussed below and the impact on the audit report considered individually and in aggregate.

Share-based payment scheme

The adjustment in relation to the share-based payment scheme is material individually to profit, representing 12% of revenue. It represents less than 1% of total assets and is not material to the statement of financial position.

IFRS 2 Share-based Payment requires an expense and a corresponding entry to equity to be recognised over the vesting period of a share-based payment scheme, with the amount recognised based on the fair value of equity instruments granted. Management's argument that no expense should be recognised because the options are unlikely to be exercised is not correct. IFRS 2 would classify the fall in Ambu Steel Co.'s share price as a market condition, and these are not relevant to determining whether an expense is recognised or the amount of it.

Therefore management should be requested to make the necessary adjustment to recognise the expense and entry to equity of NRs. 300,000. If this is not recognised, the financial statements will contain a material misstatement, with consequences for the auditor's opinion.

Restructuring provision

The adjustment in relation to the provision is material to profit, representing 2% of revenue. It represents less than 1% of total assets so is not material to the statement of financial position.

The provision appears to have been recognised too early. IAS 37 Provisions, Contingent Liabilities and Contingent Assets requires that for a restructuring provision to be recognised, there must be a present obligation as a result of a past event, and that is only when a detailed formal plan is in place and the entity has started to implement the plan, or announced its main features to those affected. A board decision is insufficient to create a present obligation as a result of a past event. The provision should be recognised in September 2014 when the announcement to employees was made.

Management should be asked to explain why they have included the provision in the financial statements, for example, there may have been an earlier announcement before 31 August 2014 of which the auditor is unaware.

In the absence of any such further information, management should be informed that the accounting treatment of the provision is a material misstatement, which if it remains unadjusted will have implications for the auditor's opinion.

Inventory provision

The additional slow-moving inventory provision which the auditor considers necessary is not material on an individual basis to either profit or to the statement of profit or loss or the statement of financial position, as it represents only 0.4% of revenue and less than 1% of total assets.

Despite the amount being immaterial, it should not be disregarded, as the auditor should consider the aggregate effect of misstatements on the financial statements. ISA 450 does state that the auditor need not accumulate balances which are 'clearly trivial', by which it means that the accumulation of such amounts clearly would not have a material effect on the financial statements. However, at 0·4% of revenue the additional provision is not trivial, so should be discussed with management.

This misstatement is a judgemental misstatement as it arises from the judgements of management concerning an accounting estimate over which the auditor has reached a different conclusion. This is not a breach of financial reporting standards, but a difference in how management and the auditor have estimated an uncertain amount. Management should be asked to confirm the basis on which their estimate was made, and whether they have any reason why the provision should not be increased by the amount recommended by the auditor.

If this amount remains unadjusted by management, it will not on an individual basis impact the auditor's report.

ii. Impact on auditor's report

Aggregate materiality position

In aggregate, the misstatements have a net effect of NRs. 260,000 (NRs. 310,000 – NRs. 50,000), meaning that if left unadjusted, profit will be overstated by NRs. 260,000 and the statement of financial position overstated by the same amount. This is material to profit, at 10.4% of revenue, but is not material to the statement of financial position at less than 1% of total assets.

Impact on auditor's report

The statement of profit or loss is materially misstated if the adjustments are not made by management. According to ISA 705 Modifications to the Opinion in the Independent Auditor's Report, the auditor shall modify the opinion in the auditor's report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.

The type of modification depends on the significance of the material misstatement. In this case, the misstatements in aggregate are material to the financial statements, but are unlikely to be considered pervasive even though they relate to a number of balances in the financial statements as they do not represent a substantial proportion of the financial statements, and do not make them misleading when viewed as a whole. If that were the case, the opinion would be adverse in nature.

Therefore a qualified opinion should be expressed, with the auditor stating in the opinion that except for the effects of the matters described in the basis for qualified opinion paragraph, the financial statements show a true and fair view.

The basis for qualified opinion paragraph should be placed immediately before the opinion paragraph, and should contain a description of the matters giving rise to the qualification. This should include a description and quantification of the financial effects of the misstatement.

8. Solution

Consultation
It may not be possible to hold extensive consultations on specialist issues within a small firm, due to a lack of specialist professionals. There may be a lack of suitably experienced peers to discuss issues arising on client engagements. Arrangements with other practices for consultation may be necessary. Where special skills are needed within an engagement; the skills may be bought in, for example, by seconding staff from another practice. Alternatively if work is too specialised for the firm, the work could be sub-contracted to another practice.

Review procedures
It may not be possible to hold an independent review of an engagement within the firm due to the small number of senior and experienced auditors. In this case an external review service may be purchased.
The firm may lack resources to establish an in-house set of audit manuals or standard working papers. In this case documentation can be provided by external firms or professional bodies.

9. Solution

Forensic accounting utilises accounting, auditing, and investigative skills to conduct an examination into a company's financial statements. The aim of forensic accounting is to provide an accounting analysis that is potentially suitable for use in court. Forensic accounting is an umbrella term encompassing both forensic investigations and forensic audits. It includes the audit of financial information to prove or disprove a fraud, the interview process used during an investigation, and the act of serving as an expert witness.
Specifically it is the process of gathering, analysing and reporting on data for the purpose of finding facts and/or evidence in the context of financial/legal disputes and/or irregularities. The forensic accountant will also give preventative advice based on evidence gathered. This advice is based usually on recommendations to improve the internal control systems to prevent and detect fraud.

Forensic investigation is a process whereby a forensic accountant carries out procedures to gather evidence, which could ultimately be used in legal proceedings or to settle disputes. This could include, for example, an investigation into money laundering. A forensic investigation involves many stages (similar to an audit), including planning, evidence gathering, quality control reviews, and finally results in the production of a report.

Forensic auditing is the specific use of audit procedures within a forensic investigation to find facts and gather evidence, usually focused on the quantification of a financial loss. This could include, for example, the use of analytical procedures, and substantive procedures to determine the amount of an insurance claim.

10. Solution

The relevance here is that the Woodland Furniture is likely to hire a consultant to provide a forensic accounting service. The investigation will consider two issues – firstly whether the fraud actually happened, and secondly, if a fraud has taken place, the financial value of the fraud. The investigation should determine who has perpetrated the fraud, and collect evidence to help prosecute those involved in the deception.
In this case the suspicion that inventory is being stolen should be investigated, as there could be other reasons for the discrepancy found in the inventory records. For example, the discrepancy could be caused by:

- Obsolete or damaged inventory thrown away but not eliminated from the inventory records
- Despatches from the warehouse not recorded in the inventory management system

- Incoming inventory being recorded incorrectly (e.g. recorded twice in the inventory management system)
- Inventory being held at a separate location and therefore not included in the count.

If it is found that thefts have taken place, then the forensic accountant should gather evidence to:
- Prove the identity of the persons involved
- Quantify the value of inventory taken.

The evidence gathered could be used to start criminal proceedings against those found to have been involved in the fraud.

11. Solution

Balances held at fair value are frequently recognised as material items in the statement of financial position. Sometimes it is required by the financial reporting framework that the measurement of an asset or liability is at fair value, e.g. certain categories of financial instruments, whereas it is sometimes the entity's choice to measure an item using a fair value model rather than a cost model, e.g. properties. It is certainly the case that many of these balances will be material, meaning that the auditor must obtain sufficient appropriate evidence that the fair value measurement is in accordance with the requirements of financial reporting standards. ISA 540 Auditing Accounting Estimates Including Fair Value Accounting Estimates and Related Disclosures and ISA 545 Auditing Fair Value Measurements and Disclosures contain guidance in this area.

As part of the understanding of the entity and its environment, the auditor should gain an insight into balances that are stated at fair value, and then assess the impact of this on the audit strategy. This will include an evaluation of the risk associated with the balance(s) recognised at fair value.

Audit risk comprises three elements; each is discussed below in the context of whether material balances shown at fair value will lead to increased risk for the auditor.

Inherent risk

Many measurements based on estimates, including fair value measurements, are inherently imprecise and subjective in nature. The fair value assessment is likely to involve significant judgments, e.g. regarding market conditions, the timing of cash flows, or the future intentions of the entity. In addition, there may be a deliberate attempt by management to manipulate the fair value to achieve a desired aim within the financial statements, in other words to attempt some kind of window dressing.

Many fair value estimation models are complicated, e.g. discounted cash flow techniques, or the actuarial calculations used to determine the value of a gratuity fund etc. In addition to the complexities, some fair value measurement techniques will contain significant assumptions, e.g. the most appropriate discount factor to use, or judgments over the future use of an asset. Management may not always have sufficient experience and knowledge in making these judgments.

Thus the auditor should approach some balances recognised at fair value as having a relatively high inherent risk, as their subjective and complex nature means that the balance is prone to contain an error. However, the auditor should not just assume that all fair value items contain high inherent risk. Each balance recognised at fair value should be assessed for its individual level of risk.

Control risk

The risk that the entity's internal monitoring system fails to prevent and detect valuation errors needs to be assessed as part of overall audit risk assessment. One problem is that the fair value assessment is likely to be performed once a year, outside the normal accounting and management systems, especially where the valuation is performed by an external specialist. Therefore, as a non-routine event, the assessment of

fair value is likely not to have the same level of monitoring or controls as a day-to-day business transaction.
However, due to the material impact of fair values on the statement of financial position, and in some circumstances on profit, management may have made great effort to ensure that the assessment is highly monitored and controlled. It therefore could be the case that there is extremely low control risk associated with the recognition of fair values.

Detection risk
The auditor should minimise detection risk via thorough planning and execution of audit procedures. The audit team may lack experience in dealing with the fair value in question, and so would be unlikely to detect errors in the valuation techniques used. Over-reliance on an external specialist could also lead to errors not being found.

Conclusion
It is true that the increasing recognition of items measured at fair value will in many cases cause the auditor to assess the audit risk associated with the balance as high. However, it should not be assumed that every fair value item will be likely to contain a material misstatement. The auditor must be careful to identify and respond to the level of risk for fair value items on an individual basis to ensure that sufficient and appropriate evidence is gathered, thus reducing the audit risk to an acceptable level.

12. Solution
ISA 570 Going Concern provides a clear framework for the assessment of the going concern status of an entity, and differentiates between the responsibilities of management and of auditors. Management should assess going concern in order to decide on the most appropriate basis for the preparation of the financial statements. IAS 1 Presentation of Financial Statements (revised) requires that where there is significant doubt over an entity's ability to continue as a going concern, the uncertainties should be disclosed in a note to the financial statements. Where the directors intend to cease trading, or have no realistic alternative but to do so, the financial statements should be prepared on a 'break up' basis. Thus the main focus of the management's assessment of going concern is to ensure that relevant disclosures are made where necessary, and that the correct basis of preparation is used.
The auditor's responsibility is to consider the appropriateness of the management's use of the going concern assumption in the preparation of the financial statements and to consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in a note. The auditor should also consider the length of the time period that management have looked at in their assessment of going concern. The auditor will therefore need to come to an opinion as to the going concern status of an entity but the focus of the auditor's evaluation of going concern is to see whether they agree with the assessment made by the management. Therefore whether they agree with the basis of preparation of the financial statements, or the inclusion in a note to the financial statements, as required by IAS 1, of any material uncertainty.

Evaluation techniques
In carrying out the going concern assessment, management will evaluate a wide variety of indicators, including operational and financial. An entity employing good principles of corporate governance should be carrying out such an assessment as part of the on-going management of the business.
Auditors will use a similar assessment technique in order to come to their own opinion as to the going concern status of an entity. They will carry out an operational review of the business in order to confirm business understanding, and will conduct a financial review as part of analytical procedures. Thus both management and auditors will use similar business risk assessment techniques to discover any threats to the going concern status of the business.

However, one difference is that when going concern problems are discovered, the auditor is required by IAS 570 to carry out additional procedures. Examples of such procedures would include:

- Analysing and discussing cash flow, profit and other relevant forecasts with management
- Analysing and discussing the entity's latest available interim financial statements
- Reviewing events after the period end to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern, and
- Reading minutes of meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.

Management are not explicitly required to gather specific evidence about going concern, but as part of good governance would be likely to investigate and react to problems discovered.

13. Solution

Identification of related parties

Related parties and associated transactions are often difficult to identify, as it can be hard to establish exactly who, or what, are the related parties of an entity. IAS 24 Related Party Disclosures contains definitions which in theory serve to provide a framework for identifying related parties, but deciding whether a definition is met can be complex and subjective. For example, related party status can be obtained via significant interest, but in reality it can be difficult to establish the extent of influence that potential related parties can actually exert over a company.

The directors may be reluctant to disclose to the auditors the existence of related parties or transactions. This is an area of the financial statements where knowledge is largely confined to management, and the auditors often have little choice but to rely on full disclosure by management in order to identify related parties. This is especially the case for a close family member of those in control or having influence over the entity, whose identity can only be revealed by management.

Identification of material related party transactions

Related party transactions may not be easy to identify from the accounting systems. Where accounting systems are not capable of separately identifying related party transactions, management need to carry out additional analysis, which if not done makes the transactions extremely difficult for auditors to find. For example sales made to a related party will not necessarily be differentiated from 'normal' sales in the accounting systems.

Related party transactions may be concealed in whole, or in part, from auditors for fraudulent purposes. A transaction may not be motivated by normal business considerations, for example, a transaction may be recognised in order to improve the appearance of the financial statements by 'window dressing'. Clearly if the management is deliberately concealing the true nature of these items it will be extremely difficult for the auditor to discover the rationale behind the transaction and to consider the impact on the financial statements.

Finally, materiality is a difficult concept to apply to related party transactions. Once a transaction has been identified, the auditor must consider whether it is material. However, materiality has a particular application in this situation. ISA 550 Related Parties states that the auditor should consider the effect of a related party transaction on the financial statements. The problem is that a transaction could occur at an abnormally small, even nil, value. Determining materiality based on monetary value is therefore irrelevant, and the auditor should instead be alert to the unusual nature of the transaction making it material.

14. Solution

A report to those charged with governance is produced to communicate matters relating to the external audit to those who are ultimately responsible for the financial statements. ISA 260 Communication of Audit Matters With Those Charged With Governance requires the auditor to communicate many matters, including independence and other ethical issues, the audit approach and scope, the details of management representations, and the findings of the audit. The findings of the audit are commonly referred to as management letter points. By communicating these matters, the auditor is confident that there is written documentation outlining all significant matters raised during the audit process, and that such matters have been formally notified to the highest level of management of the client. For the management, the report should ensure that they fully understand the scope and results of the audit service which has been provided, and is likely to provide constructive comments to help them to fulfil their duties in relation to the financial statements and accounting systems and controls more effectively. The report should also include, where relevant, any actions that management has indicated they will take in relation to recommendations made by the auditors.

Control weakness

ISA 260 contains guidance on the type of issues that should be communicated. One of the matters identified is a control weakness in the capital expenditure transaction cycle. The assets for which no authorisation was obtained amount to 0.3% of total assets (225,000/78 million x 100%), which is clearly immaterial. However, regardless of materiality, the auditor should ensure that the weakness is brought to the attention of the management, with a clear indication of the implication of the weakness, and recommendations as to how the control weakness should be eliminated.

The auditor is providing information to help those charged with governance improve the internal systems and controls and ultimately reduce business risk. In this case there is a high risk of fraud, as the lack of authorisation for purchase of office equipment could allow expenditure on assets not used for bona fide business purposes.

Disagreement with accounting treatment of brand

Audit procedures have revealed a breach of IAS 38 Intangible Assets, in which internally generated brand names are specifically prohibited from being recognised. Axis Management Co. has recognised an internally generated brand name which is material to the statement of financial position (balance sheet) as it represents 12.8% of total assets (10/78 x 100%).

The statement of financial position (balance sheet) therefore contains a material misstatement.

The report to those charged with governance should clearly explain the rules on recognition of internally generated brand names, to ensure that the management has all relevant technical facts available. In the report the auditors should request that the financial statements be corrected, and clarify that if the brand is not derecognised, then the audit opinion will be qualified on the grounds of a material disagreement – an 'except for' opinion would be provided. Once the breach of IAS 38 is made clear to the management in the report, they then have the opportunity to discuss the matter and decide whether to amend the financial statements, thereby avoiding a qualified audit opinion.

Audit inefficiencies

Documentation relating to inventories was not always made readily available to the auditors. This seems to be due to poor administration by the client rather than a deliberate attempt to conceal information. The report should contain a brief description of the problems encountered by the audit team. The management should be made aware that significant delay to the receipt of necessary paperwork can cause inefficiencies in the audit process. This may seem a relatively insignificant issue, but it could lead to an increase in audit fee. Management should react to these comments by ensuring as far as possible that all requested documentation is made available to the auditors in a timely fashion.

15. Solution

The definitions of 'overall audit strategy' and 'audit plan' are found in ISA 300 Planning an Audit of Financial Statements.

The overall audit strategy sets the scope, timing and direction of the audit. Scope involves determining the characteristics of the audit client, such as its locations, and the relevant financial reporting framework, as these factors will help to establish the scale of the assignment. Timing refers to establishing deadlines for completion of work and key dates for expected communications. Establishing the overall audit strategy also includes the consideration of preliminary materiality, and initial identification of high risk areas within the financial statements. All of these matters contribute to the assessment of the nature, timing and extent of resources necessary to perform the engagement.

The overall audit strategy should then lead to the development of the audit plan.

The audit plan is more detailed than the audit strategy and includes a description of the risk assessment procedures, and the further planned audit procedures necessary at the assertion level for gathering evidence on the material transactions and balances in the financial statements. The general purpose of developing the audit plan is to design audit procedures which will reduce audit risk to an acceptably low level.

The difference between the audit strategy and the audit plan is therefore that the strategy is the initial planning to ensure there will be adequate resources allocated to the audit assignment in response to an initial evaluation of the entity's characteristics, whereas the audit plan is a detailed programme of audit procedures.

The strategy will therefore usually be developed before the plan; however, the two activities should be seen as inter-related, as changes in one may result in changes to the other. Both the strategy and the plan should be fully documented as this represents the record of proper planning of the audit assignment.

16. Solution

Subsequent events are defined as those events occurring between the date of the financial statements and the date of the auditor's report, and also facts discovered after the date of the auditor's report.

ISA 560 Subsequent Events differentiates the auditor's responsibilities in relation to subsequent events depending on when the subsequent event occurs.

Events occurring up to the date of the auditor's report

The auditor has an active duty to perform audit procedures designed to identify, and to obtain sufficient appropriate evidence of all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements. These procedures should be performed as close as possible to the

date of the auditor's report, and in addition, representations would be sought on the date that the report was signed.
Procedures would include reviewing management procedures for ensuring that subsequent events are identified, reading minutes of meetings of shareholders and management, reviewing the latest interim financial statements, and making appropriate enquiries of management.

Where a material subsequent event is discovered, the auditor should consider whether management have properly accounted for and disclosed the event in the financial statements in accordance with IAS 10 Events after the Reporting Period.

Facts discovered after the date of the auditor's report but before the date the financial statements are issued
The auditor does not have any responsibility to perform audit procedures or make any enquiry regarding the financial statements or subsequent events after the date of the auditor's report. In this period, it is the responsibility of management to inform the auditor of facts which may affect the financial statements.
When the auditor becomes aware of a fact which may materially affect the financial statements, the matter should be discussed with management. If the financial statements are appropriately amended then a new audit report should be issued, and procedures relating to subsequent events should be extended to the date of the new audit report. If management do not amend the financial statements to reflect the subsequent event, in circumstances where the auditor believes they should be amended, a qualified or adverse opinion of disagreement should be issued.

Facts discovered after the financial statements have been issued
After the financial statements have been issued, the auditor has no obligation to make any enquiry regarding the financial statements. However, the auditor may become aware of a fact which existed at the date of the audit report, which if known at the date may have caused a modification to the auditor's report. In this case, the matter should be discussed with management. This could result in the revision of the financial statements, in which case the auditor should issue a new audit report on the revised financial statements. This report should include an emphasis of matter paragraph referring to a note to the financial statements in which the reason for the revision is fully discussed. If management do not revise the financial statements, the auditor should take legal advice with the objective of trying to prevent further reliance on the auditor's report.

17. Solution

i. The announcement of a restructuring after the reporting date is a non-adjusting event after the reporting date, according to IAS 10 Events after the Reporting Period. This is because the event does not provide evidence in relation to a condition that existed at the year end.

Materiality calculations in respect of the potential cost of closure are as follows:
Based on revenue: NRs. 250,000/15 million = 1·67%
Based on profit: NRs. 250,000/3 million = 8·3%
Based on assets: NRs. 250,000/80 million = <1%
Therefore this amount is material to the statement of comprehensive income.

As per IAS 10, a note should be provided to the financial statements, which describes the nature of the event, and provides an estimate of the financial effect.
Audit procedures could include:

- Review any potential note to financial statements which should disclose the non-adjusting event, providing a brief description of the event, and an estimate of the financial effect.
- Discuss the reason for the restructuring with a member of key management personnel, and read minutes of board meetings where the plan was discussed, in order to gain an understanding about the reason for the restructuring.
- Verify the approval of the plan itself, and the approval of the announcement of the plan, which can be performed through a review of board minutes.
- Confirm the date on which the plan was approved, and also the date of the announcement, using supporting documentation such as press release, letters sent to employees, internal meetings held with employees, etc.
- Obtain a copy of the announcement and review for details, particularly a description of the exact nature of the restructuring, including the number of employees to be affected.
- Agree the NRs. 250,000 potential cost of closure to supporting documentation, including a schedule showing the number and grade of staff to be made redundant, which should be supported by payroll/contract details.
- Using the results of the discussion with management, assess the planned restructuring in the context of the auditor's knowledge of the business, considering whether any further costs are likely to be incurred.

ii. Actions to be taken by the auditor

If no note is provided to the financial statements, then there is a breach of IAS 10. In this case there is insufficient disclosure provided in the notes to the financial statements regarding a material non-adjusting event after the reporting date.

According to ISA 701 Modifications to the Independent Auditor's Report, in cases where the auditor is in disagreement with management regarding the application of a financial reporting standard and where the disagreement is material to the financial statements, the auditor should express a qualified or an adverse opinion. Here, the matter is material (as discussed in (b) (i) above) but is not pervasive to the financial statements, so a qualified 'except for' opinion should be given.

The audit report should contain a paragraph which explains the reason for the qualification, specifying the breach of accounting standards, and stating the relevant financial amount. It would also be best practice for the auditor to clarify that the profit for the year is not affected by the breach of accounting standards, and that the disagreement is solely due to inadequate disclosure in the notes to the financial statements.

The auditors should ensure that the matter, and the potential consequence for the audit report, has been made known to those charged with governance. This will allow the highest level of management (including executive and non-executive directors) the opportunity to discuss the matter, having reference to all relevant facts of the disagreement and implications thereof.

Finally, the auditors could choose to raise this issue at the annual general meeting, where the matter leading to the qualified audit opinion should be explained to the shareholders of the company.

18. Solution

As per Section 27(1) of the Cooperatives Act, 2048, from the surplus made by a Cooperative in any financial year, the funds as prescribed may be apportioned after allocating into the reserve fund at least one fourth of the net saving. Sub Section 2 of the same Act mentions that a dividend to the extent mentioned in the By-law may be distributed from the funds, other than the reserve fund in consonance with the purpose of such funds. Provided that, the amount of share dividend for a year, shall not exceed fifteen percent of the share capital.

In the given case, M/S Rely More Cooperative Limited which has a share capital of NRs. 2,000,000, apportioned NRs. 100,000 to the reserve fund. As per Section 27(1), the minimum appropriation to general reserve required is one fourth i.e., NRs. 187,500. So, the proposed appropriation

is inadequate and hence the Cooperative is required to make appropriation of at least one fourth of the net surplus.

Similarly approved dividend of NRs. 500,000 is 25% of the share capital of Rely More Cooperative Limited. Section 27 (2) of the Act specifies that the Cooperative can distribute dividend to the maximum 15% of its share capital i.e., NRs. 300,000. Hence, the board has to rectify earlier decision and make appropriation of net surplus as per provision of Cooperatives Act and Bylaws of the Rely More Cooperative Limited.

19. Solution

The reason for the proposed change in auditor should be ascertained via discussion with the directors. It is possible that the reason may prevent acceptance of the nomination (e.g. the existing auditors intend to qualify their opinion and your firm agrees with their view).

The permission of Surya Group must be sought in order to communicate with the existing auditors to assess any reasons for not accepting the nomination. If permission is not granted, the nomination should be declined.

The response of the existing auditors should be carefully considered, especially in the light of the reason given by the directors. If the reasons differ, this will reflect upon the directors' integrity and, again, the nomination should be declined.

Surya Group's reputation (employee relations, investigation by the authorities and any other adverse opinions) will also impact on the assessment of the directors' integrity.

Auditor independence should not be in any doubt. For example, there should be no family or personal relationships with key staffs at Surya Group, or beneficial shareholdings in Surya Group held by audit staff.

If the existing audit clients have any relationships with Surya Group (e.g. competitor, supplier, customer) a conflict of interest could arise. As a small firm (only four partners) appropriate safeguards may not be feasible. The firm must also be careful not to become unduly dependent on the client. Furthermore, an audit fee based on a percentage of profits would seem to detract from objectivity as it would be in the auditors' interest to allow profits to be overstated. Even if the auditors would not allow this to happen, the acceptance of an appointment with such a bonus would detract from the appearance of the objectivity.

Sufficient staff at the right time of year will be required to undertake the audit. Audit staff must be sufficiently competent to deal with a listed company manufacturer and retailer. If the firm's expertise lies in other market sectors this may not be the case.

If a flat fee is to be accepted, it should be fair & reasonable with regards to the level of staff needed on the audit and times spent by them. If the fee is likely to be insufficient to cover such cost then this may give the appearance to the outside world that a poor quality audit is being performed. The flat fee should also leave the directors in no doubt as to the range of services being offered (i.e. statutory audit only).

Regardless of the integrity of the directors, Surya Group's poor reputation may affect the auditors' reputation and they might therefore not wish to be associated with such a company, as existing and potential clients might be influenced by such adverse publicity.

20. Solution

A hot review is a review of working papers that is performed by a more senior member of staff during the course of the audit, and is usually performed soon after the work is completed. The reviewer will indicate that he has performed the review by dating and initialling the piece of work. The review should ensure that the work has been performed in line with the audit programme and that the conclusions are consistent with the results obtained.

A cold review is one that is performed at the end of the audit- usually by the audit manager or partner. This will be done before the audit report is signed off and will comprise a review of the whole file together with the financial statements. The purpose of this review is to ensure that the audit work has been fully completed and that the results conclusions for the entire audit are consistent.

21. Solution

a) Meaning of and relationship between

Materiality

Materiality is an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole. A matter is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

Materiality may also be considered in the context of any individual statements within the financial statements or of individual items included in them (performance materiality)

Materiality is not capable of general mathematical definition as it has both qualitative & quantitative aspects

True & Fair

The term 'a true & fair view is not defined in a statute and it has therefore fallen to the auditing profession to reach a reasoned and consistent interpretation of the term. Accounts should be true & fair if prepared in accordance with recommended accounting policies.

Truth relates to factual accuracy and correctness of the financial statements. For example, the statement of financial position should be an 'accurate' reflection (within acceptable limits) of the company's assets and liabilities at the year end.

Fairness relates to the presentation of information and the view conveyed to the reader. It is important that information in the financial statements is presented in a manner that is free from bias and does not lead the reader to any view that is not a reasonable reflection of the company's financial situation.

Relationship between materiality and true & fair

'True & Fair' is a matter of professional judgement. Materiality is just one of the factors considered in making such a judgement.

For example, if a company's actual revenue for a year of NRs. 2,200,000 was inaccurately stated (e.g. at NRs. 2,200,000) the financial statements could still be judged 'true & fair' as knowledge of the error would not cause a reader of the financial statements to change his opinion of them (i.e. the misstatement is not material).

Conversely, if a misstatement is judged to be material, the true and fair view is impaired.

Accounting standards are intended to give a true & fair view and need not be applied to immaterial items. Where material, compliance with accounting standards will normally be necessary for financial statements to give a true and fair view.

Effect on audit report

The audit opinion on the current year income statement/ statement of comprehensive income and comparative income statement/statement of comprehensive income (closing inventories) and statement of financial position (inventories) will be qualified (except for).

The qualification arises because of the auditor's inability to obtain sufficient appropriate evidence (limitation on scope). It will not be a disclaimer of opinion as the item is not likely to be pervasive as well as material.

The report will refer to how the scope of work has been limited.

The opinion paragraph will state that except for adjustments that might be necessary to opening inventories and/ or closing inventory comparatives; the financial statements show a true and fair view and have been properly prepared.

Reasons
Comparatives are part of the audited financial statements.
In addition, last year's closing inventories become the current year's opening inventories and this affects current year profits.

b) Effect on audit report
If the auditor assess that the contract is unlikely to be renewed and that, as a result, the company will no longer be a going concern, a modified opinion is likely on the grounds of a material misstatement (disagreement with the application of going concern concept). A qualified or adverse opinion would be given.
If the auditor assesses that the going concern assumption is appropriate but a material uncertainty exists and the directors have adequately disclosed the situation, an unmodified opinion would be given but an emphasis of matter paragraph should be used to highlight the uncertainty and the note in the financial statements disclosing it.
If the auditor assess that disclosures are inadequate for a true and fair view, an except for qualification would be required on the grounds of a material misstatement (disagreement with disclosure).
If the auditors believe that the directors have not provided sufficient information and explanations on the matter a qualified opinion (limitation on scope) may be required.

Reasons
Inventories may not be stated at lower of cost or NRV, as required by IAS 2.
There is some uncertainty as to whether the contract is a going concern, given the potential loss of over half of their trade.

22. Solution

a)

Audit work	Reasons
Damage Claim	
Ask the directors how they propose to treat the claim in the financial statements (and on what grounds)	The matter is potentially material even a claim of just NRs. 650,000 represents 13% of trading profit.
Inspect the invoice/ contract with the customer to ascertain the terms and conditions and whether the antiques collection is identified	The customer's claim may be invalid if they were responsible for insurance or if high value items should have been specified.
Review correspondence with the customer and with solicitors and the accident report/damage record.	In order to obtain consistent third party evidence to support internal evidence.
Examine company's own insurance policy documents.	The company may have its own insurance policy to cover such claims from customers.

Enquire whether the damage was an isolated incident.	To ascertain whether there may be other similar claims for which provision is needed.
Overdraft Limit	
Ask the directors why they consider the company to be a going concern	If it is not possible to determine that the going concern presumption is appropriate then there will be an impact on the audit report.
Review the current refurbishment program and related finance arrangement	The going concern presumption may not be appropriate if finance is not forthcoming to complete the refurbishment project (e.g. if the company is unable to operate).
Review correspondence with the bank and prospective lenders seeking additional borrowing facilities	The company should take steps to increase its borrowing facilities as long term investment cannot be sustained on an overdraft facility.
Discuss with directors any alternative courses of action to alleviate the cash flow problem	If the recent investment in new vehicles was for outright purchase, sale & leaseback may be arranged to raise funds.

b) Letter of Representation Extracts

i) No provision is considered necessary in respect of a legal claim by the customer (Mr. X) for damage to reproduction furniture. No amounts are expected to be paid, and no similar claims have been received or are expected to be received.

ii) We confirm our considered view that the company has adequate resources to continue operations for the foreseeable future (i.e. is a going concern). This conclusion has been reached based on forecast expenditure and current & future borrowing arrangements.

23. Solution

Briefing notes

To: Audit partner
From: Audit manager
Subject: Audit planning for Nagarik Pharmaceuticals, year ending 31 Ashad 2073

Introduction

These briefing notes are prepared to assist in planning the audit of Nagarik Pharmaceuticals, our client operating in the pharmaceutical industry. Specifically, the briefing notes will evaluate the business risks facing our client, identify and explain four risks of material misstatement, recommend audit procedures in relation to a new brand acquired during the year, and finally explain ethical threats to our firm.

e) Business risks

Licensing of products

A significant regulatory risk relates to the highly regulated nature of the industry in which the company operates. If any of Nagarik Pharmaceuticals's products fail to be licensed for development and sale, it would mean that costs already incurred are wasted. Research and development costs are significant. For example, in 2072-73 the cash outflow in relation to research and development amounted to 7.5% of revenue, and the failure to obtain the necessary licences is a major threat to the company's business objectives.

Patent infringements

In developing new products and improving existing products, Nagarik Pharmaceuticals must be careful not to breach any competitor's existing patent. In the event of this occurring, significant legal costs could be incurred in defending the company's legal position. Time and effort must be spent monitoring product developments to ensure legal compliance with existing patents. Similarly, while patents serve to protect Nagarik Pharmaceuticals's products, if a competitor were found to be in breach of one of the company's patents, costs of bringing legal action against that company could be substantial.

Advertising regulations

The company risks running inappropriate advertising campaigns, and failing to comply with local variations in regulatory requirements. For example, if television campaigns to promote products occurred in countries where this is not allowed, the company could face fines and reputational damage, with consequences for cash flow and revenue streams.

Skilled personnel

The nature of Nagarik Pharmaceuticals's operations demands a skilled workforce with the necessary scientific knowledge to be able to develop new drugs. Loss of personnel, especially to competitors in the industry, would be a drain on the remaining resources and in the worst case scenario it could delay the development and launch of new products. It may be difficult to attract and retain skilled staff given the pending court case and potential reputational damage to the company.

Diversification and rapid growth

During the year Nagarik Pharmaceuticals has acquired a new brand name and range of products, and has also diversified into a new market, that of animal health products. While diversification has commercial and strategic advantages, it can bring risks. Management may struggle to deal with the increased number of operations which they need to monitor and control, or they may focus so much on ensuring the success of the new business segments that existing activities are neglected. There may also be additional costs associated with the diversification which puts pressure on cash and on the margins of the enlarged business. This may be the reason for the fall in operating profit of 10.8% and for the decline in operating margin from 24% to 20%.

Cash flow and liquidity issues

Nagarik Pharmaceuticals seems to be struggling to maintain its cash position, as this year its cash flow is negative by NRs. 1.2 million. Contributing factors to this will include the costs of acquiring the 'Cold Comforts' brand name, expenditure to launch the new animal-related product line, and the cash outflow in relation to on-going research and development, which has increased by 7.1% in the year. The first two of these are one-off issues and may not create a cause for concern over long-term cash management issues, but the company must be careful to maintain a positive cash inflow from its operating activities to provide a sound foundation for future activities.

Companies operating in this industry must be careful to manage cash flows due to the nature of the product lifecycle, meaning that large amounts have to be expended long before any revenue is generated, in some cases the time lag may be many years before any cash inflow is derived from expenditure on research activities.

The fact that the company has approached its bank to make cash available in the event of damages of NRs. 3 million having to be paid out indicates that the company is not very liquid, and is relying to some degree on external finance. If the bank refuses to extend existing borrowing facilities, the company may have to find finance from other sources, for example, from an alternative external provider of funds or from an issue of equity shares, which may be difficult to achieve and expensive. The company has relatively high gearing, which may deter potential providers of finance or discourage potential equity investors. If finance is refused, the company may not be able to pay liabilities as they fall due, and other operational problems may arise, for example, an inability to continue to fund in-progress research and development projects. Ultimately this would result in a going concern problem, though much more information is needed to assess if this is a risk at this yearend.

Court case and bad publicity

The court case against the company will create reputational damage, and publicity over people suffering side effects while participating in clinical trials will undoubtedly lead to bad publicity, affecting market share especially if competitors take advantage of the situation. It is also likely that the bad publicity will lead to increased scrutiny of the company's activities making it more vulnerable should further problems arise.

Risk of overtrading

The fall in operating margin and earnings per share is a worrying sign for shareholders, though for the reasons explained above this may not be the start of a long-term trend as several events in this year have put one-off pressure on margins.

However, there could be a risk of overtrading, as the company's revenue has increased by 5.2%.

f) Risks of material misstatement

Inherent risk of management bias

Nagarik Pharmaceuticals's management is attempting to raise finance, and the bank will use its financial statements as part of their lending decision. There is therefore pressure on management to present a favourable position. This may lead to bias in how balances and transactions are measured and presented. For example, there is a risk that earnings management techniques are used to overstate revenue and understate expenses in order to maximise the profit recognised. Estimates included in the financial statements are also subject to higher risk. ISA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures states that auditors shall review the judgements and decisions made by management in the making of accounting estimates to identify whether there are indicators of management bias.

Research and development costs – recognition

There is a significant risk that the requirements of IAS 38 Intangible Assets have not been followed. Research costs must be expensed and strict criteria must be applied to development expenditure to determine whether it should be capitalised and recognised as an intangible asset. Development costs are capitalised only after technical and commercial feasibility of the asset for sale or use have been established, and Nagarik Pharmaceuticals must demonstrate an intention and ability to complete the development and that it will generate future economic benefits. The risk is that research costs have been inappropriately classified as development costs and then capitalised, overstating assets and understating expenses.

A specific risk relates to the drug which was being developed but in relation to which there have been side effects during the clinical trials. It is unlikely that the costs in relation to this product development continue to meet the criteria for capitalisation, so there is a risk that they have not been written off, overstating assets and profit.

Development costs – amortisation

When an intangible asset has a finite useful life, it should be amortised systematically over that life. For a development asset, the amortisation should correspond with the pattern of economic benefits generated from the sale of associated goods. The risk is that the amortisation period has not been appropriately assessed. For example, if a competitor introduces a successful rival product which reduces the period over which Nagarik Pharmaceuticals's product will generate economic benefit, this should be reflected in a reduction in the period over which that product is amortised, resulting in an increased amortisation charge. The risk if this does not happen is that assets are overstated and expenses are understated.

Patents – recognition and amortisation

The cost of acquiring patents for products should be capitalised and recognised as an intangible asset as the patent provides protection over the economic benefit to be derived. If patent costs have been expensed rather than capitalised, this would understate assets and overstate expenses. Once recognised, patents should be amortised over the period of their duration, and non-amortisation will overstate assets and understate expenses.

Court case – provisions and contingent liabilities

The court case which has been brought against Nagarik Pharmaceuticals may give rise to a present obligation as a result of a past event, and if there is a probable outflow of economic benefit which can be measured reliably, then a provision should be recognised.

The clinical trial took place in 2071-72, so the obligating event has occurred. Depending on the assessment of probability of the case going against Nagarik Pharmaceuticals, it may be that instead of a provision, a contingent liability exists. This would be the case if there is a possible, rather than probable, outflow of economic benefit. The risk is that either a necessary provision is not recognised, understating liabilities and expenses, or that a contingent liability is not appropriately disclosed in the notes to the financial statements, in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

Legal fees relating to the court case should also be accrued if they have been incurred before the year end, and failure to do so will understate current liabilities and understate expenses.

Segmental reporting

The diversification into the new product area relating to animal health may warrant separate disclosure according to IFRS 8 Operating Segments. This requires listed companies to disclose in a note to the financial statements the performance of the company disaggregated over its operating or geographical segments, as the information is viewed by management. As the new product area has been successful and contributes 15% to revenue, it could be seen as a significant operating segment, and disclosure of its revenue, profit and other figures may be required. The risk is non-disclosure or incomplete disclosure of the necessary information.

g) Recommended audit procedures

- Review board minutes for evidence of discussion of the purchase of the acquired brand, and for its approval.
- Agree the cost of NRs. 5 million to the company's cash book and bank statement.
- Obtain the purchase agreement and confirm the rights of Nagarik Pharmaceuticals in respect of the brand.

- Discuss with management the estimated useful life of the brand of 15 years and obtain an understanding of how 15 years has been determined as appropriate.
- If the 15-year useful life is a period stipulated in the purchase document, confirm to the terms of the agreement.
- If the 15-year useful life is based on the life expectancy of the product, obtain an understanding of the basis for this, for example, by reviewing a cash flow forecast of sales of the product.
- Obtain any market research or customer satisfaction surveys to confirm the existence of a revenue stream.
- Consider whether there are any indicators of potential impairment at the yearend by obtaining pre year-end sales information and reviewing terms of contracts to supply the products to pharmacies.
- Recalculate the amortisation expense for the year and agree the charge to the financial statements, and confirm adequacy of disclosure in the notes to the financial statements.

h) Ethical threats

There are two ethical threats relevant to the audit firm.

First, the bank has asked our firm to provide a guarantee in respect of the bank loan which may be advanced to our client. The provision of such a guarantee represents a financial interest in an audit client, and creates a self-interest threat because the audit firm has an interest in the financial position of the client, causing loss of objectivity when auditing the financial statements.

According to Code of Ethics for Professional Accountants (the Code), if an audit firm guarantees a loan to an audit client, the self-interest threat created would be so significant that no safeguards could reduce the threat to an acceptable level unless the loan or guarantee is immaterial to both the audit firm and the client. In this case the loan would be material as it represents 5% of Nagarik Pharmaceuticals's total assets, and would also be considered material in nature because of the company's need for the additional finance.

The second threat relates to Nagarik Pharmaceuticals's request for our firm to provide advice on the new accounting and management information systems to be implemented next year. If the advice were given, it would constitute the provision of a non-assurance service to an audit client. The Code has detailed guidance in this area and specific requirements in the case of a public interest entity such as Nagarik Pharmaceuticals which is a listed entity.

The Code states that services related to IT systems including the design or implementation of hardware or software systems may create a self-review threat. This is because when auditing the financial statements the auditor would assess the systems which they had recommended, and an objective assessment would be difficult to achieve. There is also a risk of assuming the responsibility of management, especially as Nagarik Pharmaceuticals has little experience in this area, so would rely on the auditor's suggestions and be less inclined to make their own decision.

In the case of an audit client which is a public interest entity, the Code states that an audit firm shall not provide services involving the design or implementation of IT systems which form a significant part of the internal control over financial reporting or which generate information which is significant to the client's accounting records or financial statements on which the firm will express an opinion.

Therefore the audit firm should not provide a service to give advice on the accounting systems. With further clarification on the nature of the management information systems and the update required to them, it may be possible for the audit firm to provide a service to Nagarik Pharmaceuticals, as long as those systems are outside of the financial reporting system. However, it may be prudent for the audit firm to decline offering any advice on systems to the client.

These ethical issues should be discussed with those charged with governance of Nagarik Pharmaceuticals, with an explanation provided as to why the audit firm cannot guarantee the loan or provide the non-audit service to the company.

Conclusion

Nagarik Pharmaceuticals faces a variety of business risks, some of which are generic to the industry in which it operates, while others are more entity-specific. A number of risks of material misstatement have been discussed, and the audit planning must ensure that appropriate responses are designed for each of them. The purchase of a new brand will necessitate detailed audit testing.

Two ethical issues have been raised by requests from the client for our firm to provide a loan guarantee and to provide advice on systems, both of which create significant threats to independence and objectivity, and the matters must be discussed with the client before advising that we are unable to provide the guarantee or to provide the systems advice.

24. Solution

d) Measurement of goodwill on acquisition

The goodwill arising on the acquisition of Basera Co is material to the Group financial statements, representing 6% of total assets.

The goodwill should be recognised as an intangible asset and measured according to IAS 38 Intangible Assets and IFRS 3 Business Combinations. The purchase consideration should reflect the fair value of total consideration paid and payable, and there is a risk that the amount shown in the calculation is not complete, for example, if any deferred or contingent consideration has not been included.

The non-controlling interest has been measured at fair value. This is permitted by IFRS 3, and the decision to measure at fair value can be made on an investment by investment basis. The important issue is the basis for measurement of fair value. If Basera Co is a listed company, then the market value of its shares at the date of acquisition can be used and this is a reliable measurement. If Basera Co is not listed, then management should have used estimation techniques according to the fair value hierarchy of inputs contained in IFRS 13 Fair Value Measurement. This would introduce subjectivity into the measurement of non-controlling interest and goodwill and the method of determining fair value must be clearly understood by the auditor.

The net assets acquired should be all identifiable assets and liabilities at the date of acquisition. For such a significant acquisition some form of due diligence investigation should have been performed, and one of the objectives of this would be to determine the existence of assets and liabilities, even those not recognised in Basera Co's individual financial statements. There is a risk that not all acquired assets and liabilities have been identified, or that they have not been appropriately measured at fair value, which would lead to over or understatement of goodwill and incomplete recording of assets and liabilities in the consolidated financial statements.

The fair value adjustment of NRs. 300,000 made in relation to Basera Co's property is not material to the Group accounts, representing less than 1% of total assets. However, the auditor should confirm that additional depreciation is being charged at Group level in respect of the fair value uplift. Though the value of the depreciation would not be material to the consolidated financial statements, for completeness and accuracy the adjustment should be made.

The auditor should also consider if any further adjustments need to be made to Basera Co's net assets to ensure that Group accounting policies have been applied. IFRS 3 requires consistency in accounting policies across Group members, so if the necessary adjustments have not been made, the assets and liabilities will be over or understated on consolidation.

Impairment

IAS 38 requires that goodwill is tested annually for impairment regardless of whether indicators of potential impairment exist. The goodwill in relation to Basera Co is recognised at the same amount at the

year-end as it was at acquisition, indicating that no impairment has been recognised. It could be that management has performed an impairment review and has concluded that there is no impairment, or that no impairment review has been performed at all.
However, Group profit has declined by 30·3% over the year, which in itself is an indicator of potential impairment of the Group's assets, so it is unlikely that no impairment exists unless the fall in revenue relates to parts of the Group's activities which are unrelated to Basera Co. There is a risk that Group assets are overstated and profit overstated if any necessary impairment has not been recognised.

Loan
The loan is material, representing 13.3% of the Group's total assets.
The loan taken out to finance the acquisition should be accounted for under IFRS 9 Financial Instruments. It should be initially measured at fair value, and classified according to whether it is subsequently measured at amortised cost or at fair value. As the loan is not held for trading, it should be measured at amortised cost unless Group management decides to use the fair value option.
Assuming subsequent measurement is based on amortised cost, an effective interest rate should be calculated to allocate the premium to be paid on maturity over the 20-year life of the loan, meaning that the annual finance charge will be more than just the actual interest paid. There is a risk that the finance charge does not include an element relating to the premium, in which case both the finance charge and the liability are understated.

Evidence:
- Agreement of the purchase consideration to the legal documentation pertaining to the acquisition, and a review of the documents to ensure that the figures included in the goodwill calculation are complete.
- Agreement of the NRs. 75 million to the bank statement and cash book of the acquiring company (presumably the parent company of the Group).
- Review of board minutes for discussions relating to the acquisition, and for the relevant minute of board approval.
- A review of the purchase documentation and a register of significant shareholders of Basera Co to confirm the 20% non-controlling interest.
- If Basera Co's shares are not listed, a discussion with management as to how the fair value of the non-controlling interest has been determined and evaluation of the appropriateness of the method used.
- If Basera Co's shares are listed, confirmation that the fair value of the non-controlling interest has been calculated based on an externally available share price at the date of acquisition.
- A copy of any due diligence report relevant to the acquisition, reviewed for confirmation of acquired assets and liabilities and their fair values.
- An evaluation of the methods used to determine the fair value of acquired assets, including the property, and liabilities to confirm compliance with IFRS 3 and IFRS 13.
- Review of depreciation calculations, and recalculation, to confirm that additional depreciation is being charged on the fair value uplift.
- A review of the calculation of net assets acquired to confirm that Group accounting policies have been applied.
- Discussion with management regarding the potential impairment of Group assets and confirmation as to whether an impairment review has been performed.
- A copy of any impairment review performed by management, with scrutiny of the assumptions used, and re-performance of calculations.
- Re-performance of management's calculation of the finance charge in relation to the loan, to ensure that the loan premium has been correctly accrued.
- Agreement of the loan receipt and interest payment to bank statement and cash book.

- Review of board minutes for approval of the loan to be taken out.
- A copy of the loan agreement, reviewed to confirm terms including the maturity date, premium to be paid on maturity and annual interest payments.
- A copy of the note to the financial statements which discusses the loan to ensure all requirements of IFRSs 7 and 13 have been met.

e) Property complex

The carrying value of the property complex is material to the Group financial statements, representing 3.6% of total assets.

The natural disaster is a subsequent event, and its accounting treatment should be in accordance with IAS 10 Events after the Reporting Period. IAS 10 distinguishes between adjusting and non-adjusting events, the classification being dependent on whether the event provides additional information about conditions already existing at the year end. The natural disaster is a non-adjusting event as it indicates a condition which arose after the year end.

Disclosure is necessary in a note to the financial statements to describe the impact of the natural disaster, and quantify the effect which it will have on next year's financial statements.

The demolition of the property complex should be explained in the note to the financial statements and reference made to the monetary amounts involved. Consideration should be made of any other costs which will be incurred, e.g. if there is inventory to be written off, and the costs of the demolition itself.

The contingent asset of NRs.18 million should not have been recognised. Even if the amount were virtually certain to be received, the fact that it relates to the non-adjusting event after the reporting period means that it cannot be recognised as an asset and deferred income at the year end.

The financial statements should be adjusted to remove the contingent asset and the deferred income. The amount is material at 4% of total assets. There would be no profit impact of this adjustment as the NRs. 18 million has not been recognised in the statement of profit or loss.

Evidence:

- A copy of any press release made by the Group after the natural disaster, and relevant media reports of the natural disaster, in particular focusing on its impact on the property complex.
- Photographic evidence of the site after the natural disaster, and of the demolished site.
- A copy of the note to the financial statements describing the event, reviewed for completeness and accuracy.
- A schedule of the costs of the demolition, with a sample agreed to supporting documentation, e.g. invoices for work performed and confirmation that this is included in the costs described in the note to the financial statements.
- A schedule showing the value of inventories and items such as fixtures and fittings at the time of the disaster, and confirmation that this is included in the costs described in the note to the financial statements.
- A copy of the insurance claim and correspondence with the Group's insurers to confirm that the property is insured.
- Confirmation that an adjustment has been made to reverse out the contingent asset and deferred income which has been recognised.

f) Intercompany trading

The intercompany receivables and payables represent 4.4% of Group assets and are material to the consolidated statement of financial position. The inventory is also material, at 11% of Group assets.

On consolidation, the intercompany receivables and payables balances should be eliminated, leaving only balances between the Group and external parties recognised at Group level. There is a risk that during the consolidation process the elimination has not happened, overstating Group assets and liabilities by the same amount.

If the intercompany transaction included a profit element, then the inventory needs to be reduced in value by an adjustment for unrealised profit. This means that the profit made by Ishara Co on the sale of any inventory still remaining in the Group at the year-end is eliminated. If the adjustment has not been made, then inventory and Group profit will be overstated.

Evidence:

- Review of consolidation working papers to confirm that the intercompany balances have been eliminated.
- A copy of the terms of sale between Ishara Co and Tishara Co, scrutinised to find out if a profit margin or mark-up is part of the sales price.
- A reconciliation of the intercompany balances between Tishara Co and Ishara Co to confirm that there are no other reconciling items to be adjusted, e.g. cash in transit or goods in transit.
- Copies of inventory movement reports for the goods sold from Ishara Co to Tishara Co, to determine the quantity of goods transferred.
- Details of the inventory count held at Tishara Co at the year end, reviewed to confirm that no other intercompany goods are held at the year end.

25. Solution

Additional information needed to plan the audit of land includes the following:

- Details of the reason for the purchase, to understand the business rationale, e.g. is the land held for capital appreciation?
- Does management have any specific plans for how Faster Jets Co may make use of the land in the future, e.g. are there plans to construct buildings and if so what will be their purpose?
- The date of purchase to ascertain how long it has taken for the land to increase in value by NRs. 2 million and whether this seems reasonable.
- Whether the land was purchased for cash or if finance was taken out to raise the NRs. 12.5 million paid.
- Who is renting the land? This could establish whether the arrangement is with a related party.
- The type of rental arrangement and whether it constitutes a finance or operating lease.
- What is the land being used for? As the legal owner, Faster Jets Co should be aware of its use and any associated risks, e.g. activities close to airports may convey security risks, e.g. terrorism.
- The location of the purchased land – this is necessary to plan the logistics of the audit.
- Does the company hold any other investment property, and if so, is that also held at fair value? The accounting treatment should be consistent for all investment property.
- What is management's rationale for the accounting policy choice to measure the land at fair value? It will result in profit for the year including the NRs.2 million fair value increase.
- Establish who holds the title deeds to the land as this may need to be inspected.

26. Solution

Matters to consider before placing reliance on the work of the auditor's expert

ISA 620 Using the Work of an Auditor's Expert contains requirements relating to the objectivity and capabilities of the auditor's expert, the scope and objectives of their work, and assessing their work.

Objectivity

According to ISA 620, the auditor shall evaluate whether the auditor's expert has the necessary objectivity and that this should include inquiry regarding interests and relationships which may create a threat to the expert's objectivity. The audit firm will need to ensure that the expert has no connection to Soma Air, for example, that they are not a related party of the company or any person in a position of

influence over the financial statements. If the expert's objectivity is threatened, less reliance can be placed on their work.

Competence
ISA 620 also requires the competence of the expert to be considered; this should include considering the expert's membership of appropriate professional bodies. Any doubts over the competence of the expert will reduce the reliability of audit evidence obtained. The expert should in this case have experience in valuing land, and be familiar with the framework for measuring fair value in accordance with IAS 40 Investment Property and IFRS 13 Fair Value Measurement.

Scope of work
ISA 620 requires the auditor to agree the scope of work with the expert. This may include agreement of the objectives of the work, how the expert's work will be used by the auditor and the methodology and key assumptions to be used.
In assessing the work performed by the expert, the auditor should confirm that the scope of the work is as agreed at the start of the engagement. If the expert has deviated from the agreed scope of work, it is likely to be less relevant and reliable.

Relevance of conclusions
ISA 620 states that the auditor shall evaluate the relevance and adequacy of the expert's findings or conclusions. This will involve consideration of the source data which was used, the appropriateness of assumptions and the reasons for any changes in methodology or assumptions. The conclusion should be consistent with other relevant audit findings and with the auditor's general understanding of the business. Any inconsistencies should be investigated as they may indicate evidence which is not reliable.

27. Solution
Ethical threats created by long association of senior audit personnel and relevant safeguards
When a senior auditor acts for an audit client for a long period, several ethical problems can arise. First, the professional scepticism of the auditor can be diminished. This happens because the auditor becomes too accepting of the client's methods and explanations, so stops approaching the audit with a questioning mind.
Familiarity and self-interest threats are created by using the same senior personnel on an audit engagement over a long period of time. The familiarity threat is linked to the issues relating to the loss of professional scepticism discussed above, and is due to the senior auditor forming a close relationship with the client's personnel over a long period of time.
As with any ethical threat, the significance of the threat should be evaluated and safeguards which reduce the threat to an acceptable level put in place. Matters which should be considered in evaluating the significance of the ethical threat could include the seniority of the auditor involved, the length of time they have acted for the client, the nature, frequency and extent of the individual's interactions with the client's management or those charged with governance and whether the client's management team has changed.

Examples of safeguards which can be used include:
- Rotating the senior personnel off the audit team;
- Having a professional accountant who was not a member of the audit team review the work of the senior personnel; or
- Regular independent internal or external quality control reviews of the engagement.

28. Solution

Quality control, ethical and other issues raised

It is a requirement of ISA 520 Analytical Procedures that analytical procedures are performed at the overall review stage of the audit. An objective of ISA 520 is that the auditor should design and perform analytical procedures near the end of the audit which assist the auditor when forming their opinion as to whether the financial statements are consistent with the auditor's understanding of the entity.

It is unlikely that the audit senior's 'quick look' at Ambu Steel Co's financial statements is adequate to meet the requirements of ISA 520 and audit documentation would seem to be inadequate. Therefore if the audit senior, or another auditor, does not perform a detailed analytical review on Ambu Steel Co.'s financial statements as part of the completion of the audit, there is a breach of ISA 520. Failing to perform the final analytical review could mean that further errors are not found, and the auditor will not be able to check that the presentation of the financial statements conforms to the requirements of the applicable financial reporting framework. It is also doubtful whether a full check on the presentation and disclosure in the financial statements has been made. The firm should evidence this through the use of a disclosure checklist.

The lack of final analytical review increases audit risk. Because Ambu Steel Co. is a new audit client, it is particularly important that the analytical review is performed as detection risk is higher than for longer-standing audit engagements where the auditor has developed a cumulative knowledge of the audit client.

The fact that the audit manager suggested that a detailed review was not necessary shows a lack of knowledge and understanding of ISA requirements. An audit client being assessed as low risk does not negate the need for analytical review to be performed, which the audit manager should know. Alternatively, the audit manager may have known that analytical review should have been performed, but regardless of this still instructed the audit senior not to perform the review, maybe due to time pressure. The audit manager should be asked about the reason for his instruction and given further training if necessary.

The manager is not providing proper direction and supervision of the audit senior, which goes against the principles of ISA 220 Quality Control for an Audit of Financial Statements, and ISQC1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements and other Assurance and Related Services Engagements. Both of these discuss the importance of the audit team having proper direction and supervision as part of ensuring a good quality of audit engagement performance.

The second issue relates to the chairman's statement. ISA 720 The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements requires that the auditor shall read the other information to identify material inconsistencies, if any, with the audited financial statements.

The audit manager has discussed the chairman's statement but this does not necessarily mean that the manager had read it for the purpose of identifying potential misstatements, and it might not have been read at all. Even if the manager has read the chairman's statement, there may not be any audit documentation to show that this has been done or the conclusion of the work. The manager needs to be asked exactly what work has been done, and what documentation exists. As the work performed does not comply with the ISA 720 requirements, then the necessary procedures must be performed before the audit report is issued.

Again, the situation could indicate the audit manager's lack of knowledge of ISA requirements, or that a short-cut is being taken. In either case the quality of the audit is in jeopardy.

29. Solution

iii. Evaluation of Uncorrected Misstatements

During the completion stage of the audit, the effect of uncorrected misstatements must be evaluated by the auditor, as required by ISA 450 Evaluation of Misstatements Identified during the Audit. In the event that management refuses to correct some or all of the misstatements communicated by the auditor, ISA 450 requires that the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. Therefore a discussion with management is essential in helping the auditor to form an audit opinion.

ISA 450 also requires that the auditor shall communicate with those charged with governance about uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report.

Each of the matters included in the schedule of uncorrected misstatements will be discussed below and the impact on the audit report considered individually and in aggregate.

Share-based payment scheme

The adjustment in relation to the share-based payment scheme is material individually to profit, representing 12% of revenue. It represents less than 1% of total assets and is not material to the statement of financial position.

IFRS 2 Share-based Payment requires an expense and a corresponding entry to equity to be recognised over the vesting period of a share-based payment scheme, with the amount recognised based on the fair value of equity instruments granted. Management's argument that no expense should be recognised because the options are unlikely to be exercised is not correct. IFRS 2 would classify the fall in Ambu Steel Co.'s share price as a market condition, and these are not relevant to determining whether an expense is recognised or the amount of it.

Therefore management should be requested to make the necessary adjustment to recognise the expense and entry to equity of NRs. 300,000. If this is not recognised, the financial statements will contain a material misstatement, with consequences for the auditor's opinion.

Restructuring provision

The adjustment in relation to the provision is material to profit, representing 2% of revenue. It represents less than 1% of total assets so is not material to the statement of financial position.

The provision appears to have been recognised too early. IAS 37 Provisions, Contingent Liabilities and Contingent Assets requires that for a restructuring provision to be recognised, there must be a present obligation as a result of a past event, and that is only when a detailed formal plan is in place and the entity has started to implement the plan, or announced its main features to those affected. A board decision is insufficient to create a present obligation as a result of a past event. The provision should be recognised in September 2014 when the announcement to employees was made.

Management should be asked to explain why they have included the provision in the financial statements, for example, there may have been an earlier announcement before 31 August 2014 of which the auditor is unaware.

In the absence of any such further information, management should be informed that the accounting treatment of the provision is a material misstatement, which if it remains unadjusted will have implications for the auditor's opinion.

Inventory provision

The additional slow-moving inventory provision which the auditor considers necessary is not material on an individual basis to either profit or to the statement of profit or loss or the statement of financial position, as it represents only 0.4% of revenue and less than 1% of total assets.

Despite the amount being immaterial, it should not be disregarded, as the auditor should consider the aggregate effect of misstatements on the financial statements. ISA 450 does state that the auditor need not accumulate balances which are 'clearly trivial', by which it means that the accumulation of such amounts

clearly would not have a material effect on the financial statements. However, at 0·4% of revenue the additional provision is not trivial, so should be discussed with management.

This misstatement is a judgemental misstatement as it arises from the judgements of management concerning an accounting estimate over which the auditor has reached a different conclusion. This is not a breach of financial reporting standards, but a difference in how management and the auditor have estimated an uncertain amount. Management should be asked to confirm the basis on which their estimate was made, and whether they have any reason why the provision should not be increased by the amount recommended by the auditor.

If this amount remains unadjusted by management, it will not on an individual basis impact the auditor's report.

iv. Impact on auditor's report

Aggregate materiality position

In aggregate, the misstatements have a net effect of NRs. 260,000 (NRs. 310,000 – NRs. 50,000), meaning that if left unadjusted, profit will be overstated by NRs. 260,000 and the statement of financial position overstated by the same amount. This is material to profit, at 10.4% of revenue, but is not material to the statement of financial position at less than 1% of total assets.

Impact on auditor's report

The statement of profit or loss is materially misstated if the adjustments are not made by management. According to ISA 705 Modifications to the Opinion in the Independent Auditor's Report, the auditor shall modify the opinion in the auditor's report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.

The type of modification depends on the significance of the material misstatement. In this case, the misstatements in aggregate are material to the financial statements, but are unlikely to be considered pervasive even though they relate to a number of balances in the financial statements as they do not represent a substantial proportion of the financial statements, and do not make them misleading when viewed as a whole. If that were the case, the opinion would be adverse in nature.

Therefore a qualified opinion should be expressed, with the auditor stating in the opinion that except for the effects of the matters described in the basis for qualified opinion paragraph, the financial statements show a true and fair view.

The basis for qualified opinion paragraph should be placed immediately before the opinion paragraph, and should contain a description of the matters giving rise to the qualification. This should include a description and quantification of the financial effects of the misstatement.

30. Solution

Consultation

It may not be possible to hold extensive consultations on specialist issues within a small firm, due to a lack of specialist professionals. There may be a lack of suitably experienced peers to discuss issues arising on client engagements. Arrangements with other practices for consultation may be necessary. Where special skills are needed within an engagement; the skills may be bought in, for example, by seconding staff from another practice. Alternatively if work is too specialised for the firm, the work could be sub-contracted to another practice.

Review procedures

It may not be possible to hold an independent review of an engagement within the firm due to the small number of senior and experienced auditors. In this case an external review service may be purchased.

The firm may lack resources to establish an in-house set of audit manuals or standard working papers. In this case documentation can be provided by external firms or professional bodies.

31. Solution

Forensic accounting utilises accounting, auditing, and investigative skills to conduct an examination into a company's financial statements. The aim of forensic accounting is to provide an accounting analysis that is potentially suitable for use in court. Forensic accounting is an umbrella term encompassing both forensic investigations and forensic audits. It includes the audit of financial information to prove or disprove a fraud, the interview process used during an investigation, and the act of serving as an expert witness.

Specifically it is the process of gathering, analysing and reporting on data for the purpose of finding facts and/or evidence in the context of financial/legal disputes and/or irregularities. The forensic accountant will also give preventative advice based on evidence gathered. This advice is based usually on recommendations to improve the internal control systems to prevent and detect fraud.

Forensic investigation is a process whereby a forensic accountant carries out procedures to gather evidence, which could ultimately be used in legal proceedings or to settle disputes. This could include, for example, an investigation into money laundering. A forensic investigation involves many stages (similar to an audit), including planning, evidence gathering, quality control reviews, and finally results in the production of a report.

Forensic auditing is the specific use of audit procedures within a forensic investigation to find facts and gather evidence, usually focused on the quantification of a financial loss. This could include, for example, the use of analytical procedures, and substantive procedures to determine the amount of an insurance claim.

32. Solution

The relevance here is that the Woodland Furniture is likely to hire a consultant to provide a forensic accounting service. The investigation will consider two issues – firstly whether the fraud actually happened, and secondly, if a fraud has taken place, the financial value of the fraud. The investigation should determine who has perpetrated the fraud, and collect evidence to help prosecute those involved in the deception.

In this case the suspicion that inventory is being stolen should be investigated, as there could be other reasons for the discrepancy found in the inventory records. For example, the discrepancy could be caused by:

- Obsolete or damaged inventory thrown away but not eliminated from the inventory records
- Despatches from the warehouse not recorded in the inventory management system
- Incoming inventory being recorded incorrectly (e.g. recorded twice in the inventory management system)
- Inventory being held at a separate location and therefore not included in the count.

If it is found that thefts have taken place, then the forensic accountant should gather evidence to:

- Prove the identity of the persons involved
- Quantify the value of inventory taken.

The evidence gathered could be used to start criminal proceedings against those found to have been involved in the fraud.

33. Solution

Balances held at fair value are frequently recognised as material items in the statement of financial position. Sometimes it is required by the financial reporting framework that the measurement of an asset or liability is at fair value, e.g. certain categories of financial instruments, whereas it is sometimes the entity's choice to measure an item using a fair value model rather than a cost model, e.g. properties. It is certainly the case that many of these balances will be material, meaning that the auditor must obtain sufficient appropriate evidence that the fair value measurement is in accordance with the requirements of financial reporting standards. ISA 540 Auditing Accounting Estimates Including Fair Value Accounting Estimates and Related Disclosures and ISA 545 Auditing Fair Value Measurements and Disclosures contain guidance in this area.

As part of the understanding of the entity and its environment, the auditor should gain an insight into balances that are stated at fair value, and then assess the impact of this on the audit strategy. This will include an evaluation of the risk associated with the balance(s) recognised at fair value.

Audit risk comprises three elements; each is discussed below in the context of whether material balances shown at fair value will lead to increased risk for the auditor.

Inherent risk

Many measurements based on estimates, including fair value measurements, are inherently imprecise and subjective in nature. The fair value assessment is likely to involve significant judgments, e.g. regarding market conditions, the timing of cash flows, or the future intentions of the entity. In addition, there may be a deliberate attempt by management to manipulate the fair value to achieve a desired aim within the financial statements, in other words to attempt some kind of window dressing.

Many fair value estimation models are complicated, e.g. discounted cash flow techniques, or the actuarial calculations used to determine the value of a gratuity fund etc. In addition to the complexities, some fair value measurement techniques will contain significant assumptions, e.g. the most appropriate discount factor to use, or judgments over the future use of an asset. Management may not always have sufficient experience and knowledge in making these judgments.

Thus the auditor should approach some balances recognised at fair value as having a relatively high inherent risk, as their subjective and complex nature means that the balance is prone to contain an error. However, the auditor should not just assume that all fair value items contain high inherent risk. Each balance recognised at fair value should be assessed for its individual level of risk.

Control risk

The risk that the entity's internal monitoring system fails to prevent and detect valuation errors needs to be assessed as part of overall audit risk assessment. One problem is that the fair value assessment is likely to be performed once a year, outside the normal accounting and management systems, especially where the valuation is performed by an external specialist. Therefore, as a non-routine event, the assessment of fair value is likely not to have the same level of monitoring or controls as a day-to-day business transaction.

However, due to the material impact of fair values on the statement of financial position, and in some circumstances on profit, management may have made great effort to ensure that the assessment is highly monitored and controlled. It therefore could be the case that there is extremely low control risk associated with the recognition of fair values.

Detection risk

The auditor should minimise detection risk via thorough planning and execution of audit procedures. The audit team may lack experience in dealing with the fair value in question, and so would be unlikely to detect errors in the valuation techniques used. Over-reliance on an external specialist could also lead to errors not being found.

Conclusion

It is true that the increasing recognition of items measured at fair value will in many cases cause the auditor to assess the audit risk associated with the balance as high. However, it should not be assumed that every fair value item will be likely to contain a material misstatement. The auditor must be careful to identify and respond to the level of risk for fair value items on an individual basis to ensure that sufficient and appropriate evidence is gathered, thus reducing the audit risk to an acceptable level.

34. Solution

ISA 570 Going Concern provides a clear framework for the assessment of the going concern status of an entity, and differentiates between the responsibilities of management and of auditors. Management should assess going concern in order to decide on the most appropriate basis for the preparation of the financial statements. IAS 1 Presentation of Financial Statements (revised) requires that where there is significant doubt over an entity's ability to continue as a going concern, the uncertainties should be disclosed in a note to the financial statements. Where the directors intend to cease trading, or have no realistic alternative but to do so, the financial statements should be prepared on a 'break up' basis. Thus the main focus of the management's assessment of going concern is to ensure that relevant disclosures are made where necessary, and that the correct basis of preparation is used.

The auditor's responsibility is to consider the appropriateness of the management's use of the going concern assumption in the preparation of the financial statements and to consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in a note. The auditor should also consider the length of the time period that management have looked at in their assessment of going concern. The auditor will therefore need to come to an opinion as to the going concern status of an entity but the focus of the auditor's evaluation of going concern is to see whether they agree with the assessment made by the management. Therefore whether they agree with the basis of preparation of the financial statements, or the inclusion in a note to the financial statements, as required by IAS 1, of any material uncertainty.

Evaluation techniques

In carrying out the going concern assessment, management will evaluate a wide variety of indicators, including operational and financial. An entity employing good principles of corporate governance should be carrying out such an assessment as part of the on-going management of the business.

Auditors will use a similar assessment technique in order to come to their own opinion as to the going concern status of an entity. They will carry out an operational review of the business in order to confirm business understanding, and will conduct a financial review as part of analytical procedures. Thus both management and auditors will use similar business risk assessment techniques to discover any threats to the going concern status of the business.

However, one difference is that when going concern problems are discovered, the auditor is required by IAS 570 to carry out additional procedures. Examples of such procedures would include:

- Analysing and discussing cash flow, profit and other relevant forecasts with management
- Analysing and discussing the entity's latest available interim financial statements
- Reviewing events after the period end to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern, and
- Reading minutes of meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.

Management are not explicitly required to gather specific evidence about going concern, but as part of good governance would be likely to investigate and react to problems discovered.

35. Solution

Identification of related parties

Related parties and associated transactions are often difficult to identify, as it can be hard to establish exactly who, or what, are the related parties of an entity. IAS 24 Related Party Disclosures contains definitions which in theory serve to provide a framework for identifying related parties, but deciding whether a definition is met can be complex and subjective. For example, related party status can be obtained via significant interest, but in reality it can be difficult to establish the extent of influence that potential related parties can actually exert over a company.

The directors may be reluctant to disclose to the auditors the existence of related parties or transactions. This is an area of the financial statements where knowledge is largely confined to management, and the auditors often have little choice but to rely on full disclosure by management in order to identify related parties. This is especially the case for a close family member of those in control or having influence over the entity, whose identity can only be revealed by management.

Identification of material related party transactions

Related party transactions may not be easy to identify from the accounting systems. Where accounting systems are not capable of separately identifying related party transactions, management need to carry out additional analysis, which if not done makes the transactions extremely difficult for auditors to find. For example sales made to a related party will not necessarily be differentiated from 'normal' sales in the accounting systems.

Related party transactions may be concealed in whole, or in part, from auditors for fraudulent purposes. A transaction may not be motivated by normal business considerations, for example, a transaction may be recognised in order to improve the appearance of the financial statements by 'window dressing'. Clearly if the management is deliberately concealing the true nature of these items it will be extremely difficult for the auditor to discover the rationale behind the transaction and to consider the impact on the financial statements.

Finally, materiality is a difficult concept to apply to related party transactions. Once a transaction has been identified, the auditor must consider whether it is material. However, materiality has a particular application in this situation. ISA 550 Related Parties states that the auditor should consider the effect of a related party transaction on the financial statements. The problem is that a transaction could occur at an abnormally small, even nil, value. Determining materiality based on monetary value is therefore irrelevant, and the auditor should instead be alert to the unusual nature of the transaction making it material.

36. Solution

A report to those charged with governance is produced to communicate matters relating to the external audit to those who are ultimately responsible for the financial statements. ISA 260 Communication of Audit Matters With Those Charged With Governance requires the auditor to communicate many matters, including independence and other ethical issues, the audit approach and scope, the details of management representations, and the findings of the audit. The findings of the audit are commonly referred to as management letter points. By communicating these matters, the auditor is confident that there is written documentation outlining all significant matters raised during the audit process, and that such matters have been formally notified to the highest level of management of the client. For the management, the report should ensure that they fully understand the scope and results of the audit service which has been provided, and is likely to provide constructive comments to help them to fulfil their duties in relation to the financial statements and accounting systems and controls more effectively. The report should also include, where relevant, any actions that management has indicated they will take in relation to recommendations made by the auditors.

Control weakness

ISA 260 contains guidance on the type of issues that should be communicated. One of the matters identified is a control weakness in the capital expenditure transaction cycle. The assets for which no authorisation was obtained amount to 0.3% of total assets (225,000/78 million x 100%), which is clearly immaterial. However, regardless of materiality, the auditor should ensure that the weakness is brought to the attention of the management, with a clear indication of the implication of the weakness, and recommendations as to how the control weakness should be eliminated.

The auditor is providing information to help those charged with governance improve the internal systems and controls and ultimately reduce business risk. In this case there is a high risk of fraud, as the lack of authorisation for purchase of office equipment could allow expenditure on assets not used for bona fide business purposes.

Disagreement with accounting treatment of brand

Audit procedures have revealed a breach of IAS 38 Intangible Assets, in which internally generated brand names are specifically prohibited from being recognised. Axis Management Co. has recognised an internally generated brand name which is material to the statement of financial position (balance sheet) as it represents 12.8% of total assets (10/78 x 100%).

The statement of financial position (balance sheet) therefore contains a material misstatement.

The report to those charged with governance should clearly explain the rules on recognition of internally generated brand names, to ensure that the management has all relevant technical facts available. In the report the auditors should request that the financial statements be corrected, and clarify that if the brand is not derecognised, then the audit opinion will be qualified on the grounds of a material disagreement – an 'except for' opinion would be provided. Once the breach of IAS 38 is made clear to the management in the report, they then have the opportunity to discuss the matter and decide whether to amend the financial statements, thereby avoiding a qualified audit opinion.

Audit inefficiencies

Documentation relating to inventories was not always made readily available to the auditors. This seems to be due to poor administration by the client rather than a deliberate attempt to conceal information. The report should contain a brief description of the problems encountered by the audit team. The management should be made aware that significant delay to the receipt of necessary paperwork can cause inefficiencies in the audit process. This may seem a relatively insignificant issue, but it could lead to an increase in audit fee. Management should react to these comments by ensuring as far as possible that all requested documentation is made available to the auditors in a timely fashion.

37. Solution

The definitions of 'overall audit strategy' and 'audit plan' are found in ISA 300 Planning an Audit of Financial Statements.
The overall audit strategy sets the scope, timing and direction of the audit. Scope involves determining the characteristics of the audit client, such as its locations, and the relevant financial reporting framework, as these factors will help to establish the scale of the assignment. Timing refers to establishing deadlines for completion of work and key dates for expected communications. Establishing the overall audit strategy also includes the consideration of preliminary materiality, and initial identification of high risk areas within the financial statements. All of these matters contribute to the assessment of the nature, timing and extent of resources necessary to perform the engagement.
The overall audit strategy should then lead to the development of the audit plan.
The audit plan is more detailed than the audit strategy and includes a description of the risk assessment procedures, and the further planned audit procedures necessary at the assertion level for gathering evidence on the material transactions and balances in the financial statements. The general purpose of developing the audit plan is to design audit procedures which will reduce audit risk to an acceptably low level.
The difference between the audit strategy and the audit plan is therefore that the strategy is the initial planning to ensure there will be adequate resources allocated to the audit assignment in response to an initial evaluation of the entity's characteristics, whereas the audit plan is a detailed programme of audit procedures.
The strategy will therefore usually be developed before the plan; however, the two activities should be seen as inter-related, as changes in one may result in changes to the other. Both the strategy and the plan should be fully documented as this represents the record of proper planning of the audit assignment.

38. Solution

Subsequent events are defined as those events occurring between the date of the financial statements and the date of the auditor's report, and also facts discovered after the date of the auditor's report.
ISA 560 Subsequent Events differentiates the auditor's responsibilities in relation to subsequent events depending on when the subsequent event occurs.
Events occurring up to the date of the auditor's report
The auditor has an active duty to perform audit procedures designed to identify, and to obtain sufficient appropriate evidence of all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements. These procedures should be performed as close as possible to the date of the auditor's report, and in addition, representations would be sought on the date that the report was signed.
Procedures would include reviewing management procedures for ensuring that subsequent events are identified, reading minutes of meetings of shareholders and management, reviewing the latest interim financial statements, and making appropriate enquiries of management.

Where a material subsequent event is discovered, the auditor should consider whether management have properly accounted for and disclosed the event in the financial statements in accordance with IAS 10 Events after the Reporting Period.

Facts discovered after the date of the auditor's report but before the date the financial statements are issued
The auditor does not have any responsibility to perform audit procedures or make any enquiry regarding the financial statements or subsequent events after the date of the auditor's report. In this period, it is the responsibility of management to inform the auditor of facts which may affect the financial statements.

When the auditor becomes aware of a fact which may materially affect the financial statements, the matter should be discussed with management. If the financial statements are appropriately amended then a new audit report should be issued, and procedures relating to subsequent events should be extended to the date of the new audit report. If management do not amend the financial statements to reflect the subsequent event, in circumstances where the auditor believes they should be amended, a qualified or adverse opinion of disagreement should be issued.

Facts discovered after the financial statements have been issued
After the financial statements have been issued, the auditor has no obligation to make any enquiry regarding the financial statements. However, the auditor may become aware of a fact which existed at the date of the audit report, which if known at the date may have caused a modification to the auditor's report. In this case, the matter should be discussed with management. This could result in the revision of the financial statements, in which case the auditor should issue a new audit report on the revised financial statements. This report should include an emphasis of matter paragraph referring to a note to the financial statements in which the reason for the revision is fully discussed. If management do not revise the financial statements, the auditor should take legal advice with the objective of trying to prevent further reliance on the auditor's report.

39. Solution

iii. The announcement of a restructuring after the reporting date is a non-adjusting event after the reporting date, according to IAS 10 Events after the Reporting Period. This is because the event does not provide evidence in relation to a condition that existed at the year end.

Materiality calculations in respect of the potential cost of closure are as follows:
Based on revenue: NRs. 250,000/15 million = 1·67%
Based on profit: NRs. 250,000/3 million = 8·3%
Based on assets: NRs. 250,000/80 million = <1%
Therefore this amount is material to the statement of comprehensive income.

As per IAS 10, a note should be provided to the financial statements, which describes the nature of the event, and provides an estimate of the financial effect.
Audit procedures could include:

- Review any potential note to financial statements which should disclose the non-adjusting event, providing a brief description of the event, and an estimate of the financial effect.
- Discuss the reason for the restructuring with a member of key management personnel, and read minutes of board meetings where the plan was discussed, in order to gain an understanding about the reason for the restructuring.
- Verify the approval of the plan itself, and the approval of the announcement of the plan, which can be performed through a review of board minutes.
- Confirm the date on which the plan was approved, and also the date of the announcement, using supporting documentation such as press release, letters sent to employees, internal meetings held with employees, etc.
- Obtain a copy of the announcement and review for details, particularly a description of the exact nature of the restructuring, including the number of employees to be affected.
- Agree the NRs. 250,000 potential cost of closure to supporting documentation, including a schedule showing the number and grade of staff to be made redundant, which should be supported by payroll/contract details.

- Using the results of the discussion with management, assess the planned restructuring in the context of the auditor's knowledge of the business, considering whether any further costs are likely to be incurred.

iv. Actions to be taken by the auditor

If no note is provided to the financial statements, then there is a breach of IAS 10. In this case there is insufficient disclosure provided in the notes to the financial statements regarding a material non-adjusting event after the reporting date.

According to ISA 701 Modifications to the Independent Auditor's Report, in cases where the auditor is in disagreement with management regarding the application of a financial reporting standard and where the disagreement is material to the financial statements, the auditor should express a qualified or an adverse opinion. Here, the matter is material (as discussed in (b) (i) above) but is not pervasive to the financial statements, so a qualified 'except for' opinion should be given.

The audit report should contain a paragraph which explains the reason for the qualification, specifying the breach of accounting standards, and stating the relevant financial amount. It would also be best practice for the auditor to clarify that the profit for the year is not affected by the breach of accounting standards, and that the disagreement is solely due to inadequate disclosure in the notes to the financial statements.

The auditors should ensure that the matter, and the potential consequence for the audit report, has been made known to those charged with governance. This will allow the highest level of management (including executive and non-executive directors) the opportunity to discuss the matter, having reference to all relevant facts of the disagreement and implications thereof.

Finally, the auditors could choose to raise this issue at the annual general meeting, where the matter leading to the qualified audit opinion should be explained to the shareholders of the company.

40. Solution

As per Section 27(1) of the Cooperatives Act, 2048, from the surplus made by a Cooperative in any financial year, the funds as prescribed may be apportioned after allocating into the reserve fund at least one fourth of the net saving. Sub Section 2 of the same Act mentions that a dividend to the extent mentioned in the By-law may be distributed from the funds, other than the reserve fund in consonance with the purpose of such funds. Provided that, the amount of share dividend for a year, shall not exceed fifteen percent of the share capital.

In the given case, M/S Rely More Cooperative Limited which has a share capital of NRs. 2,000,000, apportioned NRs. 100,000 to the reserve fund. As per Section 27(1), the minimum appropriation to general reserve required is one fourth i.e., NRs. 187,500. So, the proposed appropriation is inadequate and hence the Cooperative is required to make appropriation of at least one fourth of the net surplus.

Similarly approved dividend of NRs. 500,000 is 25% of the share capital of Rely More Cooperative Limited. Section 27 (2) of the Act specifies that the Cooperative can distribute dividend to the maximum 15% of its share capital i.e., NRs. 300,000. Hence, the board has to rectify earlier decision and make appropriation of net surplus as per provision of Cooperatives Act and Bylaws of the Rely More Cooperative Limited.

41. Solution

The reason for the proposed change in auditor should be ascertained via discussion with the directors. It is possible that the reason may prevent acceptance of the nomination (e.g. the existing auditors intend to qualify their opinion and your firm agrees with their view).

The permission of Surya Group must be sought in order to communicate with the existing auditors to assess any reasons for not accepting the nomination. If permission is not granted, the nomination should be declined.
The response of the existing auditors should be carefully considered, especially in the light of the reason given by the directors. If the reasons differ, this will reflect upon the directors' integrity and, again, the nomination should be declined.
Surya Group's reputation (employee relations, investigation by the authorities and any other adverse opinions) will also impact on the assessment of the directors' integrity.
Auditor independence should not be in any doubt. For example, there should be no family or personal relationships with key staffs at Surya Group, or beneficial shareholdings in Surya Group held by audit staff.
If the existing audit clients have any relationships with Surya Group (e.g. competitor, supplier, customer) a conflict of interest could arise. As a small firm (only four partners) appropriate safeguards may not be feasible. The firm must also be careful not to become unduly dependent on the client. Furthermore, an audit fee based on a percentage of profits would seem to detract from objectivity as it would be in the auditors' interest to allow profits to be overstated. Even if the auditors would not allow this to happen, the acceptance of an appointment with such a bonus would detract from the appearance of the objectivity.
Sufficient staff at the right time of year will be required to undertake the audit. Audit staff must be sufficiently competent to deal with a listed company manufacturer and retailer. If the firm's expertise lies in other market sectors this may not be the case.
If a flat fee is to be accepted, it should be fair & reasonable with regards to the level of staff needed on the audit and times spent by them. If the fee is likely to be insufficient to cover such cost then this may give the appearance to the outside world that a poor quality audit is being performed. The flat fee should also leave the directors in no doubt as to the range of services being offered (i.e. statutory audit only).
Regardless of the integrity of the directors, Surya Group's poor reputation may affect the auditors' reputation and they might therefore not wish to be associated with such a company, as existing and potential clients might be influenced by such adverse publicity.

42. Solution

A hot review is a review of working papers that is performed by a more senior member of staff during the course of the audit, and is usually performed soon after the work is completed. The reviewer will indicate that he has performed the review by dating and initialling the piece of work. The review should ensure that the work has been performed in line with the audit programme and that the conclusions are consistent with the results obtained.

A cold review is one that is performed at the end of the audit- usually by the audit manager or partner. This will be done before the audit report is signed off and will comprise a review of the whole file together with the financial statements. The purpose of this review is to ensure that the audit work has been fully completed and that the results conclusions for the entire audit are consistent.

43. Solution

c) Meaning of and relationship between
Materiality
Materiality is an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole. A matter is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
Materiality may also be considered in the context of any individual statements within the financial statements or of individual items included in them (performance materiality)

Materiality is not capable of general mathematical definition as it has both qualitative & quantitative aspects

True & Fair

The term 'a true & fair view is not defined in a statute and it has therefore fallen to the auditing profession to reach a reasoned and consistent interpretation of the term. Accounts should be true & fair if prepared in accordance with recommended accounting policies.

Truth relates to factual accuracy and correctness of the financial statements. For example, the statement of financial position should be an 'accurate' reflection (within acceptable limits) of the company's assets and liabilities at the year end.

Fairness relates to the presentation of information and the view conveyed to the reader. It is important that information in the financial statements is presented in a manner that is free from bias and does not lead the reader to any view that is not a reasonable reflection of the company's financial situation.

Relationship between materiality and true & fair

'True & Fair' is a matter of professional judgement. Materiality is just one of the factors considered in making such a judgement.

For example, if a company's actual revenue for a year of NRs. 2,200,000 was inaccurately stated (e.g. at NRs. 2,200,000) the financial statements could still be judged 'true & fair' as knowledge of the error would not cause a reader of the financial statements to change his opinion of them (i.e. the misstatement is not material).

Conversely, if a misstatement is judged to be material, the true and fair view is impaired.

Accounting standards are intended to give a true & fair view and need not be applied to immaterial items. Where material, compliance with accounting standards will normally be necessary for financial statements to give a true and fair view.

Effect on audit report

The audit opinion on the current year income statement/ statement of comprehensive income and comparative income statement/statement of comprehensive income (closing inventories) and statement of financial position (inventories) will be qualified (except for).

The qualification arises because of the auditor's inability to obtain sufficient appropriate evidence (limitation on scope). It will not be a disclaimer of opinion as the item is not likely to be pervasive as well as material.

The report will refer to how the scope of work has been limited.

The opinion paragraph will state that except for adjustments that might be necessary to opening inventories and/ or closing inventory comparatives; the financial statements show a true and fair view and have been properly prepared.

Reasons

Comparatives are part of the audited financial statements.

In addition, last year's closing inventories become the current year's opening inventories and this affects current year profits.

d) Effect on audit report

If the auditor assess that the contract is unlikely to be renewed and that, as a result, the company will no longer be a going concern, a modified opinion is likely on the grounds of a material misstatement (disagreement with the application of going concern concept). A qualified or adverse opinion would be given.

If the auditor assesses that the going concern assumption is appropriate but a material uncertainty exists and the directors have adequately disclosed the situation, an unmodified opinion would be given but an emphasis of matter paragraph should be used to highlight the uncertainty and the note in the financial statements disclosing it.
If the auditor assess that disclosures are inadequate for a true and fair view, an except for qualification would be required on the grounds of a material misstatement (disagreement with disclosure).
If the auditors believe that the directors have not provided sufficient information and explanations on the matter a qualified opinion (limitation on scope) may be required.

Reasons
Inventories may not be stated at lower of cost or NRV, as required by IAS 2.
There is some uncertainty as to whether the contract is a going concern, given the potential loss of over half of their trade.

44. Solution

c)

Audit work	Reasons
Damage Claim	
Ask the directors how they propose to treat the claim in the financial statements (and on what grounds)	The matter is potentially material even a claim of just NRs. 650,000 represents 13% of trading profit.
Inspect the invoice/ contract with the customer to ascertain the terms and conditions and whether the antiques collection is identified	The customer's claim may be invalid if they were responsible for insurance or if high value items should have been specified.
Review correspondence with the customer and with solicitors and the accident report/damage record.	In order to obtain consistent third party evidence to support internal evidence.
Examine company's own insurance policy documents.	The company may have its own insurance policy to cover such claims from customers.
Enquire whether the damage was an isolated incident.	To ascertain whether there may be other similar claims for which provision is needed.
Overdraft Limit	
Ask the directors why they consider the company to be a going concern	If it is not possible to determine that the going concern presumption is appropriate then there will be an impact on the audit report.
Review the current refurbishment program and related finance arrangement	The going concern presumption may not be appropriate if finance is not forthcoming to complete the refurbishment project (e.g. if the

	company is unable to operate).
Review correspondence with the bank and prospective lenders seeking additional borrowing facilities	The company should take steps to increase its borrowing facilities as long term investment cannot be sustained on an overdraft facility.
Discuss with directors any alternative courses of action to alleviate the cash flow problem	If the recent investment in new vehicles was for outright purchase, sale & leaseback may be arranged to raise funds.

d) Letter of Representation Extracts

iii) No provision is considered necessary in respect of a legal claim by the customer (Mr. *X*) for damage to reproduction furniture. No amounts are expected to be paid, and no similar claims have been received or are expected to be received.

iv) We confirm our considered view that the company has adequate resources to continue operations for the foreseeable future (i.e. is a going concern). This conclusion has been reached based on forecast expenditure and current & future borrowing arrangements.

REVISION TEST PAPER
CORPORATE LAW
DECEMBER 2016

The Companies Act 2063:

Case No. 1.

In a prospectus issued by a company the Managing Director stated that the company had paid dividend every year during 2011-2013, which was a fact. However, the company had sustained losses during the relevant period and had paid dividends out of secret reserves accumulated in the past.

You as an expert examine the consequences of the observation made by the Managing director.

Answer:

Background: Prospectus is an information book for all concerned, published by a body corporate at the time of issuing shares.

Legal procedures: According to Section 23(1) of the Companies Act 2063 A public company should publish its prospectus prior to issuing its security publicly. Under Section 23(2) of the Companies Act 2063 prior to the publication of prospectus it is to be signed by all directors of the company and has to be submitted along with written application made to the Securities Board for approval. (Sub Sec. (3) (4) to sub sec (8) not material in this regard.) Securities Act 2063 sections 27, 29, 30, 31, & 32 are also relevant.

In this regard Under Section 23(9) of the Act, the concern company has to make a declaration before the Securities Board that the provisions of the Act have been complied with.

Theoretical approach: Disclosure made in the prospectus should give true and fair view of Company's position. Public is invited to take shares on the faith of the representations contained in the prospectus. The public is at the mercy of company promoters. Everything must, therefore, stated in it must be strict and scrupulous accuracy. Nothing should be stated as fact which is not so, and no fact should be omitted the existence of which might in any degree affect the nature or quality of the privileges and advantages which the prospectus holds out as inducement to take share. In other words, the true nature of the company's venture should be disclosed.

According to Section 30 of the Securities Act 2063 a body corporate should publish a prospectus approved by the Securities Board for making public issue of securities. At the time of publishing prospectus it is required to mention the place where the general public can obtain or inspect prospectus. According to Section 31 the Securities Board will grant permission to publish it, if it contains all the required information.

Section 31 of the Securities Act 2063 prescribes the matters required to be contained in a prospectus. According to it, a prospectus must contain such information as may be adequate for investors to make evaluation as to the assets and liabilities, financial status, profit and loss of the issuer and matters expected in future. According to Section 32 it also requires to provide information regarding main functions to be done by the issuer, information pertaining to legal action, economic condition, general administration, management of the issuer, information relating to the expert preparing the prospectus and the economic statements and other

information as supportive to evaluate financial conditions to make it capable of affecting the transaction the value of securities.

As per the given issue where the managing director mislead the public by misrepresenting the fact of the issue of dividend of the company, the security purchaser can treat it as breach of implied condition and can rescind the contract and claim return of price and damages. It is because an active concealment of a fact is fraudulent. In this regard as per Section 23(9) of the Act, whatever the declaration made by concern company before the Securities Board that the provisions of the Act have been complied with amounts to fraudulent act. One of the condition of prospectus is that the disclosure made in the prospectus should give true and fair view of Company's position. Public is invited to take shares on the faith of the representations contained in the prospectus. The public is at the mercy of company promoters. Everything must, therefore, stated in it must be strict and scrupulous accuracy. Nothing should be stated as fact which is not so, and no fact should be omitted the existence of which might in any degree affect the nature or quality of the privileges and advantages which the prospectus holds out as inducement to take share. In other words, the true nature of the company's venture should be disclosed. Therefore if the declaration made is fraudulent or false represented the concern Board of the Directors of the company will be totally liable for that. Sec 24(3) of the Companies Act specifically prescribes the provision regarding the personal liability of directors who have signed in the prospectus for matters maliciously or deliberately contained in the prospectus.

According to sec 160(f) of the companies Act, 2063 any director or officer who issues the prospectus of a company prior to its being registered with the office who gives false details in the prospectus will be punished with fine not exceeding fifty thousand rupees or with imprisonment for a term not exceeding two years or with both.

Conclusion: Thus the managing director or officer who issues the prospectus, here of the company prior to its being registered with the office who has given false details in the prospectus will be liable for the punishment as said above under section 160(f) of the Act.

Case No. 2.:

Mahesh Paneru is one of the shareholders in a company. He borrowed certain sum of loan from a bank against the pledge or security of the shares held by him. He failed to repay the loan and the bank instituted legal action against him. It is claimed that since he is defaulter in repaying the loan he must be prevented from exercising voting right in respect of shares in the annual general meeting for a period until he repays the loan. State your opinion in this regard if he should be prevented from enjoying voting right.

Answers a)

Background: Section 71 of the Companies Act 2063 prescribes the provision regarding right to vote in general meeting. According to it, the person whose name is registered as shareholder in the share holder register book will be entitle to attend the general meeting and cast the vote in the general meeting. Unless the Articles of Association prohibits, a shareholder who is entitled to vote is not able to personally attend the meeting, he/she may appoint a proxy to vote in his/her stead, by an instrument of proxy executed in the prescribed format and signed by him/her and the proxy so appointed shall be entitled to attend or vote in the meeting, except where the Articles of Association of the concern company so prohibits.

However there are certain cases where the voting rights can be restricted. Section 70 of the Companies Act, 2063 prescribes the cases of restriction on voting as follows:

(1) No person shall be entitled to attend and vote in any general meeting, in the capacity of a shareholder, either in person or by proxy on any discussion to be held in respect of any terms and conditions entered into or to be entered into between him/herself and the company.

(2) No director or his/her partner or his/her proxy shall be entitled to vote on any discussion to be held at any General Meeting in respect of the responsibility for any act done or omitted to be done or done wrongfully by him/her or in respect of his/her own appointment, dismissal, transfer or confirmation, with respect to the provision of , or reduction or increment in remuneration, allowance or bonus or in respect of any agreement, contract or arrangement regarding his/her employment or anything in which his/her interest or concern is involved.

(3) Any shareholder who has not paid calls on the shares shall not be entitled to attend and vote in the general meeting.

(4) Where any shareholder appoints a director of the concerned company as his/her proxy, where proxy is permitted, such director shall not be entitled to vote in the general meeting ,as a proxy of any one , on any matter in which his/her interest or concern is involved or on the matter of his/her appointment.

(5) Notwithstanding anything contained in this Act or the prevailing law, where a bank or financial institution incorporated under the prevailing law, which institutes legal action against a shareholder, who has borrowed a loan from such bank or financial institution against the pledge or security of the shares held by him/her, for his/her default in repaying the loan, writes to the concerned company to prevent him/her from exercising voting right in respect of shares, then the company shall prevent such shareholder from exercising voting right in respect of the shares held by him/her for a period until he/she repays the loan.

Conclusion: As provided under section 70 (5) where a bank or financial institution incorporated under the prevailing law, which institutes legal action against a shareholder, who has borrowed a loan from such bank or financial institution against the pledge or security of the shares held by him/her, for his/her default in repaying the loan, writes to the concerned company to prevent him/her from exercising voting right in respect of shares, then the company will prevent such shareholder from exercising voting right in respect of the shares held by him/her for a period until he/she repays the loan.

In the given issue it is claimed that since Mahesh Paneru is defaulter in repaying the loan he must be prevented from exercising voting right in respect of shares in the annual general meeting for a period until he repays the loan is maintainable.

Case No. 3.

Nepal Shipping Co. Ltd passed a special resolution to amend name and objective clause in its memorandum of association and articles of association and also informed the same to the Office. However, one of the shareholders has objected over the change in objective of the

company and has filed a petition at the court against the decision of the company. What are the provisions in the Company Act, 2063 to make such changes valid?

Answers:

Section 21 of the Companies Act 2063 prescribes the provision regarding the amendment of memorandum of association and articles of association as follows:

(1) The general meeting of a company may, amend the memorandum of association or articles of association, by adopting a special resolution to that effect.
(2) The company should give information of any amendment made to the memorandum of association or articles of association pursuant to Sub-section (1) to the Office within thirty days; and the Office will record the same and give information thereof to the concerned company, within seven days after the receipt of such information.
(3) If any company has to amend its name along with memorandum of association and articles of association, it should adopt a special resolution to that effect at its general meeting and make an application, accompanied by the fees as prescribed, for prior approval of the Office: and if the Office gives approval to amend the names as per the application so received, the name of that company will be amended.

Under S. 21(4) of the Act, if a shareholder of a public company who is not satisfied with an amendment made to the objectives of the company may, on fulfilling the following requirements, file a petition, setting out the reasons therefore, in the court to have that amendment declared null and void:
(a)A shareholder or shareholders holding at least five percent shares of the paid-up capital of the company, except the shareholders who consent to or vote for the amendment or alteration, may make a petition within twenty one days after the adoption of the resolution to amend the objectives of the company. Where anyone is to file a petition on behalf of one or more than one shareholder entitled to make petition, the petition has to be filed by a person who is authorized in writing for that purpose.

Unless and until the court is satisfied that the information about the contents, date, time and venue of a petition made as said above has also been given to the company, the petition shall not be heard.
Where a petition is filed in the court as said above, the amendment made to the objectives of the company will not be effective pending the final decision or order by the court in that matter.
On a petition as referred above, the court may issue an appropriate order, specifying the following terms and conditions:
(a)Declaring the amendment made to the objectives of the company to be fully or partly valid or void,
(b)Requiring the company to subscribe for a reasonable value, the shares and other rights held by the shareholders making a petition under Sub-section (4), upon being disagreed with the making of alteration in the main objectives of the company,
(c)The shares have to be subscribed under Clause (b) from the moneys as referred to in Sub-section(2) of Section 61; and in the case of a company which has no such moneys, issuing an order to decrease the capital of the company as if the share capital were decreased to the extent of such subscription by adopting a special resolution by the company; and where such order is issued, the company shall amend its memorandum of association and articles of association, subject to the provisions of this Act.

Where an order is issued by the court to fully or partly void the decision made by the company to amend its objectives, the company will not be entitled to amend its memorandum of association or articles of association in that matter without permission of the court or in a manner contrary to the order of the court.
Where the memorandum of association or articles of association of a company is altered by an order of the court or the amendment made by the company is fully or partly endorsed by the court, such alteration or endorsement shall be enforced as if such alteration or endorsement were made by the general meeting of the company on its own.

In the given issue it is not clear, if the shareholder, who is not satisfied with the resolution passed regarding the amendment of objective clause, possess the shares at least five percent shares of the paid-up capital of the company, and the information about the contents is enough to proceed the case. If possess all required conditions, the court may entertain the petition and will be decided the case accordingly.

Case No. 4.

Nepal Hydro Power Public Company is involved in a controversy over convening its extra-ordinary general meeting. You as a legal consultant, advise the company as who and in what circumstances, they are entitled to make written request for convening an extra-ordinary general meeting of the company in case the board of directors of the company does not convene it? Explain.

Answers:

Background: Any other meeting other than Annual General Meeting (AGM) is commonly known as Extra Ordinary General Meeting (EGM). EGM is convened, when it is required to decide certain matters, for which it cannot wait till the next AGM. EGM is convened only relating to the special matters for which it is convened.

Legal provision: Pursuant to Section 82(1) of the Companies Act, 2063, the board of directors of a company may convene an extra-ordinary general meeting if it deems necessary.

In case the Board of Directors of Nepal Hydro Power Public Company does not convene its extraordinary general meeting where necessary, in that case the following persons in the following manner pursuant to sub-sections (2), (3), (4) and (5) of Section 82 of the Companies Act, 2063 may make a written request with reasons to the Board of Directors and if the Board of directors fails to call the meeting accordingly and make an application to the CRO to call or cause to call such meeting by the Board of Directors.
Pursuant to such sub-section (2) if, in the course of examining the account of the company, it is deemed necessary to call an extra ordinary general meeting for any reason, **the auditor** may request the board of directors to call such meeting; and if the board of directors fails to call the meeting accordingly, the auditor may make an application, setting out the matter, to the CRO; and if an application is so made, the CRO may call the extra-ordinary general meeting of the company.
Pursuant to such sub-section (3), if the shareholders holding at **least ten percent shares** of the paid–up capital of a company or **at least twenty five per cent shareholders of the total number of shareholders** make an application, setting out the reasons there for, to the registered

office of the company for calling an extra-ordinary general meeting of the company, the Board of Directors should call the extra-ordinary general meeting of the company. Pursuant to such sub-section (4), if the board of directors does not call the extra-ordinary general meeting within thirty days from the date on which an application is made pursuant to sub-section (3) above, the concerned shareholders may make a petition to the CRO setting out the matter; and if such a petition is made, the CRO may cause to call such meeting.

Pursuant to such sub-section (5), if the **CRO deems necessary to call an extra-ordinary general meeting in view of the findings of any inspection or investigation** or for any other reason, it may itself call or cause the board of directors to call such meeting.

Conclusion: Depending upon the cases, the Board of Directors itself, or Auditor, or shareholders holding at least ten percentage shares of the paid up capital of the company itself may make to call the extra-ordinary general meeting of the company. In certain cases i.e. in the course of investigation and examination the CRO may make an order to the Board to convene the EGM. So if the Board of Directors of the Nepal Hydro Power Public Company is fails to convene the EGM where necessary as per the request made the Board of Directors of the company will be liable for that.

Case No 5:

Everest Fashion Ltd. has not sent any reports to the Registrar of Companies for long time including the change of the registered office address. The Registrar issued a public notice in a newspaper with wide circulation intending to cancel the name from the roster but the company could not reply it because the notice was published on just before the Dasain Festival and it could not gone through the newspaper as it was thrown away during long holiday of the Dasain festival . After 3 years of cancellation, the company management came to know that the company was already cancelled. What will be the impact of the transaction done during the period? Can it be revived? Discuss.

Answer:

Under Section 137 of the Companies Act 2063, deregistration of the company by the Registrar of Companies can be challenged within 5 years from the date of decision of deregistration. If the Registrar issued a notice having a reply period of 2 months intending to deregister the company but not replied by it or the Registrar is not satisfied with replies, Registrar can deregister the company. In the given case CRO has sent the notice but the registered office has shifted from there where it was registered. The public notices were issued but the management was unaware of it and the CRO decided deregistration. The transactions were done without notice of deregistration for 3 years.

In those cases any member/creditor of the company may apply to the court to revive the company within 5 years. The company can be revived upon the decision of the court in this favour. If the court decides so, all the transactions were deemed as done by a normal company and valid for law. The legal status of the company shall be deemed as perpetual within the period of deregistration as a normal company.

Case No 6:

1. **S & S Solar Power Pvt. Ltd. was in process of incorporation. Promoters of the company signed an agreement for the purchase of certain equipments for the company and payment was to be made to the suppliers by the company after its**

incorporation. Shortly, after incorporation the company went into liquidation and the debt for the purchase of assets could not be paid by the company. As a result suppliers sued the promoters of the company for recovery of the dues.

Examine, with reference to the provisions of the Companies Act, 2063 when the company can be held liable for payment in the given case.

Answer:

This issue is related to pre-incorporation contract. A pre-incorporation contract is one which is made by a person on behalf of or purporting to be the company at a date prior to that on the company's certificate of incorporation.

Section 17(1) of the Companies Act prescribes that a contract made prior to the incorporation of a company shall be a proposed contract only, and such contract shall not be binding on the company. Section 17(2) makes persons liable for any contract related with transaction so carried on. However, Section 17(3) prescribes provision regarding the non-liability of a person for any such transaction. According to it if within the time mentioned in any transaction or within the reasonable time after incorporation of a company, the company through its act, action or conduct, accept any act, action or borrowing done or made prior to the date of authorization to commence its transaction or endorses such act or action that transaction shall be binding on the company and the other contracting party, and the person carrying out such act or action shall be released from the personal liability to be borne. So, under Section 17(3) company can be made liable for the pre-incorporation contract, if the company after its incorporation accepts any act or action done prior to the date of incorporation and endorses such act that transaction shall be binding on the company.

Moreover under Section 18(2)(c) of the companies Act the company may be made liable for transaction made by pre-incorporation contract by prescribing the provision in MOA and AOA expressly i.e. if the company itself is to bear the expenses incurred in its incorporation that can be made valid by prescribing it in MOA.

Case o. 7:

Krishana Kumar Barma was appointed as a director of a company in an Annual General Meeting of Nepal Clean Power Company Ltd. He took over the office and carried out his functions as director. Subsequently, it was found that there were some irregularities in that appointment and hence the appointment was declared invalid. Would the duties performed by Mr. Krishna Kumar Barma, while in office as director, be binding upon the company? Also mention when a company be bound by the decision or action taken by its director under the Companies Act, 2063?

Answer:

Section 106 of the Companies Act 2063 prescribes the provision regarding the validity of the acts already done by a director whose appointment comes to be invalid. According to it if it is afterwards discovered that any provision under this Act has not been complied with in respect

of the appointment of any director, the acts already done by such director before the discovery of such fact does not become invalid by that fact.

Moreover, Section 104 of the Act prescribes the provision regarding company to be bound by the act doe by a director. It states that any act doe or action taken by or document signed by at least one director authorized by a company or any person authorized to act for the company will be valid ad binding for the company.

Where any person does any transaction with a company in good faith, such transaction will be binding for the company, and nothing contained in memorandum of association, articles of association of the company or in any resolution adopted by the general meeting or in any agreement concluded between the company and its shareholder will be deemed to have made any limitation in or restriction on the authority of director or the authorized person to do such transaction.

Provided, however, that if any officer does any act or transaction mentioned above in excess of his/her authority, such officer will be personally liable for such act or transaction unless such authority is ratified by the general meeting pursuant to this Act, and the company may also recover from his/her the loss or damage, if any caused to the company from such act or transaction.

Case No. 8:

Nepal Pashmina Udyog Ltd. has decided to appoint independent director(s) to the company. Managing Director of the company is not familiar with the provision regarding the appointment of independent director. You as an expert of law, advise the company on the following legal issues as to the appointment of independent director(s) pursuant to the Companies Act, 2063.

a) What is the legal provision of appointment of independent director(s)?
b) Who are the persons not eligible to be appointed as an independent director?

Answer:

(i) Section 86 of the Companies Act, 2063 prescribes provision regarding the appointmet of the Directors of the Compay.
Pursuat to Sectio 86(2) of the Compaies Act, 2063 every public company should have a Board of Directors consisting of a minimum of three and maximum of eleven directors.

As per Section 86(3) of the Act, in forming the board of directors pursuant to sub-section (2) above at least oe independent director, I the case of the number of directors not exceeding seven, will be appointed from amongst the persons who have the knowledge as prescribed in the articles of association of the company and gained knowledge and experience in the subject related to the business of the company concerned.

This legal provision should be considered by the Nepal Pashmina Udyog Ltd for the appointment of the independent directors depending upon the number of directors it appoints.

(ii) In pursuance to Section 89(2) of the Companies Act, 2063 any of the following persons will not be eligible to be appointed to the office of independent director.

a. Who is a person disqualified to be appointed to the office of a director pursuant to sub-section(1) of the Section 89 of the Companies Act, 2063;
b. Who is the shareholder of the concerned company;
c. Who has not obtained at least bachelor degree in a subject that is related to the business to be carried on by the concerned company and gained at least ten years of experience I the related field or I the company management affairs or who has not obtained bachelor degree in finance, economics management, accounts, statistics, commerce, trade or law and gained at least ten years of experience I the related field;
d. Who is an officer, auditor or employee of concerned company or a period of three years has not lapsed after his/her retirement from any such office;
e. Who is close relative of the office of the concerned company;
f. Who is an auditor of the concerned company or his/her partner?

Write Short Notes on:

a. **Company Accounts.**

Answer: S 108 of the Companies Act 2063 prescribes that every company has to duly maintain its accounts in the Nepali or the English language. The company should maintain such books of accounts as are necessary to exhibit and explain the transactions and financial positions of the business of company including books containing entire made from day to day in sufficient detail of all cash received and case paid. The Act also prescribes that the accounts is to be maintained according to the double entry system of accounting and in consonance with the accounting standards enforced by the competent body under the prevailing law and in such a manner as to clearly reflect the actual affairs of the company. The books of account of a company is to be kept in its registered office, except with the approval of the Office. The cash balance of a company, other than the amount specified by the board of directors, is to be deposited in a bank and transaction should be done through the bank. It is the final responsible of the directors or other officers to maintain the books of account and records of the company.

Where there is default in complying with the provisions prescribed by the Act in respect of books of account and annual financial statements of a company, the director or officer himself, during whose tenure the annual financial statement is made, will be liable.

Annual financial statement, like balance sheet as at the end of last date of the financial , profit and loss account of the financial year, description of cash flow, should be prepared by the board of directors.

b. **Audit Committee** (under Company Act) Also relevancy of **NRB Act** as well:

Section 164 of the Companies Act, 2063 prescribes provisions regarding Audit Committee. According to it a listed company with paid up capital of thirty million rupees or more or a company which fully or partly owned by the Government of Nepal has to form an audit committee under the chairpersonship of a director who is not involved in day to day operation of the company and consisting of at least three members. The Act also prescribes the disqualification of the member of the committee. In other words a person who is a close relative of the chief executive of a company should not be appointed as a member of the committee. Similarly, the Act prescribes the provision that at least one member of the audit

committee should be an experienced person having obtained professional certificate on accounting or a person having gained experience in accounting and finance with bachelor degree in commerce or economics.

It is the board of directors to arrange all means and resources as may be adequate for the fulfillment of responsibilities of the audit committee. Audit may fix its internal rules of procedures on its own.

Section 165 prescribes the functions, duties and powers of audit committee. Major functions, duties and powers of the committee may be noted as follows:

a. To review the accounts and financial statements of the company and ascertain their truth.
b. To review the internal financial control system and the risk management system of the company.
c. To supervise and review the internal auditing activity of the company.
d. To recommend the names of potential auditors for the appointment of the auditor of the company.
e. To prepare the accounts related policy of the company and enforce, or cause to be enforced the same.
f.. To perform such other terms as prescribed by the board of directors in respect of the accounts, financial management and audit of the company.

NRB Audit committee:

Section 34 of the Nepal Rastra Bank Act, 20258 has defined an Audit Committee. As per the Act the NRB /board has to constitute an Audit Committee comprising of the following members which will be accountable to the Board:

a) One Director- Convener
b) Chief of Internal Audit Department of the Bank- Member
c) One senior officer of the bank designated by the Board- Member

S. 35 of the same act has explained the functions, duties and powers of the NRB Audit committee as follows;

a) To submit its report and recommendations to the Board on accounts, budget and audit procedures and control system o the Bank

b) To ascertain whether or not the audit and preparation of periodic balance sheet and other documents of the Bank have been carried out properly

c) To supervise the implementation of the appropriate risk management adopted by the Bank

d) To audit managerial and performance of works of the Bank in order to be assured that the prevailing laws applicable to the Bank have been fully complied with

e) To frame bye-law for auditing of the Bank in accordance with the prevailing laws and international auditing standard and to submit it to the Board for approval.

The audit committee has to furnish the information thereof to the Governor at the time of submitting report according to clause (a).

c. Directors' Responsibility for the Loss of Net Worth of a Company

Answer:

Under section 60 of the Companies Act 2063 if the net worth of a public company is reduced half the paid up capital or less, the directors shall prepare a suitable strategy or plan in the interest of the company and shareholders within 30 days of the knowledge of the fact and present an appropriate resolution at the general meeting to be held at the earliest. However, where an approval of the general meeting is required to implement such a strategy an extra-ordinary general meeting shall be called. The directors of the company who fail to prepare a strategy or to present a resolution at the general meeting or who knowingly permit the

existence of the situation where such a meeting is not called, will be liable to punishment. If it is held that net worth of a company has been reduced as mentioned as a result of a malafied intention of any director, such a director shall be liable to pay compensation.

ICAN ACT 2053:

Case No 1:

Mr. Sunil Roy was appointed as an auditor by the AGM of the Surya Power Company to audit its accounts of the Fiscal Year 2014-2015. The auditor committed certain offences in the course of auditing the accounts of the company. The company removed the auditor and complained this matter to Institute of Chartered Accountants of Nepal (ICAN). SuryaPower Company has sought your advice on the following questions:

a. What are the punishments imposed against the auditor for his offences under the Companies Act, 2063?
b. What action the Council of ICAN can take against the auditor, in this case?

Answer:

a) (1) Section 160 of the Companies Act, 2063, has imposed the following punishment against the auditor who commits the following offense shall be punished by the Court with a fine from twenty thousand rupees to fifty thousand rupees or with imprisonment for a term not exceeding two years or with both:

(a) where the auditor of the company states a false matter in his report in the course of carrying out his duty or omits necessary comments while making audit, with *mala fide* intention or malicious recklessness; or

(b) an auditor who carries out auditing of the company even after he knows that he is not qualified to carry out auditing of any company (section 160(k) of the Act).

(2) pursuant to section 161 of the Companies Act, 2063 the auditor who does not present a report of audit shall be punished with a fine from ten thousand rupees to fifty thousand rupees.

b) The Council of ICAN can take disciplinary action against an auditor under sections 35 and 14 of Nepal Chartered Accountants Act, 2053. Pursuant to section 35 of this Act:

(1) The Surya Power Company may lodge a complaint to the ICAN against the auditor (holding certificate of practice) for not upholding the conduct mentioned in or for violation of this Act or Regulation framed under this Act.

(2) The Secretary shall, if he finds convincing information that proves any member or member holding certificate of practice is not observing the conduct, submit the proposal along with the related facts to the Council of the ICAN for further action against such member.

The Disciplinary Committee constituted by the ICAN Council under section 14 of the Act, require to inquire into a complaint and recommend the Council for necessary action in cases where anyone lodges a complaint in the Council that any member has done any act or action contrary to this Act or the Rules or code of conduct framed under this Act, or where the Council receives such information:

The Disciplinary Committee will make recommendation, along with its opinion and finding, to the Council for taking necessary action against a member found guilty from its investigation; and the Council may, in view of such recommendation, impose any of the following penalties on the concerned member, according to the gravity of the offence:

(a) Reprimanding;
(b) Removing from the membership for a period not exceeding Five years;
(c) Prohibiting from carrying on the accountancy profession for any specific period;
(d) Cancellation of the certificate of practice or membership.
Under section 22 of the Act, there is a provision of removal of names and re-instatement of the membership. Accordingly;

(1) The Council may issue an order to remove the name of the auditor from the Membership Register for not abiding by the professional conduct referred to in this Act and the Rules framed under this Act.
(2) If his name has been removed from membership pursuant to sub-section (1) above makes an application, accompanied by a reasonable ground, to again obtain membership, the Council may decide to grant membership, by re-registering his or her name, upon receipt of the fees as prescribed.

Case No 2:

Mr Dinesh Maskey, a practicing auditor and a member of ICAN, published a compilation of all the existing audit principles of various sectors. While publishing the compilation he gave his personal resumes and detail as one of the leading auditor in respect of his professional experience of an auditor and his present association as a partner with M/s XYZ, a firm.

i) Examine whether the details given by Mr Dinesh Maskey is a violation of the code of conduct as prescribed by the Nepal Chartered Accountant Act 1997?

ii) If there is violation of code of conduct to what extent Mr. Dinesh Maskey can be penalized?

Answer:

i) Mr Dinesh Maskey as a member of ICAN one has to be fully abided by the NCA Act and the Regulations of it. As profession of auditor it has been prescribed as a mandatory duties of an auditor. In the given context publishing a compilation regarding the existing audit principles of various sectors is an act for promoting professional job and is not a violation of the code as prescribed by the Act. However, publishing the personal detail regarding the professional experience of an auditor is a kind of violation of code of conduct of the Act. Chapter VIII of the Nepal Chartered Accountants Act 1997 prescribes provision regarding conducts that are to be fully observed by Members of it. One of the conduct prescribed by the Act is that members should not disclose or divulge any information and explanations acquired in the course of professional service to any person other than the employer employing him and the person whom he is complied by the law to do so. The Act further prescribes that members should not directly or indirectly influence any person by way of enticement in order to secure any professional business. Finally it is the duty of a member to be abided by all other matter concerning the conduct in the course of his profession. In the given issue it is clear that the publishing the personal details as one of the leading auditor and his professional experience of an auditor is a violation of code prescribed by the Act and liable for it.

ii) One of the prime functions of NCA Council is to monitor as to whether or not the members and members holding certificate or practice have acted in conformity with the prescribed professional code of conduct. In the given issue it is clear that Mr. Dinesh Maskey has violated code of conduct prescribed by the NCA Act 1997 by giving his personal detail regarding professional experience of an auditor and his present association as a partner with an audit firm. In such case if a member lodge a complaint to the Institute against such member in respect of not upholding the conduct mentioned in the Act, an action can be taken against such member by NCA and the member so violated will liable to be punished for committing an act contrary to the provision of NCA Act or Regulation framed there on with a suspension for a maximum period of five years and will be liable of punishment with a maximum penalty of two thousand rupees or imprisonment for a maximum period of three months or both.

Case No 3:

Mr. S.N Bannerjee, a foreign citizen has passed the CAP III level examination conducted by ICAN in the June 2014 and now he intends to practice accountancy profession in Nepal. Will it be possible for a foreign national to practice accountancy in Nepal as per the Nepal Chartered Accountants Rules?

Answer:

Nepal chartered accountant Rules, 2061 provides opportunities to foreign nationals qualified from ICAN to practice the accountancy profession as follows:

Rule 56.Person other than Nepali citizen can practice accountancy profession:

(1) Notwithstanding anything contained anywhere in this Nepal Chartered Accountants Rules, 2061, any foreign citizen eligible according to these rules can perform accountancy profession in the kingdom of Nepal only after registering a firm in partnership with a citizen of Nepal.

(2) Nature, scope and limitations of the firm in partnership according to sub-rule (1) shall be as decided by the council.

(3) Notwithstanding anything contained anywhere in this Nepal Chartered Accountants Rules, 2061 a foreign citizen performing accountancy profession acquiring membership from the ICAN shall have to register a firm in partnership as stated in sub-rule (1) within 2 years of the date these rules came into effect.

Rule 58 (5) The share of a foreign citizen as a partner in an accounting firm must not exceed 51 %.

Case No 4:

M/s. Suder & Company has been involved in providing recurring professional services to Hydro Ltd. for the last five years however from this year onwards the company intends to

employ M/s Kamala & Company. State the duties of both the existing and proposed accountant as laid out in the Code of Ethics for the members of the ICAN?

Answer:

The Code of Ethics for the members of ICAN prescribes communication between and existing and proposed accountant as follows:

13.21 Before accepting an appointment involving recurring professional services hitherto carried out by another professional accountant in public practice, the proposed professional accountant in public practice should:

(a) Ascertain if the prospective client has advised the existing accountant of the proposed change and has given permission, preferably in writing, to discuss the client's affairs fully and freely with the proposed professional accountant in public practice.

(b) When satisfied with the reply received from prospective client, request permission to communicate with the existing accountant. If such permission is refused or the permission referred to in a) above is not given, the proposed professional accountant in public practice should, in the absence of exceptional circumstances of which there is full knowledge, and unless there is satisfaction as to necessary facts by other means, decline the appointment.

(c) On receipt of permission, ask the existing accountant, preferably in writing:

(i) To provide information on any professional reasons which should be known before deciding whether or not to accept the appointment and, if there are such matters; and

(ii) To provide all the necessary details to be able to come to a decision.

13.22 The existing accountant, on receipt of the communication referred to in paragraph 13.21 (c) should forthwith:

(a) Reply, preferably in writing, advising whether there are any professional reasons why the proposed professional accountant in public practice should not accept the appointment.

(b) If there are any such reasons or other matters which should be disclosed ensure that the client has given permission to give details of this information to the proposed professional accountant in public practice. If permission is not granted, the existing accountant should report that fact to the proposed professional accountant in public practice.

(c) On receipt of permission from the client, disclose all information needed by the proposed professional accountant in public practice to be able to decide whether or not to accept the appointment, and discuss freely with the proposed professional accountant in public practice all matters relevant to the appointment of which the latter should be aware.

Securities Act 2063 & Secured Trasaction Act 2063:

Case No 1:

Nabraj Kandel is a chief accountant of a commercial bank listed on the stock exchange. Whilst drawing up the annual accounts, Nabraj knows that the bank has made a better profit than expected. On the basis of that knowledge, he buys shares of the bank before the good results are announced. He makes a substantial profit on the share dealing. Nabraj also discloses the fact to his

friend Madan Baset before they are announced. Madan also buys shares of the bank. Whether Nabraj and Madan have committed any immoral act? Explain how these problems are tried to control under the prevailing law of Nepal?

Answer:

The stock market value of shares in a company fluctuates according to the underlying performance of the company and the expectations of investors. Amongst other things, good company results will lead to an increase in the value of the shares. Since share prices fluctuate on the stock market, the possibility arises for individuals to make large profits, or losses, by speculating in shares. It can also provide people with the opportunity to take advantage of their close relationship with particular companies, in order to make profits from illegal share dealing. Such illegal trading in shares, known as insider trading, occurs when someone trades on the basis of price sensitive information before the general public has access to that information. Insider trading is illegal and restricted activity. It is a trading of securities by individuals with potential access to non-public information about the company, in breach of a fiduciary duties or other relationship. It is a violation of trust confidence or misappropriation of information. In other words insider dealing refers to the improper use of price sensitive information in respect of listed securities by a person for private gain. This principle has been adopted in the Companies Act, 2063 and Securities Act, 2063. Securities Act, 2063 Section 91 prescribes insider trading as if any person deals in securities or causes any other person to deal in securities on the basis of any insider information or notice that are unpublished or communicates any information or notice known to such a person in the course of discharge of his or her duties in manner likely to affect the price of securities such a person shall be deemed to have been committed an insider trading in securities. It further explains that insider information or notice means any such specific kind of information or notice not published by a body corporate issuing any securities as may be capable of affecting the price of such securities if such information or notice is disclosed. Section 92 of the Act prescribes the provision regarding the persons likely to be involved in insider trading as those who have access to the insider information or notice not published by anybody corporate such as: director, employee, a person, who can obtain any information or a notice in the capacity of a shareholder of that body corporate, professional and other having direct or indirect contact with the person or source above.

Section 93 of the Act prescribes regarding the public notice or information. According to it information or notice deemed to have been made public if information for the benefit of investors in general or all to a particular group is given or information given or available as per laws and regulation. According to the Securities Act, 2063 false transaction, artificial up and downs in prices, unnatural influence to stock exchange, cheating statistics, conspiring transactions or hiding or destroying particulars are punishable under Section 94 to 100. To control the insider trading practices section 92 of The Companies Act, 2063 has prescribed that a director within seven days of assuming office has to disclose in writing to the company, if he has any dealing or transactions in share or debenture of the company or its holding or subsidiary company, details of such transaction. If any director or concerned officer is in the position of non-compliance of these provisions they are subject to the criminal offence as well as civil offence as the case may be.

BAFIA 2063 Section 11 restricts, during the tenure and a year after the tenure expires, the Director, CEO, auditor, accounting and management and their family member to deal in securities of his company or its subsidiaries and of companies controlled by him or his families. The Act further prescribes that if any person does any act in contravention to above act the concerned bank or financial institution can forfeit such securities and the Board may sell and dispose off the securities forfeited as it may think appropriate.

In the given issue it is clear that there is insider trading on the part of Nabraj as well as Madan under Section 91 of Securities Act, 2063, and also under Section 11 of BAFIA. In this case the Bank can forfeit their shares as per Section 11(2) of BAFIA.

Case No 2:

Answer the following questions:

a) To regulate and manage the activities of the securities markets and persons involved in the business of dealing in securities by regulating the issuance, purchase, sale and exchange of securities for the purpose of protecting the interests of investors in securities, Securities Act 2063 is enacted.
Explain how securities of a body corporate issues securities under the Act?

i) In case of issuing securities to less than 50 persons.
ii) In case of issuing securities to more than 50 persons.

Answer:

<u>Process of issuing shares:</u> The body corporate will issue its securities under the Securities Act as follows:
Under S.27(1) of the Act a body corporate shall have to register securities to be issued by it with the Board prior to their issuance. For this a body corporate shall have to make an application in the prescribed format, accompanied by its memorandum of association, articles of association, documents related with such securities, and the prescribed fees, to the Board for registering securities pursuant to Sub-section (1).
Where an application is received the board shall make necessary inquiry into the matter and, if it considers appropriate to register such securities, register such securities in the register as prescribed, indicating the details of such securities and issue the securities registration certificate in the prescribed format to the concerned body corporate.

i) **<u>Issuing less than 50 persons</u>**: Under S.28. where a body corporate allots or sells securities after registering such securities, the body corporate shall have to give a notice along with the details of securities so allotted or sold to the Board within seven days.

Upon receipt of a notice as referred as above, where it appears necessary to make the allotment and sale of such securities fair and informative for the interests of investors a nd the body corporate, the Board may give necessary directive to the concerned body corporate. It shall be the duty of the concerned body corporate to abide by such directive.

ii)More than 50 persons

Under S.29. where a body corporate is to sell and distribute securities to more than fifty persons at a time, it shall make public issue for the sale and distribution of such securities. The period to be open for making application of the securities to be

issued as above shall be as prescribed. The provisions relating to the value and allotment of securities for which public issue has to be made shall be as prescribed.

Where securities for which public issue has been made once could not be sold and have to be re-issued again within one year, the body corporate which so issues the securities may, with the approval of the Board, issue such securities by mentioning the matters which are different than the matters set forth in the previously published prospectus and the prospectus previously published.

Under S.30. a body corporate shall have to get a prospectus approved by the Board for making public issue of securities in accordance with this Act and publish the prospectus for information to all the concerned. While publishing the prospectus in such a way, the prospectus shall also mention the place where the general public can obtain or inspect the prospectus.

Case No 3:

Generally to issue shares to the public it is required to publish prospectus of the company. Discuss the situation where prospectus is not required to issue:

Generally to issue shares to the public it is required to publish prospectus of the company. However it is not required to issue a prospectus in the following securities:
(a) Securities issued by the Nepal Rastra Bank,
(b) Securities issued against the full guarantee of the Government of Nepal,
(c) Securities proposed to be sold to up to fifty persons at a time,
(d) Securities issued to own workers or employees,
(e) Securities permitted by the Board as to issue and sell without issuing a prospectus.
Under S. 31. The Board shall approve only a prospectus which contains such information as may be adequate for investors to make evaluation as to the assets and liabilities, financial status, profit and loss of the issuer and matters expected in the future.

Under S.34. Every body corporate issuing securities shall provide information on the following matters to the Board and its shareholders as soon as possible:

(a) Such matters as may be necessary and supportive to evaluate its financial condition,
(b) Such information as may be capable of affecting the transaction of stock exchanges or the value of securities.
(2) Every body corporate issuing securities shall also provide the Board
and its shareholders with the notice and information as prescribed, in addition
to the above matters

Case No 4:

XYZ is a corporate body dealing securities business. Being a securities business person, it requires submitting accounts and statements including the affairs of the securities business

carried on in the preceding financial year to the Nepal Securities Board and concerned stock exchange. XYZ Company Ltd. failed to submit the statements by reason of not having them audited within the time limit. In this regard, what action can be taken by the stock exchange upon corporate body, which has listed its securities, fails to submit its financial statements and other related documents under Securities Act, 2063?

Answer:

Securities business person, in carrying on the securities business has to adopt certain business principles like maintaining securities business fair and of high standards, to carry on the business with proper skills, care and hard working by keeping on the higher standard of stock exchanges etc. Under Sec 78 of The Securities Act 2063 a securities business person has to maintain accounts and records with a view to reflect the actual affairs of the business. To make such statement transparent the Sec 82 of the Act also prescribes the provision regarding the mandatory submission of accounts and statements including the affairs of the securities business carried on in the preceding financial year within three months from the date of expiry of the fiscal year to the Nepal Securities Board. If a securities business person fails to submit the accounts and statements within three months from the date of expiry of the fiscal year, it can submit an application by mentioning the reasonable grounds for such failure requesting for the extension of the time limit. On receipt of the application the Board may extend the time limit for a period not exceeding three months. In the event of failure to submit such accounts and statements even within the period of time limit so extended, the Board may fine such securities business person with a sum of five thousand to twenty five thousand rupees. This provision is prescribed by the Sec 82 (2) of the Securities Act 2063. As per the question where a securities business person failed to submit the statements by reason of not having them audited within the time limit, they are allowed to submit unaudited accounts and statements on the condition of submission of actual accounts and statements audited subsequently under Sec 82 (3) of the Act.

Banks and Financial Institutions Act, 2063 & Nepal Rastra Bank Act, 2058:

Case No 1:

What are the provisions in the Bank and Financial Institutions Act, 2063 for a ban on the payment of dividends to the shareholders based on the capital structure?

Answer:

Relevant Section is S. 46 of BAFIA

Nepal Rasta Bank can issue directives to the banks regarding capital structure to be maintained. So long as the banks do not comply with the directives issued regarding the paid up capital, issued capital and authorized capital. No dividends be distributed.

So long as the general reserves do not become double of paid up capital, 20% of the net profit be credited to the general reserves fund. The conditions for the provisioning against doubtful debts and also for foreign exchange loss are to be complied with.

Also without writing off the past losses, the preliminary expenses, compliance with different funds as specified to be maintained, and also without fully distributing public issue of shares as agreed upon, dividend to the shareholders be not distributed, For distribution of dividends also prior approval of NRB is essential.

Case No 2:

How does Nepal Rastra Bank mobilize Foreign Exchange Reserve? Explain it in the light of Nepal Rastra Bank Act, 2058.

Answer:

In pursuance to section 66 of NRB Act, 2058, NRB shall mobilize Foreign Exchange Reserve in the following manner:

(1) NRB shall mobilize the foreign exchanges reserve. Such reserve shall be denominated in the respective foreign exchange and such reserve shall consist of the following assets:-
- (a) Gold and other precious metals held by or for the account of NRB;
- (b) Foreign currencies held by or for the account of NRB;
- (c) Foreign currencies held in the accounts of NRB on the books of a foreign central bank or other foreign banks;
- (d) Special drawing rights (SDR) held by NRB at the International Monetary Fund;
- (e) Bill of exchange, promissory note, certificate of deposit, bonds, and other debt instrument payable in convertible foreign currencies issued by any debtor or liability holder and held by NRB;
- (f) Any forward purchase or repurchase agreements of NRB concluded with or guaranteed by foreign central banks or public international financial institutions, and any futures and option contracts of NRB providing for payment in freely convertible foreign currency.

(2) While selecting the assets referred to in Sub-section (1), due consideration should be given to NRB's capital and liquidity to maximize earnings.

(3) NRB shall maintain international reserve at a level, which shall be adequate for the execution of monitory and exchange rate policies and for the prompt settlement of the international transaction.

(4) If international reserves have declined or, in the opinion of Bank, are in danger of declining to such an extent as to jeopardize the execution of the monetary or exchange rate policies in the prompt settlement of the country's international transactions, NRB shall submit to Government of Nepal a report on the international reserves position and the causes which have led or may lead to such a decline, together with such recommendations as it considers necessary to remedy the situation.

(5) Until such time as, the situation referred in Sub-section (4) has been rectified, NRB shall make further such report and recommendations to Government of Nepal.

(6) NRB shall hold the foreign exchange reserve referred to in sub-section (1) in its balance sheet.

Case No 3:

Mention the conditions when there are possibilities of downgrading a bank by the central bank.

Answer No.

Under section 37 of the Banks and Financial Institution Act, 2063 the downgrading of a bank/financial institution may be decided by the Nepal Rastra Bank in any one of the following conditions:

i. If the capital is not raised as directed by the Nepal Rastra Bank;
ii. If there were losses for the five consecutive financial years;
iii. If penalized by the Nepal Rastra Bank quite a number of times due to violation of the directives issued; and
iv. If the risk-bearing fund is not maintained as directed by the Nepal Rastra Bank. However, a reasonable opportunity is given to the bank/financial institution to explain before such a decision is effected.

Case No 4:

What are the procedures of the appointment of the directors and who are not eligible to be appointed to be a directors under BAFIA, 2006

The term director includes any person occupying the position of director by whatever the name called like Chairperson and an alternate director. Similarly the mere description of someone as a director (e.g. an employee as an associate director) will not necessarily make them one for present purposes. Therefore the articles may provide for the appointment of senior employees as special directors etc. but without the right to attend board meetings and they are not directors for the purpose of company law.

Sec.17 of Banks and Financial Institution Act (BAFIA) 2006 prescribes the provision regarding appointment of directors. The directors of a bank or financial institution will be appointed by the general meeting of the bank or financial institution who are eligible to be appointed as a director.

Sec.18 of Banks and Financial Institution Act (BAFIA) 2006 prescribes the provision regarding disqualification of directors. According to it any of the following persons will not be eligible to be elected or nomination to the office of, or continue to hold the office of, a director.

i) Who is below 21 years of age,
ii) Who is of unsound mind or insane,
iii) Who is a declared insolvent,
iv) Who has been blacklisted in connection with any transaction with any bank
v) Who is director of any bank or financial institution carrying on the similar business
vi) Who is a partner in any kind of contract agreement with concern bank.
vii) Who has acquired membership of Stock Exchange to act as a securities dealer.
viii) Who has not subscribed the minimum number of share to be eligible for appointment as a director.
ix) Who is employee of Government of Nepal, or Rastra Bank or bank or financial institution.
x) Who, having a liability to pay tax pursuant to the laws in force, has failed to pay the same.
xi) Who is convicted by a court of law on an offence of corruption or cheating.

A director will continue to hold the office of a director until he suffers from disqualification as mentioned. Similarly a directorship may not be retained where the general meeting passes a resolution to remove him from the office of director, or if he is held by a court to have done any act involving dishonesty in the activities of the bank and financial institution or if he did any act prohibited by the Act from being done as a director.

The tenure of office of a director of a bank or financial institution will be as prescribed in its articles of association, but not exceeding four years.

Case No 5:

Sunshine Bank Ltd. has nine directors inclusive of one independent professional director. Advise whether the Bank complies BAFIA and Companies Act, 2063 clearly stating the provision regarding formation of the Board and number of directors?

Answer :

Section 12 of Banking and Financial Institution Act(BAFIA), 2063 prescribes the provision regarding the formation of Board of directors as follows:

(1) Every bank or financial institution shall have a Board of Directors. The Board shall consist of not less than five and not more than nine directors.

(2) Subject to sub-section (1), there shall be appointed to the Board a professional director from the list of professional experts maintained by Nepal Rastra Bank pursuant to Section 13 of the Act. The director to be so appointed shall not be required to have subscribed any share of the concerned bank or financial institution.

(3) A director chosen by the directors from among themselves by a majority decision shall be the chairman of the Board of Directors.

Accordingly Section 86 of the Companies Act, 2063 prescribes the provision regarding the Board of directors and number of directors of the company as follows:

(1) The appointment and number of directors of a private company shall be as provided in its articles of association.

(2) Every public company shall have a board of directors consisting of a minimum of three and a maximum of eleven directors.

(3) In forming the board of directors pursuant to sub-section (2), at least one independent director, in the case of the number of directors not exceeding seven, and at least two independent directors, in the case of the number of directors exceeding seven, shall be appointed from amongst the persons who have the knowledge as prescribed in the articles of association of the company and gained knowledge and experience in the subject related with the business of the company concerned.

(4) Any one director selected by the directors from amongst themselves shall be the chairman of the board of directors.

Considering the above mentioned provisions we can conclude that the Bank has complied BAFIA. However, as the number of directors is nine it is suggested to reduce one non professional director and introduce an independent director to comply with requirements of the Companies Act, 2063.

Case No 6:

Nepal Rastra Bank, in the process of going through the examination and investigation, is in the opinion that the particular banking institution is not conducting its business in a proper way and not in a position to carry out its business properly. Nepal Rastra Bank formed the opinion to cancel the registration of that particular licensed institution. You as an expert, explain the circumstance how the Rastra Bank can proceed to deregister the ban under the Banks and Financial Institutions Act 2063.

Answer:

Sec. 35 of the Banks and Financial Institutions Act (BAFIA) 2063 prescribes the provision regarding deregistration of the Banking and Financial Institutions. According to it, if any institutions having license under the Act to carry out financial transactions does anything in violation of the provisions of Nepal Rastra Bank Act 2058 or BAFIA or the rules and regulation made there under or fails to comply with the order and direction given by NRB or fails to carry out the transactions in the interest of the depositors, NRB can cancel the license give for doing financial transaction by prescribing certain time or can suspend the transaction of such bank and financial institution fully or partially.

Under Sub-Section 2 of the Section 35 of the Act, Nepal Rastra Bank may cancel the license obtained by a licensed institution to carry on the financial transactions pursuant to this Act for doing financial transactions by license holder bank and financial institution under following conditions:

a. If the concerned bank and financial institution request for cancellation of license;
b. If financial transaction is not commenced within six months after receiving license;
c. If no banking transaction is carried out continuously for more than a month continuously;
d. If banking transaction is carried out in such a manner as to the contrary to the right and interest of the depositors;
e. If any provisions of NRB Act 2058 or rules and regulation and bye-laws framed there under the Act is violated;
f. If condition prescribed by NRB is violated;
g. If it fails to comply with the order and directives issued by NRB;
h. If it becomes insolvent;
i. If the banks and financial institution is found to have obtained the license by submitting false details;
j. If the banks and financial institution licensed is amalgamated with another bank or financial institution.

If a banks and financial institutions duly makes an application for the cancellation of its license voluntarily to Nepal Rastra Bank, NRB have to give its decision within 45 days after the receipt of such notice. NRB will give its decision in writing with the reason for its order. If a decision is made to cancel a license pursuant to this provision, the Rastra Bank should publish a public notice thereof. A notice in writing of the decision will be provided to the concern institution. Where a decision is made to cancel a license as said above, the Rastra Bank should publish a public notice thereof.

Industrial Enterprises Act, 2049 & Foreign Investment and Technology Transfer Act 2049:

Case No. 1:

Kathmandu Bidyut Udyog is in operation with 499 Nepalese workers. Mr. Krishna Prasad Paneru, the manager of the udyog thinks that the business of the udyog would be more successful, if he recruited certain foreign national in the post of knitting master and dying workers. Do you think Mr. Krishna Prasad Paneru, can appoint foreign nationals in his udyog?

Answer:

Section 22 of the Industrial Enterprises Act 1992 prescribes that industrial manpower required for any industry should have to be recruited from among Nepali citizens. The Act permits only national human resources required for any industry and not foreign nationals. Similarly, section 4A of the Labour Act 1992 also prescribes the provision regarding prohibition of engaging Non-Nepalese citizens at work. According to it non-Nepalese citizens should not be permitted to be engaged at work in any of the posts in the establishment. Labour Act also prescribes the procedure of selection and appointment of an employee in the industrial establishment. Under section 4 of the Labour Act 1992 where it is required to appoint a worker or employee in any post classified in the establishment, the manager should advertise in order to select such a worker or employee and worker or employee so selected shall have to be provided with appointment letter and be engaged at work.

In the given issue, first the udyog management should try to employ among Nepalese only by advertising the recruitment notice in the national level public newspaper and journals. If a Nepalese citizen could not be available for any skilled technical post even after publishing an advertisement in national level public newspaper and journals, the manager may appoint foreign national by obtaining prior approval of the concerned authority. So proviso clause to Section 4A of the Labour Act 1992 permits to recruit foreign national in certain cases. According to it if any industry cannot be operated without person living outside his own country expatriate manpower, foreign national may be appointed in such industry with the prior approval of the Department of Labour for maximum period of five years. If a person so appointed happens to be a technician of a special category but not available within Nepal, such person may, with the approval of the Department of Labour, be appointed for up to an additional period of five years.

Therefore the proviso clause of the Act prescribes provision allowing appointment of non-Nepalese in certain circumstances. According to it if a Nepalese citizen could not be available for any skilled technical post even after publishing an advertisement in national level public newspapers and journals, the manager of the establishment may submit an application to the Department of Labour along with the evidence of such fact for the approval to appoint a non-Nepalese citizen. In such case the Department of Labour after conducting an inquiry regarding non-available for the skilled technical post as mentioned in the application, may, on the recommendation of the Labour Office grant approval to engage a non-Nepalese citizen at work for a maximum period of five years not exceeding two years at a time and, in the specialized kind of skilled technical post, for a period upto seven years. Knitting master workers being skilled and technical post, may be permissible to appoint by the Udyog by obtaining approval from Department of Labour and dying is simple job which does not require special skill so may not be a valid appointment. However, the validity is backed by the evidence of non-availability of the required skilled technical manpower among national people.

Case No. 2:

Who is foreign investor? What facilities and concessions are granted to the foreign investors under the Foreign Investment and Technology Transfer Act 2049?

Answer:

According to The Foreign Investment and Technology Transfer Act 1992 foreign investor is a person who makes an investment in share, reinvestment of the earning derived from the investment share, and investment made in the form of loan or loan facilities.

Section 5 of the Foreign Investment and Technology Transfer Act 1992 prescribes the facilities and concession provided to the foreign investor. According to it a foreign investor making investment in foreign currency will be entitled to repatriate the following amount outside the Kingdom of Nepal:

a) The amount received by the sale of the share of foreign investment as a whole or any part thereof.
b) The amount received as profit or dividend in lieu of the foreign investment.
c) The amount received as the payment of the principal of and interest on any foreign loan.

Similarly a foreign investor will be entitled to repatriate outside the Kingdom of Nepal the amount received the under an agreement for the transfer of technology in such currency as set forth in the concerned agreement.

S. 6 of the Act prescribes the visa facilities. A foreign national visiting the Kingdom of Nepal in connection with undertaking any study or carrying out any research with the objective of making investment in the Kingdom on Nepal will be provided a non tourist visa for up to six month. A foreign investor or dependent family will for the purpose of stay in Kingdom of Nepal be provided a business visa until the foreign investment is returned. There is a provision of residential visa where a foreign investor or his dependent family who, at a time makes investment in an amount no less than one hundred thousand US dollar or in convertible foreign currency equivalent thereto.

Case No. 3:

For the overall economic development of the country, it is expedient to make arrangements for fostering industrial enterprises in a competitive manner through the increment in the productivity by making the environment of industrial investment more congenial, straightforward and encouraging Industrial Enterprises Act 2049 is enacted.

Explain how the Act intends to achieve aforesaid objective through the classification of Industries?

Answer:

Industrial Enterprises Act 2049 is enacted for the overall economic development of the country, with a view to make arrangements for fostering industrial enterprises in a competitive manner through the increment in the productivity by making the environment of industrial investment more congenial, straightforward and encouraging. For the purpose of this Act, industries are classified as follows under S.3 of the Act.

a) **Manufacturing Industries**: Industries which produce goods by utilizing or processing raw materials, semi-processed materials, by-products or waste products or any other goods.
b) **Energy-Based Industries:** Industries generating energy from water resources, wind, solar, coal, natural oil, gas, bio-gas or any other sources.
c) **Agro and Forest – Based Industries**: Business mainly based on agriculture or forest products such as integrated sericulture and silk production, horticulture and fruit processing, animal husbandry, dairy industry, poultry farming, fishery, tea gardening and processing, coffee farming and processing, horticulture and herb processing, vegetable seed farming,* mushroom, vegetable farming or vegetable processing, tissue-culture, green house, bee-keeping, honey production,

rubber farming, floriculture and production, and forestry related businesses such as leasehold forests, agro-forestry, etc.

d) **Mineral Industries:** Mineral excavation or processing thereof.

e) **Tourism Industries:** Tourist lodging, motel, hotel, restaurant, resort, travel agency, skiing, gliding, water rafting, cable car complex, pony-trekking, trekking, hot air ballooning, parasailing, golf-course, polo, horse-riding, etc.

f) **Service Industries:** Workshop, printing press, consultancy service, ginning and baling business, cinematography, construction business, public transportation business, photography, hospital, nursing home, educational and training institution, laboratory, air services, cold storage, etc.

g) **Construction Industries**: Road, bridge, ropeway, railway, trolley bus, tunnel, flying bridge and industrial, commercial and residential complex construction and operation.

4. **Cottage Industries:**

The traditional industries utilizing specific skill or local raw materials and resources, and labour intensive and related with national tradition, art and culture mentioned in Annex 1 shall be named as cottage industries.

* Inserted by the First Amendment.

5. **Small Industries**:

Industries with a fixed asset of up to an amount of **thirty million rupees** shall be named as small industries.

6. **Medium Industries:**

Industries with a fixed asset between **thirty million rupees and one hundred million** rupees shall be named as medium industries.

7. **Large Industries**:

Industries with a fixed asset of **more than one hundred million rupees** shall be named as large industries.

a) Land and land improvement (works such as land levelling, filling and fencing)

b) Physical infrastructures (such as sewerage internal road),

c) Office, factory building, godown, electric distribution, water distribution system and residential buildings,

d) Machinery, equipment and tools

e) Means of transportation,

f) Electrical equipment and office equipment,

g) Furniture, fixture, communication system and equipment.

2) In addition to the assets referred above, expenses incurred or to be incurred in connection with technical consultancy and supervision prior tothe making to investment in any industry or during different stages of construction, and which is to be capitalized, pre-investment and pre-operation costs as well as the amount of interest during the construction period, which is to be capitalized, shall be considered.

Write short Notes on:

a. Micro Enterprises as per Industrial Policy 2067

In accordance with the recently introduced "Industrial Policy 2067", Micro Enterprises denotes business entities fulfilling the following conditions:

i) Fixed Capital Investment not exceeding two lacs excluding investment incurred in Land and Building;

ii) Entrepreneur compulsorily involved in the Management of the entity.

iii) Number of employees not exceeding nine (inclusive of the entrepreneur);

iv) Total annual financial turnover of less than Rs 20.00 lac;

v) In case of utilization of engine or equipment, electric motor or oil engine capacity of the engine or equipment shall be less than 10 KW.

Explanation: Industries requiring permission as well as manufacturers of liquor, beer, cigarette, bidi or tobacco related products or their use cannot be considered as micro enterprises even if they fulfill the conditions mentioned above. Similarly, once a registered micro enterprise is upgraded into any other forms of industry, it shall cease to remain in the category of a micro enterprise.

b. Industrial Promotion Board:

Industrial Promotion Board has been defined by The Industrial Enterprises Act, 2049 under section 2(g). According to it "Board" means the industrial Promotion Board constituted under Section 12.
Section 12 of the Act has empowered Government of Nepal to constitute an Industrial Promotion Board consisting of the following members:

i. The Minister or State Minister for Industries- Member
ii. The Assistant Minister of Industries – Member
iii. Member (looking after industries), National Planning Commission- Member
iv. The Governor, Nepal Rastra Bank – Member
v. The Secretary, Ministry of Industry- Member
vi. The Secretary, Ministry of Finance – Member
vii. The Secretary, Ministry of Tourism – Member
viii. The Secretary, Ministry of Commerce – Member
ix. The Director General, Department of Cottage and Small Industries – Member
x. Representative, Federation of Nepal Chamber of Commerce and Industry – Member
xi. Two persons nominated by Government of Nepal, either from among the industry, Commerce and tourism sector organizations or from among the person of high distinction in the same field.
xii. The Director General, Department of Industries- Member Secretary.

However Government of Nepal may, by notification published in the Nepal Gazette, make necessary alteration or change in the membership of the Board.

The Act further prescribes that the Board, if it deems necessary, is entitle to invite any national or foreign expert or consultant at any meeting of the Board to participate there in as an observer. The Board can fix the procedures relating to the meetings of the Board.
Section 13 of the Act prescribes Functions, Duties and powers of the Board. According to it Industrial Promotion Board is to provide co-operation in formulation and implementation of policies, laws and regulations pertaining to the industrialization of the country so as to make it competitive along with coordination between the policy and implementation level of industrial policy. It attempts to avoid and prevent effects of environmental pollution and its effect in public health. IPB can recommend to Government of Nepal for the inclusion of any industry in the classification of industries. IPB is also entitle to give directives to the concerned body on receipt of complain regarding facilities and concessions to be made available by the committee.
Under Section 26 IPB may delegate its power to concerned Department, Office, official Committee of any member of the Board as necessary.

Money Laundering Prevention Act 2063:

Case No 1:

What activities are considered as money laundering offence under the Money Laundering Prevention Act, 2063? What provision has been made for the prevention of money laundering activities under the Act?

Answer:

Principally an offence refers to an act done against the state. In other words it refers to do an act which has been forbidden by law or prohibited by the prevailing law of the nation. In this context Government of Nepal has enacted an Act to prevention Laundering of criminally earned money (assets).

Chapter-2 of the Act prescribes the provisions relating to offences under it.
According to Sec 3.It has been prohibited to launder the assets personally or cause to launder assets. It clearly prescribes that any one committing acts in respect of laundering assets will be deemed to have committed offence as per this Act.
Sec 4 of the Act prescribes the condition when it is considered as laundering of assets. According to it, assets will be supposed to have laundered in case anyone, directly or indirectly, earns from tax evasion or terrorist activities or invests in such activities or acquires, holds, possesses or utilizes assets by committing any or all offences committed under arms and ammunitions laws, foreign exchange regulation laws, Offences of murder, theft, cheating, forgery documents, counterfeiting, kidnap or abduction, drug control laws national park and wild animals conservation laws, human trafficking and transportation control laws, cooperatives laws, forest laws, corruption control laws, bank and financial institution laws, ancient monuments conversation laws, along with any other offence that the Government of Nepal has prescribed in Nepal Gazette. If assets are acquired, held or accumulated from the above said offence is possessed, held or used, utilized or consumed or committed any other act so as to present such assets as legally acquired or earned assets will be deemed as laundering of assets. It also includes an act as laundering of assets where it conceals sources of origin of such assets or assists any one to transform, conceal or transfer such assets with an objective of avoiding legal actions to the person having such assets. Sec. 4 of the Act further clarifies the concept of an offence under this Act.

Case No 2:

What activities are considered as money laundering offence under the Money Laundering Prevention Act, 2063? What provision has been made for Laundering Prevention Department under the Act?

Answer:

Principally an offence refers to an act done against the state. In other words it refers to do an act which has been forbidden by law or prohibited by the prevailing law of the nation. In this context Government of Nepal has enacted an Act relating to prevention of laundering of criminally earned money (assets).
Chapter-2 of the Act prescribes the provisions relating to offences under it.

According to Sec 3.It has been prohibited to launder the assets personally or cause to launder assets. It clearly prescribes that any one committing acts in respect of laundering assets will be deemed to have committed offence as per this Act.

Sec 4 of the Act prescribes the condition when it is considered as laundering of assets. According to it, assets will be supposed to have laundered in case anyone, directly or indirectly, earns from tax evasion or terrorist activities or invests in such activities or acquires, holds, possesses or utilizes assets by committing any or all offences committed under arms and ammunitions laws, foreign exchange regulation laws, Offences of murder, theft, cheating, forgery documents, counterfeiting, kidnap or abduction, drug control laws national park and wild animals conservation laws, human trafficking and

transportation control laws, cooperatives laws, forest laws, corruption control laws, bank and financial institution laws, ancient monuments conversation laws, along with any other offence that the Government of Nepal has prescribed in Nepal Gazette. If assets are acquired, held or accumulated from the above said offence is possessed, held or used, utilized or consumed or committed any other act so as to present such assets as legally acquired or earned assets will be deemed as laundering of assets. It also includes an act as laundering of assets where it conceals sources of origin of such assets or assists any one to transform, conceal or transfer such assets with an objective of avoiding legal actions to the person having such assets. Sec. 4 of the Act further clarifies the concept of an offence under this Act.

Chapter – 5 (Sec.11-12) of the Money Laundering Prevention Act, 2063 prescribes Provision Relating to *Formation of the Laundering Prevention Department* and its Functions, Duties and Powers.

Under Sec. 11 of the Act, Government of Nepal has to establish an Asset Laundering Prevention Department to carryout investigation and inquiry of offences under this Act. As per Sec 12 of the Act the Department may exercise the following powers in course of investigation and inquiry of the offences under this Act:-

(a) To issue order to any concern government entity, bank, financial institution to submit the concerned document, evidence or other required detail remained with such entity, bank, financial institution to the Department within a particular time limit,

(b) To conduct search operation of any concerned government entity, bank, financial institution or non-financial institution or of any other places, to seize, take control of concerned document, deed, material evidence and other evidence and hand its receipts to the concerned official,

(c) To get present and inquire, call explanation or clarification from the concern official of the concerned government entity, bank, financial institution or other staff or a concerned person supposed to have obtained information of related facts as deemed by the Department,

(d) To release a person with a written condition to present at requirement or on dated attendance, or release with guarantee or bail in case there are reasonable grounds that he/she may disappear or to keep under custody at the failure of providing guarantee or bail with the permission of the court after the inquiry, explanation or clarification as per Clause (c),
Provided that the concerned person shall not be placed under custody for more than the period punishable for offences under this Act when decision is given against him/her.

(e) To order the concerned entity to freeze assets, located in Nepal, of a concerned person at the request of another nation where the offence under this Act has occurred or any other international organization or in accordance with bilateral or multilateral treaty or agreement or on the other grounds like that,

(f) To require to freeze assets related to the offence under this Act in the course of inquiry and investigation of the offence.

Where any government entity, bank, financial institution is communicated by the Department to submit any documents or any other matters, freeze assets or provide information about any matter in the course of investigation and inquiry of the offences under this Act, the entity, bank, financial institution, concerned official, staff or agent of the institution not submitting such document or other matters, not freezing assets or not providing information and any official or staff of such entity, bank, financial institution absenting even at the order of the Department to be present, the Department may require him/her to submit documents or matter or to freeze assets or to provide required information by arresting him/her and may fine him/her up to one thousand rupees.

Case No 3:

What activities are considered as money laundering offence under the Money Laundering Prevention Act, 2063? What provision has been made for the Investigation and Inquiry under the Act?
Answer:

Principally an offence refers to an act done against the state. In other words it refers to do an act which has been forbidden by law or prohibited by the prevailing law of the nation. In this context Government of Nepal has enacted an Act relating to prevention of laundering of criminally earned money (assets).

Chapter-2 of the Act prescribes the provisions relating to offences under it.

According to Sec 3.It has been prohibited to launder the assets personally or cause to launder assets. It clearly prescribes that any one committing acts in respect of laundering assets will be deemed to have committed offence as per this Act.

Sec 4 of the Act prescribes the condition when it is considered as laundering of assets. According to it, assets will be supposed to have laundered in case anyone, directly or indirectly, earns from tax evasion or terrorist activities or invests in such activities or acquires, holds, possesses or utilizes assets by committing any or all offences committed under arms and ammunitions laws, foreign exchange regulation laws, Offences of murder, theft, cheating, forgery documents, counterfeiting, kidnap or abduction, drug control laws national park and wild animals conservation laws, human trafficking and transportation control laws, cooperatives laws, forest laws, corruption control laws, bank and financial institution laws, ancient monuments conversation laws, along with any other offence that the Government of Nepal has prescribed in Nepal Gazette. If assets are acquired, held or accumulated from the above said offence is possessed, held or used, utilized or consumed or committed any other act so as to present such assets as legally acquired or earned assets will be deemed as laundering of assets. It also includes an act as laundering of assets where it conceals sources of origin of such assets or assists any one to transform, conceal or transfer such assets with an objective of avoiding legal actions to the person having such assets. Sec. 4 of the Act further clarifies the concept of an offence under this Act.

Chapter – 6 (Sec.13-29) of the Money Laundering Prevention Act, 2063 prescribes Provision Relating to Investigation and Inquiry under the Act.

Investigation and inquiry is a most important part in respect of fulfilling the objective of the Money Laundering Prevention Act, 2063. It is the investigation process, by which it becomes possible to bring an action against the culprits of assets by money laundering. According to this chapter it to follow the following process:

1. **Complaint(Sec.13):** Any person, who has information regarding an offence under this Act, may submit a complaint, application, to the Department in written or oral form. As per Sec. 14 the Department will conduct necessary investigation and inquiry After receiving the application or information regarding the offence, it proceeds for the investigation.
In the course of investigation and inquiry, where there is risk of

absconding or destroying the evidence or document, taking control of any document or asset by the person committing an offence, the Department may arrest the person involve in it, and may take control of such relevant evidences and assets at place where offence was committed or being committed. The Department may obtain opinion of government attorney in this respect.

2. **To Appoint or Designate Investigation Officer(Sec. 15):** The Department may appoint or designate any officer of the Department or other officer as an investigation officer, in order to conduct investigation and inquiry of the offences under this Act and designate other staff as required.
3. **Functions, Duties and Powers of the Investigation Officer (Sec. 16)**: The functions, powers and duties of the investigation officer, appointed or designated will be as follows:-

a) To take necessary action by arresting the offender (suspect) immediately,
b) To conduct search or cause to conduct search operation of any office, residence, building, storage, vehicles or of any place in the course of investigation and inquiry,
c) To exercise other powers vested to the Department.

The investigation officer, while proceeding necessary action may keep the offender (suspect) on date, release him by obtaining bail or guarantee or keep under custody with the permission of the court if he/she fails to provide bail or guarantee.

As per Sec. 17, the investigation officer may detain the person against whom proceedings have been initiated as per this Act, if there is risk of extinct or destroy any evidence or create obstacles or perverse effects in the proceedings of investigation and inquiry according to the prevailing law of the nation. While detaining the person committing an offence It must be obtained prior approval by fulfilling required legal formalities before the adjudicating officer. However, the detainee will not be exempted from making a petition for his release with reasons thereof.

4. **To Order for Freezing Assets (Sec.** 18**):** The investigation officer may give order to the concerned entity to prevent any transfer, pledge, sale/disposal of the assets collected by offence for a time period fixed, if it is deemed transfer or conceal such assets. The Department may impose fine to the chief of the concerned entity, who fails to freeze the assets.
5. **Suspension of Account or Transactions (Sec. 19)**: The Department may issue an order, in the course of a inquiry and investigation of an offence under this Act, to prevent transactions or freeze bank account of a person transacting with a bank, financial institution or nonfinancial institution if any information is obtained that he/she has maintained transactions or account with such bank, financial institution.

Provided that such transaction or account operated with a bank, financial institution, situated or person living abroad, the Department will make a request of freezing such transactions or account through a diplomatic channel. In pursuance to the Sec. 20, the investigation officer should keep the assets and documents seized in course of inquiry and investigation under this Act safe.

The Department may demand support of any entities or public corporate bodies along with Nepal police in the course of conducting inquiry and investigation of offence under the Sec. 21 of this Act. It will be the duty of the concerned entity or police officer to provide support where it is demanded. The Department, if it deems by the nature of offence under investigation and inquire, consult with the specialist belonging with an entity.

6. **Filing of a Case (Sec. 22):** If any one, whosoever, is deemed to have committed an offence under this Act from investigation and inquiry, the Department should write to the concerned government attorney for taking decision whether a case is to be filed against him/her or not. Where the concerned government attorney decides to file a case, in response to writing, the Department will file the case with concerned court.

7. **Limitation (Sec.23)**: There will be no limitation to file a case relating to the offence under this Act. According to Sec, 24 of the Act, the Government of Nepal will be plaintiff in the case relating to an offences under this Act.

Under Section 26 of the Act certain code of conduct regarding confidentiality against the Investigation Officer or staff, or person involved in the investigation and inquiry has been prescribe for not to violate confidentiality of any matter document that came to his notice in the course of investigation and inquiry. According to Sec 27 any official or staff of any bank, financial institution or civil servant will be deemed to be in automatic suspension for a period he/she is under custody as per this Act if violated the code of conduct prescribed.

8. **Assets Deemed to Have Gained by Laundering(Sec 28):** In case assets of a person sued for an offence under this Act is found to be unnatural in comparison to the income source or financial condition or one is living a life unnaturally high in standard or proved to have donated, granted, gifted, provided loans, contribution or
endowment more than his/her capacity, he/she is required to prove the source of earnings and in case he/she fails to prove so he/she shall be deemed to have earned such assets by committing offences under this Act.

Case No. 4:
What activities are considered as money laundering offence under the Money Laundering Prevention Act, 2063? What Provisions has been made for Coordination Committee and Financial Information Unit
Principally an offence refers to an act done against the state. In other words it refers to do an act which has been forbidden by law or prohibited by the prevailing law of the nation. In this context Government of Nepal has enacted an Act relating to prevention of laundering of criminally earned money (assets).
Chapter-2 of the Act prescribes the provisions relating to offences under it.

According to Sec 3.It has been prohibited to launder the assets personally or cause to launder assets. It clearly prescribes that any one committing acts in respect of laundering assets will be deemed to have committed offence as per this Act.

Sec 4 of the Act prescribes the condition when it is considered as laundering of assets. According to it, assets will be supposed to have laundered in case anyone, directly or indirectly, earns from tax evasion or terrorist activities or invests in such activities or acquires, holds, possesses or utilizes assets by committing any or all offences committed under arms and ammunitions laws, foreign exchange regulation laws, Offences of murder, theft, cheating, forgery documents, counterfeiting, kidnap or abduction, drug control laws national park and wild animals conservation laws, human trafficking and transportation control laws, cooperatives laws, forest laws, corruption control laws, bank and financial institution laws, ancient monuments conversation laws, along with any other offence that the Government of Nepal has prescribed in Nepal Gazette. If assets are acquired, held or accumulated from the above said offence is possessed, held or used, utilized or consumed or committed any other act so as to present such assets as legally acquired or earned assets will be deemed as laundering of assets. It also includes an act as laundering of assets where it conceals sources of origin of such assets or assists any one to transform, conceal or transfer such assets with an objective of avoiding legal actions to the person having such assets. Sec. 4 of the Act further clarifies the concept of an offence under this Act.

Chapter – 4 (Sec. 8-10) of the Money Laundering Prevention Act, 2063 prescribes Provision Relating to *Formation of Coordination Committee*. To coordinate inter-related to the prevention of assets laundering Sec. 8 of the Act prescribes the provision of Coordination Committee, consisting of the members as follows:

(a) Secretary, Ministry of Finance - Coordinator
(b) Secretary, Ministry of Law, Justice and Parliamentary System -Member
(c) Secretary, Ministry of Home -Member
(d) Secretary, Ministry of Foreign Affairs -Member
(e) Deputy Governor, Nepal Rastra Bank - Member

To fulfill the objective of the Act, Sec.9 prescribes the provision of Financial Information Unit in Rastra Bank for collection and analysis of information relating to assets laundering.

The Functions, Powers and Duties of Financial Information Unit has been set in Sec. 10 of the Act as follows:

(a) To obtain details of transactions under Section 7 from government entities, bank, financial institution and non-financial institution regularly and maintain records of those details by scrutinizing them,
(b) To conduct preliminary inquiry, in case the notice, details and documents available to it requires inquiry and investigation on assets laundering and send its details to the concerned Department, government entity, bank, financial institution and non-financial institution,
(c) To communicate the Department the details received pursuant to Clause (a) or including the extensive details if it appears doubtful or arises any doubt or prevails reasonable ground not to believe the transaction upon conducting the inquiry pursuant to Clause (b), write to the Department with extensive details, should there appear doubtful transactions or looks dubious or there are reasonable grounds to doubt in the details received pursuant to clause (a) or from the inquiry made pursuant to clause (b),
(d) To send notice, details and documents regarding assets laundering to the Financial Information Units of other country and international organization, institutions reciprocally and receive such notice from concerned country and international organization and institution,
(e) To inspect transactions and records of bank, financial institution and non financial institution, to obtain any information or clarification about such transactions and records and their copies if necessary,
(f) To manage required training programs for the staffs of government entities, Departments and Financial Information Unit for prevention of assets laundering,
(g) To carry out other functions as prescribed.

The Act also specify the that an entity authorized to regulate bank, financial institution and nonfinancial institution under prevailing laws may receive information from the Financial Information Unit and may provide information available with it to the Unit. The Financial Information Unit may give necessary directives to the concerned institutions about the method, form, time and other procedures regarding the submission of details, statistics, notices and information and it will be the duty of such institution to be abide by such directives.

Public Procurement Act 2063

Case No 1:

The Public Procurement Act 2063 has been enacted to make the procedures, processes and decisions relating to public procurement much more open, transparent, and reliable. How far this Act objective has been tried to achieve under the Act. Explain with reference to the legal provisions as prescribed by the Act.

Answer:

It is rightly said that the Public Procurement Act 2063 has been enacted to make the procedures, processes and decisions relating to public procurement much more open, transparent, and reliable. Preamble of the Act clearly states the objective of the Act. According to it, the Act is expedient to make legal provisions in order to make the procedures, processes and decisions relating to public

procurement much more open, transparent, objective and reliable, obtain the maximum returns of public expenditures in an economical and rational manner by promoting competition, fairness, honesty, accountability and reliability in public procurement processes, and; ensure good governance by enhancing the managerial capacity of procurement of public entities in procuring, or causing to be procured, construction work and procuring goods, consultancy services and other services by such entities and by ensuring the equal opportunity for producers, sellers, suppliers, construction entrepreneurs or service providers to participate in public procurement processes without any discrimination.

As it is prescribed by the Preamble of the objective of the Act can be listed as follows:

- to make the procedures, processes and decisions relating to public procurement much more open, transparent, and reliable
- to obtain the maximum returns of public expenditures in an economical and rational manner
- to promote competition, fairness, honesty, accountability and reliability in public procurement processes
- to ensure good governance
- to enhance the managerial capacity of procurement of public entities in procuring, or causing to be procured,
- procurement of construction work and procuring goods, consultancy services and other services and other services by such entities
- and to ensure the equal opportunity for producers, sellers, suppliers, construction entrepreneurs or service providers to participate in public procurement processes without any discrimination.

In this respect Sec 2(a) of the Act defines "Procurement" means as the acquisition of any goods, consultancy services or other services or carrying out or causing to be carried out any construction works, by a public entity pursuant to this Act;

Accordingly section 2 (b) of the Act "Public Entity" has been defined and means the following entity:-

(1) Constitutional organ or body, Court, Ministry, Secretariat, Commission, Department of the Government of Nepal or any other Governmental Entity or Office there under,

(2) Corporation, Company, Bank or Board owned or controlled fully or in majority by the Government of Nepal or Commission, Institute, Authority, Corporation, Academy, Board, Center, Council established at the public level or formed by the Government of Nepal under the laws in force and other corporate body of a similar nature,

(3) University, College, Research Center, which is operated by the Government of Nepal or receives grants fully or in majority from the Government of Nepal, and other Academic or Educational Institution of a similar nature,

(4) Local body,

(5) Development Board formed under the Development Board Act,1956,

(6) Body operated with loan or grant of the Government of Nepal, and

(7) Other Bodies as specified by the Government of Nepal by publishing a notification in the Nepal Gazette, as a Public Entity;

Accordingly section 2 (c) of the Act "Goods" has been defined as any kind of object, whether movable or immovable, and this term includes services incidental to the supply of such goods.

Case No 2:

The Public Procurement Act 2063 has been enacted to make the procedures, processes and decisions relating to public procurement much more open, transparent, and reliable. Discuss Provisions Relating to Responsibility for Procurement and Procurement Methods.

Answer:

Chapter-2 of the Act prescribes the Provisions Relating to Responsibility for Procurement and Procurement Methods.

Under Sec 4. A Public Entity will have to prepare a specifications, plan, drawing, design, special requirement or other descriptions pertaining thereto prior to procuring goods, construction works or services,

The description as referred above will have to be prepared on the basis of relevant objective technical and quality characteristics and functions of such goods, construction works or services.

(3) In preparing the description it unless it is required to mention, the characteristics of the goods, construction works or services, like a particular brand, trademark, name, patent, design, type, origin or producer's name cannot be mentioned to avoid competition.

Provided that where there is no other way than such mentioning, a particular brand, trademark, name, patent, design, type, origin or producer's name will be mentioned and the words "equivalent to" shall be mentioned thereafter.

Under Sec. 5 of the Act. A Public Entity will have to prepare a cost estimate as prescribed for any procurement whatsoever except for any procurement valuing up to twenty five thousand rupees.

Under Sec 6 A Public Entity will, in making procurement valued at an amount in excess of the prescribed limit, have to prepare a master procurement plan and annual procurement plan, as prescribed.

Sec 7. Of the Act prescribes the Responsibility Towards Procurement Activities: According to it the chief of the concerned Public Entity will be responsible for preparing a procurement plan and carrying out or causing to be carried out all other activities relating to procurement to be made by fulfilling the procedures referred to in this Act. A Public Entity will, in carrying out procurement related activity carry out so through an employee who has the qualification prescribed by the Public Procurement Monitoring Office and has knowledge or training on procurement business. For this a Public Entity sh0uld establish a procurement unit or assign the responsibilities thereof in order to carry out the following acts:

(a) Preparing a procurement plan,

(b) Preparing prequalification documents, bidding documents and procurement contract related documents by making necessary amendments in the standard bidding documents, standard prequalification documents and standard procurement contract documents prepared by the Public Procurement Monitoring Office,

(c) Preparing documents relating to proposals for consultancy services

(d) Publicly publishing the procurement notice,

(e) Issuing pre-qualification documents, bidding documents or forwarding documents relating to proposals for consultancy service,

(f) Receiving and safely keeping pre-qualification proposals, bids or consultancy service proposals,

(g) Submitting the pre-qualification proposals, bids or consultancy service proposals to the evaluation committee for evaluation and submit the evaluated bids for acceptance,

(h) Notifying the acceptance of the pre-qualification proposals,bids or consultancy service proposals,

(i) Obtaining, examining and safely keeping the performance guarantee,

(j) Examining, or causing to be examined, the quality standards of the goods, construction works or services that have been procured,

(k) Making available the information and documents asked for by the Public Procurement Monitoring Office, and

(l) Performing other functions as may be prescribed.

Case No 3:

The Public Procurement Act 2063 has been enacted to make the procedures, processes and decisions relating to public procurement much more open, transparent, and reliable. Discuss the provisions relating to monitoring of procurement activities by which the public procurement of an entity?

Answer:

Merely making the legal provisions regarding the public procurement to make the procedures, processes and decisions relating to public procurement much more open, transparent, and reliable will not be effective unless and until the monitoring activities of the concern authority is active and effective.

Chapter-9 of the Act prescribes the Provision Relating to Monitoring of Procurement Activities the Act. Under Sec 64 of the Act A Public Procurement
Monitoring Office under the Office of the Prime Minister and Council of
Ministers will have to be established in order to monitor procurement activities, the chief of the office will be an employee of the gazetted special class of the civil service of Government of Nepal.
Under Sec. 65 of the Act, the functions, duties and powers of Public Procurement Monitoring Office will be as follows:-

(a) To make recommendation to the government of Nepal for reform in the procurement policy or laws in force,
(b) To issue technical guidelines and manuals required for implementing this Act,
(c) To prepare standard model of the standard bidding documents, prequalification documents, procurement contract document and documents relating to proposal to be used by a Public Entity to conduct procurement proceedings,
(d) To collect statistics of procurement proceedings to be operated or operated by a Public Entity and to monitor or to make or cause to be made technical auditing of whether or not such proceedings are conducted in compliance with this Act or
Regulations or manual, made there under.
(e) If the Public Entity seeks opinion, advice about a matter as referred to in this Act or Regulations, Manuals made there under, to provide opinion, advice,
(f) To establish and operate procurement website,
(g) To publish a bulletin in order to have made public this Act and the Regulations, Manuals, Technical Notes made there under and public procurement related writings, article, material and similar other matters,
(h) To prepare procedures required for coordination in the procurement proceedings and submit to the Government of Nepal for approval,
(i) To make arrangements for regular training program for the bidder or the employee involved or to be involved in procurement proceedings,
(j) To make necessary criteria of exclusion from the blacklist under Section 63 and exclude from such blacklist as per such criteria,
(k) To review, appraise construction works, supply, consultancy service, and other services system in order to make the procurement system effective, and to solicit regularly suggestion from customers or international organization and other foreign bodies as per necessity,
(l) To prepare plan of domestic or foreign assistance required to systematize and reform procurement system and to act as the central body for coordinating such assistance,
(m) To submit the annual report of the procurement proceedings to the Government of Nepal, and
(n) To do other prescribed functions.

However the Public Procurement Monitoring Office shall not involve in any manner in the procurement proceedings, except the procurement proceedings of its office, of other public entities nor shall resolve any dispute arisen in respect thereof.

Insolvency Act 2063:

Case No 1:

What do you mean by Restructuring of a company. What are the process prescribed by the Insolvency Act 2063 when a company becomes insolvent due to financial difficulty?

Answer:

Reorganization or restructuring means the act of organizing a company in a different way, where a company may become insolvent due to financial difficulty. Restructuring means a process to be adopted under the insolvency Act 2063 in order to a company which may become insolvent because of financial difficulty (s.2 (e))

Where the court issues an order to restructure the company in pursuant to section 22(2), on the basis of report submitted by the investigation office, certain procedures is adopted as accordance to the chapter 4 of the insolvency Act 2063.

Procedures:

1. **Court order to the appointment of reorganization manager.**
According to the court order the reorganization office is appointed and, the office has to prepare a reorganization program as accordance to the law.

2. **Preparation of reorganization program (Sec. 23(2)**
Where the Court makes an order to restructure a company pursuant to Sub-section (2) of Section 22, the restructuring manager has to prepare a restructuring scheme containing the
Following matters of the company in writing.

a) To capitalize the debt of the company and alter the capital structure ;
(b) To pay the claims of creditors by selling any portion of the assets of the company;
(c) To change the nature of claims of creditors of the company and issue securities for the same;
(d) To get the creditors of the company to participate in capital investment by issuing shares in consideration for their claims;
(e) To amalgamate the company with any other company;
(f) To change the management of the company; or
(g) To do any such other act which the Court considers appropriate to restructure the company.

3. Procedures of reorganization of the company:

After the appointment of reorganization manager he prepares the program for this purpose. Then the manager starts to execute the procedures of reorganization.

a. The reorganization manage has to call a meeting of the creditors as accordance to the provision of Sec 21 and to fulfill all the legal formalities within 15 days from the date of commencement of business and such notice shall be published in a daily newspaper of national circulation for at least two times; and such notice may also be put on the website. . (Sec. 24).

b. The meetings of the creditors called pursuant to Sec. 21(3), discuss the details of the Reorganization program proposal presented by the manager and adopts a resolution:

i. With or without amendment on the program proposal, acceptance or
ii. Recommendation for the immediate liquidation of the company.

If the court issues order approving the resolution of reorganization program, that will be implemented.

c. The reorganization officer within the period of reorganization has to submit a report to the court accompanied by the transactions, assets, financial situation of the company and the reorganization program, if any amendment made.(Sec.25):
Where reorganization program is proposed in the report submitted by the manager, the following matters must be stated:

i. Summary and analysis of the proposed program
ii. Details of the effect likely to be caused by the implementation of the program to the creditors.
iii. Details of the consideration and effect available to the creditors from the implementation of reorganization program in comparison to the immediate liquidation of the company.

iv. Opinion and description accompanied by the finding in the report of the manager that the company would not be insolvent if the reorganization program was implemented.
Thus, reorganization program proposal must contain following matters in the written form:

i. All details and relevant in written form about the future program,
ii. All details of the benefit to creditors by implementation of the program,
iii. Details about the matter that proposal is not illegal and prohibited by law
iv. Details to the consequences of implementation that company will be rescued from insolvency, and details about the costs between investigation and reorganization period as well as remuneration of manager and officer

Case No 2:

When a company can be deemed to have become insolvent under the Insolvent Act 2063? Explain the cases when insolvency proceedings can be proceed, in respect of certain companies although there is no application for the insolvency proceedings.

Answer:

According to Sec. 7 of the insolvency Act 2063, a company will be deemed to have become insolvent on the following condition:

(a) Where the general meeting of shareholders adopts a resolution that the company has become insolvent or a meeting of the board of directors of the company makes such decision; or
(b) where the Court issues an order requiring the company to pay the debt and the debt is not paid up within thirty five days from the date of receipt by the company of such order; or
(c) Where the company fails to pay the debt within thirty five days after the service by the creditor on the company a notice for the payment of the debt or fails to make an application to the Court within the said period to void such notice.
(2) Nothing contained in this Section shall prevent the establishing of the fact that a company has become insolvent where it is proved from any other matter that the liability of the company exceed the value of the assets of the company or the company itself admits that it has become insolvent.

According to Section 4 of the Insolvency Act 2063 an Application is to be made to the court for insolvency proceedings
Where it is required to institute insolvency proceedings against any company, any of the concern person like share holder, creditor or debenture holder having the qualification as prescribed may make an application to the Court in the prescribed format for the institution of such proceedings.

Section 8 of the Act prescribes that an insolvency proceedings may be initiated in case of certain companies although there is no application from the concern persons. In pursuant to Section 8 of the Act, no application may be made to the Court for insolvency proceedings in relation to the following company without obtaining prior approval of the following authority:

(a) In the case of a bank or financial institution carrying on banking and financial business, the Nepal Rastra Bank, or
(b) In the case of an insurance company carrying on insurance business, the Insurance Board formed pursuant to the Insurance Act, 2049, or
(c) In the case of a company which cannot undergo voluntary liquidation without approval of the competent body or authority, except that mentioned in Clause (a) or (b), such authority.

(2) Every application to be made for insolvency proceedings in relation to a company as mentioned above should be accompanied by a copy of the approval given by the authority set forth in that Sub-section for that purpose.

Case No 3:

What do you understand by liquidation of a company? Explain the process of liquidation of a company as prescribed by the Insolvency Act 2063.

Answer:

The term "liquidation" means the act of determining the exact amount of something as a debt that before was uncertain. It is the process of realizing upon assets and of discharging liabilities in concluding the affairs of a business/company. Liquidation of company means situation where the registration of company is cancelled by fulfilling the procedure referred to the Insolvency Act 2063. The company of which financial condition cannot be reformed by the reorganization process, that can be preceded in the issue of the order of the court on the basis of recommendation or reorganization manager, under the Insolvency Act 2063.

Procedures of Liquidation of the Company:

1. The Court order to liquidate the company: The procedure of liquidation of a company starts when the court issues an order to terminate the company, on the ground of application of reorganization manager that the reorganization program failures.
2. Liquidation of the company on the issuance of order of Court to appointment of Liquidator (Sec. 37) : Where the court makes an order to liquidate a copany pursuant to their Insolvency Act, 2063, the court makes an order to appoint one person as a liquidator, from among the persons who are capable as per law to carry on the insolvency business at the time of making of such order. Following the court order to appoint a liquidator for the liquidation, the liquidation proceedings of the company is deemed to have commenced.
3. **Consequences on the commencement of liquidation proceedings(Sec 38):**
   On the commencement of the liquidation proceedings of any company, the following provisions shall govern the following matters in relation to such company:

(a) Where the director and officer of the company are relieved of office, the liquidator will exercise all such powers as may be exercisable by the director and officer of the company in relation to the management of that company;
b) The liquidator will take in his or her custody and control all assets, accounts and books of account of the company, except the properties in possession of secured creditors;
(c) Except as ordered otherwise by the liquidator, the service of all employees appointed by the company will terminate.
d) except for the following matter, the provision relating to 'ipso facto' suspension set forth in Sec. 19 of this Act, applies apply during the period of company of liquidation proceedings:
a) Implementation of the right of secured creditors to execute pursuant to this Act;
b) Implementation of the right of the lesser of any property leased to the company to redeem the property pursuant to this Act.

4. **Conversion of liquidation of company into restructuring program(Sec.39) :**

   Where, based on the study and examination of the business and assets of the company, nature of the goods or services to be produced by the company and market potentiality thereof, the liquidator thinks

that the restructuring program of the company can be adopted by a meeting of creditors and approved, the liquidator may make an application, accompanied by the reasons, to the Court for an order to keep pending the order on liquidation of company issued by the Court pursuant to this Act for a certain period of time and to implement the restructuring program pursuant to this Act.

Audit Act 2048

Case No. 1:

What do you understand by "Corporate body wholly owned by government of Nepal"? Who is entitle to audit of such corporate bodies which is wholly owned by Government of Nepal?

Answer:

S 2(d) of Audit Act 2048 prescribes the meaning of "Corporate body wholly owned by government of Nepal". According to it Corporate body wholly owned by government of Nepal means a corporate body whose all shares of assets are owned by Government of Nepal, or a corporate body whose all shares or assets are owned by Government of Nepal corporate body or by such corporate body and Government of Nepal. It also further prescribes that it includes such corporate body for whom Government of Nepal is required to bear full responsibility. However it is difference from "corporate body substantially owned by government of Nepal" S 2(e) of the Act prescribes meaning of corporate body substantially owned by government of Nepal which means a corporate body whose more than fifty percent shares or assets are owned by Government of Nepal. Audit Act 2048 S.6 prescribes provision regarding audit of the corporate bodies wholly owned by Government of Nepal. According to the legal provision the Auditor General is responsible and entitle to do the audit of the corporate bodies wholly owned by Government of Nepal. If the Auditor General is not in a position to audit such corporate body due to constraint by time and resources, he may appoint a licensed auditor, with a preference to Nepali citizen, as an assistant. The auditor so appointed will act under the direction, supervision and control of the Auditor General. The powers, functions, duties and responsibilities including remuneration to be paid by the concerned organization of such appointed auditor will be as prescribed by the Auditor General. The remuneration, however, will be fixed by the Auditor General on the basis of volume of financial transactions, status of accounts, number of branches and sub-branches, work load and work progress of the concerned organization.

Case No 2:

Sleepwell Corporation Ltd., a corporation wholly owned by the Government of Nepal has not audited its books of accounts for the last two financial years. The shareholders of the company feels that the Auditor General could not perform the audit due to his time constraint and hence decided to appoint Mr. Rasik Lal, a practicing Fellow Chartered Accountant, as its auditor in its AGM.

i)Is his appointment valid?

ii) Will your answer be the same if Mr. Rasik Lal is appointed by the Auditor General as his assistant to complete the audit of the corporation?

Answer

a) As per Section 6 (1) of the Audit Act, 2048, notwithstanding anything contained in the existing laws, the audit of the corporate bodies wholly owned by the government of Nepal shall be audited by the Auditor General pursuant to this Act. Hence, the appointment of Mr. Rasik Lal as an auditor of Sleep well Corporation Ltd, by AGM will be void and illegal.

Section 6 (2) of Act further provides that if the Auditor General in constraint of time and resource to audit the corporate bodies wholly owned by the government of Nepal, he may appoint professional auditors as his assistants. Hence, the appointment of Mr. Rasik Lal will be valid if it is appointed by Auditor General as his assistant due to his constraint of time and resources to audit.

Section 112 - Disqualifications of auditor:
Section 112(1): following person shall not be qualified for appointment as auditor and shall, despite appointment as auditor, not continue to hold office:

(e) A substantial shareholder of the company or a shareholder holding one percent or more of the paid up capital of the company or his close relative;

Section 112(2) The auditor shall, prior to his appointment, give information in writing to the company that he is not disqualified pursuant to sub-section (1).

Section 112(3) Where any auditor becomes disqualified to audit the accounts of a company or there arises a situation where he becomes disqualified for appointment or can no longer continue to act as an auditor of the company, he shall immediately stop performing audit which is required to be performed or is being performed by him and give information thereof to the company in writing.

Section 112(4) The audit performed by an auditor who has been appointed in contravention of this Section shall be invalid.
Section - 2(z9) of the Companies Act, 2063
"Close relative" means a partition member of an undivided family or husband, wife, father, mother, mother-in-law, father-in-law, elder brother, younger brother, elder sister, younger sister, sister-in-law (elder or younger brother's wife), brother-in-law, sister-in-law, brother-in-law (husband of elder sister), uncle, aunt, maternal uncle, maternal aunt, son, daughter, daughter-in-law, grand-son, grand-daughter, grand-daughter-in-law or son-in-law.

Considering the provisions of Section 112(1)(e) read with Section 2(z9) the appointment of the Auditor is invalid and has to be given up immediately notifying the company.

Case No 3:

State the authority of Auditor General's report and the directives issued by him/her under the Audit Act, 2048.

Answer:

Pursuant to section 8 of the Audit Act, 2048 the Auditor General shall submit its annual audit report, including his comments and opinions thereon, to the President of the State of Nepal on the final audit of Government Offices and other offices and organization prescribed by prevailing laws, which are subject to audit by the Auditor General.

Provided that the Auditor General may submit a report if he deems necessary at any time to take immediate action against any loss or damage already happened or impending upon to the national assets.

The President shall forward the Report pursuant to the legislative -parliament.

Pursuant to section 10 of this Act, the Auditor General may, subject to the Interim Constitution of Nepal, 2007 and the prevailing laws, issue directives to the concerned Government Offices, and Corporate Bodies wholly or substantially owned by Government of Nepal, from time to time to make proper arrangements on matters of accounts and to maintain regularity therein. It shall be the duty of the concerned offices or organizations to abide by such directives.

Thus, the Auditor General's Reports whether annual or occasional are very important state documents, proper execution of which shall be highly valued for the maintenance of fiscal good governance of this state and counter-active to fiscal irregularities and fiscal indiscipline. Hence, the government may take necessary legal action in respect of the faults and irregularities observed during the audit of income and expenditure and other financial matters of Government of Nepal, according to the prevailing laws pursuant to section 12 of this Act.

Pursuant to section 10 of Audit Act 2048 (1991) the Auditor General may, subject to constitution of Nepal and prevailing laws, issue directives to the concerned Government offices, and Corporate Bodies wholly or substantially owned by Government of Nepal, from time to time to make proper arrangement on matters of account and to maintain regularity therein. It shall be the duty of concerned offices or organization to abide by such directives.

Short Note on:

Audit Committee

Answer :

Section 164 of the Companies Act, 2063 prescribes provisions regarding Audit Committee. According to it a listed company with paid up capital of thirty million rupees or more or a company which fully or partly owned by the Government of Nepal has to form an audit committee under the chairpersonship of a director who is not involved in day to day operation of the company and consisting of at least three members. The Act also prescribes the disqualification of the member of the committee. In other words a person who is a close relative of the chief executive of a company should not be appointed as a member of the committee. Similarly, the Act prescribes the provision that at least one member of the audit committee should be an experienced person having obtained professional certificate on accounting or a person having gained experience in accounting and finance with bachelor degree in commerce or economics.

It is the board of directors to arrange all means and resources as may be adequate for the fulfillment of responsibilities of the audit committee. Audit may fix its internal rules of procedures on its own.

Section 165 prescribes the functions, duties and powers of audit committee. Major functions, duties and powers of the committee may be noted as follows:

a. To review the accounts and financial statements of the company and ascertain their truth.
b. To review the internal financial control system and the risk management system of the company.
c. To supervise and review the internal auditing activity of the company.
d. To recommend the names of potential auditors for the appointment of the auditor of the company.
e. To prepare the accounts related policy of the company and enforce, or cause to be enforced the same.

f. To perform such other terms as prescribed by the board of directors in respect of the accounts, financial management and audit of the company.

Privatization Act, 2050:

Case o. 1:

What basic terms and conditions shall be included in the agreement to be concluded between the parties during privatization of an enterprise?

Answer:

Pursuant to Section 11 of the Privatization Act, 2050, prior to handing over an enterprise, an agreement shall be entered into between the Parties (offerer and offeree) specifying clearly the terms and conditions to be observed by both.
Provided, that no such agreement shall be required to be entered into where the shares are being sold in open market to the general public, employees, and workers of the enterprise and private sector through capital markets or any other means.

The terms of payment to the Government of Nepal on account of the privatization shall be clearly spelled out in the agreement to be concluded as above.

The time schedule for handing over of the enterprise by the Government of Nepal to the buyer and other terms and conditions that the Government of Nepal may wish to prescribe, in respect thereof, shall be clearly spelled out in the agreement to be concluded as above.

A brief note about the terms and conditions of the privatized enterprise shall be published within one month from the day of signing of the agreement, pursuant to this section for information of the public.

Case No 2:

Government of Nepal deems necessary to privatize an enterprise classified for privatization. You are appointed as a consultant for the privatization process and also for the consideration of the terms and the determination factors in respect of the evaluation of enterprise are to be adopted. As a consultant how would you suggest?

Answer:

Where Government of Nepal deems necessary to privatize an enterprise classified for privatization, it shall publish notice to this effect in the Nepal Gazette. After publication of the notice Government of Nepal shall determine the process of privatization. Section 8 of the Privatization Act, 2050 provides for the determination factor of the privatization process by Government of Nepal.

Government of Nepal may privatize any enterprise which has been classified for privatization in pursuance of any or all of the following process:

i. By sale of shares of the enterprise to the general public, employees, workers, and any person or company, interested in the management of such enterprise with maximum participation of the general public, workers, and employees.
ii. By formation of cooperatives;
iii. By leasing out the assets of the enterprise;
iv. By involving private sector in the management of the enterprise, and
v. By adopting any the modalities considered appropriate by Government of Nepal on the basis of recommendation of the committee.

Section 7 of the Privatization Act, 2050 provides for evaluation process of enterprise. According to it, for privatization of an enterprise the privatization committee shall appoint a team of national experts or a joint team of national and foreign experts as necessary, for evaluation of the enterprise.

The team of experts, while performing the task of evaluation of the enterprise as formed shall make an assessment on the following basis:

a. The assets of the enterprise;
b. Market price of the shares;
c. Profit and loss of the enterprise;
d. Its potential for future production;
e. Its potential for future sale;
f. Its potential for future profit and loss.

From the above discussion it is clear that the process of privatization is to be adopted according to the Section 8 of the Privatization Act, 2050 and the terms and determination factors are to be considered in respect of evaluation of an enterprise is according to S.7 of the Privatization Act, 2050.

Case No 3:
What basic terms are considered as the determination factors of privatization process under Privatization Act, 2050 and under which basic factors the evaluation process of enterprise is adopted?
Answer:

Where Government of Nepal deems necessary to privatize an enterprise classified for privatization, it shall publish notice to this effect in the Nepal Gazette. After publication of the notice Government of Nepal shall determine the process of privatization. Section 8 of the Privatization Act, 1993 provides for the determination factor of the privatization process by Government of Nepal.
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ii. By formation of cooperatives;
vi. By selling assets of the enterprise;
vii. By leasing out the assets of the enterprise;
viii. By involving private sector in the management of the enterprise, and
ix. By adopting any the modalities considered appropriate by Government of Nepal on the basis of recommendation of the committee.

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iii. Profit and loss of the enterprise;
iv. Its potential for future production;
v. Its potential for future sale;
vi. Its potential for future profit and loss.

For short note:

Formation of Privatization Committee:

Section 3 of Privatization Act 2050, states that a privatization committee shall be formed to manage the privatization of enterprises which shall consist of the following members.

a. Minister or State Minister for finance…… Chairman
b. Chairman, Finance Committee (House of Representatives) …… Member
c. Two Members of Parliament nominated by the G. of Nepal ……..Member
d. Member, National Planning Commission…..... ..Member
e. Secretary, Ministry of Finance…….....……...Member
f. Secretary, Ministry of Law, Justice and Parliamentary Affairs…… Member
g. Secretary, Ministry of Labour……Member
h. Secretary (Ministry Concerned with the enterprise being privatized).. Member
i. President, Federation of Nepalese Chamber of Commerce and Industry ….Member
j. Joint-Secretary, Ministry of Finance (Corp. Co-ordination Division...Member-Secretary
The Committee shall, if necessary, invite the Chief of the enterprise, labour representatives and any distinguished economist in the meetings of the Committee.

Labour Act 2048

Case No. 1:

Mr. Ramesh Karki, a permanent security guard at XYZ Bank Ltd. is shot by a gang of robbers during working hours while being on duty at the premises of the Bank. The death of Mr. Karki has left his family in deep financial problem as he was the only bread earner for the family. State the provisions regarding notice and compensation as per the Labour Act, 1992 and Labour Rules, 1993? Also mention the circumstances when compensation is not payable according to the rules?

Answer:

Under Section 35 of the Notice is to be furnished before going for the action as follows:

1) In case any worker or employee dies or becomes unable to work for more than 48 hours after sustaining injury due to any accident in the establishment, or for any other reason, the concerned establishment shall notify the labor office within three days. In case the establishment finds any worker or employee to have contracted any occupation-related disease, it shall notify the labour office within seven days from the date when it becomes aware of it.

2) The authority empowered to conduct investigations into the disease or accident mentioned in the notice received under Sub-Section (1), and its functions, duties and powers, as well as the working procedures, shall be as prescribed.

Labour Rules 1993 Rule 17 prescribes the provision regarding the compensation in the event as follows:

1. In case any worker or employee dies instantly or in the course of treatment as a result of an accident while discharging the duties assigned to him by the establishment, an amount equal to his three year remuneration calculated at the rate of remuneration being drawn by him shall be paid in lump sum to his nearest heir as compensation
2. Accordingly Rule 19 prescribes the provision regarding the circumstances when compensation is not payable

   In case any worker or employee dies or becomes physically disabled as a result of a natural calamity while discharging the duties assigned to him by the establishment, he or his heir shall not be entitled to compensation under these rules.

Considering the above mentioned provisions the Bank has a duty to notify the labour office within three days regarding the death. The nearest heir of Mr. Karki shall be eligible for compensation equal to three year remuneration as drawn by him and compensation would not be payable only if such death is due to a natural calamity

Case No 2:

Bidyut Udyog Co. Ltd. wishes to curtail its part of productions for 45 days due to some unavoidable reasons. You are required to examine the following and suggest as per the provisions of the Labor Law.

i) **Can the company do so? If yes, suggest the steps required to be taken by the management for such closure.**

ii) **Is the company liable to pay salary/wages to its staff/workers for the closed period? If yes, mention the minimum prescribed rate.**

Answer:

i) As per the provision of Section 11 (1) of the Labor Act, 2048, a company can curtail its production or services partially or fully or close its' whole or part of units if the manager thinks that continuation of production or delivery of services that the company is being undertaken is not possible due to some deserving causes provided permission from appropriate authority is obtained. In case of the Fastspin co. ltd, they have to obtain permission from the Department of Labor since the closure is proposed for more than 15 days section 11 (2) of the Labor Act. 2048.

ii) The company is required to keep the permanent workers in reserve to whom a minimum of 50% salary of wages is to be payable under section 11 (3) of the Act. However, other benefits being received by such workers shall not be discontinued and made available fully.

In case, a worker who is under reserve, refuses to work either in the same institution or another institution owned by the employer for similar nature of job on same salary or does not present once in a day during work hour in the institution may be deprived of such payment or benefits under section 11 (4).

Case No 3:

"Workers Participation in Management is a system of communication and consultation, either formal or informal, by which employees of an organization are kept informed about the affairs of

the undertaking and through which they express their opinion and contribute to management in decisions making process". Discuss, in the light of above statement with reference to its legal provision incorporated in the Labour Act, 2048.

Answer:

Workers' participation in management is an essential ingredient of industrial democracy. The concept of workers' participation in management is based on human relations approach to management which brought about a new set of values to labour and management

It is distribution of social power in industry so that it tends to be shared among all who are engaged in the work rather than concentrated in the hands of minority.

Thinkers like Comte and Owen advocated the participation of workers in management for achieving distributive social justice.

Traditionally the concept of Workers' Participation in Management (WPM) refers to participation of non-managerial employees in the decision-making process of the organization.

Workers' participation in management implies mental and emotional involvement of workers in the management of Enterprise. It is considered as a mechanism where workers have a say in the decision-making.

Legal Provision in Nepal:

- There are four ways where Worker are seen Participating in Management of the Company in Nepal specially in Nepalese industries under Labour Act 1992 are as follows:
  - Collective Bargaining Section 74, 75 and 79
  - Labor Relation Committee Section 63
  - Minimum Wages Fixation Committee Section 21
  - Central Labor Advisory Committee Section 62

Collective Bargain Section under Section 74 of the Act:

With the enactment of Labour Act 1992 and Trade Union Act, 1993 the basic legal requirements for entering into collective bargaining under the Constitution of Nepal 2072 guarantee freedom of association. Trade Union Act, 1993 provides for the registration and recognition of Trade Union at plant level. Same Act provides that an authorized trade union is eligible to undertake collective bargaining with the employer. Sec. 74, 75 and 79 of the Labour Act 192 are particularly relevant for collective bargaining process. Sec. 74 lays down the process of settling collective disputes. Sec 75 limits items to be collectively demanded and finally Sect 79 set down the rules for implementing the collective agreements. Under this process the authorized union i.e. fifty one percent of the workers can submit their collective demands to the management, such demands have to be settled either by the management through bipartite negotiation or if not through the intervention by the Labour Office. If it cannot be settled the, the dispute will be settled through an arbitrator, unanimously appointed by worker and management. If fails to appointing arbitrator unanimously the disputes will be referred to tripartite committee and dispute is to be settled within 15 days. An agreement arrived through collective bargaining is binding and enforceable as law and is valid for next two years for both parties. To make it more attractive, Nepal has adopted the principles concerning collective bargaining laid down by the ILO by ratifying the ILO convention No. 98 of 1949 concerning "The Right to Organise and Collective Bargaining". However such settlement is permissible only in the plant level . So the legal provision regarding the collective is inadequate for the national level collective bargaining.

So upon receiving claim, dialogue by management need to be initiated. If not resolved, the dispute shall be resolved by Labor office. If not resolved, then it may be referred to mediator.

Collective Bargain regarding Labor Relation Committee under Section 63 of the Act Section 63:
The Proprietor should constitute a Labour Relation Committee in each Enterprise in order to create amicable harmonious atmosphere between the workers or employees and the management for whole workers of the establishment. The main object behind it is to develop healthy labour or industrial relation on the basis of mutual participation and co-ordination. The method of composition of the Committee pursuant to Sub-section(2) depends upon the size of the establishment. The committee can have, minimum membership of four to the maximum of twenty members. The tenure of the committee is of two years. One of the distinct features of Labour Relation Committee is that the position of the Chairman, Joint Secretary and that of the Treasurer are to be occupied by the management representative and Vice Chairman, Secretary are to be occupied by the representative from employees. This gives a feeling of management having a upper hand in the functioning of the committee.

The basic duties and function of the Committee have been spelt out in the Labour Regulation 1993. These include: matters related to improvement of quality production, operation of the various funds like welfare fund, accommodation fund and provident fund, welfare activities, determination of public holidays as negotiated in the collective bargaining agreement.

Collective Bargain provision regarding minimum wage/remuneration fixation Committee under Section 21 of the Act:
Government of Nepal may fix the minimum remuneration, dearness allowances and facilities of workers or employees or Enterprises on the recommendation of the Minimum Remuneration Fixation Committee and the notification on rates so fixed shall be published in the Nepal Gazette. Sec. 21 of the Labour Act, 1992 and Labour Rules 9 and 10 prescribes a provision to form a Minimum Wage Fixation Committee at national level. It consists equal number of representatives from three industrial relation actors i.e. employees, management and government. Minimum wage fixation committee deals with matters relating to minimum wage fixation or the minimum remuneration, dearness allowances and facilities, which constitute a

Collective Bargain provision regarding Central labour Advisory Board under Section 62 of the Act:
Government of Nepal may constitute a Central Labour Advisory Board consisting of representatives from workers or employees, Proprietors and Government of Nepal to receive necessary opinion and advice in relation to formulating policies and drafting of laws with regards to labour. Sec. 62 of Lsbour Act, 1992 and Labour Rules 45 and 46 prescribes for the setting up of a Central Labour Advisory Commmittee. The duty of the CLAC is to recommend and advice matters relating to labour policies and labour legislation. The Act prescribes for the equal number of representative from trade union and management in this committee along with government authorities which includes Labour Minister, Secretaries of Labour, Tourism, Transport, Agriculture, and Ministry of Industry.

Case No. 4:

Mr. Chandika Lama, the employer of Chandika Carpet Factory committed certain misconduct under the Labour Act, 2048. The workers of this factory made hue and cry demanding legal action and punishment against him. Now, answer the following under the Labour Act, 2048: **3**

i) Identify the various defined misconducts of an employer;

ii) What legal action could be taken and punishment be imposed against Mr. Chandika Lama for his misconduct?

Answer:

(i) Pursuant to section 55 of the Labour Act, 2048 the defined misconducts of proprietor or manager (employer) are:

If the proprietor or manager commits any of the following acts, it shall be deemed as misconduct:

(a) In case he/she contravenes or disobeys this Act or the Rules made hereunder or any order or directive issued there under.

(b) In case the enterprise (Chandika Carpet Factory) is closed or the workers or employees are retrenched in contravention of this Act;

(c) In case a lock-out declared illegal is continued;

(d) In case any worker or employee is assaulted or manhandled; or

(e) In case he/she performs any activity to incite or provoke the workers or employees in order to create dissension or enmity among the workers or employees.

(ii) The concerned Labour Office may fine Mr. Chandika Lama, the employer of Chandika Carpet Factory, who conducts any misbehavior under Section 55(1) above of the Labour Act, 2048, upto ten thousand rupees, may make available proper compensation if any damage or loss is caused to any worker or employee and may give an order to reinstate the worker or employee retrenched pursuant to Clause (b) of Section 55(1) above.

Chandika Lama if not satisfied with this punishment may file an appeal within thirty five days from the date of such punishment or receipt of order at the concerned Labour Court.

Case No 5:

A dispute regarding amount of bonus was arisen between the employer and employee of Siddhi Shoe Factory. Explain how the dispute will be settled under the Bonus Act, 2030.

Answer:

Settlement of dispute regarding to the amount of bonus between the employer and employee of Siddhi Shoe Factory shall have to be made under the following provisions of section 16 of the Bonus Act, 1974:

(1) If any dispute arises between employee and management with respect to the bonus to be payable under this Act, the Labour Office shall resolve such dispute by negotiations having invited both the parties.

(2) If the dispute could not be resolved by negotiations pursuant to subsection (1) above, the Labour Office shall ask to the concerned enterprise (Siddhi Shoe Factory) and employees to produce necessary documents and statements of accounts and shall give a decision on the basis of such documents and statements.

(3) The party who is dissatisfied with the decision of Labour Office made pursuant to section 55 (2) of Labour Act, 2048, may appeal to the Labour Court, within thirty five days of receipt of such notice and the decision made by the Labour Court shall be final.

Insurance Act 2049

Case No 1:

Discuss the punishment which has been prescribed by the Insurance Act 2049, where there is violation of the Act or the Rules made under the Insurance or directives issued or perform the functions as to be performed under the Act?

Answer:

Section 36 of the Insurance Act, 2049 prescribes the provision regarding the Punishment of concerned responsible persons as follows:

1. If any insurer or the Director of the insurer, employee or surveyor, broker of insurance agent knowingly violates this Act or the Rules made under this Act or order or directives of does not perform any function to be performed or does any act to be done, the Board may punish to such insurer or the director, employee of surveyor, broker of insurance agent with a fine raging from three thousand rupees to ten thousand rupees. If such offense has been made frequently, he will be fined at the rate of extra five hundred rupees for each subsequent offense.
2. If any insurer of insurance agent or broker has made ay insurance business without following the procedures to be followed pursuant to Act, the board may fine him up to ten thousand rupees.
3. If the accounts, records, register, details information or any other documents to be maintained, prepared, formed or submitted pursuant to this Act or the Rules made under this Act has not maintained or submitted in time by knowingly or with malafied intention or has maintained or submitted the false details or documents by anybody he may be punished with a fine up to thirty thousand rupees or imprisonment up to two years or with both.

   Any person or corporate body dissatisfied with the decision made by the board pursuant to this Act, may make a appeal in the concerned Appellate Court within thirty five days from the date of such decision under Section 37 of the Act.

No 2:

State how the Insurer is registered under the Insurance Act 2049. Can the Board refuse to register the insurer? State in what conditions the it may not be registered? Whether the insurer business can be cancelled when it is registered?

Answer:

Chapter-4 Section 10 of the Insurance Act, 2049 has prescribes the provision regarding Registration and Cancellation of the Insurer. According to the section 10 the registration procedures has been prescribed as follows:

(1) No Person shall operate or cause to operate the Insurance Business without obtaining a certificate pursuant to this Act.

(2) Any national or foreign corporate body desirous to operate an Insurance Business shall submit an application to the office of the Board in the prescribed form along with the following documents and prescribed fees for the registration of its name as an Insurer :

(a) Memorandum and articles of association of the corporate body,

(b) Insurance Business to be operated and its policies and terms and conditions,

(c) If life Insurance Business to be operated, documents displaying calculations of the premiums to be received in operating such business and liability,

(d) The documents regarding the methods of utilizing the amounts to be received from the Insurance, and

(e) Other necessary documents as prescribed by the Board.

(3) The Board shall make necessary investigation upon the application received pursuant to Sub-section (2) and shall make an inquiry with the applicant, if necessary, and shall register the name of such applicant in the prescribed register-book by mentioning the types of the Insurance Business to be operated by the applicant and shall provide the registration certificate of Insurer to the applicant in the form as prescribed. In case there is any reasonable ground for not registering the name, the Board shall inform the concerned applicant
accordingly.

(4) Notwithstanding anything contained elsewhere in this Section, in the case of the Life Insurance, the Board shall, with the approval of the Nepal Government, issue a certificate to operate the Business, based on the fulfillment of the criteria which it has fixed, from time to time, in respect of the operation of the Insurance Business.

Section 12 of the Act prescribes the provision regarding the refusal to be registered the insurance company in the following conditions:

Notwithstanding anything contained in Section 10, no national or foreign corporate body shall be registered as an Insurer in the following circumstances :

(a) If the name of an Insurer to be registered is identical to the name of another Insurer which has been already registered in the office of the Board, and

(a1) If any Insurer wants to be registered for operating Life Insurance and Non-Life Insurance Business, Provided that, the registered Insurer who is operating the Life Insurance and Non-Life Insurance Business before the commencement of this Act, shall operate the business through a separate organization for Life and Non-Life Insurance Business as prescribed from the date specified by the Board.

(b) If the paid-up capital does not amount to at least two hundred fifty million rupees for the Life Insurance Business and to at least one hundred million rupees for the Non-life Insurance Business.

(c) In the event that the Board has made a decision to ban to register to additional corporate body as an Insurer to operate Insurance Business on the basis of the report, regarding to the study, research and evaluation of the Insurance Business market.

According to Section 13 of the Insurance Act 2049 Registration of an Insurer may be Canceled as follows:

(1) The Board may cancel the registration of an Insurer by providing a written notice with effect from the date prescribed in the same notice in the following circumstances:

(a) If the Insurance Business is not started within six months from the date of obtaining the certificate,

(b) If it is felt that the liability of the Insurer exceeds its assets within Nepal,

(c) If the Insurer could not fulfill the liability pursuant to the decision within three months from the date of final decision of the court in the case filed under the Insurance Policy issued within Nepal,

(d) If the head office of the Insurance Business of any foreign Insurer is situated out side Nepal and in case it is felt that Nepalese Insurer has not obtained equal facilities there which are enjoyed by the foreign Insurer pursuant to the prevailing law of such country,

(e) If the Insurer does not open its office inside Nepal,

(f) If the Insurer does not perform the functions to be performed or has performed any functions which is not to be performed pursuant to this Act or the Rules made under this Act.

(2) Before canceling the registration of an Insurer pursuant to Subsection (1), the Board shall provide a reasonable time-limit to submit clarification to the concerned Insurer, stating the reasons for canceling its registration.

(3) If the concerned Insurer does not submit its clarification within the time period mentioned in Sub-section (2) or in case the clarification submitted by it is found not to be satisfactory, the Board shall cancel the registration of such Insurer pursuant to Sub-section (1), and shall publish a notice in two major newspapers to be published Nepal for the information public in general.

(4) Mere cancellation of the registration of an Insurer pursuant to this Section shall not make any effect to the rights and liabilities of the concerned Insurer regarding to any action taken or functions performed before the cancellation.

When the registration of insurer is cancelled the arrangement of payment of insurance claims after the cancellation of the Insurer is to be made under Section 16 of the Act as follows:

The Insurer, dissolved by the cause of the cancellation of its registration pursuant to Section 13, shall refund the amount received by it for Insurance to the person, organization or the Board, within the period and method specified by the Board. It shall refund the principal amount along with bonus as specified by the Board in the case of Life Insurance and it shall refund the principal amount as specified by the Board on a proportional basis in the case of Non-Life Insurance.

Case No 3:

Discuss the legal provision regarding the renewal of registration of the insurer according to the Insurance Act, 2049. In what conditions the registration of the insurer can be refused to be renewed?

Answer:

Section 11 prescribes the provision regarding the renewal of registration of the insurer.

According to it the insurer has to follow the procedure as follows:

(1) The Insurer shall have to submit an application to the office of the Board in the prescribed form along with the prescribed fees up to the last day of *Chaitra* of each year for the renewal of the certificate of registration.

(2) Upon the receipt of the application pursuant to Sub-section (1), the Board shall have to renew the *certificate of registration.

(3) In case any Insurer submits an application to the Board within thirty days from the date of expiry of the time-limit pursuant to Sub-section (1), mentioning the reason for its failure to submit an application for the renewal of the certificate of registration within the aforesaid time-limit, the Board may, if it considers the reasons to be appropriate, renew the certificate of registration of such Insurer.

According to Section 11A. Certificate of Registration of the Insurer Cannot be Renewed in the following Circumstance :

(1) Notwithstanding anything contained in Section 11, the Board shall not renew the certificate of registration of the Insurer in any of the following circumstances :

(a) If the balance-sheet has not submitted pursuant,

(b) If the statement of income has not submitted,

(c) If the audit report has not submitted,

(d) If the report of Actuary has not submitted,

(e) If the service-charge has not paid pursuant to Section 40,

(f) If it has been prohibited to operate the Insurance Business as prescribed.

(2) If a circumstance has been created for not renewing the certificate of registration of an Insurer due to any of the circumstance mentioned in subsection (1), the Board shall notify the Insurer within fifteen days from the emergence of such circumstances.

(3) If the Insurer has submitted an application to the Board within fifteen days from the date of receiving the notice pursuant to Sub-section (2), stating reasonable grounds for not performing the liabilities to be performed pursuant to Section 23, 24, 25, 26 and 40, the Board may, if it considers the reasons to be appropriate, provide an additional time-limit of up to one month to perform such liabilities.

Cooperative Act 2048:

Case No 1:

Binod & Associates, the auditor of Yala Cooperative Ltd. in course of its audit comes through mass irregularities in the accounts of the co-operative but due to certain reasons it is unable to provide an adverse opinion. The auditors feel that the members need to know about the matter hence, have requested the Board of the Cooperative to convene an Extraordinary General meeting (EGM). The Board refuses to convene the meeting on the ground that the auditor can present its observations in the audit report which shall be placed at the AGM. Advice, elaborating the provisions for convening an EGM as provided in Rule 12 of the Cooperatives Rules, 1993?

Answer:

Co-operatives Rules, 1993, Rule 12 – Extraordinary General Meetings:

(1) The Board may convene an extraordinary general meeting of the Society or Union by adopting the working procedure prescribed in the bye-rules in the following circumstances:

a) In case the auditor deems it necessary in the course of auditing the accounts and records of the Society or Union to convene an extraordinary general meeting, and requests the Board in writing for the same, explicitly mentioning the reasons thereof, or
b) In case the Accounts Committee mentioned in Section 17 of the act, or any sub-committee formed under Section 19 of the act, deems it necessary to convene an extraordinary general meeting for any special purpose and requests the Board in writing for the same, explicitly mentioning the reasons thereof, or
c) In case a resolution submitted by any Director to the Board pointing out the need for convening an extraordinary general meeting by explicitly mentioning the reasons thereof is passed by the Board, or
d) In case at least 10 percent of the total membership, or 10 members, whichever is higher in the case of a Society, and 20 percent of the total membership, in the case of a Union, submit an application for convening and extraordinary general meeting by indication the reasons thereof.

(2) The quorum for an extraordinary general meeting shall be 15 percent of the total membership, or 11 members, whichever is higher, in the case of a Society, and 40 percent of the total membership in case of a Union.
(3) Extraordinary general meetings shall be presided over by the Chairman of the Board and in his absence, by a person chosen by the members present at the meeting from among themselves.
(4) All issues to be presented at the extraordinary general meeting shall be presented in the form of resolutions. Decision on such resolution shall be taken on the basis of a majority of the members present at the meeting. In the event of a tie, the Chairman shall exercise his casting vote.
Considering the provisions of Rule 12 as mentioned above the auditor can approach the Office of the Registrar for convening the EGM to report the irregularities to the members.

Short Notes:

a. Powers of cooperative to carry on banking transactions:

Answer:

Section 26 of cooperative Act, 2048 provides that a cooperative association or society may accept saving deposits from its member and lend loans to its members. A cooperative association or society has to obtain prior approval of the Nepal Rastra Bank in order to carry on other banking transactions than above. Such association or society has to observe the terms and conditions prescribed and directions given by the Nepal Rastra Bank.

Notwithstanding anything contained elsewhere in this Act, associations or societies may jointly form a cooperative bank. If an application, accompanied by a recommendation of the Nepal Rastra Bank, is made for the establishment of a cooperative bank pursuant to Cooperative Act, 2048 the Registrar may hold necessary inquiry and register such bank. A bank registered and established pursuant this may carry on the banking transactions under the Bank and Financial Institution Act 2006, approved by the Nepal Rastra Bank; and the bank has to observe the terms and conditions prescribed by and the directions given from time to time by the Nepal Rastra Bank.

b. How a cooperative Society arrange financial source and mobilize them?

Answer: Co-operative Act 2048 is made to Provide for the Cooperative Associations and Societies. Preamble of the Act prescribes expedient of the Act to make provisions on the formation and operation of cooperativeness for the economic and social development of the general pubic consumers by the farmers, craftsperson (Kaligadh), class of people with low capital and low income.

Chapter-6 of the Act prescribes the provision regarding Financial Source and Mobilization it.

Under Section 23 of the Act financial source and their mobilization will be made among its members, and other bodies as prescribed.

The mode of collection of financial source has been made by Sale of shares. An association or society may collect share capital by selling its shares to those persons who are under its jurisdiction and are eligible to become member of it.

An association or society may, with approval of Government of Nepal, sell a maximum of twenty percent share of its total share capital to a foreign member of the International cooperative association or society. In the course of selling its shares as mentioned above an association shall so sell shares to a person or association that it does not exceeds twenty percent of its share capital.

Provided that, this restriction shall not apply to Government of Nepal or an organization or body owned by Government of Nepal. A member shall be entitled to cast vote only on the basis of one person one vote irrespective of the number of shares subscribed by that person.

The Society has power to issue debentures and borrow loans: An association or society may issue debentures and borrow loans from a native or foreign bank or other body.

Provided that, approval of Government of Nepal has to be obtained prior to issuing debentures or borrowing loans.
Security of Government of Nepal may be obtained while borrowing loans: If an association or society intends to obtain the security of Government of Nepal against debentures to be issued by the association or society or loans borrowed from a foreign bank or other body, the association or society has to make an application to Government of Nepal for the same. If Government of Nepal, upon consideration of an application made as stated above thinks appropriate, it may provide security against such debentures or loans. In providing such security, Government of Nepal may prescribe necessary terms and restrictions in respect of repayment of such debentures or loans; and the association or society has to make repayment accordingly.
Section 26 of the Act prescribes powers to carry on banking transactions. According to it An association or society may accept saving deposits from its member and lend loans to its members. An association or society has to obtain prior approval of the Nepal Rastra Bank in order to carry on other banking transactions including acceptance of deposits and disbursement of loans limited only to its members, other than the debentures or loans subject to those terms and restrictions.
Notwithstanding anything contained elsewhere in this Act, associations or societies may jointly form a cooperative bank.
If an application, accompanied by a recommendation of the Nepal Rastra Bank is made for the establishment of a bank as said above Registrar may hold necessary inquiry and register such bank. A bank so registered and established may carry on the banking transactions under the approval of the Nepal Rastra Bank; and the bank has to observe the terms and conditions prescribed by and the directions given from time to time by the Nepal Rastra Bank.

Insolvency Act 2063:

Case No 1:

What do you mean by Restructuring of a company. What are the process prescribed by the Insolvency Act 2063 when a company becomes insolvent due to financial difficulty?
Answer:
Reorganization or restructuring means the act of organizing a company in a different way, where a company may become insolvent due to financial difficulty. Restructuring means a process to be adopted under the insolvency Act 2063 in order to a company which may become insolvent because of financial difficulty (s.2 (e))
Where the court issues an order to restructure the company in pursuant to section 22(2), on the basis of report submitted by the investigation office, certain procedures is adopted as accordance to the chapter 4 of the insolvency Act 2063.

Procedures:
1. **Court order to the appointment of reorganization manager.**
According to the court order the reorganization office is appointed and, the office has to prepare a reorganization program as accordance to the law.

2. **Preparation of reorganization program (Sec. 23(2)**
Where the Court makes an order to restructure a company pursuant to Sub-section (2) of Section 22, the restructuring manager has to prepare a restructuring scheme containing the

Following matters of the company in writing.
a) To capitalize the debt of the company and alter the capital structure ;
(b) To pay the claims of creditors by selling any portion of the assets of the company;
(c) To change the nature of claims of creditors of the company and issue securities for the same;
(d) To get the creditors of the company to participate in capital investment by issuing shares in consideration for their claims;
(e) To amalgamate the company with any other company;
(f) To change the management of the company; or
(g) To do any such other act which the Court considers appropriate to restructure the company.

3. Procedures of reorganization of the company:
After the appointment of reorganization manager he prepares the program for this purpose. Then the manager starts to execute the procedures of reorganization.

a. The reorganization manage has to call a meeting of the creditors as accordance to the provision of Sec 21 and to fulfill all the legal formalities within 15 days from the date of commencement of business and such notice shall be published in a daily newspaper of national circulation for at least two times; and such notice may also be put on the website. . (Sec. 24).
b. The meetings of the creditors called pursuant to Sec. 21(3), discuss the details of the Reorganization program proposal presented by the manager and adopts a resolution:
   i. With or without amendment on the program proposal, acceptance or
   ii. Recommendation for the immediate liquidation of the company.
   iii. If the court issues order approving the resolution of reorganization program, that will be implemented.
c. The reorganization officer within the period of reorganization has to submit a report to the court accompanied by the transactions, assets, financial situation of the company and the reorganization program, if any amendment made.(Sec.25):

Where reorganization program is proposed in the report submitted by the manager, the following matters must be stated:

i. Summary and analysis of the proposed program
ii. Details of the effect likely to be caused by the implementation of the program to the creditors.
iii. Details of the consideration and effect available to the creditors from the implementation of reorganization program in comparison to the immediate liquidation of the company.
iv. Opinion and description accompanied by the finding in the report of the manager that the company would not be insolvent if the reorganization program was implemented.

Thus, reorganization program proposal must contain following matters in the written form:

i. All details and relevant in written form about the future program,
ii. All details of the benefit to creditors by implementation of the program,
iii. Details about the matter that proposal is not illegal and prohibited by law
iv. Details to the consequences of implementation that company will be rescued from insolvency, and details about the costs between investigation and reorganization period as well as remuneration of manager and officer

Case No 2:
When a company can be deemed to have become insolvent under the Insolvent Act 2063? Explain the cases when insolvency proceedings can be proceed, in respect of certain companies although there is no application for the insolvency proceedings.
Answer:

According to Sec. 7 of the insolvency Act 2063, a company will be deemed to have become insolvent on the following condition:

a. Where the general meeting of shareholders adopts a resolution that the company has become insolvent or a meeting of the board of directors of the company makes such decision; or
b. where the Court issues an order requiring the company to pay the debt and the debt is not paid up within thirty five days from the date of receipt by the company of such order; or
c. Where the company fails to pay the debt within thirty five days after the service by the creditor on the company a notice for the payment of the debt or fails to make an application to the Court within the said period to void such notice.

(2) Nothing contained in this Section shall prevent the establishing of the fact that a company has become insolvent where it is proved from any other matter that the liability of the company exceed the value of the assets of the company or the company itself admits that it has become insolvent.

According to Section 4 of the Insolvency Act 2063 an Application is to be made to the court for insolvency proceedings

Where it is required to institute insolvency proceedings against any company, any of the concern person like share holder, creditor or debenture holder having the qualification as prescribed may make an application to the Court in the prescribed format for the institution of such proceedings.

Section 8 of the Act prescribes that an insolvency proceedings may be initiated in case of certain companies although there is no application from the concern persons. In pursuant to Section 8 of the Act, no application may be made to the Court for insolvency proceedings in relation to the following company without obtaining prior approval of the following authority:

a. In the case of a bank or financial institution carrying on banking and financial business, the Nepal Rastra Bank, or
b. In the case of an insurance company carrying on insurance business, the Insurance Board formed pursuant to the Insurance Act, 2049, or

c. In the case of a company which cannot undergo voluntary liquidation without approval of the competent body or authority, except that mentioned in Clause (a) or (b), such authority.

(2) Every application to be made for insolvency proceedings in relation to a company as mentioned above should be accompanied by a copy of the approval given by the authority set forth in that Sub-section for that purpose.

Case No 3:

What do you understand by liquidation of a company? Explain the process of liquidation of a company as prescribed by the Insolvency Act 2063.

Answer:

The term "liquidation" means the act of determining the exact amount of something as a debt that before was uncertain. It is the process of realizing upon assets and of discharging liabilities in concluding the affairs of a business/company. Liquidation of company means situation where the registration of company is cancelled by fulfilling the procedure referred to the Insolvency Act 2063. The company of which financial condition cannot be reformed by the reorganization process, that can be preceded in the issue of the order of the court on the basis of recommendation or reorganization manager, under the Insolvency Act 2063.

Procedures of Liquidation of the Company:

The Court order to liquidate the company: The procedure of liquidation of a company starts when the court issues an order to terminate the company, on the ground of application of reorganization manager that the reorganization program failures.

Liquidation of the company on the issuance of order of Court to appointment of Liquidator (Sec. 37) : Where the court makes an order to liquidate a copany pursuant to their Insolvency Act, 2063, the court makes an order to appoint one person as a liquidator, from among the persons who are capable as per law to carry on the insolvency business at the time of making of such order. Following the court order to appoint a liquidator for the liquidation, the liquidation proceedings of the company is deemed to have commenced.

Consequences on the commencement of liquidation proceedings(Sec 38):

On the commencement of the liquidation proceedings of any company, the following provisions shall govern the following matters in relation to such company:

(a) Where the director and officer of the company are relieved of office, the liquidator will exercise all such powers as may be exercisable by the director and officer of the company in relation to the management of that company;

b) The liquidator will take in his or her custody and control all assets, accounts and books of account of the company, except the properties in possession of secured creditors;

(b) Except as ordered otherwise by the liquidator, the service of all employees appointed by the company will terminate.

c) except for the following matter, the provision relating to 'ipso facto' suspension set forth in Sec. 19 of this Act, applies apply during the period of company of liquidation proceedings:

i. Implementation of the right of secured creditors to execute pursuant to this Act;

ii. Implementation of the right of the lesser of any property leased to the company to redeem the property pursuant to this Act.

Conversion of liquidation of company into restructuring program(Sec.39) :

Where, based on the study and examination of the business and assets of the company, nature of the goods or services to be produced by the company and market potentiality thereof, the liquidator thinks that the restructuring program of the company can be adopted by a meeting of creditors and approved, the liquidator may make an application, accompanied by the reasons, to the Court for an

order to keep pending the order on liquidation of company issued by the Court pursuant to this Act for a certain period of time and to implement the restructuring program pursuant to this Act.

Case No 4:

DGK Ltd. is facing insolvency proceedings from its creditors and the court has appointed an inquiry official under Section 10(3) on the basis of an application made under Section 4(1). Elaborate the area of inquiry for the official and the provision regarding management of the company during inquiry period as per the Insolvency Act, 2063?

Answer:

The provision regarding duty of the inquiry official and management of the company during the inquiry period as laid out in the Insolvency Act are as follows:

Section 13 - To inquire into insolvency proceedings:

a. Where the Court issues order to inquire into insolvency proceedings pursuant to Sub-section (3) of Section 10, the inquiry official shall independently inquire into the financial situation of the concerned company in order to determine the following:
   i. Whether or not there should be issued an order for immediate liquidation of the company by the reason that its financial situation cannot be improved;
   ii. Whether or not the period of inquiry as referred to in Section 14 should be extended;
   iii. Whether or not there should be issued an order for the restructuring of the company through the restructuring program;
   iv. Whether or not the company has become or is likely to become insolvent.
b. The inquiry official shall make inquiry pursuant to Sub-section (1) and submit an inquiry report to the Court within the period specified by the Court, and such report shall contain, *inter alia*, the resolution, if any, adopted by the meeting of creditors, the company's report and evaluation and recommendation made by the official.

Section 15 of the prescribes the provision regarding management of company during inquiry period as follows:

a. Notwithstanding anything contained in the laws in force, the board of director of the company shall carry out the management and ordinary transactions of the company during the period of inquiry of insolvency proceedings, under the regular supervision of the inquiry official.
b. Notwithstanding anything contained in Sub-section (1), where the inquiry officer submits to the Court a report indicating that the board of directors of the company has not operated the company properly, the Court may issue an order to remove the board of directors and order the inquiry officer to carry out the management and ordinary transactions of the company.
c. Where the Court orders the inquiry officer to carry out the management and ordinary transactions of the company pursuant to Subsection (2), the inquiry officer shall carry out the transactions accordingly.
d. Where any special transaction such as the sale of the assets or business of the company shall be carried out in the course of operating the ordinary business of the company pursuant to Sub-section (3), an application setting out the reason thereof shall be made to the Court for permission, and where the Court issues an order granting such permission, the inquiry officer may carry out such transaction.

International Financial Transaction Act, 2054

Case No 1:

How would the Promotion Board be formed as per International Financial Transactions Act, 2054? Can it give suggestions to Nepal Government? **Aswer:**

The Promotion Board would be formed on follows under section 9 of the International Financial Transaction Act, 2054

i. Minister or state minister of the minister of finance-Chairman
ii. Chair person, finance committee, the House of Representatives-Member
iii. Vice chairperson, National commission-Member
iv. Governor, Nepal Rastra Bank-Member
v. Secretary, Minister of Finance-Member
vi. Secretary, Minister of Law and Justice- Member
vii. A person nominated by government of Nepal from among persons having experience in financial transactions-Member.

The Promotion Board can make necessary recommendation the government of Nepal in respect of exemptions, facilities, and concessions to be accorded to international financial entities for the purpose of establishing Nepal as an attractive centre for financial transaction.

Case No 2:

Trinity holdings an International Financial Institution licensed under Section 14 of the International Financial Transaction Act, 2054 intends to construct its own building to facilitate its operation? Advise the company if it is allowed and state the functions restricted by the Act to be carried by the international financial entity.

Answer:

As provided for in Section 5 of International Financial Transaction Act, 2054
International Financial Entities are not allowed to do the following acts:

(a) To purchase any kind of immovable property within Nepal or to keep in their name otherwise;
(b) To carry out any type of international financial transactions with any resident of Nepal;
(c) To purchase shares or debentures of any company incorporated in Nepal under the existing laws; and
(d) To open an account in any commercial bank of Nepal
However, an account may be opened in any commercial bank with the permission of the Accreditation Committee for the purpose of running the day-to-day administrative business of the office up to such amount as may be fixed by the Accreditation Committee.

Considering the above mentioned provisions, the Entity is advised not to construct its own building as it is restricted to acquire any kind of immovable property in Nepal.

Revision Test Paper - December 2016
Management Information and Control System

1. **What is transaction processing system? Discuss briefly the major components of transaction processing system?**

   Transaction Processing System (TPS) is an information system that manipulates data from business transactions. Any business activity such as sales, purchase, production, delivery, payments or receipts involves transaction and these transactions are to be organized and manipulated to generate various information products for external use. For example, selling of a product to a customer will give rise to the need of further information like customer billing, inventory status and increase in account receivable balance. TPS will thus record and manipulate transaction data into usable information. Typically, a TPS involves the following activities:

   - Capturing data to organize in files or databases;
   - Processing of files/databases using application software;
   - Generating information in the form of reports; and
   - Processing of queries from various quarters of the organization.

   The principal components of a TPS include inputs, processing, storage and outputs. The components or elements are part of both manual and computerized systems.

   Inputs
   Source documents, such as customer orders, sales, slips, invoices, purchase orders, and employee time cards, are the physical evidence of inputs in to the Transaction Processing System.

   Processing
   This involves the use of journals and registers to provide a permanent and chronological record of inputs. Journals are used to record financial accounting transactions, and registers are used to record other types of data not directly related to accounting.

   Storage
   Ledgers and files provide storage of data on both manual and computerized systems. The general ledger, the accounts/vouchers payable ledgers, and the accounts receivable ledger are the records of final account that provide summaries of a firm's financial accounting transactions.

   Outputs
   Any document generated in the system is output. Some documents are both output and input. The trial balance lists the balances of all the accounts on the gametal ledger and tests the accuracy of the record keeping. Financial reports summarize the results of transaction processing and express these results in accordance with the principles of financial reporting.

2. **What is knowledge management system? Explain the two types of knowledge in relation to knowledge management system.**

Knowledge Management (KM) is the process of capturing, developing, sharing, and effectively using organizational knowledge. It refers to a multi-disciplined approach to achieving organizational objectives by making the best use of knowledge. Knowledge Management Systems (KMS) refers to any kind of IT system that stores and retrieves knowledge, improves collaboration, locates knowledge sources, mines repositories for hidden knowledge, captures and uses knowledge, or in some other way enhances the KM process.

Knowledge management systems enable organizations to better manage processes for capturing and applying knowledge and expertise. These systems collect all relevant knowledge and experience in the firm, and make it available wherever and whenever it is needed to improve business processes and management decisions. They also link the firm to external sources of knowledge.

KMS treats the knowledge component of any organization's activities as an explicit concern reflected in strategy, policy, and practice at all levels of the organization. There are two broad types of knowledge - Explicit and Tacit. KMS makes a direct connection between an organization's intellectual assets — both Explicit [recorded] and Tacit [personal know-how] — and positive results.

Explicit knowledge: Explicit knowledge is the knowledge that can be formalized easily and as a consequence is easily available across the organization. Explicit knowledge is expressed, and represented as spoken words, written material and compiled data. This type of knowledge is codified, easy to document, transfer and reproduce. For example – Online tutorials, Policy and procedural manuals.

Tacit knowledge: Tacit knowledge, on the other hand, resides in a few, often in just one person, and hasn't been captured by the organization or made available to others. Tacit knowledge is unarticulated and represented as intuition, perspective, beliefs, and values that individuals form based on their experiences. It is personal, experimental and context-specific. It is difficult to document and communicate. For example – hand-on skills, special know-how, employee experiences.

3. **"A decision support system supports the human decision-making process rather than providing a means to replace it". Justify the statement by stating the characteristics of decision support system.**

A decision support system (DSS) is defined as a system that provides tools to managers to assist them in solving semi-structured and unstructured problems in their own way. A DSS is not intended to make decisions for managers, but rather to provide managers with a set of capabilities that enables them to generate the information required by them in making decisions. The DSS are characterized by following three properties:

(i) **Semi-structured / Unstructured decisions –** Structured decisions are those that are easily made from a given set of inputs. Unstructured decisions and semi-structured decisions are decisions for which information obtained from a computer system is only a portion of the total knowledge needed to make the decision. The DSS is particularly well adapted to help with semi-structured / unstructured decisions. In DSS, the problem is first defined and formulated. It is then modeled with DSS software. The model is run on the computer to provide results. The modeler, in reviewing these results, might decide to completely reformulate the problem, refine the model, or use the model to obtain other results.

(ii) **Ability to adapt to changing need –** Semi-structured / unstructured decisions often do not conform to a predefined set of decisions-making rules. Because of this, their decision support system must provide for enough flexibility to enable users to model their own information needs. The DSS designer understands that managers usually do not know in advance what information they need and, even if they do, those information needs keep changing constantly. Thus, rather than locking the system into rigid information producing requirements, capabilities and tools are provided by DSS to enable users to meet their own output needs.

(iii) **Ease of Learning and Use -** Since decision support systems are often built and operated by users rather than by computer professionals, the tools that company possesses should be relatively easy to learn and use. Such software tools employ user-oriented interfaces such as grid, graphics, non-procedural 4GL and easily read documentation. These interfaces make it easier for user to conceptualize and perform the decision making process.

4. **Define artificial intelligence? Give some possibilities where artificial intelligence can be used in accounting and auditing profession?**

Artificial Intelligence (AI) consists of computer-based systems (both hardware and software) that attempt to emulate human behavior. Such systems would be able to learn languages, accomplish physical tasks, use a perceptual apparatus, and emulate human expertise and decision making

Artificial intelligence (AI) is the capacity of machines or software to create and exhibit intelligence. AI tools and applications are being developed to think, feel, and react like living creatures.

Accountants' responsibilities often involve following long-established methodologies for information analysis and professional standards for report preparation. Specialized software already automates many accounting, tax, and audit data-gathering and processing tasks and provides the results to professionals who use their professional judgment to review. AI has the potential to completely transform the accountancy profession. In the near future, automation will alleviate many cumbersome processes, such as bookkeeping and transaction coding, enabling accountants to focus on advisory services and other higher-value work. As a result, the future will offer smart applications that drive value for accountants and their clients.

Financial institutions have long used artificial neural network systems to detect charges or claims outside of the norm, flagging these for human investigation.

5. **What are business processes? What is the role of MIS in an organization?**

Business Process

A business process is a logically related set of activities that define how specific business tasks are performed. Business processes are the ways in which organizations coordinate and organize work activities, information, and knowledge to produce their valuable products or services.

How well a business performs depends on how well its business processes are designed and coordinated. Well-designed business processes can be a source of competitive strength for a company if it can use the processes to innovate or perform better than its rivals. Conversely, poorly designed or

executed business processes can be a liability if they are based on outdated ways of working and impede responsiveness or efficiency.

Information systems automate manual business processes and make an organization more efficient. Data and information are available to a wider range of decision-makers more quickly when information systems are used to change the flow of information. Tasks can be performed simultaneously rather than sequentially, speeding up the completion of business processes. Information systems can also drive new business models that perhaps wouldn't be possible without the technology.

Role of MIS in the organization

Management information system refers to a computer-based system that provides managers with the tools to organize, evaluate and efficiently manage departments within an organization. In order to provide past, present and prediction information, a management information system can include software that helps in decision making, data resources such as databases, the hardware resources of a system, decision support systems, people management and project management applications, and any computerized processes that enable the department to run efficiently.

The following are some of the important roles of the MIS:

- The MIS satisfies the diverse needs through variety of systems such as query system, analysis system, modeling system and decision support system.
- The MIS helps in strategic planning, management control, operational control and transaction processing.
- The MIS helps the junior management personnel by providing the operational data for planning, scheduling and control and helps them further in decision-making at the operation level.
- The MIS helps the middle management in short term planning, target setting and controlling the business functions. It is supported by the use of the management tools of planning and control.
- The MIS helps the top level management in goal setting, strategic planning and evolving the business plans and their implementation.
- The MIS plays the role of information generation, communication, problem identification and helps in the process of decision-making. Therefore, it plays a vital role in the management, administration and operation of an organization.

6. **Write short notes on the following**

   a. **Expert systems**

   Expert Systems are software systems that imitate the reasoning processes of human experts and provide decision makers with the type of advice they would normally receive from such expert systems.

An expert system captures human expertise in a limited domain of knowledge as a set of rules in a software system that can be used by others in the organization. These systems typically perform a limited number of tasks that can be performed by professionals in a few minutes or hours, such as diagnosing a malfunctioning machine or determining whether to grant credit for a loan. They are useful in decision-making situations where expertise is expensive or in short supply.

b. **Materials Requirement Planning (MRP)**

Material Requirements Planning (MRP) is a computer-based production planning and inventory control system. MRP is concerned with both production scheduling and inventory control. It is a material control system that attempts to keep adequate inventory levels to assure that required materials are available when needed. MRP is applicable in situations of multiple items with complex bills of materials. MRP is not useful for job shops or for continuous processes that are tightly linked.

The major objectives of an MRP system are to:

1. Ensure the availability of materials, components, and products for planned production and for customer delivery,
2. Maintain the lowest possible level of inventory,
3. Plan manufacturing activities, delivery schedules, and purchasing activities.

c. **Cognitive Science**

Cognitive science is an area of artificial intelligence based on research in biology, neurology, psychology, mathematics, and many allied disciplines. It focuses on researching how the human brain works and how humans think and learn. The results of such research in human information processing are the basis for the development of a variety of computer-based applications in artificial intelligence. Applications in the cognitive science area of AI include the development of expert systems and other knowledge-based systems that add a knowledge base and some reasoning capability to information systems. It includes adaptive learning systems that can modify their behaviors based on information they acquire as they operate.

d. **Data representation by computer**

All information that is stored on a computer is represented in a sequence of zeros and ones. The computer interprets different sequences of these numbers as different types of data. Computer codes are based upon the binary number system (a base-two system) as opposed to a more common decimal system. Computer memory is stored as bits (0 or 1), bytes (8 bits), words (2,4 or 8 bits), or byte addressable (each byte has its own address).

e. **Database Management Systems**

A database management system (DBMS) is a software that permits an organization to centralize data, manage them efficiently, and provide access to the stored data by application programs. The DBMS acts as an interface between application programs and the physical data files. When the application program calls for a data item, such as gross pay, the DBMS finds this item in the database and presents it to the application program.

A database management system has three components:

1. data definition language
2. data manipulation language
3. data dictionary

f. **Server high availability**

Server high availability (also known as high availability cluster or fail-over clusters) are groups of computers that support server applications that can be reliably utilized with a minimum amount of down-time. They operate by using high availability software to harness redundant computers in groups or clusters that provide continued service when system components fail. Without clustering, if a server running a particular application crashes, the application will be unavailable until the crashed server is fixed. HA clustering remedies this situation by detecting hardware/software faults, and immediately restarting the application on another system without requiring administrative intervention, a process known as failover.

g. **Sales Force Automation**

Sales force automation modules in CRM systems help sales staff increase their productivity by focusing sales efforts on the most profitable customers, those who are good candidates for sales and services. CRM systems provide sales prospect and contact information, product information, product configuration capabilities, and sales quote generation capabilities. Such software can assemble information about a particular customer's past purchases to help the salesperson make personalized recommendations. CRM software enables sales, marketing, and delivery departments to easily share customer and prospect information. It increases each salesperson's efficiency by reducing the cost per sale as well as the cost of acquiring new customers and retaining old ones. CRM software also has capabilities for sales forecasting, territory management, and team selling.

h. **Single Point of Failure**

A **single point of failure** (**SPOF**) is a part of a system that, if it fails, will stop the entire system from working.

In a data center or other information technology (IT) environment, a single point of failure can compromise the availability of workloads – or the entire data center – depending on the location and interdependencies involved in the failure.

i. **System Development Life-cycle**

The system development life cycle is the overall process of developing, implementing, and retiring information systems through a multistep process from initiation, analysis, design, implementation, and maintenance to disposal. There are many different SDLC models and methodologies, but each generally consists of a series of defined steps or phases.

The system development life cycle generally involves the following steps:

1. **Planning -** identify the scope and boundary of the problem, and plan the development strategy and goals
2. **Analysis** – study and analyze the problems, causes and effects. Then identify and analyze the requirements that must be fulfilled by any successful solution.
3. **Design** – If necessary, design the solution.
4. **Implementation** – implement the solution.
5. **Support** – analyze the implemented solution, refine the design, and implement improvements to the solution.

j. **Cloud computing**

Cloud computing is a model of computing in which computer processing, storage, software, and other services are provided as a pool of virtualized resources over a network, primarily the Internet. These "clouds" of computing resources can be accessed on an as-needed basis from any connected device and location.

A cloud can be public or private. A **public cloud** is owned and maintained by a cloud service provider, such as Microsoft or Amazon Web Services, and made available to the general public or industry group. A **private cloud** is operated solely for an organization. It may be managed by the organization or a third party and may exist on premise or off premise.

7. **Differentiate between**

a. **Cyberterrorism vs Cyberwarfare**

Cyberterrorism is the act of Internet terrorism in terrorist activities, including acts of deliberate, large-scale disruption of computer networks, especially of personal computers attached to the Internet, by the means of tools such as computer viruses.

It is the intentional use of computer, networks, and public internet to cause destruction and harm for personal objectives. Objectives may be political or ideological since this can be seen as a form of terrorism. This can include use of information technology to organize and execute attacks against networks, computer systems and telecommunications infrastructures, or for exchanging information or making threats electronically. Examples are hacking into computer systems, introducing viruses to vulnerable networks, web site defacing, Denial-of-service attacks, or terroristic threats made via electronic communication.

Cyberwarfare has been defined as "actions by a nation, political or ideological extremist groups, hacktivists, and transnational criminal organizations to penetrate another nation's computers or networks for the purposes of causing damage or disruption. Some governments have made it an integral part of their overall military strategy, with some having invested heavily in cyberwarfare capability.

The major difference between the cyberterrorism and cyberwarfare is – cyberterrorism is undertaking cyber-attacks as terrorist activities by terrorist groups whereas cyber warfare

involves undertaking cyberattacks in support of a country's strategic objectives by nation or nation sponsored groups.

b. **RAID vs Mirroring**

R**AID**, **redundant array of independent disks**, refers to a data storage scheme using multiple hard drives to share or replicate data among the drives. Depending on the configuration of the RAID, the benefit of RAID is one or more of increased data integrity, fault-tolerance, throughput or capacity compared to single drives.

Mirroring is also a form of RAID. Mirroring consists of at least 2 disk drives that duplicate the storage of data. As such, if 1 disk drive fails in the first array, the system fails over to the second array of functional drives so the system can continue to operate. Mirroring generally is faster for reads and can be slightly faster for writes.

c. **ERP vs CRM**

ERP

ERP is an abbreviation for enterprise resource planning. ERP software is used to manage the business. It integrates all facets of an operation, including product planning, development, manufacturing processes, human resources, financials and sales and marketing.

Today's ERP solutions are designed to help organizations improve the operational efficiency of business resources. Businesses use ERP systems to integrate all its business processes into a single system to efficiently and effectively manage business goals.

CRM

CRM is an abbreviation for customer relationship management and usually covers all aspects of interaction that a company has with its customer, whether it is sales or service-related. It's a business strategy that helps organization to better understand its customer, retain customers, provide excellent customer service, win new clients and increase profitably.

CRM software collect, manage and link information about the customer. CRM software can be used to create marketing campaigns, view a customer's entire of history of interactions with the business and use it to streamline daily business and sales tasks.

Differences Between ERP and CRM

CRM Software is used to manage front-office activities like:

Organize marketing efforts, manage the sales pipeline, calculate time spent on converting leads to closing deals, streamline sales processes, automates customer service, track customer's interactions with business, create data reports, learn which products sell best and when, prioritize leads, manage inventory based on historical sales data, collaborate to sell as a team, manage business contacts, manage business leads, share customer profiles with co-workers and see where leads come from.

ERP Software is used to manage back-office activities and tasks like:

Distribution process management, supply chain management, services knowledge base, configure, prices, improve accuracy of financial data, facilitate better project planning, automate employee life-cycle, standardize critical business procedures, reduce redundant tasks, assess business needs, accounting and financial applications, lower purchasing costs, manage human resources and payroll.

d. **Risk Identification vs Risk Assessment**

Risk Identification
Risk identification is the act of identifying negative and positive risks that impact an objective.

Risk Assessment
After a risk has been identified, it needs to be assessed both qualitatively and quantitatively. Risk assessment is gauging the consequence of the risk - the probability and impact of the risk is taken into account.

Difference
The key difference is that risk identification takes place before risk assessment. This is logical because to assess anything, first it needs to be identified. Risk Identification tells what the risk is, while risk assessment tells how the risk will affect the business objective.

e. **Executive Information System vs. Traditional Information System**

Executive Information Systems differs from Traditional Information Systems in many ways. The following table presents the difference on various related dimensions:

Area	Executive Information System	Traditional Information System
Level of management	For top or near top executives	For lower staff
Nature of Information Access	Specific issues/problems and aggregate reports	Status reporting
Nature of information provided	Online tools and analysis	Offline status reporting
Information Sources	More external, less internal	Internal
Drill down facility to go through details at successive levels	Available	Not available
Information format	Text with graphics	Tabular
Nature of interface	User-friendly	Computer-operator generated

8. **Bring out the reasons as to why the organizations fail to achieve their Systems Development Objectives?**

Following are the major reasons due to which organizations fail to achieve their system development objectives:

(i) User Related Issues:

It refers to those issues where user/customer is the primary reason. Some of the aspects with regard to this problem are mentioned as follows:

Shifting User Needs: User requirements for IT are constantly changing. As these changes accelerate, there will be more requests for Information systems development and more development projects. When these changes occur during a development process, the development team faces the challenge of developing systems whose very purpose might change after the development process began.

Resistance to Change: People have a natural tendency to resist change, and information systems development projects signal changes - often radical - in the workplace. When personnel perceive that the project will result in personnel cutbacks, threatened personnel will dig in their heels, and the development project is doomed to failure.

Lack of User Participation: Often users do not participate in the development stage because they are preoccupied with their existing work, or do not understand the benefits of the new system. User apathy 'I have nothing to gain if I participate' is also a reason.

Inadequate Testing and User Training: Often systems are not tested due to lack of time and rush to introduce the new system or because problems were not envisaged at the development stage. Inadequate user training may be a result of poor project planning, or lack of training techniques, or because user management does not release personnel for training due to operational pressure.

(ii) Developer Related Issues:

It refers to the issues and challenges with regard to developers. Some of the critical bottlenecks are mentioned as follows:

Lack of Standard Project Management and System Development Methodologies: Many organizations do not formalize their project management and system development methodologies, thereby making it very difficult to consistently complete projects on time or within budget.

Overworked or Under-Trained Development Staff: In many cases, system developers lack sufficient educational background and requisite state of the art skills.

(iii) Management Related Issues:

It refers to the bottlenecks with regard to organizational set up, administrative and overall management to accomplish the system development goals. Some of such bottlenecks are mentioned as follows:

Lack of Senior Management Support and Involvement: Developers and users of information systems watch senior management to determine 'which systems development projects are important' and act accordingly by shifting their efforts away from any project, which is not receiving

management attention. In addition, management may not allocate adequate resources, as well as budgetary control over use of resources, assigned to the project.

Development of Strategic Systems: Because strategic decision making is unstructured, the requirements, specifications, and objectives for such development projects are difficult to define.

(iv) New Technologies:

When an organization tries to create a competitive advantage by applying advance technologies, it generally finds that attaining system development objectives is more difficult because personnel are not as familiar with the technology.

In order to overcome these aforementioned issues, organizations must execute a well-planned systems development process efficiently and effectively. Accordingly, a sound system development team is inevitable for project success.

9. **What do you understand by ERP? Explain any three major components of ERP.**

Enterprise Resource Planning (ERP) systems are core software programs used by companies to integrate and coordinate information in every area of the business. ERP programs help organizations manage company-wide business processes, using a common database and shared management reporting tools.

ERP software supports the efficient operation of business processes by integrating tasks related to sales, marketing, manufacturing, logistics, accounting, and staffing—throughout a business. In addition to this cross-functional integration, which is at the heart of an ERP system, companies connect their ERP systems, using various methods, to coordinate business processes with their customers and suppliers.

Three major components or ERP

Financial Management: At the core of ERP are the financial modules, including general ledger, accounts receivable, accounts payable, billing and fixed asset management. Financial management modules include budgets, cash-flow, expense and tax reporting.

Supply Chain Management: Supply Chain Management (SCM) improves the flow of materials through an organization by managing planning, scheduling, procurement, and fulfillment, to maximize customer satisfaction and profitability. Sub modules in SCM include production scheduling, demand management, distribution management, inventory management, warehouse management, procurement and order management.

Human Resource Management Human resource management ERP modules enhance the employee experience – from initial recruitment to retirement. Sub modules can include payroll, performance management, time tracking, benefits, compensation and workforce planning. Self-service tools that allow managers and employees to enter time and attendance, choose benefits and manage PTO are available in many ERP solutions.

10. **What do you understand by the term Information System? Discuss some of the advantages of Information Systems in business.**

An information system (IS) can be defined as a set of interrelated components that collect (or retrieve), process, store, and distribute information to support decision making, coordinating, and control in an organization. In addition, information systems may also help managers and workers analyze problems, visualize complex subjects, and create new products. Information systems contain information about significant people, places, and things within the organization or in the environment surrounding it.

Following are some of the important advantages of Information Systems in business:

- Information Systems help managers in efficient decision-making to achieve organizational goals.
- An organization will be able to survive and thrive in a highly competitive environment on the strength of a well-designed Information system.
- Information Systems help in making right decision at the right time.
- A good Information System may help in generating innovative ideas for solving critical problems.
- Knowledge gathered though Information Systems may be utilized by managers in unusual situations.
- Information System is viewed as a process; it can be integrated to formulate a strategy of action or operation.

11. **An owner of a small local store is currently using manual system for her day to day business activities viz. purchase, sales, billing, payments receipts etc. In the last few years, turnover of the store is increased manifold and now it has become increasingly difficult to handle all these activities manually. You being an IT expert and her auditor, are requested to suggest which operation support system will be most suitable for her. Also advise her what activities can be performed by the proposed system and what are major limitation of it.**

In the given scenario, I would suggest the owner of the local store to go for Transaction Processing System (TPS), which will be the most suitable option for her. Because TPS at the lowest level of management is an information system that manipulates data from business transactions efficiently and if properly computerized, TPS provides speed and accuracy too.

Various day-to-day business activities such as sales, purchase, production, billing, payments or receipts involves transactions and these transactions are to be organized and manipulated to generate various information products for external use.

Following are the major activities, which can be performed by the proposed TPS:

- Capturing data to organize in files or databases;
- Processing of files / databases using application software;
- Generating information in the form of reports;
- Processing of queries from various quarters of the organization.

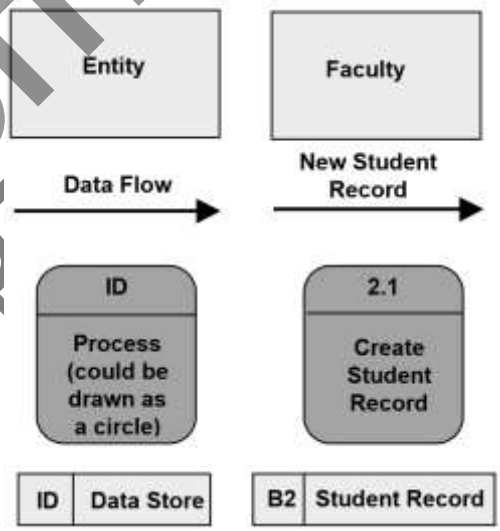
A TPS May follow periodic data preparation and batch processing (as in payroll application) or on-line processing (as in inventory control application). In industries and business houses, now-a-days, on-line approach is preferred as it provides information with up-to-date status. However, the people involved in TPS, usually are not in a position to take any management decision. This is the major limitation of it.

12. **What are DFDs and their major components. What are the advantage and disadvantages of DFDs?**

Data flow diagrams (DFDs) reveal relationships among and between the various components in a program or system. DFDs are an important technique for modeling a system's high-level detail by showing how input data is transformed to output results through a sequence of functional transformations. DFDs consist of four major components: entities, processes, data stores, and data flows. The symbols used to depict how these components interact in a system are simple and easy to understand

DFDs help system designers and others during initial analysis stages visualize a current system or one that may be necessary to meet new requirements. Systems analysts prefer working with DFDs, particularly when they require a clear understanding of the boundary between existing systems and postulated systems.

DFDs consist of four basic components that illustrate how data flows in a system: entity, process, data



store, and data flow.

Entity: An entity is the source or destination of data. The source in a DFD represents these entities that are outside the context of the system. Entities either provide data to the system (referred to as a source) or receive data from it (referred to as a sink). Entities are often represented as rectangles (a diagonal line across the right-hand corner means that this entity is represented somewhere else in the DFD).

Process: The process is the manipulation or work that transforms data, performing computations, making decisions (logic flow), or directing data flows based on business rules. In other words, a

process receives input and generates some output. Process names (simple verbs and dataflow names, such as “Submit Payment” or “Get Invoice”) usually describe the transformation, which can be performed by people or machines. Processes can be drawn as circles or a segmented rectangle on a DFD, and include a process name and process number.

Data Store: A data store is where a process stores data between processes for later retrieval by that same process or another one. Files and tables are considered data stores. Data store names are simple but meaningful, such as “customers,” “orders,” and “products.” Data stores are usually drawn as a rectangle with the right- hand side missing and labeled by the name of the data storage area it represents, though different notations do exist.

Data Flow: Data flow is the movement of data between the entity, the process, and the data store. Data flow portrays the interface between the components of the DFD. The flow of data in a DFD is named to reflect the nature of the data used. Data flow is represented by an arrow, where the arrow is annotated with the data name.

Advantages of DFD

The DFD method is an element of object- oriented analysis and is widely used. Use of DFDs promotes quick and relatively easy project code development. DFDs are easy to learn with their few- and- simple-to-understand symbols. DFDs are simple, employing English nouns or noun- adjective- verb constructs.

Disadvantages

DFDs for large systems can become cumbersome, difficult to translate and read, and be time consuming in their construction. Data flow can become confusing to programmers without the prerequisite detail. And different DFD models employ different symbols

13. **Why systems under development should be audited and what are the auditors concerns during the system development?**

Often auditors are not involved in development or deployment of systems and are only called upon when systems are already in operation. With the advancement of technology and dependence on IT systems (which are the lifeline of enterprises today), it is important that auditors are involved in system development and deployment in order to ensure that IT controls, security, and other important system features are included in the new or upgraded systems. The role of the auditor is not to get involved in the design and implementation of the systems but to ensure that the required controls, security, and user specifications are incorporated in the systems being deployed and that the systems are properly tested.

The audit of systems under development can have three main objectives. It is primarily aimed to provide an opinion on the efficiency, effectiveness, and economy of project management. An auditor’s role is to assess the extent to which the system being developed provides for adequate audit trails and controls to ensure the integrity of data processed and stored; and the effectiveness of controls being enacted for the management of the system's operation.

In order to achieve these goals, an auditor has to attend project and steering committee meetings and examine project control documentation and conducting interviews. This is to ensure what project

control standards are to be complied with, (such as a formal systems development process) and determining the extent to which compliance is being achieved. For addressing the second objective, the auditor can examine system documentation such as functional specifications to arrive at an opinion on controls. The auditor's opinion will be based on the degree to which the system satisfies the general control objectives that any information system should meet.

Moreover, in order to audit technical work products (such as database design or physical design), auditor may opt to include a technical expert to seek his/her opinion on the technical aspects of SDLC. However, auditor will have to give control objectives, directives and in general, validate the opinion expressed by technical experts.

Some of the control considerations for an auditor include the following:

- Documented policy and procedures;
- Established project team with all infrastructure and facilities;
- Developers/ IT managers are trained on the procedures;
- Appropriate approvals are being taken at identified mile-stones;
- Development is carried over as per standards, functional specifications;
- Separate test environment for development/ test/ production / test plans;
- Design norms and naming conventions are as per standards and are adhered to;
- Business owners testing and approval before system going live;
- Version control on programs;
- Source Code is properly secured;
- Adequate audit trails are provided in system; and
- Appropriateness of methodologies selected.

Further, Post-Implementation Review is performed to determine whether the system adequately meets earlier identified business requirements and needs (in feasibility studies or requirements specifications). Auditors should be able to determine if the expected benefits of the new system are realized and whether users are satisfied with the new system. In post implementation review, auditors need to review which of the SDLC phases have not met desired objectives and whether any corrective actions were taken. If there are differences between expectations and actual results, auditors need to determine the reasons for the same. Such discrepancies may be due to incomplete user requirements or any other shortcoming. Such reasons can help auditors to evaluate the current situation and offer guidelines for future projects.

14. **What is object oriented programming and what are the benefits of object oriented programming?**

Object-oriented programming (OOP) is a programming language model organized around objects rather than "actions" and data rather than logic. It is a type of computer programming (software design) in which programmers define not only the data type of a data structure, but also the types of operations (functions) that can be applied to the data structure.

In this way, the data structure becomes an object that includes both data and functions. In addition, programmers can create relationships between one object and another. For example, objects can inherit characteristics from other objects.

Some of the advantages of object-oriented programming include:

1. **Improved software - development productivity**: Object-oriented programming is modular, as it provides separation of duties in object-based program development. It is also extensible, as objects can be extended to include new attributes and behaviors. Objects can also be reused within and across applications. Because of modularity, extensibility, and reusability, object-oriented programming provides improved software development productivity over traditional procedure-based programming techniques.

2. **Improved software maintainability**: For the reasons mentioned above, object - oriented software is also easier to maintain. Since the design is modular, part of the system can be updated in case of issues without a need to make large - scale changes.

3. **Faster development**: Reuse enables faster development. Object-oriented programming languages come with rich libraries of objects, and code developed during projects is also reusable in future projects.

4. **Lower cost of development**: The reuse of software also lowers the cost of development. Typically, more effort is put in to the object-oriented analysis and design, which lowers the overall cost of development.

5. **Higher quality software**: Faster development of software and lower cost of development allows more time and resources to be used in the verification of the software. Although quality is dependent upon the experience of the teams, object-oriented programming tends to result in higher quality software.

15. **What is Input Design? What are the general principles for input design?**

Input facilities the entry of data into the computer system. Input design involves the selection of the best strategy for getting data into the computer system at the right time and as accurately as possible.

The use of well-defined documents can encourage users to record data accurately without omission. Input design must capture all the data that the system needs, without introducing any errors. Input errors can be greatly reduced when inputting directly by using appropriate forms for data capture and well-designed computer screen layout.

Because inputs originate with system users, human factors play a significant role in input design. Inputs should be as simple as possible and be designed to reduce the possibility of incorrect data being entered. The needs of system users must be considered. With this in mind, several human factors should be evaluated.

The volume of data to be input should be minimized. The more data that is input, the greater the potential number of input errors and the longer it takes to input that data. Thus, numerous considerations should be given to the data that is captured for input. The following general principles should be followed for input design:

- Capture only variable data. Do not enter constant data.
- Do not capture data that can be calculated or stored in computer programs.
- Use codes for appropriate attributes. Codes can he translated in computer programs by using tables.

If source documents are used to capture data, they should be easy for system users to complete and subsequently enter into the system.

- Include instructions for completing the form
- Minimize the amount of handwriting
- Data to be entered should be sequential so that it can be read like the book, top to bottom and left to right.
- When possible, use designs based on known metaphors (for example real life documents like printed invoices and cheques)

16. **What do you understand by prototyping? What are the disadvantages of prototyping?**

A prototype is a usable system or system component that is built quickly and at a lesser cost, and with the intention of modifying/replicating/expanding or even replacing it by a full-scale and fully operational system. The goal of prototyping approach is to develop a small or pilot version called a prototype of part or all of a system. As users work with the prototype, they learn about the system criticalities and make suggestions about the ways to manage it. These suggestions are then incorporated to improve the prototype, which is also used and evaluated. Finally, when a prototype is developed that satisfies all user requirements, either it is refined and turned into the final system or it is scrapped. If it is scrapped, the knowledge gained from building the prototype is used to develop the real system.

The generic phases of prototyping are as follows:

Identify Information System Requirements: In traditional approach, the system requirements are to be identified before the development process starts. However, under prototype approach, the design team needs only fundamental system requirements to build the initial prototype, the process of determining them can be less formal and time consuming than when performing traditional systems analysis.

Develop the Initial Prototype: The designers create an initial base model and give little or no consideration to internal controls, but instead emphasize system characteristics such as simplicity, flexibility, and ease of use. These characteristics enable users to interact with tentative versions of data entry display screens, menus, input prompts, and source documents. The users also need to be

able to respond to system prompts, make inquiries of the information system, judge response times of the system, and issue commands.

Test and Revise: After finishing the initial prototype, the designers first demonstrate the model to users and then give it to them to experiment and ask users to record their likes and dislikes about the system and recommend changes. Using this feedback, the design team modifies the prototype as necessary and then resubmits the revised model to system users for reevaluation. Thus iterative process of modification and reevaluation continues until the users are satisfied.

Obtain User Signoff of the Approved Prototype: Users formally approve the final version of the prototype, which commits them to the current design and establishes a contractual obligation about what the system will, and will not, do or provide.

Weaknesses

Some of the weaknesses of the prototyping approach are as follows:

- Approval process and control are not strict.
- Incomplete or inadequate problem analysis may occur whereby only the most obvious and superficial needs will be addressed, resulting in current inefficient practices being easily built into the new system.
- Requirements may frequently change significantly.
- Identification of non-functional elements is difficult to document.
- Designers may prototype too quickly, without sufficient upfront user needs analysis, resulting in an inflexible design with narrow focus that limits future system potential.
- Prototype may not have sufficient checks and balances incorporated.
- Prototyping can only be successful if the system users are willing to devote significant time in experimenting with the prototype and provide the system developers with change suggestions. The users may not be able or willing to spend the amount of time required under the prototyping approach.
- The interactive process of prototyping causes the prototype to be experimented with quite extensively. Because of this, the system developers are frequently tempted to minimize the testing and documentation process of the ultimately approved information system. Inadequate testing can make the approved system error-prone, and inadequate documentation makes this system difficult to maintain.
- Prototyping may cause behavioral problems with system users. These problems include dissatisfaction by users if system developers are unable to meet all user demands for improvements as well as dissatisfaction and impatience by users when they have to go through too many interactions of the prototype.

17. **Describe the importance of e-commerce and describe any three types of e-commerce.**

E-commerce refers to the use of the Internet and the Web to transact business. It refers to carrying out digitally enabled commercial transactions between and among organizations and individuals.

Because of the following reasons, e-commerce has become very important to business:

1) **E-Commerce Influences Purchase Decisions**

When customers are deciding on a purchase, they start by looking online.

Many organization's website has become their showroom, where customers can research the product or services and see all the reasons it is right for them.

A well-designed e-Commerce site can influence purchase decisions by showcasing organization's product at its best, and making it as easy as pie to take action and make a purchase.

2) E-Commerce Taps into Social Media

It's a social world out there, with customers turning to social media such as Facebook and Twitter to research potential purchases.

For a smart business, an engaging social media presence can raise their company profile and encourage traffic and sales. Offers, competitions and other shareable content can be used to grab attention and encourage visits to your e-Commerce store.

3) E-Commerce Is Convenient

It is convenient for customers to shop online from their home instead of travelling and visiting multiple stores.

Through e-Commerce an organization can fit into its customer's busy lives, offering the products they want, when they want them.

4) E-Commerce Can Broaden the Brand

E-Commerce can be used in ways a traditional shop couldn't, whether that is by offering intangible products, providing some kind of web search, or giving customers the ability to order a product to their exact specifications.

E-Commerce can be used to broaden the range of products for sale, bringing the organization more custom and diversifying sales.

5) E-Commerce Offers a Personalized Experience

There are many ways in which e-Commerce can be used to forge a more personal connection with customers.

For example, an e-Commerce site could include personal recommendations, order tracking, quick customer service, or personalized rewards, allowing a business to offer the same kind of personal service online that it would offer face to face.

Thus, e-Commerce offers businesses a vital opportunity to offer customers round-the-clock convenience, global presence and increased revenue.

The three major electronic commerce categories are:

1. business-to-consumer (B2C) e-commerce

2. business-to-business (B2B) e-commerce, and
3. consumer-to-consumer (C2C) e-commerce.

Business-to-consumer (B2C) electronic commerce involves retailing products and services to individual shoppers.

Business-to-business (B2B) electronic commerce involves sales of goods and services among businesses.

Consumer-to-consumer (C2C) electronic commerce involves consumers selling directly to consumers.

18. **What is IT Risk and how the IT Risk can be treated?**

Information technology risk, or IT risk is any risk related to information technology. While information has long been appreciated as a valuable and important asset, the rise of the knowledge economy has led to organizations becoming increasingly dependent on information, information processing and especially IT. Various events or incidents that compromise IT in some way can therefore cause adverse impacts on the organization's business processes or mission, ranging from inconsequential to catastrophic in scale.

Depending on the type and nature of the risk, the following options are available:

Avoid - deciding not to proceed with the activity that introduced the unacceptable risk, choosing an alternative more acceptable activity that meets business objectives, or choosing an alternative less risky approach or process.

Reduce - implementing a strategy that is designed to reduce the likelihood or consequence of the risk to an acceptable level, where elimination is considered to be excessive in terms of time or expense.

Share or Transfer - implementing a strategy that shares or transfers the risk to another party or parties, such as outsourcing the management of physical assets, developing contracts with service providers or insuring against the risk. The third-party accepting the risk should be aware of and agree to accept this obligation.

Accept - making an informed decision that the risk rating is at an acceptable level or that the cost of the treatment outweighs the benefit. This option may also be relevant in situations where a residual risk remains after other treatment options have been put in place. No further action is taken to treat the risk, however, ongoing monitoring is recommended.

19. **How software are vulnerable and how they can be managed in a business organization?**

Vulnerabilities are “weakness or exposures in IT assets, software or processes that may lead to a business risk or security risk”.

Software errors pose a constant threat to information systems, causing untold losses in productivity, and sometimes endangering people who use or depend on systems. Growing complexity and size of software programs, coupled with demands for timely delivery to markets, have contributed to an increase in software flaws or vulnerabilities.

A major problem with software is the presence of hidden bugs or program code defects. Studies have shown that it is virtually impossible to eliminate all bugs from large programs. The main source of bugs is the complexity of decision-making code. A relatively small program of several hundred lines will contain tens of decisions leading to hundreds or even thousands of different paths. Important programs within most corporations are usually much larger, containing tens of thousands or even millions of lines of code, each with many times the choices and paths of the smaller programs.

Zero defects cannot be achieved in larger programs. Complete testing simply is not possible. Fully testing programs that contain thousands of choices and millions of paths would require thousands of years. Even with rigorous testing, we cannot know for sure that a piece of software was dependable until the product proved itself after much operational use. Flaws in commercial software not only impede performance but also create security vulnerabilities that open networks to intruders.

A vulnerability management process is needed to combat the risk. This includes the identification, evaluation, and remediation of vulnerabilities. Prerequisites for responding to vulnerabilities includes asset management processes to determine the software installed on organization hardware and change management processes to manage the testing of patches. Patches should be reviewed and tested before implementation to verify that the system continues to work as intended and that no new vulnerabilities are introduced.

To correct software flaws once they are identified, the software vendor should create patches to repair the flaws without disturbing the proper operation of the software. This process is called patch management.

20. **What is Business Continuity Planning and what are its objectives?**

Business Continuity Planning (BCP) is the creation and validation of a practical logistical plan for how an enterprise will recover and restore partially or completely interrupted critical functions within a predetermined time after a disaster or extended disruption. The logistical plan is called a business continuity plan.

Planning is an activity to be performed before the disaster occurs otherwise it would be too late to plan an effective response. The resulting outage from such a disaster can have serious effects on the viability of an organization's operations, profitability, quality of service, and convenience.

The primary objective of a Business Continuity Plan is to minimize loss by minimizing the cost associated with disruptions and enable an organization to survive a disaster and to reestablish normal business operations. In order to survive, the organization must assure that critical operations can resume normal processing within a reasonable time frame.

The key objectives of the contingency plan should be to:

1. Provide the safety and well-being of people on the premises at the time of disaster;
2. Identify critical lines of business and supporting functions.
3. Continue critical business operations;
4. Minimize the duration of a serious disruption to operations and resources
5. Minimize immediate damage and losses;
6. Facilitate effective co-ordination of recovery tasks;
7. Reduce the complexity of the recovery effort;

REVISION TEST PAPER
DECEMBER 2016

ADVANCE TAXATION

Question No. 1

Management of Kumar & Co. has provided the following income and expenses details and additional information for the FY 2073/74.

Particulars	**Amount (Rs)**
Sales	25,000,000
Misc. Income	5,000
Dividend Income	2,500,000
Opening stock	1,500,000
Raw material import	11,000,000
Freight	900,000
Custom duty	1,500,000
Repair & Maintenance (Block C)	700,000
Closing Stock	1,600,000
Interest paid to Financial Institution	300,000
Govt. Penalties	200,000
Repair expenses of hired vehicle (all revenue nature)	50,000
Vehicle rent	600000
Donation	200,000
Depreciation	258,000
Other expenses	2,000,000

Details of depreciable assets

Vehicles (Cars)	
Gross cost	7,000,000
Accumulated depreciation at the end of last FY	6,000,000
Addition (7th Poush 2073)	500,000

Other information

- Opening & closing stock each overstated by Rs 300,000.
- Custom Duty includes Rs 200,000 related to the import in F.Y 2072/73 for which custom clearance was done on deposit basis by paying Rs 150,000. Now the duty amount is finalized at Rs 200,000, the firm paid rest Rs 50,000 and settled.
- Vehicle rent is paid without deducting withholding tax to VAT registered vendor of hired vehicle.
- 60% of freight is paid through Account Payee Demand Draft and rest is deposited in account of transporters on last week of year end.
- As per Amendment Assessment Order of IRO for F.Y 2072/73, the opening WDV is Rs 500,000. No any legal measure has been taken within prescribed time.
- Other expenses include personal nature expenses of telephone Rs 100,000, Personal travelling cost included in other expenses Rs 500,000.
- Profit on sale of One Vehicle is Rs 80,000 (WDV 20,000, sales proceeds 100,000), which has not been shown above.

- Dividend income is received after deducting dividend tax from resident Joint-Venture firm.

Required:

a) Compute the tax liability of the business income of Kumar & Co. a partnership firm of three partners for the FY 2073/74, if it is operating a special industry at Kathmandu.
b) What shall be the amount of Income Tax, if it is operating Liquor industry?
c) Calculate the dividend tax, if they distributed dividend of Rs 2,000,000 after dividend tax.

(Answer should include the related provisions of Income Tax Act & Rules)

Question No. 2

If Mr. Nayak Shakya who is going to retire from 31st Ashad 2073, submits the following details with respect to his employment for the Income Year 2073/74.

a) Net Salary received Rs. 4,77,000
TDS Paid Rs. 17,000
b) Contribution by employer to retirement fund (approved) Rs. 1,00,000
c) His Contribution to approved retirement fund Rs. 1,50,000
d) Compensation received as per Employee Rule Rs. 70,000
e) Encashment of un-availed leave upto Chaitra 18, 2058 Rs. 50,000.
f) Emergency Medical Treatment paid by Employer Rs. 10,000. But he didn't claim Medical Tax Credit.
g) Reimbursement of Tour Expenses during Official visit to Hong Kong Rs. 2,40,000.
h) Gratuity Received (lump sum payment) Upto 18 Chaitra, 2058 Rs. 4,00,000
i) Provident Fund Received
Upto Chaitra 18, 2058 (Lump sum Payment) Rs. 4,00,000 (unapproved)
After Chaitra 18, 2058 Rs. 6,00,000 (approved)

Mr. Nayak also conducts a small trading business M/S Nayak Concerns of his own. Information relating to which are as follows:

Particulars	Rs.	Particulars	Rs.
To Opening Stock	80,000	By Sales	5,00,000
To Purchase	3,90,000	By Closing Stock	1,20,000
To Gross Profit	1,50,000		
Total	**6,20,000**	**Total**	**6,20,000**
To Personal Drawings	60,000	By Gross Profit	1,50,000
To Office Expenses	18,000	By Office Furniture Sales	35,000
To Printer Purchased	7,000	By Bad Debt Recovered	1,00,000
To Net Profit	2,50,000	By Dividend	50,000

The couple has opted to be assessed separately for Income Tax Purpose.

Additional Information:

a) Mr. Nayak Concern has the following WDV of Fixed Assets as on 01.04.2072.

Furniture	Rs. 100,000
Computer	Rs. 45,000
Car	Rs. 80,000

One Spare Table is sold on Rs. 35,000

b) Above Office Expenses includes Rs. 2,000 for the purpose of rice cooker gifted to a customer on his wedding party.

c) Printer was purchased on 15th Poush, 2072.

d) Bad debt Recovered Rs. 100,000 was not allowed as expenses in F/Y 2072/73.

e) Dividend Rs. 50,000 is from NIC Bank Ltd.

He also provides following further information not related to his employment, and business.

a) Donation to a political Party Rs. 50,000.

b) Interest of Rs. 20,000 from personal deposit account of Natural Bank Ltd.

(Note: Assume retirement payments were received after deducting withholding tax)

Required

i) Assessable Income from Employment
ii) Assessable Income from Business
iii) Total Assessable Income
iv) Tax Liability

Question No. 3

Discuss whether the source of income lies in Nepal and rate of withholding tax to be deducted for the following transactions:

a) Ms. Shrijana living in UK has let out her house at Butwal to Mr. John Brown for US $ 5,000 per month payable at UK.
b) A Barrister of Law from UK visits Nepal and appears for a case and she is paid fees in Norway for such services.
c) Subusu Cable Industries Pvt. Ltd. has paid Indian Rupees 20,00,000 as an interest to Indian Bank for the loan taken for business purposes.
d) ABC Cafe Nepal Pvt. Ltd paid Rs 1,000,000 royalty to ABC Cafe India Pvt. Ltd for using brand name "Good Pizza" at its Pizza store.
e) Reinsurance premium paid by a domestic insurance company to the insurance company of USA for coverage of risk of Upper Khimti Hydropower at Nepal.

Question No. 4

Answer the following in the light of Income Tax Act, 2058.

a) Mr. Ram Kumar has opened a bank account with rural based Grameen Bikas Bank in Parbat with a deposit of Rs. 200,000 with interest at the rate of 8 percent per annum. During the year, the bank has to pay Mr. Ram Kumar Rs.16,000 as Bank Interest. The bank seeks for your advice regarding the applicability of tax liability.
If for same deposit of Rs. 200,000 with the interest rate of 15% p.a., the bank has to pay Rs. 30,000 for that year, then will your answer differ?

b) As we know, as per section 11kha of Income Tax Act, 2058 there are certain sectors of investment for which income source of investment shall not be asked. In this relevance, the following investments shall not be asked for income source. Is it true?
   i) Investment in the shares of a construction company which got tender of construction of hydropower project and completed it.
   ii) Investment in the share of a hydropower of national interest
   iii) Investment in the shares of a cement industry employing 300 domestic labour and consuming 50% local raw material.
   iv) Investment in the shares of a chewing tobacco industry employing 1000 domestic labour and consuming 75% local raw materials.
   v) Investment in the shares of a trading company employing 900 domestic labour and selling 90% local product.

<u>Question No. 5</u>
Answer the following in the light of Income Tax Act, 2058.

a) Calculate the amount of TDS to be deducted by a payer of the following payments as per the provisions of the Income Tax Act, 2058. Also state whether the payments are final withholding payments or not?
   i) M/S Lama Construction Pvt. Ltd. has received an invoice for Rs. 3,39,000 including VAT from M/S Jurist Company Pvt. Ltd. for legal advisory services rendered during fiscal year 2072/73.
   ii) Amount paid by an approved retirement fund Rs. 15,00,000. The accumulated principal and the interest thereon as on Chaitra 19, 2058 for the same amount was Rs. 4,00,000
   iii) Amount paid by an unapproved retirement fund Rs. 15,00,000. The accumulated principal and the interest thereon as on Chaitra 19, 2058 for the same amount was Rs. 4,00,000.
   Total amount deposited by the account holder after Chaitra 19, 2058 to the retirement fund Rs. 9,00,000.
   iv) Binod paid Rs. 50,000 as interest to Green Bank Ltd., Kathmandu for loan taken by him. Binod has taken the loan in his proprietorship firm.
   v) A college is paying Rs. 20,000 to Mr. Ramesh for setting various question papers. Mr. Ramesh is an employee of the college and getting regular remuneration.

b) A & Co. Pvt. Ltd. received Rs. 1 Million as dividend after withholding of tax from B & Co. Pvt. Ltd., resident entity. The Profit of A & Co. Pvt. Ltd. before including the dividend is Rs. 9 Million. The company decided to declare dividend to its shareholders during the current F/Y 2073/74 amounting to Rs. 10 Million (Rs. 1 Million from dividend received from B & Co. Pvt. Ltd. and Rs 9 Million from its own earning). Mr. Bibek is one of the shareholder of A & Co. Pvt. Ltd. and supposed to receive Rs. 5 Lakhs (gross) as dividend. Calculate the tax to be withheld from Mr. Bibek at the time of dividend payment quoting the relevant provisions of the Act.

c) More than fifty percent of the ownership of M/s Neptune International Pvt. Ltd. is transferred in comparison to the ownership three years previously. The date of such transfer of ownership was

2068.11.10. The company has not sought for extension of time limit for filing the return of income. The company seeks your advice on the due date of filing of tax returns in the referred case.

In Tax Department's point of view, what would be the due date for Amended Assessment in such case?

d) Mr. Ram & Mr. Shyam jointly owned a house property costing Rs. 5,00,00,000. At the time of acquisition of the said house property, Mr. Ram had invested Rs. 1 crore and rest of the amount invested by Mr. Shyam. This house property has been sold out for Rs. 6,40,00,000, and incurred Rs. 7,00,000 on account of brokerage commission plus other incidental charges.
You are required to appropriate between Mr. Ram & Mr. Shyam- as per sec 30 of Income Tax Act 2058- for the net income that originated from the jointly owned investment.

Question No. 6

Explain the following terms as per section 2 of Income Tax Act, 2058.

a) Foreign Permanent Establishment
b) Non Business Chargeable Assets
c) Underlying Ownership

Question No. 7

Answer the following in the light of Income Tax Act, 2058.

a) An international chain hotel desires to establish a hotel in Kathmandu with investment of 300 Crore. Is there any special tax rebate/exemption for such industry?
b) Jhumi Distillery Pvt. Ltd. has income tax due since long. The management of the company was looking for the settlement from Tax Settlement Commission (TSC). But, TSC deny accepting their application since there is case of false VAT bills too.
Now, the management decided to pay the due tax but they don't have adequate money to pay at a time. Hence they seek your advice. Is there any process of paying due tax in installment?
c) What is the rate of withholding tax for the following payments by resident person?
   i) For the use of bandwidth.
   ii) Return on investment to a company by mutual fund.
   iii) Service charge to a hydropower development company not registered in VAT.
   iv) Vehicle rent to VAT registered hired vehicle vendor.
   v) Gain on sale of not listed share at SEBON to a resident natural person.

Question No. 8

Answer the following in the light of Income Tax Act, 2058.

a) PQR Builder Pvt. Ltd, is a housing Company. It has following assets to be sold in 2073.04.25.

Particulars	Cost	Cost	Total of Cost	Selling Price (Proposed)

Corporate Office Building	10,000,000.00	-	10,000,000.00	12,500,000.00
Land (Trading Stock)		50,000,000.00	50,000,000.00	75,000,000.00
Land for Corporate Building	5,000,000.00		5,000,000.00	10,000,000.00
Buildings (Trading)		100,000,000.00	100,000,000.00	120,000,000.00
Total	**15,000,000.00**	**150,000,000.00**	**165,000,000.00**	**217,500,000.00**

Calculate the Capital gain tax to be paid if the above assets sold on proposed price. Ignore the depreciation for calculation of gain.

b) What are the pools of Depreciable assets as per Income Tax Act 2058?

c) What are the values of perquisites for the following facilities provided by the employer to the employee?
   i) For Residence Facility:

- Providing House Rent Allowance
- Providing House for residence

   ii) For Vehicle Facility:

d) What are the conditions to be satisfied to allow the health insurance premium paid by natural person for deduction while calculating taxable income of the person? And what is the limit?

e) Lama Koshi Hydropower Development Company limited located at Sindhupalchock has suffered a hung damage on its civil structure due to earthquake in 2072. The WDV of the civil structure (pool) on Ashad end 2073 is Rs 10 crore. However the repair and maintenance expense is Rs 2 crore in F/Y 2072/73. The company desires to claim all the repair and maintenance expenses in FY 2072/73 as expenses. Is it advisable?

<u>Question No. 9</u>

Answer the following in the light of Income Tax Act 2058

a) PQR Pvt. Ltd has Adjusted Taxable Income of Rs 300 lakhs. It has donated the following amount:
   i) Rs 3 lakh to ABC charitable trust, a Tax Exempted Entity.
   ii) Rs 100 lakh to Prime Minister Relief Fund.

   Is above donation of Rs 103 lakh allowable for deduction as donation as per Income Tax Act?

b) Smart Cell P. Ltd is a company running telecom services in the Nepal. It has financial position as on fiscal year end of 2072/73 as following:

Capital and liabilities	**Amounts**	**Assets**	**Amount**
Capital (100,000 shares @ 100 each)	10,000,000	Bank balance	50,000,000
Reserve	40,000,000		

Total	**50,000,000**	**Total**	**50,000,000**

One of the shareholders of the company holding 25% of the share sold his entire share on above year end date at Rs 5,000,000 and got his share transferred by paying Rs 250,000 Capital Gain Tax. Now, the Inland Revenue Office disagree with the transfer price of the share and issue the notice to furnish the real sale price of the transferred share and pay the required Capital Gain Tax.
Discuss the matter in the light of Income Tax Act 2058.
(Assume the business of the company shall be prosperous)

c) What are the provisions of tax on turnover for following person?
   i) Person running business of the gas cylinder dealer
   ii) person running service industry

Question No. 10

Answer the following in the light of ethics and professional conduct in providing taxation services.

a) What are the tax services provided by professional accountants?

b) What are the documents & details that should be kept by an auditor while doing transaction with any client as per Directives of NRB?

c) What is the format for sending details of suspicious transaction by auditor to FIU of Nepal Rastra Bank?

d) What are the ethical requirements of non-financial professional as per Assets (Money) Laundering Prevention Act, 2064?

e) What are the ethical requirements for the person who are in accounting/taxation service must comply as per Income Tax Act, 2058?

Question No. 11

Answer the following in the light of Double Taxation Avoidance Agreement.

a) What are the methods of eliminating double taxation?

b) What are the major scopes of double taxation avoidance agreements?

c) Which are the countries with which Nepal has entered into DTAA?

d) What is "Competent Authority"?

Question No. 12

Answer the following in the light of International Taxation.

a) What is Arm's length price and what are the methods of determining Arm's length price?

b) Determine the amount to be included in the income of Alfa Laval Nepal Ltd. in the following transaction as per Resale Price Method.
Tetra Pack Austria holds 55% shares of Alfa Laval Nepal Ltd. Alfa Laval Nepal Ltd. imports 1,000 towel dispensers from Tetra Pack Austria at a price of Rs 2,900 per Unit and these are sold to Hyyat Regency Kathmandu at a price of Rs 3,000 per unit. Alfa Laval Nepal Ltd. has bought similar products from Ultimate Industries Ltd., Nepal and sold to Soltee Plaza at a gross profit of 12% on sales. Tetra Pack Austria offers a quantity discount of Rs 10 per unit whereas Ultimate Industries Ltd. does not offer such quantity discount. Alfa Laval Nepal Ltd. incurred freight of Rs 10 and customs of Rs 25 per unit in case of purchases made from Tetra Pack Austria.

Question No. 13

Supreme Garment Pvt. Ltd had the following transaction in the month of Ashwin 2073. Calculate the VAT payable/ receivable from the information below.

Particulars	**(Amount Rs)**
Purchase & Expenses	
Purchase of clothes	3,500,000
Material for stitching	200,000
Packing materials	300,000
Special packing for export	200,000
Loose tools for machineries	50,000
Payment of consultancy charges abroad	250,000
Purchase of van for staff transportation	1,000,000
Purchase of motorcycle on hire purchase	200,000
Telephone expenses	38,000
Purchase of diesel for generator	40,000
Purchase of diesel for van	12,000
Purchase of petrol for motorcycle	15,000
Purchase of computers	45,000
Purchase of soft drinks	6,000
Purchase of Stationery	14,000
Sales	
Local Sale	2,500,000
Export Sale	5,000,000

Additional information:

- Opening VAT receivable for the month was Rs. 45,780.
- Diesel for van for Rs. 8,000 and soft drinks for Rs. 3,000 was purchased through abbreviated tax invoice.
- Stationery was purchased from non-registered vendor. Amount above are exclusive of VAT.

Question No. 14

Obi Cellular Ltd., a cellular mobile phone set producing domestic enterprise, is engaged in producing and selling of cellular mobile phone sets. As a tax expert, Obi Ltd. seeks your advice on the refund of VAT paid on purchase of its raw materials. Give your opinion on this.

Question No. 15

Nepal Philanthropic Society is a "Company not Distributing Profit" registered under the Company Act, 2063. The source of fund of this company comes from membership fees, donation from the member groups and other outsiders. The company deals with various goods other than those mentioned in schedule 1 to VAT Act 2052. Annual turnover of this company ranges from Rs. 50 lakh to 75 lakh every year. Though profits earned by the company are not for the distribution amongst its members, more than 50% of its profits are utilized towards activities related to the Corporate Social Responsibilities (CSR) every year. The members of the company when approached by IRD staffs for VAT registration contended that the company need not be registered in VAT. As you are the tax consultant of the entity you are required to comment this statement by the company.

Question No. 16

Rai Pvt. Ltd. working in Bhojpur has the following amounts of sales and purchases excluding VAT. Can VAT refund be claimed in Falgun return?

Month	**Sales**	**Purchase**
Bhadra	500,000	600,000
Aswin	520,000	500,000
Kartik	520,000	500,000
Mangsir	450,000	500,000
Poush	320,000	500,000
Magh	400,000	500,000
Falgun	350,000	500,000

Question No. 17

State the provision of VAT refund for the following as per VAT Act 2052.

a) Domestic Oil manufacturing industry
b) Dairy Industry
c) Domestic textile industry producing cotton textile.
d) Maida industry

Question No. 18

State the provisions of the Act for set off VAT for losses of goods due to fire.

Question No. 19

What are the penalties mentioned in section 29 of the act on the following infringements:

i) Registration as mentioned in section 10(1) and (2) related infringement.
ii) An unregistered person issuing an invoice or documents showing collection of tax.
iii) On obstruction in inspection by a tax officer.
iv) On infringement of the VAT act and the rules.
v) To erase and edit the data in software of approved computer Billing System

Question No.:20

Elaborate the provisions relating the market value and its determination under VAT Act.

Question No. 21

Answer in the light of Customs Act, 2064

a) Roshan commercial co. imported the followings goods from Hong Kong in CIF to Kolkatta Port. The cost of transporting from Kolkata to Birgunj was US$ 6000. The quantity and CIF cost of goods are as follows:

Commodities	**Quantities**	**Unit price**	**Total cost (CIF kolkatta)**
A	100	US$ 900	US$ 90,000
B	160	US$ 300	US$ 48,000
C	120	US$ 400	US$ 48,000
D	80	US$ 700	US$ 56,000

From the examination of goods in customs point the custom differ found that the price of A is US$ 1000. Accordingly, the quantity of the D was 90 pieces in the place of 80. Compute the custom duty assuming the rate 25%, 20%, 5%, 10% for A, B, C and D respectively. The per unit weight & volume of each commodity is same.
Use exchange rate US $1 = 110.

b) ABC Company Ltd. imported a Toyota Land Cruiser from Japan at US $ 56,000 in CIF to Kolkata Port. The cost of Freight and insurance from Kolkata to Birgunj was Rs 65,000. As a customs officer, determine the amount of customs duty, excise duty and VAT. The prevailing rates of customs duty, excise duty and VAT are 80%, 60% and 13% respectively. Assume the exchange rate for 1 US$ is Rs 110/US$. Consider the custom service fee.

Question No. 22

a) Shree Airlines had sent following items to Israel for repairs on 5th Shrawan, 2073.

Helicopter engine priced USD 10 million

It had taken the items back in Nepal on 15th Bhadra, 2073 and for the period the helicopter engine was on repairs it brought an identical engine for the helicopter from Israel on the same day.

The airlines found that the engine of helicopter was not repaired correctly and therefore again on 20th Ashwin, 2073 sent the engine back for repairing to Israel. It took another 2 months for the repairs to complete and finally the engine was back in Nepal after repair on 20th Mangsir, 2073. And the identical engine imported is re-exported on 20th Mangsir, 2073.

Cost of repair was USD 1 million. Assuming the custom rate to be 10%, calculate the deposit/bank guarantees that the airline had to provide and the custom duty to be paid. Consider only custom duty in your calculation.

Exchange rates were as follows:
On 5th Shrawan, 2073 Rs. 98
On 15th Bhadra, 2073 Rs. 100
On 20th Ashwin, 2073 Rs. 101
On 20th Mangsir, 2073 Rs. 103

b) A car manufactured in Jan 2011 was imported in Nepal in Jan 2014 by a project under custom duty privilege paying 2% custom duty. The value determined at the time of import was $ 20,000 and rate of exchange was Rs 78 for $ 1.

On July 14, 2016 the project has allowed the General Manager in Nepal to get the ownership of the car in his own name free of cost, but the Manager has to pay duty in cases payable. The exchange rate on the day of customs clearance was Rs 100 for $ 1.

Calculate the transaction value of the car for custom duty purpose.

c) A car manufactured in Jan 2005 was imported in Nepal on Jan 2009 by Mr. Ramesh Chandra for his personal use with partial exemption of custom duty for IRs 25 lacs. On 15 May, 2016, Mr. Ramesh Chandra wants to transfer its ownership to his nephew Mr. Hari.

i) Calculate the transaction value of the car for Custom Duty purpose.
ii) What would be the transaction value if the car was manufactured and imported in year 2009?

d) A & A Enterprises has paid custom of Rs. 25,400 on 2072.06.02 and cleared the required raw materials. On scrutiny of accounts, it came to knowledge that custom has been overpaid to the department by Rs. 3,200. Answer the following in this regards.
i) A & A Enterprises wanted to claim refund of the custom and applied to related custom department on 2072.09.03. Is A & A Enterprises entitled to claim for refund?
ii) What are the conditions under which overpaid custom shall not be refunded by the department? Answer should be based on provisions of Custom Act, 2064.

e) Vogue Fashions, an international brand of apparel, has opened a manufacturing unit in Nepal. Company plans to import the fabrics and other material from its head office in France and export the product to India. Advise the company the most suitable custom process, so that duty on import shall not be paid in cash and also mention the conditions that it needs to fulfill.

f) Rock Cement Industries (P) Ltd. has paid custom duty of Rs. 100,000 as deposit at the custom duty rate of one percent on Rs. 10,000,000 ($100,000 @ 100 as on 17.07.2072) for the import of raw material of 10,000 MT @ $ 10 for partial import on following period. The quantity and date of import were as follows:

Date	**MT (Qty.)**	**Exchange Rate for 1 USD**
18.07.2072	8,000	Rs. 101

19.07.2072	2,000	Rs. 100

Is the duty deposited on import i.e. Rs. 100,000 adequate?

Question No. 23

a) Write short notes on the following under Customs Act, 2064.
   i) Transaction value of identical goods and similar goods method.
   ii) Deductive value method and computed value method.

b) What is harmonized coding system? How are these determined in Nepal?

Question No. 24

Answer the following in the light of Excise Act, 2058

a) Biratnagar Manufacturing (self-removable items)company provided the following facts to the excise officer:

- Raw material purchase Rs 2,000,000 which includes VAT of Rs 160,000.
- Indirect material (chemical etc.) Rs 300,000, out of which Rs 60,000 is excise paid on import.
- Carriage inward Rs 60,000 and outwards 75,000 were incurred
- Manufacturing expenses amounted to Rs 500,000.
- Opening and closing stock of material were Rs 150,000 and Rs 250,000 respectively.
- Net profit of the company is Rs 250,000.

You as an excise officer determine the factory price and the amount of excise duty to be paid if rate of the excise duty is 20%.

b) XYZ manufacturing company producing excisable goods and have obtained approval for self-removal system. As per the financial statements for the year 2072/73 of the company, there is excise payable of Rs. 15,00,000 of which Rs. 2,50,000 is related to Baisakh, 2073, Rs. 4,50,000 is related to Jestha, 2073 and the balance amount is related to Ashad, 2073. The company has paid the excise on 15th Bhadra, 2073.
In this case, briefly mention the provision of excise duty payment in case of self-removable system and calculate fee if applicable on 15th Bhadra, 2073. (No. of Days: Baisakh 2072: 31, Jestha 2072: 32, Ashad 2072: 31, Shrawan 2072: 32, Bhadra 2072: 31).
Ignore provisions of time extension given by Finance Act, 2073.

c) XYZ Liquors Pvt. Ltd., a liquor Industry has sold liquor to following parties and gives cash discount during the Fiscal Year 2072/73:

Party	**VAT Registration Status**	**Taxable Amount**	**Cash Discount**
Friendly Liquor House	Not registered	400,000	2,000
Family Department	Registered	2,500,000	50,000

Store Pvt. Ltd.			
Aladin Liquor Mat Pvt. Ltd.	Registered	1,400,000	28,000

XYZ Liquors received a letter from excise office stating that above sale is not in compliance to the clause mentioned in license.

Is the excise office correct? Answer stating the provision of Excise Act in this regard.

d) What is liquor? Mention the conditions a producer of liquor should fulfill as per Excise Act.
e) Who is the responsible person liable to pay excise duty under Excise Act, 2058?

Question No. 25

Write short notes on:
a) Demurrage (as per Customs Act)
b) Under Invoicing (as per Customs Act)
c) Physical Control System and Self Removal System (as per Excise Act)

ANSWERS

Question No. 1

Working Notes

1. Allowable cost of sales

		Remarks
Opening Stock	(1500000 - 300000	1,200,000 (over stated adjustment)
Raw material		11,000,000
Freight		900,000
Custom duty (1,500,000 – 2,00,000)		1,300,000 (Previous year expenses u/s 13)
Less: Closing Stock (1,600,000 – 3,00,000)		(1,300,000) (overstated adjustment)
Allowable amount		13,100,000

2. Repair & Maintenance of Vehicle (Block C)

Claimed amount	700,000
Allowable 7% of depreciation basis (900,000 x 7%)	63,000
Disallowed to be capitalized	*637,000*

Depreciation basis

Opening WDV	500,000
(As no legal measure has been taken, opening WDV as per assessment order is accepted)	
Add: Absorbed Additions (100%-as added before poush)	500,000

Less: Disposal proceed (100,000) (Since Pool is in existence)

Depreciation basis 900,000

3. Depreciation
   Depreciation basis 900,000 Refer W.N. 2
   Depreciation @ 20% of 900,000 180,000

4. Allowable donation
   Minimum of following
   a) Actual donation 200,000
   b) 5% of adjusted taxable income (5% of 93,12,000) 465,600
   c) Maximum Limit 100,000

Therefore eligible amount 100,000

5. Eligible other expenses
   Expenses given in question 2,000,000
   Less: personal nature telephone expenses (100,000)
   Less: personal nature travel expenses (500,000)
   Eligible other expenses 14,00,000

Personal nature expenses shall not be allowed as per section 21.

6. Repair expenses of hired vehicles are business expenses incurred during the income year by the person, and hence allowed for deduction as per section 13.

7. As per Sec. 21(1) (b), penalties paid as a result of non-compliance with any statute of any country are not deductible for tax purpose. It is assumed that penalties to the Government are paid due to the infringement of law of land.
8. Dividend income is final withholding payments thus exempted from inclusion.
9. Rate of income tax for special industry is 20%, since it is a partnership firm i.e. there is no any exemption.
10. Though withholding tax is not deducted on vehicle rent, expenses is allowed but withholding tax is to be paid @ 1.5% i.e. 9,000 plus penalty & interest.
11. Payment through A/c Payee DD and cash deposited into bank account of payee is not considered as cash payment.
12. Since the Pool C is in existence, the sale proceed is deducted from pool. Hence, the gain is not treated as income

a) Calculation of Taxable income of Kumar & Co. for the FY 2073/74

Particulars	**Refer W.N**	**Amount**	**Remarks**
Sales		25,000,000	

Miscellaneous Income		5000	
Dividend Income	9	-	
Total Inclusion in Income(A)		**25,005,000**	
Allowable deductions			
Interest expense		300,000	
Cost of sales	1	13,100,000	
Repair and maintenance (Block C)	2	63,000	
Repair expenses of hired vehicles		50,000	U/s 13
Depreciation	3	180,000	
Other expenses	5	14,00,000	
Vehicle Rent	10	600,000	
Government penalties		-	
Total Deductions(B)		**15,693,000**	
Assessable Income from Business(A-B)		**9,312,000**	
Assessable Income from Investment		-	
Assessable Income from Windfall Gain		-	
Total Assessable income		**9,312,000**	
Less: Allowable donation	4	100,000	
Taxable Income		**9,212,000**	
Tax Liability @ 20%		**1,842,400**	

b) If it is operating liquor industry, the income tax rate shall be 30%. Then the tax amount will be Rs 2,763,600.

c) Dividend tax is 5% on gross distribution. Hence,

Amount of Dividend Tax $= \frac{\text{Dividend Paid}}{(1 - \text{tax rate})} - \text{Dividend Paid}$

$= \frac{20,00,000}{(1 - 0.05)} - 20,00,000$

= Rs 105,263

Question No. 2

Calculation of assessable income from employment of Mr. Nayak Shakya for the Income Year 2072/73.

Particulars	Refer W.N	Amount
Gross salary received(Net+ TDS)		494,000
Employer's contribution to ARF		100,000
Compensation received		70,000
Investment insurance premium paid by employer		-
Emergency Medical treatment paid by employer		10,000
Assessable Income from employment		**674,000**

Calculation of Assessable income from Business:

Particulars	Refer W.N	Amount
Sales		500,000
Office furniture sales	1	-
Recovery of Bad Debts	2	-
Dividend Income	3	-
Total Inclusions(A)		**5,00,000**
Allowable deductions		
Interest expenses		-`
Cost of trading stock	4	3,50,000
Depreciation	5	45,250
Office expenses	6	16,000
Total Deductions(B)		**411,250**
Assessable Income from Business(A-B)		**88,750**

Statement showing Total Assessable Income, taxable income:

Particulars	Refer W.N	Amount
Assessable income from Business		88,750
Assessable income from Employment		6,74,000
Assessable income from Investment		-
Assessable income from windfall gain		-
Total assessable income		7,62,750
Less: Allowable Deductions		
Contribution to approved retirement fund	11	2,50,000
Donations	12	25,637
Taxable income		487,113
Less: Allowable reductions		-
Balance taxable income		487,113

Calculation of tax liability:

Particulars	Rate	Amount
1st Rs. 3,00,000	1%	3,000
Next Rs. 1,00,000	15%	15,000
Next Rs.87,113	25%	21,779
(487,113 - 400,000)		
Less: tax credit		-
Tax liability after tax credits		**21,779**
Less: Withholding Tax Credit		17,000
Tax Payable		**4,779**

Working Notes:

1. Sale of office furniture is considered while determining depreciation so not included in Inclusion.
2. Bad debts expenses are not allowed for deduction while at the time of write off, so recovery of bad debts are not included in Income.
3. Dividend received from resident company is final withholding income.
4. Cost of trading stock:

Value of opening stock	80,000
Add: Purchase	3,90,000
Less: Closing Stock	(1,20,000)
Cost of trading stock	3,50,000

5. Calculation of depreciation:

Particulars	Pool B	Pool C	Total
A. Opening Depreciation Base	1,45,000 (Furniture & computer)	80,000 (car)	
B. Absorbed Addition	7000 (100% cost of printer)	-	
C. Disposal Proceeds	35,000 (spare table)	-	
D. Depreciation Base(A+B-C)	1,17,000	80,000	
E. Depreciation Rate	25%	20%	
Depreciation	29,259	16,000	45,250

6. Gift to a customer is personal expenses so it is non deductible expenses. Deductible office expense is Rs. 16,000.
7. Reimbursement of business expenses Rs. 2,40,000 is not included in income.
8. Encashment of retirement payment(approved & unapproved) after 18 chaitra 2058 is final withholding payment, hence not included in income.
9. Retirement payments accrued up to 18 Chaitra 2058 are exempted from income tax. Encashment of un-availed leave, Gratuity and approved retirement fund accrued up to 18 Chaitra are not taxable.
10. Interest is assumed to be received not connected with business.
11. Contribution to Approved Retirement Fund:
    Minimum of following:

    a) 300,000
    b) 1/3rd of total assessable income 762,750 = 254,250

c) Actual contribution 250,000 (100,000 + 150,000)
Therefore, deductible Approved Retirement Fund = 250,000.

12. Donation:
    Minimum of following:
    a) 5% of ATI (Assessable income - Eligible contribution to ARF- contribution u/s 12B)

    = 5% of (762,750 – 250,000)
    = 25,637
    b) 100,000
    c) Actual = 50,000
    Therefore, allowable donation is Rs 25,637.

13. Personal drawing is not allowed for deduction.

Question No. 3(a)

As per Section 6, non- resident person is required to pay tax on such incomes having source in Nepal. Rental income is deemed having source in Nepal in case the income is generated from assets located in Nepal as per Section 67(6)(d).

The rate of withholding tax is 10%, therefore Ms. Shrijana's rental income from house located at Butwal is deemed having source in Nepal. Though Ms. Shrijana is non-resident, she is obliged to pay tax in Nepal. Assuming Mr. Brown is also non-resident, Ms. Shrijana is required to pay tax on rental income in Nepal although she receives the incomes in UK.

Question No. 3(b)

As per Section 6, non-resident person is required to pay tax on incomes having source in Nepal. As per Section 67(6), for any service to have source in Nepal, it shall satisfy any of the following two conditions:

- Wherever the place of the payment for service, the service shall be provided within the territory of Nepal.
- Where the payment for the service is made by Government of Nepal, regardless the place of service is rendered.

In the given question, Barrister of UK has appeared in a case here in Nepal.in this case, she has derived incomes from the services provided within the territory of Nepal. Regardless of person making the payment, the service fee received by her is having source in Nepal and she is required to pay tax in Nepal and rate of withholding tax is 15%.

Question No. 3(c)

In case of Interest, the interest is deemed having source in Nepal in case interest is paid by Resident person as per Section 67(6)(b).

In this case Subisu cable is Resident of Nepal, thus interest to Indian Bank is deemed having source in Nepal. As per Sec. 88 (1), a resident person shall withhold tax at 15% while making payment of interest having source in Nepal.

Question No. 3(d)

As per Section 67(6)(e), the source of payment of royalties arising from the use, right to use or forbearance from using an asset situated in Nepal is considered to be in Nepal and TDS @ 15% should be deducted.. Therefore amount of TDS to be deducted is Rs 150,000. i.e (1,000,000*15%)

Question No. 3(e)

As per Section 67(6)(f) the source premium for general insurance paid to and proceeds from general insurance paid by a person in respect of the insurance of any risk involved in Nepal is considered to be in Nepal and taxed @ 1.5%.

Question No. 4(a)

As per Section 11(2Ka) of the Income Tax Act, tax on interest derived by an individual up to Rs 25,000 paid by Micro finance institutions, Rural development banks, post office saving bank and cooperatives based in rural areas is exempted.

In the given case, Ram Kumar received Rs 16,000 as interest from Grameen Bikas Bank which is exempted as per above provision.

However, if he received Rs. 30,000 as interest from bank, which is above Rs. 25,000 it (i.e. Rs 5,000) would be taxable.

Question No. 4(b)

As per section 11kha, for the investment made in hydropower projects, international airport, subways & roadways, railways & infrastructure development projects of national interest and manufacturing industries providing employment to more than 300 domestic labours and consuming more than50% of local raw materials (except for cigarette, bidi, cigar, chewing tobacco, tobacco, gutka, paan masala, liquors and beers industries), the source of such investment shall not be asked.

i) False, this provision is applicable to hydropower project only not for the construction company.
ii) True.
iii) False, this provision shall be applicable if it gives employment to more than 300 local people and consumes more than 50% local raw material.
iv) False, this provision excludes chewing tobacco industry.
v) False, this provision is applicable to industry not for trading business.

Question No. 5(a)

i) Total invoice amount excluding VAT is Rs. 3,00,000 and TDS shall be Rs. 4,500 (1.5% of Rs. 3,00,000). This is not the final withholding payment.

ii) Total amount of Retirement Fund 15,00,000
Less: Balance as on Chaitra 19, 2058 4,00,000
Total Taxable amount of Retirement Fund payment 11,00,000

Exemption (50% of Rs. 11,00,000) 5,50,000
Net Taxable Amount 5,50,000
TDS shall be deducted @ 5% Rs. 27,500 and this is final withholding payment.

iii) Total amount of fund after Chaitra 19, 2058 11,00,000 (1,500,000 – 400,000)
Less: Amount deposited by account holder 9,00,000
Taxable amount of unapproved retirement fund 2,00,000
TDS to be deducted @ 5% of Rs. 2,00,000 i.e. Rs. 10,000 and it is final withholding payment.

iv) TDS deduction is not required by Binod in this payment as the payee is resident bank & financial institution.

v) TDS deduction is not required by the college in this payment (payment for question setting is not subject to TDS) as per the provision of section 88(4)(ka1). But this amount will be added in the total income of Mr. Ramesh while calculating his taxable income for inclusion in employment income.

Question No. 5(b)

As per Section 54(1) of the Income Tax Act,2058, dividends distributed by a resident company to its shareholders shall be taxed in the form of final withholding tax.

Section 54(3) further envisages that notwithstanding anything contained in section 54(1), distribution of dividend that is derived after withholding tax as per subsection(1) shall be exempt from tax.

It means there shall be no further dividend tax on the payment of that portion of dividend which is distributed from the amount received as dividend after levying dividend tax i.e. out of Rs. 5 lakhs received by Mr. Bibek, there shall be no dividend tax on Rs 50,000 (500,000 x 1/10) amount which has been distributed out of profit where dividend tax is already levied.

Amount subject to tax=90/100*5,00,000 = 450,000

Dividend Tax=5% of 4,50,000 = Rs.22,500

Question No. 5(c)

An entity is deemed to be disposed off its assets & liabilities when 50% or more of its ownership in comparison to the ownership three years previously is transferred. In such a case as per section 57(3) of the act, period before the date of such ownership and period after such ownership are treated as separate income years. Further, as per section 96(1) of the act, tax return should be filed within three months from the expiry of the income year as the company has not sought for extension of time. Similarly section 101 of the act fixes the time limit for amended assessment as four years from the due dates of filing of return.

In the given case, date of transfer of ownership is 2068.11.10. Hence, periods before and after this date is segregated into two income years. From 2068.04.01 to 2068.11.10 is one period whose due date will be 2069.02.10. From 2068.11.11 to 2069 Ashadh end is another income year whose due date will be 2069 Ashoj end.

For income tax department, time limit for amended assessment in the first case will be 2073.02.10 and for the latter 2073 Ashoj end.

Question No. 5(d)

As per Section 30, for the purpose of calculating a person's income from an investment which is jointly owned with another person, amounts to be included and deducted in that calculations should be apportioned among the joint in proportion to their respective interests in the investment.

	Mr. Ram	Mr. Shyam
Investment	Rs. 1 crore	Rs. 4 crore

Investment ratio is 1:4

Computation of net income:

Sales (Incoming)	Rs. 6.40 crore
Less: Brokerage commission	Rs. 0.07 crore
Balance	Rs. 6.33 crore
Total initial investment (Outgoing)	Rs. 5.00 crore
Net Income	**Rs. 1.33 crore**

Net income of Rs. 1.33 crore to be appropriated based on contributory ratio of 1:4 between Mr. Ram & Mr. Shyam are as follows:

	Mr. Ram	**Mr. Shyam**	**Total**
Net Income	Rs. 26,60,000	Rs. 1,06,40,000	Rs. 1,33,00,000

Question No. 6(a)

A Foreign Permanent Establishment (FPE) is a permanent establishment of such a person who is a resident of some other country. The person may be a company or a partnership registered in a foreign country, a trust established abroad, a foreign government or its political sub division up to village level etc. When any one of these foreign persons establishes a foreign permanent establishment in Nepal under the same incorporated status in Nepal, the permanent establishment is said to be a foreign permanent establishment.

Test of a foreign permanent establishment:

i. It is entirely owned by a foreign person. Owner foreign person may be controller foreign entity too.
ii. It is a branch, a division, warehouse, construction site, factory, sales outlet or site office of a foreign person.
iii. It has not got any incorporated status in Nepal.

iv. It has its effective control and management situated outside Nepal.

Question No. 6(b)

As per section 2(Da) of the Income Tax Act, 2058 non business chargeable assets is a sum total of Land, Building and Interest in any entity but excluding the following:

a. Business Assets, Depreciable Assets or Business Inventories
b. In case of Natural Person a personally owned house fulfilling with the following conditions
   1. Owned continuously for 10 years or more
   2. Resided for 10 years or more at once or in part
c. Land and private building of an individual that is disposed for a value less than Rs.30 lakh.
d. Non business assets of an individual that is disposed of by way of any type of transfer other than sales and purchase made within three generations.
e. Interest in Retirement Fund of the Beneficiary.

Question No. 6(c)

As per Sec 2 (Ra) of Income Tax Act, "Underlying ownership" means following ownership:-

i) in relation to an entity, an ownership created on basis of an interest held in the entity directly or indirectly through one or more interposed entities by an individual or by an entity in which no individual has an interest; or
ii) in relation to an asset owned by an entity, an ownership of the asset that is determined on basis of proportion to the ownership held by the persons having underlying ownership of the entity.

Question No. 7(a)

Yes, there is special provision for such industry. As per section 11(3Ta), any tourism related industry or international airlines company established with more than 200 crore capital investment shall enjoy rebate of 100% income tax for the first 5 years and 50% rebate for the next 3 years from the date of its operation.

Also, for already such existing industries or airlines company if they raise their capital to 200 crore and increase their capacity by more than 50% of existing capacity then they shall enjoy rebate of 100% income tax for the first 5 years and 50% rebate for the next 3 years

Question No. 7(b)

Yes. As per section 110ka if the taxpayer gives written application for paying the due tax in installments then the tax officer may provide reasonable time frame for paying the due tax in installments before lodging legal case to recover the due tax.

Question No. 7(c)

i) 10%. As per section 88(7), 10% withholding tax shall be deducted for the payment for the use of satellite, bandwidth, optical fiber, telecommunication related equipment or electricity transmission line.
ii) 15%. As per section 88(6), 5% withholding tax shall be deducted for the payment of return to a natural person by a mutual fund. Hence for others applicable rate is 15%.

iii) 1.5%. As per section 88(4), 1.5% withholding tax shall be deducted for the payment of service charge to VAT registered resident person or to resident entities doing non-taxable (non-VATable) transactions.

iv) 1.5%. As per section 88(5), 10% withholding tax shall be deducted for the payment of rent whose source is in Nepal by a resident person whereas, 1.5% withholding tax shall be deducted for the payment of vehicle rent to a VAT registered vehicle rental business.

v) 10%. As per section 95ka(2)(kha), a company not listed in SEBON shall deduct withholding tax @ 10% to a resident natural person and 15% in case of others, on the amount of gain from the sale of share of the company.

Question No. 8(a)

Particulars	Total of Cost	Selling Price (Proposed)	Profit on sale	Withholding Tax @ 10%
Corporate Office Building	10,000,000.00	12,500,000.00	2,500,000.00	250,000.00
Land (Trading Stock)	50,000,000.00	75,000,000.00	25,000,000.00	-
Land for Corporate Building	5,000,000.00	10,000,000.00	5,000,000.00	500,000.00
Buildings (Trading Stock)	100,000,000.00	120,000,000.00	20,000,000.00	2,000,000.00
Total	**165,000,000.00**	**217,500,000.00**	**52,500,000.00**	**2,750,000.00**

(Refer Circular No 13 2073.74 dated 2073.04.09 for details.)

As per the circular,

1. Withholding tax @ 10% should be collected at the time of disposal (sale or transfer of ownership in any way) of land or buildings of any value in possession of any sole proprietorship firm, partnership firm, company, NGOs, trusts, private schools/universities and other entities.
2. Withholding tax need not be collected at the time of sale of land or buildings by companies established with the objective of purchasing, constructing and selling land or building and treat such land and buildings as trading stock.
3. The person who does transaction as per point no. 2 must self-declare that the sold land & building are trading stock.

Question No. 8(b)

The pools of Depreciable Assets as per Income as per Income TAX Act 2058 are mentioned below:

Block	Classes
A	Buildings+ Structures +Other works of Permanent Nature.
B	Computers + Statistical Processing Equipment+ Furniture+ Fixtures+ Office Equipments
C	Automobiles+ Buses +Minibus

D	Production Equipment+ Earthmoving Equipment +Pollution Cost Capitalization Under Section 17(3)+Research And Development Cost Capitalization Under Section 18(3)+ Expenses Incurred On Prospecting, extracting or Developing Natural Resource +Other Depreciable Tangible Assets not Falling Under Pool A,B, and C
E	Intangible assets (Except fall on Block D, Goodwill is not tax asset, which is spread within assets and liability as per Sec 49.

For the purpose of Income Tax, a person may disclose the pool-wise presentation of tangible assets but the intangible assets must be presented separately as per their classes.

Question No. 8(c)

Rule 13 of the Income Tax Rules has quantified the residence facility and the vehicle facility. The quantified amount is only included in the income from employment irrespective of the expenses borne by the employer in providing the facility.

The quantify amounts are as follows:

i) For Residence Facility
- Providing House Rent Allowance
  In case the employer is providing an amount of house rent, the amount is included in income from employment rather than the quantified amount.
- Providing House for Residency
  The quantified amount of house facility is 2% of the salary regularly provided during the year.

ii) For Vehicle Facility
In case an employer has provided a vehicle to an employee for his exclusive use or for a part time use, an amount equal to 0.5% of the salary being paid is the quantified amount included in the income from employment. Here, the salary being paid regularly means the Basic salary and grades.

Question No. 8(d)

As per Section 1(16) of Schedule 1 of Income Tax Act 2058, the natural person should satisfy the following conditions to allow the health insurance premium paid for deduction while calculating taxable income of the person.

iii) The person should be resident natural person.
iv) The natural person has purchased insurance policy from resident insurance company.
v) The natural person should purchase health insurance policy
The allowable health insurance premium for deduction is minimum of the following.
- Actual premium paid or
- Rs 20,000

Question No. 8(e)

As per section 16 of the Income Tax Act 2058, repair and maintenance expenses is allowed maximum of 7% of the deprecation base at the end of the fiscal year. However all repair and maintenance expenses are allowed until 2073/74 at the earthquake affected district specified by the Nepal Government.

In this case Lama Koshi Hydropower Development Company limited located at Sindhupalchok. Its WDV of Civil structure is Rs 10 core and its repair and maintenance expenses is Rs 2 core for the fiscal year 2072/73, though it is above the limit of 7%.

In the given case all expenses is allowed for the repair and maintenance expenses for the fiscal year 2072/73. Yes, it is advisable.

Question No. 9(a)

i) As per the section 12 of the Income Tax Act 2058, for computing the taxable income in any income year, any person may claim to subtract the amount of the donation, gift given to an organization entitled to tax exemption approved by the department. The expenditure deductible in any income year under that heading shall not exceed one hundred thousand rupees or five percent of the adjusted taxable income of this income year.

   In the given question PQR Pvt. Ltd. has 300 lakh Adjusted Taxable Income and Rs 3 lacs given to the ABC charitable trust, a Tax Exempted Entity.

   Maximum of the following is allowable under section 12:

Actual donation	3 lacs or
Five percent of the adjusted taxable income	15 lacs or
Maximum Limit	1 lakh

   In this case PQR Pvt. Ltd. is allowed of Rs 1 lakh as a donation under section 12 of the Income Tax Act 2058.

ii) As per the section 12B of the Income Tax Act 2058, all amount given to the Prime Minister Relief Fund is allowed for the deduction for calculation of taxable income, all of the RS 100 lacs is deductible for the calculation of the taxable income.
   Hence, only 101 i.e (100+1) lacs is allowed for deduction.

Question No. 9(b)

As given in the case, the future of the company is prosperous. It has four times free reserve & surplus of paid up capital. It has bank balance equivalent to paid up capital & free reserve i.e. most liquid asset, which mean there is no any assets which are doubtful/fictitious/unamortized etc. It clearly shows that the book net worth of Rs 50,000,000.

If the company liquidated at same date, the shareholder will get 400 per share above the investment of 100 per share. Then, how can the price of share sold be only doule of cost i.e. Rs 200 per share.

Again, the future business of the company shall be prosperous & book net worth is backed by the most liquid assets i.e. bank balance. In this scenario, the book net worth of 25% shareholding is Rs 12,500,000 (50,000,000 x 25%) and that should be the bear minimum transfer price. If so,

Capital gain = Transfer Price- Cost
= Rs 12,500,000 - (10,000,000 x 25%)
` = Rs 10,000,000

Capital gain tax = Capital gain x Rate of withholding tax
= Rs 10,000,000 x 10%
= Rs 1,000,000

However the capital gain tax paid is 250,000 only.

Hence the IRO can re-characterize the arrangement as per sec 35.

As per Section 35 General Anti- Avoidance Rule

For the purposes of determining liability to tax under this Act, the Department may -

- Re-characterize an arrangement or part of an arrangement that is entered into or carried out as part of a tax avoidance scheme;
- Disregard an arrangement or part of an arrangement that does not have substantial economic effect; or
- Re-characterize an arrangement or part of an arrangement the form of which does not reflect its substance

<u>Question No. 9(c)</u>

i) As per the section1(17) of the schedule 1 of the Income Tax Act 2058, if any person running gas, cigarette and similar business having commission or value addition up to 3 percent, shall pay tax at the rate of the 1.5 percent of the turnover.

ii) 2 percent of the tax shall be levied on the service business.
However Rs 5000 tax is levied, if above calculated tax is less than Rs 5000. As per the provision of the section 4(4A) of the Income Tax Act 2058, Resident natural person satisfied the following condition for the application of the above tax rate:
   - only Nepal source business income
   - Medical tax credit is not taken as per section 51
   - advance tax is not taken as per section 93
   - Not registered on the VAT
   - Turnover having 20 lakhs to 50 lakhs
   - Income not related with consultant or expert service by doctor, engineer auditor, lawyer, player, consultant and artist and similar natural person.

<u>Question No. 10(a)</u>

Tax services provided by professional accountants may include the following:

- Tax Preparation
- Tax Return Verification
- Tax Advisory
- Tax Accounting
- Tax Compliance

- Tax Expert

Question No. 10(b)

An auditor must keep the documents and details as per Annexure - 1 while maintaining a relationship with any person in regards of professional activities. Again as per Annexure – 1, an auditor must keep the following documents and details while doing transactions with any customer/client:

1) Clear name and address of the association, organization, firm or company
2) Certificate of incorporation
3) Telephone number and Email (if available)
4) Permanent Account Number or VAT Number
5) Telephone number, Email, etc. of Board of Director and person working as chief
6) Other necessary documents (can be determined by the auditor himself)

Question No. 10(c)

It is the responsibility of the customer/client to provide the necessary details as per directive (1) as requested by the auditor. An auditor can immediately decline from maintaining the professional or business relationship with the customer/client who does not provide such details under any circumstances. If the professional or business relationship cannot be declined due to any circumstances, the auditor must assume the transactions of the customer/client to be suspicious and submit the details to the FIU as per Annexure – 2 as follows;

Name of the Auditor:

S.N.	Name and Address of Customer/Client	National or International Company	Date of Providing Service	Nature of Transaction of the Customer/Client	Reason for Being Suspicious	Remarks
1						
2						
3						
4						
5						
6						
7						
8						
9						

Signature of Submitter:
(Execution Officer/ Person Working as Chief)
Name:
Phone:
Email:
Fax:

Date:

Question No. 10(d)

As per Section 2(dha) of Assets (Money) Laundering Prevention Act 2064, non-financial professional includes auditor, accounting professional.

Again as per Section 2(sa), "informant" means financial institutions or non-financial professionals.

The ethical requirements for non-financial professionals i.e. informants (auditor or Accountant) are as follows:

a) Customer to be identified [Section 7 (ka)]
b) Risk management system to be applied to identify whether own customer or owner or person intend to be customer is high ranking personality or not [Section 7 (kha)]
c) Reasonable means to be applied to identify the real customer [Section 7 (ga)]
d) Risk identification & assessment is to be done in relation to Money (Assets) Laundering and investment in terrorist activities [section 7 (gha)]
e) Appropriate means to be applied while doing business with complex customers to identify them [Section 7 (nga)]
f) Simple identification process may be applied for those customers who are less risky in terms of money laundering & financial investment in terrorist activity. However, it can't be done for the customer who is suspected for money laundering & investing in terrorist activity.
g) Customer to be identified before establishing business relation or at the time of occasional transition [Section 7 (ja)]
h) On going, due diligence to be done [Section 7 (jha)]
i) Customer can be identified & endorsed from third party [Section 7 (yna)]
j) Risk identification & assessment is to be done for those risks which can be raised from existing or new technology & business practice, customer not presenting their self, distribution system or innovative system or system being developed. [Section 7 (ta)]
k) Extra ordinary transactions, to be handled cautiously like
    a. Transaction not looking clear in terms of economic or legal objectives.
    b. Transaction of unrealistic nature.
    c. Transactions or legal arrangement with people or organizations who are from those countries which are identified as countries for non-compliance or partial compliance of the standards related to prevention from money laundering & financial investment in terrorist activities. [Section 7 (tha)]
l) Not to establish business relation to those who do not provide the documents necessary to make his clear identification. [Section 7 (ana)]
m) Prepare & implement the policy & procedure on the basis of country, geographical region, area of work, size of business, customer, transaction and risk involved in relation to money laundering and financial investment in terrorism activity to comply with Assets (Money) Laundering Prevention Act 2064 & Rules. [Section 7 (ta)]
n) Records as specified to be kept safely for 5 years from the date of transaction or occasional transaction or completion of business relation. [Section 7 (tha)]

o) Inform the transaction, or assets or customer to FIU within three days if

a. There is reasonable ground to suspect those are related to money laundry and financial investment in terrorist activity or

b. Any assets suspected or reasonable ground to suspect that it is related to terrorist activity, terrorist person or terrorist organization or financial investment to terrorist activity or suspected or reasonable ground to suspect to be used in such activity, or such person or such organization. [Section 7(dha)]

<u>Question No. 10(e)</u>

Members in practice, in industry and other person who are in accounting / taxation services must comply with the following ethical requirements as per Income Tax Act 2058.

1. Tax payers needs to comply with the duties under Income Tax Act.
   [Section 74(1) of Income Tax Act 2058]
2. Confidentiality
   - Professional accountants should maintain the confidentiality of information of the client
   - While conducting Tax Expert Services to IRD also confidentiality as per Section 84 of Income Tax Act to be compiled.

     As per section 84 of Income Tax Act, 2058:

     (1) Every officer of the Department shall keep secret all documents and information coming to the officer's possession or knowledge in connection with the performance of duties under this Act.

     (2) Notwithstanding subsection (1) an officer of the Department may disclose a document or information referred to in subsection (1) before the following persons in the following manner:-

     (a) to the extent required in order to perform the officer's duties under this Act;

     (b) where required by a court or tribunal in relation to administrative review or proceedings with respect to a matter under this Act;

     (c) to the Finance Minister;

     (d) to any person where the disclosure is necessary for the purposes of any other fiscal law;

     (e) to any person in the service of Government of Nepal where who may require such disclosure is for the performance of revenue or statistic related works;

     (f) to the Auditor-General or any person authorized by the Auditor- General where such disclosure is necessary for the performance of official duties; or

     (g) to the competent authority of the government of another country with which Nepal has entered into an international agreement, to the extent permitted under that agreement.

     (3) Any person, court, tribunal, or authority receiving documents and information under subsection (2) is required to keep them secret except to the minimum extent to which the disclosure is necessary.

3. Certification

   As per section 96(3) of the Income Tax Act, 2058; A person who, in return for a payment, prepares or assists in the preparation of a return of income or attachment to a return of income of another person (other than as employee of the other person), shall be required to certify the following:-

(a) the first-mentioned person has examined the relevant documents of the other person maintained under section 81, and

(b) the return or information correctly reflects the circumstances to which it relates.

And again as per section 96(4) of the Income Tax Act, 2058; Where a person refuses to sign a return as required by subsection (3), the person shall furnish the other person with a statement in writing of the reasons for the refusal.

While certifying the Income Tax Return, professional accountant should check the compliance of relevant tax laws and report for non-compliance.

Question No. 11(a)

Means of avoidance of double taxation are:

i) Exemption Method
The Treaty may provide for exemption from the liability in one jurisdiction i.e. the country in question will refrain from taxing the particular income and allow the other jurisdiction to impose tax.

ii) Tax Credit Method
Treaty may not provide for exemption from tax liability which implies that both countries shall be entitled to levy tax. However, income tax paid by the person in the foreign income is allowed as tax credit to the extent of effective tax payable in the country of residence and only the balance, if any, shall be collected.

iii) Deduction Method
Income Tax paid by the person in the foreign income is allowed as deductible expenses.

Question No. 11(b)

A scope of DTAA under both Un Model & OECD Model mainly includes the following:

Particulars	Scope
Article 1	Persons Covered
Article 2	Taxes Covered
Article 3	General Definitions
Article 4	Resident
Article 5	Permanent
Article 6	Income from Immovable Property
Article 7	Business Profit
Article 8	Air Transport
Article 9	Shipping Income
Article 10	Associated Enterprises

Article 11	Dividend Income
Article 12	Interest
Article 13	Royalties
Article 14	Capital Gains
Article 15	Independent Personal Services
Article 16	Dependent Personal Services
Article 17	Director's Fee
Article 18	Artistes and Athletes
Article 19	Pension and Annuities
Article 20	Government Services
Article 21	Professors, Teachers & Research Scholars
Article 22	Students & Apprentices
Article 23	Other Income
Article 24	Capital
Article 25	Elimination of Double Taxation
Article 26	Non Discrimination
Article 27	Exchange of Information
Article 28	Entry Into Force
Article 29	Termination
Article 30	Protocol

The above can vary from DTAA to DTAA, in DTAA entered by Nepal, some other articles like follows are included;
- Mutual Agreement Procedure
- Assistance in the collection of Taxes
- Limitation of Benefits
- Members of Diplomatic Mission and Counselor Posts

<u>Question No. 11(c)</u>

As per section 73 of Income Tax Act, 2058 and as per provisions of previous tax laws, the Government of Nepal has entered into DTAA between followings:

- The Government Of The Republic Of India

- The Government Of The People's Republic Of China
- The Government Of The Kingdom Of Thailand
- The Republic Of Austria
- The Democratic Socialist Republic Of Sri Lanka
- The Government Of The Islamic Republic Of Pakistan
- The Government Of The State Of Qatar
- The Kingdom Of Norway
- The Republic Of Korea
- The Government Of The Republic Of Mauritius

Question No. 11(d)

This is the designated authority which is to be approached in the event of a dispute or where the resident of a Contracting State feels discriminated against in the other Contracting State. Normally the Ministry of Finance is the designated authority which can delegate its powers to the Tax Authorities. Every DTAA would also have a residuary clause to stipulate that any term which is not defined would have to be given the meaning given to in local laws. In fact, even when there are disputes in the interpretation of the terms defined the local laws and interpretation given by the local Courts are also referred to.

Question No. 12(a)

The provisions require any income arising from a transaction with an associated person must be computed having regard to the arm's length price. Further, costs or expenses allocated or apportioned between two or more associated enterprises should be determined having regard to arm's-length prices (Income Tax Act).

Though, Arm's Length price means a price of transaction between the buyer and sellers of a product or service at independently and has no relationship to each other. The concept of an arm's length transaction is to ensure that both parties in the deal are acting in their own self-interest and are not subject to any pressure or stress from other party in any means.

Methods of determining Arm's length price

The arm's-length price in relation to an transaction is to be determined using the most appropriate method out of the specified methods, having regard to the nature or class of transaction or class of associated persons or functions performed by such persons or other relevant factors. The methods specified may be as under:

- Comparable Uncontrolled Price Method (CUP);
- Resale Price Method (RPM);
- Cost Plus Method (CPM);
- Profit Split Method (PSM);
- Transactional Net Margin Method (TNMM); and
- Any other method as may be prescribed.

Question No. 12(b)

Determination of income to be included

Now, arm's length price is determined as under:

Resale Price of gods purchased from Tetra Pack Austria		Rs 3,000
Less: Normal Gross Profit Margin @ 12%		Rs 360
Less: Expenses connected with purchases (freight and customs duty paid)		Rs 35
Less: Quantity discount allowed by Tetra Pack Austria		Rs 10
Arm's Length Price		***Rs 2,595***
Price paid to Tetra Pack Austria	1,000 x 2,900	Rs 29,00,000
Arm's Length Price	1,000 x 2,595	Rs 25,95,000
Increase in income of Alfa Laval Nepal Ltd.		Rs 3,05,000

<u>Question No. 13</u>

Calculation of VAT payable for the month of Ashwin 2073 for Supreme Garment Pvt. Ltd.

Collection of VAT		**VAT**	**Remarks**
Local Sale	2,500,000	325,000	full
Export Sale	5,000,000	-	0% for export
Total output VAT	**7,500,000**	**325,000**	

Payment of VAT

Purchase of clothes	3,500,000	455,000	full
Material for stitching	200,000	26,000	full
Packing materials	300,000	39,000	full
Special packing for export	200,000	26,000	full
Loose tools for machineries	50,000	6,500	full
Payment of consultancy charges abroad	250,000	32,500	reverse charging
Purchase of van for staff transportation	1,000,000	52,000	only 40% allowed
Purchase of motorcycle of hire purchase	200,000	26,000	full
Telephone expenses	38,000	4,940	full
Purchase of diesel for generator	40,000	5,200	full
Purchase of diesel for van	12,000	520	abb. TI not allowed
Purchase of petrol for motorcycle	15,000	-	not allowed Rule 41
Purchase of computers	45,000	5,850	full
Purchase of soft drinks	6,000	-	not allowed Rule 41
Purchase of Stationery	14,000	-	non-VAT bills
Total Input tax credit		**679,510**	

Calculation of VAT Payable/Receivable for the Month of Ashwin 2073

Opening VAT Receivable	45,780
Add; input VAT	679,510
Less; output VAT	(3,25,000)
Net Receivable	**400,290**

Question No. 14

As per Schedule 1 of the VAT Act, forty percent of the VAT paid on purchase of mobile sets by importer or forty percent of VAT paid on raw materials for producing mobile sets, shall be refunded by the Inland Revenue Department on producing evidence that the mobile sets are sold to VAT registered party. The procedures of the refund shall be as prescribed by Inland Revenue Department.

In the given case Obi Cellular is a mobile set producing company, so forty percent of the VAT paid on purchase of raw material shall be refunded by IRD if it can produce evidence that the produced mobiles are sold to VAT registered party.

Question No. 15

The criteria for the requirement of a company to be registered under VAT Act are not dependent on whether Company distributed its profits or not.
If a company fulfills following two conditions, then it needs to be registered under VAT Act.

a. If such Company/entity deals with goods/services that are VAT attractive, and are not exempted as per schedule 1 of the VAT Act.
b. The transaction of such company exceeds the threshold provided under the Act i.e. annual business transactions exceeds present taxable limit of 50 lakh.

In the case of our question, both above criteria are attracted; Nepal Philanthropic society is required to be registered under the VAT Act.
Therefore, the statements of the company that it need not be registered under VAT Act do not hold true.

Question No. 16

Here, all the items are VAT attractive and output is VAT attractive. Company can offset all the VAT paid purchase since there are not any no VAT items nor partial VAT items.

Month	Sales	Purchase	Output Tax	Input Tax	Credit
Opening Credit					-
Bhadra	500,000	600,000	65,000	78,000	-13,000
Aswin	520,000	500,000	67,600	65,000	-10,400

Kartik	520,000	500,000	67,600	65,000	-7,800
Mansir	450,000	500,000	58,500	65,000	-14,300
Poush	320,000	500,000	41,600	65,000	-37,700
Magh	400,000	500,000	52,000	65,000	-50,700
Falgun	350,000	500,000	45,500	65,000	-70,200

For Falgun tax return, there is continuous credit of Rs. 7,800 for last six months. Company can claim a refund of Rs. 7,800 in Falgun.

Question No. 17

(Rates Based on 2073 Finance Bill)

- 40% of VAT out of VAT collected by selling own product to VAT registered person shall be refunded under the prescribed procedure by IRD to domestic industries manufacturing oil.
- As per schedule 1 of the VAT Act 2052, local dairy industries gets 50% refund on VAT collected on sales of dairy products as prescribed by IRD.
- As per schedule 1 of the VAT Act 2052, Domestic textile industries producing 100% suti clothes gets refund of amount equal to VAT collected on sales less Vat paid on purchases.
- As per schedule 1 of the VAT Act 2052, Maida industries gets refund of amount equal to 25% of VAT collected on sales less VAT collected on purchase.

Question No. 18

Sec. 39 Ka of the VAT Rule prescribes the conditions for set off of VAT in case of loss of goods due to fire, theft, accident, breakage, disturbance or expiry of date.

Where there is loss because of above reason and the goods are to be written off or to be sold at the lower prices, then within 30 days of such situation application is to be made to the Inland Revenue Office with the evidence.

When after the necessary enquiry by tax officer, he/she may decide to allow for the set off of the tax paid on the purchase. Irrespective of what is provided in above, in case of loss of goods which are insured, the relevant office itself can decide to allow the set off of tax to the extent of compensation received.

Question No. 19

i) Non registration within the time period mentioned attracts penalty Rs.10,000 for each tax period.

ii) ii. If an unregistered person issues an invoices or documents showing collection of tax, then 100% of the tax collected shall be the applicable penalty.

iii) iii. If obstruction is caused in inspection by a tax officer, then Rs.5,000 for each time shall be applicable as penalty.

iv) iv. On infringement of the VAT Act and the Rules, then Rs.1000 for each time shall be the applicable penalty.
v) v. If the tax payer has erased and edit the data in software of approved billing system, then Rs. 5 Lac will be the applicable penalty.

Question No. 20

Section 13 reading along with the Rule 22 will clarify the provision relating the market value and its determination.

The market value of goods or services shall be determined as the consideration in money which the supply of these goods or services would generally be agreed on if the transaction were made under similar circumstances between persons who are unrelated and the supply freely offered.

While determining the market value as per above provision, the tax officer shall determine the market value by studying the transactions and value of other vendors registered in regard to the transaction of the same nature.

In cases where the market value of any goods or services cannot be determined as set forth as prescribed in the Act, the Director General shall determine the value on the basis also of the information received in that regard by him from the registered persons of the same nature.

Question No. 21(a)

Calculation of Customs duty of different commodities

Particulars	A	B	C	D
Quantity Imported (Quantity declared or the actual quantity whichever is higher)	100	160	120	90
Price per unit in $ (Declared price or reference price whichever is higher)	1,000.00	300.00	400.00	700.00
Total purchase price in $	100,000.00	48,000.00	48,000.00	63,000.00
Transportation(Freight) cost in $	1,276.60	2,042.55	1,531.91	1,148.94
Total Valuation($)	101,276.60	50,042.55	49,531.91	64,148.94
Rate of customs duty (given)	25%	20%	5%	10%
Customs duty in $	25,319.15	10,008.51	2,476.60	6,414.89
Add: additional customs duty for under invoicing of A (WN1) in $	2,500	-	-	-
ADD: fine for less declaration of D (WN2) in $	-	-	-	7,127.66
Total customs duty (including fines) in $	26,569.15	10,008.51	2,476.60	13,542.55
Exchange Rate	110	110	110	100
Custom Duty	2,922,607	1,100,936	272,426	1,489,681

Total custom duty payable = Rs 5,785,650

Working notes:

1. <u>Calculation of additional customs duty for under invoicing of A</u>
   The differences in valuation (additional) due to under invoicing of iphone
   = 100 pcs × $ 100 ($ 1000-$ 900)
   = $ 10,000
   Customs duty on difference value: 25% of $ 10,000 = $ 2,500
   Additional customs duty: 100% of $ 2,500 = $ 2,500
   (Note: If the value declared by an importer is less than the customs value, the customs officer may do the following in relation to such goods:
   a) Clearing such goods by collecting 100% additional customs duty on such difference value or
   b) With the prior approval of the Director General, purchasing such goods in a manner to pay the amount to be set adding 5% amounts to the value so declared to the importer.

(In the absence of information, the first alternative has been used here)

2. <u>Calculation of fine for less declaration of D</u>
   Customs valuation of undeclared quantity of laptops = $ 64,148.94/90×10= $ 7,127.66
   Fines for less declaration of quantity = 100 % of Customs valuation of undeclared quantity
   = 100% of $ 7,127.66 = $ 7,127.66
3. Cost of transportation has been allocated on the basis of quantities imported.
4. Computation of the custom duty is based on the given rate at question.
5. The price of foreign currency has to be converted into Nepali rupees using the selling exchange rate fixed by Nepal Rastra Bank at the respective date. In the absence of the exchange rate, the solution is based on US dollar.

<u>Question No. 21(b)</u>

<u>Calculation of Customs duty, excise duty and VAT</u>

a. Valuation for customs purpose:

Price in CIF to Kolkata ($ 56,000×Rs 110/$)	Rs 6,160,000
Freight and Insurance	<u>Rs 65,000</u>
Total valuation	<u>Rs 6,225,000</u>

   Customs duty = 80% of Rs 6,225,000 = Rs 4,980,000
   Custom duty including customs service fees = Rs (4,980,000 + 500) = Rs 4,980,500

b. Valuation for excise duty = Rs (6,225,000+4,980,500) = Rs 11,205,500
   Excise duty = 60% of Rs 11,205,500 = Rs 6,723,300

c. Valuation for VAT = Rs (11,205,500 + 6,723,300) = Rs 17,928,800
   VAT = 13% of Rs 17,928,800 = Rs 2,330,744

   Note: Customs service fees Rs 500 imposed for each declaration in case of import.

Question No. 22 (a)

Answer:

Rule 7 of the Customs Rule provides the method and rates of deposits and applicability of the bank guarantees for import and export of the goods to/from Nepal. Similarly Rule 8 provides for the re-export and re-import of the goods. According to the provisions thereon following are the calculation for deposits and bank guarantees.

On 5th Shrawan, 2073:

Calculation of deposits for engines

For helicopter engine — Rs. 4,900,000

(10,000,000 X 0.5% X 98)

On 5th Shrawan, 2073:

Calculation of bank guarantee for replacement engine

Import value of identical helicopter engine — Rs. 980,000,000

(10,000,000 X 98)

Custom duty @10% — Rs. 98,000,000

Bank guarantee for above custom duty should be provided to Custom Office.

On 15th Bhadra, 2073:

Calculation of Customs Duty for repairs

Cost of repairs ($ 1,000,000 x 100)	Rs. 100,000,000
Custom duty @10%	Rs. 10,000,000
Less; deposit paid earlier	Rs. 4,900,000
Balance to be paid	Rs. 5,100,000

On 20th Ashwin, 2073:

Return of engine for further repairing

No duty or guarantee is required as per Rule 8(1).

Bank guarantee provided for the replacement engine will be returned by the Custom Office once the engine is sent back within 6 month of bringing the engine i.e. 20th Mangsir, 2073. Since the final repair was completed within 6 months, the engine was returned on time, therefore no further duty is payable.

Question No. 22(b)

Calculation of the transaction value of the car for custom duty purpose.

Particulars	US Dollar
Value of the car at the time of import	20,000
Depreciation allowed Before import, the car was in foreign for 3 years The maximum period for depreciation allowed is 5 years minus 3	2,000

years= 2 years only. Depreciation for 1st year	
Depreciation for 2nd year	1,800
Value for the custom duty	16,200
Value for custom duty in Nepali Currency= 16200*100	1,620,000

Question No. 22(c)

i) Calculation of transaction value

Particulars	Amount	Amount in	Remarks
Value of car at the time of import	2,500,000	IRS	
Depreciation allowed:			
60% of value at the time of import =60% X 2,500,000 =1,500,000	1,500,000	IRS	Note-1
Value for Custom Duty	1,000,000	IRS	
Value for Custom Duty in Nepali Currency	1,601,500		Exchange rate: 1IRS = 1.6015 NRS.

Thus, Value for Custom shall be 1,601,500.

Note-1s per section 9(2) of Schedule 1 of Custom Act, in case the vehicle under consideration is sold after 10 years of its production, the value for custom purpose shall be transaction value at the time of import minus 60% of the value as depreciation.

Here, car was manufactured in 2005 & sold off in 2016 i.e. more than 10 years. Thus, 60% of value shall be deducted as depreciation.

ii) If manufactured and imported in 2009:

Particulars	Amount in	Amount	Remarks
Value of car at time of import	IRS	2,500,000	
Depreciation allowed			
Depreciation for Year 1 (2,500,000 @ 10%).	IRS	250,000	Note- 2
Depreciation for Year 2 (2,500,000-250,000) X 10%	IRS	225,000	
Depreciation for Year 3 (2,500,000-250,000-225,000)X10%.	IRS	202,500	
Depreciation for Year 4 (2,500,000-250,000-225,000-202,500)X10%	IRS	182,250	
Depreciation for Year 5 (2,500,000-250,000-225,000-202,500-182,250)X10%	IRS	164,025	
Total Depreciation		1,023,775	
Transaction Value for Custom Purpose	IRS	1,476,225	
Transaction Value for Custom Purpose	NRS	2,364,174.33	Exchange

			rate, 1 IRS = 1.6015

Note-2

As per section 9 (2) of Schedule 1 of Custom Act, transaction value determined presently at the time of sale or transfer determined by deducting the depreciation allowed. The depreciation allowed is 10% each year on written down value for a maximum 5 years. Since, car is manufactured in year 2009, Depreciation shall be allowed for maximum 5 years at 10% on written down value.

Question No. 22(d)

i. As per Section 75 of Custom Act, 2064, overpaid custom shall not be refunded if the application to the related custom department is made after 60 days of goods cleared at custom. Here goods have been cleared on 2072.06.02, but the application for refund is given on 2072.09.03, i.e. after 60 days of goods clearance. So, A & A Enterprise is not entitled to get refund of extra custom paid.

ii. As per section 75 of Custom Act, 2064 overpaid custom shall not be refunded under following situations:
   - Application for refund of amount is not made within 60 days of release of goods to the concerned customs office.
   - The amount claimed for refund is less than Rs. 5000.

Question No. 22(e)

In the given case, the manufacturing unit is in Nepal and the raw materials are being brought from abroad with an arrangement to do the production in Nepal and export the finished goods to India. In this case the most suitable process to be followed would be to apply for bonded warehouse facility by Vogue Fashions in Nepal. By doing this it can import the main and sub raw material by providing the bank guarantee. Following are the process to be followed and the conditions to be fulfilled on getting the license to operate the bonded warehouse.

Vogue Fashion has to get the written recommendation from Department of Commerce to Department of Customs, where the importer would be allowed to import the goods without opening the letter of credit. While importing the raw materials, it should submit the Department of Commerce's recommendation, contract with the foreign buyer, invoice value for customs purpose along with the custom declaration form. After the customs duty is derived, the company should provide the bank guarantee equivalent to the amount of duty plus 25 percent additional amount. Rule 10 of Customs Rules provides for facilities available to Bonded warehouse licensee.

The industry using the bonded warehouse facility should export the goods though establishing the letter of credit or established banking channels. Finished goods must be exported within 11 months from the time the raw materials or ancillary raw materials are imported. There should be at least 10 percent value addition as per the valuation during import and export of finished goods.

Question No. 22(f)

As per section 24(1), (2) & (3) of Custom Act, 2064; in case of goods cleared at custom on partial basis, the exchange rate prevailing at the day of clearance of consignment shall be considered for computation of duty.

Thus, the custom duty shall be as follows:

Date	MT	Value (USD)	Exchange rate	Value in NRS	Duty @ 1%
18.07.2072	8,000	80,000	Rs. 101	8,080,000	80,800
19.07.2072	2,000	20,000	Rs. 100	2,000,000	20,000
Total Custom Duty					100,800
Advance deposited					100,000
Balance due					800

Hence the duty deposited is inadequate by Rs 800.

Question No. 23(a)

i) Transaction value of identical goods and similar goods method:
If the customs value of any goods cannot be determined on the basis of the transaction value declared by the importer or the bills, invoices and documents submitted by the importer, the customs officer will give a notice, accompanied by the reason for the same to the concerned importer. If the customs value cannot be determined on the basis of the transaction value, the customs duty of such goods will be determined on the basis of the transaction value of identical goods already imported into Nepal prior to the import of such goods. The term identical goods means goods which are the same in all respects, including the physical characteristics, quality and reputation. If the customs value cannot be determined on the basis of the transaction value of identical goods, the customs duty of such goods will be determined on the basis of the transaction value of similar goods already imported into Nepal prior to the import of such goods. The term similar goods means goods which although not alike in all respects, have like characteristics and like component materials which enable them to perform the same functions and to be commercially interchangeable.

ii) Deductive value method and computed value method:
If the customs value cannot be determined on the basis of the transaction value of similar goods and such goods have already been imported into Nepal and sold at market to a person who is not related to the importer, the customs value of such goods will be determined on the basis of deductive value method, by deductive the tax, duty levied in Nepal on the selling price of each unit of the maximum unit so sold, and other related costs and profits. If the customs value cannot be determined on the basis of deductive value method, the customs value will be determined on the basis of computed value method, also calculating the costs incurred in the production or manufacturing of such goods and profits made or likely to be made by the seller while selling such goods to the importer.

Question No. 23(b)

Goods imported or exported are valued as per Harmonized System. As there could be multiple variation on the similar products, custom tariff are determined based on the harmonic code of the goods rather than

their names. According to Section 89 of the Customs Act, if in determining the customs duty, there is a doubt as to in which heading or sub-heading of the harmonized system do any goods fall, the Custom Officer shall classify such goods in the heading or sub-heading as prescribed by the Director General.

There may be ambiguity as to which code a particular goods fall, in such case prior to the exportation or importation of any goods, exporter or importer submits and application to the prescribed committee also comprising an expert in the field concerned for the specification of the heading or sub-heading of commodity classification of such goods, the committee may, also examining a sample of such goods, prescribe the heading or sub-heading of such goods. The Director General and the committee shall, in prescribing a heading or sub-heading, respectively, so prescribe based on the authentic text of the harmonized system of the "World Customs Organization".

For the purposes of prescribing the heading or sub-heading of any goods, advice of the concerned expert or national or international body may be sought.

Question No. 24(a)

Statement showing calculation of factory price

Particulars	Amount (Rs)
Raw material consumed(WN1)	17,40,000
Indirect material (3,00,000-60,000)	2,40,000
Carriage inwards	60,000
Manufacturing expenses	500,000
Net profit	2,50,000
Total factory price	**2,790,000**

Calculation of Excise to be Paid

Excise duty = 20% of Rs 27,90,000	Rs 5,58,000
Less: excise duty on import of indirect materials	(Rs 60,000)
Excise duty to be paid	Rs 4,98,000

Working note:

WN1 Calculation of Raw material consumed

Opening stock of Raw material	Rs 1,50,000
Add: purchase of Raw material(purchase –VAT)	Rs 18,40,000 (20,00,000-1,60,000)
Less: closing stock of Raw material	(Rs 2,50,000)

Raw material consumed Rs 17,40,000

Question No. 24(b)

As per (1) (kha) of section 4kha of Excise Act, 2058, the taxpayer has to pay the excise duty collected during a month within 25th day of the end of the month in which the invoice for excisable goods or services is issued. Further, sub-section 2 of section 4kha states that if a tax payer did not make payment as per 1 (kha), late fee @ 0.05% per day shall be charged on the outstanding excise amount. The company has excise payable of Rs. 15,00,000 that is related to Baisakh, Jestha and Ashadh, 2073. So, late fee shall be as follows till Bhadra 15, 2073.

Month	**Amount Payable (Rs)**	**Stipulated time for deposit**	**per day late fee (Rs)**	**No. of delay days till Bhadra 15, 2073**	**Late Fee(Rs)**
Baisakh	2,50,000	Jestha 25,2072	125	85	10,625
Jestha	4,50,000	Ashadh 25,2072	225	53	11,925
Ashadh	8,00,000	Shrawan 25, 2072	400	22	8,800
Total	15,00,000				31,350

Question No. 24(c)

i) As per section 4e of Excise Act, manufacturers and traders of liquor, Beer and cigarette Industry are not allowed to conduct any type of gift program or provide discount on sale of production to persons unregistered in VAT.
ii) When it is observed that such activities have been committed, the clause of license will be deemed to have been violated.

Since, Friendly Liquor house is not registered in VAT, XYZ Liquors Pvt. Ltd. cannot give cash discount on sale of its production to it.

Thus, XYZ Liquors has violated the clause of license. Hence, excise officer is correct.

Question No. 24(d)

Section 2(Nga 1) of the Excise Duty Act has defined Liquor, as per which liquor means an alcoholic substance made by organic chemical reaction in decayed fruits or starchy materials, or otherwise, having more than 0.5% alcohol contents. Liquor includes rakshi, jand, chhyang, whiskey, rum, gin, brandy, vodka, beer, wine, sherry, cider, perry, mead, malt, industrial alcohol, rectified spirit, ENA (extra Neutral Alcohol) and heads spirit.

Conditions to be fulfilled by a producer of liquor are as follows;

- Every person holding license for producing liquor should fulfill the following conditions:
- Should produce liquor using the blending of spirit manufactured by patent steel plant.
- Must bottle liquor of 15, 25, 30, 40 and 50 UP power.
- Must bottle liquor of 70 UP power in pet bottles of 300 ml.
- Make arrangements for preservation of molasses, spirit, and other raw materials.
- Properly labeling in each of the bottle before sending the items to the godown with batch number, serial number, trade mark, power and producers name.

- Should keep batch control register in the prescribed form.
- Should maintain records explicitly mentioning particulars thereof, of raw materials and water used at the time of fermentation for manufacturing wash.
- Should maintain records of the quantity and vat number of the wash to be distilled before pouring the wash ready for distillation into the wash distillation plant.
- No outsider other than staff of the distillery and brewery may enter into the place where the liquor is manufactured or where it is preserved.
- Should maintain the accounts of sales of liquor and excise duty chargeable on the sales in the format prescribed.

Question No. 24(e)

As per section 4ka of Excise Act, the following person shall be responsible for paying excise duty;

i) In case of goods or services produced in Nepal – Producer.
ii) In case of Import of goods – Person mentioned in Bill of Lading, Airway Bill or application for checking.
iii) Auction of excisable substance – Person accepting the auction.
iv) Sale from duty free shop except liquor or cigarette if resold or used in any other purpose – Person reselling or reusing the goods.
v) Change in status from not excisable goods or services to excisable goods or services – Person in ownership of goods.
vi) Apart from above referred in a to e – Person specified by the department.

Question No. 25

a) As defined in the Section 2 (sha) of the Customs Act, Demurrage is a fee levied by the government as penalty for not releasing the goods from the customs warehouse in time by the importer or exporter. There is certain time allowed to the importer/exporter to clear the goods from the custom godowns, if till such time the goods are not cleared then the demurrage is charged
However if the delay is on the part of custom officer due to issue in valuation, classification or any other reason than in such situation demurrage is not charged.
In some other special situation, the demurrage can be waived also by the authorized officer.

b) As per the WTO's General Agreement on Trade and Tariff agreement, the value of imported goods is determined on transaction value basis. This means that the duty is paid based on the invoice value of the goods. But there can be cases where the value declared by the importer for the custom valuation purpose is lower than the value estimated by the custom officer. Such situation is referred as under invoicing. This means that the valuation shown by the invoice is suppressed so that the goods could be imported paying lesser duty. This is a major issue in the developing economy, and this will have far reaching implication of illegal trade etc.

Rule 29 of the Customs Rule has prescribed the process to control such practice by empowering the Department to have the right to purchase the goods by paying 5% excess on the declared value of the goods through a special fund created for the purpose. Ministry of Finance may

provide the budget for this fund which does not get freeze once the fiscal year is closed. The department should notify the importer or his agent of its decision to buy the goods from the fund. Goods purchased through the fund may be auctioned or can be used for the government purposes. There have been cases in the past where the government decided to buy the goods through this provision.

c) Section 2 of the Excise Act defines the terms Physical Control System and Self Removal System. As per the definition, Physical Removal System is a system where the excisable good's production, removal, export or import take place under the control of Excise Officer or the staff nominated by Excise Officer. This is adopted in the case of cigarettes and tobacco products and liquor. Without payment of excise duty in advance, the goods are not allowed to be transported outside the factory premises.

Self-Removal system on the other hand is the system where the production, removal, export or import of excisable goods and services takes place not under the direct control of the excise officer but the production, removal, export or import of excisable goods and services takes place with freedom to the manufacturer but he has to keep proper records so that the excise officials cannot any time visit the place of manufacture and check the records for its correctness.
Under this system the manufacturer can pay the excise duty as per his records within 25 days from the end of each month.

CAP III COSTING

REVISION TEST PAPER
DECEMBER 2016

Standard Costing

Q1. The following information is available from the records of CAS Ltd. which follows the Partial plan of accounting for standard costs for May 2016.

Material purchased 10'000 pieces at Rs.11 Rs. 110'000
Materials consumed 9'500 pieces at Rs.11 Rs. 104'500
Actual wages paid 2'475 hours at Rs. 35 Rs. 86'625
Actual factory expenses incurred Rs. 170'000 (budgeted Rs. 165'000)
Units produced: 900 units and sold at Rs. 60 per unit
The standard rates and prices are as under:
Direct materials Rs. 10 per unit
Standard input 10 pieces per unit
Direct labour rate Rs 30 per hour
Standard requirement 2.5 hours per unit
Overheads Rs. 60 per labour hour

Required

a) Prepare Standard Cost Sheet b) Calculate the variances c) Show the journal entries to record the transactions d) Show Journal Entry for disposal of variances e) Prepare material control Account and WIP Control account.

Solution:

a) Standard Cost sheet

Cost	SQ	SR	Standard Cost Rs.
Direct material	9'000	10	90'000
Direct Labour	2'250	30	67'500
Overheads	2'250	60	135'000
			292'500

b) Calculation of Variances

Material Price variance=AQ (SP-AP) =9'500 (Rs 10-Rs 11) = Rs 9'500 (A)

Material usage variance=SR (SQ-AQ) = Rs 10 (9'000pcs-9'500pcs) = Rs 5'000 (A)

Labour rate variance= AH (SR-AR) = 2'475 hrs. (Rs 30- Rs 35) = Rs 12'375 (A)

Labour efficiency variance=SR (SH-AH) =Rs. 30 (2'250 hrs-2'475 hrs) = Rs 6'750 (A)

Overhead variances
1. Absorbed overheads (SH*SR) = (2'250* Rs.60) = Rs. 135'000

2. Standard Overheads (AH*SR) = (2’475* Rs.60) = Rs. 148’500
3. Budgeted Overheads= Rs.165’000
4. Actual Overheads= Rs. 170’000

Efficiency variance: Absorbed overheads- Standard Overheads= Rs. 13’500 (A)
Capacity variance: Standard Overheads- Budgeted Overheads= Rs. 16’500 (A) (idle time)
Expense variance: Budgeted Overheads- Actual Overheads= Rs. 5’000 (A)
Total variance: Absorbed overheads- Actual Overheads= Rs. 35’000 (A)

c) Journal entries to record the transactions

Particulars	Dr. (Rs)	Cr. (Rs)
Material Control A/C To General Ledger Adjustment A/C (Being the purchase value of 10’000 pieces of material at Rs. 11 each)	110’000	110’000
Work in Progress A/C To Material Control A/C (Being the cost of 9’500 pieces of materials actually issued to production at the actual price of Rs. 11 each)	104’500	104’500
Work in Progress A/C To wages Control A/C (Being the actual amount of direct wages paid for 2’475 hours at Rs. 35 per hour)	86’625	86’625
Work in Progress A/C To Overhead expense Control A/C (Being the actual overhead expense incurred)	170’000	170’000
Finished stock control A/C To work in progress A/C (Being the standard cost of production transferred to finished goods account)	292’500	292’500
Cost of sales A/C To Finished stock control A/C (Being the standard cost of production transferred to finished goods account)	292’500	292’500

After the basic transactions are posted, the materials control account will show the actual value of stock of material in hand and the work in progress account will show a balance representing the cumulative variances on all the accounts and closing balance of work in progress at standard cost. The variances have already been analysed in para (b) above and they will be carried to the respective accounts pending investigation before being finally disposed off. In this question we have assumed that there is no closing balance of work-in-progress.

d). Journal entry for disposal of variances

Particulars	Dr. (Rs)	Cr. (Rs)
Material Price variance A/C	9’500	
Material Usage variance A/C	5’000	
Labour rate variance A/C	12’375	
Labour Efficiency variance A/C	6’750	
Overhead Efficiency variance A/C	13’500	
Overhead Capacity variance A/C	16’500	
Overhead Expense variance A/C	5’000	
To Work in Progress A/C		68’625

e). Material Control Account

Particulars	Rs.	Particulars	Rs.
To opening balance	-	By Work in progress A/C	104’500
To Gen Led Adj. A/C	110’000	By balance C/D	5’500
	110’000		110’000

Work In Progress Control Account

Particulars	Rs.	Particulars	Rs.
To opening balance	-	By Finished stock control A/C	292’500
To Material Control A/C	104’500	By Material Price Variance A/C	9’500
To wages Control A/C	86’625	By Material Usage Variance A/C	5’000
To overhead control A/C	170’000	By Labour rate Variance A/C	12’375
		By Labour efficiency Variance A/C	6’750
		By Overhead efficiency Variance A/C	13’500
		By Overhead capacity Variance A/C	16’500
		By Overhead expense Variance A/C	5’000
	361’125		361’125

Transfer Pricing

Q2. SV Ltd. has two divisions. Division A manufactures components which are used by division B to produce a finished product. For the next period output and costs has been budgeted follows:

Particulars	Division A	Division B
Component (units)	50’000	
Finished (units)		50’000
Total variable costs	Rs 250’000	Rs 600’000
Fixed Costs	Rs 150’000	Rs 200’000

The fixed costs are separable for each division.

Required: Advise on the transfer price to be fixed for Division A’s component under the following situation:

Situation 1: Division A sells the component in a competitive market for Rs. 10 per unit. Division B can also purchase the component in the open market at that price.

Situation 2: As per the situation in 1, but assessing that Division B currently buys the component from an external supplier at the market price of Rs. 10 and there is a reciprocal agreement between the external supplier and another division C within the group. Under this agreement the external supplier agrees to buy one product from Division C at a profit of Rs. 4 per unit to that division for every component which division B buys from the supplier.

Situation 3: Situation 1 and 2 do not apply as there is no external market for the component produced by division A and division B’s product is selling in a very competitive market at Rs 28 per unit.

Solution: I. Statement of transfer price

Particulars	Amount Rs.
Cost to be incurred due to transfer	5
Add: benefit to be lost due to transfer	5
Transfer Price	10

II. Statement of transfer price

Particulars	Amount Rs.
Cost to be incurred due to transfer	5
Add: benefit to be lost (by non selling) to market	5
Add: Benefit to be lost due to C Division	4
Minimum Transfer Price	14

III. Statement of Company profit

Particulars	Amount Rs.
Sale (50’000*28)	1’400’000
Less: Cost	
Department A	400’000
Department B	800’000
Profit	200’000

Distribution of Profit

A’s Profit= 400’000*200’000/1’200’000= Rs 66’666.66

B’s Profit= 200’000-66’666.66= Rs 133’333.33

Statement of transfer price

Particulars	Amount Rs.
Cost	400’000
Add: Profit	66’666.6
Total Cost	466’666.6

Hence, Transfer Price 466’666.6/50’000=9.33 per unit

Cost Audit

Q3. Enumerate the advantages of Cost Audit?

Solution:

Cost audit offers many advantages to management, cost accountant, shareholders, statutory auditor, consumers and the government.

These advantages are summarized below:

Advantages to Management:

(i) Errors in following costing principles and techniques are detected. Inconsistencies and frauds can also be detected. This keeps everyone alert and promotes efficiency.

(ii) Cost audit can serve to measure performance of managers and better performance can be rewarded.

(iii) It helps to prepare accurate cost reports and thus business planning can be more accurate.

(iv) Inter-firm comparisons can be made with ease and this might be a very useful proposition if industrial intelligence is good.

(v) Cost audit can give an idea about the comparative operational efficiency of each department of division; and may thus pin-point deficiencies and also encourage to operate in a competitive spirit.

Advantages to Management/Cost Accountant:

(i) His task is facilitated since errors, deficiencies, etc., are pointed out. Costing plans can be prepared to take care of these things.

(ii) Cost audit may help in easier reconciliation of cost and financial accounts.

(iii) If the cost auditor is an outsider and is an expert, he can certainly give some practical and sound advice to streamline costing systems and organization.

(iv) Cost audit helps to focus attention of management on the problems faced by the cost accountant. This helps him to realize his goals and objectives with ease.

Advantages to Statutory Auditor

(i) Audited cost data helps him to determine the value of stocks, remuneration of managerial personnel, etc., with ease and accuracy.

(ii) Data and statements of cost audit help him to prepare his audit programme and plan so that he concentrates more on those aspects which have not been adequately covered by cost audit.

Advantages to Consumers:

(i) The direct benefit accrues where a statutory cost audit has been done to fix a reasonable price for the consumers.

(ii) Since cost audit aims at ensuring efficiency in the organization, this may also get reflected in reduced prices to the consumers.

Advantages to Labour:

(i) If cost audit is done thoroughly labour also stands to gain through increased profitability in the shape of bonus and other benefits.

(ii) Also it brings into focus the role of labour in improving efficiency in term of increased productivity.

Advantages to Shareholders:

(i) There is correct valuation of all kinds of inventories. This may project a true picture of the organisation before shareholders and other investors and help them to assess its performance.

(ii) External cost audit highlights efficiency or inefficiency, utilisation of manpower and other resources, adequacy of return, etc.

Advantages to Government and Economy:

(i) It helps the government to settle accounts where cost-plus contracts have been made.

(ii) The government can intervene to protect the interests of the consumers, labor, shareholders and investors from exploit-age or inefficient managements.

(iii) At the national level, cost audit promotes cost consciousness and overall efficiency. This means that every rupee invested produces the maximum quantity of goods and services.

Total Quality Management

Q.4 KNM Road carriers is a transporting company that transport goods from one place to another. It measures quality of service in terms of:

(i) Time required to transport goods

(ii) On-time delivery

(iii) Number of lost or damaged cartons.

To improve its business prospects and performance the company is seriously considering to install a scheduling and tracking system, which involves an annual outlay of Rs. 125'000. The company furnishes the following information about its present and anticipated future performance:

	Current	Expected
On time delivery	85%	95%
Variable cost per carton lost or damaged	Rs 55	Rs 55
Fixed cost per carton lost or damaged	Rs 45	Rs 45
Number of cartons lost or damaged	2'500	1'200

The company expects that each half percent point increase in on-time performance will result in revenue increase of Rs 9'000 per annum. Contribution margin of 45% is required.

Required

(i) Should KNM Road Carriers acquire and install the new system?

(ii) Also calculate additional amount of revenue required if benefits from new system is equal to cost and contribution margin is 47.5%.

Solution:

(i) Should KNM Road Carriers acquire and install the new system?

	Amount Rs
Per annum additional cost for new scheduling and tracking system	125'000
Additional revenue from improvement in on- time performance (Rs. 9000*10%/0.5%)	180'000
Contribution from additional annual revenue (Rs 180'000*45%) (A)	81'000
Cost savings in respect of cartons [(2'500-1'200)]* Rs 55] (B)	71'500
Total benefits (A)+(B)	152'500

As expected benefit is more than the cost. Accordingly company should install the new system.

(ii) Calculation of additional amount of revenue required if benefits from new system is equal to cost and contribution margin is 47.5%.

		Amount Rs
Additional cost for new scheduling and tracking system	(A)	125’000
Cost savings in respect of cartons [(2’500-1’200)]* Rs 55]	(B)	71’500
Contribution margin	(A)-(B)	53’500
Contribution margin %		47.5
Corresponding additional revenue		112’632

Linear Programming

Q5. The manufacturing company has 100 kg of A, 180 kg of B & 120 kg of C ingredients available per month. Company can use these materials to make three basic products namely 5-10-5, 5-5-10 and 20-5-10, where the numbers in each case present the percentage of weight of A, B and C respectively in each of products. The costs of these raw materials are as under:

Ingredient	Cost per kg Rs
A	64
B	16
C	40
Inert Ingredients	16

Selling price of these products are Rs 32.60, Rs 34.80 and Rs 36 per kg respectively. There is capacity restriction of the company product 5-10-5, so that company cannot produce more than 30 kg per month.

Required

Formulate this problem as an LP model to determine the productions (in kg.) of each product which will maximize its monthly profit.

Formulate only.

Solution:

Let P1, P2 & P3 be the three products to be manufactured. Then the data are as follows:

Products	Product ingredients			
	A	B	C	Inert ingredients
P1	5%	10%	5%	80%
P2	5%	5%	10%	80%
P3	20%	5%	10%	65%
Cost per kg Rs	64	16	40	16

Cost of product P1

=5%*Rs64+10%*Rs16+5%*Rs40+80%*Rs16

=Rs19.6 per kg

Cost of product P2

=5%*Rs64+5%*Rs16+10%*Rs40+80%*Rs16

=Rs 20.80 per kg.

Cost of product P3

=20%*Rs64+5%*Rs16+10%*Rs40+65%*Rs16

=Rs 28 per kg

Let X1, X2 & X3 be the quantity (in Kg) of P1,P2 & P3 respectively to be manufactured.

The LP Problem can be formulated:

Objective function:

Maximise Z= (Selling price-cost price)* Quantity of product

= (Rs 32.60- Rs19.60) X1+ (Rs 34.8- Rs20.8) X2+(36-28) X3

= 13X1+14X2+8X3

Subject to Constraints:

1/20X1+1/20X2+1/5X3≤100

Or X1+X2+4X3≤2'000

1/10X1+1/20X2+1/20X3≤180

Or 2X1+X2+X3≤3600

1/20X1+1/10X2+1/10X3≤120

Or X1+2X2+2X3≤2'400

X1≤30

And X1,X2, X3≥0

Activity based costing

Q.6 (a) A manufacturing company produces ball pens that are printed with the logos of various companies. Each pen is priced at Rs 5. Costs are as follows:

Cost driver	Unit variable cost Rs	Level of cost driver
Units sold	2.5	-

Setups	225	40
Engineering hours	10	250

Other data

Total fixed cost (conventional) Rs 48’000

Total fixed cost (ABC) Rs 36’500

Required

(i) Compute the break-even point in units using activity-based analysis.

(ii) Suppose that company could reduce the set up cost by Rs 75 per set up and could reduce the number of engineering hours needed to 215. How many units must be sold to breakeven in this case?

Just in time

Q 6(b) Haigh ltd is a leading manufacturing company. Under increasing pressure to reduce costs, to certain inventory and to improve service, Haigh costing department has recently undertaken a decision to implement a JIT system.

The management of Haigh is convinced of the benefits of their changes. But supplies manager Mr. Smith fears with the costing department’s decision. He said:

‘’ We have been driven by suppliers for years…… they would insist that we could only purchase in thousands, that we would have to wait weeks, or that they would only deliver on Mondays!’’

Required

Is Mr. Smith’s point correct and why?

Solution: 6 (a)

(i) Breakeven units

[Fixed cost+ (set up cost*set ups)+ (Engineering cost*engineering hours)]/(sale price-variable cost)

= [36’500+ (Rs 225*40)+(Rs10*250)]/(Rs5-Rs2.5)

= 19’200 units

(ii) Units required to breakeven if certain variables are changed

[Fixed cost+ (set up cost*set ups) + (Engineering cost*engineering hours)]/(sale price-variable cost)

= [36’500+ (Rs 150*40)+ (Rs10*215)]/(Rs5-Rs2.5)

=17’860units

Solution 6(b)

‘’For successful implementation of JIT inventory system, the suppliers chosen must be willing to make frequent deliveries in lots. Rather than deliver a week’s or a month’s material at one time, suppliers must be willing to make deliveries several times a day and in the exact quantities specified by the buyer.’’

It is specified in the problem that suppliers are not willing to

-make frequent deliveries and

-make supplies in the exact quantities as required

Accordingly, Mr. Smith's doubt is correct on successful implementation of JIT system.

Break-even point – Production in Batches:

Q.7 Electro Life Ltd. is a leading Home Appliances manufacturer. The company uses just-in-time manufacturing process, thereby having no inventory. Manufacturing is done in batch size of 100 units which cannot be altered without significant cost implications. Although the products are manufactured in batches of 100 units, they are sold as single units at the market price. Due to fierce competition in the market, the company is forced to follow market price of each product. The following table provides the financial results of its four unique products.

	Alpha	Beta	Gamma	Theta	Total
Sales(units)	2,00,000	2,60,000	1,60,000	3,00,000	
	(Rs)	(Rs)	(Rs)	(Rs)	(Rs)
Revenue	2,60,000	45,20,000	42,40,000	32,00,000	145,60,000
Less: Material Cost	6,00,000	18,20,000	18,80,000	10,00,000	53,00,000
Less: Labour Cost	8,00,000	20,80,000	12,80,000	12,00,000	53,60,000
Less: Overheads	8,00,000	7,80,000	3,20,000	12,00,000	31,00,000
Profit/(Loss)	4,00,000	(1,60,000)	7,60,000	(2,00,000)	8,00,000

Since, company is concerned about loss in manufacturing and selling of two products so, it has approached you to clear picture on its product and costs. You have conducted a detailed investigation whose findings are below:

The overhead absorption rate of Rs 2 per machine hour has been used to allocate overheads into the above product costs. Further analysis of the overhead cost shows that some of it is caused by the number of machine hours used, some is caused by the number of batches produced and some are product specific fixed overheads that would be avoided if the product were discontinued. Other general fixed overhead cost would be avoided only by the closure of the factory. Numeric details are summarized below:

	Rs	Rs
Machine hour related		620,000
Batch related		460,000

Product specific fixed overhead:

Alpha	1,000,000	
Beta	100,000	
Gamma	200,000	
Theta	100,000	1,400,000
General fixed overheads		620,000
		3,100,000

The other information is as follows:-

	Alpha	Beta	Gamma	Theta	Total
Machine Hours	4,00,000	3,90,000	1,60,000	6,00,000	15,50,000
Labour Hours	1,00,000	2,60,000	1,60,000	1,50,000	6,70,000

(i) Prepare a profitability statement that is more useful for decision making than the profit statement prepared by Electro Life Ltd.

(ii) Calculate the break even volume in batches and also in approximate units for Product 'Alpha'.

Solution:

	Products (Amount in Rs)				
	Alpha	Beta	Gamma	Theta	Total
Sales	26,00,000	45,20,000	42,40,000	32,00,000	1,45,60,000
Direct Materials	6,00,000	18,20,000	18,80,000	10,00,000	53,00,000
Direct Wages	8,00,000	20,80,000	12,80,000	12,00,000	53,60,000
Overhead(W.N.2)					
Machine Related	1,60,000	1,56,000	64,000	2,40,000	6,20,000
Batch Related	1,00,000	1,30,000	80,000	1,50,000	4,60,000
contribution	9,40,000	3,34,000	9,36,000	6,10,000	28,20,000
Product Specific	10,00,000	1,00,000	2,00,000	1,00,000	14,00,000

Fixed Overheads					
Gross profit	(60,000)	2,34,000	7,36,000	5,10,000	14,20,000
General Fixed Overheads					6,20,000
Profit					8,00,000

(ii) Break-even Point

Total Sale Value of Product 'Alpha' = Rs 2,600,000

Total Contribution of Product 'Alpha' = Rs 940,000

Specific Fixed Overheads (Product Alpha) = Rs 1,000,000

Break-even Sales (Rs) = Specific Fixed Cost/ Total contribution × Total Sales Value

= Rs 1,000,000 / Rs 940,000 × Rs 26,00,000

= Rs 2,765,957.45

Break-Even Sales (units) = Rs 2,765,957.45 / Rs13.00

= Rs 212,766 units

However, production must be done in batches of 100 units. Therefore **2,128 batches** are required for break even. Due to the Production in batches, 34 units (2,128 batches x 100 units – 212,766 units) would be produced extra. These 34 units would add extra cost Rs 282.20 (34 units x Rs 8.3*). Accordingly, break- even units as calculated above will increase by 22 units (Rs 282.20/Rs13.00).

(*) (Rs 6,00,000 + Rs 8,00,000 + Rs 1,60,000 + Rs 1,00,000 / 2,00,000 units)

Break- even units of product 'Alpha' is 212,788 units (2,12,766 units + 22 units).

Workings:

W.N.-1 Calculation Showing Overhead Rates

Overhead's Related Factors	Overhead Cost (Rs) [a]	Total No. of Units of Factors [b]	Overhead Rate (Rs) [a]/[b]
Machining Hour	6,20,000	1,550,000 hrs.	0.40
Batch Production	4,60,000	9,200 batches	50.00

W.N.-2 Statement Showing- Overhead Costs related to product

Particulars	Alpha	Beta	Gamma	Theta
Machining hrs. Related overheads	Rs 1,60,000 (4,00,000 hrs x Rs0.40)	Rs1,56,000 (3,90,000 hrs x Rs0.40)	Rs64,000 (1,60,000 hrs x Rs0.40)	Rs2,40,000 (6,00,000 hrs x Rs0.40)
Batch related overheads	Rs1,00,000 (2,000 batches x Rs50)	Rs1,30,000 (2,600 batches x Rs50)	Rs80,000 (1,600 batches x Rs50)	Rs1,50,000 (3,000 batches x Rs50)

PERT and CPM – Basic Concepts

Q.8 (a) State the validity of following statements along with the reasons:

(i) Two activities have common predecessor and successor activities. So, they can have common initial and final nodes.

(ii) In respect of any activity whether real or dummy, the terminal node should bear a number higher than the initial node number.

(iii) The difference between the latest event time and the earliest event time is termed as free float.

(iv) For every critical activity in a network, the earliest start and the earliest finish time as well as the latest finish time and the latest start time are the same.

(v) The optimal duration of a project is the minimum time in which it can be completed.

(vi) Resources levelling aims at smoothening of the resource usage rate without changing the project duration.

Limiting Factor

Q 8 (b) List out the basis for deciding the priority of selecting the best product in the different circumstances stated below:

(i) When maximum sales (in value) is a limiting factor.

(ii) When raw material is a limiting factor.

(iii) When labour hour is a limiting factor.

(iv) When there is a heavy demand for the product.

Solution: 8 (a)

(i) Invalid

Reason: As per the rules of network construction, parallel activities between two events, without intervening events, are prohibited. Dummy activities are needed when two or more activities have same initial and terminal events. Dummy activities do not consume time or resources.

(ii) Valid

Reason: As per the conventions adopted in drawing networks, the head event or terminal node always has a number higher than that of initial node or tail event.

(iii) Invalid

Reason: The difference between the latest event time and the earliest event time is termed as slack of an event. Free float is determined by subtracting head event slack from the total float of an activity.

(iv) Invalid

Reason: For every critical activity in a network, the earliest start time and the latest start time is same and also the earliest finish time and the latest finish time is same.

(v) Invalid

Reason: The optimum duration is the time period in which the total cost of the project is minimum.

(vi) Valid

Reason: Resource leveling is a network technique used for reducing the requirement of a particular resource due to its paucity or insufficiency within a constraint on the project duration. The process of resources leveling utilize the large floats available on non-critical activities of the project and cuts down the demand of the resources.

Solution: 8 (b)

Case	Basis for selecting priority of product
If maximum sales (in value) is a limiting factor.	Profit volume ratio
If raw material is a limiting factor	Contribution per unit of raw material required to produce one unit of product
If labour is a limiting factor	Contribution per unit of labour hour required to produce one unit of product
If there is a heavy demand for the product	Profit volume ratio

Service sector costing

Q 9 Ace tours and travels Pvt. Ltd is planning to run a fleet of 15 buses in Dhanusha district on a fixed route. Company has estimated a total of 25’185’000 passenger kilometers per annum. It is estimated buses to have 100% load factor. Buses are purchased at a price of Rs. 4,400,000 per unit whose scrap value at the end of 5 years life is Rs 550’000. Seating capacity of a bus excluding a driver’s seat is 42.

Each bus can give a mileage of 5 kmpl. Average cost of fuel is Rs 66 per litre. Cost of lubricants and sundries per 1000 km would be Rs 3'300, Company will pay Rs 27'500 per month to driver and two attendants for each bus.

Other annual charges per bus: Insurance Rs 55'000, Garage charge Rs.33'000, Repairs and maintenance Rs 55'000. Route permit charges upto 20'000 km is Rs 5'500 and Rs 2'200 for every additional 5'000 km or part thereof.

Required

(i) Calculate a suggested fare per passenger/km taking into account markup on cost @20% to cover general overheads and sufficient profit.

(ii) The transport sector of Dhanusha is highly regulated. The Government has fixed the fare @ Rs 1.35 for next two years. Comment on the two year's profitability taking into consideration the inflation rate of 8%.

Note: Route permit charges is not subject to inflation.

Solution:

(i) Statement suggested fare per passenger-km (Each Bus)

Particulars	Cost per annum Rs
Fixed Expenses:	
Insurance	55'000
Garage charges	33'000
Depreciation	770'000
Running expenses	
Repair and maintenance	55'000
Cost of lubricants and sundries	138,517.50
Fuel cost	554'070
Salary of driver and two attendants	330'000
Route permit charges	16'500
Total cost per annum	1,952,087.50
Add: Mark up 20% of total cost or 16.67% of total revenue	390,417.50
Total Revenue	2'342'505

Rate per passenger-km equals to Rs 1.395

Workings

Total passenger kms 25’185’000

Total Buses 15

Passenger km per bus 1’679’000 (25,185,000kms/15)

Total passenger capacity per bus 42-2=40

Annual distance covered by bus 41’975kms. (1’679’000kms/40)

(ii) Regulated fare per passenger km is Rs 1.35

Profitability statement for each bus

Particulars		Year I (Rs.)	Year II (Rs.)
Fixed Expenses:			
Insurance		59’400	64’152
Garage charges		35’640	38’491.20
Depreciation		770’000	770’000
Running expenses			
Repair and maintenance		59’400	64’152
Cost of lubricants and sundries		149’598.90	161’566.81
Fuel cost		598’395.60	646’267.25
Salary of driver and two attendants		356’400	384,912
Route permit charges		16’500	16’500
Total Cost	(A)	2’045’334.50	2’146’041.26
Total Revenue regulates	(B)	2’266’650	2’266’650
Gross Margin	(B)-(A)	221’315.50	120’608.74
Gross margin to total revenue		9.76%	5.32%

The gross margin is showing a downward trend because the cost components have taken into effect of inflation but the total revenue remained stagnant due to Government regulations which resulted in reduction in gross margin per bus.

The Company’s gross margin to total revenue ratio has come out to be 9.76% and 5.32% in first and second year respectively but initially the company’s desired gross margin to total revenue ratio is 16.67% to cover general overheads and sufficient profit. Though the amount of general overheads is not given but

we can safely assume that they may also subject to inflation i.e. increase year by year then in such case the company needs to maintain or increase its gross margin per bus to maintain its net profit after general overheads which is not possible in regulated environment. The information about regulated fare in the given case is regarding first two years only but if this regulated fare scenario persists for further years then the project may not be viable for the company.

Learning Curve Theory

Q 10 KD Sports manufactures cricket bat purely carried out by manual labour. It has a capacity of 16,000units.It estimates the following cost structure:

Direct material	Rs.35/Unit
Direct labour (1.5 hours/unit)	Rs.24/Unit
Variable Overhead	Rs.15/Unit

Fixed overhead at maximum capacity is Rs.225,000.

It is estimated that at the current level of efficiency, each unit requires one and half hour for the first 4,000units. Subsequently it is possible to achieve80%learning rate. The market can absorb the first 4,000 units@Rs.150/unit.
What should be the minimum selling price acceptable for an order of 12,000 units for a prospective client?

Solution: Computation of minimum selling price

Particulars	For 4,000 Units (Rs.)	For 16,000 Units (Rs.)
Material	140,000	560,000
Direct Labour	96,000	245,760(W. N 1)
Variable Overhead	60,000	240,000
Total Variable Cost	296,000	1,045,760
Fixed Cost	225,000	225,000
Total Cost	521,000	1,270,760
Total Cost/Unit	130.25	79.42
Sales	600,000	600,000+12000X
Profit	79,000	12000X-(1,270,760-600,000)

Minimum selling price for the order of 12000 demand from a prospective customer should not be less than Rs. 55.89 (Working Note-2)
Working Note-1
Direct labour cost at 16,000units level

Units	Hours
4,000	4,000*1.5=6,000
8,000	8,000*1.5*80%=9,600
16,000	16,000*1.5*80%*80%=15,360

15,360 hours*24/1.5=Rs.245,760

Working Note-2

Sales at 16,000 units level

Let X be the selling price per unit for an order of 12,000 units

Total sales=Rs.600,000+12'000X

Cost to be covered by the further sale of 12,000 units

1,270,760-600,000≤12,000X

670,760≤12,000X

55.89≤X

Therefore, minimum selling price should be Rs.55.89 i.e.Rs.670,760/12000 units.

Simulation

Q11 Finance controller of Drunk Ltd. has drawn the following projections with probability distribution:

Raw material		Wages & other variable overheads		Sales	
Rs in 000	Probability	Rs in 000	Probability	Rs in 000	Probability
08-10	0.2	11-13	0.3	34-38	0.1
10-12	0.3	13-15	0.5	38-42	0.3
12-14	0.3	15-17	0.2	42-46	0.4
14-16	0.2			46-50	0.2

Opening cash balance is Rs 40'000 and fixed cost is estimated at Rs 15'000 per month.

Required

Simulate cash flow projection and expected cash balance at the end of the sixth month. Use the following single digit random numbers.

Raw material	4 3 1 0 4 6
Wages & other variable overheads	2 7 9 1 8 9
Sales	0 6 6 0 2 8

Solution

Allocation of random numbers

Raw material			Wages & other variable overheads			Sales		
Mid Point	Cum Prob.	Random Nos.	Mid Point	Cum Prob.	Random Nos.	Mid Point	Cum Prob.	Random Nos.
9	0.2	0-1	12	0.3	0-2	36	0.1	0
11	0.5	2-4	14	0.8	3-7	40	0.4	1-3
13	0.8	5-7	16	1	8-9	44	0.8	4-7
15	1	8-9				48	1	8-9

Simulation table

Month	Raw material	Wages & other V.O	Sales	Fixed cost	Net cash flow	Cash balancing (Opening Rs 40 thousand)
1	11	12	36	15	-2	38
2	11	14	44	15	+4	42
3	9	16	44	15	+4	46
4	9	12	36	15	0	46
5	11	16	40	15	-2	44
6	13	16	48	15	+4	48

Optimal product mix/Decision making

Q12 Four products P, Q, R and S are produced by profit center Division A. Each product is sold in the external market also. Data for the period are as follows:

	P	Q	R	S
Market price per unit Rs	70	69	56	46
Variable cost of production per unit Rs	66	59	36	37
Labour hours per unit	3	2	2	3
Specific fixed costs Rs per 10’000 units of product	2’500	12’600	15’000	18’000

Product S can be transferred to Division B but the maximum quantity that might be required for transfer is 20'000 units of S. The specific fixed costs given above are avoidable if a product is not made. They are uncured for every 10'000 units.

The maximum sales units in the external market are:

P	30'000
Q	31'000
R	28'000
S	18'000

Division B can purchase the same product at a slightly cheaper price of Rs 45 per unit instead of receiving transfers of product S from Division A without any extra transport/inspection costs. B can also take partial supplies from A.

The total labour hours available in Division A is 192'000 hours.
(i) What is A's optimal product mix and the corresponding contribution net of specific fixed costs?
(ii) How much units should A transfer to B and at what price?
(iii) Is it in the Company's interest to transfer 20'000 units of S to B?

Solution: Statement showing Contribution per unit as well as contribution per labour hour

Maximum sales units	30'000	31'000	28'000	18'000
Products	P	Q	R	S
Market price per unit (Rs)	70	69	56	46
Less: variable cost of production per unit (Rs)	66	59	36	37
Contribution per unit(Rs)	4	10	20	9
Labour hours per unit	3	2	2	3
Contribution per labour hour	1.33	5	10	3
Rank	IV	II	I	III
Specific Fixed Costs Rs per 10'000 units	2'500	12'600	15'000	18'000

Rank would be same in case of '' Contribution net of Specific Fixed Cost''

Allocation of labour hours on the basis of ranking

Particulars	Hours
Hours Available	92'000
Less: Allocated for R (Rank I) (28'000 Units * 2 hrs)	56'000
Balance	136'000

Less: Allocated for Q (Rank II) (30’000 Units * 2 hrs)	60’000
Balance	76’000
Less: Allocated for S (Rank III) (18’000 Units * 3 hrs)	54’000
Balance	22’000
Hours allocated for P (Rank IV) (22’000/3=7’333.33)	22,000

Note: Manufacturing of 30’000 units of Q is only justified due to additional Rs 12’600 being spent.

Statement showing optimal product mix and contribution net of specific fixed costs on the basis of ranking

Product	P	Q	R	S	**Total**
Rank	IV	II	I	III	
Units	7’333.33	30’000	28’000	18’000	
Contribution (Rs/unit)	4	10	20	9	
Total Contribution Rs	29’333.32	300’000	560’000	162’000	1’051’333.32
Specific fixed cost Rs	2’500	37’800	45’000	36’000	121’300
	26’833.32	262’200	515’000	126’000	930’033.32

Statement showing contribution per unit as well as contribution per labour hour- Product P & S

	P	S ext.	S divB
Maximum sales/transfer (units)	30’000	18’000	20’000
Market price (Rs per unit)	70	46	45
Less: Variable cost of production (Rs per unit)	66	37	37
Contribution (Rs per unit)	4	9	8
Labour hours per unit	3	3	3
Contribution per labour hour	1.33	3	2.66
Ranking	III	I	II
Specific Fixed Costs (Rs/10’000 units)	2’500	18’000	18’000

Statement showing computation of quantity transfer to Division B

Particulars	Hours
Hours available after allocation to Q & R	76’000
Less: Allocated for Sext (Rank I) (18’000units*3hrs)	54’000
Balance	22’000
Less: Allocated for SdivB (Rank II)(22’000/3=7’333.33units)	22’000

Statement showing computation of transfer price

Particulars	Units
Variable Cost (7333.33 units* Rs 37)	271’333.21
Add: Loss of contribution net of specific fixed cost ‘’P’’	26’833.32
Add: Additional specific fixed cost ‘’S’’	18’000
Total	316’166.53
Transfer qty	7333.33
Transfer price (Rs 316’166.53/7’333.33)	43.11

Statement showing quantity of loss of external sales

Particulars	Units
Requirement S divB	20’000
Less: On the basis of allocation above	7’333.33
Loss of external sales Sext	12’666.66

Statement showing net gains on transfer of 20’000 units to Division B

Particulars	Rs
Savings (20’000 units*(Rs 45-Rs 37))	160’000
Less: Loss of contribution Sext. (12’666.67* Rs9)	114’000
Less: Loss of contribution net of specific fixed cost ‘’P’’	26’833.32
Less: Additional Specific Fixed Cost ‘’S’’	18’000
Net gain	1’166.68

Conclusion

From the financial perspective net gain from transfer of 20’000 units to division B is negligible. To take final call to transfer 20’000 units to Division B Company should consider other factors also such as its market share, future market demand, market price and transportation cost etc.

Budget & Budgetary Control

Q13 The budgeted cost data of a product manufactured by XYZ Co. ltd. is furnished below:

Budgeted units to be produced	200’000
Variable cost per unit Rs	32
Fixed Cost Rs	16 lacs

It is proposed to adopt cost plus pricing approach with a mark-up of 25% on full budgeted cost basis.

However, research by the marketing department indicates that demand of the product in the market is demand sensitive. The likely market responses are as follows:

Selling price per unit Rs.	44	48	50	56	60
Annual demand units	168’000	152’000	140’000	128’000	108’000

Analyse the above situation and determine the best course of action.

Solution: Analysis of Cost plus pricing approach

The company has a plan to produce 200’000 units and it proposed to adopt cost plus pricing approach with a mark-up of 25% on full budgeted cost. To achieve this pricing policy, the company has to sell its product at the price calculated below:

Quantity	200’000 units
Variable cost (200’000 units * Rs 32)	6’400’000
Add: Fixed Cost	1’600’000
Total budgeted cost	8’000’000
Add: Profit (25% of Rs 8’000’000)	2’000’000
Revenue (need to earn)	10’000’000
Selling price per unit (10’000’000/200’000)	Rs 50

However, at selling price Rs 50 per unit the company can sell 140’000 units only, which is 60’000 units less than the budgeted production units.

After analyzing the price-demand pattern in the market (which is price sensitive), to sell all the budgeted units market price needs to be further lowered, which might be lower than the total cost of production.

	I	II	III	IV	Budgeted
Qty units	168’000	152’000	140’000	128’000	108’000
					Amount in Rs
Sales	7’392’000	7’296’000	7’000’000	7’168’000	6’480’000
Less: variable cost	5’376’000	4’864’000	4’480’000	4’096’000	3’456’000
Total contribution	2’016’000	2’432’000	2’520’000	3’072’000	3’024’000
Less: Fixed cost	1’600’000	1’600’000	1’600’000	1’600’000	1’600’000
Profit	416’000	832’000	920’000	1’472’000	1’424’000
Profit(% on total cost)	5.96	12.87	15.13	25.84	28.16

Determination of best course of action

(i) Taking the above calculation and analysis into account, the company should produce and sell 128’000 units at Rs 56. At this price company will not only be able to achieve its desired mark up of 25% on the total cost but can also earn maximum contribution as compared to other even higher selling price.

(iii) If the Company wants to uphold its proposed pricing approach with the budgeted quantity, it should try to reduce its variable cost per unit for example by asking its suppliers to provide a quantity discount on the materials purchased.

Assignment Problem

Q 14 Imagine yourself to be the executive director of a 5 Star hotel which has four banquet halls that can be used for all functions including weddings. The halls were all about the same size but the facilities in each hall differed. During the heavy marriage season, 4 parties approached you to reserve a hall for the marriage to be celebrated on the same day. These marriage parties were told that the first choice among these 4 halls would cost Rs 10,000 for the day. They were also required to indicate the second, third and fourth preferences and the price that they would be willing to pay. Marriage party A & D indicated that they won’t be interested in Halls 3 & 4. Other particulars are given in the following table:

Marriage party	Revenue per hall			
	1	2	3	4
A	10,000	9,000	X	X

B	8,000	10,000	8,000	5,000
C	7,000	10,000	6,000	8,000
D	10,000	8,000	X	X

Where X indicated that the party does not want that hall.

Required: Decide on an allocation that will maximize the revenue to your hotel.

Solution:

The objective of the given problem is to identify the preferences of marriage parties about halls so that hotel management could maximize its profit.

To solve this problem first convert it to a minimization problem by subtracting all the elements of the given matrix from its highest element. The matrix so obtained known as loss matrix is given below:

Step 1 → **Deriving loss matrix** by deducting all events from the largest element (10,000)

Marriage party	Loss Matrix/ Hall			
	1	2	3	4
A	0	1,000	X	X
B	2,000	0	2,000	5,000
C	3,000	0	4,000	2,000
D	0	2,000	X	X

Step 2 → **Column Subtraction:** Subtracting the minimum element of each column from all elements of that column and drawing the minimum number of lines to cover all zeros.

Marriage party	Loss Matrix/ Hall			
	1	2	3	4
A	0	1,000	X	X
B	2,000	0	0	3,000
C	3,000	0	2,000	0
D	0	2,000	X	X

Since Number of lines=3 and order of matrix=4, the above matrix will not provide the optimal solution.

Step 3 ⟶ Subtracting the minimum uncovered element (1,000 in this case) from all uncovered elements and adding it to all elements at the intersection points of the above lines and drawing the minimum number of lines to cover all zeros.

Marriage party	Loss Matrix/ Hall			
	1	2	3	4
A	0	0	X	X
B	3,000	0	0	3,000
C	4,000	0	2,000	0
D	0	1,000	X	X

Since number of lines (4)=order of matrix (4), the above matrix will provide the optimal solution.

Step 4 ⟶ **Assignment:** Selecting a row containing exactly one unmarked zero and surrounding it by '[ ]' and draw a vertical line through the column containing this zero. Repeating this process till no such row is left; then selecting a column containing exactly one unmarked zero and surrounding it by '[ ]' and draw a horizontal line through the row containing this zero and repeating the process till no such column is left.

Marriage party	Loss Matrix/ Hall			
	1	2	3	4
A	0	[0]	X	X
B	3,000	0	[0]	3,000
C	4,000	0	2,000	[0]
D	[0]	1,000	X	X

Step 5 ⟶ Computing maximum:

		Revenue
Marriage Party	A	9,000
Marriage Party	B	8,000
Marriage Party	C	8,000
Marriage Party	D	10,000
Total		**35,000**

CPM/PERT

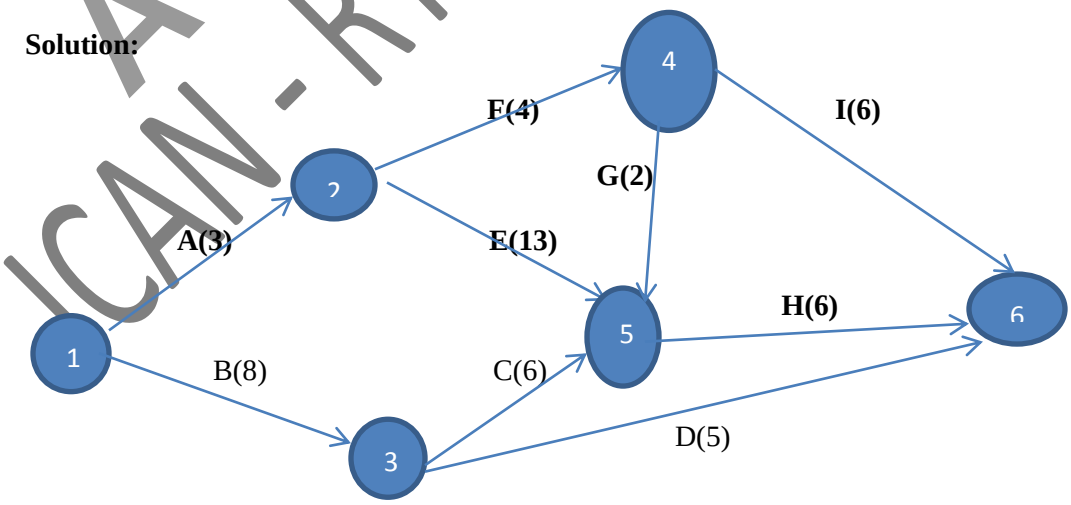
Q15 The data for a project are

Activity	Preceding activity	Time in weeks		Cost (in Rs)	
		Normal	Crash	Normal	Crash
A	-	3	2	18,000	19,000
B	-	8	6	600	1,000
C	B	6	4	10,000	12,000
D	B	5	2	4,000	10,000
E	A	13	10	3,000	9,000
F	A	4	4	15,000	15,000
G	F	2	1	1,200	1,400
H	C,E,G	6	4	3,500	4,500
I	F	2	1	7,000	8,000

(a) Draw the project network diagram and find the critical path.

(b) If a deadline of 17,000 Rs is imposed for completion of the project, what activities will be crashed, what would be the additional costs and what would be the critical activities of the network after crashing.

Solution:



Critical Path=A-E-H

Project duration=22 weeks

(ii) Calculation of incremental cost of crashing

Activity	Nodes	Normal Cost	Crash cost	Cost	No. of week crashed	Incremental cost of crashing per week
A	1-2	18,000	19,000	1,000	1	1,000
B	1-3	600	1,000	400	2	200
C	3-5	10,000	12,000	2,000	2	1,000
D	3-6	4,000	10,000	6,000	3	2,000
E	2-5	3,000	9,000	6,000	3	2,000
F	2-4	15,000	15,000	0	0	-
G	4-5	1,200	1,400	200	1	200
H	5-6	3,500	4,500	1,000	2	500
I	4-6	7,000	8,000	1,000	1	1,000

Various path	Duration
A-F-I	2
A-E-H	22(Critical Path)
A-F-G-H	15
A-B-C-H	20
B-D	13

Crashing	Critical path	Option	Cost Involved	Suction after crashing
(1)	A-E-H	H (2 day)	1,000	20
(2)	A-E-H	A (1 day)	1,000	19
(3)	A-E-H	E (1 day)	2,000	18
(4)	A-E-H	E (1 day)	2,000	
	B-C-H	B (1 day)	200	17
			6,200	

Crashing Cost=6,200

Normal Cost=62,300

Total Cost=Normal Cost+ Crashing Cost=68,500

Transportation Problem

Q 16 A company has three plants located at A, B and C. The production of these plants is absorbed by four distribution centers located at X, Y,W and Z, the transportation cost per unit has been shown in small cells in the following table:

Distribution Centers / Factories	X	Y	W	Z	Supply (Units)
A	[6	[9	[7		6000
B	[6	[10	[5		6000
C	[4	[7	[8		6000
Demand Units	4000	4000	4500	5000	17500 18000

Find the optimal solution of the transportation problem by applying Vogel's Approximation Method.

Solution:

Step 1. Initial Allocation based on least cost cells corresponding to highest differences

	X	Y	W	Z	Dummy	Total
A		2,000	3,500		500	6,000
B			1,000	5,000		6,000
C	4,000	2,000				6,000
Total	4,000	4,000	4,500	5,000	500	18,000

Step 2. **Ij Matrix values for Unallocated Cells**

	X	Y	W	Z	Total
A	0			0	

B	2	3			2
C			3	3	2

Ij>0.Therefore initial solution is optimal.

Step 3. Optimal Transportation Cost

	Units	Costs involved	Total
A to Y	2,000	9	18,000
A to w	3,500	13	45,500
B to w	1,000	11	11,000
B to Z	5,000	5	25,000
C to X	4,000	4	1,6000
C to Y	2,000	7	14,000
Total Minimum Cost			129,500

Q 17 Write short notes on

(a) Phases of Product life cycle

(b) Five steps of Theory of Constraints

(c) Approach to target costing

(d) Meaning & definition of Value chain

Solution (a)

The product life cycle has 4 very clearly defined phases, each with its own characteristics that mean different things for business that are trying to manage the life cycle of their particular products.

Introduction Phase – This phase of the cycle could be the most expensive for a company launching a new product. The size of the market for the product is small, which means sales are low, although they will be increasing. On the other hand, the cost of things like research and development, consumer testing, and the marketing needed to launch the product can be very high, especially if it's a competitive sector.

Growth Phase – The growth phase is typically characterized by a strong growth in sales and profits, and because the company can start to benefit from economies of scale in production, the profit margins, as well as the overall amount of profit, will increase. This makes it possible for businesses to invest more money in the promotional activity to maximize the potential of this growth stage.

Maturity Phase – During the maturity phase, the product is established and the aim for the manufacturer is now to maintain the market share they have built up. This is probably the most competitive time for most products and businesses need to invest wisely in any marketing they undertake. They also need to consider any product modifications or improvements to the production process which might give them a competitive advantage.

Decline Phase – Eventually, the market for a product will start to shrink, and this is what's known as the decline phase. This shrinkage could be due to the market becoming saturated (i.e. all the customers who will buy the product have already purchased it), or because the consumers are switching to a different type of product. While this decline may be inevitable, it may still be possible for companies to make some profit by switching to less-expensive production methods and cheaper markets.

Solution (b)

Theory of constraints is based on the premise that the rate of goal achievement by a goal-oriented system (i.e., the system's throughput) is limited by at least one constraint.

The argument by reductio ad absurdum is as follows: If there was nothing preventing a system from achieving higher throughput (i.e., more goal units in a unit of time), its throughput would be infinite — which is impossible in a real-life system.

Only by increasing flow through the constraint can overall throughput be increased.

Assuming the goal of a system has been articulated and its measurements defined, the steps are:

1. Identify the system's constraint(s).

   This step involves identification of constraints which restrict output from being expanded.

2. Decide how to exploit the system's constraint(s).

   Having identified the constraints it becomes the focus of attention since only the constraint can restrict or enhance the flow of products. It is therefore essential to ensure that the bottleneck activity is fully utilized. Decision regarding the optimum mix of products to be produced by the bottleneck activity must be made.

3. Subordinate everything else to the above decision(s).
4. Elevate the system's constraint(s).
5. Warning! If in the previous steps a constraint has been broken, go back to step 1, but do not allow inertia to cause a system's constraint.

The goal of a commercial organization is: "Make more money now and in the future", and its measurements are given by throughput accounting as: throughput, inventory, and operating expenses.

The five focusing steps aim to ensure ongoing improvement efforts are centered on the organization's constraint(s). In the TOC literature, this is referred to as the *process of ongoing improvement* (POOGI).

Solution (c)

The four steps approaches to target costing process are:

1. *Conduct research*. The first step is to review the marketplace in which the company wants to sell products. The design team needs to determine the set of product features that customers are most likely to buy, and the amount they will pay for those features. The team must learn about the perceived value of individual features, in case they later need to determine what impact there will be on the product price if they drop one or more features. It may be necessary to later drop a product feature if the team decides that it cannot provide the feature while still meeting its target cost. At the end of this process, the team has a good idea of the target price at which it can sell the proposed product with a certain set of features, and how it must alter the price if it drops some features from the product.
2. *Calculate maximum cost*. The company provides the design team with a mandated gross margin that the proposed product must earn. By subtracting the mandated gross margin from the projected product price, the team can easily determine the maximum target cost that the product must achieve before it can be allowed into production.
3. *Engineer the product*. The engineers and procurement personnel on the team now take the leading role in creating the product. The procurement staff is particularly important if the product has a high proportion of purchased parts; they must determine component pricing based on the necessary quality, delivery, and quantity levels expected for the product. They may also be involved in outsourcing parts, if this results in lower costs. The engineers must design the product to meet the cost target, which will likely include a number of design iterations to see which combination of revised features and design considerations results in the lowest cost.
4. *Ongoing activities*. Once a product design is finalized and approved, the team is reconstituted to include fewer designers and more industrial engineers. The team now enters into a new phase of reducing production costs, which continues for the life of the product. For example, cost reductions may come from waste reductions in production (known as kaizen costing), or from planned supplier cost reductions. These ongoing cost reductions yield enough additional gross margin for the company to further reduce the price of the product over time, in response to increases in the level of competition.

Solution (d)

To understand how to conduct a value chain analysis, a business must first know what its value chain is. A value chain is the full range of activities — including design, production, marketing and distribution — businesses go through to bring a product or service from conception to delivery. For companies that produce goods, the value chain starts with the raw materials used to make their products, and consists of everything that is added to it before it is sold to consumers. The process of actually organizing all of these activities so they can be properly analyzed is called value chain management. The goal of value chain management is to ensure that those in charge of each stage of the value chain are communicating with one another, to help make sure the product is getting in the hands of customers as seamlessly and as quickly as possible.

The idea of a value chain was first suggested by Michael Porter (1985) to depict how customer value accumulates along a chain of activities that lead to an end product or service.

Porter's definition: He described the value chain as the internal processes or activities a company performs '' to design, produce, market, deliver and support its product.'' He further stated that '' a firm's value chain and the way it performs individual activities are a reflection of its history, its strategy, its approach of implementing its strategy, and the underlying economics of the activities themselves''.

Decision Making

Q18. A company manufacturing agricultural machinery is preparing its budget for the year 2017. An initial review shows that it will not be possible to manufacture all requirements for components A, B, C & D because the normal metal pressing capacity of 20'000 hours would be exceeded. The company can choose between the alternative courses of action given below to obtain the products in excess of normal production capacity:

(i) to buy entirely from outside suppliers

(ii) to buy from outside suppliers/or use a partial second shift

The data given below are for the year 2016:

Standard Production Cost per unit

Particulars	Components			
Variable Costs:	A (Rs)	B (Rs)	C (Rs)	D (Rs)
Direct materials	18.5	13.5	12.5	22
Direct wages	5	4	11	20
Direct expenses	5	10	5	30
Fixed overheads	2.5	2	5.5	10
Total Production cost	31	29.5	34	82
Requirements in units	2'000	3'500	1'500	2'800

Direct expenses relate to the use of metal presses, which cost Rs 5 per machine hour to operate. Fixed overhead is absorbed as a percentage of direct wages.

Quotations obtained from outside suppliers indicate willingness to manufacture all or any part of the total requirements at the following prices; each delivered to the factory:

Components	Amount Rs
A	30
B	29.5
C	26
D	84

Second shift operations would increase direct wages cost by 25% over the normal shift, and fixed overhead by Rs 250 for each 1'000 (or part thereof) second shift hours worked.

Required: Using the information given above and showing your supporting calculations, to state (a) which components, and in what quantities, should be manufactured in the 20'000 hours of press time available; (b) whether it would be profitable to make any of the balance of components required on a second shift basis instead of buying them from outside suppliers.

Solution:

Calculation of hours required per unit

Components	Expense/Rate per hour	Hours per unit
A	5/5	1
B	10/5	2
C	5/5	1
D	30/5	6

Calculation of Fixed cost

Range	Amount Rs
0-1’000	250
1’000-2’000	500
2’000-3’000	750
3’000-4’000	1’000
4’000-5’000	1’250
5’000-6’000	1’500

Statement of ranking for manufacture

Particulars	Components			
	A (Rs)	B (Rs)	C (Rs)	D (Rs)
Variable Costs (Direct mat+wages+exp.)	28.5	27.5	28.5	72
Purchase cost	30	29.5	26	84
Saving in manufacture over purchase	1.5	2	(2.5)	12
Required hours per unit	1	2	1	6
Saving in manufacture per hour	1.5	1	x	2
Ranking for manufacture	II	III	Purchase	I

Statement of optimum Product mix

Component	Quantity	Hrs/unit	Time in hrs
D	2’800	6	16’800
A	2’000	1	2’000
B	600	2	1’200 (B.F)
Total Hours			20’000

Statement of comparative cost

Manufacture	Amount Rs	Purchase	Amount Rs
Cost to be incurred:		Purchase Cost (2'900*29.5)	85'500
Material (2'900*13.5)	39'150		
Wages (2'900*4)	11'600		
Direct expenses (2'900*10)	29'000		
Wages extra (2'900*1)	2'900		
Fixed Cost	1'500		
	84'150		85'500

Hence, It is better to produce 2'900 units of B in 2nd shift working instead of purchase from outside market.

Relevant Cost

Q19. The operating results of Nepasus Ltd. for the year 2016 were as under:

Sales mix product	Sales mix %	P/V Ratio %
A	40	20
B	10	6
C	30	12
D	20	10

Total sales value of all the products was Rs 80 lakhs. Total fixed overheads amounted to Rs 10 Lakhs. Raw material contents of each product represented 50% of the respective variable cost. The forecast for the year 2017 is as under:

(i) The raw material costs will go up by 10%

(ii) The company has been able to obtain import quota of raw material of the value of Rs 35 lakhs.

(iii) The maximum sale potential of any of the above four products is 40% of the total 2016 sale value. (Potential)

(iv) The company expects to secure an increase of 5% in the selling prices of all the products uniformly.

Required

(a) Prepare a statement showing the profitability of 2016.

(b) set a product mix to maximize profit in 2017.

(c) Prepare a statement showing the profitability of 2017.

Solution:

(a) Statement showing profitability of 2016

Particulars	Product

	A	B	C	D
Sales value	3’200’000	800’000	2’400’000	1’600’000
PV Ratio (%)	20	6	12	10
Contribution	640’000	48’000	288’000	160’000
Total contribution (640’000+48’000+288’000+160’000)				1’136’000
Less: Fixed Cost				1’000’000
Profit				136’000

(b) Statement of raw material cost and other variable cost:

Product	Sales	Variable cost	Raw material	Other variable cost
A	3’200’000	2’560’000	1’280’000	1’280’000
B	800’000	752’000	376’000	376’000
C	2’400’000	2’112’000	1’056’000	1’056’000
D	1’600’000	1’440’000	720’000	720’000

(c) Statement showing ranking 2017:

Particulars	Product			
	A	B	C	D
Sales value (105%)	3’360’000	840’000	2’520’000	1’680’000
Less: Variable Cost				
Raw material (110%)	1’408’000	413’600	1’161’600	792’000
Other variable cost	1’280’000	376’000	1’056’000	720’000
Contribution	672’000	50’400	302’400	168’000
Contribution/Material Rs	0.477	0.122	0.26	0.21
Ranking	I	IV	II	III

Statement of optimum product mix

Product	Sales	Raw material	Contribution/Rs Material	Total contribution
A	3’360’000	1’408’000	0.477	672’000
B	-	-		-
C	3’360’000	1’548’800	0.26	403’200

D	1’152’242	543’200 (B.F)	0.21	115’225
		3’500’000		1’190’425

Statement showing profitability of 2017

Product	Contribution
A	672’000
B	-
C	403’200
D	115’225
Total Contribution	1’190’425
Less: Fixed Cost	1’000’000
Net Profit	190’425

Decision Making

Q 20 ZED Ltd. operates two shops. Product A is manufactured in shop-1 and customers jobs against specific orders are being carried out in shop-2.Its annual statement of Income is:

Particulars	Shop-1(Product-A) Rs.	Shop-2(Job works)Rs.	Total Rs.
Sales/Income	125,000	250,000	375,000
Material	40,000	50,000	90,000
Wages	45,000	100,000	145,000
Depreciation	18,000	31,500	49,500
Power	2,000	3,500	5,500
Rent	5,000	30,000	35,000
Heat & Light	500	3,000	3,500
Other expenses	4,500	2,000	6,500
Total Costs	115,000	220,000	335,000
Net Income	10,000	30,000	40,000

The depreciation charges are for machines used in the shops. The rent & heat & light are apportioned between the shops on the basis of floor area occupied. All other costs are current expenses identified with the output in a particular shop.

A valued customer has given a job to manufacture 5,000 units of X for shop-2.As the company is already working at its full capacity, it will have to reduce the output of product-A by 50% to accept the said job. The customer is willing to pay Rs.25 per unit of X. The material & labour will cost Rs. 10 and Rs.18 respectively per unit. Power will be consumed on the job just equal to the power saved on account of reduction of output of A. In addition the company will have to incur additional overheads of Rs.10,000.

You are required to compute the following in respect of this job:

(a)Differential Cost

(b) Full Cost

(c)Opportunity Costs

(d)Sunk Costs

Advise whether the Company should accept the job.

Solution:

(a)Differential Cost of the job

Particulars	Increase Rs.	Decrease Rs.
Material Cost	50,000	20,000
Labour Cost	90,000	22,500
Additional Overhead	10,000	-
Other expenses	-	2,250
Total	150,000	44,750

Net differential cost of the jobs=Rs.150,000-44,750=Rs.105,250

(b)Full cost of the job

Cost as above (Increased cost) =Rs. 150,000

Depreciation =Rs.9,000

Power =Rs.1,000

Rent =Rs.2,500

Heat & Light =Rs.250

Total =Rs.162,750

(c) Opportunity cost of taking the order

Particulars	Rs.	Rs.
Sale of Product A		62,500

Less: Material	20,000	
Labour	22,500	
Power	1,000	
Other expenses	2,250	45,750
Opportunity cost of taking the order		16,750

(d)Sunk cost of the jobs

Particulars	Rs.
Depreciation	9,000
Rent	2,500
Heat & Light	250
	11,750

Advice Regarding the Jobs:

ZED Ltd. should not accept the job as there will be a cash disadvantage of Rs. 42,750 as computed below:

Incremental Revenue=Rs.125,000 (5000*25)-Rs.62,500 (sale of product A)=Rs. 62,500

Differential Costs (a)-computed above =Rs.105,250

Cash disadvantage =Rs.42,750