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GUIDELINES TO STUDENTS

1. Students are advised to consult Study Notes and Text Books supplemented by the Suggested Answers.
2. Working Notes should be a part of Answers, particularly in Capital Market Analysis & Corporate laws, Financial Management and International Finance.
4. Assumptions should be logical and clearly stated in the Answers.

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FINAL EXAMINATION (SYLLABUS - 2008)

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FINAL EXAMINATION - GROUP III
(SYLLABUS 2008)

SUGGESTED ANSWERS TO QUESTIONS

DECEMBER 2009

PAPER FP-11 : CAPITAL MARKET ANALYSIS & CORPORATE LAWS

Section I (60 Marks)

(CAPITAL MARKET ANALYSIS)

Answer Question No. 1 which is *compulsory* and any two from the rest in this section.

Time Allowed : 3 Hours **Full Marks : 100**

Question:

1.(a) Fill up the blanks with the appropriate answers:

(i) For LMN Ltd., the market standard deviation is 0.03, standard deviation of an asset is 0.027 and the correlation coefficient of the profit with the market is 0.8. The market sensitivity index is __________.

(ii) Continuing (i) above, if the expected market return is 12% and the risk-free rate of return is 8%, the expected rate of return of a portfolio applying Capital Asset Pricing Model is __________%.

(iii) In the context of Capital Adequacy Ratio (CAR) of banks, Tier II Capital __________ [can/cannot] be more than Tier I Capital.

(iv) __________ is regarded as the father of modern portfolio theory.

(v) The external factor that affects the industry as a whole is termed as __________ risk, in capital market analysis.

(vi) In the case of options, only the __________ is obligated to perform the contract.

(vii) The entire pre-issue share capital, other than locked in as promoter's contribution, shall be locked-in for a period of __________.

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(viii) Premium settlement is adopted by stock exchanges for the products ________ and ________. 1x 8

(b) State **with reasons**, whether the following statements are True or False (*Mere conclusion will not be sufficient):*

(i) In the capital issuance through the book building process, the merchant banker acting as book runner determines the subscription price.

(ii) Gross exposure limits of members of stock exchange are computed in absolute terms, ignoring positive and negative sings (purchase values and sale values).

(iii) Junk bonds are corporate bonds, considered as unfit for investment purposes and so branded, by the investing fraternity.

(iv) Repo and reserve repo trade are also termed as collateralized lending and borrowing mechanism.

(v) An e-mail is not an acceptable form of approved evidence towards receipt of communication from a person.

(vi) Efficient Market Hypothesis implies that a new information revealed about a firm will effect the share price rapidly and rationally. 2× 6

Answer to question no. 1 (a)

(i) 0.72

(ii) 10.88

(iii) Cannot

(iv) Harry Markowitz

(v) Systematic

(vi) Seller/writer

(vii) One year

(viii) Options contracts on index and individual securities.

Answer to question no. 1 (b)

(i) FALSE. In the book building process, the investors make the bids, 'at' or 'above' the floor price. The price opted by the majority of the bidders shall be decided as the subscription price.

(ii) TRUE. Members of stock exchanges are subject to gross exposure limits. Gross exposure for a member, across all securities in rolling settlements, is computed as absolute (buy value and sell value), i.e. ignoring +ve and –ve signs, across all open settlements. Open settlements would be all those settlements for which trading has commenced and for which settlement pay-in is not yet completed.

(iii) FALSE. Junk bonds are corporate bonds with low ratings given by major credit rating agencies and not the investors. High-rated bonds are called investment grade bonds, low rate bonds are called speculative – grade or junk bonds.

(iv) TRUE. Repos and reserve repos are commonly used in the money markets as instruments of short-term liquidity management and can also be termed as a collateralized lending and borrowing mechanism. Banks and Financial Institutions usually enter into reserve repo transaction to manage their reserve requirements or to manage liquidity.

(v) FALSE. The Information Technology Act, 2000 has legalized the e-mail and gives it the status of being *valid form of carrying out communication in India*. This implies that e-mails can be duly produced and approved in a court of law, thus can be a regarded as substantial document to carry out legal proceedings. An e-mail received from a person can be produced in a Court of law as evidence of communication received from such person.

(vi) TRUE. The efficient market hypothesis (EMH) implies that new information is revealed about a firm it will be incorporated into the share price rapidly and rationally, with respect to the direction of the share price movement and the size of that movement.

Question:

2.(a) There are two portfolios L and M, known to be on the minimum various set for a population of three securities A,B and C. The weights for each of the portfolios are given below:

WA	WB	WC	
Portfolio L	0.18	0.63	0.19
Portfolio M	0.24	0.60	0.16

Ascertain the stock weights for a portfolio made up with investment of Rs. 3000 in L and Rs. 2000 in M. 4

(b) Explain how a trader who has bought an option can exit the trade. 5

(c) What is a Load Fund? How are Net Asset Values, public offer price and redemption price calculated? 5

(d) Janak Constructions Ltd. had received an e-mail from Hiroshi Ltd., emanating from the company's official website, accepting the former's offer. Later on, Hiroshi Ltd. failed to fulfill their promise. Can Janak Construction Ltd. launch proceedings against Hiroshi Ltd. on the strength of the e-mail? What precaution should Janak Constructions Ltd. have taken in this regard? 6

Answer to question no.2 (a)

It is given that Rs. 3000 is invested in portfolio L and Rs, 2000 in portfolio M. the investment committed in each will be:

Particulars	A	B	C	Total
1	2	3	4	5
Portfolio L	540	1890	570	3000
Portfolio M	480	1200	320	2000
Combined Portfolio Stock weights for combined portfolio of earlier row	1020 Column 2/5	3090 Column 3/5	890 Column 4/5	5000
i.e.	0.204	0.618	0.178	

Answer to question no.2 (b)

Liquidating Option Positions

When a trader buys an option, he can exit the trade in one of three ways:

- Sell the option and collect whatever the premium is – If the premium is more than what is initially cost plus commission, there's a profit. If the premium is less, it's a loss, but keeping some money is better than losing all the money.
- Exercise the option, covering it into a future position – The broker must be notified before options expire. Not all options have an automatic exercise provision. Therefore, an in-the-money option that expires without any action taken, loses the buyer money (a seller somewhere will be very happy). An option can be exercised if the trader feels the market will continue to move favourable to the trader's position or an option can be exercised if the trading in the option is not very liquid. The trader, in this case feels he can exercise and then liquidate the futures more economically than selling his option position.
- Ride the option into the dust – Let it expire worthless, especially if getting out will cost more than the premium is worth.

When a trader sells an option, he or she can exit the trade by buying the option back. If the premium is higher, the option seller has lost money. The option seller cannot exercise his or her option.

Answer to question no.2 (c)

Load Fund

A Load Fund is one that charges from the investor a percentage of NAV for entry or exit. This means that, each time one buys or sells units in the fund, a charge will be payable. This charge is used by the mutual fund for marketing and distribution expenses.

Net Asset Value:

NAV is calculated as follows:

NAV = (Fair market value of Scheme's Investments + Receivable + Accrued Income + Other assets – Accrued expenses – Payable – Other liabilities) / Number of units outstanding

Calculation of Public offer price

$$\text{Public Officer Price} = \frac{\text{Net Asset Value}}{1 - \text{Front–end Load}}$$

Calculation of Redemption price

$$\text{Redemption Price} = \frac{\text{Net Asset Value}}{1 - \text{Back-end Load}}$$

Answer to question no.2 (d)

The Information technology Act, 200 would come to the rescue of Janak Constructions Ltd.

Section 4 and 5 of the said Act may be referred to in this context.

Section 4 accords legal recognition of electronic records. As per this section, where any law provides that information or any other matter shall be in writing or in the typewritten or printed form, then, notwithstanding anything contained in such law, such requirement shall be deemed to have been satisfied if such information or matter is –

(a) rendered or made available in an electronic form; and

(b) accessible so as to be for a subsequent reference.

Section 5 speaks of legal recognition of digital signatures. Accordingly, where any law provides that information or any other matter shall be authenticated by affixing the signature or any document shall

be signed or bear the signature of any person then, notwithstanding anything contained in such law, such requirement shall be deemed to have been satisfied, if such information or matter is authenticated by means of digital signature affixed in such manner as may be prescribed by the Central Government. The *Explanation* to this section states that for the purposes of this section, "signed", with its grammatical variations and cognate expressions, shall, with reference to a person, mean affixing of his hand written signature or any mark on any document and the expression "signature" shall be construed accordingly.

Janak Construction Ltd can proceed against Hiroshi Ltd. on the strength of these provisions.

Janaks Construction Ltd should ensure that in respect of important emails/e-document/e-records, the sender affixes his digital signature. A digitally signed document is a perfect piece of legal evidence as to its timing, contents, integrity and ,authenticity.

Question:

3.(a) Mrs. VANI has furnished the following information relating to the portfolio of two securities held by her for the past 5 years:

Year	Returns (%)	
	Security L	Security M
2005	10	12
2006	12	10
2007	9	11
2008	11	7
2009	15	12

She has invested Rs. 50,000 in security L and Rs. 75,000 in security M in all these years. You are required to help her in ascertaining

(i) Which security has higher historic level return and which security has lower risk;

(ii) Return of portfolio; and 15

(iii) Risk of portfolio.

(b) Under what circumstances can a company be registered as a Collective Investment Management Company raise funds from the public? 5

Answer to question no. 3 (a)

The mistake appears to be that number of years is ignored.

Computation of mean return and standard deviation of security L

Year	Return % R	$R - \bar{R}$	$(R - \bar{R})^2$
2005	10	-1.4	1.96
2006	12	0.6	0.36
2007	9	-2.4	5.76
2008	11	-0.4	0.16
2008	15	3.6	12.96
	$\Sigma R = 57$	0	21.2

Mean return ($\bar{R}$) = 57/5 i.e 11.4%

Standard deviation SD(L) = $\frac{\sqrt{21.2}}{5}$ i.e. 2.06%

Computation of mean return and standard deviation of security M

Year	Return % R	R - $\bar{R}$	(R - $\bar{R}$)²
2005	12	1.6	2.56
2006	10	-0.4	0.16
2007	11	0.6	0.36
2008	7	-3.4	11.56
2009	12	1.6	2.56
	Σ R = 52	0	17.2

Mean return ($\bar{R}$) = 52/5 i.e. 10.4%

Standard Deviation [SD(M)] $\frac{\sqrt{17.2}}{5}$ 1.85%

Computation of covariance of returns in Securities L and M

Year	R1= R(L) - $\bar{R}$ (L)	R2 = R(M) - $\bar{R}$ (M)	R1 x R2
2004	-1.4	1.6	-2.24
2005	0.6	-0.4	-0.24
2006	-2.4	0.6	-1.44
2007	-0.4	-3.4	1.36
2008	3.6	1.6	5.76
			3.2

Covariance = $\frac{3.2}{5}$ 0.64

Correlation coefficient between L & M = $\frac{\text{Covariance}}{\text{SD (L) x SD(M)}}$

= 0.64/(2.06 x 1.85)

=0.17

Weightage of funds investment = 50: 75

L = 0.4

M = 0.6

Return of the portfolio = (0.4 x 11.4) + (0.6 x 10.4) = 10.8%

Risk of portfolio (RP)

$(RP)^2 = (0.4 \times 2.06)^2 + (0.6 \times 1.85)^2 + (2 \times 0.4 \times 0.6 \times 2.06 \times 1.85 \times 0.17)$

= 2.222054

RP = SQRT of (RP) i.e. √2.222054 = 1.4907

Conclusions

(a) Security L has higher historic return as compare to security M (Mean of this security is higher) Since the Standard deviation of security M is lower than that of L, it has lower risk as compared to security L

(b) Return of the Portfolio is: 10.8%

(c) Risk of the Portfolio is : 1.491%

Answer to question no. 3 (b)

- A registered Collective Investment Management Company is eligible to raise funds from the public by lunching schemes.
- Such schemes have to be compulsorily credit rated as well as appraised by an appraising agency.
- The schemes also have to be approved by the Trustee and contain disclosures, as provided in the Regulations, which would enable the investors to make informed decision.
- A copy of the offer document of the scheme has to be filed with SEBI and if no modifications are suggested by SEBI within 21 days from the date of filing then the Collective Investment Management Company is entitled to issue the offer document to the public for raising funds from them.

Question:

4.(a) The following data relating to two stocks L and M are made available to you:

Year	Returns on L (%)	Return on M (%)
2008	12	14
2009	15	19

From the above, you are required to compute:

(i) Standard deviation of the return from stocks L and M; 2

(ii) Co-variance of returns from the two stocks; 2

(iii) Correlation coefficient between the returns of the two stocks L and M; 2

(iv) Expected return of a portfolio comprising of 30% of L and 70% of M; and 2

(v) Risk of a portfolio consisting of L and M in the same proportion. 2

(b) Vashisht Telecom Ltd. has been in existence for the past seven years. The relevant extracts from the company's financial statement and other records for the year ended 31-3-2009 are as under:

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(i) Assets position:

Fixed Assets:	(Rs. In lacs)
Patents trademarks and copyrights	200
Goodwill	40
Land and buildings	120
Equipments	80
Vehicles	70
Current assets	20
Total value of assets	530
Share capital and reserves:	
Paid up share capital	85
General reserve	55

(a) The company was originally in the hotel business and during April, 2008, it forayed into the telecom sector also, changing to the current name. The net profits earned by the company was Rs. 120 lacs (total turnover Rs. 400 crores), of which Rs. 75 lacs (turnover Rs. 195 crores) was from the hotel sector.

(b) The company was consolidating its financial position and hence even through it had distributable surplus during the last five years, it declared dividend during the last two years only (including current year).

The company wishes to make a public issue of shares to the extant of rupees eight crores. It dose not want to go through the book building route or engage in 'market building' process after the listing, and does not want the participation of financial institutions or scheduled commercial banks. The company seeks your advice whether it is possible to make a public issue, in the light of the SEBI requirements, and if it is not possible, what it should do to correct its position so as to comply with the requirements. You may tabulate your views as under:

Sl. No.	Requirements under the option	Does the company fulfill the norms?	Action to be taken by the company

10

Answer to question no. 4 (a)

Year	Return on L (%) R_L	$(RL - \bar{R}_L)$	$(RL - \bar{R}_L)^2$	Return on M(%) R_M	$(R_M - \bar{R}_M)$	$(R_M - \bar{R}_M)^2$	$(RL - \bar{R}_L)$ X $(R_M - \bar{R}_M)$
2008	12	-1.5	2.25	14	-2.5	6.25	(-1.5 X -2.5)
2009	12	1.5	2.25	19	2.5	6.25	(1.5 X 2.5)
Sum	27	0	4.50	33	0	12.50	7.50

$\bar{R}_L = \frac{27}{2} = 13.5$ $\bar{R}_M = \frac{33}{2} = 16.5$

$\sigma_L = \sqrt{Variance} = \sqrt{4.5 \div 2} = \sqrt{2.25} = 1.5\%$

(i) Standard deviation of the return from stock (L) $\sigma_L = 1.5\%$

Standard deviation of the return from stock (M)

$\sigma_M = \sqrt{12.5 \div 2} = \sqrt{6.25} = 2.5\%$

(ii) Covariance of Return (L,M) $= \frac{7.50}{2} = 3.75\%$

(iii) Correlation co-efficient between the returns of the two stock L and M :

$P_{LM} = \frac{Cov\,(LM)}{\sigma_L \times \sigma_M} = \frac{3.75}{1.5 \times 2.5} = \frac{3.75}{3.75} = 1$

(iv) Expected return of a portfolio comprising of 30% of L and 70% of M

$R_P = (0.30 \times 13.5) + (0.70 \times 16.5) = 4.05 + 11.55 = 15.60\%$

(v) Risk of a Portfolio consisting of L and M in the same proportion.

$$\sigma p = \sqrt{Variance} = \sqrt{\sigma p} = \sqrt{W_L^2 \sigma 1^2 + W_m^2 \times \sigma_m^2 + 2w_2 w_m P_{LM} \sigma L \sigma M}$$

$$= \sqrt{(0.5)^2 \times 1.5^2 + 0.50^2 \times 2.5^2 \times (2 \times 0.50 \times 0.50 \times 1 \times 1.5 \times 2.5)}$$

$$= \sqrt{0.5625 + 1.5625 + 1.875}$$

$$= \sqrt{4} = 2\%$$

Alternative Solution of Q no 4(a)

$\bar{R}_L = 27/2 = 13.5\%$ $\bar{R}_M$ $33/2 = 16.50\%$

$$\text{Variance of L} = \frac{\sum (R_1 - \dot{R}_2)^2}{n-1} = \frac{4.5}{2-1} = 4.5$$

Standard Deviation of L = $\sigma_L = \sqrt{4.5} = 2.12\%$

$$\text{Variance of M} = \frac{\sum (R_M - \bar{R}_M)^2}{n-1} = \frac{12.50}{2-1} = 12.50$$

(ii) Standard Deviation of M $\sigma_M = \sqrt{12.50} = 3.54\%$

(iii) Correlation Co- efficient of LM $= \frac{Cov(LM)}{SD(L) \times SD(M)}$

$$= \frac{7.50}{2.12 \times 3.54} = \frac{7.50}{7.50} = 1$$

(iv) Return of portfolio (LM) = 0.30 x 13.50 + 0.70 x 16.50
[Rp] = 15.60%

Risk of Portfolio (σp) of L and M in the same proportion

$$= \sqrt{\text{Variance}(\sigma p^2)}$$

$$= \sqrt{0.50^2 \times 2.12^2 + 0.50^2 \times 3.54^2 + 2 \times 0.50 \times 0.50 \times 2.12 \times 3.54}$$

$$= \sqrt{1.1263 + 3.1329 + 3.7524}$$

$$= \sqrt{8.0089} = 2.83\%$$

Answer to question no. 4 (b)

SEBI offers four options to a public company for coming out with a public issue of shares. One of the options involves book building process. Another option involves the appraisal of the project and participation by financial institution or scheduled commercial bank. The third is there shall be a compulsory market-making for at least 2 years from the date of listing of the shares. Since the company is not interested in either of these, it has to necessarily fit itself in the other option available.

The requirements of the said option, whether it fulfills the SEBI norms, and if not, what it should do in this context, are tabulated below:

Sl. No.	Requirement under the option	Does the company fulfill the norms?	Action to be taken by the company
1.	Tangible assets of the company should be a minimum of Rs 3 crores for the preceding three full years of twelve months each, of which not more than 50% is held in monetary assets.	No, as the tangible assets of the company amount to Rs. 2.9 crores only	The company should increase its tangible assets by Rs 10 lacs and maintain the same at not below Rs. 3 crores for 3 full years. It should also ensure that not more than 50% is held in monetary assets.
2.	The company has a track record of distributable profit in terms of Section 205 of the Companies Act, 1956, for at least three(3) out of immediately preceding five(5) years; extraordinary items shall not be considered for calculating distributable profit in terms of Section 205 of Companies Act, 1956.	Requirement complied with Declaration of dividends is immaterial. It has to be ensured that extraordinary items have not been considered for calculating distributable profits in terms of Section 205 of Companies Act, 1956.	No action required.
3.	Net worth of least Rs 1 crore in all the preceding three years of twelve months each.	Net worth 31-3-2008 is more than one crore rupees. No information in the problem, whether it has been so for minimum 3 years.	Company may check up this aspect as to whether it has had net worth of Rs 1. crores for minimum 3 years, otherwise fulfill this norm.
4.	In case of change in name, 50% of preceding year's revenue should be from new activity.	Requirement is relating to **revenue** and not net profit. More than 50% of revenue has been from the new activity.	No action required.
5.	The aggregate of the proposed issue and all previous issue made in the same financial year in terms of size (i.e., offer through offer document + firm allotment + promoters' contribution through the offer document), does not exceed five(5) times its pre-issue net worth as per balance sheet of the last financial year.)	Pre-issue net worth being 1.4 crores, 5 times the same is Rs 7 crores only. Firm allotment + promoters' contribution to be duly considered	Anyway, two more years at the least are required (condition 1). The company is likely to fulfill this norm then. Action to be taken accordingly.

SECTION II (40 Marks)
(CORPORATE LAWS)

Answer Question No. 5 *which is compulsory* and any two *from the rest in this section.*

Question:

5.(a) Fill up the blanks:

(i) Every public company having a paid-up capital of not less than rupees ________ shall constitute the Audit Committee.

(ii) In the context of classification of risk, tax risk will fall under ________ risk (credit, liquidity, disaster).

(iii) The Competition Commission shall consist of a Chair person and more than ________ other Members to be appointed by the Central Government.

(iv) In the context of corporate governance, Narayana Murthy Committee was formed in the year________. 1x4

(b) State with reasons whether true or false (*Mere conclusion will not suffice*):

(i) Where a charge requiring registration is not registered, the charge becomes voidable against the creditor and not against the liquidator.

(ii) To effect buy back of shares, the same should be, inter alia, after passing an ordinary resolution in a meeting of the Board of directors.

(iii) Amalgamation in the nature of merger is to be accounted as per the purchase method. 3x2

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Answer to question no. 5 (a)

(i) 5 crores

(ii) Liquidity

(iii) 10

(iv) 2003

Answer to question no. 5 (b)

(i) **FALSE.** Where the company fails to register the charge, the charge becomes void (not voidable) as against the creditor as well as the liquidator. The given statement is thus false on two counts.

(ii) **FALSE.** As per section 77A(2) of the Companies Acts, 1956, the buy-back of shares can effected, inter alia, where a special resolution has been passed in the general meeting of the company authorizing the buy back. This clause shall not be applicable, where the buy back is or less than 10% of the total paid up equity capital and free reserves of the company and such buy back has been authorized by the Board by means of resolution passed at its meeting.

(iii) **FALSE.** Amalgamation in the nature of merger is to be accounted as per the Pooling of interest Method and in case of amalgamation in the nature of purchase accounting needs to be done as per the Purchase Method.

Question:

6.(a) A public company sought extension of time from the ROC for holding AGM up to of 3 months and it was granted. However, when the actual AGM was to be held, the company faced a situation that the annual accounts were up to a period beyond which it is permissible. The company contended that since ROC granted extension of time for holding the AGM, the same would also be applicable for presentation of accounts as well. Referring to the relevant provisions of the Companies Act, 1956 state whether the contention of the company holds good. 4

(b) The Board of Directors of Moonshine Ltd. are contributing every year to a charitable trust a sum of Rs. 1 lac. In a particular year, the company suffered losses and the directors are contemplating to contribute the same amount in spite of the losses. In this connection, discuss whether the directors can do so. 4

(c) Ganga Plastics Ltd. and Yamuna Tubeplasts Ltd. entered into a scheme of amalgamation by which former would transfer its entire undertaking to the later. However, the Central Government raised an objection that unless the objects clause of the companies are similar and the Memorandum empowers to do so, the scheme of amalgamation cannot be permitted. Is the objection of the Central Government tenable? 7

Answer to question no. 6(a)

While a company may hold its AGM in a year within the time limit of 15 months as enjoined in Section 166(1), it may still contravene Section 210. A company and its directors may commit offences if they do not fulfill the three requirements and failure to comply with any of them, unless an extension of time has been given by the ROC for holding the meeting. However the extension of time for holding the AGM is only with reference to the meeting and not to that of submission of accounts.

Answer to question no. 6(b)

The power to give donation to general charities does not hinge on the existence of any profit during the year in question. In such a case they may contribute up to the limit given in Section

293 (1) (e), even though the company may be functioning at a loss. As stipulated in the section, a public company can contribute in any financial year not exceeding Rs.50,000 or 50% of its average net profits during the three preceding financial years whichever is greater.

Answer to question no. 6(c)

The power to amalgamate may be derived from the Memorandum of Association of the company or its may be acquired by resorting to the Companies Act, 1956.

Section 17 of the Companies Act, 1956 lays down that a company which desires to amalgamate with another company will take necessary steps to come before a Court for alteration of its Memorandum authorizing such amalgamation. The Companies Act, 1956 confers a right on a company to alter its Memorandum in aid of amalgamation with another company. The provisions contained in section 391 to 396 and 494, illustrate instances of statutory power of amalgamating a company with another company without any specific power in the Memorandum *[Hari Krishna Lokia vs. Hoolungoore Tea Co. Ltd. 1996]*.

Section 391 is not only a complete code, but it is the nature of a single window clearance system to ensure that parties are not put to avoidable, unnecessary and cumbersome procedure for making repeated applications to court for various alternations and changes. What is to be seen is the over all fairness mid feasibility of scheme of amalgamation and there need not be any 'unison of objects' of both transferor and the transferee company. *[R Morarjee Goku/das spg. Wrg. Co., 1995]*.

To amalgamate with another company is the power of the company and not an object of the company. *[Re. Hari Krishna Lohia, 1996]*. Irrespective of the objects clause, the Court is empowered to sanction scheme of amalgamation provided it does not prejudice the interest of the public. Therefore, based on the above judicial rulings, the contention of the Central Government is not tenable in law.

Question:

7.(a) Fruits Ltd. has its subsidiary company Oranges Ltd., which was formed to carry out some of the objectives of the former. Fruits Ltd. suspends one of its several businesses, by passing a resolution at the company's extra-ordinary general meeting, with effect from 1st January, 2009. The business so suspended continues to be suspended until the end of March, 2009. On 1st April 2009, a group of shareholders of Fruits Ltd. File a petition in the Court for winding of the company on the ground of suspension of business by the company.

Referring to the provisions of the Companies Act, 1956,

(i) State whether the contention of the shareholders is legally correct;

(ii) Will your answer be the same in case Fruits Ltd. suspends all its business? 8

(b) What do you comprehend by the term "Corporate Governance"? Explain how the provisions of the Companies Act, 1956 relating to Audit Committee will help in realizing some of the objectives of Corporate Governance. 7

Answer to question no. 7(a)

The problem is concerned with suspension of business by a company.

Section 433 provides that a company may be wound up by the court if it does not commence its business within a year from its incorporation or suspends its business for a whole year, it. The contention of the shareholders of XYZ Ltd that the company is liable to be wound up on the ground of suspension of business, is not tenable for the following reasons:

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(i) (a) A Company may be wound up by court if a company suspends its business for a whole year. In the given situation, the business was suspended only on 01.01.2009. Hence on 1st April, 2009, it cannot be said that the business has been suspended for the whole year, so as to attract the provisions of Section 433 (c).

(b) Where a company having more than one business discontinues one of them, it cannot be said to have suspended business within the meaning of Section 433 (c).

(a) Where a company ceases to do any business but is a holding company of subsidiaries engaged in the pursuit of the business, which it was previously doing, it cannot be said the company has suspended its business *(Ref: Eastern Telegraph Company Ltd.)*

(ii) Even if Fruits Ltd suspended all its businesses, the suspension was not for a period of more that 1 year as on 01.04.2009 and hence the provisions of Section 433(c) are not applicable. Again for the reasons stated in (i) (c) above Fruits Ltd cannot be said to have suspended its business as its subsidiary Orange Ltd, is carrying on the business.

Answer to question no. 7(b)

CORPORATE GOVERANCE

The vast amount of literature available on the subject ensures that there exist innumerable definitions of corporate governance. To get a fair view on the subject it would be prudent to give a narrow as well as a board definition of corporate governance.

In a narrow sense, corporate governance involves a set of relationships amongst the companys' management, its board of directors, its shareholders, its auditors and other stakeholders. These relationships, which involve various rules and incentives, provide the structure through which the objectives of the company are set, and the means of attaining these objectives as well as monitoring performance are determined. Thus, the key aspects of good corporate governance include transparency of corporate structures and operations, the accountability of managers and the boards to shareholders, and corporate responsibility towards stakeholders.

In a broader sense, however, good corporate governance, the extent to which companies are run in an open and honest manner, is important for overall market confidence, the efficiency of capital allocation, the growth and development of countries' industrial bases, and ultimately the nations' overall wealth and welfare.

AUDIT COMMITTEE

For better corporate governance, the concept of Audit Committee for companies was introduced by section 292A of the Companies Act, 1956. Every public company having paid up capital of not less than Rs. 5 Crores must have an Audit Committee.

The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee [Section 292A (5)]

As per section 292A (6) of the said Act, the functions of the Audit Committee include the following:

(a) The Audit Committee should discuss with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors.

(b) The Audit Committee should review half yearly and annual financial statements before submission to the Board.

(c) The Audit Committee should ensure compliance of internal control systems.

The Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purposes, shall have full access to information contained in the records of the company and external professional advice, if necessary [Section 292A (7) of the Companies Act, 1956].

The recommendations of the Audit Committee on any matter relating to financial management including the audit report, shall be binding on the Board and if the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefore and communicate such reasons to the shareholders. [Section 292A (8) & (9) of the Companies Act, 1956].

The above provisions of the Companies Act, 1956 relating to powers and functions of the Audit Committee relating to financial statements will help in achieving one of the objectives of corporate governance, i.e., accountability and avoidance of poor financial reporting. It also ensures that the companies are managed in clean and transparent manner.

Question:

8.(a) Can it be said that management audit incorporates in itself, an efficiency audit? What are the main objects of efficiency audit? 7

(b) State the importance of going concern concept in preparation of corporate financial statements in India. How is the term "foreseeable future" defined in this context? 8

Answer to question no. 8 (a)

Management Audit incorporates in itself an efficiency audit. Efficiency audit ensures "application of the basic economic principle so that resources flow into the most remunerative channels". The main object of efficiency audit is to ensure that

1. Every rupee invested in capital or in other fields give the optimum returns and
2. The planning of Investment between the different functions and aspects is designed to give optimum results.

The parameters for measuring efficiency with its concomitant details are

1. Overall rate of return on capital employed
2. Better capacity utilization
3. Better utilization of raw material, power, labor, equipments, and finance
4. Effective incentive system
5. Better export performance and import substitution
6. Cost Control

It is necessary to make study activity wise so as to identify areas of deficiency in particulars activity.

To conclude we can infer saying that Investor in order to protect his investment in any company expects proper exhibition of corporate governance which is taken care by Management Audit as Management Audit would encompass compliance audit, efficiency audit, propriety audit and systems audit as well as management audit is concerned with the overall objectives of an organization.

Answer to question no. 8(b)

Management may not prepare financial statements applying going concern basis in case there exists significant doubt about the going concern status of the enterprises. The point has not been taken care of in section 217(2AA).

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In India preparation and presentation of corporate financial statements are governed by accounting policies stated in the Companies Act and any other statutes that govern the reporting entity, accounting standards and other documents stating accounting policies, measurement and disclosure issued by the Institute of Chartered Accountants of India or any other regulatory authority like SEBI, RBI, IRDA etc. They together form Indian GAAP. In fact while preparing financial statements it is necessary to follow Indian GAAP.

Corporate financial statement are prepared following "going concern" assumption which implies that the reporting entity is expected to continue operations in the foreseeable future and it has neither the intention nor necessity of liquidation or of curtailing the scale of operations. In India the Corporate management is not required to make explicit disclosure as regards the validity of going concern assumption. The term foreseeable future is also not defined in the accounting standard. Considering the uncertainties involved in the predication of business continuity, foreseeable future should not taken as distant future.

Parameters of identifying going concern uncertainty:

Forecasts and budgets

Borrowings requirement

Liability management

Contingent liabilities

Product and markets

Financial risk management

Other factors including consistency of earning, stability of cost base, recurring operation losses, arrears of dividends, work stoppage, etc.

The Institute of Chartered Accountants of India has issued SAP – 16 Going Concern. This audit standard attempt to capture going uncertainty in the of ISA – 23. Generally, financial statements are prepared on the basis of fundamental assumption of going concern. It is necessary for the auditors to consider the appropriateness of the going concern assumptions. The auditors should consider the existence of the following indications which risks the going concern

Assumption:

Financial Indications

1) Negative net worth or negative working capital
2) Fixed term borrowing approaching maturity without realistic prospects of renewal or repayment or excessive reliance on short term borrowings to finance long term assets.
3) Adverse key financial ratios
4) Substantial operating losses
5) Substantial negative cash flow from operations
6) Arrears or discontinuance of dividends
7) Inability to pay creditors on due dates
8) Difficulty in complying with the terms of loan agreements
9) Change from credit to cash on delivery transaction with suppliers
10) Inability to obtain financing for essential new product development or other essential investments
11) Entering into a scheme of arrangement with creditors for reduction of liability

Operating Indications

1) Loss of key management without replacement
2) Loss of a major market, franchise, license, or principle supplier
3) Labour difficulties or shortage or important supplies

Other Indications

1) Non-Compliance with capital or other statutory requirements
2) Pending legal proceedings against the entity may if successful result in judgments that could not be met.
3) Changes in legislation or government policy
4) Sickness of the entity under any statutory definition
5) The significance of such dedications can often be mitigated by other factors.

To resolve the doubt about the appropriateness of the going concern assumption the auditor should gather sufficient audit evidence.

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