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Further, in the Elective Papers which are Case Study based, the solutions have been worked out on the basis of certain assumptions/views derived from the facts given in the question or language used in the question. It may be possible to work out the solution to the case studies in a different manner based on the assumption made or view taken.

**MULTIDISCIPLINARY CASE STUDY – 6F**

The solutions to case studies have been worked out on the basis of certain assumptions/views derived from the facts given in the question or language used in the question. It may be possible to work out different solutions based on the assumption made or view taken. In general, case study based questions may have more than one correct answer. The fact that case study based questions may have multiple correct answers should be kept in mind while evaluating the answers. Further, there should be no negative marking for wrong answers in MCQ based questions.

**Question I****Background**

*You are the Chief Financial Officer (CFO) of Tom & Tinken Limited, an Infrastructure Company specializing in various fields such as buildings, dams, bridges, airports, power plants etc. You have taken over this role after having a successful tenure of about 15 years in Wisdom Constructions Limited, who is the direct competitor to Tom & Tinken Limited. Timing of your entry in Tom & Tinken Limited is very crucial especially since the previous CFO, Mrs. Ramamani, has resigned due to personal reasons in the middle of the year-end financial audit process and the Company has recently appointed M/s. Jags & Raghav Associates, Chartered Accountants, as the auditors of the Tom & Tinken Ltd. for a period of 5 years in view of the audit rotation requirements stipulated under the Companies Act, 2013.*

*The management has very high expectations from you regarding the role you need to play in contributing to Tom & Tinken Ltd. given the timing as well as the multiple challenges impacting the organization with respect to financial reporting. The following key priorities for you have been spelt out by the management;*

- *Transform the Finance Team*
- *Ensure smooth completion of the audit*
- *Maximize the shareholder's value*
- *Ensure Zero non-compliance with Regulatory requirements*

*To better understand your role and the team, you have started your journey by interacting with various personnel in the company and collected certain valuable inputs.*

**Company Profile**

*Tom & Tinken Limited is a listed company which has a tremendous track record of showing consistent business growth and is one of the key companies closely monitored by the Analysts and other shareholders. It has 3 subsidiaries in America, Asia and also in Africa and one joint venture in Dubai. It also has an insignificant trading activity relating to certain construction machinery spares which is primarily exported to European market.*

The company is professionally managed and various financial institutional investors are holding about 40% of the overall equity share capital of the company. The company has a vibrant leadership team lead by Mr. Prasanna Pai, who is the Chief Executive Officer (CEO), an MBA from Indiana Institute of Management. He is very action oriented and is consciously pushing all his team leads to deliver the best. The company's business is primarily dependent on the infrastructure projects of the government and government agencies since the share of the private sector entities has come down drastically over a period of time. Being a market leader, Tom & Tinken is able to withstand the pressure from the competition even though the margins are becoming thin.

#### Profile of the Finance Team

Mr. Vamsy Krishna is the Financial Controller who will be directly reporting to you and he has about 10 years of experience. He is a veteran in the company and has an indepth understanding of various business activities of the Company and the operating environment. He is a Cost & Management Accountant and also a Bachelor of Commerce from the Tagore University. He is supported by 2 Finance Managers, namely, Ms. Supraja and Ms. Sukanya who are Commerce Graduates specializing in Statutory Finance and Business Finance respectively. There are also 4 other Accountants and 6 executives supporting the Finance managers in their respective areas.

#### Key Financial Highlights

Vamsy has informed you that a draft financial summary for the FY 2017-18 was prepared subject to certain pending items and the same was presented to the management and also to auditors. Key financial highlights as per such management accounts subject to certain open items are as under:

<b>Particulars</b>	<b>FY 2017-18 Draft Unaudited/ Provisional ₹ in crores</b>	<b>FY 2016-17 Audited ₹ in crores</b>
Revenue From Operations	72,430	68,776
Other Income	344	213
<b>Total Income</b>	<b>72,774</b>	<b>68,989</b>
Operating Expenses+	61,288	52,348
Administration & selling Expenses	4,333	1,455
Finance Cost	2,322	1,888
Depreciation*	2,876	2,487
<b>Total Expenditure</b>	<b>70,819</b>	<b>58,178</b>
<b>Profit Before Tax</b>	<b>1,955</b>	<b>10,811</b>

\* Also includes amortization of Expenses of ₹22 crores.

+ Excludes GST paid and claimed as refund on certain eligible items amounting to ₹ 1254 crores.

Open Accounting Matters requiring resolution

Supraja and Sukanya, the Finance Managers summarized the following items which are open and are pending to be dealt with in the financial statements for your consideration. They already finished having a discussion with Vamsy and their views, were available, are also provided for your reference.

- (a) An amount of ₹ 2.45 crores towards Accrual of certain liabilities relating to Refurbishment of certain spares meant for a specialized crane is yet to be made. The spares for refurbishment were sent in March 2018. Completion of the refurbishment/receipt of spares by the Company is expected only in March 2019.
- (b) An amount of ₹ 4.35 crores relating to certain export benefits relating to export of construction machinery to Europe is yet to be accounted pending submission of export benefit documents with the concerned authority though the entitlement is more or less established.
- (c) Certain employees are taken on a contract basis from a manpower service provider and the leave/gratuity liabilities calculated in accordance with the accounting standards relating to such employees are not accrued for in the financials of the company though contractually all the payments statutorily required to be made to such contract employees are to be borne by the company under the contractual terms entered into with the manpower service provider. The amount involved as at 31 March, 2018 is ₹ 2.44 crores.
- (d) The stock option cost was not accounted under the Indian GAAP in prior years and the amount of fair value, if required, pending to be dealt with for FY 2017-18 is ₹ 1.46 crores.
- (e) The amount of expected credit loss for doubtful receivables pending to be accounted as at 31 March, 2018 is ₹ 1.20 crores and the company intend to account it proportionately on a Straight line basis over the calendar year 2018 to spread the impact of the same. Further, no Expected Credit Loss (ECL) provision is considered for the Retention Receivables under the contractual terms, which, if determined, would be ₹ 0.75 crores as at 31 March, 2018.
- (f) An amount of ₹ 0.50 crores committed to the political party as at 31 March, 2018 by the CEO, is pending to be accounted in view of the approvals required under the Companies Act, 2013.
- (g) Certain foreign exchange payables are accounted using the forward rate instead of the closing spot rate as at 31 March, 2018. The impact of change required, if any, on recalculation under the spot rate basis would be ₹ 0.23 crores of exchange loss.
- (h) An amount of ₹ 3.49 crores is adjusted against the Retained earnings directly as at 1 April, 2017 in view of the significant estimation difference relating to loss provision made for certain construction contracts pertaining to prior periods based on actual crystallizations in line with the accounting standard requirements.

- (i) An amount of Provision for losses relating to an ongoing Dam construction project at Goa amounting to ₹ 12 crores is considered for budget purposes in FY 2018-19 though the same is not included in the financial statements as at 31 March, 2018.
- (j) Dividend Proposed for the FY 2017-18 is included as part of Finance Cost amounting to ₹ 1.2 crores.

Open Audit Issues requiring Resolution

Mr. Sai Ram, Partner from M/s. Jags & Raghav Associates met with you and briefed the following outstanding matters/issues from the audit point of view:

- (a) There is an issue with respect to using BOTS for the purpose of audits especially in the area of control testing. The Finance team of the Company has objected to the usage of such BOTS in the audit process and has not provided access to the data that is required for usage of BOTS for audit purposes.
- (b) The original underlying documents/ vouchers are not available and only the scanned copies of the documents were made available for audit purposes. The audit team has requested for a visit to the scanning center at Manali which is yet to be organized. Vamsy strongly believes that such a visit/verification of the originals is unwanted and is beyond the scope of statutory audit required under the Companies Act.
- (c) The company has an internal Shared service center at Bengaluru and all the financial and accounting records for the entire Tom & Tinken Group across Asia, America, Africa and Gulf are maintained centrally and the processes followed are homogeneous in nature from a financial reporting angle. For the purpose of audit of the consolidated and stand alone financial statements of the group/ individual companies, the accounts team expects the auditors to follow a shared service approach of testing the homogeneous processes and controls and applying the conclusions to all the individual entities rather than testing it multiple times. The audit team has not accepted this view and the matter is pending resolution.
- (d) With respect to intercompany transactions between the Company and its international subsidiaries, the Arm's Length Pricing (ALP) principle of Transaction Net Margin Method (TNMM) is adopted from the Income Tax view point. The audit team has challenged this method and is insisting on a separate ALP for the purpose of reporting under the Companies Act since the requirement of evaluating the ALP for Companies Act is different from the Income Tax Act.
- (e) The Audit team wants to send out the confirmation for a key vendor, namely, Glory and Gavy Limited who has a credit balance of ₹104.12 crores as at 31 March, 2018. However, Vamsy strongly objected to the same and has not agreed to send the balance confirmation. The reason for not sending the confirmation is primarily on account of certain disputes with the party which may get revived on sending such audit confirmations.
- (f) In connection with 4 major contracts entered into during the year for which sizable margins are recognised, the audit team would like to use their engineering specialist for validating

*the assumptions relating to costs incurred, cost to come and the expected margins/ losses, if any, since such estimates are critical and would have a substantial impact on the results of the company. Supraja has objected to the same since the same was never done in the past and such an exercise would only delay the audit/financial reporting and beyond the audit scope requirements.*

- (g) The Audit team would like to review the audit work papers of the previous auditors and has requested the company to facilitate the same. However, Sukanya strongly believes that no such practice is in vogue in India and the opening balances/ previous year audited financials can be presumed to be correct and the company will not entertain any such requests from the current auditors.*
- (h) Similarly the audit team wanted to review the books of account of the Joint Venture in Dubai which is audited by another auditor based out of Dubai. However, the finance team of the company is unable to facilitate/ support any such review by the parent company auditors.*
- (i) The Audit Manager, Kodali Ashish Krishna has also put in a request to the Finance Team that the entire draft annual report of the Company may please be provided to them upfront before finalizing the same since they have to validate/verify the same. However, Vamsy feels that the audit is required only for the financial statements and is not intended for the annual report which has various elements such as Directors Report, Management Discussion and Analysis, Corporate Governance Report, Financial Highlights etc. which are beyond the purview of statutory auditors.*
- (j) The audit team requested for a reconciliation of the transactions as per books with the details as per the Goods and Service Tax Network (GSTN) data w.r.t input credit, expenses accounted, income accounted etc. and also between the TDS credits taken and the interest income accounted as per books with the Form 26AS of the Company and also the reconciliation of profit between the costing records maintained for cost audit purposes with that of the financial records. Sukanya strongly believes that the audit is required only based on the books maintained by the company and there is no need to extend such audit to third party/independent data maintained by the Regulators intended for different purposes.*
- (k) The Audit team has also highlighted various deficiencies, which are not material weaknesses, in the Procure to Pay process and has indicated its intention of qualifying the Internal Control over Financial Report to be issued on the financial statements as part of the audit report under the Companies Act.*
- (l) Sai Ram has also indicated that in the absence of all the details/support required for finalizing the audits, he cannot issue the audit report and will also consider withdrawing the Review Reports issued on the quarterly financial information earlier based on Limited Review.*

Key Items of discussion with the Company Secretary

Based on your discussion with Ms. Divya, Company Secretary, following matters requires your attention/action:

- (a) The Audit Committee (AC) of the company has recommended referring an item relating to the whistle blower referral on one of the directors of the Company to an independent investigating agency which was over ruled by the Board of Directors. The same was concluded by the Board as frivolous complaint based on its own independent assessment.
- (b) One of the Directors of the company has recorded his dissent for approving the quarterly unaudited financial results of the company last time though the majority approved the unaudited financial results.
- (c) A shareholder of the Company has sent a request to the company as well as to the auditor of the company seeking explanation on the provisions made for diminution in the value of investments which is pending disposal.
- (d) The financial analysis details as provided to the analysts by the CEO with respect to various segmentation of the business is completely different from that of the segment disclosures made in the financial statements/ results and there has been several questions raised on the same.
- (e) There is a request from a Foreign Institutional Investor (FII), who is a shareholder of the company to make the presentation made/ to be made by the statutory auditors to the AC/Board public.
- (f) Further, Divya is also having apprehensions regarding various accounting matters and, hence, is evaluating the feasibility of not signing the statutory financial statements in view of the legal issues that could come up at a later point of time.

Inputs from the CEO

Prasanna Pai, the CEO has requested you to consider the treatment of following items:

- (a) The amount of provision made for the diminution in the value of investments in the African Subsidiary amounting to ₹ 12.30 crores included as part of Administrative Expenses. He wants to explore the possibility of directly adjusting this against the reserves in the Balance Sheet considering that the same represents the write down of a capital investment.
- (b) Since the liquidity is a challenge for the company in the near future, the possibility of taking a short term borrowing from the bank for working capital purposes and using it for dividend distribution, if approved by the board/ shareholders.
- (c) Certain amounts in the range of ₹ 4.30 Crores were not recognised in the financial statements as revenue in view of the uncertainties associated with the recognition in line with the accounting principles followed by the Company. He wants to explore the possibility of disclosing it somewhere in the financial statements so as to reflect the realistic picture.

- (d) *The amount of unclaimed liabilities of ₹1.97 Crores relating to employees who have left the company and the depositors who have not claimed for the past 10 years currently disclosed as part of liabilities may be written back to the Profit & loss account since the same was no longer payable.*
- (e) *Providing Asset Retirement obligations on cash basis at actuals which has been accounted currently on estimation basis in line with the accounting policy followed by the Company.*
- (f) *The possibility of presenting the financial results under the previous Indian GAAP (pre Ind AS) along with the Ind AS numbers in the financial statements for bench marking purposes.*

*You have to deal with the open accounting matters, address the audit concerns, deal with the issues raised by the Company secretary and also revert to the CEO of the Company on various matters raised by him. Please note that the financial statements of the company for the year under review are prepared using Ind AS for the first time.*

#### **PART- A**

**Answer the following questions:**

**2 Marks each)**

- 1.1 *The amount to be accrued, if any, in connection with the refurbishment of spares as at 31 March 2018 referred to above is in the nature of:*
  - A. *Contingent Liability*
  - B. *Constructive Obligation*
  - C. *Construction Obligation*
  - D. *Crystallized Liability*
- 1.2 *Expected Credit Loss Provisioning (ECL) is not required for Retention Receivables arising out of contractual terms.*
  - A. *Not Correct since it is a financial asset / contract asset*
  - B. *Correct since it is a contract asset*
  - C. *Depends on the facts and circumstances*
  - D. *ECL is Not applicable for Infrastructure companies*
- 1.3 *Difference between estimate and the actual relating to the prior periods would be considered as a prior period adjustment under IND AS:*
  - A. *Yes, based on matching Principle*
  - B. *No, actualisations of estimate difference are period adjustments in Profit & Loss Account*
  - C. *Depends on the outcome of evaluation of differences by the Board*
  - D. *Depends on the nature of the item requiring estimation*



- 1.4 *Board has the power to overrule the decisions of the Audit Committee (AC) under the Indian Companies Act, 2013:*
- A. No
  - B. Yes, after informing the Regulator
  - C. Yes, but disclosure need to be made with reasons therefor in the Board Report
  - D. Would vary based on the nature of the decisions of the AC and the profile of the AC Chair )
- 1.5 *Auditor of the Company is having an obligation to validate all the financial and non-financial information provided along with the audited financial statements as part of the Annual Report*
- A. Yes, as required under the Auditing Standards
  - B. No, it is only voluntary on the part of the auditors
  - C. Limited to financial information only
  - D. Yes, to the extent it related to the relevant Information not reported as part of the financial statements.
- 1.6 *Company Secretary is equally responsible for ensuring compliance with the accounting standards and other reporting requirements relating to the financial statements under the Indian Companies Act, 2013 similar to that of the CFO*
- A. Yes, it is demonstrated by his requirement to sign the financial statements where required
  - B. No
  - C. Yes, for listed Companies
  - D. Depends on the decision of the Board
- 1.7 *The Company and the Auditor is duty bound to provide the information required by the shareholders at any time.*
- A. No
  - B. Company is responsible but not the auditor as per the requirements of the Companies Act, 2013
  - C. Auditor is responsible but not the Company as per the requirements of the Companies Act, 2013
  - D. Yes, both are responsible under the Companies Act, 2013
- 1.8 *All deficiencies irrespective of its nature, as identified by the auditors relating to internal control over financial reporting, would need to be reported appropriately as part of their audit report to the shareholders under the Companies Act, 2013.*

- A. Yes, material weaknesses, significant deficiencies and other deficiencies need to be included as part of the audit report to the shareholders.
  - B. Yes to the extent approved by the AC/Board.
  - C. Nothing needs to be reported to the shareholders.
  - D. Deficiencies which are material weaknesses need to be considered suitably for reporting to the shareholders.
- 1.9 Auditee can decide on the nature/ extent of the audit procedures required to be carried out by the statutory Auditors in connection with the audit if the financial statements under the Indian Companies Act, 2013
- A. No
  - B. Yes, with the approval of the shareholders
  - C. Yes, since the company appoints the statutory Auditor
  - D. Depends on the facts and circumstances
- 1.10 Any additional information as determined by the management can be provided as part of the financial statements over and above the minimum disclosure requirements stipulated under the Indian Companies Act, 2013.
- A. Strictly No, since the disclosure requirements are mandated under the Indian Companies Act, 2013
  - B. Yes always, as long as the minimum/stipulated disclosure requirements are complied with
  - C. Can be discussed and decided based on the mutual consent of the auditor and the auditee
  - D. Yes, provided the same is required for better understanding of the financial statements.

### **PART B**

#### **Answer the following:**

- 1.11 What will be your response to the Statutory Auditors regarding various matters highlighted by them as part of the audit process? (12 Marks)
- 1.12 Based on your review of the aforesaid case, Analyse the various adjustments & also items which do not require any adjustments in your view, to the draft financial statements of the company. (6 Marks)
- 1.13 How will you deal with the issues raised by the company secretary from the financial reporting and compliance perspective? (6 Marks)
- 1.14 What will be your response to the CEO on his proposals regarding various matters and explain the basis for your conclusion. (6 Marks)

**Answer to Question 1****PART – A**

- 1.1 (D)
- 1.2 (A)
- 1.3 (B)
- 1.4 (C)
- 1.5 (C)
- 1.6 (A)

**Alternative- Option (B)**

- 1.7 (A)
- 1.8 (D)
- 1.9 (A)
- 1.10 (D)

**PART – B**

- (1.11) (1)** An entity's system of internal control contains manual elements and often contains automated elements. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported. An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of information technology. Further as per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", IT system also poses specific risks to an entity's Internal Control. They are reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both. Thus, objection of Finance team of the company regarding usage of BOTS in the audit process is not correct. The auditor should be provided access to the data that is required for usage of BOTS for audit purpose.
- (2)** As per SA 500, "Audit Evidence", when designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence. Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. Inspection involves examining records or documents, whether internal or external, in paper form,

electronic form, or other media, or a physical examination of an asset. Thus, visit for verification of original is not beyond the scope of statutory audit required under the Companies Act.

- (3) In carrying out the audit of the standalone financial statements, the computation of materiality for the purpose of issuing an opinion on the standalone financial statements of each component would be done component-wise on a standalone basis. However, with regard to determination of materiality during the audit of consolidated financial statements (CFS), the auditor is required to compute the materiality for the group as a whole. This materiality should be used to assess the appropriateness of the consolidation adjustments (i.e. permanent consolidation adjustments and current period consolidation adjustments) that are made by the management in the preparation of CFS. The principal auditor also computes materiality for each component and communicates to the component auditor, if he believes is required for true and fair view on CFS. The parent auditor can also use the materiality computed on the group level to determine whether the component's financial statements are material to the group to determine whether they should scope in additional components, and consider using the work of other auditors as applicable. Thus, contention of management with respect to apply shared service approach of testing the homogeneous process and controls and applying the conclusion to all the individual entities rather than testing it multiple times is not tenable.

**Alternative:** Hold discussion with the auditors to highlight the structure of the shared service centre set up of the Company. Also highlight to them that the processes are so streamlined and structured that the shared service team ensures all processes are managed in a homogeneous manner and appropriate internal control exists which would provide the required comfort to the auditors for applying the SSC approach. Also inform the auditors that, they could do their own controls testing and understanding of the process before deciding on the same, duly considering the requirements of SA 500 on Audit Evidence and SA 315 on Identification and assessing risks of material misstatements through understanding of the entity and its environment. Reaffirm to the auditors that, whatever information is required for the auditors to conclude on the homogeneity and operating effectiveness of the controls at the shared service center, the same would be provided to them.

- (4) So far as the Arm's Length Pricing (ALP) principle of Transaction Net Margin Method (TNMM) is concerned which is adopted from Income Tax view point, it is an approved method under Income Tax Act, but there is no such separate ALP for the purpose of reporting under the Companies Act. Therefore, challenge of audit team contemplating separate ALP for the purpose of reporting under the Companies Act is not correct. However, acknowledge the fact that the arm's length determination under Companies Act, 2013 cannot be exclusively only on the basis of TNMM as considered for Income Tax Act. Rather, for Companies Act, the arm's length determination should be based on the related party transactions approval policy framed by the Audit

Committee/Board as per the Companies Act. Inform the auditors that the same would be aligned and a proper justification would be provided to them to substantiate the arm's length nature of the related party transactions.

- (5) SA 505 "External Confirmations", establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. If the management refuses to allow the auditor to send a confirmation request, the auditor shall (i) inquire as to Management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness, (ii) evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures, and (iii) perform alternative audit procedures designed to obtain relevant and reliable audit evidence. If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those in charge of governance and also determine its implication for the audit and his opinion.
- (6) As per SA 620, "Using the Work of an Auditor's Expert", during the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert. Expertise in a field other than accounting or auditing may include expertise in relation to specified matters. In the instant case, the auditee has entered into 4 major contracts for which sizeable margins are recognized, audit team can use their expert i.e. engineering expert for validating the assumption relating to cost incurred, cost to come and the expected margins/losses as such estimates are critical and would have a substantial impact on the result of the company. Therefore, objection of Supraja is not correct.
- (7) As per SA 510 "Initial Audit Engagements-Opening Balances, if the prior period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated. Thus, requirement of reviewing the audit working papers of previous auditor is not correct.
- (8) As per SA 600, Using the work of Another Auditor, when the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit. In certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component,

the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. Further, the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. Thus, audit team can review the books of accounts of the joint venture in Dubai, in case finance team deny auditor may qualify the report accordingly.

**Alternative:** Inform the finance team that section 143 of the Companies Act, 2013 provides the auditors with the right to access the books of accounts and other information's of subsidiaries including joint ventures. Accordingly, if the auditor believes that the review of the JV records is relevant duly considering materiality, organize the same. In the absence of same auditor may qualify the report accordingly.

- (9) Request by the Audit manager that the entire draft annual report of the company be provided to them upfront before finalizing the same is not valid because in annual report auditor is required to provide the audited balance sheet along with audit report with respect to financial statements. It has nothing to do with draft annual report. The objective of the audit is to express an opinion on financial statements and other information relating to financial statements only. The auditor does not report on Director's Report, Management Discussion and Analysis, Corporate Governance Report, Financial Highlights etc.
- (10) The auditor is required to verify compliance with laws and regulation. Further he is also required to verify the same as per SA 500 Audit Evidence. For the same he is required to reconcile the transactions as per books with the details as per the Goods and Service Tax Network data w.r.t input credit, expenses accounted, income accounted and also between the TDS credits taken and the interest income accounted as per books with the Form 26AS of the Company. Further it is also required for reconciliation of profits between the costing records maintained for cost audit purposes with that of financial records. Thus contention of Sukanaya that the audit is required only based on the books maintained by the company and there is no need to extend such audit to third party/independent data maintained by the regulators/intended for different purposes is not correct.
- (11) The auditor's objective in an audit of internal financial controls over financial reporting is to express an opinion on the effectiveness of the company's internal financial controls over financial reporting. It is carried out along with an audit of the financial statements. Because a company's internal controls cannot be considered effective if one or more material weakness exists, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain sufficient appropriate evidence to obtain reasonable assurance about whether material weakness exists as of the balance sheet date. A material weakness in internal financial controls may exist even when the financial statements are not materially misstated.

Further, the auditor must evaluate the severity of each control deficiency that comes to his or her attention to determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses as of the balance sheet date. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a significant deficiency.

- (12) Contention of auditor Sai Ram to withdraw the review reports issued on the quarterly financial information earlier based on limited review and not to report is not correct however, he may issue qualified or modified opinion in the absence of all the details/support required for finalising the audit. Therefore, the auditor could consider issuing the report after required modifications or qualifications.

**(1.12) Analysis of all the Open Accounting Matters**

- (a) Since spares are meant to be used for a specialised crane and is expected for completion in March, 2019, (assuming that the spares has an estimated useful life of more than one year), it will not be expensed. However, liability has to be accounted for as follows:

Capital work-in-progress (spares) A/c	Dr.	₹ 2.45 crore
	To Provision / Liability for spares (vendor) A/c	₹ 2.45 crore

**Note:** If it is assumed that the estimated useful life is less than a year, then the debit will be to inventory account.

- (b) As per para 7 of Ind AS 20, "Accounting for Government Grants and Disclosure of Government Assistance", Government grants, including non-monetary grants at fair value, shall be recognised when there is reasonable assurance that:
- the entity will comply with the conditions attaching to them; and
  - the grants will be received.

Here, as per the information given in the question, it is clear that the entitlement is more or less established though the submission of export benefit documents is pending. Looking over the substance of the transaction, it can be considered as there is a reasonable assurance for receiving the export benefit and also it can be measured reliably. Further, it is assumed that the entity will comply with the conditions attached to it. Hence, it shall be accounted (assuming that the benefit is received in cash), as follows:

Bank A/c	Dr.	₹ 4.35 crore
	To Government Grant	₹ 4.35 crore

**Note:** It is assumed that ₹ 4.35 crore is the fair value of the grant received.

- (c) Since, as per the information given in the question, contractually all the payments statutorily required to be made to contract employees are to be borne by the company under the contractual terms entered into with the manpower service provider, the company has to account for the leave/gratuity liabilities in the reporting period ending on 31<sup>st</sup> March, 2018 for ₹ 2.44 crore. Here the relation is not exactly of employer and employee as they are contractual employees, such expense would be under the head "Other expense" as follows:

Other Expense A/c	Dr.	₹ 2.44 crore
To Provision for expense (gratuity/leave liabilities)		₹ 2.44 crore

- (d) Since from the question it can be inferred that the ESOP was in existence on the transition date and no accounting for its outstanding expense was done in prior periods, it will be considered as error and retrospective effect will be given impacted through 'Retained Earnings'. Further, it is assumed that ₹ 1.46 crore is the amount to be expensed in the current year.

Profit and Loss A/c	Dr.	₹ 1.46 crore
To ESOP expense A/c		₹ 1.46 crore

**Note:** The above assumption is made since if ₹ 1.46 crore is the total value of the ESOP to be expensed then it should be spread over the vesting period which is not given in the question.

Further, non-accounting of stock option cost is an error and non-compliance of the guidance note, it shall be accounted for retrospectively by impacting "Retained Earnings". It is also subject to defer tax.

- (e) As per Ind AS 109, the amount of expected credit loss for doubtful receivables should be accounted for in the year ended on 31<sup>st</sup> March, 2018 for ₹ 1.20 crore. Also ECL provision shall be made on Retention Receivables also as they are financial asset of the company. So ECL provision on it of ₹ 0.75 crore shall also be made in the year ended on 31<sup>st</sup> March, 2018. Total provision to be made is of ₹ 1.95 crore.
- (f) Contribution to the political party needs to be accounted for only if an obligation has arisen as at the balance sheet date. A mere commitment would not warrant an accounting for such provision. Hence, it shall not be provided for in the books as on 31<sup>st</sup> March, 2018.
- (g) Foreign exchange payables are to be accounted on each reporting date on the basis of the spot rate only. Therefore, following correction entry shall be passed:

Forex loss A/c	Dr.	₹ 0.23 crore
To Foreign Exchange payables A/c		₹ 0.23 crore

- (h) Actualisations of estimate difference are period adjustments which shall be recognized in the Profit and Loss Account. Adjustment of the same in the Retained



Earnings directly as on 1<sup>st</sup> April, 2017 is not correct. A reversal entry should be passed as follows:

Profit and Loss A/c	Dr.	₹ 3.49 crore
To Retained Earnings		₹ 3.49 crore

Further, as per the accounting standard also the difference in estimate is not adjusted retrospectively.

- (i) As per para 22 of Ind AS 11\*, when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period. Also as per para 36 of the standard, when it is probable that total contract costs will exceed total contract revenue, the expected loss shall be recognised as an expense immediately. Accordingly, estimated future loss of ₹ 12 crore shall be provided for in the books as on 31<sup>st</sup> March, 2018.
- (j) As per Ind AS 10, Proposed dividend shall not be included in the finance cost in the financial year 2017-2018, because generally it is declared after the reporting period. In the given case, the date of declaration of proposed dividend has not been given. It is assumed to be after the reporting date. With respect to dividend, evidence for its declaration does not exist at the end of the reporting period. Hence ₹ 1.2 crores should be accounted in the year 2018-2019.
- (1.13)(a) According to section 177(6) of the Companies Act, 2013, the Audit Committee shall have authority to investigate into any matter in relation to the items specified in sub-section (4) or referred to it by the Board and for this purpose shall have power to obtain professional advice from external sources and have full access to information contained in the records of the company.

As per section 177(7), the auditors of a company and the key managerial personnel shall have a right to be heard in the meetings of the Audit Committee when it considers the auditor's report but shall not have the right to vote.

As per section 177(8), the Board's report under section 134(3) shall disclose the composition of an Audit Committee and where the Board had not accepted any recommendation of the Audit Committee, the same shall be disclosed in such report along with the reasons therefor.

Thus, the Audit committee can refer the investigation related director to outside agency. Further, since the Board has not accepted the recommendation of the Audit

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\* In November, 2018 Examination Ind AS 11 was applicable. Therefore, answer has been provided as per Ind AS 11 only.

Committee, the same shall be disclosed in Board's report under section 134(3) along with the reasons therefor.

- (b) As per section 134 auditor and company secretary is required to check the compliance with financial statements and secretarial standards however, section does not specify anything about the directors compliance. So, dissent of one of the director on the approval of unaudited financial statements will not affect the approval by majority.
- (c) As shareholders are the main stakeholders in a company, they have the right to inspect the accounts register and also the books of the firm and can ask questions about the same if they feel so.
- (d) If there is difference between the various segment disclosures as per the business and as per the financial statements, the CEO may be asked for the explanation. Further, the same could be discussed with the auditors to obtain their views on compliance with the accounting standards and necessary changes be made, as required in order to ensure such inconsistency is avoided.
- (e) As per section 134(3) of the Companies Act, 2013, there shall be attached to statements laid before a company in general meeting, a report by its Board of Directors, which shall include explanations or comments by the Board on every qualification, reservation or adverse remark or disclaimer made (i) by the auditor in his report; and (ii) by the company secretary in practice in his secretarial audit report. Further, the presentation made by the statutory auditors to those charged with governance is not for reporting to general public/shareholders and cannot be shared as it is.
- (f) According to section 134 (1) of the Companies Act, 2013, the financial statement, including consolidated financial statement, if any, shall be approved by the Board of Directors before they are signed on behalf of the Board at least by the chairperson of the company where he is authorised by the Board or by two directors out of which one shall be managing director and the Chief Executive Officer, if he is a director in the company, the Chief Financial Officer and the company secretary of the company, wherever they are appointed, or in the case of a One Person Company, only by one director, for submission to the auditor for his report thereon.

The Company Secretary has to see the compliance of the provisions of the Companies Act, 2013.

Also, discussions with Divya should be held to understand the concerns and ensure the same are addressed wherever those are relevant to ensure appropriateness of the financial reporting. Where it involves matters of interpretation, hold discussions to share the views and back them with professional opinion so that the decisions taken by the Company are well thought through and is in compliance with laws and regulations.

- (1.14)(a) As per Ind AS 109, diminution in the value of investment in subsidiary shall be routed through Profit and Loss and not adjusted against the reserves in the Balance sheet.
- (b) According to proviso to section 123 (1):  
 “Provided further that where, owing to inadequacy or absence of profits in any financial year, any company proposes to declare dividend out of the accumulated profits earned by it in previous years and transferred by the company to the free reserves, such declaration of dividend shall not be made except in accordance with such rules as may be prescribed in this behalf.  
 Provided also that no dividend shall be declared or paid by a company from its reserves other than free reserves.”  
 Hence, in the given case, the company cannot use the short- term borrowings from the bank for working capital purposes to pay the dividend.
- (c) In case revenue is not recognized due to uncertainty of its collection, the company can disclose the same by way of Notes to accounts and the accounting policy followed in compliance with the standard. Additional disclosures, if provide better understanding of the financial statements, can be given by way of notes to accounts.
- (d) The amount of deposit repayable has to be transferred to the deposit reserve account and the same cannot be used by the company for any other purpose excepts repayment of deposits.
- (e) As per the Companies Act, 2013, only accrual basis has to be followed for accounting of financial data. Hence providing Asset Retirement obligations on cash basis at actuals is not appropriate.
- (f) As per the information given in the question, the company is adopting Ind AS. Therefore, it has to present its financial results on the basis of Ind AS only along with the corresponding Ind AS numbers for bench marking. Also comparatives should also be given as per Ind AS only. It cannot provide the financial results as per AS alongwith the Ind AS numbers.

### Question II

*You are the leading Consultant, advising companies with respect to various compliance related matters impacting their operations in India. In particular, your primary focus is on Direct/Indirect Taxes, Economic Laws and Corporate Laws. Your clients are spread across the country and you have a large team of professionals working under you supporting your entire advisory practice.*

#### **Introduction**

*Ringling Bell Group based out of Singapore has a Liaison Office (LO) in Mumbai and currently has very limited operations in India. The Group specializes in the area of developing 3 D Printing capabilities and is fast growing in this segment globally. The Indian LO, at present, employs*

about 40 people primarily to represent the parent in dealing with the customers in India. The group is well recognised for its governance standards and is very keen to implement its zero tolerance for Non-compliances policy.

The Chief Executive Officer of the Group, Mr. Jim, has visited India recently and has identified India as a core market for the group's global growth and is very keen to develop the Indian operations of the group significantly. Considering the complex regulatory set up in India, he wants to ensure that the growth plans does not result in regulatory non-compliances having an impact on the group's brand image. He has asked his Chief Compliance Officer, Mr. Thompson to visit India and give him a report on the applicability of various aspects including the current state of affairs, compliance standards, and regulatory hygiene assessment and also on the various laws and regulations which may potentially have an impact for Ringing Bell duly considering its business plans for India.

The financial controller who manages finance as well compliance for the Ringing Bell, India's LO operations, Mr. Ram Kumar has requested you, as an independent consultant, to assist Thompson in his mission, who is on a business visit to Mumbai.

You have accepted this offer and meeting Thompson and Ram Kumar in their Office at Navi Mumbai with your colleagues, Mr. Hari, Manager Taxation and Mr. Porus, Director, Economic & Corporate Laws.

#### Overview of Significant Laws impacting Ringing Bell. India

In the meeting, Ramkumar gave an overview of the Indian Companies Act, Income Tax Act, GST Act and other Economic Laws at a high level to the extent relevant for the current operations of the Indian LO and also presented the financial state of affairs of the Indian entity. Thompson explained the group's plans for focusing on the Indian market more vigorously and wanted to understand the overall regulatory reforms in the country.

You have highlighted to Thompson that India is embarked on a journey of simplifying the complex regulatory set up and is committed to Ease of Doing Business. In addition, you have also highlighted that whilst every effort is made to simplify the laws, the penalties for non-compliances have been made more severe and hence at most care has to be taken in ensuring due compliance with all the applicable laws and regulations.

Thompson was very keen to understand the regulatory environment including the litigation settlement process especially the time taken for disposal of cases by the judiciary. The various discussion points/questions raised/clarifications sought are summarised below for your consideration.

#### Questions on the Income Tax Related Aspects

Thompson expressed his intention to understand the Taxation aspects relating to Indian Entities. In particular, he was very keen on understanding the transfer pricing provisions relating to

transactions with the group companies. His specific clarifications on Transfer Pricing relate to the following:

- (1) *Whether the transfer pricing policy followed by the group globally would be acceptable to Indian Income Tax authorities?*
- (2) *Is there a mechanism to get that understanding confirmed upfront to avoid legal battles at a later stage?*
- (3) *Is there a requirement to apply different yardsticks for evaluating the transfer pricing from different laws other than the Income Tax Act?*

Thompson was also very keen to understand the implications of GAAR under the Income Tax Act. Hari, Manager Taxation has explained the provisions of GAAR under the Indian Income Tax Act, which needs to be duly considered in evaluating the relevant transactions from the tax angle.

Thompson was also interested in understanding the difference between tax planning and tax evasion given the complexity of the Indian income tax laws. Ram Kumar indicated that both look alike and he also raised some specific issues which may be clarified in this regard. The issues raised by Ram Kumar on this aspect are summarised below:

- (1) *Setting up their Unit in a Special Economic Zone and claiming tax exemption and the implications of the same under the applicable provisions in the Income Tax Act.*
- (2) *Requesting the Supplier of the Group based out of Singapore to provide a loan to the Indian entity of the group from its shell/loss making subsidiary in India at a higher rate of interest for claiming tax deduction for interest and adjusting this at the group level as part of overall price negotiation by the parent*
- (3) *Declaring dividend based on the applicable provisions of the income tax rate only when it is favourable notwithstanding the availability of adequate profits in the financial year.*
- (4) *Providing rebates and discounts to channel partners who are customers of the Company instead of sales incentives and not withholding the taxes.*

Thompson was also keen in understanding tax aspects relating to payment of royalty on patents developed and registered in India. He was curious to know the applicable tax rates on such payments.

#### Clarifications on Foreign Exchange Transactions

Thompson was inquiring about the Foreign Exchange Regulations as applicable for their proposed Indian operations and sought your clarifications on the following aspects:

- *Carrying out large scale business activities using the existing LO model.*

- Possibility of exporting from India to its various customers in Europe and requirements relating to receipt of money especially time limits, if any, and other compliance involved in connection with the non-realizations.
- Procedural aspects relating to funding the Indian entity through external commercial borrowings/advance from the parent against future supplies.
- Possibility of arranging for remittance of funds on exports made by the Indian entity to various customers by the parent directly for ensuring administrative convenience.

Ram Kumar explained that the proposed Indian operations would also require import of certain capital assets from its parent. He inquired about the accounting and tax implications of possible waiver of liabilities relating to payable to the group companies in Singapore arising out of supply of capital goods to the Indian entity as an indirect funding mechanism. He was also wondering whether such capital assets could be supplied to Indian entity at free of cost and what would be the accounting/tax requirements relating to the same?

Thompson was concerned about the definition of the term "Hawala" under Indian laws and the implications for the Key Managerial Personnel of the Company on such Hawala transactions, if any. He wanted to understand the same in detail and in particular the difference between Hawala and Round Tripping.

Thompson was also curious to understand the requirement relating to donating certain amounts from Singapore as part of their group Corporate Social Responsibility (CSR) commitment to the Indian entity which can be used for various charitable purposes/welfare measures in India. This would go a long way in building their brand in India.

Porus, explained that whilst the provisions of the foreign exchange regulations have been simplified substantially from the "Control based approach" to "Management based approach", a thorough evaluation of the various foreign currency transactions would be absolutely essential for ensuring zero non-compliance.

#### Issues on Recovery and Legal Protection Mechanism

Ramkumar raised the issues of legal remedies available in India for recovering amounts rightfully due to the Company, in case of default by the customer. He was curious to understand the provisions relating to the Insolvency and bankruptcy code, 2016 which would come in handy for enforcing timely actions by the defaulting customers, where required.

He also wanted to understand how the settlement of the dues would be prioritized as compared to various secured creditors of the defaulting company at the time of insolvency. Further he was keen to understand the deductibility of provisions made for bad and doubtful receivables under the Indian Income Tax Act.

#### Corporate Law Implications

Ram Kumar suggested that it would be better to incorporate a company for the purpose of business expansion. Thompson wanted to understand the need for such a new corporate set

up and if required, the statutory audit requirements, if any, relating to the existing LO and the new corporate set up.

Thompson wanted to find out if there is any mandatory requirement to appoint the independent Director for the subsidiary, which if incorporated, would be a closely held company of Ringing Bell, Singapore. He was also keen to find out the compliances relating to notices of the board meetings to be sent to directors, including the directors residing in foreign countries and the timelines indicated, if any, under the Companies Act, 2013.

Ram Kumar raised the issue that compliance requirements relating to Related Party transactions under the Companies Act would be very complicated. Thompson wanted to understand the same in detail and in particular, aspects relating to compliance reporting requirements, when the relationship is structured in such a way that it ceases to exist, of course, within the legal framework!

Thompson also wants your inputs on the following specific aspects under the Indian Companies Act, 2013:

- Need for setting up a compliance and governance committee Compliance audit
- Roles and Responsibilities of the Directors for Compliance with laws and Regulations
- Immunity available to Directors of the Company for Ignorance of laws/professional indemnity

He was wondering whether statutory auditors would give him comfort on the compliance requirements and what would be the role and the responsibility of the statutory auditors on this matter under the auditing standards prevailing in India as referred to under the Indian Companies Act.

#### Asks from You

You are requested to advise Ringing Bell based on your understanding of their requirements, issues, if any, and clarifications sought. Please make relevant assumptions as may be required to explain your answer so as to provide a holistic and relevant feedback. Your response would be very vital for the group's decision to expand the Indian operations and hence the group is expecting your best advice!

### **PART- A**

#### **Answer the following questions:**

**(2 Marks each)**

- 2.1 In responding to Thompson, you have explained that under Hawala System
- A. Money exits the Hawala system in local currency and enters as foreign currency
  - B. Money enters the Hawala system in foreign currency and also in local currency
  - C. Money enters the Hawala system in local currency and leaves as foreign currency
  - D. Money exits the Hawala system in foreign currency and also in local currency

- 2.2 *In your role as an advisor to Ringing Bell, you will indicate to them that under the provisions of the Companies Act, 2013, a notice of the Board meeting must be served to:*
- A. *All the directors except to an interested Director.*
  - B. *All the directors except to a Director who has expressed his inability to attend a Board Meeting.*
  - C. *All the directors, except a person who has gone abroad (for less than 3 months).*
  - D. *All the Directors.*
- 2.3 *Write off of Foreign Exchange receivables arising out export sales of Ringing Bell is permissible*
- A. *No, it is not allowed*
  - B. *Yes, it can be done through credit notes by reversal of export sales subsequently*
  - C. *Only with the approval of the Authorized Dealer*
  - D. *Only in compliance with the FEMA/RBI Guidelines*
- 2.4 *Assume that one of the group companies of Ringing Bell, Singapore rendered certain services to its Indian entity for the first quarter ending 30 June 2019 and after that the related party relationship does not exist under the Companies Act, 2013 due to certain reorganisation at the group level. If such services were rendered to the Indian entity for the whole year like any other ordinary customer*
- A. *The transactions for the whole year must be disclosed as related party transaction.*
  - B. *The transactions for the first quarter ending 30 June, 2019 alone should be disclosed as related party transactions*
  - C. *Since the transactions were only for the first quarter and not for the whole year, no disclosure is required to be made*
  - D. *Only the transactions other than the 1<sup>st</sup> quarter ending 30 June, 2019 should be disclosed as related party transactions.*
- 2.5 *Ringing Bell can carry out export business activities with commercial arrangements in India directly through their LOs indefinitely without having any legal requirement to incorporate a domestic setup*
- A. *Yes, it is permissible under Ease of Doing Business Guidelines.*
  - B. *No, since the LOs are not permitted to be engaged in income generation activities.*
  - C. *Allowed with the approval of the RBI if the parent company is located in any of the SAARC countries.*
  - D. *Will be decided by the DGFT on a case to case basis after obtaining the clearance from the Income Tax Authorities and the Authorized Dealer.*



- 2.6 *Liabilities arising out supply of capital goods by the foreign parent company to Ringing Bell and written back subsequently based on the waiver letter from the parent;*
- A. *Can be taken to other income with the approval from the Authorized Dealer*
  - B. *No accounting is required; only intimation to the RBI is intended*
  - C. *To be netted against the cost of the capital asset and no RBI approvals are required for the same.*
  - D. *To be adjusted against opening Retained Earnings and approval from the RBI / AD and the appropriate authority in the foreign jurisdiction is required.*
- 2.7 *Amounts Receivable from the Foreign Party towards supply of goods or services by Ringing Bell and remaining as outstanding (in excess of the stipulated thresholds for suo moto writeoff) and considered as doubtful of recovery*
- A. *To be continued to be treated as good till such time the approval from the RBI/AD is obtained for write off*
  - B. *Can be written off in the accounts and claimed as an allowable expense for taxation purposes and the procedural aspects of approvals from the RBI/AD may be obtained later.*
  - C. *Provided for in the accounts towards doubtful receivables, disallowed for income tax computation purposes and the write off to be effected in compliance with the FEMA/RBI directions and income tax requirements.*
  - D. *Will remain in the books for ever and nothing needs to be done.*
- 2.8 *Under the Indian Insolvency and Bankruptcy code, 2016, Ringing Bell-India can initiate action against the defaulting companies in India for non-payment of its enforceable dues;*
- A. *For any amounts in excess of USD 100 in its capacity as financial creditor*
  - B. *For any amounts in excess of ₹100 in its capacity as corporate debtor*
  - C. *For any amounts in excess of ₹0.1 Million with the approval of NCLT*
  - D. *For any amounts in excess of ₹0.1 Million without the approval of NCLT*
- 2.9 *Arm's Length Principle (ALP) established under the various legal requirements in India would be the same;*
- A. *Yes, it cannot be different for different purposes*
  - B. *No, it can be different for different purposes as stipulated under the legal provisions:*
  - C. *Depends on the facts and circumstances and the nature and the type of the entity*
  - D. *The Central Government has the authority to establish the ALP which can either be the same or different under different laws.*

- 2.10 Compliance Audit of applicable laws and regulations is mandatory for all companies registered under the Indian Companies Act, 2013
- Yes, for All Companies registered under the Companies Act, 2013
  - No, it is applicable only for companies investigated by the SFIO under the Companies Act, 2013
  - It is part of the Internal Audit mandatorily stipulated under the Companies Act, 2013
  - Compliance Audit is not specifically mandated for all companies under the Indian Companies Act, 2013

### PART- B

#### Answer the following:

- 2.11 What would be your advice to Ringing Bell in developing a framework for ensuring compliance with laws and regulations in India? (4 Marks)
- 2.12 You are requested to provide detailed response to the 3 specific clarifications sought by Thompson in connection with the Transfer Pricing aspects under the Indian regulatory requirements. (6 Marks)
- 2.13 Explain the difference between Tax Planning and Tax Evasion using the 4 specific issues raised by Ram kumar. (4 Marks)
- 2.14 What would be your response to Thompson regarding the specific requirements of the Indian Companies Act, 2013 relating to
- Need for setting up a compliance and governance committee
  - Compliance audit
  - Roles and Responsibilities of the Directors for Compliance with laws and Regulations
  - Immunity available to Directors of the Company for Ignorance of laws/ professional indemnity (8 Marks)
- 2.15 What is the role and the responsibility of the statutory auditors in connection with the laws and regulations under the applicable auditing standards in India / Indian Companies Act, 2013? (4 Marks)
- 2.16 What do you understand by the term Round Tripping under the Tax laws and explain the same with an example. (4 Marks)

#### Answer Question 2

### PART – A

- (C)
- (D)
- (D)

- 2.4 (B)
- 2.5 (B)
- 2.6 (C)
- 2.7 (C)
- 2.8 (C)
- 2.9 (B)
- 2.10 (D)

### PART – B

(2.11) In developing a compliance framework for laws and regulations in India, Ringing Bell could consider the following:

- Develop a compliance manual/checklist which captures all compliance requirements as applicable to Ringing Bell in India. This manual should be made specific to address applicable laws including specific aspects that would be relevant for the nature of entity finally chosen for carrying out the operations of Ringing Bell in accordance with the Regulatory framework.
- Develop a comprehensive compliance program which will align with the business objectives and strategy of the Group.
- Consider creating a compliance monitoring group or a committee which could be made responsible for monitoring and oversight.
- Make compliance monitoring and adherence the responsibility of everyone in the organization.
- A periodical statement of compliance from all key stakeholders confirming compliance with all applicable regulations under their responsibility.
- A program of compliance audit or an independent compliance assurance could be introduced on a periodic basis.
- Consider having a compliance tool/dashboard which provides instant visibility to Senior Management on the compliance status at the Company at any point in time.
- Having an effective Board oversight on the compliance status.

#### Alternative

**As per the Master Circular on Establishment of Liaison / Branch / Project Offices in India by Foreign Entities**

**Permissible Activities for a Liaison Office:**

A Liaison Office (also known as Representative Office) can undertake only liaison activities, i.e. it can act as a channel of communication between Head Office abroad and parties in India. It is not allowed to undertake any business activity in India and cannot earn any income in India. Expenses of such offices are to be met entirely through inward remittances of foreign exchange from the Head Office outside India. The role of such offices is, therefore, limited to collecting information about possible market opportunities and providing information about the company and its products to the prospective Indian customers. Permission to set up such offices is initially granted for a period of 3 years and this may be extended from time to time by an AD Category I bank.

**A Liaison Office can undertake the following activities in India:**

- i Representing in India the parent company / group companies.
- ii Promoting export / import from / to India.
- iii Promoting technical/financial collaborations between parent/group companies and companies in India.
- iv Acting as a communication channel between the parent company and Indian companies.

**Reporting by Liaison Offices (LO)**

1. All new entities setting up LO shall submit a report containing information, as per given format within five working days of the LO becoming functional to the Director General of Police (DGP) of the state concerned in which LO has established its office; if there is more than one office of such a foreign entity, in such cases to each of the DGP concerned of the state where it has established office in India;
2. Branch Offices / Liaison Offices have to file Annual Activity Certificates (AAC) from Chartered Accountants, at the end of March 31, along with the audited Balance Sheet on or before September 30 of that year.

**(2.12)(i)** Since the profits derived by enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in intra-group transactions, thereby, leading to erosion of tax revenues, the Indian Income Tax authorities would not accept the transfer pricing policy followed by the group globally in all cases.

Sections 92 to 92F had been included in Chapter X of the Income-tax Act, 1961, through the Finance Act, 2001, providing for a transfer pricing mechanism, which has to be followed by the Assessing Officer for determining the Arm's Length Price of the transactions entered among group companies.

**Alternate Answer**

Yes, the transfer pricing policies of group would be acceptable if policies are framed in compliance with Indian transfer pricing regulations.

- (ii) Yes; in order to gain certainty prior to entering into an international transaction with an Associated Enterprise, the taxpayers have an option of applying for an Advance Pricing Agreement (APA) and obtaining results before the transaction is actually undertaken. The same has the potential to reduce litigation for the taxpayer and provide certainty for a longer period of time.

An APA is an agreement between a tax payer / applicant and the CBDT, which determines the arm's length price of future intercompany transactions. It can also be used for existing intercompany transactions. The tax payer/ applicant mutually agree on the transfer pricing methodology to be applied and its application, in relation to the taxpayer's international transactions for certain future period of time.

Once an APA has been entered into with respect to an international transaction, the arm's length price with respect to that international transaction, for the period specified in the APA, will be determined only in accordance with the APA. The APA shall be binding on the person as well as the Income-tax authorities for the specified transaction and period as covered in the APA.

- (iii) Section 188 of the Companies Act, 2013 prohibits companies from entering into related party transactions except with the consent of the Board of Directors given by a resolution at the Board meeting and subject to prescribed conditions. However, this restriction would not apply if the transactions are entered into by the company in its ordinary course of business other than transactions which are not on an arm's length basis. For this purpose, arm's length transaction has been defined to mean a transaction between two related parties that is conducted as if they are unrelated, so that there is no conflict of interest.

Therefore, for the purpose of application of arm's length principle under the Companies Act, 2013, a related party is defined under section 2(76) of the said Act, whereas for the purpose of application of arm's length price under the Income-tax Act, 1961, an associated enterprise has been defined under section 92A of the said Act for an international transaction.

Likewise, under customs laws, separate rules are notified to value import and export transactions for the purpose of paying custom duties at arm's length. Essentially, the valuation under customs law is based on transaction value with addition of certain specified cost and services. In cases where transaction value cannot be adopted, like, related party transactions, the rules provide for valuation through identical or similar goods in that order. It may be noted that related party has been defined separately under the Customs Valuation Rules. Similarly, under GST laws also, in case of related persons, transaction value is not accepted and separate rules have

been provided for valuing the supply made between related persons. Here again, related persons have been defined in the GST Act.

Yes, since there are separate provisions under different laws for determination of ALP, the yardsticks prescribed under the Income-tax Act, 1961 will not apply to other laws. Each law contains its own definition of related party to whom arm's length determined as per the provisions said law would be applied.

- (2.13)(i) Setting up a unit in a special economic zone and taking advantage of a fiscal incentive offered to him by complying with the conditions imposed and economic consequences of the provisions in the legislation is permitted tax planning under the provisions of income-tax law.
- (ii) Loan from shell/ loss making Indian subsidiary of supplier based out of Singapore at a higher rate of interest is tax evasion. Indian entity would claim deduction of interest payable at a higher rate to shell/ loss making Indian subsidiary from the profit of business.
- The arrangement appears to be to avoid payment of tax on interest income by Singapore entity in case loan is directly provided by Singapore entity to Indian entity.
- (iii) Whether to pay dividend to a shareholder or not is a business choice of the company, which a company is entitled to exercise at any point of time. Accordingly, this would not tantamount to tax evasion.

**Alternate answer**

Retention of profits without dividend declaration by a closely held company outside India in a no tax or low tax jurisdiction is a method of tax avoidance/evasion. These companies are referred to as Controlled Foreign Corporations (CFCs), which resort to retention of profits rather than distribution of dividend, so that the shareholders are not subject to tax on such distributed income.

*Note - Many countries have CFC Rules to bring such undistributed profits to tax in the hands of shareholders. However, at present, there are no CFC rules under the Income-tax Act, 1961. Since the question does not specify whether the company is a closely-held company or not, the alternate answer is given on the basis of the assumption that company is a closely held company situated in a no tax or low tax jurisdiction.*

- (iv) Providing rebates and discounts to channel partners who are customers of the company is a business practice. Hence, it is not a tax evasion.

(2.14)

Sl. No.	Clarifications	Suggested Response
1.	Need for setting up a	There is no specific requirement to

	compliance and governance committee	mandatorily set up a compliance and governance committee for the companies registered under the Indian Companies Act, 2013.
2	Compliance audit	There is no specific requirement to carry out a compliance audit under the Companies Act, 2013. However, for the Directors to confirm existence of a proper system to ensure compliance with all laws, an effective monitoring mechanism has to be put in place by the Company, which could be in the nature of a periodical compliance audit or other similar exercise.
3	Roles and responsibilities of Directors for compliance with laws and regulations	<p>It is duty of the Directors to ensure the compliance with all laws. Accordingly, it is the responsibility of the Directors to ensure:</p> <ul style="list-style-type: none"> <li>• Appropriate compliance monitoring mechanism is in place in the company</li> <li>• Such a system covers all relevant regulations</li> <li>• Appropriate oversight and review mechanisms exist to monitor the same</li> <li>• The business processes and policies are aligned with compliance requirements</li> <li>• The outcome from the system is monitored and measures and accountability is fixed</li> <li>• A periodical compliance audit is undertaken which confirms the existence of a robust system as well as compliance with all laws and regulations</li> </ul> <p><b>Alternative</b> According to section 166 of the Companies Act, 2013,</p> <p>(1) Subject to the provisions of this Act, a director of a company shall act in accordance with the articles of the company.</p> <p>(2) A director of a company shall act in good faith in order to promote the objects of</p>

		<p>the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment.</p> <p>(3) A director of a company shall exercise his duties with due and reasonable care, skill and diligence and shall exercise independent judgment.</p> <p>(4) A director of a company shall not involve in a situation in which he may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company.</p> <p>(5) A director of a company shall not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates and if such director is found guilty of making any undue gain, he shall be liable to pay an amount equal to that gain to the company.</p> <p>(6) A director of a company shall not assign his office and any assignment so made shall be void.</p> <p>(7) If a director of the company contravenes the provisions of this section such director shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.</p>
4	Immunity available to directors of the Company for ignorance of laws/professional indemnity	Ignorance of law is not a valid defence for the Directors under the Companies Act, 2013. Accordingly, no immunity is available to directors under the Companies Act, 2013 for ignorance.

**(2.15) Role and Responsibility of the Auditor :** Requirements of SA 250 " Consideration of Laws and Regulations in an Audit of Financial Statements" are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.



1. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error as per SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, in conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.
2. In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:
  - There are many laws and regulations, relating principally to the operating aspects of an entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
  - Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.
  - Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognise the non-compliance.

3. This SA distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows:
  - (a) The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws; and
  - (b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements .

In this SA, differing requirements are specified for each of the above categories of laws and regulations. For the category referred to in para (a), the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance

with the provisions of those laws and regulations. For the category referred to in paragraph (b), the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

4. The auditor is required by this SA to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected non-compliance to the auditor's attention. Maintaining professional skepticism throughout the audit, as required by SA 200, is important in this context, given the extent of laws and regulations that affect the entity.
5. As part of obtaining an understanding of the entity and its environment in accordance with SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", the auditor shall obtain a general understanding of:
  - (a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and
  - (b) How the entity is complying with that framework.
6. The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements.
7. The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:
  - (a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and
  - (b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.
8. During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.
9. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.

10. In the absence of identified or suspected non-compliance, the auditor is not required to perform audit procedures regarding the entity's compliance with laws and regulations,
  11. If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.
  12. If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.
  13. The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action.
  14. In accordance with specific statutory requirements, the auditor may be specifically required to report, as part of the audit of the financial statements, on whether the entity complies with certain provisions of laws or regulations. In these circumstances, Revised SA 700, "Forming an Opinion and Reporting on Financial Statements" or SA 800 "Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks", deal with how these audit responsibilities are addressed in the auditor's report. Furthermore, where there are specific statutory reporting requirements, it may be necessary for the audit plan to include appropriate tests for compliance with those provisions of the laws and regulations.
- (2.16) As per section 97(1), an arrangement *inter alia* shall be deemed to lack commercial substance if it involves or includes round trip financing. Section 97(2) provides that round trip financing includes any arrangement in which, through a series of transactions—
- (a) funds are transferred among the parties to the arrangement; and
  - (b) such transactions do not have any substantial commercial purpose other than obtaining the tax benefit,
- without having any regard to—
- (A) whether or not the funds involved in the round trip financing can be traced to any funds transferred to, or received by, any party in connection with the arrangement;
  - (B) the time, or sequence, in which the funds involved in the round trip financing are transferred or received; or

- (C) the means by, or manner in, or mode through, which funds involved in the round trip financing are transferred or received.

**Example:**

A Ltd. incorporates a S Inc. in a NTJ (Low Tax Jurisdiction) with equity of US \$100. S Inc. gives a loan of US \$ 100 to another Indian company (X Ltd.) at the rate of 10% p.a. X Ltd. claims deduction of interest payable to S Inc. from the profit of business. There is no other activity in S Ltd.

The arrangement appears to be to avoid payment of tax on interest income by A Ltd. in case loan is directly provided by A Ltd. to X Ltd. The arrangement involves round tripping of funds even though the funds emanating from A Ltd. are not traced back to A Ltd. in this case. Hence, the arrangement may be deemed to lack commercial substance.

**Question III**

*You are the well-known Corporate Guru specializing in assisting companies in carrying out business valuations, due diligences and providing various transactional advisory services including the Risk assessment for corporates. Your clients are typically start-up companies which are looking for capital infusion/advice and support in building their core operational and governance model.*

*Ding Dong Ventures is a Private Equity (PE) fund which specializes in funding the startups in the area of E-commerce. They have reached out to you to help them in carrying out the Risk assessment, due diligence and also a business valuation of one of their targets, namely, Quick & Qual Sys Limited specializing in developing innovative last mile connectivity products to facilitate seamless delivery of retail products quickly and efficiently. Ms. Harini, the Managing Partner of Ding Dong Ventures introduced you to Mr. Ramaswamy, the promoter and the Managing Director of Quick & Qual Sys Limited and also to Mr. Sarvesh, the Chief Finance Officer of Quick & Qual Sys Limited. They have given you an overview of the Company and the business along with the various financial metrics for your perusal.*

Company Overview

*The company is promoted 5 years back by Ramaswamy in Pune. It commenced its commercial operations after a year of incorporation after augmenting the sizable capital and debt. It has grown in its size steadily. Currently it has 80 employees located primarily in Pune. Mr. Frederick is the Chief Operating Officer and Mr. Naveen is the Chief Strategy Officer of the Company who have joined hands with Ramaswamy in expanding the operations of the Company. Sarvesh, the Chief Financial Officer of the Company joined recently and has the experience of taking couple of startups for listing in the past.*

Business Outlook

*The strategic focus of the Company is to get listed in the Indian Stock market in the next 5 years of time. The management believes that with the rapid growth in the E-commerce space, the need for developing a viable solution for the last mile connectivity using the power of technology and the knowledge of the Indian customer would be absolutely critical. The company is also*

embarked on a journey of using artificial intelligence for responding to the requests of the E-commerce players in bringing a holistic technology network platform. It is expected that in the next few years with the considerable liberalization in the foreign investment policy, several global players are expected to target the Indian market and hence, the market is going to grow exponentially. It is worth nothing that the Company spends about 10% of the profits for innovation.

The company's continued business success depends on the support provided by 2 of its major customers namely Gamazon and Blip Kart though there are other innumerable small volume customers. The market share put together from these 2 customers is expected to be around 27% in the last year. Further, the company is also dependent on the continued support from its core employees, who are categorized as Platinum Players, numbering 10. Whilst every effort is made for rewarding these employees suitably with stock options and other monetary benefits, the chances of them leaving the company and joining the competition are very high.

#### Competition Landscape

There are several players who have entered this space due to the renewed interest evinced by the foreign players in the Indian E-commerce business. Whilst the craze is noticeable, there are only handful of viable competitors to Quick & Qual Sys, namely. Humble Honey Bee Solutions and Golmart Global Solutions who are also having a similar volume of operations and the business outlook. Humble Honey Bee Solution was valued at USD 12.50 Million recently for its second round of PE funding whereas Golmart is yet to raise funds from third parties and is solely managed by promoter funding at present.

#### Financial Overview

Sarvesh has presented a detailed strategic profitability analysis of the Company. During the presentation, several questions were raised on various aspects including the growth, profitability, sensitivity analysis of price trends, impact of forex fluctuations on the operations of the company, sustainability aspects etc.

An analysis of the operating income for 2017 and 2018 is given below:

(Amount in ₹)

Particulars	Amount as per P&L in 2017	Revenue and Cost Effect of Growth component in 2018	Cost and Revenue Effect of Price Recovery Component in 2018	Cost Effect of Productivity Component in 2018	Amount as per P&L in 2018
Revenue	4,60,08,571	21,00,000	43,00,000		5,24,08,571
Cost	2,85,00,000	6,00,000	25,60,000	(6,80,000)	3,09,80,000
Operating Income*	1,75,08,571	15,00,000	17,40,000	6,80,000	2,14,28,571

\*Represents profit before tax

Company added 300 and 500 customers in 2017 and 2018 respectively by focusing more on the client base rather than on the value of the revenue generated from each and every customer. During 2018, the E-commerce market has registered a general growth of about 10% in terms of number of customers and all other changes are due to the company's differentiation cum marketing strategy and the productivity based efficiencies brought into operations due to innovations.

The customers of the company are primarily located in India. Whilst the company has several domestic borrowings, it has also borrowed through Forex Tech Fund channel, an amount of USD 5,00,000 where the rate of interest is pegged at 5% flat. The loan was taken when the USD was at 1 USD - ₹61 and the company expects that there will not be any wide variation when the loan is to be settled after a period of 4 years and, hence, has not taken any forward/swap for covering the forex fluctuations.

#### Business Case for Funding

Quick & Qual Sys has recently registered its name convincingly in the investor community through their endorsement by the E-Commerce World Association as Rising Star! In addition, it also has got favourable reviews from several Analysts in this space who are watching their marketing strategy and the customer penetration style closely. Several PEs including Ding Dong has evinced keen interest in building a relationship with Quick & Qual Sys.

Naveen presented an overview of the business case for funding by Ding Dong and provided various vital information based on his assessment. He indicated that for fueling the growth in the business, adequate capital infusion would be required given the ongoing technological disruptions.

He has indicated that for business valuation purposes, there is no point in using asset based valuation model which will not be suitable for such high potential E-commerce startups since the model has several drawbacks. He said that he would not entertain any valuation exercise based on such models. He suggested that any business valuation needs to be "Forward looking" duly considering the income generating potential of the entity on a sustainable basis.

He added that the average cost of debt for the company is about 11% and the tax rate can be presumed to be around 30%. The Company has an EBITDA of ₹ 26,453,571 for FY 2017-18 and the leverage beta based on E-commerce industry is 2.3 which is 0.86 less than the unlevered Beta. The average Equity-Debt ratio is about 70:30. The rate of return provided by highly liquid bonds is around 4%. The Enterprise value is pegged at a multiple of 3 on EBITDA. The E-commerce industry generally expects a market return of about 8% as per the recent research report published by Gartners. Free Cash flow for the next 3 years is expected to be flat at about ₹ 19,300,000. The value arrived based on Relative Valuation technique is around ₹ 53 Million.

You wanted the details of EBITDA and noted the following on perusal:

An amount of ₹5.5 Million has been taken as intangible asset which represents the management derived salary cost equivalent of time spent by the senior management in building innovative E-

commerce platforms. There is nothing specific which can be identified specifically as an intangible item.

An amount of ₹3 Million has been accrued towards unbilled revenue which remains unbilled for over 18 months and the same represents the additional amounts claimed by the company which is challenged by the customer.

An amount of ₹2 Million, including ₹0.45 Million of GST towards sales promotion expenses for which no input credit was availed/eligible, has been considered as deferred revenue expenditure where such promotion expenses incurred by the company is expected to yield benefits over the next 2 years excluding 2018.

An amount of ₹6 Million has been paid to Ramaswamy towards his salary cost for the services rendered by him to the Company even though the comparable startups would pay roughly 50% of the amounts paid by the Company.

The Chief Finance Officer, Sarvesh indicated that the Capital Asset Pricing Model (CAPM) could also be considered for evaluating the risks attached and the returns expected from the investors view point which will make the investment in the company very attractive.

Harini wanted to have an idea on the Economic Value Added (EVA) by the Company for which Sarvesh responded that the same could be derived based on the information already made available to Ding Dong and no further details are required to compute the same.

To a specific query raised by you on abnormal costs, if any, identified by the management, Sarvesh responded that he is not aware of any such things under the Cost Accounting Standards though he was unsure of the applicability of the same to the Company.

#### PE Expectations

Post your introduction meeting with Quick & Qual Sys, Harini of Ding Dong explained her expectations from you and gave the following additional inputs.

The company has a Company Secretary who also acts as a compliance officer. Being a promoter driven set up which has transformed in the last 2 years more rapidly, the company is putting in place a robust platform for strengthening the compliance controls. The promoter, Ramaswamy was banned by SEBI in the past in connection with the trading in shares by using the insider information for a period of 3 years in 2006. He has come out of this ban now and has repositioned himself as an Emerging Business Magnet with this Startup venture. Further, he is also a director in another Company unrelated to Quick & Qual Sys, namely, Wine and Wonder Limited which did not file the financial statements for the years ended 31 March 2016 and 2017 and did not pay interest on loans taken from a public financial institution from 1<sup>st</sup> April 2017. However, it has promptly repaid matured deposits taken from public on due dates.

The company currently uses Tally for its accounting and operational book keeping purposes. Cheques are signed by the Chief Financial Officer only as a single signatory. The company does not have any system of organizational hierarchy from the finance view point and is taking this up as a key priority for FY 2019.

Harini has indicated that they are very excited to pursue this investment opportunity and hence apart from the Risk assessment, Due Diligence and Business Valuation to be carried out by you, she wants to assess the Value at Risk (VAR) for the proposed investment of Ding Dong. She was also keen to understand the implications of using Gordons Model for assessing the value potential of similar E-Commerce companies in the startup space. She is also open to consider Leveraged Buyout options, if the same is found to be more attractive and needs your inputs on the same as well.

You are requested to critically evaluate the Business Case presented by Quick & Qual Sys and provide your inputs to help Ding Dong in making their investment decision. Please note that Ding Dong would present your findings and the responses provided by you for the various clarifications/questions directly to their investment committee based out of New York and hence you need to put in your best in meeting the stakeholders expectations!

Good luck.....!

#### PART-A

##### Answer the following questions:

- 3.1 As indicated by Harini of Ding Dong, the concept of VAR can be applied
- A. For Business valuations
  - B. For Goodwill valuations
  - C. For using as a tool for asset/liability management
  - D. For deriving Beta variable (2 Marks)
- 3.2 Adjusted EBITDA to be considered for business valuation of Quick & Qual Sys is ₹:
- A. 12,953,571
  - B. 15,953,571
  - C. 14,953,571
  - D. 26,453,571 (2 Marks)
- 3.3 Gordon Model of valuation can be applied to Quick & Qual Sys
- A. Yes, it is widely used by PEs since it is practical
  - B. No, it is Rarely used by PEs since it is theoretical
  - C. No, it is used only when the entities plough back the profits
  - D. No, it is used only when the entities declare dividends continuously (2 Marks)
- 3.4 The concept of Equity Value and the Enterprise Value for Quick & Qual Sys
- A. is different
  - B. is one and the same
  - C. depends on the purpose of valuation
  - D. Not applicable since it operates in E- commerce space (2 Marks)



- 3.5 The concept of EVA referred to by Harini
- A. is derived based on the expected value addition using the value at risk
  - B. Is derived based on surplus of returns over the capital charge
  - C. Is derived based on PBT and the Beta attached to the business
  - D. Is derived based on deficit of returns over the capital charge (2 Marks)
- 3.6 Leveraged Buyout Option based investment model proposed by Ding Dong envisages
- A. Long Term Business based investment through Equity
  - B. Clever Mix of Debt and Equity and leveraging on the debt to create value
  - C. Funding through Long Term Debt focused on high yields
  - D. Investing through creeping acquisitions of Equity based on Business growth (2 Marks)
- 3.7 Horizon Value typically considered in business valuations represents
- A. The value of the business derived based on Free Cash Flow
  - B. The value the investor will forecast for valuing the investment at the exit point
  - C. The value of the business derived using the perpetual growth model
  - D. The value the buyer is willing to pay at the end of the negotiation (2 Marks)
- 3.8 The Capital Assets Pricing Model for valuing Quick and Qual Sys is to be developed based on the principle of
- A. Valuing the investment returns based on indirect benefit of assuming risks
  - B. Valuing the investment returns based on the direct benefit of assuming risks
  - C. Valuing investment returns using the hybrid model of capital and assets deployed
  - D. Valuing investment returns using the sales pricing model and Beta. (2 Marks)
- 9 Strategic Profitability Analysis presented by Sarvesh for Quick & Qual Sys is carried out using the
- A. Standard Cost, Margin Analysis, Product Profitability
  - B. Marginal Cost Recovered, Fixed Costs, Product Mix
  - C. Strategic Objectives, Profit Component, Cost Component
  - D. Growth Component, Price Recovery Component and the Productivity Component. (2 Marks)
- 3.10 In view of the provisions of the Companies Act, 2013, duty considering the aspects relating to non-compliances associated with Wine & Wonder Limited, promoter Director of Quick & Qual Sys, Mr. Ramaswamy is;
- A. Disqualified to continue as a Director in. Quick & Qual Sys

- B. Disqualified to continue as a Director in Wine & Wonder.
- C. Disqualified to continue as a Director in Quick & Qual Sys as well as Wine & Wonder.
- D. Not Disqualified and hence he can continue as a Director of Quick & Qual Sys and Wine & Wonder. (2 Marks)

**PART B****Answer the following:**

- 3.11 How would you rate Quick & Qual Sys based on the information provided and elucidate various positive and negative aspects that needs to be considered in the overall evaluation of the investment by Ding Dong? (5 Marks)
- 3.12 You are required to identify different types of Risk faced by Quick & Qual Sys and also assess the Risk critically to facilitate investment decision by Ding Dong. (7 Marks)
- 3.13 Prepare a Buildup statement of Operating Income of Quick & Qual Sys by taking 2017 as a base and arrive at 2018 operating income by deriving the extent of change in operating income from 2017 to 2018 due to the industry market size factor, productivity and product differentiation. (5 Marks)
- 3.14 Based on the Business Case details provided by Quick & Qual Sys, what would be the potential value that can be placed for the Company? (7 Marks)
- 3.15 What is the difference between Risk Assessment, Due Diligence and Valuation exercises which you need to carry out on behalf of Ding Dong in connection with their potential investment in Quick, & Qual Sys and how are they inter related? (6 Marks)

**Answer to Question 3****PART – A**

- 3.1 (C)
- 3.2 (A)
- 3.3 (C) or (B)
- 3.4 (A)
- 3.5 (B)
- 3.6 (C) or (B)
- 3.7 (B)
- 3.8 (D) or (B)
- 3.9 (D)
- 3.10 (D)

**PART – B**

- (3.11) Quick & Qual Sys can be rated as a reasonably good company. The various positive and negative aspects that need to be considered in the overall evaluation of the investment by Ding Dong are discussed as below:

**Positive Aspects:**

- (i) Quick & Qual Sys is using artificial intelligence for responding to the requests of the major E-commerce players in bringing a holistic technology network platform.
- (ii) Continued support from so called “Platinum Players” – company’s 10 core employees.
- (iii) Company’s operating income increased from ₹ 1,75,08,571 in 2017 to ₹ 2,14,28,571 in 2018.
- (iv) Company’s differentiation cum marketing strategy and the productivity based efficiencies executed due to innovations practiced by the company.
- (v) Endorsement by E-Commerce World Association as Rising Star. In addition, it got favourable reviews from several analysts.

**Negative Aspects:**

- (i) An amount of ₹ 3 million has been accrued towards unbilled revenue which remains unbilled for over 18 months and the same represents the additional amounts claimed by the company which is challenged by the customer.
- (ii) An amount of ₹ 6 million has been paid to Ramaswamy (MD of the company), towards his salary cost which is quite high as compared to other startups that would pay about 50% of what has been paid by Quick & Qual Sys.
- (iii) Ramaswamy was banned by SEBI for 3 years in 2006 for providing insider information in connection with the trading in shares.
- (iv) The company does not have any system of organizational hierarchy from the finance view point.

**Alternate****(3.11) Positive factors:**

- A Good business track record for the Company
- Leading companies as its customers
- Availability of High quality employees who know their business
- Focus on innovation and newer products
- Recognition in the investor community

**Negative factors**

- Heavy Competition
- Concentration with few customers
- Dependence on few high performing employees
- Absence of sound compliance and reporting platform
- Track record of the promoter

(3.12) The various types of risks faced by the company and their critical assessment have been explained in the following paragraphs:

- (i) **Strategic Risk** – Company's strategic risks have been managed well by using artificial intelligence for responding to the requests of the major E-commerce players for smooth technology network platform. Also, the company spends 10% of the profits for innovation which helped it to execute differentiation cum marketing strategy and develop productivity based efficiencies. Company is mainly dependent on the support provided by two of its major customers i.e. Gamazon and Blip Kart. Further, the company is also dependent upon the continued support from its so called "Platinum Players" – company's 10 core employees.  
It is a challenge for the company to maintain good relations with its core customers and well as the core employees. However, in spite of rewarding these employees reasonably well, their chances of leaving the organization are reasonably high.
- (ii) **Competition Risk** – The Company has only handful of viable customers like Humble Honey bee Solutions and Golmart Global Solutions. So, it can be said that competition risk is manageable by the company.
- (iii) **Operational Risk** - Higher salary paid to the promoter of the company may dent the profitability of the company in future. Also, the company does not have any system of organizational hierarchy from the finance view point. However, it is taking this up as a key priority for FY 2019.
- (iv) **Foreign Exchange Risk** – The Company has not taken any forward/swap for covering the foreign exchange fluctuations which might take place when the loan amount of USD 5,00,000 has to be settled after a period of 4 years.
- (v) **Counter Party Risk** - An amount of ₹ 3 million has been accrued towards unbilled revenue which remains unbilled for over 18 months and the same represents the additional amounts claimed by the company which is challenged by the customer. Therefore, the counter party risk remains with the company.
- (vi) **Reputation/Governance Risk** – Ramaswamy (MD) of the company was banned by SEBI for insider trading. Ban is over now but it may still affect the reputation of Quick & Qual Sys. Further, he is also a director in an unrelated company which has not filed its financial statements for 2016 and 2017 and did not pay interest on loans taken from financial institutions from 1 April 2017. So, reputation risk of the company is at stake which has to be managed wisely.
- (vii) **Compliance Risk** – The Company has a Company Secretary who also acts as a compliance officer. Further, the Company is putting in place a robust platform for strengthening the compliance controls. Thus, it can be said that the company is managing its compliance risk well.

Alternate

(3.12)

The risks faced by Quick and Qual Sys are summarized below:

S.No	Particulars	Indicative Risks
1.	Strategic risk	Considering heavy competition from two of its closest competitors, the Company's strategic plan should be robust such that the Company's strategy does not become less effective and becomes outdated. Innovation should be a focus area and the Company should constantly review its innovation spends, outcomes with its key stakeholders including employees and see ways of retaining talent as well as knowhow within the Company.
2.	Compliance risks	Considering certain past action by SEBI on the promoter, this is a risk that will be closely watched by the investors.  Company should also consider setting up a strong financial reporting/ compliance platform which can be used for effective and compliant financial reporting as the volume grows rather than dependence on tally.  As the Company intends to get listed, compliance should be at the forefront of priorities.
3.	Operational risks	Dependence on core employees who could be tapped by competitors.
4.	Market Concentration risks	High concentration with two customers who contribute about 27% of the volume.
5.	Political risk	Whilst there are no specific political risks, the perception about the Country and its environment including the states in which the Company operates needs to be dealt with by the Company.  Customers of the Company are currently located only in India. No geographical diversification in terms of customers.
6.	Financial risks: - Interest rate risk	The Company has borrowings where the interest rate could vary depending on market factors.
7.	Financial risks: - Currency risk	The Company has unhedged foreign currency exposures and the risk of variability in foreign currency rates.

## (3.13) Reconciliation of Operating Income

Particulars	Amount (₹)
Operating Income in 2017	1,75,08,571
Add: Change Due to Industry Market Size Factor (W.N.-1)	2,25,000 (F)
Changes Due to Productivity (W.N.-2)	6,80,000 (F)
Changes Due to Product Differentiation (W.N.-3)	30,15,000 (F)
Operating Income in 2018	2,14,28,571

**Workings**

Total Increase in Customers 200 (500 – 300). Out of this increase in customer of 200 customers, 30 customers (10% of 300) is due to *growth in market size*, and the remaining 170 customers are due to an increase in *market share*.

W.N.1 Effect of the Industry Market Size Factor on operating income:

= Revenue and Cost Effect of Growth Component in 2018

×  $\frac{\text{Increase in Sales Unit Due to Market Growth}}{\text{Total Growth in Sales Unit (from 2017 to 2018)}}$

= ₹ 15,00,000 ×  $\frac{30 \text{ Customers}}{200 \text{ Customers}}$

= ₹ 2,25,000 (F)

W.N.2. Effect of Productivity on operating income:

= Cost Effect of Productivity Component in 2018

= ₹ 6,80,000 (F)

W.N.3 Effect of Product Differentiation on operating income:

Particulars	Amount (₹)
Increase in the Selling Price (Revenue Effect of the Price Recovery Component)	43,00,000 (F)
Increase in Prices of Inputs (Cost Effect of the Price Recovery Component)	25,60,000 (A)
Growth in Market Share Due to Product Differentiation* $\left( ₹15,00,000 \times \frac{170 \text{ Customers}}{200 \text{ Customers}} \right)$	12,75,000 (F)
Total	30,15,000 (F)

\* Revenue and Cost Effect of Growth Component in 2018 ×  $\frac{\text{Increase in Sales Unit Due to Product Differentiation}}{\text{Total Growth in Sales Unit (from 2017 to 2018)}}$

(3.14) Cost of debt =  $11 - (11 \times 0.30) = 7.7\%$

Industry Levered Beta = 2.3

So, Industry Unlevered Beta =  $2.3 + 0.86 = 3.16$

And, Beta of the security =  $3.16 \left[ 1 + \frac{30}{70} (1 - 0.30) \right]$

$$= 3.16 \left[ 1 + \frac{30}{70} \times 0.70 \right] = 3.16 \times 1.30 = 4.108$$

Or

Beta of the security can also be calculated as follows;

$$3.16 = \beta \times \frac{0.70}{0.30(1 - 0.30) + 0.70}$$

Or  $\beta = 4.108$

Cost of Equity (Ke) =  $R_f + \beta (R_m - R_f)$

$$= 4\% + 4.108 (8\% - 4\%)$$

$$= 20.43\%$$

So, WACC =  $0.30 \times 7.70\% + 0.70 \times 20.43\%$

$$= 2.31 + 14.30 = 16.61\%$$

Therefore, the potential value that can be placed for the company

$$= 19.30 \text{ million} \times \text{PVF} (16.61\%, 3)$$

$$= 19.30 \text{ million} \times 2.224 = 42.9232 \text{ million}$$

Alternate

(3.14)

Particulars	Year 1	Year 2	Year 3
Free Cash flows (Rs.)	19,300,000	19,300,000	19,300,000
Discount factor	0.877	0.77	0.676
PV Of cash flows (Rs.)	16,937,370	14,863,963	13,044,375
Value of the Entity (Rs.)			44,845,708

Workings:



Particulars	Details	Basis
Levered Beta	2.3	As provided
Unlevered Beta	3.16	$\text{beta}/1+(1-\text{tax rate } (30\%)) \times (\text{debt } (30)/\text{equity}(70))$
Adjusted EBITDA (Rs.)	12,953,571	(EBITDA as given less adjustments for amount treated as intangible asset of Rs. 5.5 Mio, unbilled revenue of Rs. 3 Mio, deferred revenue expenditure of Rs. 2 Mio and higher salary cost of Rs. 3 Mio)
Enterprise Value (Rs.)	38,860,713	Adjusted EBITDA * multiple of 3, as given
Cost of equity as per CAPM	16.63%	4% being expected return from liquid bonds + unlevered beta * (market expected return of 8% less 4% being the risk free return)
Weighted average cost of capital	13.95%	COE of 17% * (Equity of 70/100)+ Cost of debt of 11% adjusted for tax @70% * (Debt of 30/100)



## (3.15)

**Risk assessment** – Business organisations face several kinds of Risks. Risk assessment exercise primarily analysis what could go wrong, how likely it is to happen, what could be the potential consequences and how tolerable the risk is. This is an important step in the overall progress and growth journey of an enterprise as well as an important aspect of any evaluation carried out by investors/stakeholders about a Company's true value. The various types of Risks could range from internal to external and also be categorized under strategic, compliance, operational, financial, political currency, interest rate risks etc.

**Due diligence** is an investigation or examination of a potential investment or product to confirm all facts, such as reviewing all financial records, plus anything else deemed material. It refers to the care a reasonable person should take before entering into an agreement or a financial transaction with another party. The due diligence could range from financial due diligence, legal due diligence, technical due diligence and would require specialized skills to carry out the same. Due diligences are generally viewed as deal breakers and satisfactory resolution of the issues raised as part of due diligence would be very crucial for making investments and also providing the required inputs for business valuations.

**Valuation** – as an enterprise grows, it adds more number of stakeholders in its progress. Whilst presentation of financial statements, quarterly results etc, provide the stakeholders with information, these becomes staple diet for them who sow the seeds in capital and in turn wait for the enterprise to multiply its progressive potencies. In a relative world, there is a persisting curiosity for the investors to know the real worth of the Company, which results in the concept of valuation. Need for valuation arises on account of the below:

- Information for its internal stakeholders
- Comparison with similar enterprises
- Future public listing of the enterprise
- Strategic planning, i.e finding out value drivers and/or for sources for correct deployment of funds
- Acquisition price etc.

In any valuation exercise, depending on the purpose of the valuation, an important factor is the risk that the entity faces which will need to be factored in the valuation. Accordingly, risk assessment is an important step/input in the entire valuation exercise. For the right identification of risks by a strategic investor, an exercise such as due diligence provides a solid platform that can be used as a source for narrowing down on the key risks that could be weighed appropriately in carrying out the valuation of an enterprise.

**Alternate**

(3.15) Due Diligence is a wide term and it includes both Risk Assessment as well as valuation. Due Diligence is a kind of audit or investigation of potential investment in any venture, acquisition, or any other transaction from all angles. Risk Assessment can be called a sub-part of Due Diligence which covers the assessment of risks. So, the decision to enter into an agreement can be analyzed properly.

The risk assessment is more of a Strategic Analysis on which various factors depend. So, far as valuation is concerned, it mainly depends upon various factors including the risk assessed as mentioned above. And, it is more viewed as a commercial evaluation of the target.

In the present case study, Risk assessment of Quick & Qual Sys has been considered taken into account Strategic Risk, Competition Risk, Operational Risk, Foreign Exchange Risk, Counter Party Risk, Reputation/Governance Risk and Compliance Risk.

Further, Due Diligence mechanism of the company seems to be good as it has been mentioned in the case study itself that company is putting in place a robust platform for strengthening the compliance controls.

Also, with regard to Valuation, the company has categorically stated that there is no point in using asset based valuation model which will not be suitable for such high potential E-commerce startups since the model has several drawbacks. Further, presently, the value has been based on Relative Valuation technique.