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February - 2023 Issue

CMA Student E - Bulletin

FINAL

The Institute of Cost Accountants of India

Statutory Body under an Act of Parliament

www.icmai.in

CONTENTS

KNOWLEDGE
Update

In this section of e-bulletin we shall have a series of discussion on each of these chapters to provide a meaningful assistance to the students in preparing themselves for the examination at the short end and equip them with sufficient knowledge to deal with real life complications at the long end.

GROUP: 3, PART: 13

CORPORATE

LAWS & COMPLIANCE - (CLC)

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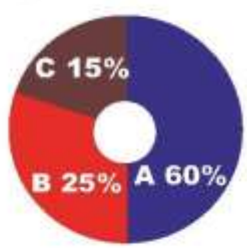
Your Preparation Quick



Syllabus Structure
A Companies Act 60%
B Other Corporate Laws 25%
C Corporate Governance 15%

Learning Objectives:

Read the Study Material minutely.

- For details or if you don't understand Study Material or the section is important to identify the topic, then refer to Bare Act, otherwise reference to Bare Act is not necessary. For Company Law, book by Avtar Singh is recommended. For other laws Institute Study Material is sufficient.
- The words used in any of the texts as mentioned above should be understood by immediate reference to the Dictionary.
- The main points coming out in any of the provisions should be either underlined or written in separate copy which has to be repeated again and again.
- Theoretical knowledge should be adequate and clear before solving practical problems.
- Don't write wrong English. It changes the meaning and therefore answer may be wrong even when the student's conception is clear. Also don't make spelling mistakes.

COMPANY CAPITAL

1.0 CAPITAL MARKET TERMINOLOGIES

1.1 Contract:

'Contract' means a contract for or relating to the purchase or sale of securities.

1.2 Securities:

'Securities' includes the following:

- Shares, scrip, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in any incorporated company or other body corporate.
- Derivative.
- Government securities.
- Rights or interests in securities.
- Such other instruments as defined in clause (zg) of section 2 of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

1.3 Government security:

'Government security' means a security created and issued, whether before or after the commencement of this Act, by the Central Govt. or a State Govt. for the purpose of raising a public loan and having one of the forms specified in clause (2) of section 2 of the Public Debts Act, 1944.

1.4 Derivative:

'Derivative' includes-

- A security derived from a debt instrument, share, loan, whether secured or not, risk instrument or contract for differences or any other form of security;
- A contract which derives its value from the prices, or index of prices, of underlying securities.

1.5 Beneficial owner:

1.6 "Beneficial owner" means a person whose name is recorded as such with a depository.

1.7 Depository:

"Depository" means a company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration by SEBI Act, 1992.with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making securities of public limited companies freely transferable subject to certain exception; (b) dematerializing the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form.

Process:

The depository system involves:

(a) Conversion of securities from physical mode to electronic mode.

(b) Settlement of trades in electronic segment.

(c) Electronic transfer of ownership.

(d) Electronic custody of securities.

(e) All the securities are identical in all respects and are fungible.

(f) The system is not mandatory for the owner of the securities but it is mandatory for the companies.

1.8 Merchant Banker:

A financial intermediary who can manage issue of shares, make valuation of shares and is involved in various formalities of issue and transfer of securities.

1.9 Broker – a person who is agent of either buyer or seller. In case of market transaction, brokers should be registered with SEBI.

1.10 Stock Exchange – a company which provides a platform for buying and selling of securities through brokers and is called market transaction. Only CG authorized exchanges can operate.

1.11 Underwriter – any person/organization who agrees to subscribe securities in case they are not subscribed by investors in public issue.

1.12 <u>Share Transfer Agents</u> – organizations who keep account of share transfer for other companies.

1.13 <u>Insider Trading</u> – passing of information by any insider of a company. Insider means any person who, is or was connected with the company or is deemed to have been connected with the company, and who is reasonably expected to have access to the unpublished price sensitive information in respect of securities of a company, or who has received or has had access to such unpublished price sensitive information. Price sensitive information' means any information which relates directly or indirectly to a company and which if published is likely to materially affect the price of the securities of the company.

1.14 <u>Book Building Process</u> – Price discovery. Demand for securities is built up and the price for the securities is assessed on the basis of the bids obtained from Qualified Institutional Buyers (QIB).

1.15 <u>Promoter</u> – Person/persons controlling the plan/programme of the company pursuant to which public issue is made. Directors in professional capacity are not promoters.

1.16 <u>Promoter's Group</u> – (1) Promoter's relative. (2) In case of a company – (a) Subsidiary/holding company. (b) Any company whose promoter holds 10% or more of the equity or which holds 10% or more of the promoter.

1.17 <u>Red Herring Prospectus</u> – This is an indicative prospectus without any details of price and number of shares or amount of issue. The floor price or price band is declared one day prior to the opening the issue. After the price is obtained through bidding the offer document is filed as prospectus.

1.18 <u>Abridged Prospectus</u> –

- Salient features of prospectus and accompanied with a form.
- Letter of offer – documents for rights issue filed Stock Exchange.
- Abridged Letter of Offer – abridged form of the above, compulsorily to be sent to each shareholder. Details to be given on request.

2.0 SEBI Regulations (Issue of Capital and Disclosure Requirements).

2.1 <u>Entry Norms (IPO or FPO)</u>

At least 25 per cent of each class or kind of securities issued by a company is offered to the public for subscription through advertisement in newspapers. The limit of 25% can be relaxed to 10% if following conditions are satisfied:

a) Minimum 20 lakh securities (excluding reservations, firm allotment and promoters' contribution) are offered to the public;

b) The size of the offer to the public, i.e. the offer price multiplied by the number of securities offered to the public was minimum Rs.100 crores; and

c) The issue was made only through book building method with allocation of 60 per cent of the issue size to the qualified institutional buyers as specified by the Securities and Exchange Board of India;

Recognized stock exchange may relax any of the conditions with the previous approval of the SEBI, in respect of a Government company.

2.2 An unlisted company may make an initial public offering (IPO) of equity shares or any other security, which may be converted into or exchanged with equity shares at a later date, only if it meets all the following conditions:

(i) The company has net tangible assets of at least 3 crores in each of the preceding 3 full years (of 12 months each), of which not more than 50% is held in monetary assets:

Provided that if more than 50% of the net tangible assets are held in monetary assets, the company has made firm commitments to deploy such excess monetary assets in its business/project;

(ii) The company has a track record of distributable profits in terms of Section 205 of the Companies Act, 1956, for at least (3) out of immediately preceding five (5) years.

Provided further that extraordinary items shall not be considered for calculating distributable profits in terms of Section 205 of the Companies Act, 1956;

(iii) The company has a net worth of at least 1 crore in each of the preceding 3 full years (of 12 months each)

(iv) In case the company has changed its name within the last one year, at least 50% of the revenue for the preceding 1 full year is earned by the company from the activity suggested by the new name; and

(v) The aggregate of the proposed issue and all previous issues made in the same financial year in terms of size (i.e., offer through offer document + firm allotment + promoters' contribution through the offer document), does not exceed five (5) times its pre-issue net worth as per the audited balance sheet of the last financial year.)

(vi) Eligibility – Unlisted company whose commercial operation of less than two years and the post issue capital shall not exceed Rs.5 crore and not less than Rs.3 crore.

vii) Appoint market maker to the issue on all stock exchanges where the securities are proposed to be listed.

viii)The unlisted companies whose capital after the proposed issue of securities is less than Rs.3 crore shall be eligible to be listed only on the Over the Counter Exchange of India.

2.3 <u>Pricing by Companies Issuing Securities</u>

An unlisted company eligible to make a public issue and desirous of getting its securities listed on a recognized stock exchange may freely price its equity shares.

2.4 <u>Price Band:</u>

Issuer company can mention a price band of 20% in the offer document filed with the Board and actual price can be determined at a later date before filing of the offer document with the ROCs.

2.5 <u>Promoters' Contribution and Lock-in Requirements.</u>

In a public issue by an unlisted company, the promoters shall contribute not less than 20% of the post issue capital.

Promoters shall bring in the full amount of promoters' contribution including premium at least one day prior to the issue opening date.

Minimum Promoters' contribution

Lock-in period: 3 years.

Excess Promoters' contribution:

Lock in period: 1 year.

2.6 <u>Book Building Process:</u> Price discovery. Demand for securities is built up and the price for the securities is assessed on the basis of the bids obtained from subsidiaries. RHP do not contain price. It contains either the floor price or a price band.

2.7 <u>Pre- issue Obligations:</u>

1.The lead merchant banker shall exercise due diligence.

1. Documents to be submitted along with the offer document by the Lead Manager:
    - Memorandum of Understanding.
    - *Inter se* allocation of responsibilities
    - Due diligence certificate.
    - Undertaking.
    - List of Promoters' group and other details.
    - Appointment of intermediaries like merchant bankers, co-managers and other intermediaries.

2.8 <u>Public Issue Steps:</u>

- The lead merchant banker's minimum underwriting obligation: 5% of the total underwriting commitment or Rs.25 lakhs whichever is less.
- Offer document to be made Public.
- Pre-issue advertisement.
- IPO grading: By rating agency approved by SEBI.
- Despatch of issue material.
- No complaints certificate.
- Mandatory collection centers of applications in major cities.
- Authorized collection agents.
- Appointment of compliance officers: To be notified in the advertisement who is responsible for the compliance.
- Agreement with depositories: For data access of shareholders

2.9 <u>Reservation for Employees</u>:

- As per Rule 19(2)b of SC(R) rules, 1957 the reservation for employees cannot exceed 10% of the total issue amount.

The main object of the SEBI Act are as follows:

(a) Protect the interests of the investors in securities.

(b) Promoting orderly and healthy growth of the securities market.

(c) Regulation of the securities market and other incidental matters.

(d) Promoting the fair dealings by the issuer of securities and raising of funds at a relatively lower cost.

(e) Monitoring the activities of stock exchanges, mutual funds and merchant bankers etc.

3.0 Powers of SEBI

(1) Specific powers like regulating the business of stock exchanges, registering and regulating the functions of stock brokers, share transfer agents, bankers, registrars, trustees, underwriters, portfolio managers etc.

(2) Power to make inspection.

(3) Powers of civil court exercisable by SEBI.

(4) Power to issue direction.

(5) Power to regulate and prohibit the issue of prospectus.

(6) Power to seize documents like books and papers.

4.0 Guidelines on initial public issue through the stock exchange

1) Agreement with the stock exchange.
2) Appointment of brokers.
3) Appointment of Registrar to the issue.
4) Listing.
5) Responsibility of Lead Managers.
6) Mode of operation.
7) Demat

5.0 Book Building:

SEBI Guidelines define Book Building as a process undertaken by which a demand for the securities proposed to be issued by a corporate body is elicited and built up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document

Difference between offer of shares through book building and offer of shares through normal public issue :

Price at which securities will be allotted is not known in case of offer of shares through book building while in case of offer of shares through normal public issue, price is known in advance to investor. In case of Book Building, the demand can be known everyday as the book is built. But in case of the public issue the demand is known at the close of the issue.

GROUP: 3, PART: 14

STRATEGIC
FINANCIAL MANAGEMENT - (SFM)

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Your Preparation Quick

Syllabus Structure

A Investment Decisions **25%**
B Financial Markets and Institutions **20%**
C Security Analysis and Portfolio Management **25%**
D Financial Risk Management **30%**

Learning Objectives:

After studying this section on Strategic Financial Management, you will be able to:

- understand the direct and indirect quotations
- know the European terms and American terms

Section C & Study Note 8: Security Analysis and Portfolio Management

- **Portfolio Risk Calculation - Some Special Cases:**

The formula for calculating portfolio risk can be further simplified under the following situations (values of correlation coefficient).

Value of Correlation Coefficient	Portfolio Risk
ρ_{xy} = -1	$\sigma_P = \lvert w_x\sigma_x - w_y\sigma_y \rvert$
ρ_{xy} = 0	$\sigma_P = \sqrt{w_x^2\sigma_x^2 + w_y^2\sigma_y^2}$
ρ_{xy} = +1	$\sigma_P = w_x\sigma_x + w_y\sigma_y$
All other cases	$\sigma_P = \sqrt{w_x^2\sigma_x^2 + w_y^2\sigma_y^2 + 2w_xw_y\sigma_x\sigma_y\rho_{xy}}$

However, in all the cases, the formula for portfolio return remains the same.

- **Diversification – The Driving Force behind Portfolio Formation**

There is an old saying that do not put all your eggs in one basket. The same is applicable for investment also. Given the choice between two securities, if any investor selects only one alternative, his risk and return will simply be the replication of the investment alternative he has selected. In such a case if the alternative faces adverse market movement, entire investment may be at a stake. Thus, it is suggested that forming a portfolio would be a better idea. Though, it may lead to an average return, obviously lower than the better among the two alternatives, if properly selected, it may lead to reduction of risk. This process of reducing the portfolio risk by combining appropriate investment alternatives is known as diversification.

- **Systematic vs. Unsystematic Risk**

Systematic risk refers to the volatility in return due to various macroeconomic factors which are beyond the control of a single firm, for example, interest rate, inflation rate etc. Thus, this risk is economy specific and uncontrollable. Formation of portfolio can never reduce this risk. Hence, it is also called non-diversifiable risk. Some of the systematic risk are purchasing power risk, interest rate risk etc.

On the other hand, unsystematic risk is firm specific and often arises due to the inefficient management, faulty capital structure of the firm etc. Formation of portfolio can reduce this risk and hence this is called diversifiable risk.

- **Types of Diversification Strategies**

There are two types of diversification strategy available – Naive Diversification and Markowitz Diversification. These are discussed as follows.

A. Naive Diversification

Naive diversification is best described as a rough and, more or less, instinctive common-sense division of a portfolio, without bothering with sophisticated mathematical models. Naïve diversification says that an investor or analyst over the time can identify which securities can be combined together to form a portfolio. There is no hard and fast rule about this. As a result, the recommendation is highly subjective and often cannot be backed by any objective argument.

B. Markowitz Diversification

As against Naïve Diversification, Markowitz diversification strategy relies on the mean-variance principle of portfolio risk and return calculation and objectively shows that portfolio formation can reduce risk.

- **Markowitz Rule for Diversification**

According to Markowitz, a portfolio based on securities whose returns have negative or zero correlation or weakly positive correlation can effectively reduce the diversifiable risk and hence total risk.

- **Proof of Markowitz Rule for Diversification**

Suppose, there are two securities A and B with the following return and risk.

$E(R_x)$ = 20%, $E(R_y)$ = 15% and σ_x = 12%, σ_y = 10%, W_x = 50% and W_y = 50%.

Portfolio return and risk at different values of correlation coefficient will be as follows:

Value of ρ_{xy}	Portfolio Return	Portfolio Risk
ρ_{xy} = -1	$E(R_P) = W_x \times E(R_x) + W_y \times E(R_y)$ = 0.5*20 + 0.5*15 = 17.5%	$\sigma_P = \lvert w_x\sigma_x - w_y\sigma_y \rvert$ $= \lvert 0.5 \times 12 - 0.5 \times 10 \rvert$ = 1%
ρ_{xy} = -0.5	17.5%	$\sigma_P = \sqrt{w_x^2\sigma_x^2 + w_y^2\sigma_y^2 + 2w_xw_y\sigma_x\sigma_y\rho_{xy}}$

		$= \sqrt{0.25 \times 144 + 0.25 \times 100 + 2 \times 0.5 \times 0.5 \times 12 \times 10 \times (-0.5)}$ = 5.57%
ρ_{xy} = 0	17.5%	$\sigma_P = \sqrt{w_x^2\sigma_x^2 + w_y^2\sigma_y^2}$ $= \sqrt{0.25 \times 144 + 0.25 \times 100}$ = 7.81%
ρ_{xy} = + 0.5	17.5%	$\sigma_P = \sqrt{w_x^2\sigma_x^2 + w_y^2\sigma_y^2 + 2w_xw_y\sigma_x\sigma_y\rho_{xy}}$ $= \sqrt{0.25 \times 144 + 0.25 \times 100 + 2 \times 0.5 \times 0.5 \times 12 \times 10 \times (0.5)}$ = 9.54%
ρ_{xy} = + 1	17.5%	$\sigma_P = w_x\sigma_x + w_y\sigma_y$ = 0.5 × 12 + 0.5 × 10 = 11%

Thus, it can be seen that the more the correlation approaches to -1, the higher is the diversification benefits.

- **When diversification is not beneficial?**

Very high positive correlation often hinders diversification benefits. The general rule is, for diversification to be effective, correlation coefficient must be lower than 'Lower S.D to Higher S.D' ratio.

In the previous example, Lower S.D to Higher S.D ratio = 10/12 = 0.83.

Thus, correlation higher than 0.83 will render diversification ineffective.

For example, if ρ_{xy} = 0.9, $\sigma_P = \sqrt{w_x^2\sigma_x^2 + w_y^2\sigma_y^2 + 2w_xw_y\sigma_x\sigma_y\rho_{xy}}$ = 10.72%.

It may be noted that the portfolio risk is higher than the risk of security B which is the lower risky security. Thus, here, portfolio cannot reduce the risk.

- **Risk Minimization Through Diversification**

Formation of portfolio can reduce the diversifiable risk (or unsystematic risk). As a result, the investor changes his securities weight in such a manner that can reduce portfolio risk to its minimum.

a. Concept of Minimum Variance Portfolio:

The portfolio which has been constructed in such a way that its risk (measured in terms of S.D or variance) has become the minimum is known as minimum variance portfolio.

b. Determination of Optimum Weights:

The weights of individual securities for which the portfolio variance (i.e., risk) becomes minimum are known as optimum weights. Mathematically, these can be obtained by setting the first order derivative of portfolio variance as zero and obtaining values of weights for which the second order derivative is positive.

The general rule is as follows:

$W_x = \frac{\sigma_y^2 - \sigma_x\sigma_y\rho_{xy}}{\sigma_x^2 + \sigma_y^2 - 2\,\sigma_x\sigma_y\rho_{xy}}$ and $W_y = 1 - W_x$

Under special cases, when $\rho_{xy} = 0$, $W_x = \frac{\sigma_y^2}{\sigma_x^2 + \sigma_y^2}$ and $W_y = 1 - W_x$.

Similarly, when $\rho_{xy} = -1$, $W_x = \frac{\sigma_y}{\sigma_x + \sigma_y}$ and $W_y = 1 - W_x$.

Consider the following example.

Given, $E(R_x) = 20\%$, $E(R_y) = 15\%$ and $\sigma_x = 12\%$, $\sigma_y = 10\%$ and $\rho_{xy} = 0.6$

The optimal weights are:

$W_x = \frac{\sigma_y^2 - \sigma_x\sigma_y\rho_{xy}}{\sigma_x^2 + \sigma_y^2 - 2\,\sigma_x\sigma_y\rho_{xy}} = \frac{100-72}{144+100-144} = 28\%$ and $W_y = 1 - W_x = 72\%$

At these weights $\sigma_P = \sqrt{w_x^2\sigma_x^2 + w_y^2\sigma_y^2 + 2w_xw_y\sigma_x\sigma_y\rho_{xy}} = 9.17\%$ which is the minimum variance portfolio.

If $\rho_{xy} = 0$, $W_x = \frac{\sigma_y^2}{\sigma_x^2 + \sigma_y^2} = \frac{100}{244} = 41\%$ and $W_y = 1 - W_x = 59\%$.

If $\rho_{xy} = -1$, $W_x = \frac{\sigma_y}{\sigma_x + \sigma_y} = 45\%$ and $W_y = 1 - W_x = 55\%$.

Note: For $\rho_{xy} = -1$, the optimum weights will completely eliminate the portfolio risk (i.e. it will become zero).

GROUP: 3, PART: 15

STRATEGIC

COST MANAGEMENT DECISION MAKING - (SCMD)

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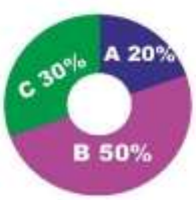
Your Preparation Quick



Syllabus Structure
A Cost Management **20%**
B Strategic Cost Management Tools and Techniques **50%**
C Strategic Cost Management - Application of Statistical Techniques in Business Decisions **30%**

Learning Objectives:

The Strategic cost management framework provides a clear plan of attack for addressing costs and decisions that affect them. It helps to get answers on:

- Is there a plan for strategic cost management
- Have the controlling functions for each significant cost in the organization been identified
- Are there resources devoted to finding or obtaining new approaches to breaking cost barriers
- Is cost modelling being used or is there an active effort to develop or buy cost modeling capability

Five Forces in a Nutshell

01.00: The Primer

In order to sustain long-term profitability every enterprise must respond strategically to competition. The evident instinct is to keep tabs on established rivals. But the immense need could be to look beyond the direct competitors. As Michael Porter explains in his revolutionary 1979 HBR (Harvard Business Review) article, five competitive forces can hurt the prospective profits:

- Aspiring entrants, armed with new capacity and hungry for market share, can notch up the investment required for others to stay in the game.
- Powerful suppliers may restrict the profits if they charge higher prices.
- Savvy customers can force down prices by playing the rivals against one another.
- Substitute offerings can lure customers away.
- Cut-throat competitive measures can drive away the other players from the industry.

Michael Porter's famous Five Forces of Competitive Position model provides a simple perspective for assessing and analysing the level of competition within an industry. The analysis guides an entity towards formulating an appropriate Business Strategy. As a result, the entity is enabled to optimize its core competencies and position itself above the industry averages and become the industry leader.

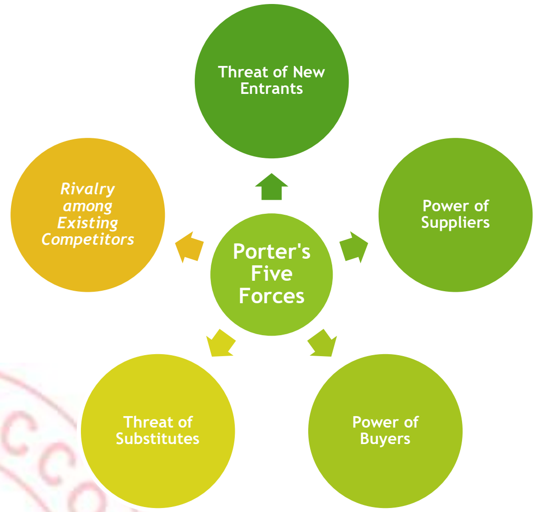
02.00: The Concept

Porter developed his Five Forces analysis in reaction to the then-popular SWOT analysis. Porter felt that SWOT analysis was too simple and ad hoc, and so he evolved the Five Forces Analysis as a better alternative. Porter's five forces analysis is based on the Structure–Conduct–Performance paradigm in Industrial Organisational Economics. The analysis has been applied to a diverse range of problems, from helping businesses become more profitable to helping governments stabilise industries.

Frequently used to identify an industry's structure to determine corporate strategy, Porter's model can be applied to any segment of the economy to search for profitability and attractiveness.

Porter's five forces are classified as:

1. Threat of New Entrants
2. Power of Suppliers
3. Power of Buyers
4. Threat of Substitutes
5. Rivalry among Existing Competitors



(i) Threats of New Entrants (Barriers to Entry)

- Supply-side economies of scale: The economies arise when firms that produce at larger volumes enjoy lower costs per unit.
- Demand-side benefits of scale: Buyers may trust larger companies more for a crucial product.
- Customer switching costs: Switching costs are fixed costs that buyers face when they change suppliers.
- Capital requirements: The need to invest large financial resources in order to compete can deter new entrants.
- Incumbency advantages independent of size: No matter what their size, incumbents may have cost or quality advantages not available to potential rivals.
- Unequal access to distribution channels: The more limited the wholesale or retail channels are and the more that existing competitors have tied them up, the tougher entry into an industry will be.
- Restrictive government policy: Government policy can hinder or aid new entry directly, as well as amplify (or nullify) the other entry barriers.
- Expected retaliation: How potential entrants believe incumbents may react will also influence their decision to enter or stay out of an industry.

(ii) Power of Suppliers

- Supplier group is more concentrated than the industry it sells to.
- The supplier group does not depend heavily on the industry for its revenues.
- Industry participants face switching costs in changing suppliers.
- Suppliers offer products that are differentiated.
- There is no substitute for what the supplier group provides.
- The supplier group can credibly threaten to integrate forward into the industry.

(iii) Power of Buyers

- There are few buyers, or each one purchases in volumes that are large relative to the size of a single vendor.
- The industry's products are standardized or undifferentiated.
- Buyers face few switching costs in changing vendors.
- Buyers can credibly threaten to integrate backward and produce the industry's product themselves if vendors are too profitable.
- Buyer group is price sensitive

(iv) Threat of Substitutes

- Existence of an attractive price-performance trade-off to the industry's product.
- The buyer's cost of switching to the substitute is low.

(v) Rivalry among Existing Competitors

- Competitors are numerous or are roughly equal in size and power.
- Industry growth is slow.
- Exit barriers are high.
- Rivals are highly committed to the business and aspire for leadership.
- Firms cannot read each other's signals well

03.00: The Upshot

The analysis encompasses stakeholders of two competitive dimensions, viz. three forces from 'horizontal' competition: the threat of new entrants, the threat of substitute products or services, and the threat of established rivals; and two forces from 'vertical' competition: the bargaining power of suppliers and the bargaining power of customers. "If the forces are intense, as they are in such industries as airlines, textiles, and hotels, almost no company earns attractive returns on investment," Porter wrote. "If the forces are benign, as they are in industries such as software, soft drinks, and toiletries, many companies are profitable."

The Five Forces Analysis draws upon industrial economics to derive the five forces that determine the competitive density and attractiveness or otherwise of a market. In an 'attractive industry', the combination of the Five Forces gears up the overall profitability, whereas in an "unattractive" industry the combination acts to drive down overall profitability. A very unattractive industry would be the one approaching "pure competition", in which available profits for all firms are driven to normal level.

Towards the outcome that would follow the analysis, Porter advocated three "generic strategies" of Cost Leadership, Product Differentiation and Market Focus that can be implemented in any industry, and in companies of any size. Porter said the new strategy should be executed at the corporate, business unit and departmental levels. Of these, Porter considered the business unit as the most significant.

04.00: The Application

By understanding how the five competitive forces influence profitability in an industry, appropriate strategy can be evolved for long-term competitive edge. Some of the examples suggested by Porter include the following:

(i) Position your company where the forces are weakest

In the heavy-truck industry, many buyers operate large fleets and are highly motivated to drive down truck prices. Trucks are built to regulated standards and offer similar features, so price competition is stiff; unions exercise considerable supplier power; and buyers can use substitutes such as cargo delivery by rail.

To create and sustain long-term profitability within this industry, heavy-truck maker Paccar chose to focus on one customer group where competitive forces are weakest: individual drivers who own their trucks and contract directly with suppliers. These operators have limited clout as buyers and are less price sensitive because of their emotional ties to and economic dependence on their own trucks.

For these customers, Paccar has developed such features as luxurious sleeper cabins, plush leather seats, and sleek exterior styling. Buyers can select from thousands of options to put their personal signature on these built-to-order trucks. Customers pay Paccar a 10% premium, and the company had been profitable for 68 straight years and earned a long-run return on equity above 20%.

(ii) Exploit changes in the forces

With the advent of the Internet and digital distribution of music, unauthorized downloading created an illegal but potent substitute for record companies' services. The
record companies tried to develop technical platforms for digital distribution themselves, but major labels didn't want to sell their music through a platform owned by a rival. Into this vacuum stepped Apple, with its iTunes music store supporting its iPod music player. The birth of this powerful new gatekeeper has whittled down the number of major labels from six in 1997 to four later.

(iii) Reshape the forces in your favour

Use tactics designed specifically to reduce the share of profits leaking to other players.
For example:

- To neutralize supplier power, standardize specifications for parts so your company can switch more easily among vendors.
- To counter customer power, expand your services so it's harder for customers to leave you for a rival.

- To temper price wars initiated by established rivals, invest more heavily in products that differ significantly from competitors' offerings.
- To scare off new entrants, elevate the fixed costs of competing; for instance, by escalating your R&D expenditures.
- To limit the threat of substitutes, offer better value through wider product accessibility.

Soft-drink producers did this by introducing vending machines and convenience store channels, which dramatically improved the availability of soft drinks relative to other beverages.

Quick Take

Five Forces Analysis paves the way for striding towards Competitive Advantage.

GROUP: 3, PART: 16

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DIRECT TAX

LAWS AND INTERNATIONAL TAXATION - (DTI)

Your Preparation Quick

Syllabus Structure
A Advanced Direct Tax Laws **50%**
B International Taxation **30%**
C Case Study Analysis **20%**

Learning Objectives:

- To develop basic idea about the problem of International double taxation
- To get acquainted with the methods of reliefs
- To have acquaintance with the basic provisions of the provisions of the Indian Income-tax Act regarding reliefs for double taxation.

Basics of Transfer Pricing

"Transfer Pricing is not an exact science but does require the exercise of judgement on the part of both the tax administration and taxpayer"

Commercial transactions between the different parts of the multinational groups may not be subject to the same market forces shaping relations between the two independent firms. One party transfers goods or services to another for a price. That price is known as "transfer price". This may be arbitrary and dictated, with no relation to cost and added value, diverge from the market forces. Transfer price is, thus, a price which represents the value of goods or services between independently operating units of an organisation. But, the expression "transfer pricing" generally refers to prices of transactions between associated enterprises which may take place under conditions differing from those taking place between independent enterprises. It refers to the value attached to transfers of goods, services and technology between related entities. It also refers to the value attached to transfers between unrelated parties which are controlled by a common entity.

Suppose a company A purchases goods for ₹ 100 and sells it to its associated company B in another country for ₹ 200, who in turn sells in the open market for ₹ 400. Had A sold it direct, it would have made a profit of ₹ 300. But by routing it through B, it restricted it to ₹ 100, permitting B to appropriate the balance. The transaction between A and B is arranged and not governed by market forces. The profit of ₹ 200 is, thereby, shifted to the country of B. The goods is transferred on a price (transfer price) which is arbitrary or dictated (₹ 200), but not on the market price (₹ 400).

Thus, the effect of transfer pricing is that the parent company or a specific subsidiary tends to produce insufficient taxable income or excessive loss on a transaction. For instance, profits accruing to the parent can be increased by setting high transfer prices to siphon profits from subsidiaries domiciled in high tax countries, and low transfer prices to move profits to subsidiaries located in low tax jurisdiction. As an example of this, a group which manufacture products in a high tax countries may decide to sell them at a low profit to its affiliate sales company based in a tax haven country. That company would in turn sell the product at an arm's length price and the resulting (inflated) profit would be subject to little or no tax in that country. The result is revenue loss and also a drain on foreign exchange reserves.

Computation of income from international transaction or specified domestic transaction having regard to arm's length price [Sec. 92]

The provisions are as under:

Provisions	Example	Treatment	Impact on income
Any income arising from an *international transaction* shall be computed having regard to the *arm's length price*.	X Ltd., resident, sold goods or services to its associated enterprises, XY Plc. (a foreign company), for ₹ 5 lacs whereas the arm's length price of such goods or services is ₹ 9 lacs	While computing income of X Ltd., ₹ 9 lacs shall be considered as sale value	**Income of X Ltd. will be increased by ₹ 4 lacs.**
The allowance for any expense or interest arising from an international transaction or specified domestic transaction[1] shall also be determined having regard to the arm's length price.	R Ltd. takes a loan of ₹ 20 lacs from an associated enterprise in Ireland @ 20% p.a. whereas the arm's length rate of interest is 12% p.a.	Interest @ 12% p.a. shall be allowed as deduction to R Ltd.	**Income of R Ltd. will be increased by ₹ 1,60,000/-**
Where in an international transaction or specified domestic transaction, • **two or more *associated enterprises*** • **enter into a mutual agreement or arrangement for the apportionment of, or any contribution to, any cost incurred** • **in connection with a benefit, service or facility provided to any such enterprises,** **the cost apportioned to (contributed**	An enterprise in Germany makes research on a new product and incurred ₹ 50 lacs. Out of this, ₹ 40 lacs has been allocated to its Indian associated enterprises dealing in the same product.	While computing income of Indian enterprise, it will be required to be examined whether the Indian enterprise is deriving proportionate benefit to the research	**If no such benefit is available to the Indian enterprise, total income of such enterprises is suitably increased by disallowing**

[1] Any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the specified domestic transaction shall be computed having regard to the arm's length price.

by), any such enterprise shall be determined having regard to the arm's length price of such benefit, service or facility.		expenditure allocated	**proportionate allocated cost.**
The provisions (in any of aforesaid situation) shall not apply in a case where the computation of income or the determination of the allowance for any expense or interest or the determination of any cost or expense allocated or contributed has the *effect of reducing the income* chargeable to tax or increasing the loss, as the case may be, computed on the basis of entries made in the books of account in respect of the previous year in which the international transaction or specified domestic transaction was entered into.	X Ltd., resident, sold goods or services to its associated enterprises, XY Plc. (a foreign company), for ₹ 5 lacs whereas the arm's length price of such goods or services is ₹ 3 lacs	The provision of transfer pricing is not applicable	No Impact

Meaning of associated enterprise [Sec. 92A]

Associated enterprise, in relation to another enterprise, means an enterprise:

(a) which participates, directly or indirectly, or through one or more intermediaries, in the *management* or *control* or *capital* of the other enterprise; or

(b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

Deemed associated enterprise [Sec. 92A(2)]

For the above purpose, two enterprises shall be deemed to be associated enterprises if, at any time during the previous year fulfill any of the following conditions (if one of following conditions are not satisfied, then mere participation in management or control or capital of the other enterprise, etc. shall not make them associate):

(a) one enterprise holds (directly or indirectly) shares carrying not less than 26% of the voting power (i.e., equity shares in case of company) in the other enterprise; or

(b) any person or enterprise holds (directly or indirectly) shares carrying not less than 26% of the voting power in each of such enterprises; or

(c) the manufacture or processing of goods or articles or business carried out by one enterprise is *wholly* (not partially) dependent on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has *exclusive* rights; or

(d) 90% or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise **or** by persons specified by the other enterprise, **and** the prices and other conditions relating to the supply are influenced by such other enterprise; or

(e) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or

(f) where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or

(g) where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family, or by a relative of a member of such Hindu undivided family, or jointly by such member and his relative; or

(h) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than 10% interest in such firm, association of persons or body of individuals; or

(i) a loan advanced by one enterprise to the other enterprise constitutes not less than 51% of the **book value** of the total assets of the other enterprise; or

Taxpoint: *Revaluation of asset shall not be ignored.*

(j) one enterprise guarantees not less than 10% of the total borrowings of the other enterprise; or

(k) more than ½ of the board of directors or members of the governing board, **or** one (not ½ of total number of executive director) or more executive directors or executive members of the governing board of one enterprise, are **appointed** by the other enterprise; or

Taxpoint: *Mere power to appoint director is not sufficient, such power must be exercised.*

(l) more than ½ of the directors or members of the governing board, **or** one or more of the executive directors or members of the governing board, of each of the two enterprises are **appointed** by the same person or persons; or

(m) there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

Equity Holding	Management	Activities	Control
1. >= 26% direct / indirect holding by enterprise **OR** **2. By same person in each enterprise** **3. Loan >= 51% of Total Assets** **4. Guarantees > = 10% of debt** **5. > 10% interest in Firm / AOP / BOI**	**6. Appointment > 50% of Directors / one or more Executive Director by an enterprise** **OR** **7. Appointment by same person in each enterprise**	**8. 100% dependence on use of intangibles for manufacture / processing / business** **9. Direct / indirect supply of > = 90% Raw Materials under influenced prices and conditions** **10. Sale under influenced prices and conditions**	**11. One enterprise controlled by an individual and the other by himself or his relative or jointly** **12. One enterprise controlled by HUF and the other by** **- a member of HUF** **- his relative or** **- Jointly by member and relative**

Computation of arm's length price [Sec. 92C]

- The arm's length price in relation to an international transaction or specified domestic transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely:

Transaction Based Methods

a. comparable uncontrolled price method;

b. resale price method;

c. cost plus method;

Profit Based Methods

d. profit split method;

e. transactional net margin method;

f. such other method as may be prescribed by the Board.

GROUP: 4, PART: 17

CORPORATE

FINANCIAL REPORTING - (CFR)

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Your Preparation Quick

Syllabus Structure

A GAAP and Accounting Standards **20%**
B Accounting if Business Comminations & Restructuring **20%**
C Consolidated Financial Statements **20%**
D Developments in Financial Reporting **25%**
E Government Accounting in India **15%**

Learning Objectives:

After studying the present section of Corporate Financial Reporting you will be able to:

- Learn how to highlight the achievements of a company to its investors, creditors, bankers, public, employees, regulatory bodies and Government on a periodic basis
- To convey future based strategic roadmap for the company.

Discounted Cash Flow (DCF) Model

The last issue discussed the market approach of valuation of a business. This issue will focus on the Income Approach which measures the value of a business or value of its equity based on the future income. Income can be represented by cash flows, operating profits, net profits or dividends as the case may be. This approach is appropriate mostly for going concern situations as the worth of a business or equity is generally a function of its ability to earn income/cash flow in future. The Income approach includes a number of models/Techniques: (1) Discounted Cash Flow Model (2) Dividend Discount Model (3) Residual Income Model and many other techniques. In this issue we shall discuss about the Discounted Cash Flow (DCF) model.

Discounted Cash Flow (DCF) model measures value of a business by aggregating all its future cash flows (income) duly discounted for time value of money. These cash flows (CF) are from operating activities and not from financing or investing activities. A business being a going concern future cash flows will occur for infinite time. Thus, value of a business is the aggregate or sum total of infinite series of future cash flows discounted at the appropriate rate. A firm might be able to project future cash flows for a limited period of time (say, 3 to 5 years). After that it either assumes a constant cash flows or a cash flow growing at a constant rate for infinity.

Discounted Cash Flows (DCF) are computed as shown below.

$DCF = CF_t / (1 + r)^t$ where t is the year in future and r is the discounting rate.

$V = \sum DCF = CF_1 / (1 + r)^1 + CF_2 / (1 + r)^2 + CF_3 / (1 + r)^3 + \ldots + CF_t / (1 + r)^t + \ldots\ldots\ldots$continuing to infinity

When cash flows are constant:

$V_0 = CF_1/r = CF/r$ (since CF is constant, $CF_1 = CF_2 = CF_3 = \ldots = CF$)

When cash flows are growing at a constant rate of g [implies that $CF_{t+1} = CF_t(1 + g)$]

$V_0 = \sum DCF = CF_1/(r – g)$

Thus, value of the business at time 0 is the year 1 cash flow divided by the discounting rate, when cash flows are constant and the series of cash flows in future is infinite.

At the beginning, we may take a simple case, where cash flows of a firm is constant.

Illustration 1. A firm earns annual cash flows of Rs. 80000 at present and believes it to remain constant in future for infinity. Given the discounting rate of 10% pa, the value of the firm (V) will be the sum total of the Discounted Cash Flows for infinity. [$V = \sum DCF = CF1/(1+.1) + CF2/(1+.1)^2 + CF3/(1+.1)^3 + \ldots\ldots\infty = CF/r$]

$V = \sum DCF = CF/r = 80000/0.1 =$ Rs. 800000.

Next, we are considering the case of cash flows growing at a constant rate for infinity.

Illustration 2. The firm in Illustration 1 believes the cash flow to grow at a constant rate of 3% pa in future for infinity. The value of the firm (V) will be the sum total of the Discounted Cash Flows for infinity. As present cash flow is Rs. 80000, $CF_1 = CF_0(1 + g) = 80000*(1 + 0.3) = 82400$

$V_0 = \sum DCF = CF_1/(r - g) = 82400/(0.1 - 0.03) =$ Rs. 1177143

Illustration 3. A Ltd. earned annual cash flows of Rs. 71119.71 for the year ended on 31-03-2020 and it grew at 4% pa for the next two years. The company projected its cash flows to grow at the same rate for the years to come in future. Given the discounting rate of 10% pa find the value of the firm at 01-04-2022.

Solution: Here, $V_0 = V_{01\text{-}03\text{-}2022} = CF_1/(r - g) = 80000/(0.10 - 0.04) =$ Rs. 13,33,333

Since, $CF_1 = CF_{31\text{-}03\text{-}2023} = CF_{01\text{-}03\text{-}2020}(1 + g)^3 = (71119.71)*(1 + 0.04)^3 =$ Rs. 80000

Illustration 4. A Ltd. earned annual cash flows of Rs. 71119.71 for the year ended on 31-03-2020 and it grew at 4% pa for the next two years. The company projected its cash flows to remain constant thereafter for infinity. Given the discounting rate of 10% pa find the value of the firm at 01-04-2022.

Solution: Here, $V_0 = V_{01\text{-}03\text{-}2022} = CF_{31\text{-}03\text{-}2023}/r = 76923/0.10 =$ Rs. 7,69,230

Since, $CF_{31\text{-}03\text{-}2023} = CF_{31\text{-}03\text{-}2022} =$ Rs. 76923

$CF_{31\text{-}03\text{-}2022} = CF_{31\text{-}03\text{-}2020}(1 + g)^2 = (71119.71)*(1 + 0.04)^2 =$ Rs. 76923

And $CF_{31\text{-}03\text{-}2023} = CF_{31\text{-}03\text{-}2022} =$ Rs. 76923 [Since, it remains constant after 31-03-2022.]

Illustration 5. B Ltd. earned annual cash flows of Rs. 60000 for the year ended on 31-03-2020 and it grew at 10% pa (g_1) for the next two years. The company projected its cash flows for the year ended on 31-03-2023 and 31-03-2024 to maintain a growth of 8% pa (g_2), and thereafter at 3% pa (g_3)for infinity. Given the discounting rate of 10% pa find the value of the firm at 01-04-2021.

Solution:

Here, time zero is 01-04-2021. Value of the firm is the sum total of all discounted cash flows arising on and after 01-04-2021. Future cash flows are:

Year 1 Cash flows in 2021-2022 = $60000*(1.1)^2 = 72600$;

Years 2 and year3 Cash flows for 2022-23 and 2023-24 will be growing at 8% pa amounting to Rs. 78408 and Rs. 84680.64 respectively. Thereafter CF will grow at 3% (g_3). $CF_{31\text{-}03\text{-}2025} = 84680.64*(1 + 0.03) =$ Rs. 87221

$V_0 = V_{01\text{-}04\text{-}2021} = \sum DCF = CF_{31\text{-}03\text{-}2022}/(1 + r) + CF_{31\text{-}03\text{-}2023}/(1 + r)^2 + CF_{31\text{-}03\text{-}2024}/(1 + r)^3 + CF_{31\text{-}03\text{-}2025}/(r - g_3)*1/(1 + r)$

$= 72600/(1 + 0.1) + 78408/(1 + 0.1)^2 + 84680.64/(1 + 0.1)^3 + [87221/(0.10 - 0.03)]*1/(1 + 0.1)^3$

= Rs. 66000 + 64800 + 63622 + 936149 = Rs. 1130571

Explanation: As after 31-03-2024 cash flows are growing at constant rate of 3% for infinity, at 01-04-2024 the Terminal Value = 87221/(0.10 – 0.03) = Rs. 1246014. To find the present value we count the years the Terminal Value is away from the valuation date. It is three years. Hence, we discount the Terminal Value for three years.

Terminal Value can be measured at 31-03-2024, because henceforth constant growth starts. Then, TV = 84680.64/(0.10 – 0.03) = 1209723

$V_0 = V_{01\text{-}04\text{-}2021} = \sum DCF = CF_{31\text{-}03\text{-}2022}/(1 + r) + CF_{31\text{-}03\text{-}2023}/(1 + r)^2 + CF_{31\text{-}03\text{-}2024}/(r – g_3)*1/(1 + r)^2$

$= 72600/(1 + 0.1) + 78408/(1 + 0.1)^2 + 1209723/(1 + 0.1)^2$

= Rs. 66000 + 64800 + 999771 = Rs. 1130571

GROUP: 4, PART: 18

INDIRECT TAX

LAWS & PRACTICE - (ITP)

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Your Preparation Quick

Syllabus Structure

A Advanced Indirect Tax and Practice **80%**

B Tax Practice and Procedures **20%**

Learning Objectives:

Through the following MCQ, students can refresh themselves about

- Supply of goods
- Location of service
- Refund of tax
- Coastal goods & protective duties
- Levy of GST
- Casual taxable person
- Exempted goods
- Availing Input Tax Credit

Indirect Tax

Choose the correct option from the followings –

1. Storing of business goods in the residential premises

(a) Considered as supply and eligible for GST
(b) Not a supply so no GST is payable
(c) Zero rated tax will be considered
(d) NIL rated tax will be considered

2. Place of supply of service of a tour operator is

(a) Location of the service provider
(b) Location of the service recipient
(c) Where actual service been provided
(d) Final destination of the service provider / tour operator

3. Recipient of goods / services should pay to the supplier (including taxes) from the date of issue of invoice, else the Input Credit shall be reversed within

(a) 90 days
(b) 120 days
(c) 150 days
(d) 180 days

4. As per section 54 (14) of the CGST Act 2017 no refund shall be granted if refund amounts is less than

(a) Rs 500/-
(b) Rs 1000/-
(c) Rs 1500/-
(d) Rs 2000/-

5. As per Section 2(7) of the Customs Act goods other than imported goods, transported in a vessel from one port in India to another is

(a) Transit goods.
(b) Transshipment goods
(c) Coastal goods
(d) Taxable goods

6. A duty imposed on imported goods for the protection of interests of any industry established in India on the recommendation of Tariff Commission is

(a) Protective Duties
(b) Special customs Duties
(c) Safeguard Duties
(d) Anti dumping Duties

7. Mr Amit runs a restaurant. He purchased a Fridge worth of Rs 26000/- only for business purpose and availed the ITC. After two years he transfer the Fridge to his partner without consideration. State whether the transaction will be a supply in terms of GST Act?

(a) It is a supply
(b) It is not a supply
(c) It is deemed supply
(d) It is zero rated supply

8. Which of the following supply will be considered as exempted supply

(a) Speed Post Service provided by Department of Post to Government
(b) Express Parcel Post Services by Department of Post provided to a business entity
(c) Services in relation to an aircraft or a vessel, inside or outside the precincts of a port or an airport.
(d) Transport of goods or passengers

9. In which of the following event GST will be levied

(a) Exchange

(b) Mortgage
(c) Hypothecations
(d) Pledge

10. As per the CGST,2017 normal period of operation by a Casual Taxable Person is

(a) Thirty days
(b) Sixty days
(c) Ninety days
(d) Hundred twenty days

11. A warehouse, a godown, or any other place where a taxable person stores in goods, supplies or receives goods or services both is to considered as

(a) Registered warehouse or godown of the taxable person
(b) Branch of the principal office
(c) Additional place of business
(d) Place of business

12. Which of the following will be considered as exempted goods

(a) Exercise books
(b) Printed books
(c) Staplers
(d) pencils

13. Developing country means a country

(a) Notified by the Central Government in the Official Gazette for the purpose of making various policy.
(b) Notified by the Central Government in the Official Gazette for the purpose of Section 8B of the Customs Tariff Act,1975.
(c) As decided by the Ministry of Finance looking into the import and export scenario of the country.
(d) As decided by the UNO time to time in their Official Gazette.

14. If the assessment is delayed for imported goods, then those goods can be stored in public warehouse without executing bond is called as

(a) Deemed warehousing
(b) Warehousing without warehousing
(c) Special warehousing
(d) Public warehousing

15. In case of imported goods are sent to shore in a small cargo due to inadequate depth of sea or vessel may not find the time in having berth in port should accompany

(a) Boat Note
(b) Small Cargo Certificate
(c) Special Customs Note
(d) Port Advice

16. As per GST Act Information Technology Software will be treated as

(a) Supply of Services
(b) Supply of goods
(c) Supply of goods or services both
(d) Supply of goods or services

17. Acupuncture treatment is

(a) Taxable supply of service
(b) Exempted from GST
(c) Fall under special category exemption
(d) Zero rated tax

18. The basic concept of Input Tax Credit (ITC) is to

(a) helps in expansion of business
(b) generate more revenue
(c) avoid cascading effect of duty
(d) avoid unfair competition

19. Under GST a tax invoice is an essential document

(a) to avoid the interest for late payment
(b) to avoid the penalty for late submission of return
(c) to avail tax benefit
(d) to avail the input tax credit

20. M/S Favourite Ltd has factories in Ranchi, Patna, Guwahati and Raipur and offices at Kolkata. M/S Favourite obtains Insurance for the assets located in Ranchi, Patna Guwahati , Raipur and Kolkata from an Insurance company located at Mumbai. Insurence premium receipt issued to Kolkata office. Find the place of supply.

(a) Mumbai
(b) Kolkata

(c) Ranchi

(d) Patna

ANSWERS

1	a	6	a	11	d	16	a
2	a	7	c	12	b	17	a
3	d	8	a	13	b	18	c
4	b	9	a	14	b	19	d
5	c	10	c	15	a	20	b

GROUP: 4, PART: 19,

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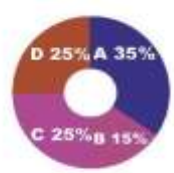
COST & MANAGEMENT

AUDIT – (CMAD)

Your Preparation Quick



Syllabus Structure

A Cost Audit 35%
B Management Audit 15%
C Internal Audit, Operational Audit and other related issues 25%
D Case Study on Performance Analysis 25%

Learning Objectives:

- To verify the correctness of the cost accounting records.
- To find out whether the principles of cost accountancy have been fully and correctly applied in maintaining cost records.
- To search for the deficiencies in the cost record system of the company.
- To attain efficiency in cost accounting systems and procedures.

Cost & Management Audit

Provisions with respect to applicability of maintenance of cost records and Cost Audit

Introduction:

Cost audit is a systematic and independent examination of the cost records and cost statements of an organization. The provision for applicability of cost audit is governed by the Companies Act, 2013. The Central Government (Ministry Of Corporate Affairs) empowered under the Companies Act, 2013 to make the rules and regulations in the area of maintenance of cost records by the companies engaged in the production, processing, and manufacturing or mining activities, whose turnover exceeds a specified limit; and for getting such cost records audited.

In exercise of the powers conferred by section 148 of the Companies Act, 2013, Ministry Of Corporate Affairs issued in the year 2014, The Companies (Cost Records and Audit) Rules, 2014 (CCRAR 2014). as amended, with the objective to provide a structured approach to maintenance of Cost Record and filing of Cost Audit report with Ministry of Corporate Affairs.

Provisions for applicability of Maintenance of cost records and Cost Audit:

Cost audit is undertaken to check the accuracy of cost records and adherence to the cost accounting principles and policies. Therefore it is pertinent to first understand "what is cost record " as per CCRA, 2014).

As per Rule 2(e) the "cost records" means 'books of account relating to utilization of materials, labour and other items of cost as applicable to the production of goods or provision of services as provided in section 148 of the Act and these rules'. There cannot be any exhaustive list of cost accounting records. Any transaction – statistical/quantitative or other details that has a bearing on the cost of product/ activity is important and forms part of cost record.

As per the provisions of CCRA, 2014 (as amended) the industries / sectors who are under the purview of this rule, has been categorised in two group i.e. Regulated sector and Non-regulated sector and a detailed list of industries has been specified in the rule.

Any class of Companies who falls either of the categories i.e. Regulated sectors / Non-regulated sectors and having an overall turnover from all its products and services of Rupees thirty five crore or more during the immediately preceding financial year, shall include cost records for such products or services in their books of account.

However, Micro enterprise or a small enterprise as per MSMED Act, 2006 have been taken out of the purview.

The CRA – 1 of the CCRA, 2014 contains details about area for which cost records are to be maintained by the classified company, for each of the product manufactured and / or services rendered, and also location wise if manufactured at different locations, per details below as applicable considering the type and nature of industry.

Particulars relating to the Items of Costs to be included in the Books of Accounts

1. Material Costs.
2. Employee Cost
3. Utilities
4. Direct Expenses
5. Repairs and Maintenance
6. Fixed Assets and depreciation
7. Overheads
8. Administrative Overheads
9. Transportation Cost
10. Royalty and Technical Know-how
11. Research and Development Expenses
12. Quality control expenses
13. Pollution control expenses
14. Service department expenses
15. Packing expenses
16. Interest and financing charges
17. Any other item of cost
18. Capacity determination
19. Work-in-progress and finished stock
20. Captive consumption
21. By-Products and Joint Products
22. Adjustment of cost variances
23. Reconciliation of cost and financial accounts
24. Related party transactions
25. Expenses or incentives on exports
26. Production Records
27. Sales records
28. Cost statements
29. Statistical Records
30. Records of Physical Verification

Further these classified companies are also subject to cost audit on achieving a specified level of Turnover which has been set differently for Regulated and Non-regulated sector industries.

For companies falling in Regulated sector, the overall annual turnover of from all its products and services during the immediately preceding financial year is Rupees fifty crore or more And the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is Rupees twenty five crore or more.

For companies falling In non-regulated sector, the provisions are same except that the overall turnover threshold is Rupees one hundred crore or more and the aggregate turnover of the individual product (S) is Rupees thirty five crore or more.

It may be noted that the product or product(s) to be covered under maintenance of cost records or cost audit must find mention in the column of the table heading Customs Tariff Act (CTA Heading).

The objective of cost audit is to ensure that the cost records and cost statements of a company are accurate and reliable, and that they provide a true and fair view of the company's cost of production or cost of operations. Cost audit also helps the management of a company in identify the areas where cost effectiveness could be achieved.

However, the requirement for cost audit under the CCRA, 2014, covered in rule 3, shall not apply to the following companies.

I) whose revenue from exports, in foreign exchange, exceeds seventy five per cent of its total revenue; Or

II) Which is operating from a special economic zone (SEZ); Or

III) Which is engaged in generation of electricity for captive consumption through Captive Generating Plant.

In addition to the mandatory cost audit provisions, a company may also opt for a voluntary cost audit if they wish to have a detailed analysis of their cost records.

GROUP: 4, PART: 20,

STRATEGIC

PERFORMANCE MANAGEMENT AND BUSINESS VALUATION – (SPBV)

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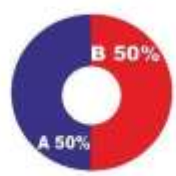
Your Preparation Quick



Syllabus Structure
A Strategic Performance Management **50%**
B Business Valuation **50%**

Learning Objectives:

After studying this section on Strategic Performance Management and Business Valuation, you will be able to:

- understand H Model and Three Stage Growth Model of equity share
- solve the problems on H Model and Three Stage Growth Model of equity share

Free Cash Flow Valuation

Free cash flow valuation defines the value of the firm to be the present value of its expected future cash flows discounted at the company's cost of capital. Free cash flow available to the firm (FCFF) represents cash flow available to both debt and equity holders. Free cash flow to equity (FCFE) is what remains after debt holders have received their contractually obligated payments namely interest.

FCFF = Net Operating Profit - Taxes - Net Investment - Net Change in Working Capital

Or

FCFF = Net Income + Non-Cash Charges + Interest (1-T) - Net Investment - Net Change in Working Capital

A positive value would indicate that the firm has cash left after expenses. A negative value, on the other hand, would indicate that the firm has not generated enough revenue to cover its costs and investment activities.

FCFF can be calculated from the statement of cash flows as follows:

FCFF=Cash Flow from operations + After-tax interest expense - Capital expenditures

Free Cash Flows to Equity (FCFE) Model

Free Cash Flow to Equity (FCFE) is a measure of how much cash can be paid to the equity shareholders of the company after all expenses, reinvestment and debt repayment. Free cash flow to equity (FCFE) represents the cash flow a company generates after necessary expenses and expenditures and after satisfying the claims of debt holders. It can be calculated from Free Cash Flow to the Firm (FCFF) as follows:

FCFE = FCFF - After-tax interest expense + Net borrowing

Once the free cash flows are estimated from the right perspective, the value of the firm is the sum of the present values of the free cash flows for a "planning period" plus the present value of the cash flows beyond the planning horizon (i.e., the terminal value), i.e.,

$$= \sum_{t=1}^{T} \frac{FCF_t}{(1+k)^t} + \frac{FCF_{T+1}}{k-g} \times \frac{1}{(1+k)^T}$$

Where,

g = growth

t = time

k = cost of equity

(I) The stable-growth FCFE Model:

The value of equity, under the stable-growth model, is a function of expected FCFE in the next period, the stable growth rate, and the required rate of return.

$$P_0 = \frac{FCFE_1}{r - g_n}$$

P_0 = Value of stock today

FCFE = Expected FCFE next year

r = Cost of equity of the firm

g_n= Growth rate in FCFE for the firm forever.

(II) FCFE Model – Two stage and Three stage FCFE Model

(a) Two stage FCFE Model:

The value of any stock is the present value of the FCFE per year for the extra ordinary growth period plus the present value of the terminal price at the end of the period.

Value = PV of FCFE + PV of Terminal price.

$$= \sum_{t=1}^{t=n} FCFE_1 (1+r)^t + P_n (1+r)^n$$

Where,

$FCFE_t$ = FCFE in year t

P_n= Price at the end of extra ordinary growth period

r = Required rate of return to equity investors in high growth period calculated using CAPM

The terminal price is generally calculated using the infinite growth rate model

P_n = $FCFE_{n+1}$ (r_n +g_n)

g_n = Growth rate after the terminal year forever

r_n = Required rate of return to equity investors in stable-growth period.

(b) Three stage FCFE model - E model

This model is designed to value firms that are expected to go through three stages of growth: an initial phase of high growth rates, a transition period where growth rate declines and a steady state where growth is stable.

$$P_0 = \sum_{t=1}^{t=n_1} \frac{FCFE_t}{(1+r)^t} + \sum_{t=n_1+1}^{t=n_2} \frac{FCFE_t}{(1+r)^t} + \frac{P_{n_2}}{(1+r)^{n_2}}$$

Where P_0 = Value of stock today

$FCFE_t$ = FCFE in year t

r = Cost of equity

P_{n2} = Terminal price at the end of transition period

$$= \frac{FCFE_{2+1}}{(r - g_n)}$$

n_1 = End of the initial high growth period

n_2 = End of transition period

Multiple Choice Questions (MCQ)

1. A Company based on up-to-date financial statements has determined that the current Free Cash Flows to Equity (FCFE) per share is ₹1.00. It has outstanding number of shares 100 crores with a face value of ₹10 each. Its interest expenses are ₹30 crores and tax rate is 30%. Given this information, The Free Cash Flow to the Firm (FCFF) will be-
   (a) ₹109 crores
   (b) ₹112 crores
   (c) ₹121 crores
   (d) ₹130 crores

2. Inland Ltd. is intending to acquire Global Ltd. by merger and the following information is available in respect of both the companies.

Particulars	Inland Ltd.	Global Ltd.
No. of equity shares	6,00,000	2,00,000
Profit after tax (₹)	20,00,000	10,00,000
Market Price Per Share (₹)	20	15

   Based on the above information, EPS of the both the firms are:
   (a) ₹3.33 and ₹5.00
   (b) ₹3.45 and ₹5.25
   (c) ₹3.65 and ₹5.50
   (d) ₹3.85 and ₹5.75

3. Based on the information in question no 2, exchange ratio is:
   (a) 1.4
   (b) 1.5
   (c) 1.6
   (d) 1.8

4. 12. A firm has PAT of ₹33.6 lakh with extraordinary income of ₹6 lakh. Cost of capital is 20% and the applicable tax rate is 40%. The value of the firm is
   (a) ₹250 lakh
   (b) ₹150 lakh
   (c) ₹180 lakh
   (d) ₹168 lakh

5. 32. If capitalization rate is reduced by growth rate, the Cash Flows should also be reduced by ______________.
   (a) Dividend payment
   (b) Cost of capital
   (c) Discounted cash flow
   (d) Capital expenditure

Answer Hints:

Question	1	2	3	4	5
Answer	c	a	b	b	d

Example 1

ABC Ltd has FCFF of ₹170 Crores and FCFE of ₹130 Crores. The WACC of ABC Ltd is 13% and its cost of equity is 15%. FCFF is expected to grow forever at 7% and FCFE is expected to grow forever at 7.5%. ABC Ltd has debt outstanding at ₹1500 Crores. Find the value of ABC Ltd using FCFF approach and FCFE approach.

Answer:

The value of ABC Ltd. is the present value of FCFF discounted at the weighted-average cost of capital (WACC).

Value = $FCFF_t$ /(k-g)

= 170 x 1.07 / (0.13 - 0.07)

= ₹3031.67 Crores

The market value of equity is the value of the firm minus the value of debt.

Value of Equity = ₹3031.67 Crores - ₹1500 Crores

= ₹1531.67 Crores

FCFE Approach: (discount rate = Cost of Equity)

Using the FCFE valuation approach, the present value of FCFE, discounted at Cost of equity

$= FCFE_t / (k-g)$

$= 130 \times 1.075/(0.15 - 0.075)$

= ₹1863.33 Crores

Example 2

From the following information compute the value of goodwill on the basis of 3 years purchase of super profits of the business calculated on the average profit of the last four years.

(i) Capital employed – ₹60,000

(ii) Trading Profits (after tax)

Year	Profit (₹)
2015	12,000
2016	15,000
2017	(2,000)
2018	20,000

(iii) Rate of interest expected from capital with reference to the risk involved in the business is 10%

(iv) Remuneration from alternative employment of the proprietor (if not engaged in business) ₹4,000 p.a.

Answer:

(i) Calculation of Average Profits

Year	Profit (₹)
2015	12,000
2016	15,000
2017	(2000)
2018	20,000

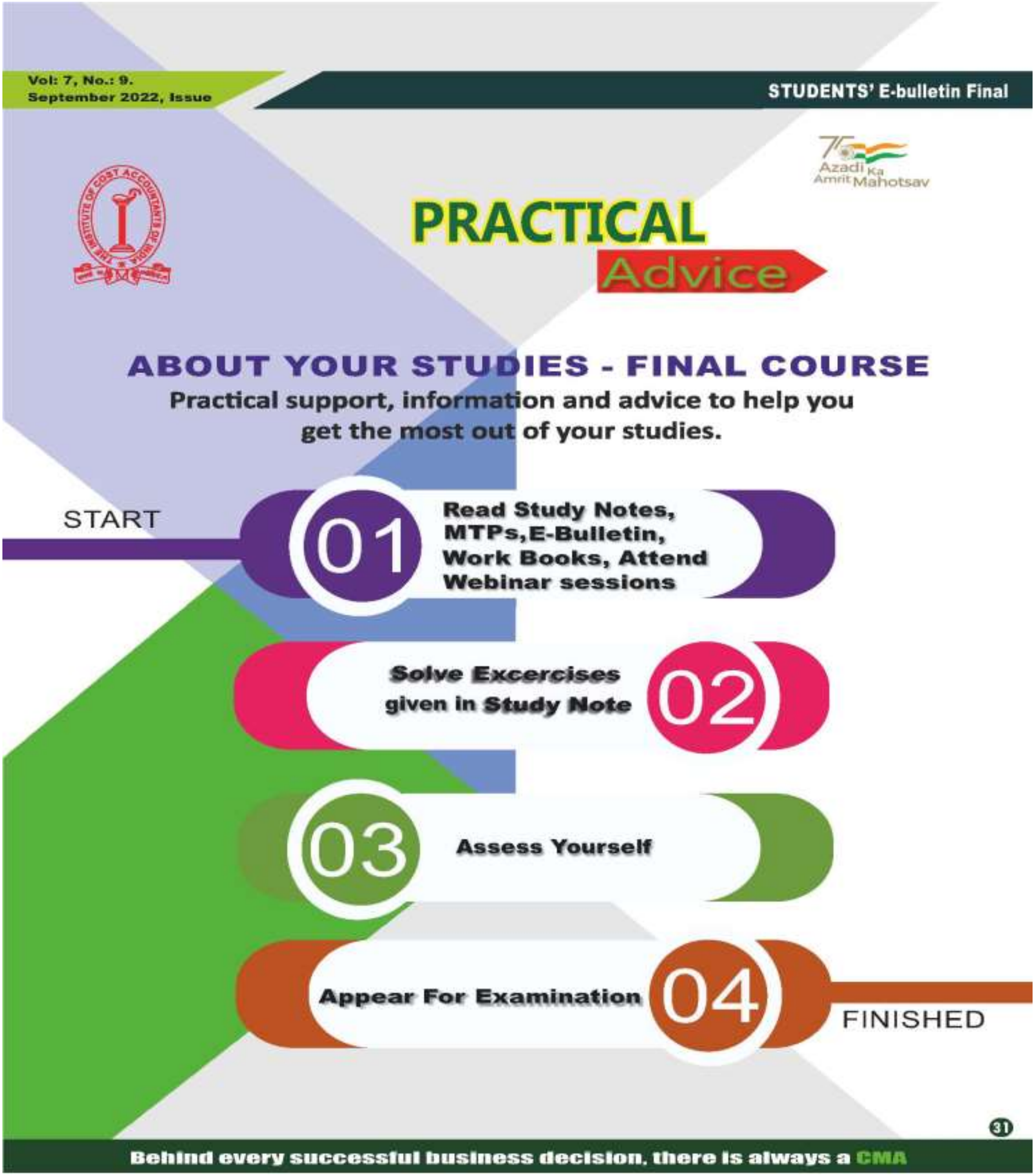
Average Profit =₹ (12000 + 15000 – 2000 + 20000) = 45,000 / 4 = ₹11,250

(ii) Calculation of Super Profits

Year	Amount (₹)
Average Profit	11,250
Less: Remuneration	4,000
Average Trading Profit	7,250
Less: Normal return @ 10% on capital employed	6,000
Super Profits	1,250

Goodwill = 3 years Purchase of Super Profits = 3 × ₹1,250 = ₹ 3,750

Practical Advice



Submissions


Vol: 7, No.: 9.
September 2022, Issue

STUDENTS' E-bulletin Final

SUBMISSIONS

YEARS OF CELEBRATING THE MAHATMA

Submissions

Dear Students,

We are very much delighted to receive responses from all of you; for whom our effort is!

We have noted queries and your requests will definitely be carried out. Further, requesting you to go through the current edition of the bulletin. All the areas will be covered gradually. Expecting your responses further to serve you better as we believe that there is no end of excellence! One of the mails received is acknowledged below.

Please put your opinions so that we can make your e-bulletin everything that you want it to be.

Send your Feedback to:
e-mail: studies.ebulletin@icmai.in
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Behind every successful business decision, there is always a CMA

Message form Directorate of Studies

Dear Students,

We from the Directorate of Studies understand your expectations from us and accordingly we are trying to deliver some meaningful tips through various publications in soft versions like-E-bulletins, Mock Test Papers (MTPs), and we also have conducted Webinar Sessions for the benefit of the students. Supplementary and Amendments are also uploaded from time to time to keep the students updated about the recent changes made in the papers; wherever applicable.

You must be aware that India is celebrating Azadi Ka Amrit Mahotsav, which is an initiative of the Government of India to celebrate and commemorate 75 years of independence and the glorious history of its people, culture and achievements. Along with pan India, your Institute has also observed and took part in various meaningful activities throughout the year. We also expect that our students should also take part in the development of the nation and make the country proud.

"Freedom has only one motto, may our country be happy and prosperous" ....

let you all observe the message cited above.

- Certain general guidelines are listed below and which will help you in preparing for the examinations:
- Conceptual understanding and overall understanding of the subjects should be clear,
- Students are advised to go through the study material provided by the Institute meticulously,
- Students should know and learn the basic understandings of the subjects with focus on core concepts,
- Students are expected to give to the point answer which is a pre-requisite for any professional examination,
- To strengthen the answers, students are advised to answer precisely and in the structured manner,
- Proper time management is also important while answering.

Please refer the link mentioned below:
https://icmai.in/studentswebsite/index.php

GOOD LUCK
Be prepared and be successful

Disclaimer:
Although due care and diligence have been taken in preparation and uploading this E-Bulletin, the Institute shall not be responsible for any loss or damage, resulting from any action taken on the basis of the contents of this E-Bulletin.


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Behind every successful business decision, there is always a CMA

Few Snapshots

Few Snapshots

Inauguration of "3rd floor Office Premise" of Noida Building of the Institute held on Thursday, the 26th January, 2023 at CMA Bhawan, C-42, Sector 62, Noida, Uttar Pradesh.

Release of 1st Corporate Law Connect- a fortnightly bulletin on Corporate Laws by Corporate Laws Committee by Shri Santosh Kumar, Regional Director (Western Region), MCA at Mumbai on 14th February 2023

46th International Kolkata BOOK FAIR 2023

CMA Vijender Sharma, President, CMA Neeraj D Joshi, Council Member and CMA Nanty Shah, Chairman Surat-Gujarat Chapter met Shri Chandrakant Raghunath Patil BJP State President - Gujarat, MP-Navsari appraising him on Skill Development Project of the Institute for the State of Gujarat.

CMA Neeraj D Joshi, Council Member and CMA Ashish P Thatte, Council Member extending greetings to Dr. Bhagwat Karad, Minister of State, Ministry of Finance on 17th January 2023

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