

FINAL EXAMINATION

GROUP III

(SYLLABUS 2008)

SUGGESTED ANSWERS TO QUESTIONS

December 2012

Paper-11 : Capital Market Analysis & Corporate Laws

Time Allowed : 3 Hours

Full Marks : 100

The figures in the margin on the right side indicate full marks.

Working notes should form part of the answer.

Please: (a) Answer all bits of a question at one place.

(b) Open a new page for answer to a new question.

(c) Attempt the required number of questions only.

SECTION I (60 Marks)

(Capital Market Analysis)

Answer Question No.1 (carrying 20marks) which is compulsory and answer any two (carrying 20 marks each) from the rest in this Section

1. (a) In each of the cases given below, one out of four is correct. Indicate the correct answer (=1 mark) and give workings/ reasons briefly in support of your answer (= 1 mark):

- (i) SIDBI came out with an issue of Deep discount Bond. Each bond having a face value of ₹1,00,000 was issued at a deep discounted price of ₹5,000 with a maturity period of 25 years from the date of allotment. The corporate tax rate applicable is 20%. If the Indexed Cost of acquisition is 6%, what will be the Post tax Yield to maturity of the bond?

- A. 14.90%
B. 11.96%
C. 10.10%
D. None of (A), (B), (C)

- (ii) The closing prices of the stock of TORRENT LTD on five consecutive trading days are as under:

Days	Closing Prices(₹)
0	274.90
1	275.60
2	268.00
3	270.00
4	272.00

The Relative Strength of the stock of Torrent Ltd. is

- A. 1.0169
- B. 1.0366
- C. 1.0925
- D. None of the above

(iii) MS. MOUSHIP holds a portfolio consisting of two stocks-stock A and stock B. Stock A has a standard deviation of returns of 0.6 and stock B has a standard deviation of 0.80. The correlation co-efficient of the two stock returns is 0.50. If MS. Mouship holds equal amount of each stock, what will be risk of the portfolio consisting of two stocks?

- A. 0.40
- B. 0.52
- C. 0.61
- D. Insufficient Information

(iv) ZENION LTD. has an excess cash of ₹9,00,000 which it wants to invest in short-term marketable securities. Expenses relating to investment will be ₹21,000. If the securities invested will have an annual yield of 10%, what would be the period of investment so as to earn a pre-tax income of 6%? (Ignore time value of money)

- A. 6.50 months
- B. 9.50 months
- C. 10.00 months
- D. Insufficient data

(v) PETRONET LTD. has both European Call and Put options traded on NSE. Both options have an expiration date of 6 months and exercise price of ₹40. The call and put are currently selling for ₹12 and ₹5 respectively. If the risk-free rate of interest is 8% p.a., what would be the stock price of Petronet Ltd?

[Given PVIF (8%,0.5 yrs) = 0.9615]

- A. ₹55.46
- B. ₹45.46
- C. ₹31.46
- D. None of (A),(B), (C)

(vi) MR.ADHIRAJ is planning to construct a minimum risk portfolio by investing in the shares of ARIHANT LTD. and SUZLON LTD. The risk associated with the returns of Arihant Ltd. and Suzlon Ltd. are 23% and 25% respectively. If the co-efficient of correlation between the returns of shares of both companies is "0" , the proportion of Funds to be invested in the shares of ARIHANT LTD. is

- A. 45.84%
- B. 54.16%
- C. 66.67%
- D. Insufficient Information

[2x6=12]

(b) Choose the most appropriate one from the stated options and write it down (only indicate A or B or C or D as you think correct).

(i) Interest rate sensitivity for bonds with embedded options is most accurately measured by:

- A. Convexity
- B. Effective duration
- C. Modified duration
- D. Macaulay duration

(ii) The following Act legalizes the e-mail and gives it the status of being valid form of carrying out communication in India:

- A. Indian Contract Act
- B. The Post & Telegraphs Act
- C. The Information Technology Act.
- D. The Sale of Goods Act

(iii) If an investor believes that the probability of the price of a stock moving up is higher than the probability of the price plummeting, he/she should

- A. Buy an in-the-money put and sell an in-the-money call.
- B. Buy an in-the-money call and sell an in-the-money put.
- C. Buy an in-the-money call and buy an out-of the money put.
- D. Sell an out-of-the money call and buy an in- the – money put

(iv) If conclusions and opinions of equity analysts and other experts based on publicly available information are reflected in stock prices, then stock market exhibits

- A. Weak form of efficiency
- B. Semi- strong form of efficiency
- C. Strong form of efficiency
- D. None of the above.

(v) Which among the following increases the NAV of a Mutual Fund Scheme?

- A. Value of investments
- B. Receivables
- C. Accrued Income
- D. All of the above.

[1 x 5=5]

(c) Fill in the blanks in the following sentences by using appropriate word(s)/phrase(s)/number(s):

- (i) The Depositories Act was passed in the year-----.
- (ii) An aggressive portfolio consists of Bonds and Stock in the ratio of -----
- (iii) The fringe market is ----- money market, deemed to include everything that is outside the scope of the money market. [1x3=3]

Answer 1.(a)

(i) B: 11.96%

Post-tax redemption value:

Redemption Value- [Redemption Value- Indexed Cost of acquisition] x Tax rate

₹1,00,000 - [1,00,000-5,000x(1.06)²⁵]x0.20

= 1,00,000 - [1,00,000-5,000x4.2919]x0.20= ₹84,292

∴ Cost of acquisition x (1+r)²⁵ = Post tax redemption Value

5000 (1+r)²⁵ = 84292 or (1+r)²⁵ = 16.8584

$$r = 25\sqrt{(16.8584)} - 1$$

$$= 1.1196 - 1 = 0.1196 \text{ i.e. } 11.96\%$$

(ii) A: 1.0169

Relative strength of the stock = $\frac{\text{Average of up closing prices}}{\text{Average of down closing prices}}$

$$= \frac{(275.60 + 270 + 272) / 3}{268} = \frac{272.53}{268.00} = 1.0169$$

(iii) C: 0.61

$$\begin{aligned}\sigma_p &= \sqrt{W_A^2 \sigma_A^2 + W_B^2 \sigma_B^2 + 2W_A W_B P_{AB} \sigma_A \sigma_B} \\ &= \sqrt{0.5^2 \times 0.6^2 + 0.5^2 \times 0.8^2 + 2 \times 0.5 \times 0.5 \times 0.5 \times 0.6 \times 0.8} \\ &= \sqrt{0.09 + 0.16 + 0.12} = 0.61 \\ &\text{Hence Risk of the Port folio is 0.61}\end{aligned}$$

(iv) C: 10 Months

Pre- tax income required in investment of ₹900000

$$= ₹900000 \times 0.06 = ₹54,000$$

Let the period of investment be "P"

$$\therefore (900000 \times 0.10 \times \frac{P}{12}) - 21000 = 54000$$

$$\text{Or } 7500 P = 54000 + 21000 = 75000$$

$$\text{Or } P = 75000 \div 7500 = 10 \text{ Months}$$

(v) B : ₹45.46

According to CALL-PUT Parity

$$C_o = P_o + S_o - PV(E)$$

$$12 = 5 + S_o - 40 \times 0.9615$$

$$\therefore S_o = 12 - 5 + 38.46 = ₹ 45.46$$

Where $C_o = 12$, $P_o = 5$

PV (E) = PV of Exercise Price

S_o = Stock Price

(vi) B: 54.16%

Let the proportion of investment to be made in the shares of ARIHANT LTD be W_A

For constructing a minimum risk portfolio the condition to be satisfied is

$$\begin{aligned}W_{A^*} &= \frac{\sigma_S^2 - \text{COV}(A, S)}{\sigma_A^2 + \sigma_S^2 - 2\text{COV}(A, S)} \\ &= \frac{(0.25)^2 - 0}{(0.23)^2 + (0.25)^2 - 2 \times 0} \\ &= \frac{0.0625}{0.1154} = 0.5416 \text{ i.e } 54.16\%\end{aligned}$$

Where $\text{CoV}(A, S) = P_{AS} \sigma_A \sigma_S$

P_{AS} = Correlation Coefficient

$$\text{COV}(A, S) = 0 \times 0.23 \times 0.25 = 0$$

1. (b) :

- (i) (B)
- (ii) (C)
- (iii) (C)
- (iv) (B)
- (v) (D)

1. (c):

- (i) 1996
- (ii) 10:90
- (iii) a dis-organized

2. (a) Explain the terms “Certificates of Deposit” and “Commercial Paper”. [3+3=6]

(b) Mr. ANUP KAPUR, analyst at ASHEEKA SECURITIES LTD is considering the stocks of Spark Ltd. and ZESLIN LTD. for investment. Expected returns on the these stocks depend on the growth rate of the GDP. The conditional Returns of the Stocks and the returns of the market are given below:

Economic Scenario (GDP Growth rate)	Probability	Returns associated with (in %)		
		Spark Ltd.	Zeslin Ltd.	Market
Less than 1.00%	0.20	-12	15	-15
1.00-2.50%	0.15	30	35	20
2.50-5.00%	0.30	40	20	30
5.00-7.00%	0.10	20	-30	35
More than 7.00%	0.25	-15	-10	-10

The expected risk-free real rate of return and the premium for inflation are 3% and 5% per annum respectively. Assume that CAPM holds good in the market.

You are required to :

- (i) Calculate the ex-ante betas for two stocks.
- (ii) Find out whether the stocks of Spark Ltd. and Zeslin Ltd. are under price or over price.
- (iii) Determine the proportions of systematic and unsystematic risk in the two stocks.
- (iv) Determine which stock the analyst would suggest to invest, if he is required to select only one stock.--- justify. [6+2+4+2=14]

Answer 2**(a) Certificate of Deposits :**

Certificates of Deposit (CDs) is a negotiable money market instrument issued in dematerialized form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. CDs can be issued by (i) Scheduled Commercial Banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs) ; (ii) Selected all-India Financial institutions that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI. Banks have the freedom to issue CDs depending on their requirements, An FI may issue CDs within the overall umbrella limit fixed by RBI, i.e. issue to CD together with other instruments viz., term money, term deposits, commercial papers and inter corporate deposits should not exceed 100 percent of its net owned funds, as per the latest audited balance sheet.

Commercial Paper (CP): CP is a note in evidence of the debt obligation of the issuer. On issuing commercial paper the debt obligation is transformed into an instrument. CP is thus an unsecured promissory note privately placed with investors at a discount rate to face value determined by market forces.

CP is freely negotiable by endorsement and delivery. A company shall be eligible to issue CP provided – (a) the tangible net worth of the company, as per the latest audited balance sheet, is not less than ₹4 crore ; (b) the working capital (fund – based) limit of the company from the banking system is not less than ₹4 crore and (c) the borrowed account of the company is classified as a Standard Asset by the financing banks.

The minimum maturity period of CP is 7 days. The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other agencies.

(b).(i).

Probability (P)	SPARK (%)				MARKET INDEX (%)				
	Expected Return (RS)	P x RS	$(RS - \overline{RS})$	$\text{VARs} = \overline{(RS - \overline{RS})^2} \times P$	Expected Return Rm	Rm x P	$(Rm - \overline{Rm})$	$\text{VARm} = \overline{(Rm - \overline{Rm})^2} \times P$	Cov (S,M) = $\overline{(RS - \overline{RS})(Rm - \overline{Rm})} \times P$
0.20	-12	-2.40	-24.35	118.58	-15	-3.00	-25	125	121.75
0.15	30	4.50	17.65	46.73	20	3.00	10	15	26.47
0.30	40	12.00	27.65	229.36	30	9.00	20	120	165.90
0.10	20	2.00	7.65	5.85	35	3.50	25	62.50	19.13
0.25	-15	-3.75	-27.35	187.01	-10	-2.50	-20	100.00	136.75
		12.35		587.53		10.00		422.50	470.00

Expected Returns of SPARK (Stock) (\overline{RS}) = 12.35%
 Variance of SPARK (Stock) (VARs) = 587.53 ∴ $\sigma_s = 24.24\%$
 Beta of Stock Spark = COV (s,m)/ VARm
 $\beta_s = (470/422.50) = 1.1124$

Probability (P)	ZESLIN (%)				MARKET INDEX (%)				
	Expected Return (RZ)	P x RZ	$(Rz - \overline{Rz})$	$\text{VARZ} = \overline{(Rz - \overline{Rz})^2} \times P$	Expected Return Rm	P x Rm	$(Rm - \overline{Rm})$	$\text{VARm} = \overline{(Rm - \overline{Rm})^2} \times P$	Cov (S,M) = $\overline{(Rz - \overline{Rz})(Rm - \overline{Rm})} \times P$
0.20	15	3.00	6.25	7.81	-15	-3.00	-25.00	125.00	-31.25
0.15	35	5.25	26.25	103.36	20	3.00	10.00	5.00	39.37
0.30	20	6.00	11.25	37.97	30	9.00	20.00	120.00	67.50
0.10	-30	-3.00	-38.75	150.16	35	3.50	25.00	62.50	-96.87
0.25	-10	-2.50	-18.75	87.89	-10	-2.50	-20.00	100.00	93.75
		8.75		387.19		10.00		422.50	72.50

Expected Returns of ZESLIN (Stock) (\overline{Rz}) = 8.75%
 Variance of ZESLIN (Stock) (VARz) = 387.19 ∴ $\sigma_z = 19.68\%$
 Beta of ZESLIN Stock = (β_z) = COV (Zeslin, Market)/Variance of Market
 $= (72.50/422.50) = 0.1716$

Expected Return of Market (\overline{Rm}) = 10%

(ii) Required Return for Spark – Stock = $R_f + (R_m - R_f) \times \beta_s$
 $= 8 + (10 - 8) \times 1.1124 = 10.22\%$

Where R_f = Inflation Adjusted nominal Risk Free Rate = $(3 + 5)\% = 8\%$
 Required Return for Zeslin Stock = $8 + (10 - 8) \times 0.1716 = 8.34\%$

Excess return (Alpha) for Spark Stock = $12.35 - 10.22 = 2.13\%$

Excess Return (Alpha) for Zeslin Stock = $8.75 - 8.34 = 0.41\%$

The Alpha (α) is Excess return of both companies is positive. Hence the stock of Spark Ltd. and Zeslin Ltd. is under priced.

(iii) Systematic Risk of SPARK Stock $= \sigma_m^2 \beta_s^2 = 422.50 \times (1.1124)^2$
 $= 522.82\%$

Unsystematic Risk of SPARK Stock $= 587.53 - 522.82 = 64.71\%$

Proportion of Systematic Risk of SPARK Stock $= (522.82)/587.53 = 88.99\%$

Proportion of Unsystematic Risk of SPARK $= (64.71)/587.53 = 11.01\%$

Systematic Risk of ZESLIN Stock $= \sigma_m^2 \beta_z^2 = 422.50 \times (0.1716)^2$
 $= 12.44\%$

Unsystematic Risk of ZESLIN Stock $= 387.19 - 12.44$
 $= 374.75\%$

Proportion of Systematic Risk of Zeslin Stock $= (12.44)/387.19 = 3.21\%$

Proportion of Unsystematic Risk of Zeslin Stock $= (374.75)/387.19 = 96.79\%$

(iv) SPARK LTD :

(Excess Return) / Standard Deviation : $(2.13)/(24.24) = 0.088$

ZESLIN LTD:

Excess Return (Alpha) / Standard Deviation: $(0.41)/(19.68) = 0.021$

As the excess Return (Alpha) to Standard Deviation is higher for the stock of SPARK LTD.; Mr. KAPUR (Analyst) should suggest to invest on the said stock (Spark Ltd.)

3. (a) What is meant by “Exercising the option”? What are the implications for a buyer ? [6]

(b) The market received rumour about PRUDENTIAL PHARMA LTD’S tie up with a multinational company. This has included the market price to move up . If the rumour is false, Prudential Pharma Ltd.’s stock price will probably fall dramatically. To protect from this Ms. Kritika, an investor has bought the call and put options.

She purchased a 3-month call option for 100 Stocks in Prudential Pharma Ltd. at a premium of ₹12 per stock with an exercise price of ₹250. She also purchased a 3-month put option for 100 stocks of the said company at a premium of ₹6 per stock with an exercise price of ₹240.

Required:

- (i) Determine the Investor’s (Kritika) position if the tie up offer bids the price of Prudential Pharma Ltd’s stock up to ₹260. in 3 months.
- (ii) Determine the Investor’s (Kritika) position if the tie up programme fails and the price of stock falls to ₹215 in 3 months. [1+3+3=7]

(c) Bonds of TUXEDO TECH LTD., an Engineering Company which carries AA rating with 5 years to maturity and 14.50% coupon rate, payable annually, is being traded at ₹1015.50. You as a Fund Manager of the Trust Fund, a 80% Debt fund, want to ascertain the intrinsic Value and take a decision accordingly. Face Value of the bond is ₹1000.

Your Asset Management Company has laid down the guideline that for AA rated Instruments, the discount rate to be applied is 364 day T-Bill rate+4%. (Assume the 364 day T-Bill rate to be 10%).

You are required to

- (i) Calculate the Intrinsic value of the Bond
- (ii) Calculate the current yield (CY) and the yield to Maturity of the bond (YTM).

Note: (i) Ignore Flotation Costs and transaction costs,
(ii) Extracted from the table of PV.

Interest rate	10%	11%	12%	13%	14%	15%
PVIFA (5 years)	3.791	3.696	3.605	3.517	3.433	3.352
PVIF (5 years)	0.621	0.593	0.567	0.543	0.519	0.497

[3+4=7]

Answer 3.

(a) Exercise of Option Position and Strategies:

The call option gives the buyer a right to buy the requisite shares on a specific date at a specific price. This puts the seller under the obligation to sell the shares on that specific date and specific price. The Call Buyer exercises his option only when he/she feels it is profitable. This process is called "Exercising the Option". This leads us to the fact that if the spot price is lower than the strike price then it might be profitable for the investor to buy the share in the open market and forgo the premium paid.

The implications for a buyer are that it is his/her decision whether to exercise the option or not. In case the investor expects prices to rise far above the strike price in future then he/she would surely be interested in buying call options. On the other hand, if the seller feels that his shares are not giving the desired returns and they are not going to perform any better in the future, a premium can be charged and returns from selling the call option can be used to make up for desired returns. At the end of the options contract there is an exchange of the underlying asset. In the real world, most of the deals are closed with another counter or reverse deal. There is no requirement to exchange the underlying assets then as the investor gets out of the contract just before its expiry.

(b)

MS. KRITIKA

Cost of Call and put options:

$$[(₹12 \times 100) + (6 \times 100)] = ₹1800$$

(i) POSITION if price increases to ₹260_

Particulars	₹
Cost of Options	(1,800.00)
Since Market Price is higher than the strike price of put option, Investor may not exercise the put but she will exercise call option.	
Gain on Call : (spot price on expiry date – Exercise price) i.e. (260-250)×100 Stocks	1,000.00
Net Profit / (Loss)	(800.00)

(ii) POSITION if price falls to ₹215 :

Particulars	₹
Cost of Options	(1,800.00)
Since Market Price is lower than the strike price of call, Investor may not exercise the call but she will exercise put option.	
Gain on Put: (Exercise price – spot price on expiry date) (240-215) x 100 Stocks	2,500.00
Net Profit/ (Loss)	700.00

(c) **TUEXDO TECH LTD**

(i) **Calculation of Intrinsic Value of the Bond**

Appropriate discount rate for valuing the Bond is: $R = 10 + 4 = 14\%$

Cash Flows:

YEARS		P.V. Factor @ 14%	Present Value
1-5	Dividend ₹145 annually for 5 years	3.433	₹497.78
5	Maturity Value : ₹1000	0.519	519.00
Intrinsic Value per bond (P_0)			1016.78

Since the Current Market Value is less than the intrinsic value of Bond, the Bond is under priced. The Bond should be bought.

(ii) **Calculation current yield (YC):**

$$(145 \div 1015.50) \times 100 = 14.28\%$$

Calculation of YTM

Since when discounted at 14%, the value is ₹. 1016.78 (more than 1015.50)

We try at 15% discount.

$$P_0 = 145 \times PVIFA(15\%, 5 \text{ years}) + 1000 \times PVIF(15\%, 5 \text{ years})$$

$$= 145 \times 3.352 + 1000 \times 0.497 = 486.04 + 497 = ₹983.04$$

As we found (i) $P_0 = ₹1016.78$

$$YTM = 14 + (15 - 14) \times \frac{1016.78 - 1015.50}{1016.78 - 983.04}$$

$$\text{BY Interpolation} = 14 + 1 \times \frac{1.28}{33.74} = 14.04\%$$

Yield to Maturity (YTM) = 14.04%

4. (a) **CONTINENTAL INDUSTRIES LTD.** had received on e-mail from **INERTIA LTD.** emanating from the company's official website, accepting the former's offer. Later on Inertia Ltd. failed to fulfill their promise. Can Continental Industries Ltd. launch proceedings against Inertia Ltd. on the strength of the e-mail?

What precaution should Continental Industries Ltd. have taken in this regard?

[5+1=6]

(b) IREVNA MUTUAL FUND having 500 units has shown NAV of ₹12.25 and ₹13.23 at the beginning and at the end of the year respectively. This Mutual Fund has given two options:

- (i) Pay ₹1.05 per unit as dividend and ₹ 0.84 per unit as a capital gain , or
- (ii) These distributions are to be re-invested at an average NAV of ₹12.11 per unit.

Required:

What difference it would make in terms of return available and which option is preferable? [2+4=6]

(c) There are two portfolios P and Q which exist relating to three shares A,B and C. The weights for each portfolio are as under:

	W _A	W _B	W _C
Portfolio P	0.19	0.60	0.21
Portfolio Q	0.24	0.54	0.22

You are required to compute the stock weights for a portfolio made up with investment of ₹6000 in P and ₹4000 in Q. [4]

(d) What is the settlement schedule for Interest Rate Futures contracts for

- (i) Daily Mark-to Market Settlement , and
- (ii) Final Settlement [2+2=4]

Answer 4.

(a) The Information Technology Act, would come to the rescue to Continental Industries Ltd.

Section 4 and 5 of the said Act may be referred to in this context. Section 4 accords legal recognition of electronic records. As per this section, where any law provides that information or any other matter shall be in writing or in the typewritten or printed form, then, notwithstanding anything contained in such law, such requirement shall be deemed to have been satisfied if such information or matter is;

- (i) Rendered or made available in an electronic form, and
- (ii) Accessible so as to be for a subsequent reference.

Section 5 speaks about legal recognition of digital signatures. Accordingly where any law provides that information or any other matter shall be authenticated by affixing the signature or any document shall be signed or bear the signature of any person then, notwithstanding anything contained therein in such law, such requirement shall be deemed to have been satisfied, if such information or matter is authenticated by means of digital signature affixed in such manner as may be prescribed by the Central Government. The Explanation to this section states that for the purposes of this section, “signed”, with its grammatical variations and cognate expressions, shall with reference to a person , mean affixing of his hand written signature or any mark on any document and the expression “signature” shall be construed accordingly. Continental Industries LTD. can proceed against Inertia Ltd on the strength of these provisions.

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

(b)

IREVANA MUTUAL FUND

(i) Return for the year :

Change in price per unit : ₹13.23- ₹12.25 = ₹0.98

Dividend Received (Per unit) = ₹1.05

Capital Gain distribution = ₹0.84

Total Reward = ₹2.87

- (A) Holding period Reward : $(₹2.87 ÷ ₹12.25) \times 100 = 23.43\%$
 (ii) When all dividends and capital gains distributions are re-invested into additional units of the fund @ ₹12.11 per unit.
 (Dividend + Capital Gains) per unit = $(₹1.05 + 0.84) = ₹1.89$
 Total received from 500 units = $₹1.89 \times 500 = ₹945$
 Additional Units Acquired : $₹945 ÷ ₹12.11 = 78.0347$ units
 Total No. of Units : 500 units + 78.0347 units = 578.0347 units

Value of 578.0347 Units held at the end of the year:

578.0347 × ₹13.23	= ₹ 7647.40
Price paid for 500 units at the beginning of the year: 500 × ₹12.25	= ₹6125.00

Holding Period Reward / Return	= ₹1522.40

- (B) (%) Percentage of Holding Period Return / Reward : $(₹1522.40 ÷ 6125) \times 100 = 24.86\%$

Conclusion :

Since the holding period Return (Reward) is more in terms of percentage in option (ii) i.e. Re-investment of distributions at an average NAV of ₹12.11 per unit, this option is preferable.

- (C) It is given that ₹6000 is invested in portfolio P and ₹ 4000 in portfolio Q.

Hence the investment committed in each will be :

Particulars	A	B	C	Total
1	2	3	4	5
Portfolio P (₹)	1140	3600	1260	6000
Portfolio Q (₹)	960	2160	880	4000
Combined Profile	2100	5760	2140	10000
Stock weights for combined portfolio i.e	Total of (Column 2/5) 0.21	Total of (Column 3/5) 0.576	Total of (Column 4/5) 0.214	-

(D) Settlement Schedule for interest Rate Future Contracts

	Pay-in	Pay-out
Daily mark- to market settlement	T+1 working day, on or after 11.30 a.m	T+1 working day, on or after 12.00p.m
	(For above, T is the trading day)	
Final settlement	T+1 working day, on or after 11.30 a.m.	T+1 working day, on or after 12.00p.m
	(For above, T is the expiration day)	

SECTION II (40 Marks)

(Corporate Laws)

Answer Question No.5 (carrying 10 marks) which is compulsory and answer any two (carrying 15 marks each) from the rest in this Section.

5. (a) Choose the most appropriate one from the stated options and write it down (only indicate A or B or C or D as you think correct).

- (i) Any anti-competitive agreement entered into in contravention of the provisions contained in the Competition Act, 2002 will be:
 - (A) Void
 - (B) Voidable at the option of the public
 - (C) Voidable at the option of the State Government
 - (D) Voidable at the option of the Central Government
- (ii) As per Clause----- of the Listing Agreement, a listed company is required to obtain a certificate from the auditors of the entity as regards compliance of conditions of corporate governance as stipulated in that clause. (Fill in the gap from the below)
 - (A) 45
 - (B) 46
 - (C) 49
 - (D) None of the above
- (iii) MR. SHARMA is a director of ANKRIT LTD. which failed to file its annual return from the year 2009-10. The maximum period for which Mr. Sharma will be disqualified from becoming a director in any public limited company is
 - (A) 3 years
 - (B) 5 years
 - (C) 7years
 - (D) 10 years
- (iv) The Government has allowed foreign institutional investors such as pension funds, mutual funds investment trust etc. to invest in the Indian Capital Market provided they are registered with
 - (A) RBI
 - (B) SEBI
 - (C) Central Government
 - (D) Registrar of the companies
- (v) In the context of classification of risk, cash/reserve management risk will fall under -----
 -- (Fill in the gap from the below)
 - (A) Liquidity Risks
 - (B) Legal Risks
 - (C) System Risks
 - (D) Credit Risks

[1x5 = 5]

(b) Fill in the Blanks in the following sentences by using appropriate word(s)/phrase(s)/number(s):

- (i) All existing listed entities with a paid up Capital of ----- and above are required to set up an Audit Committee in a phased manner as per schedule of implementation specified in clause 49.
- (ii) The competition Act was passed in the year-----.
- (iii) All clauses in the memorandum of Association of a company can be altered following the procedures laid down, except----- clause.
- (iv) The disclosure requirement relating to “ Accounting for fixed assets” is governed by AS -----
-----.
- (v) Management may not prepare financial statements applying going concern basis in case there exists significant doubt about the going concern status of the enterprise. The point has not been taken care of in section ----- of the Companies Act, 1956. [1x5=5]

Answer 5.

(a)

- (i) (A)
- (ii) (C)
- (iii) (B)
- (iv) (B)
- (v) (A)

(b)

- (i) ₹3 Crores
- (ii) 2002
- (iii) Association
- (iv) 10
- (v) 217(2 AA)

6. (a) MOONSHINE LTD. and its subsidiary VINTEX LTD. are the only manufactures of magnesite in India. Both of them plan to appoint DM LTD. as the sole distributor for its products in India. DM LTD. is to be given the power to determine the quantum to be supplied to users in a particulars State in India. The two companies seek your advice in the context of the provisions of the Competition Act, 2002 relating to such distribution agreement. Advice them suitably. [5]

(b) PQR MINERALS LTD., is a government undertaking. The undertaking has been in existence for the past ten years and the company maintains a web site wherein particulars last updated on 20th June, 2012 are available to the public.

Few important policy decisions were taken by the company in July, 2012, but these were not posted in the company's website as on 15thDecember, 2012.

Mr. FAIRPLAY , a general public feel that the company has violated the provisions of the Right to Information Act by not disclosing the important policy decisions affecting the general public. – Is the aforesaid contention justified under the provisions of the RTI Act? [4]

(c) MR. ADAM a 15% shareholder of a company and other shareholders have lost confidence in the Managing Director (MD) of the company. He is a director not liable to retire by rotation and was re-appointed as Managing Director for 5 years w.e.f. 1.4.2012 in the last Annual General Meeting of the company.

Mr. Adam seeks your advice to remove the MD after following the procedure laid down under the Companies Act,1956:

- (i) Specify the steps to be taken by Mr. Adam and the company in his behalf;**
- (ii) Draft a suitable resolution to be passed for removal of MD;**
- (iii) Is it necessary to state to support the resolution for his removal? [3+2+1=6]**

Answer 6.

(a) Under the Competition Act, 2002 “exclusive distribution agreement” includes any agreement restricting in any manner the purchaser in the course of his trade from acquiring or otherwise dealing in any goods other than those of the seller or any other person.

As per sub-section (4), any agreement amongst enterprises or persons at different stages or levels of the production chain in different markets, in respect of production, supply, distribution, storage, sale or price of, or trade in goods or provision of services, including ---

- a) tie-in arrangement;
- b) exclusive supply agreement;
- c) exclusive distribution agreement;
- d) refusal to deal;
- e) resale price maintenance, shall be an agreement in contravention of sub-section (1) if such agreement causes or is likely to cause an appreciable adverse effect on competition in India.

In terms of sub-section (1), no enterprise or association of enterprises or person or association of persons shall enter into any agreement in respect of production supply, distribution, storage, acquisition or control of goods or provision of services, which causes or is likely to cause an appreciable adverse effect on competition within India.

Sub-section (2) enjoins that any agreement entered into in contravention of the provisions contained in subsection (1) shall be void.

The two companies will have to keep the above provision in mind. Advice should be given accordingly.

(b) Updating of particulars, as required under the RTI Act

The RTI Act casts an obligation to publish all relevant facts concerning important decisions and policies that affect the public while formulating and announcing such decisions and policies

The RTI Act requires that the necessary particulars are to be published and updated atleast every 12 months.

In the given case, the company's website has been last updated on 20-06-2012. Hence it will be sufficient if the particulars are updated by 19-06-2013.

As a consequence, there is no violation of the applicable provisions of the RTI Act.

(c)

(i) Under Section 284 of the Companies Act, 1956, a company may, by ordinary resolution, remove a director before the expiry of his tenure. However this section does not apply to a director appointed by the central Govt. under Sec 408. For the purpose, special notice from a shareholder (Mr. Adam in the present case) shall be required to be given to the company for moving a resolution to remove a director. On receipt of notice, the company shall forthwith send a copy thereof to the director concerned (MD in the present case) and he shall be entitled to be heard on the proposed resolution at the meeting. Copy of the representation, if any, made by the director be also sent to all members of the company to whom notice of the general meeting is normally sent. In case, the representation is received too late, the same shall be read at the meeting. The representation need not be sent if the Company Law Board is satisfied that it will cause needless publicity for defamatory matter.

Under Section 190, special notice of the intention to move the resolution shall be given not less than 14 days before the meeting.

In the present case, if the AGM is due to be held, Mr. Adam may send the special notice 14 days before the AGM. Otherwise, he may request the company to convene EGM under section 169 for consideration of the special notice and resolution for removal of MD. He already holds more than 10% shares in the company. Once the ordinary resolution is passed in the general meeting, MD will cease to be a director of the company and consequently MD of the company.

(ii) Mr. Adam may give special notice of his intention to move the following resolution, as ordinary resolution: "RESOLVED THAT Mr..... Managing Director of the Company be and is hereby removed as a director of the company under Section 284 of the Companies Act, 1956 with immediate effect."

(iii) A statement of reasons is not necessary to support the resolution for removal of a director. LIC vs. Escorts Ltd .(1956) 59 Comp. Cases 548 (SC)

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

8

(b) What is meant by " Assessing control risk" in the context of internal control policy and misstatements in the financial statements? How should the auditor react where the control risk is at the maximum and where it is less than the maximum?

7

Answer 7.

(a) Corporate Governance

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

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

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

Audit Committee

For better corporate governance, the concept of Audit Committee for companies was introduced by section 292A of the Companies Act, 1956. Every public company having paid up capital of not less than ₹5 Crores. must constitute a Committee of the Board, known as "Audit Committee".

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

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

- (a) The Audit Committee should discuss with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors.
- (b) The Audit Committee should review half yearly and annual financial statements before submission to the Board.
- (c) The Audit Committee should ensure compliance of internal control systems

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

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

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

(b) Assessing Control Risk:

Control Risk- the risk that the client's internal control policy and procedures are not effective in preventing or detecting material misstatement in the financial statements.

1. Control risk at the maximum

- Conclusion based upon the auditor's judgment that the client's internal control policies and procedures do not reduce to a low level the potential that the financial statements are free of material errors and or irregularities.
- After reaching this assessment the auditor would only be required to document in his/her work papers the fact that control risk is at the maximum and not the basis for reaching this conclusion.

- The auditors may decide control risk is at the maximum based upon management accounting technique called cost benefit decisions.

2. Control risk at less than the maximum

- Based upon his/her initial understanding of the internal control components, the auditor may conclude that control risk may be less than the maximum.
- The auditor in this situation must evaluate the cost/ benefit of extending his/her understanding of internal controls to make a final decision concerning control risk.
- The cost / benefit decision is based upon the auditor time involved in extending the auditor's understanding of internal controls , including tests of control, versus the time that may be saved with the possible reduction of substantive auditor tests.
- Tests of the controls- audit tests designed to determine whether specific control procedures that the auditor plans to rely on are actually in place and actually in place and operating effectively in the entity under audit.
- Substantive Tests- auditors tests designed to substantiate one or more financial statement assertions.
- Should the auditor decide not to extend his/her understanding of internal controls because of cost/benefit considerations, control risk would then be assessed at the maximum for all financial statement assertions.

8. (a) In the context of Corporate Governance, state why it is desirable to have independent directors in the Board of Directors of the company. [6]

(b) M/S MEDICA HEALTH SERVICES LTD. owns a Multi-speciality in Chennai. DR. MILTON a practicing Heart Surgeon, has been appointed by the company as its non- executive ordinary director and it wants to pay him fee. On case to case basis, for surgery performed on the patients at the hospital. A question has arisen whether payment of such fee to him would amount to payment of managerial remuneration to a director subject to any restriction under the Companies Act, 1956.

Advice the company, which seeks to ensure that the same does not contravene any provision of the Companies Act, 1956. [3]

(c) MR. WELDON was appointed as a director in SAM LTD on 1.10.2011. Certain acts were done by the Board of Directors, of which MR. WELDON also formed part. Later, on 1.9.2012, certain defect was found in the appointment of MR. WELDON as director.

Discuss whether the acts done by the Board Meeting can be considered as invalid owing to such defect being found at a later date? [6]

Answer 8.

(a) Desirability of having Independent Directors

Recent literature on Corporate Governance is replete with recommendations of various committees on the desirability of having non-executive, independent directors on the Boards of companies to promote better corporate governance practices. The Cadbury Report identifies two areas where non- executive directors can make an important contribution to the governance process as consequence of their independence from executive responsibility.

1. Reviewing the performance of executive management.
2. Taking the lead where potential conflicts of interest arise, as for instance, fixing the salary of the CEO and perquisites or dealing with boardroom succession. Apart from these, independent directors, being non-executives with no vested interests, can bring in objectivity to the boards decision making process. Opinions vary on how many independent non-executive directors are required to achieve good corporate practice.

The UK combined code recommended that non- executive directors should make up at least one-third of the board and that a majority of them should be independent. The IFSA guidelines and the Toronto Report recommend a higher standard that the majority of directors should be independent, non executive. IFSA argues that majority of directors should be genuinely independent in order to ensure that board has the power to implement decision, if and when the need arises contrary to the

wishes of management or major share-holder. IFSA contends that this creates “ a more desirable board culture” and imposes a responsibility on the independent majority to be “especially competent and diligent “ in carrying out their role.

3. The Indian Capital Market Regulator, the Securities and Exchange Board of India (SEBI) has recently amended clause 49 of the listing agreement to ensure that independent directors account for at least 50% of board of directors of listed companies, where an executive chairman heads the board. However, if the chairman is a non- executive director, at least one third of board should consist of independent directors.

(b) Under the proviso to sub-section (1) section 309 of the Companies Act, 1956, in case-

- (i) The services rendered are of a professional nature; and
- (ii) In the opinion of the Central Government, the director possesses the requisite qualifications for the practice of the profession.

The remuneration paid for these services shall be outside the scope of Section 309 of the Act and shall not be a part of managerial remuneration. It is then not open to the Government to put any restriction on the amount of remuneration payable to him for his approach work. The company is, accordingly, advised to approach the Ministry of Company Affairs to seek an affirmative expression of opinion that Dr.MILTON who is a qualified surgeon, possess the requisite qualification to practice the profession of surgery.

(c) Validity of acts done at a Board meeting

All acts done by the Board Meeting by its committee Meeting or by any person as a Director shall be as valid as if every such Director of such person had been duly appointed and was qualified to be a Director. The validity of all such acts done is not affected even if it discovered later on that there was some defect in the appointment of any one or more of such Directors or any person acting as a Director. The said acts will also remain unaffected even the Directors are later on discovered to be disqualified (Article 80). This provision has been intended to prevent the validity of transactions from being questioned where there has been as slip in the appointment of a Director. But the provision cannot be utilized to ignore or override the substantive provisions pertaining to such appointment. It is applicable only to acts of Directors whose appointment or qualification is later on discovered to be faulty. Where , however, their appointments have not taken place at all but they merely choose to act on the company’s behalf, the protection prescribed by either Article 80 or Section 290 cannot be invoked [Morris vs. Danssen (1964) 1, A.I.R. 586 (HL.)]. This is because the said subsequent discovery must be a discovery of the defect; it must not be discovery of facts which go to constitute the defect [British Asbestos Co. Vs. Body (1903) 2 Ch. 439].

Suppose a regulation like Articles 80 is included in the Article of Association of a company. What would be the possible impact of this? The impact has been summed up in Halsbury’s Laws of England (vide p. 277, 3rd Edition, Vol. VI) thus: “An Article validation the acts of persons acting as Directors, though it is a afterwards discovered that there was a defect in their appointment or qualification, operates not only between the company and outsiders but also as between the company, and its members; as where *defecto* Directors make a call, summon meetings of the company, elect other Directors or allot shares. A

defecto Director may be ordered to furnish a statement of affairs in winding up. Directors cannot take advantage of any infirmity in their proceedings in which they have themselves participated; they are stopped as between themselves and the company; they are also stopped from saying they have been improperly appointed if, they have acted after appointment, persons dealing with them who know of the invalidity are likewise stopped.”

It should also be noted that Section 290 applies to act of an individual Director, whereas Article 80 covers Act of the Board and of its committee.