SUGGESTED ANSWERS TO

THE QUESTIONS SET AT

CHARTERED ACCOUNTANCY PROFESSIONAL (CAP)-III LEVEL

December 2022 EXAMINATIONS

Group-I

The Institute of Chartered Accountants of Nepal (ICAN)

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Paper 1: Advanced Financial Reporting

Marks

Attempt all questions. Working notes should form part of the answers.

1. Alpha, a parent with a subsidiary Beta, is preparing the consolidated statement of financial position at 32 Ashadh 2079. The draft statements of financial position for both entities as at 32 Ashadh 2079 are given below:

(Rs. '000)

	Alpha	Beta
Assets		
Non-current assets:		
Property, plant and equipment (Note 1)	966,500	546,000
Development project (Note 1)	-	20,000
Investment in Beta (Note 1)	450,000	-
	1,416,500	566,000
Current assets:		
Inventories (Note 2)	165,000	92,000
Trade receivables	99,000	76,000
Cash and cash equivalents	18,000	16,000
	282,000	184,000
Total assets	1,698,500	750,000
Equity and liabilities		
Equity		
Share capital (Re. 1 shares)	360,000	160,000
Retained earnings	570,000	360,000
Other components of equity	102,000	-
Total equity	1,032,000	520,000
Non-current liabilities:		
Long-term borrowings (Note 3)	300,000	85,000
Pension liability (Note 4)	187,500	-
Deferred tax (Note 1 and 2)	69,000	54,000
Total non-current liabilities	556,500	139,000
Current liabilities:		
Trade and other payables	70,000	59,000
Short-term borrowings	40,000	32,000
Total current liabilities	110,000	91,000
Total equity and liabilities	1,698,500	750,000

Note 1 – Alpha's investment in Beta

On 1 Magh 2078, Alpha acquired 120 million shares in Beta. Alpha made a payment of Rs. 450 million in exchange for these shares. The individual interim financial statements of Beta showed a balance of Rs. 340 million on its retained earnings on 1 Magh 2078.

The directors of Alpha carried out a fair value exercise to measure the identifiable assets and liabilities of Beta at 1 Magh 2078. The following matters emerged:

- Plant and equipment having a carrying amount of Rs. 440 million had an estimated fair value of Rs. 480 million. The estimated remaining useful life of this plant and equipment at 1 Magh 2078 was four years.
- An in-process development project of Beta had a carrying amount of Rs. 8 million and a fair value of Rs. 18 million. During the six-month period from 1 Magh 2078 to 32 Ashadh 2079, Beta incurred further development costs of Rs. 12 million relating to this project. These costs were correctly capitalised in accordance with

the requirements of IAS 38 "Intangible Assets". No amortisation of the capitalised costs of this project was required prior to 32 Ashadh 2079.

- The fair value adjustments have not been reflected in the individual financial statements of Beta. In the consolidated financial statements, the fair value adjustments will be regarded as temporary differences for the purposes of computing deferred tax. The rate of deferred tax to apply to temporary differences is 20%.

On 1 Magh 2078, the directors of Alpha measured the non-controlling interest in Beta at its fair value. On that date, the fair value of an equity share in Beta was Rs. 3.80.

Note 2 – Intra-group trading

Since 1 Magh 2078, Alpha has supplied a product to Beta. Alpha applies a mark-up of 25% to its cost of supplying this product. Sales of the product by Alpha to Beta in the period from 1 Magh 2078 to 32 Ashadh 2079 totaled Rs. 30 million. One-third of the products which Alpha had supplied to Beta since 1 Magh 2078 were still unsold by Beta at 32 Ashadh 2079. Any adjustment which is necessary in the consolidated financial statements as a result of these sales will be regarded as a temporary difference for the purposes of computing deferred tax. The rate of deferred tax to apply to temporary differences is 20%. No amounts were owing to Alpha by Beta in respect of these sales at 32 Ashadh 2079.

Note 3 – Long-term borrowings

Prior to 1 Shrawan 2078, Alpha had no long-term borrowings. On 1 Shrawan 2078, Alpha borrowed Rs. 300 million to finance its future expansion plans. The term of the borrowings is five years and the annual rate of interest payable on the borrowings is 6%, payable in arrears. Alpha charged the interest paid on 32 Ashadh 2079 as a finance cost in its financial statements for the year ended 32 Ashadh 2079.

The borrowings are repayable in cash at the end of the five-year term or convertible into equity shares on that date at the option of the lender. If the borrowings had not contained a conversion option, the lender would have required an annual return of 8%, rather than 6%. Discount factors which may be relevant are as follows:

Discount factor	Present value of Re. 1 payable at the end of year 5	Cumulative present value of Re. 1 payable at the end of years 1–5 inclusive
6%	74·7 Paisa	Rs. 4·21
8%	68·1 Paisa	Rs. 3·99

Note 4 – Pension liability

Alpha has established a defined benefit pension plan for its eligible employees. The statement of financial position of Alpha at 32 Ashadh 2079 currently includes the estimated net liability at 31 Ashadh 2078. The following matters relate to the plan for the year ended 32 Ashadh 2079:

- The estimated current service cost was advised by the actuary to be Rs. 60 million.
- On 32 Ashadh 2079, Alpha paid contributions of Rs. 70 million into the plan and charged this amount as an operating expense.
- The annual market yield on high quality corporate bonds on 1 Shrawan 2078 was 8%.
- The estimated net liability at 32 Ashadh 2079 was advised by the actuary to be Rs. 205 million.
- No benefits have been paid to date.

Required: **20**

On the basis of above information, prepare the consolidated statement of financial position of Alpha as at 32 Ashadh 2079. Unless specifically told otherwise, you can ignore the deferred tax implications of any adjustments you make.

Answer

1) Consolidated statement of financial position of Alpha as at 32 Ashadh 2079

Particulars	Rs.'000
Assets	
Non-current assets:	
Property, plant and equipment (966,500 + 546,000 + 35,000 (WN1))	1,547,500
Goodwill (WN 2)	62,000
Development project (20,000 + 10,000 (WN 1))	30,000
	1,639,500
Current assets:	
Inventories (165,000 + 92,000 – (30,000 x 1/3 x 25/125%))	255,000
Trade receivables (99,000 + 76,000)	175,000
Cash and cash equivalents (18,000 + 16,000)	34,000
	464,000
Total assets	2,103,500
Equity and liabilities	
Equity	
Share capital (Rs. 1 shares)	360,000
Retained earnings (WN 4)	571,310
Other components of equity (WN 8)	113,380
Total equity	1,044,690
Non-controlling interest (WN 3)	156,000
Total equity	1,200,690
Non-current liabilities:	
Long-term borrowings (WN 10)	365,210
Pension liability	205,000
Deferred tax (WN 11)	131,600
Total non-current liabilities	701,810
Current liabilities:	
Trade and other payables (70,000 + 59,000)	129,000
Short-term borrowings (40,000 + 32,000)	72,000
Total current liabilities	201,000
Total equity and liabilities	2,103,500

WN 1 – Net assets of Beta

(Rs. '000)

Particulars	1 Magh 2078	32 Ashadh 2079
Share capital	160,000	160,000
Retained earnings:		
Per financial statements of Beta	340,000	360,000
Fair value adjustments:		
Plant and equipment [(480-440) and 40-(40/4×6/12)]	40,000	35,000
Development project	10,000	10,000

Deferred tax on fair value adjustments:		
Date of acquisition (20% x (40,000 + 10,000))	(10,000)	
Year end (20% x (35,000 + 10,000))		(9,000)
	540,000	556,000
Increase in net assets post-acquisition (556,000 – 540,000)	16,000	

WN 2 – Goodwill on acquisition of Beta

Particulars	Rs.’000
Cost of investment:	
Cash paid	450,000
Non-controlling interest at date of acquisition (40,000 x Rs.3·80)	152,000
Net assets at date of acquisition (WN1)	(540,000)
Goodwill	62,000

WN 3 – Non-controlling interest in Beta

Particulars	Rs.’000
At date of acquisition (WN2)	152,000
25% of post-acquisition increase in net assets of 16,000 (WN1)	4,000
	156,000

WN 4 – Retained earnings

Particulars	Rs.’000
Alpha – per draft SOFP	570,000
Adjustment for unrealised profit on unsold inventory (2,000 less 20% (deferred tax))	(1,600)
Adjustment for finance cost of loan (WN6)	(4,090)
Adjustment for: defined retirement benefit plan (WN7)	(5,000)
Beta – 75% x 16,000 (WN1)	12,000
	571,310

WN 5 – Equity component of long-term loan

Particulars	Rs.’000
Total proceeds of compound instrument	300,000
Debt component:	
Interest stream – 300,000 x 6% x Rs.3·99	(71,820)
Principal repayment – 300,000 x Rs.0·681	(204,300)
So equity component equals	23,880

WN 6 – Adjustment for finance cost of loan

Particulars	Rs.’000
Actual finance cost – 8% (300,000 – 23,880 (WN5))	22,090
Incorrectly charged by Alpha (300,000 x 6%)	(18,000)
So adjustment equals	4,090

WN 7 – Adjustment for: defined retirement benefit plan

Particulars	Rs.’000
Current service cost	60,000

Interest cost (8% x 187,500)	15,000
Contributions incorrectly charged to profit or loss	(70,000)
So adjustment equals	5,000

WN 8 – Other components of equity

Particulars	Rs.'000
Alpha – per draft financial statements	102,000
Equity element of convertible loan (WN5)	23,880
Actuarial gain/(loss) on defined retirement benefits plan (WN9)	(12,500)
	113,380

WN 9 – Actuarial gain/(loss) on defined benefit pension plan

Particulars	Rs.'000
Opening liability	187,500
Current service cost	60,000
Interest cost	15,000
Contributions paid into plan	(70,000)
	192,500
Actuarial loss on re-measurement (balancing figure)	12,500
Closing liability	205,000

WN 10 – Long-term borrowings

Particulars	Rs.'000
Opening loan element (300,000 – 23,880 (WN5))	276,120
Finance cost less interest paid (WN6)	4,090
So closing loan element for Alpha equals	280,210
Long-term borrowings of Beta	85,000
So consolidated long-term borrowings equals	365,210

WN 11 – Deferred tax

Particulars	Rs.'000
Alpha + Beta – per draft SOFP (69,000 + 54,000)	123,000
On closing fair value adjustments in Beta (WN1)	9,000
On unrealized profits in inventory (2,000 x 20%)	(400)
	131,600

2.

a)

i) On 1 Shrawan 2076, M Company granted 1000 share appreciation rights (SARs) each to its 450 employees. All of the rights vested on 31 Ashadh 2078 can be exercised from 1 Shrawan 2078 up to Ashadh end 2080. At the grant date, the value of each SAR was Rs. 100, and it was estimated that 5% of the employees would leave during the vesting period. The fair value of the SARs is as follows:

Date	Fair value of SAR
Ashadh end 2077	Rs. 90
Ashadh end 2078	Rs. 110
Ashadh end 2079	Rs. 120

All the employees who were expected to leave the employment did leave the company as expected before 31 Ashadh 2078. On Ashadh end 2079, 90 employees exercised their options when the intrinsic value of the right was Rs. 105 and was paid in cash. M Company is, however, confused as to whether to account for the SARs under NFRS 2 "Share-based Payment" or NFRS 13 "Fair Value Measurement" and would like to be advised as to how the SARs should have been accounted for from the grant date to Ashadh end 2079.

Required: **8**

Advise, with appropriate explanations, M Company on how the above transactions should be accounted for in its financial statements of Ashadh end 2077, 2078 and 2079 with reference to relevant Nepal Financial Reporting Standards (NFRS).

ii) An entity sometimes displays its financial statements or other financial information in a currency that is different from either its functional currency or its presentation currency simply by translating all amounts at end-of-period exchange rates. This is sometimes called a convenience translation. A result of making a convenience translation is that the resulting financial information does not comply with all NFRS, particularly NAS 21 "The effects of Changes in Foreign Exchange Rates".

Required: **2**

Explain the disclosure requirements when convenience translation is used to display financial information.

b) A Ltd. is engaged in the manufacturing of certain specialized chemicals. During the manufacturing process, certain waste water is produced which is released by A Ltd. in the nearby river. To reduce pollution of the rivers, the state government has introduced a scheme with the following salient features:

i) If a manufacturer installs certain pre-approved waste water treatment plant, the government will provide an interest free loan equal to 50% of the cost of the plant;
ii) Such loan will be repayable to the government in 5 years from the date of disbursal;
iii) The manufacturer availing the benefit of this scheme must treat the waste water of its factory using the specified plant before releasing it to the river. If this condition is violated, the entire loan shall become immediately repayable to the government along with a penalty of Rs. 1 million.

Cost of the wastewater treatment plant to be installed to avail the benefit of the scheme is Rs. 5 million. A Ltd. decided to utilise this scheme because, if it were to obtain the similar loan from a bank, it would be available at a market interest rate of 12% per annum. Accordingly, it applied for and obtained the government loan of Rs. 2.5 million on 1 Shrawan 2077. The company purchased and installed the plant such that it became ready for use on the same date.

A Ltd. has an accounting policy of recognising government grant in relation to depreciable assets in the proportion of depreciation expense. It has determined that the plant will be depreciated over a period of 5 years using straight-line method. In the month of Ashadh 2079, government officials conducted a surprise audit, and it was found that the company was not using the waste water treatment plant as prescribed. Accordingly, on 32 Ashadh 2079, the government ordered A Ltd. to repay the entire loan along with penalty. The company repaid the loan with interest and penalty as per the order on 32 Ashadh 2079.

Required: **(3+3+4=10)**

i) Measure the amount of government grant as on 1 Shrawan 2077 with explanation of relevant provisions of relevant NFRS.

ii) Determine the nature of the government grant and its accounting treatment (principally) for the year ended 31 Ashadh 2078.

iii) Determine the impact on profit or loss if any, on account of revocation of government grant as on 32 Ashadh 2079.

Give journal entries as well for the above three requirements.

Answer

2 a)

i) M Company will account for this transaction under the provisions of NFRS 2 "Share based payment". NFRS 13 applies when another NFRS requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements). NFRS 13 specifically excludes transactions covered by certain other standards including share-based payment transactions within the scope of NFRS 2 and leasing transactions within the scope of NFRS 16 "Leases".

For cash settled share-based payment transactions, the fair value of the liability is measured in accordance with NFRS 2 initially, at each reporting date and at the date of settlement using an option pricing model. Unlike equity settled transactions, the measurement reflects all conditions and outcomes on a weighted average basis. Any changes in fair value are recognised in profit or loss in the period.

Therefore, the SARs would be accounted for as follows:

Year	**Expense**	**Liability**	**Calculation**	
Ashadh end 2077	Rs. 19,260,000	Rs. 19,260,000	428 x 1,000 x Rs. 90 x ½	Time apportioned over the vesting period. Using the estimated (450 x 95%) 428 employees
Ashadh end 2078	Rs. 27,820,000	Rs. 47,080,000	428 x 1,000 x Rs. 110	Expense is the difference between liabilities at Ashadh end 2078 and Ashadh end 2077
Ashadh end 2079	Rs. 2,930,000	Rs. 40,560,000	338 x 1,000 x Rs. 120	Cash paid is 90 x 1,000 xRs. 105, i.e. Rs. 9,450,000. The liability has been reducedby Rs. 6,520,000 (47,080,000-40,560,000) and therefore the expense is the difference of Rs. 2,930,000 (9,450,000-6,520,000)

The liability's fair value would be Rs. 40,560,000 at Ashadh end 2079 and the expense for the year would be Rs. 2,930,000.

Statement of profit or loss for the year ended (Extracts)

	2077	2078	2079
	Rs.	Rs.	Rs.
Staff costs	19,260,000	27,820,000	2,930,000

Statement of financial position as at (Extracts)

	2077	2078	2079
	Rs.	Rs.	Rs.
SARs liabilities	19,260,000	47,080,000	40,560,000

ii) The disclosure requirement when convenience translation is used include:

- Identify the information as supplementary information to distinguish it from the information that complies with NFRS.

- Disclose the currency in which the supplementary information is displayed.
- Disclose the entity's functional currency and the method of translation used to determine the supplementary information.

2b) i) As per the principles of NAS 20 "Accounting for Government Grants and Disclosure of Government Assistance", the benefits of a government loan at a below market rate of interest is treated as a government grant. The loan shall be recognized and measured in accordance with NFRS 9 "Financial Instruments". The benefit of the below market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with NFRS 9 and the proceeds received. The benefit is accounted for in accordance with NAS 20. As per NFRS 9, the loan should be initially measured at its fair value.

Initial recognition of grant as on 1st Shrawan, 2077

Fair value of loan = Rs. 2,500,000 x 0.567 (PVF @ 12%, 5th year) = Rs. 1,417,500

A Ltd. will recognize Rs. 1,082,500 (2,500,000 – 1,417,500) as the government grant and will make the following entry on receipt of loan:

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
1.4.20X1	Bank account Dr.	2,500,000	
	To Deferred Grant Income		1,082,500
	To Loan account		1,417,500
	(Being grant initially recorded at fair value)		

ii) Accounting treatment for year ending 31st Ashadh, 2078

As per NAS 20, grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets.

As per NAS 20, Government grants related to assets, including non-monetary grants at fair value, shall be presented in the balance sheet either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset.

One method recognises the grant as deferred income that is recognised in profit or loss on a systematic basis over the useful life of the asset.

The other method deducts the grant in calculating the carrying amount of the asset. The grant is recognised in profit or loss over the life of a depreciable asset as a reduced depreciation expense.

A Ltd. has adopted first method of recognising the grant as deferred income that is recognised in profit or loss on a systematic basis over the useful life of the asset. Here, deferred income is recognised in profit or loss in the proportion in which depreciation expense on the asset is recognised.

Depreciation for the year (2077-2078) = Rs. 5,000,000 / 5 years = Rs. 1,000,000

As the loan is to finance a depreciable asset, Rs. 1,082,500 will be recognized in Profit or Loss on the same basis as depreciation.

Since the depreciation is provided on straight line basis by A Ltd., it will credit Rs. 216,500 (1,082,500 / 5) equally to its statement of profit and loss over the 5 years.

Journal Entries

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)

31.3.2078	Depreciation (Profit or Loss A/c) Dr.	1,000,000	
	To Property, Plant & Equipment		1,000,000
	(Being depreciation provided for the year)		
	Deferred grant income Dr.	216,500	
	To Profit or Loss		216,500
	(Being deferred income adjusted)		

iii) Impact on profit or loss due to revocation of government grant as on 32nd Ashadh 2079

As per para NAS 20, a government grant that becomes repayable shall be accounted for as a change in accounting estimate. Repayment of a grant related to income shall be applied first against any unamortised deferred credit recognised in respect of the grant. To the extent that the repayment exceeds any such deferred credit, or when no deferred credit exists, the repayment shall be recognised immediately in profit or loss.

Amount payable to Government on account of principal loan = Rs. 25,00,000

Amount payable to Government on account of penalty= Rs. 10,00,000

Journal Entries

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31.3.2079	Deferred grant income Dr.	216,500	
	To Profit or Loss		216,500
	(Being deferred income adjusted)		
	Loan account (WN1) Dr.	1,778,112	
	Deferred grant income (WN2) Dr.	649,500	
	Profit or Loss Dr.	72,388	
	To Government grant payable		2,500,000
	(Being refund of government grant)		
	Profit or Loss Dr.	1,000,000	
	To Government grant payable		1,000,000
	(Being penalty payable to government)		

Therefore, total impact on profit or loss on account of revocation of government grant as on 32nd Ashadh, 2079 will be Rs. 1,072,388 (1,000,000 + 72,388).

Circumstances giving rise to repayment of a grant related to an asset may require consideration to be given to the possible impairment of the new carrying amount of the asset.

Working Notes:

1. Amortisation Schedule of Loan

Year	Opening balance of Loan	Interest @ 12%	Closing balance of Loan
31.03.2078	1,417,500	170,100	1,587,600
32.03.2079	1,587,600	190,512	1,778,112

2. Deferred Grant Income

Year	Opening balance	Adjustment	Closing balance

31.03.2078	1,082,500	216,500	866,000
32.03.2079	866,000	216,500	649,500

3.

a) Delta is an entity which prepares financial statements to 31 March each year. The functional currency of Delta is the dollar ($). The following events have occurred which are relevant to the year ended 31 March 2018:

Event 1:
On 1 January 2018, Delta entered into a contract with a foreign supplier. The terms of the contract were that the supplier would construct a large machine for Delta's use and deliver the machine on 30 June 2018. The total construction price of 20 million groats (the currency of the supplier) is due for payment on 31 July 2018.

On 1 January 2018, Delta entered into an agreement for the forward purchase of 20 million groats. The settlement date for this forward purchase of foreign currency was 31 July 2018. It intends to use this forward purchase as a hedge of the expected cash outflow flows arising under the construction contract on 31 July 2018.

Delta wishes to use hedge accounting for this arrangement if this is possible under International Financial Reporting Standards. It has prepared all relevant documentation which is necessary to enable hedge accounting to be used if the qualifying conditions are met.
Data relevant to the construction contract and to the forward purchase of currency is as follows:

– Increase in expected cash flows arising under the construction contract between 1 January 2018 and 31 March 2018 = $2,600,000.
– Positive fair value of forward currency purchase contract at 31 March 2018 = $2,700,000.

Event 2:
On 1 February 2018, Delta purchased some inventory from a supplier whose functional currency was the dinar. The total purchase price was 3·6 million dinars. The terms of the purchase were that Delta would pay for the goods in two instalments. The first instalment payment of 1,260,000 dinars was due on 15 March 2018 and the second payment of 2,340,000 dinars on 30 April 2018. Both payments were made on the due dates. Delta did not undertake any activities to hedge its currency exposure arising under this transaction. Delta sold 60% of this inventory prior to 31 March 2018 for a total sales price of $480,000. All sales proceeds were receivable in $. After 31 March 2018, Delta sold the remaining inventory for sales proceeds which were in excess of their cost.

Relevant exchange rates are as follows:
– 1 February 2018 – 6·0 dinars to $1.
– 15 March 2018 – 6·3 dinars to $1.
– 31 March 2018 – 6·4 dinars to $1.

Required: **(5+5=10)**
Explain and show how the events would be reported in the financial statements of Delta for the year ended 31 March 2018.

b) Given below is the Profit and Loss Account of Nepal Cement Ltd. for the year ending 32 Ashadh 2079:

Nepal Cement Ltd.
<u>Profit and Loss Account for the fiscal year ending 32 Ashadh 2079</u>

	Notes	Amount (Rs. '000')
Income		
Sales	i	28,525
Other Income		756
		29,281
Expenditure		
Operating cost	ii	25,658
Customs Duty		1,718
Interest on Bank Overdraft	iii	93
Interest on 10% Debentures		1,157
		28,626
Profit before depreciation		655
Less: Depreciation		255
Profit before tax		400
Less: Provision for tax	iv	275
Profit after tax		125
Less: Transfer to Fixed Asset Replacement Reserve		25
		100
Less: Dividend paid and payable		45
Retained Profit		55

Notes:

i) This represents the invoice value of goods supplied after deducting discounts, returns and sales tax.

ii) Operating cost includes Rs. 10,247,000 as wages, salaries and other benefits to employees.

iii) The bank overdraft is treated as a temporary source of finance.

iv) The charge for taxation includes a transfer of Rs. 45,000 to the credit of deferred tax account.

Required: **(5+5=10)**

i) Prepare a value added statement for the year ending 32 Ashadh 2079.

ii) Reconcile total value added with profit before taxation.

Answer

3 a) Event 1:

Under the principles of NFRS 9 – Financial Instruments (revised 2014) – Delta is permitted to use hedge accounting when reporting the hedging arrangement in its financial statements. This is because:

- The relevant documentation has been prepared.
- There is a clear economic relationship between the hedged cash flows and the hedging instrument.
- Delta is entering into a forward purchase of exactly the required amount of foreign currency.

The hedging instrument is a derivative financial instrument. Derivatives are normally measured at fair value in the financial statements with changes in fair value being recognised in profit or loss.

On 31 March 2018, the derivative would be recognised in the financial statements as a current asset at its fair value of $2·7 million.

The hedged item is designated to be the changes in the expected cash flows arising on the contract. For the year ended 31 March 2018, changes in the expected cash flows arising under the contract would not be recognised since the contract is an executory contract (a contract made by two parties in which the terms are set to be fulfilled at a later date).

Since the hedging documentation indicates that the hedged item is the changes in the expected cash flows, then cash flow hedge accounting is used. In this case, this involves comparing the change in the value of the derivative (the recognised hedging instrument) with the (unrecognised) changes in the value of the expected cash flows arising under the contract.

To the extent that the change in the value of the derivative is less than or equal to the change in the value of the expected cash flows (the effective portion of the hedge), the change in value of the derivative is recognised in other comprehensive income rather than profit or loss. However, any over-hedging would result in any gains or losses arising on the hedging instrument which relate to the over-hedging (the ineffective portion of the hedge) being immediately be recognised in profit or loss.

In this case, the overall gain in fair value of the derivative between 1 January 2018 and 31 March 2018 is $2·7 million.

In the same period, the change in the expected value of the cash flows arising under the contract is $2·6 million. Therefore $2·6 million of the gain on the derivative would be recognised in other comprehensive income with the balance of $100,000 being recognised in profit or loss.

Event 2:

Under the principles of IAS 21 "The Effects of Changes in Foreign Exchange Rates" the purchase of inventory on 1 February 2018 would be recorded using the spot rate of exchange on that date. Therefore Delta would recognise a purchase and an associated payable of $600,000 (3·6 million dinars/6).

Delta would recognise revenue of $480,000 in the statement of profit or loss because goods to the value of $480,000 were sold prior to 31 March 2018.

Delta would recognise $360,000 ($600,000 x 60%) in cost of sales because the revenue of $480,000 is recognised.

The closing inventory of goods purchased from the foreign supplier would be $240,000 ($600,000 – $360,000) and would be recognised as a current asset. This would not be re-translated since inventory is a non-monetary asset.

The payment of 1,260,000 dinars on 15 March 2018 would be recorded using the spot rate of exchange on that date, therefore the payment would be recorded at $200,000 (1,260,000 dinars/$6·3).

The closing payable of 2,340,000 dinars (3,600,000 dinars – 1,260,000 dinars) is a monetary item, therefore would be translated at the rate of exchange in force at the year end (6·4 dinars to $1). Therefore the closing payable (recorded in current liabilities) would be $365,625 (2,340,000 dinars/$6·4).

The difference between the initially recognised payable ($600,000) and the subsequently recognised payment ($200,000) is $400,000. Since the closing payable is $365,625 (see above), Delta has made an exchange gain of $34,375 ($400,000 – $365,625). This gain is recognised in the statement of profit or loss, either under other income category or as a reduction in cost of sales.

3 b)

i) Value added statement

Nepal Cement Ltd.
Value Added Statement
For the year ending on 32nd Ashadh 2079

Particulars	Rs. in '000'	Rs. in '000'	%
Sales		28,525	
Less: Cost of bought in material and services			
Operating cost (25,658-10,247)	15,411		
Customs Duty	1,718		
Interest on bank overdraft	93	17,222	
Value added by manufacturing and trading activities		11,303	

Add: Other income		756	
Total value added		12,059	
Application of value added:			
To pay employees:			
Wages, salaries and other benefits		10,247	84.97
To pay government:			
Corporation tax (275-45)		230	1.90
To pay providers of capital:			
Interest on 10% Debentures	1,157		
Dividends	45	1,202	9.98
To provide maintenance and expansion of company			
Depreciation	255		
Fixed Assets Replacement Reserve	25		
Deferred Tax Account	45		
Retained profit	55	380	3.15
Total		12,059	100

ii) Reconciliation between Total Value Added and Profit Before Taxation

	Rs. in '000'	Rs. in '000'
Profit before tax		400
Add back:		
Depreciation	255	
Wages, salaries and other benefits	10,247	
Debenture interest	1,157	11,659
Total Value Added		12,059

Notes:

- Customs Duty and deferred tax could alternatively be shown as a part of "To pay government".
- Bank overdraft, being a temporary source of finance, has been considered as the provision of a banking service rather than of capital. Therefore, interest on bank overdraft has been shown by way of deduction from sales and as a part of 'cost of brought in materials and services'

4. Write short note/ answer on the following: **(5×3=15)**

a) Defined Conglomerate Merger
b) Lev and Schwartzon model of Human Resource Value Accounting
c) What is insurance contract? List down the examples that are insurance contract.
d) Fair value as set out in NFRS 13
e) When does debt seem to be equity?

Answer

4 a) Defined Conglomerate merger

This is joining of two or more companies whose businesses are not related with each other either vertically or horizontally. The companies involved in the merger may be manufacturing totally different products. Of course, there may be some common features between them such as same channel of distribution or technological area.

The basic objective behind such a merger is the diversification of activities. Such a merger may also lead to concentration of economic power by virtue of controlling by the merged corporation different fields of business activities. For example, a company engaged in manufacturing activities may get itself merged with a company engaged in Insurance business. The two companies are totally different and therefore such merger is defined conglomerate merger.

4 b) Lev and Schwartzon Model on Human Resource Value Accounting:

Human resource accounting is the process of identifying and reporting investments made in the human resources of an organization that are presently unaccounted for in the conventional accounting practices. It is an extension of standard accounting principles. Measuring the value of the human resources can assist organizations in accurately documenting their assets.

One of the important approach to the evaluation of human resource assets is to calculate their economic values. The economic value of the firm can be determined by obtaining the present value of future earnings. A number of valuation models have been developed for determining the present value of future earnings.

<u>Lev and Schwartzon</u>

Lev & Schwartz advocated the estimation of future earnings during the remaining service life of the employee and then arriving at the present value by discounting the estimated earnings at the cost of capital. The assumptions in this method are realistic and scientific.

The method has practical applicability when the availability of quantifiable and analyzable data is concerned.

Still, this model cannot give any method to record the value of human resources in the Books of Accounts. According to this model, the value of human resources is ascertained in the following ways:

- All employees are classified into specific groups according to age, experience, and skill.
- Average annual earnings are determined for various ranges of age.
- The total earnings each group will get up to retirement age are calculated.
- The total earnings calculated as above are discounted at the rate of the cost of capital.
- The value thus arrived at will be the value of human resources/assets.

This method has some limitations, which are as follows:

- This method does not indicate the accounting treatment of human resources.
- This method only considers wages and salaries, but wages and salaries are not only the costs associated with the employees. Other costs are associated with the employees.
- The model ignores the possibility and probability that an individual may leave an organization for reasons other than death or retirement. The model's expected value of human capital measures a person's human capital's expected 'conditional value.' The implicit condition is that the person will remain in an organization until death or retirement. This assumption is not practical.

4 c) Insurance contract is a "contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder." The following are examples of insurance contracts:

- Insurance against theft or damage to property
- Insurance against product liability, professional liability, civil liability or legal expenses
- Life insurance and prepaid funeral expenses
- Life-contingent annuities and pensions
- Disability and medical cover
- Surety bonds, fidelity bonds, performance bonds and bid bonds
- Credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due
- Product warranties (other than those issued directly by a manufacturer, dealer or retailer)
- Title insurance
- Travel assistance
- Catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond

- Insurance swaps and other contracts that require a payment based on changes in climatic, geological or other physical variables that are specific to a party to the contract
- Reinsurance contracts.

4 d) Fair value as set out in NFRS 13

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Basically it is an exit price. Fair value is focused on the assumptions of the market place and is not entity specific. It therefore takes into account any assumptions about risk. Fair value is measured using the same assumptions and taking into account the same characteristics of the asset or liability as market participants would. Such conditions would include the condition and location of the asset and any restrictions on its sale or use. Further, it is not relevant if the entity insists that prices are too low relative to its own valuation of the asset and that it would be unwilling to sell at low prices. Prices to be used are those in ‘an orderly transaction’.

An orderly transaction is one that assumes exposure to the market for a period before the date of measurement to allow for normal marketing activities and to ensure that it is not a forced transaction. If the transaction is not ‘orderly’, then there will not have been enough time to create competition and potential buyers may reduce the price that they are willing to pay. Similarly, if a seller is forced to accept a price in a short period of time, the price may not be representative. It does not follow that a market in which there are few transactions is not orderly. If there has been competitive tension, sufficient time and information about the asset, then this may result in a fair value for the asset.

Fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the principal market for the asset or liability or, in the absence of a principal market, in the most advantageous market for the asset or liability. The principal market is the one with the greatest volume and level of activity for the asset or liability that can be accessed by the entity.

The most advantageous market is the one which maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability after transport and transaction costs.

4 e) Many financial instruments have both features of debt and equity that this can lead to inconsistency of reporting. It is not easy always to distinguish the debt and equity in an entity‘s statement of financial position.

The key feature of debt is that the issuer is obliged to deliver either cash or another financial asset to the holder. In contrast, equity is any contract that evidences a residual interest in the entity‘s assets after deducting all of its liabilities. Thus, A financial instrument is an equity instrument only if the instrument includes no contractual obligation to deliver cash or another financial asset to another entity, and if the instrument will or may be settled in the issuer's own equity instruments.

For example,

- a bond that requires the issuer to make interest payments and redeem the bond for cash is classified as debt.
- ordinary shares, where all the payments are at the discretion of the issuer, are classified as equity of the issuer.
- preference shares required to be redeemed on a fixed date, or on the occurrence of an event that is certain to occur, should be classified as debt.
- preference shares required to be converted into a fixed number of ordinary shares on a fixed date, or on the occurrence of an event that is certain to occur, should be classified as equity.

5.

a) ‘Nepal Public Sector Accounting Standard’ states "All comparisons of budget and actual amount shall be presented on a comparable basis to the budget". Explain the detail provisions of above standard for comparison of budget and actual amount. **8**

b) Sundhara entered into a 20 years operating lease for a property on 1 Shrawan 2066 which has a remaining life of eight years at 1 Shrawan 2078. The rental payments are Rs. 2.3 million per year.

Prior to 1 Shrawan 2078, Sundhara obtained permission from the owner of the property to make some internal alterations to the property so that it can be used for a new manufacturing processes which Sundhara is undertaking. The cost of these alterations was Rs. 7 million and they were completed on 1 Shrawan 2078 (the time taken to complete the alterations can be taken as being negotiable). A condition of being granted permission was that Sundhara would have to restore the property to its original condition before handling back the property at the end of the lease. The estimated restoration cost on 1 Shrawan 2078, discounted at 8% per annum to its present value, is Rs. 5 million.

Required: **(3+4=7)**

i) Explain how the lease, the alterations to the leased property and the restoration costs should be treated in the financial statements of Sundhara for the year ended 32 Ashadh 2079.

ii) Prepare extracts from the financial statements of Sundhara for the year ended 32 Ashadh 2079 reflecting your answer to (i) above.

Answer

5 a) Clause 1.9.25 to 1.9.30 of Nepal Public Sector Accounting Standard issued by Accounting Standard Board of Nepal deals with the comparable basis for comparison of budget and the actual amount. The content of above standard are given below:

1.9.25 All comparisons of budget and actual amounts shall be presented on a comparable basis to the budget.

1.9.26 The comparison of budget and actual amounts will be presented on the same accounting basis (accrual, cash or other basis), same classification basis and for the same entities and period as for the approved budget. This will ensure that the disclosure of information about compliance with the budget in the financial statements is on the same basis as the budget itself. In some cases, this may mean presenting a budget and actual comparison on a different basis of accounting, for a different group of activities, and with a different presentation or classification format than that adopted for the financial statements.

1.9.27 Financial statements consolidate entities and activities controlled by the entity. As noted in paragraph 1.9.10, separate budgets may be approved and made publicly available for individual entities or particular activities that make up the consolidated financial statements. Where this occurs, the separate budgets may be recompiled for presentation in the financial statements in accordance with the requirements of this Standard. Where such recompilation occurs, it will not involve changes or revisions to approved budgets. This is because this Standard requires a comparison of actual amounts with the approved budget amounts.

1.9.28 Entities may adopt different bases of accounting for the preparation of their financial statements and for their approved budgets. For example, in some, cases a government or government agency may adopt the cash basis for its financial statements and the accrual basis for its budget. In addition, budgets may focus on, or include information about, commitments to expend funds in the future and changes in those commitments, while the financial statements will report cash receipts and payments and balances thereof. However, the budget entity and financial reporting entity will often be the same. Similarly, the period for which the budget is prepared and the classification basis adopted for the budget will often be reflected in financial statements. This will ensure that the accounting system records and reports financial information in a manner which facilitates the comparison of budget and actual data for management and for accountability purposes - for example, for monitoring progress of execution of the budget during the budget period and for reporting to the government, the public and other users on a relevant and timely basis.

1.9.29 In some cases, budgets may be prepared on a cash or accrual basis consistent with a statistical reporting system that encompasses entities and activities different from those included in the financial statements. For example, budgets prepared to comply with a statistical reporting system may focus on the general government sector and encompass only entities fulfilling the "primary" or "non-market" functions of government as their major activity, while financial statements report on all activities controlled by a government, including the business activities of the government.

1.9.30 In statistical reporting models, the general government sector may comprise national, state/provincial and local government levels. Sometimes, the national government may control state/provincial and local governments, consolidate those governments in its financial statements and develop, and require to be made publicly available, an approved budget that encompasses all three levels of government. In these cases, the requirements of this Standard will apply to the financial statements of those national governmental entities. However, where a national government does not control state or local governments, its financial statement will not consolidate state/provincial or local governments. Rather, separate financial statements are prepared for each level of government. The requirements of this Standard will only apply to the financial statements of governmental entities when approved budgets for the entities and activities they control, or subsections thereof, are made publicly available.

5 b)

(i) The alterations to the leased property do not affect the lease itself and this should continue to be treated as an operating lease and charging profit or loss with the annual rental of Rs. 2.3 million.

The initial cost of the alterations should be capitalized and depreciated over the remaining life of the lease. In addition to this, NAS 37 "Provisions, contingent assets and contingent liabilities" requires that the cost of restoring the property to its original condition should be provided for on 1 Shrawan 2078 as this is when the obligation to incur the restoration cost arises (as the time taken to do the alteration is negligible). The present value of the restoration costs, given as Rs. 5 million, should be added to the initial cost of the alterations and depreciated over the remaining life of the lease. A corresponding provision should be created and a finance cost of 8% per annum should be charged to profit or loss and accrued on this provision.

(ii) Extracts from the financial statements of *Sundhara*

Statement of profit or loss for the year ended 32 Ashadh 2079	Rs. 000’
Operating lease rental	2,300
Depreciation of alterations to leased property (12,000/8 years)	1,500
Finance cost (5,000 x 8%)	400
Statement of financial position as at 32 Ashadh 2079	
Non current assets	
Alterations to leased property (7,000 + 5,000)	12,000
Accumulated Depreciation (above)	(1,500)
Carrying amount	10,500
Non-current liabilities	
Provision for property restoration costs (5,000 + 400 above)	5,400

6.

a) Astha Ltd. made a decision to sell a business unit on 15 Aswin, 2079, and the criteria to classify the unit as held for sale were met on 1 Kartik 2079. Astha

Ltd.'s accounting year end is 31 Chaitra. At 1 Kartik, 2079, the carrying amount of the assets and liabilities of the business unit (before any depreciation for the year 2079 or revaluation adjustments) was as follows:

	Rs. million
Land and buildings	120
Equipment	50
Trade receivables	30
Inventories	20
Trade payables	(26)

Additional Information:

i) The land and buildings are held under the revaluation model of NAS 16 "Property, Plant and Equipment" and were last revalued on 31 Chaitra 2078 to Rs. 120 million. Their market valuation on 1 Kartik 2079 was Rs. 124 million and selling costs were estimated at Rs. 2.5 million at that date. Residual value was, and continues to be, expected to be higher than cost.

ii) The equipment is held under the cost model of NAS 16. The equipment was purchased on 1 Kartik 2077 for Rs. 80 million and is being depreciated straight line over a four-year period to a zero residual value. Its sale value at 1 Kartik 2079 was Rs. 55 million. Selling costs are insignificant.

iii) The trade receivables are recorded at invoiced value, reduced by any allowances for credit losses recognised at 31 Chaitra 2078. No adjustment to these allowances was necessary at 1 Kartik 2079. The receivables, if factored, would realise approximately Rs. 26 million, net of transaction costs at 1 Kartik 2079.

iv) The inventories are merchandise purchased for resale and are held at cost. Their market value at 1 Kartik 2079 was Rs. 28 million. Associated selling costs would amount to Rs. 1.4 million.

v) It was anticipated at 1 Kartik, 2079 that the business unit will be sold for Rs. 200 million, net of selling costs, to a rival company in a single transaction.

Required: **5**

In respect of Astha Ltd.'s year ended 31 Chaitra 2079, show and briefly explain, the amount recognised as Non-Current Assets Held for Sale under NFRS 5 at 1 Kartik 2079 and the impairment charge (if any) for the business unit.

(6)

b) The following is the Balance Sheet of Sunrise Ltd. as on 32 Ashadh 2079:

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	
10,000 Equity Shares		Machinery	800,000
of Rs. 100 each 1,000,000		Factory Shed	300,000
Less: Calls in Arrear		Vehicles	200,000
(Rs. 20 for Final Call) 50,000	950,000	Furniture	50,000
Reserve and Surplus		Current Assets	
General Reserve	400,000	Inventory	400,000
Profit & Loss Account	230,000	Sundry Debtors	750,000
Current Liabilities		Bank Balance	60,000
Bank Overdraft	500,000	Preliminary Expenses	20,000
Creditors	500,000		
Total	2,580,000	Total	2,580,000

The following additional information is furnished:

a) Machinery and Factory Shed are worth 30% above their book value. Depreciation on appreciated value of Machinery and Factory Shed is not to be considered for valuation of goodwill and shares.

b) For the purpose of valuation of shares, goodwill is to be considered on the basis of 4 years' purchase of super profits based on average profit (after tax) of the last 3 years. Profit of the last 3 years (after tax) are as follows:

For the year ended 31.3.2077	Rs. 260,000
For the year ended 31.3.2078	Rs. 350,000
For the year ended 32.3.2079	Rs. 290,000

c) During the year ended on 31.3.2077, new addition to Factory Shed costing Rs. 20,000 was charged to Profit & Loss Account. Depreciation charged on Factory Shed is @ 10% on reducing balance method.

d) In a similar business, return on Capital Employed is 15% (after tax).

e) Income Tax rate is 25%

Required: **5**

Find out the value of each fully paid and partly paid Equity Share on Net Assets basis.

Answer

6 a) Non-Current Assets Held for Sale (NFRS 5)

Carrying amount at 1 Kartik, 2079, after applying NAS 16:

	Rs. million
Land and buildings	124
Equipment (50 – (80/4 years × 6/12))	40
Trade receivables	30
Inventories	20
Trade payables	(26)
	188

Any test for impairment will be based on the disposal group as a whole. As a disposal group, fair value less costs to sell (Rs. 200 million) is higher than carrying amount (Rs.188 million) there is no impairment charge.

The amount recognised as non-current assets held for sale is therefore:

	Rs. million
Land and buildings	124
Equipment	40
	164

Trade receivables and inventories are outside the scope of NFRS 5.

6 b) Sunrise Ltd.

Statement of Valuation of Shares

Particulars	Amount (Rs.)
Net tangible assets (W N 1)	1,908,954
Add: Goodwill (W N 3)	69,208
Add: Calls in arrears	50,000
	2,028,162
No. of Equity Shares	10,000
Value of fully paid Equity share (Rs. 2,028,162/10,000)	Rs. 202.82
Value of partly paid Equity Share (Rs. 202.82-Rs. 20.00)	Rs. 182.82

Working Notes:

1) Statement of Net Tangible Assets (as on 32nd Ashadh 2079)

Particulars		Amount (Rs.)	Amount (Rs.)
Machinery		800,000	
Add: 30% increase		240,000	1,040,000
Factory Shed		300,000	
Add: 30% increase		90,000	390,000
Addition to factory shed on 2076/77		20,000	
Less: Depreciation			
For 2076/77	Rs 2,000		
For 2077/78	Rs 1,800		
For 2078/79	Rs 1,620	5,420	
		14,580	
Add: 30% appreciation		4,374	18,954
Vehicle			200,000
Furniture			50,000
Inventory			400,000
Debtors			750,000
Bank			60,000
			2,908,954

Less: Bank Overdraft	500,000	
Creditors	500,000	1,000,000
Net Tangible Assets		1,908,954

2) Average Annual Profits

Particulars	2076/77 Rs.	2077/78 Rs.	2078/79 Rs.
Reported Profit (after tax)	260,000	350,000	290,000
Add: Cost of Additional Factory Shed (net of tax) (Rs 20,000-Rs 5,000*)	15,000		
	275,000		
Less: Depreciation (net of tax) on additional factory shed*	1,500	1,350	1,215
	273,500	348,650	288,785

Average Profit of three years
(273,500+348,650+288,785)/3 = Rs 303,645

- 25% Tax saved in Expenses.

Fiscal Year	Depreciation Rs.	Tax @ 25% Rs.	Depreciation Net of Tax Rs.
2076/77	2,000	500	1,500
2077/78	1,800	450	1,350
2078/79	1,620	405	1,215

3) Value of Goodwill

Particulars	Amount (Rs.)
Capital Employed (net of tangible assets as per WN 1)	1,908,954
Average Profit (as per WN 2)	303,645
Less: Normal Profit @ 15% of Capital employed	286,343
Super Profit	17,302
Value of Goodwill (4 years' purchase of super profits) (Rs 17,302*4)	69,208

Paper 2: Advanced Financial Management

Marks

Attempt all questions.

Working notes should form part of the answers. Make assumptions wherever necessary.

1. Sagarmatha Ltd. is considering whether to set up a division in order to manufacture a new product, SML. The projected profitability per unit of the new product is:

Particulars	**Rs.**	**Rs.**
Selling price		2,200
Material (3 Kgs @ Rs. 150 per Kg)	450	
Direct Labour (2 Hours @ Rs. 250 per hour)	500	
Overheads	1,150	2,100
Profit per unit		100

A feasibility study, recently undertaken at a cost of Rs. 5,00,000 suggests that a selling price of Rs. 2,200 per unit should be set. At this price, it is expected that 10,000 units would be sold each year. Demand for the product is expected to cease after 5 years. Direct Labour and Material cost would be incurred only for the duration of the product life.

Overheads per unit have been calculated as follows:

Particulars		Rs.
Variable overheads		250
Rent	Note (a)	80
Manager's Salary	Note (b)	70
Depreciation	Note (c)	500
Head office cost	Note (d)	250
Total		1,150

Note:

(a) SML would be manufactured in a factory rented specially for the purpose. Annual rental would be Rs. 8,00,000 payable only for as long as the factory is occupied.

(b) A Manager would be employed to supervise production of SML at a salary of Rs. 7,00,000 per annum. The Manager is at present employed by the company but is due to retire in the near future on an annual pension of Rs. 200,000. If he continued to be employed his pension would not be paid during the period of employment. His subsequent pension rights would not be affected.

(c) Manufacture of the SML would require a specialized machine costing Rs. 2.5 crore. The machine would be capable of producing SML for an indefinite period, although due to its specialized nature it would not have any resale or scrap value when the production of SML ceased. It is the policy of Sagarmatha Ltd., to provide depreciation on all fixed assets using the straight line method. The annual charge of Rs. 50,00,000 for the new machine is based on a life of 5 years, equal to the period during which SML are expected to be produced.

(d) Sagarmatha Ltd. allocates its Head office fixed costs to all products at the rate of Rs. 125 per Direct Labour Hour. Total Head office fixed costs would not be affected by the introduction of the SML to the Company's range of products.

The required return of Sagarmatha Ltd. for all new projects is estimated at 5% per annum in real terms, and you may assume that all the costs and prices given above will remain constant in real terms.

All the cash flows would arise at the end of each year with exception of the cost of machine.

Required: **20**

(a) Prepare NPV calculations, based on the estimates provided, to show whether Sagarmatha Ltd. should proceed with manufacture of the SML.

(b) Determine how sensitive the NPV of manufacturing SML is to errors of estimation in each of the three factors viz. Product Life, Annual Sales Volume and Material cost per SML.

(c) Briefly explain risk analysis in capital budgeting.

Suggested answer to Q.1

a. NPV analysis

Computation of contribution and profit

Particulars	Amount (Rs.)
Selling price (A)	2,200
Variable overheads:	
Material	450
Labour	500
Variable overhead	250
Total variable overhead (B)	1,200
Contribution per unit (A-B)	1,000
No. of units	10,000
Total contribution (1,000×10,000)	10,000,000
Less: Fixed costs:	
Rental	800,000
Manager's salary (700,000-200,000)	500,000
Profit per annum	8,700,000

Notes:

1. Incremental cost of Manager's salary is Rs. 500,000 only because Rs. 200,000 is unavoidable.
2. Depreciation on machine has not been considered in calculation in the absence of information about taxation of income.
3. Head office overhead charge has not been considered since that is not an incremental cost on the project.
4. Feasibility study cost has not been considered because that is sunk cost.

Calculation of NPV of the project

Particulars	Amount (Rs.)
Profit per annum (Net cash inflows)	8,700,000
Annuity factor @ 5% for 5 years	4.329
Present value of cash inflows	37,662,300
Less: Cost of machine	25,000,000
Net present value	12,662,300

b. Sensitivity analysis

Evaluation of sensitivity of the NPV to product's life

Year	Cash flow	PV Factor	Discounted Cash Flow	Cumulative DCF
1	8,700,000	0.952	8,282,400	8,282,400
2	8,700,000	0.907	7,890,900	16,173,300
3	8,700,000	0.864	7,516,800	23,690,100
4	8,700,000	0.823	7,160,100	30,850,200

As the cost of machine is Rs. 25,000,000, it seems to recover in between year 3 and 4 as per cumulative discounted cash flows in above table.

So, Payback period = 3 + (Cost of machine - Cumulative DCF at the end of year 3) / DCF for the year 4
= 3 + (25,000,000 - 23,690,100) / 7,160,100
= 3 + 1,309,900 / 7,160,100 = 3 + 0.18 = 3.18 years

Hence, sensitivity of NPV to Product's Life is = (5-3.18) / 5 = 36.40%

Evaluation of sensitivity of the NPV to annual sales volume

Particulars	Amount (Rs.)
Target discounted cash flow	25,000,000
Annuity factor @ 5% for 5 years	4.329
So, annual cash flow needed (25,000,000 / 4.329) (rounded to zero)	5,775,000
Add: Fixed costs:	
Rental	800,000
Manager's salary	500,000
So, Target annual contribution	7,075,000
Contribution per unit	1,000
Therefore, number of units at which NPV is zero (7,075,000 / 1,000)	7,075

Hence, sensitivity of NPV to Annual Sales Volume is = (10,000 - 7,075) / 10,000 = 29.25%

Evaluation of sensitivity of the NPV to material cost per SML

Particulars	Amount (Rs.)
Target discounted cash flow	25,000,000
Annuity factor @ 5% for 5 years	4.329
So, annual cash flow needed (25,000,000 / 4.329) (rounded to zero)	5,775,000
Add: Fixed costs:	
Rental	800,000
Manager's salary	500,000
So, Target annual contribution	7,075,000
Target contribution per unit (7,075,000 / 10,000)	707.50
Selling price per unit	2,200
So, Target variable cost per unit	1,492.50
Less: Other variable costs:	
Labour cost	500
Variable overheads	250
Target Material cost per unit	742.50

Hence, sensitivity of NPV to Material cost per SML is = (742.50 - 450) / 450 = 65%

c. Risk analysis
Identification and analysis of risk in capital budgeting is important because of the potential effects of the investment decision in the company's current and future assets is usually material and pervasive. The different types of risks that are faced by a company in capital budgeting are economic risk, corporate risk, international risk, competitive risk, market risk, industry and project specific risk etc. The better the executive understands the nature and level of risks, the better the decision and ultimately, the better financial strength of the company. In practice, executives can handle risks in two ways. The simple risk adjustment method is based on the executive's estimations and intuitive adjustments to cash flows. The probabilistic risk analysis is based on evaluation of the uncertainties associated with particular variables before decisions are made. The methods of risk analysis are sensitivity analysis, scenario analysis, break even analysis, Hillier model, simulation analysis, decision tree analysis and corporate risk analysis etc.

2.

a. Bhatbhateni Florist Pvt. Ltd (BFPL) a retail florist, is for sale at an asking price of Rs 31,00,000. You have been contacted by a potential buyer who has asked you to give him opinion as to whether the asking price is reasonable. The potential buyer has only limited information about BFPL. He does not know that annual gross sales of BFPL is about Rs 41,00,000 and that last year's Income Tax Return reported an annual profit of Rs 4,20,000 before tax.

   You have collected the following information from the financial details of several retail florist that were up for sale in the past:

   Table No. 1:

Particulars	Price-to-Sale (P/S) Ratio	Price-to-Earning (P/E) Ratio
Mean Ratio	0.55	3.29
Coefficient of Variation	0.65	1.52
Maximum Ratio	2.35	6.29
Number of firms	38	33

   Table No. 2: Top 10 players (in descending P/S Order)

Particulars	Price-to-Sale (P/S) Ratio	(P/E) Multiple
1	2.35	5.65
2	1.76	6.29
3	1.32	5.31
4	1.17	4.60
5	1.09	3.95

6	1.01	3.25
7	0.96	3.10
8	0.85	2.96
9	0.72	2.9
10	0.68	2.75

Offer you opinion on the reasonableness of the Asking price **10**

Solution:

Analysis of Industry Performance:
Average P/S ratio is 0.55. Average P/E Ratio is 3.29.
The coefficient of variation of P/S Ratio is 0.65, which is much lower than that of P/E Ratio 1.52. This indicates that there is substantially less dispersion of P/S Ratio about mean than in case of P/E Ratio. Therefore, P/S Ratio is preferable over P/E Ratio for making comparision.

Details of BFPL

Ask Price : 3,100,000
Annual Gross Sales : 4,100,000
Annual Profit before Tax in tax return = 420,000
Price to Sale (P/S) Ratio = 3,100,000/4,100,000
= 0.756

The BFPL's P/S ratio (0.756) is much higher than the industry average (0.55). However, this is far below when compared to the maximum P/S ratio (2.35) of top 10 players. The company's P/S ratio stands in between 8^{th} and 9^{th} top players in the industry..

If sales of XY Pvt. Ltd. is likely to hold in the coming years the price of the company can be calculated as below:

= 4,100,000× (0.85+0.72)/2
=4,100,000×0.785
=3.218 Million

The ask price received is Rs 3.1 Million and the fair value calculated based on the industry average is Rs. 3.218 Million. Therefore, the ask price received is quite reasonable.

b. ABC Ltd. wishes to acquire BCD Ltd. The shares issued by the two companies are 10,00,000 and 5,00,000 respectively. Calculate the increase in the total value of BCD Ltd. resulting from the acquisition on the basis of the following conditions:

Particulars	Value
Current expected growth rate of BCD Ltd.	5%
Expected growth rate under control of ABC Ltd. (without any additional capital investment and without any change in risk of operations)	7%
Current market price per share of ABC Ltd.	Rs. 100
Current market price per share of BCD Ltd.	Rs. 20
Current dividend per share of BCD Ltd.	Rs. 0.60

On the basis of aforesaid conditions calculate:

(i) the gain or loss to shareholders of both the companies, if ABC Ltd. were to offer one of its shares for every four shares of BCD Ltd.

(ii) the gain or loss to the shareholders of both the companies, if ABC Ltd. pays Rs. 25 for each share of BCD Ltd., assuming the P/E ratio of ABC Ltd. does not change after the merger. EPS ABC Ltd. is Rs. 8 and that of BCD is Rs. 2.50.

It is assumed that ABC Ltd. invests its cash to earn 10%. **10**

<u>Suggested answer</u>

Calculation of cost of capital of BCD Ltd.

Divdend per share (D_0)	= Rs. 0.60
Expected dividend next year (D_1)	= Rs. 0.63 (0.60 + 0.60 × 5%)
Current market price per share (P)	= Rs. 20
Current growth rate (G)	= 5%
Cost of capital (K_e = (D_1/ P + G))	= 8.15% (0.63/ 20 + 5%)

Calculation of market price after acquisition

Cost of capital (K_e)	= 8.15%
Expected growth rate (G)	= 7%
Expected dividend next year (D_1)	= Rs. 0.642 (0.60 + 0.60 × 7%)
Market price (P = D_1/ (K_e − G))	= 0.642/ (8.15% - 7%)
	= 0.642/0.0115
	= Rs. 55.83

Calculation of increase in total value of BCD Ltd.

Expected market price per share	= Rs. 55.83
Current market price per share	= Rs. 20
Increase in market price per share	= 35.83
No of shares outstanding	= 500,000
So, increase in total value of BCD Ltd.	= Rs. 17,915,000 (500,000 ×35.83)

Calculation of post merger value of shares of ABC Ltd. on exchange of share

Value of ABC Ltd. before merger	= 1,000 Lakhs (10 Lakh shares @ Rs. 100 each)
Value of BCD Ltd. upon merger	= Rs. 279.15 Lakhs (5 Lakh shares @ Rs. 55.83 per share)
Value of ABC Ltd. after merger	= Rs. 1,279.15 Lakhs (1,000+279.15)
No of shares of ABC Ltd. os before merger	= 10 Lakhs
No of shares issued to shareholders of BCD Ltd.	= 1.25 Lakhs (5 × 1/4)
Total no of shares after merger	= 11.25 Lakhs
Value per share after merger	= Rs. 113.70 (1,279.15/11.25)

Calculation of gain or loss to shareholders on exchange of share

	ABC Ltd.	BCD Ltd.
Value per share after merger	Rs. 113.70	Rs. 113.70
Equivalent value per share	Rs. 113.70	Rs. 28.425 (107.30/ 4 shares)
Value per share before merger	Rs. 100	Rs. 20
So, gain or loss per share	Rs. 13.70	Rs. 8.425
i.e. gain or loss in %	13.70%	42.13%

Calculation of earnings per share after merger on cash purchase

Earnings of ABC Ltd.	= Rs. 80 Lakhs (Rs. 8 each for 10 Lakhs shares)
Earnings of BCD Ltd.	= Rs. 12.50 Lakhs (Rs. 2.5 each for 5 Lakhs shares)
Total earnings	= Rs. 92.50 Lakhs (80+12.50)
Less: Loss of interest on cash purchase payment	= Rs. 12.50 Lakhs (Rs.25 each for 5 Lakhs shares @10%)

Net total earnings after merger	= Rs. 80 Lakhs
No of shares os after merger	= 10 Lakhs
Earnings per share after merger	= Rs. 8 each (80/ 10)

Calculation of gain or loss to shareholders of ABC Ltd. on cash purchase

Market price of before merger	Rs. 100
EPS before merger	Rs. 8 each
PE ratio before merger (which is maintained even after)	12.50 (100/8)
EPS after merger	Rs. 8
Market price per share after merger	Rs. 100 (8 × 12.50)
Market price per share before merger	Rs. 100
So, gain or loss per share	Rs. 0 or 0%

Calculation of gain or loss to shareholders of BCD Ltd. on cash purchase

Cash received per share	= Rs. 25
Market price per share before merger	= Rs. 20
So, gain or loss per share	= Rs. 5
i.e. gain or loss in %	= 25%

3.

a) Mero Software Developer Pvt. Ltd., (MSDL) has acquired an export order of Rs. 10 million for software development to a European company. The MSDL has also planned to import bulk of hardware worth Rs. 5 million from a company in UK. The proceeds of exports will be realized in 3 months from now and the payments for imports will be due after 6 months from now. The invoicing of these exports and imports can be done in any currency i.e. Dollar, Euro or Pounds sterling at company's choice. The following market quotes are available.

	Spot Rate	Annualised Premium
Rs./$	128.10/128.20	$ - 7%
Rs. /Euro	120.15/120.20	Euro - 6%
Rs./Pound	147.65/147.75	Pound -5%

Advice MSDL about invoicing as to in which currency it would be beneficial. **10**

(Calculation should be upto two decimal places).

Suggested answer:

(i) Proceeds of Exports in Rs = Rs. 10 Million

Position of Inflow under three currencies will be as follows:

Currency	**Invoice at Spot Rate**	**Expected Rate after 3-months**	**Conversion in Rs after 3-months**
$	Rs.100,00,000/128.10	128.10 (1 + 0.07/4)	130.34 x $ 78064.01
	$ 78,064.01	130.34	10,174,863.06

€	Rs.100,00,000/ 120.15	120.15 (1 + 0.06/4)	121.95 x € 83229.30
	€ 83,229.30	121.95	10,149,813.14
£	Rs.100,00,000/ 147.65	147.65 (1 + 0.05/4)	149.50 x £67727.73
	£ 67,727.73	149.50	10125295.64

(ii) Payment of Import in Rs = Rs. 5 Million

Position of outflow under three currencies will be as follows:

Currency	**Invoice at Spot Rate**	**Expected Rate after 6-months**	**Conversion in Rs. after 6-months**
$	50,00,000/ 128.20	128.20 (1 + 0.07/2)	132.69 x $39001.56
	39,001.56	132.69	5,175,117.00
€	50,00,000/ 120.20	120.20 (1 + 0.06/2)	123.81 x € 41597.34
	41,597.34	123.81	5,150,166.67
£	50,00,000/ 147.75	147.75 (1 + 0.05/2)	151.44 x £ 33840.95
	33,840.95	151.44	5,124,873.47

Advice: Since cash inflow is highest (10,174,863.06) in case of $ hence invoicing for Export should be in $. However, cash outflow is least (5,124,873.47) in case of £ the invoicing for import should be in £.

b) Kathmandu Manufacturers has current earnings of Rs 6 per shares with 5,00,000 shares outstanding. It is planning to issue 40,000 shares of 9 percent, Rs 100 per value convertible preference shares at par. The Preference share is convertible into 2 ordinary shares for each preference share held. The current market price of ordinary shares is Rs 42 per share.

Required: **10**

(a) Compute the conversion value of preference shares.

(b) Compute the conversion premium.

(c) Assuming total earnings remain the same, determine the effect of issue on basic earnings per share (i) before conversion (ii) on a fully diluted basis.

(d) If profits after taxes increases by Rs 10 lakh, determine the basic earnings per share

(i) before conversion and

(ii) on a fully diluted basis.

Suggested answer:

(a) Conversion value = Conversion ratio market price per share = 2 Rs * 42 = Rs 84.

(b) Conversion premium = (Rs 100 / Rs 84) – 1 = 19.05 per cent.

(c) Earnings per share effect

(i) Total after-tax earnings (Rs 6 X 5,00,000 shares) Rs 30,00,000

Preference share dividend (0.09 X 40,000 X Rs 100)	3,60,000
Earnings available to ordinary shareholders (NI)	26,40,000
Number of shares (N)	5,00,000
EPS (basic) (Rs 26,40,000 / 5,00,000)	5.28
(ii) Total earnings	30,00,000
Number of shares (5,00,000 + 80,000)	5,80,000
EPS (diluted) (Rs 30,00,000 / 5,80,000)	5.17

(d) Earnings per share effect with increase in profit

(i) Total after-tax earnings	Rs 40,00,000
Preference dividend	3,60,000
NI	36,40,000
N	5,00,000
EPS (NI / N)	7.28
(ii) Total earnings (NI)	40,00,000
N (5,00,000 + 80,000)	5,80,000
EPS (NI / N)	6.90

4. Write short note on the following: **(5×3=15)**

a) Technology/ techniques of financial system
b) Global Depository Receipts and American Depository Receipts
c) Carry Trade Swap
d) Hostile Takeovers
e) Benefits of Offshore Banking

Suggested answer to Q 4.a

Financial system utilize various technologies/ techniques in various combinations in everything it does. They are described below:

i. Delegation

Delegation reduces the cost of transaction in various ways. By the use of delegation depositor in a bank delegate the work of making loan. Investors in debentures delegate to an underwriter, the task of setting up a loan and to a trustee, the task of monitoring compliance with the contract. Similarly, insured delegate to a insurance company, the task of setting up the pool and dealing with the moral hazard and adverse selection.

ii. Credit substitution

In many cases is delegation combined with credit substitution but may not always go together. A bank substitutes its own credit for the credit of the borrower i.e. depositors lend to the bank rather than to the ultimate borrower. However, underwriters do not guarantee the issues they float i.e. there is delegation but not credit substitution. When bank money is used in payment, the bank substitutes its own credit for the credit of the buyer i.e. there is credit substitution but no delegation.

iii. Pooling

Pooling makes the liabilities of a financial intermediary safer and more liquid than its assets. For example, pooling makes bank deposits safer and more liquid than bank assets.

iv. Netting

Executing every transaction is costly. Netting lowers the cost by offsetting one transaction with another, so that fewer transactions need to be executed. For example, batch based net settlement of cheque payments in clearing of cheques by banks. Netting also creates liquidity. For example, netting of new deposits and withdrawals removes the need to liquidate the underlined assets by banks.

Suggested answer to Q.4.b

Global depository receipts (GDRs) and American deposit receipts (ADRs) are the capital market instruments developed to tap into foreign capital markets to secure finance for Companies of international standard in terms of size, performance and corporate governance practices. GDRs are the depository receipts denominated in US dollars issued by a depository bank in a foreign country against the deposit with local custodian bank of local currency shares of a company in home country. They are negotiable certificate without any voting rights that represents right to the benefits of holding a share. These GDRs are freely tradable in the overseas market like any other dollar denominated security through either a foreign stock exchange or through over the counter (OTC) market or among restricted groups like qualified institutional buyers. ADRs are the depository receipts issued by depository bank in the United States of America (USA) against deposit of shares of a local company with local custodian bank in their home country like GDRs. The companies issuing ADRs are subject to stringent norms of corporate governance as imposed by Securities Exchange Commission (SEC) of USA which is a regulatory body of capital market in USA like SEBON in Nepal. ADRs like GDRs provide access to the vast capital market of United States as a source of finance when foreign direct investment is restricted in a country.

Suggested answer to Q.4.c

One of the most popular investments in the financial markets today is the carry trade. This involves selling or borrowing an asset with a low-interest rate, with the aim of using the proceeds to fund the purchase of another asset with a higher interest rate. By paying a low interest rate on one asset and collecting the higher interest earned by the other asset, you profit from the interest rate difference.

When it comes to currency trading, a carry trade is one where a trader borrows one currency (for instance the USD), using it to buy another currency (such as the JPY). While the trader pays a low interest rate on the borrowed/sold currency, they simultaneously collect higher interest rates on the currency that they bought. The interest rate differential between the two currencies is the profit. Carry trading gives currency traders an alternative to “buying low and selling high” – a tough thing to do on a day to day basis. Most forex carry trading involves currency pairs such as the NZD/JPY and AUD/JPY due to the high-interest rate spreads involved.

Placing trades to take advantage of carry interest gives you an advantage since, in addition to trading gains, you also receive interest earnings. Carry trading also lets you make use of leverage to trade assets you would not otherwise be able to afford. The daily interest paid on the carry trade is based on the leveraged amount, which can make for huge profits from a relatively modest outlay. Still, carry trading carries significant risk, specifically due to the uncertainty in exchange rates. The high levels of leverage utilized in carry trades mean that even small movements in exchange rates could result in large losses if a trader fails to hedge their position appropriately. Due to these reasons, carry trading is only a good option for traders with a high-risk appetite. In any case, it should never be the main driver of your trades, but an additional aspect that gives you an advantage over the financial markets.

Suggested answer to Q.4.d

The term hostile takeover refers to the acquisition of one company by another corporation against the wishes of the former. The company being acquired in a hostile takeover is called the target company while the one executing the takeover is called the acquirer. In a hostile takeover, the acquirer goes directly to the company's shareholders or fights to replace management to get the acquisition approved. Approval of a hostile takeover is generally completed through either a tender offer or a proxy fight. Hostile takeover has mainly following features:

- A hostile takeover occurs when an acquiring company attempts to take over a target company against the wishes of the target company's management.

- An acquiring company can achieve a hostile takeover by going directly to the target company's shareholders or fighting to replace its management.
- Hostile takeovers may take place if a company believes a target is undervalued or when activist shareholders want changes in a company.
- A tender offer and a proxy fight are two methods in achieving a hostile takeover.
- Target companies can use certain defenses, such as the poison pill or a golden parachute, to ward off hostile takeovers.
- Factors playing into a hostile takeover from the acquisition side often coincide with those of any other takeover, such as believing that a company may be significantly undervalued or wanting access to a company's brand, operations, technology, or industry foothold. Hostile takeovers may also be strategic moves by activist investors looking to effect change on a company's operations.
- The target company's management does not approve of the deal in a hostile takeover. This type of bid occurs when an entity attempts to take control of a firm without the consent or cooperation of the target firm's board of directors.

Suggested answer to Q.4.e

a) Benefits of Offshore Banking: The benefits that the host country may derive from allowing the establishment of an offshore banking unit of an overseas bank in its domain are:

a) Inflow of interest –free foreign capital
b) Supply of capital from foreign sources to capital-intensive local industries.
c) Earnings foreign exchange by way of payment for services rendered in converting raw materials into finished goods etc
d) Exemption from minimum reserve requirement of CRR/SLr (as in Nepal)
e) Low or non-existent taxes and levies.
f) Entry is relatively easy, especially for large international banks, in contrast to the situation in neighbouring countries, which may be strictly limit or prohibit the entry of foreign banks
g) License fees are generally low.
h) Close proximity to the important loan outlets or deposit sources.

5.

a)

General Electric Inc. (GE), USA currently exports 500 special electric lights per month to UAE @ $ 60 per piece. The variable cost per electric light is $ 40. In June 2022, the company was approached by the Government of UAE to establish a manufacturing plant in UAE.

After careful analysis, the company decided to make an equity investment of $ 1 million, half of which would represent working capital and the other half the fixed assets. The company would sell the plant to a local entrepreneur for a sum of $ 1 million at the end of 5 years and the Central Bank of UAE would repay the company $ 500,000 for working capital.

In return for an increase in tariffs against other companies, GE will sell its electric lights at $ 50 per piece in the UAE. In addition, the company undertakes to buy certain raw materials from local suppliers and also to employ local managers. The total cost of local managers and materials would be $ 15 per electric light. Other materials would be purchased from the parent company at $ 10 and the parent company would receive a direct contribution to overhead variable costs at $ 5 per piece sold.

Under this arrangement, the company expects to sell 1,000 electric lights per month. The fixed assets are to be depreciated on a straight line basis over a 5 year period.

The company will have to pay income tax at 50% on profits earned in UAE. The US also has 50% tax rate with direct credit for UAE taxes.
The current exchange rate is 10 Dirham per dollar and is expected to stay the same for the next 5 years. There is no restriction on cash flow repatriation.
You are required to determine the adjusted present value of the project at 10% cost of capital. Further, GE has been informed that if it decides to reject the project, it would lose its entire export sales to the UAE. How does this affect decision of GE? **8**

Suggested answer to Q.5.a

Calculation of cash flow for the project lifespan of 5 years:

Sales revenue (1,000 × 50 × 12)	600,000
Less: Variable cost [(15+10-5) × 1,000 × 12]	240,000
Less: Depreciation (1,000,000 × 0.5/5)	100,000
Profit before tax	260,000
Less: Income tax (260,000 × 50%)	130,000
Profit after tax	130,000
Add: Depreciation	100,000
Cash flow after tax	230,000

Calculation of cash flow at the end of 5th year:

Sale proceeds from sale of plant	1000,000
Less: Book value of plant	0
Profit on sale of plant	1000,000
Less: Income tax (1000,000 × 50%)	500,000
Profit after tax/ net sale proceeds from sale of plant	500,000
Add: Repayment of working capital by Central Bank	500,000
Terminal cash flow after tax	1000,000

Calculation of Net/adjusted present value of project:

Year	Cash Flows	PV Factor at 10%	PV of Cash Flow
1 - 4	230,000	3.169	728,870
5	1,230,000	0.621	763,830
	Total cash inflows		1,492,700
	Less: Initial investment		1,000,000
	Net present value		492,700

Calculation of loss to GE on rejection of Project:

Export sales revenue (500 × 60 × 12)	360,000
Less: Variable cost (500 × 40 × 12)	240,000
Profit before tax	120,000
Less: Income tax (120,000× 50%)	60,000
Profit after tax	60,000
Present value of net profit for 5 years at 10% (60,000 × 3.790)	227,400

Therefore, if GE decides to reject the Project, it would lose $ 227,400 over 5 years period. While on acceptance of the Project it will receive incremental benefit of (492,700 - 227,400) = $ 265,300 over 5 years period. Hence, GE would be compelled to accept the project due the additional information.

b)

Following data relates to share of Company X where European call option is also available for risk management:

Current price of one share	Rs. 200
Strike price of call option	Rs. 180
Risk free rate of interest	10% p.a. (on continuous compounding basis)

$e^{-0.10}$ = 0.9048 and $e^{0.10}$ = 1.1052

You are required to calculate theoretical current (fair) price of the European call option expiring after 1 year and how can an arbitrageur make profit, if the price of the call option is Rs. 30. **7**

Suggested answers to Q.5.b

Current price of 1 share	= Rs. 200
Strike/ Exercise price	= Rs. 180
Rate of interest (r)	= 10%
Time (t)	= 1 year

Since, Theoretical current price of call option = Current price in the market - Current exercise price

So, Theoretical current price of call option = 200 - Exercise Price $\times e^{-rt}$

$= 200 - 180 \times e^{-0.10\times1}$

$= 200 - 180 \times e^{-0.10}$

$= 200 - 180 \times 0.9048 = 200 - 162.86 =$ Rs. 37.14

If the price of the call option is Rs. 30, it becomes lower than theoretical or fair value, hence the arbitrageur will purchase the call option. The call option gives the right to the buyer to purchase the asset at expiration date but no obligation, so s/he will take course of action as per the then market price of share.

Suppose s/he has 1 share and he sells the share in the market.

Then, total amount available to the person as on today for investment = Rs. 200 - 30 = Rs. 170

The amount available after 1 year $= 170 \times e^{rt}$

$= 170 \times e^{0.10\times1}$

$= 170 \times e^{0.10}$

$= 170 \times 1.1052 =$ Rs. 187.88

If after 1 year, market price of share is higher than Rs. 180 i.e. Rs. 200, s/he will exercise the call option and the profit made will be = Rs. 187.88 - 180 = Rs. 7.88

If after 1 year, market price of share is lower than Rs. 180 i.e. Rs. 160, s/he will not exercise the call option and buy the share in market, hence profit made will be = Rs. 187.88 - 160 = Rs. 27.88

6.

a)

The market received rumor about ABC corporation's tie-up with a multinational company. This has induced the market price to move up. If the rumor is false, the ABC corporation stock price will probably fall dramatically. To protect from this an investor has bought the call and put options. He purchased one 3 months call with a striking price of Rs.42 for Rs. 2 premium, and paid Re.1 per share premium for a 3 months put with a striking price of Rs.40. **5**

(i) Determine the Investor's position if the tie up offer bids the price of ABC Corporation's stock up to Rs. 43 in 3 months.

(ii) Determine the Investor's ending position, if the tie up program fails and the price of the stocks falls to Rs. 36 in 3 months.

Suggested answers to Q.6.a

	(Rs.)
100 shares call @ Rs. 2 premium	200
100 shares put @ Rs. 1 premium	100
Total cost of call and put options	300

(i) If the stock price increases to Rs. 43 in 3 months
The market price is higher than the strike price, and hence exercise the call option.
Then, the position is as follows:

	(Rs.)
Initial premium on call and put options	300
Less: Gain on call option @ Rs. 1 per share	100
Net Loss	200

ii) If the stock price falls to Rs. 36 in 3 months
The market price is lower than the strike price, and hence do not exercise the call option

	(Rs.)
Initial premium paid on call and put options	300
Less: Gain on put option @ Rs. 4 per share	400
Net gain	100

a)

i) If beta (β) is 1.50; Rf (risk-free returns) is 6.00%; and Rm (market return) is12.00%, what should be the return on the share with the beta as given above?

ii) If the alpha value is 1.5, 1, 0 (zero), or -2.40, what would be the corresponding actual returns from the stock in (i)?

iii) What investment action would you suggest for each of the four different situation in (ii)

1+3+1=5

Question No. 6 (b) Solution:

The given can be detailed as under:
I. If beta (β) is 1.50; Rf = 6.00%; and Rm = 12.00%,
E (Rj) as per CAPM = Rf + β(Rm - Rf) = 6 + 1.5 × (12-6) =15%

II. Alpha = Actual return - Expected or Required return as per CAPM

Therefore, if Alpha = +1.5, since E (Rj) = 15%, Actual return = 16.5%
if Alpha = +1.0, since E (Rj) = 15%, Actual return = 16%
if Alpha = + 0 , since E (Rj) = 15%, Actual return = 15%
if Alpha = -2.4, since E (Rj) = 15%, Actual return = 12.6%

III. Whenever Alpha is positive, we retain the stock and when it turns negative we sell the stock. And when it gives the desired return we are indifferent.

Paper 3: Advanced Auditing

Marks

Attempt all questions.

1. Comment and give your views with reasons on each of the following cases, giving consideration to respective Standards, Laws and Code of Ethics:

a) You are the manager responsible for the audit of Sigma Company Private Limited. The Company's financial year ended on Ashad 32, 2079 and you are reviewing the audit work which has been completed on a payroll processing. A summary of the work which has been performed is given below and the description of audit work indicates the full extent of the audit procedures carried out by the audit team.

The payroll function is outsourced to R & J Associates Private Limited, a service organization which processes all of Sigma Company Private Limited's salary expenses. The payroll expenses recognized in the financial statements have been tracked back to year-end report issued by R & J Associates Private Limited. The audit team had no direct contact with R & J Associates Private Limited as the year end reports were sent to Sigma Company Private Limited's finance director who then passed them to the audit team. Sigma Company Private Limited employs a few casual workers who are paid in cash at the end of each month and are not entered into payroll system. The audit team has agreed the cash payments made back to the petty cash records and the amounts involved are considered immaterial.
Required:

a) Comment on the sufficiency and appropriateness of the audit evidence obtained **(3)**

b) Recommend further audit procedures to be performed by the audit team and **(5)**

c) Explain the matters which should be included in a report in accordance to NSA 265, Communicating Deficiencies in Internal Controls to Those Charged with Governance and Management. **(2)**

Answer:
(a) The audit work in respect of payroll needs to be much more thorough. Simply agreeing the amounts to the reports issued by R & J Associates Private Limited provides no evidence on the completeness, accuracy or validity of the payroll figures recognized in the financial statements. The audit team seems to have relied on R & J Associates Private Limited's year end reports as being accurate and the requirements of NSA 402 Audit Consideration Relating to an Entity Using a Service Organization do not appear to have been followed.
The audit team needs to obtain assurance on the control risk which R & J Associates Private Limited has implemented in order to assess the risk of material misstatement in the payroll figures and to respond to the risk with appropriate audit procedures. The controls which Sigma Company Private Limited uses to verify the information received from R & J Associates Private Limited also needs to be understood. With the permission of Sigma Company Private Limited, the audit team should contact R & J Associates Private Limited with the objective of obtaining more information which can be used to assess how the payroll has been processed and the controls which are in place. The controls in place at Sigma Company Private Limited should be documented and tested. It

is recommended that further substantive procedure should be carried out to provide a wider range of evidence on the payroll processing expenses recognized in the financial statements.

In relating to the casual employees, the fact that the amount involved is immaterial means that the audit team doesn't need to perform any further detailed audit procedure as there is no risk of material misstatement. However, as there is a risk over the completeness of these costs, the controls in place to ensure this process is effectively managed should be discussed with management and documented.

(b) Further audit procedure:

- Review the service agreement between Sigma Company Private Limited and R & J Associates Private Limited to understand the exact work which is conducted by R & J Associates Private Limited as a service organization
- Read all report made by R & J Associates Private Limited during the year to identify any risk of misstatement in the payroll figures.
- Discuss and document relevant controls in place at Sigma Company Private Limited over the information received from R & J Associates Private Limited and the management of casual employees, and perform test of controls on a sample basis.
- The amount of unpaid taxes in respect of the casual workers should be quantified by recalculations of the amount due.
- Read any user manuals or system overviews to assess the efficacy of the controls in place over the processing of payroll.
- If necessary, obtain a type1 or type 2 report from R & J Associates Private Limited to obtain further assurance on the controls which the service organization has in place.
- Perform a substantive analytical review on payroll, preparing an auditors expectation of the payroll figures and comparing it to that recognized in the financial statements and discussing any variance with management
- Perform test of detail by selecting a sample from the payroll records and agreeing the amounts to pay slips and HR record.

(c)Report to those charged with governance

The fact that casual employees are being paid from petty cash without being put onto the company's payroll indicates that Sigma Company Private Limited may not be complying with NSA 265 Communicating Deficiencies in Internal Controls to Those Charged with Governance and Management, for example the appropriate payroll taxes are not being paid. Despite the amount involved being immaterial, the potential noncompliance should be reported to those charged with governance, along with the recommendation that all employees, whether casual or not, should be processed through the company's payroll system. There may be implication for the financial statements if fines or penalties are imposed by the tax authority in respect of the noncompliance.

b)

You are an audit manager at S&T Associates, a firm of Chartered Accountants. The Senior Partner of S&T had summarized a number of matters he had identified for different clients and wants you to help him to address them. You have been provided with the following summary of such matters:

- S&T has been invited to be the statutory auditors of Regent Ltd., a company listed in Nepal Stock Exchange and is engaged in hospitality business. Mr. Suresh Pradhan who is an assurance partner of S&T is also a Director of Awas (Pvt) Ltd, which is controlled by Regent Ltd.

- Enlight (Pvt) Ltd is an audit client of S&T and is in the tourism business. They had offered a holiday package in a five-star hotel to the audit partner and his family. This is for a period of one week with access to other facilities such as gym, spa, and bar.
- S&T had been providing internal audit services to Nature Cosmetics (Pvt) Ltd for over 5 years. The Board of Directors of Nature Cosmetics (Pvt) Ltd has now invited S&T to be the statutory auditor.
- Continental (Pvt) Ltd is an audit client of S&T. During the course of the current audit, the team had noted inappropriate capitalization of interest costs on construction of a building even after the building was made available for use for the said purpose. The interest cost capitalized was material, but the client did not agree to adjust the financial statements or agree to a qualification in the audit report. Further, the Managing Director had stated that the Board of Directors will decide whether to reappoint S&T as statutory auditors, based on this matter.

For each of the above scenarios, identify and assess the possible threats to independence of S&T when complying with the fundamental and ethical principles, giving your reasons for each threat identified. **(2.5×4=10)**

Answer:

Scenario	Possible Threat/ Risk	Explanation
(i) New appointment and a partner is a director of the potential audit client's subsidiary company	Threat to Objectivity and Self-interest risk	Since a partner is also a director of the subsidiary company of the potential audit client, there is a threat to the objectivity of the auditor as it gives rise to a self-interest risk. Further the Companies Act prohibits appointing an audit firm when a partner is a director of the potential audit client or related entity of the potential audit client. If this appointment is to be accepted, the assurance partner (Suresh Pradhan) will have to agree to resign as a director; otherwise, S&T cannot accept this client as an audit client.
(ii) Audit client (Enlight (Pvt) Ltd) offered a holiday package in five-star hotel	Threat to Objectivity and Self-interest/ and advocacy risk	The gift and hospitality treatment cannot be considered as a token of love and it is a costly and exclusive offer to the audit partner and his family. If it is accepted, it will be a threat to the objectivity of the auditor. As the audit partner gets significant benefits, the audit client might be able to influence the decisions of the audit partner and make him take decisions in the interest of the company.
(iii) Internal audit client (Nature Cosmetics (Pvt) Ltd) offering for a statutory audit service	Self-review threat (i.e. review of own work)	If internal audit services are provided, the auditor needs to understand whether the work involved as the internal auditor would be subject to the review as part of the audit. In this case it is important to be aware of the scope of the internal audit (e.g., if the internal auditor has been involved in designing and implementing the internal controls over financial reporting, then there is a

		threat of reviewing own controls. If these controls were operational and had no direct impact on the financial statements, then the threat is reduced. The significance of the threat and the safeguards that should be in place should be assessed).
(iv) Inappropriate capitalization of interests by the audit client and not agreeing to correct FS, rather considering whether to re-appoint	Intimidation threat	In this instance, the audit partner is threatened and there is a fear of losing the audit client. If a good audit fee is generated it will have an impact on the audit firm. If that is the case, the firm will be under pressure to issue an unmodified audit opinion.

2.

(a) The audit report of Kosis Pvt. Ltd. for FY 2077-78 was issued by M/s Bishwas & Co. on 20th Kartik 2078. However, a case was filed against Kosis Pvt. Ltd. on 3rd Marg, 2078, with the Civil Court, with respect to an incident caused in its factory on 15th Baisakh, 2078, the outcome of which may result in paying heavy penalty by Kosis Pvt. Ltd.

Mr. Ramdev, the partner of M/s Bishwas & Co., discussed the said matter with the management and it was determined to amend the financial statements for FY 2077-78. Further, Mr. Ramdev inquired how the management intended to address the said matter in the financial statements to which he was told that the said matter was going to be disclosed as a "Contingent Liability for a Court case" to the foot note in the balance sheet with no additional disclosures.

The management told Mr. Ramdev that such disclosure was enough as he would further give a description of the said court case and its outcome in the 'Emphasis of Matter' paragraph in his amended audit report.

In the context of aforesaid case scenario, please answer the following questions: **10**

1. Whether Mr. Ramdev on behalf of M/s Bishwas & Co., has properly adhered to his responsibilities in accordance with NSA 560, on becoming aware of the court case filed against Kosis Pvt. Ltd.?
2. Whether the contention of management of Kosis Pvt. Ltd. is valid with respect to the disclosure of the court case in the financial statements?

Answer:

Auditor's Responsibilities as per NSA 560:

- As per NSA 560, 'Subsequent Events', the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of auditor's report but before the date the financial statements issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:
  i. Discuss the matter with management and, where appropriate, TCWG.
  ii. Determine whether the financial statements need amendment and, if so.
  iii. Inquire how management intends to address the matter in the financial statements.
- In the given case, on becoming aware of the court case filed against the company, Mr. Ramdev discussed the said matter with the management and it was

determined to amend the financial statements. Also, he inquired how the management intended to address the said matter in the financial statements.

- However, if management does not take necessary steps to ensure that everyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where Mr. Ramdev believes they need to be amended, the auditor shall notify management and, TCWG, that the auditor will seek to prevent future reliance on the auditor's report. If despite such notification the management of TCWG do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report in accordance with NSA 560.

Disclosure of the court case in the financial statements:

As per NSA 706, 'Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report', and an Emphasis of Matter paragraph is not a substitute for:

i. A modified opinion in accordance with NSA 705 (Revised) when required by the circumstances of a specific audit engagement;

ii. Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or

iii. Reporting in accordance with NSA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

In the given case, the management of company has presumed that as the auditor was going to provide a description of the said court case and its outcome in the 'Emphasis of Matter' paragraph in his amended audit report, there was no further need for it to provide additional disclosures about the court case in the financial statements.

Conclusion

Contention of management is not valid as 'Emphasis of Matter' paragraph cannot be used as a substitute for disclosures required to be made in the financial statements as per the applicable financial reporting framework or that is otherwise necessary to achieve fair presentation, which is the responsibility of the management.

(Marking Scheme: 4 marks for NSA Provision, 4 marks for Disclosures and 2 marks conclusion)

(b) D

uring the audit of Samana Ltd., a listed company, Engagement Partner (EP) completed his reviews and also ensured compliance with independence requirements that apply to the engagements. The engagement files were also reviewed by the Engagement Quality Control Reviewer (EQCR) *except* the independence assessment documentation. Engagement Partner was of the view that matters relating to independence assessment are responsibility of the Engagement Partner and not of the Engagement Quality Control Reviewer. So, the Engagement Partner did not provide documents relating to independence assessment to the Engagement Quality Control Reviewer. The Engagement Quality Control Reviewer objected to this and refused to sign off the documentation. Discuss about the responsibility of the Engagement Partner and the Engagement Quality Control Reviewer and advise as per applicable NSA. **(4+4+2=10)**

Answer:

Responsibility of Engagement Partner

As per para 11 of NSA 220, the Engagement Partner shall form a conclusion on compliance with independence requirement that apply to the audit engagement. In doing so, the engagement partner shall:

i. Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
ii. Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
iii. Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is possible under applicable law or regulation. The Engagement Partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

As per para 19 of NSA 220, for audits of financial statements of listed entities, for which the firm has determined that the engagement quality control review is required, the Engagement Partner shall determine that an EQCR has been appointed and discuss the significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the EQCR and not date the auditor's report until the completion of the engagement quality control review.

Responsibility of the Engagement Quality Control Reviewer (EQCR)

As per para 20 of NSA 220, The Engagement Quality Control Reviewer (EQCR) shall perform an objective evaluation of the significant judgements made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation shall involve:

- Discussion of significant matters with the engagement partner;
- Review of the financial statements and the proposed auditor's report;
- Review of the selected audit documentation relating to the significant judgements the engagement team made and the conclusions it reached; and
- Evaluation of conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate.

As per para 21 of the NSA 220, for audits of financial statements of listed company, the Engagement Quality Control Reviewer on performing an engagement quality control review, shall also consider the following:

- The engagement team's evaluation of the firm's independence in relation to the audit engagement;
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and
- Whether audit documentation selected for review reflects the work performed in relation to the significant judgements and supports the conclusions reached.

Conclusion

In the given case, considering the responsibility of the Engagement Partner and Engagement Quality Control Reviewer required by the NSA 220, as discussed above, the view of the Engagement Partner regarding the review of independence assessment document is not right. The independence assessment documentation should be made available to the ECQR for review purpose. The Engagement Quality

Control Reviewer is right since without reviewing the documents relating to independence assessment s/he shall not be able to sign off the reviewed documents.

3.

a) Write down the objective, need and procedure of external confirmation? What are the auditor's responsibility in case management refusal external confirmation or have doubt on external confirmation? **(4+4=8)**

Answer

Nepal Standards on Auditing 505 dealt with the external confirmation. The objective, need and procedure of external confirmation are as follows:

Objective:
The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence or whether performing further audit procedures is necessary.

Need for External Confirmation:
An auditor responsibility for the audit of the financial statement is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. The auditor identifies and assess the risks of material misstatement of the financial statements, whether due to fraud or error, designs and performs audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for opinion.
External Confirmation is required to obtain such reasonable assurance on the financials of a company. To obtain sufficient and appropriate audit evidence by performing substantive procedures one of the method of collecting audit evidence is the External Confirmation.
Procedure for External Confirmation:

1. Determining the information to be confirmed;
2. Selecting the appropriate parties from whom confirmation is required;
3. Designing the confirmation requests, being properly addressed with information for responses to be sent directly to the auditor; and
4. Sending the requests, including follow-up request.

Auditor should ensure direct communications with the confirming parties to minimize the possibility that the results of such confirmation process will be biased because of the interception and alteration of confirmation request or responses.

External Confirmation shall be obtained by sending request to third party to confirm the particular matter or amount.

The auditor may give a list of accounts selected for confirmation to the management for preparing requests for confirmations, which should be properly addressed and stamped. The auditor should ensure that it is the auditor who sends out the confirmation requests, and it is requested that all replies and the undelivered confirmations are delivered directly to the auditor. Email confirmation is also a valid confirmation.

Auditor's responsibility in case management refusal external confirmation or have doubt on external confirmation are as follows**:**

In case of Management refusal for external confirmation:

1. Inquire management's reasons for the refusal, and seek audit evidence for validity,

2. Evaluate the implications for such refusal
3. Perform alternative audit procedures

If management refusal is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance.

In case of doubt on external confirmation:

If the auditor has doubts about reliability of response, he shall obtain further evidences to resolve the doubts.

If the auditor determines that response to confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

If case auditor is even not satisfied with audit evidences obtained from alternative audit procedures and he has assessed that risk of material misstatement on such circumstances is still existed. If auditor ascertain it is the limitation of work, he has to modify his audit report in line with NSA 705 (revised) accordingly or should withdraw from the assignment. Before confirming withdrawal from the assignment auditor should inform the matter to TCOG after legal consultation if required.

b) How would you evaluate the effects of misstatements identified on financial statement during the audit? **7**

Answer:

As per NSA 450, Evaluation of Misstatements identified during the Audit, misstatement refers to a difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with NSA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results. The auditor's determination of materiality is often based on estimates of the entity's financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with NSA 320 based on the actual financial results. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

(a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and

(b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole

Communication with Those Charged with Governance:

The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. If uncorrected misstatements have been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, they need not be communicated again with those same person(s) in their governance role. The auditor nonetheless has to be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.

Documentation:

The auditor shall include in the audit documentation: (a) The amount below which misstatements would be regarded as clearly trivial; (b) All misstatements accumulated during the audit and whether they have been corrected; and (c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate and the basis for that conclusion.

4.

(3×5=15)

(a) Mr. Keshav, a practicing Chartered Accountant is the proprietor of M/s Keshav & Co. since 2065. He went abroad in the month of Chaitra 2078. He delegated the authority to Mr. Yadav a Chartered Accountant, his employee for taking care of the important matters of his office.

During his absence of Mr. Yadav has conducted the undermentioned jobs in the name of M/s Keshav & Co.

i. He issued net worth certificate to a client for furnishing to a bank.

ii. He attended the income tax proceedings for a client as authorized representative before income tax authorities.

Please comment on eligibility of Mr. Yadav for conducting such jobs in name of M/s Keshav & Co. and liability of Mr. Keshav under the Chartered Accountants Act, 1997.

Answer:

- As per the provisions of section 34 and section 41 of Nepal Chartered Accountants Act, 1997, a Chartered Accountant in practice is deemed to be guilty of professional misconduct "if he allows a person not being a member of the institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements''.
- In this case CA Keshav proprietor of M/s Keshav & Co., went abroad and delegated the authority to another Chartered Accountant Mr. Yadav, his employee, for taking care of routine matters of his office.
- The power to sign routine documents of which a professional opinion or authentication is not required to be expressed, may be delegated and such delegation will not attract the above provisions. Examples of such instances are issue of audit queries, asking for information or issue of questionnaire, attending to routine matters in tax practice etc.

  Conclusion

  i. Issuance of net worth certificate to a client for furnishing to bank by Mr. Yadav is not a routine work and it is outside his authorities. Thus, CA Keshav is guilty of professional misconduct under section 34 and penalties as per section 41(3) of the Nepal Chartered Accountant Act, 1997 can be levied to him.

  ii. Attending Income Tax proceedings for a client as authorized representative before Tax Authorities falls under routine work, hence Mr. Yadav, the employee of M/s Keshav & Co. can attend to routine matter in tax practice. Therefore, there is no misconduct in this case.

(b) Based on provisions laid down in Directive issued by the Institute on 'Criteria for Accounting Professional Firms and Fee Determination, 2078', discuss about the physical infrastructure requirements for accounting professional firms.

Answer:

The Institute, as decided in 256th Council Meeting, has issued Directives on 'Criteria for Accounting Professional Firms and Fee Determination, 2078. Preamble of this directive intends to gain stakeholders' trust towards accounting profession through quality services by the firms.

In para 4 of this Directives, physical infrastructure requirements in terms of office space, meeting room, toilet, computer, data server etc. for professional accounting firms are prescribe. These requirements include:

(i) For a professional accounting firm of Chartered Accountant and "B" class Registered Auditors having staffs up to 5 (including proprietor and partners), office area should be with work space of 250 square feet and for "C" and "D" class Registered Accountants' firm office area should be with work space of 150 square feet.

(ii) For firms having staffs more than 5 (including proprietor and partners), additional 20 square feet per staff shall be available.

(iii) The firms shall arrange for at least one meeting room, toilet and sufficient space for administrative works.

(iv) Where there is residence and office in same place, space used for personal and other purposes shall not be included in calculation of office space as mentioned above.

(v) The firms shall make available in their offices in physical or in digital form the prevailing laws, directives issued by the regulatory agencies, professional and technical standards, professional publications, newspapers and other publications.

(vi) The firms shall make available the laptop, computer for staffs and ensure security and confidentiality of data, server and internet and email.

(c)

i) When the Office of Auditor General Nepal has issued its annual report for FY 2077/78 & what are the audited figures & “Beruju” for the FY 2075/76, 2076/077 and 2077/078? **(3)**

ii) What is Good Governance Act in Nepal? Elaborate about the maintenance of Citizen`s Charter. **(2)**

Answer :

i)

The Office of Auditors General of Nepal had issued its annual report for FY 2077/78 during 2079/03/29. The status of audited figures & “Beruju” for the FY 2075/76, 2076/077 and 2077/078 are as follows:

Financial Year	Audited Figures (Rs. In Crore)	Beruju (Rs. In Crore)
2075/076	200,884	10,634
2076/077	175,604	7,106
2077/078	155,581	4,439

ii)

Good Governance (Management & Operation) Act 2064 (2008) had enforced in Nepal with effect from 2064/10/23 (06/02/2008). Section 25 of the Act has prescribed Citizen`s charter shall have to be maintained by each public entities. The charter should content the following matters:

a) Detail statement of service offered by the office and its nature,

b) Procedure to be followed by the service user (customer) to obtain the service,

c) Estimated time for delivering the service,

d) Description of the officer responsible for providing service and his/her chamber,

e) Particulars of the fees to be charged or other amount to be paid, if any, to receive the service,

f) Other matters as prescribed,

5) Answer the following: **(3×5=15)**

a) Write down the Audit procedures that may be applied to ATM operations of the bank**.**

Answer:

While auditing ATM operations, Auditor should ensure or perform that:

- Whether periodic visits and check are made/done by ATM Channel Manager?
- Whether monitoring of uptime is done on real-time basis by bank?
- Whether online System for enabling immediate notification to vendor about breakdown is available?
- Whether detailed servicing & replacement of system of ATM's is done when required?
- Whether system of periodic preventive maintenance is available?
- Whether corrective actions are taken on the basis of root cause analysis?
- Whether network penetration testing for ATM's is conducted to check that they are on network or not?
- Whether the periodic reconciliation with ATM physical cash balance and accounting system balance is done?
- Whether adequate safeguard has been made for physical security of the ATM Machine?
- Auditor should carried out physical verification of ATM cash with adequate procedures & documentation.

Further Auditor should carried assess the various risks as follows:

•Control environment- The board should periodically review policies and procedures to ensure that proper controls have been implemented. There should also be a system in place to monitor if bank employees are complying with the set policies and procedures with instances of noncompliance being reported to the Board. Incidents of noncompliance should have some follow-up and testing for compliance.

•Risk assessment- An evaluation of risks and control issues should accompany a bank's ATM operations. Internal audit personnel should always be involved in the risk assessment process for ATM operations. Technology is an integral part of ATM operations and should also be assessed for risk factors and control issues

.•Control activities- Independent verification and reconciliations are integral to the integrity of audit procedures for ATM operations. Segregation of duties and dual controls are crucial to any operation that involves the handling of bank assets, particularly cash. More important than segregation and dual controls is having a system in place that ensures that personnel are complying with the policies and procedures regarding segregation of duties and dual controls. A vacation policy in place for employees that mandate at least one consecutive week's absence from duties is necessary for critical employees involved in ATM operations.

If any, of these procedures might have resulted in the discovery of the embezzlement scheme at bank/branch then it can be taken care of immediately.

b) Peace Limited has its entire operations including accounting computerized. As the audit partner you are concerned about inherent and control risk for material financial statement assertions. What could be the areas you look forward for deficiencies and risk identification?

Answer:

The auditor in accordance with NSA 315 "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment", should make an assessment of inherent and control risk for material financial statement assertions.

In CIS environment the risk of a material financial statement ascertain being erroneously stated could arise from the deficiencies in the following case as:

(i) Program development and maintenance

(ii) System software support

(iii) Operations including processing of data

(iv) Physical CIS security

(v) Control over access to specialized utility program.

These deficiencies would tend to have a negative impact on all application systems that are processed through the computer.

c) One size does not fit all. This is common proverb which also applies to the audit practices. Realizing this fact, the International Auditing and Assurance Standards Board (IAASB) is in process of developing a new standard for audits of less complex entities. In this regard, discuss about such entities and main features of standards being developed for audits of such entities.

Answer:

International Standards on Auditing (ISAs) require proper understanding by the auditors of complex structures and transactions of their audit clients. At the same time, this complexity in the ISAs can pose challenges for audits of less complex entities.

Smaller, less complex entities (LCEs) make crucial contributions to the world economy and account for the great majority of entities globally.

Based on the feedback from a discussion paper and outreach, the IAASB developed a draft standard proportionate to the typical nature and circumstance of an audit of a less complex entity and responsive to stakeholders' challenges.

This new stand-alone standard (draft) for audits of less complex entities:

- Is designed specifically for audits of a less complex entities
- Is based on the underlying concepts from International Standards on Auditing
- Was developed to be understandable, clear and concise
- Reduces the risk of jurisdictional divergence by driving consistency and comparability globally
- Will achieve a quality audit engagement

The IAASB has already put this draft standard on exposure process and evaluated the feedback received on the exposure draft, feedback survey, and outreach and is, now, revising the draft to address stakeholder feedback.

When final, the standard will meet the growing global need for a separate standard for audits of less complex entities, while reducing the emerging risk of jurisdictional divergence.

5. Write short notes on the following: **(5×3=15)**

a. Requirements of a Risk Management System in a Bank
b. Biological Assets.
c. Access controls in IT environment
d. Negative Confirmations
e. Cold file review

6a. Answer:

The requirements of a risk management system in a Bank are as follows:

1. Involvement of TCWG:
   The risk management policies should be approved by TCWG. While approving the policies, TCWG should ensure that the policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.
2. Identification, measurement and monitoring of risks:
   Risks that may significantly affect the achievement of bank's goals and objectives should be identified, measured and monitored against pre-approved limits and criteria.
3. Control activities:
   Banks must have appropriate controls to manage its risks, including the following:
   - effective segregation of duties,
   - verification and approval of transactions,
   - setting of limits,
   - Reporting and approval of exception.
4. Monitoring activities:
   Independent risk management unit should be set up which regularly assess the risk management models, mythologies and assumptions used to measure and manage risk.
5. Reliable information systems:
   Banks must have a reliable information system that provide adequate financial, operational and compliance information on a timely and consistent basis to management and TCWG.

6b. Answer:

Biological assets are resources that are living. Usually, these include plants and animals that companies own or control. Like other resources, biological assets are crucial in generating revenues. In most cases, companies obtain products from these assets. Then, they may process those products to make them available for sale in the market. Therefore, these assets are essentially the same as other resources.

The auditors' role is to audit the fair value of biological assets determined by management, including inter alia, the appropriateness of the fair value technique used, the assumptions made by management and inputs injected into the fair value model

6c. Answer:

Access controls are procedures designed to restrict access to on-line terminal devices, programs and data. Access controls consist of "user authentication" and "user authorization." "User authentication" typically attempts to identify a user through unique logon identifications, passwords, access cards or biometric data. "User authorization" consists of access rules to determine the computer resources each user may access. Specifically, such procedures are designed to prevent or detect:

- Unauthorized access to on-line terminal devices, programs and data;
- Entry of unauthorized transactions;
- Unauthorized changes to data files;
- The use of computer programs by unauthorized personnel; and
- The use of computer programs that have not been authorized.

6d. Answer:

Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

(a) Risk of material misstatement is low and internal controls are effective,

(b) Population of items subject to negative confirmation procedures comprises a large number of small amounts,

(c) A very low exception rate is expected,

(d) No reason to believe that recipient may disregard the request.

6e. Answer:

Cold file review or cold review is an objective evaluation on the date of auditor's report and is performed by the auditor i.e. partner himself when all the audit work has been concluded and the required sufficient appropriate audit evidence has been obtained and conclusions drawn and reported. This review usually takes place when the auditor's report is signed off. The purpose of this review is to ensure compliance with relevant auditing standards and to analyze weaknesses in the way whole audit work is conducted and how it can be improved for next similar assignments by updating firm's quality control standards, training the staff etc.

Paper 4: Corporate Laws

Marks

Attempt all questions.

1. Answer the following questions:

a) All companies either private or public or company of non-distributing profit including foreign company are registered under the Company Act, 2063 in the Office of the Company Registrar and the relation of all types of companies shall be as good as it should be with the Office. Hence, the Office has retained certain power to control and monitor these companies and the Act has vested the power to do so. Generally, these companies shall have to submit information and reports to the Office as per the Act. What are the documents and information that have to be submitted or informed to the Office as per the companies Act, 2063? List out them along with the concerned section of the Act and the time period to be submitted to the office. **10**

b) DBS, a swiss bank, awarded by the World Bank of the Year (2022), has willing to open branch office to carry on banking and financial transactions within Nepal. As you are consultant of the bank, advise them the process and provisions as to open branch office of the DBS in Nepal on the basis of the legal measures provided in the Bank and Financial Institution Act, 2073. **10**

Answer

1 a) All companies registered under Companies Act, 2063 have to submit the documents and reports to Office as follows:

S.No.	Details of Information	Time Period for providing information
1	Amendment in Articles or Memorandum Section, 21 (2)	Within 30 days
2	Details of Share Distribution. Section, 31	Within 30 days from the date of distribution of shares
3	Records or shareholders, debenture holders and debt. Section 51(3)	Prepared 30 days before the annual general meeting and within 30 days of the meeting
4	Report of Public Limited Company Section,78	21 days before the annual general meeting
5	Annual details, Section, 80	• Every company within 30 days. • Every company should submit certified details within 6 months from the date of completion of FY
6	Director's declaration. Section, 92(3)	within 7 days of receipt in the company through the company in the office
7	Record book of director and company secretary. Section,107(2)	Within 15 days
8	Appointment of auditor. Section, 111(1)	Within 15 days
9	Answer to Complaint. Section, (120)	Within the specified time frame by the office
10	Death of a single shareholder. Section, 153 (2)	Within 1 month
11	Merge of company. Section, 177	Within 30 days

12	Details of Office Address, Section, 184	Within 3 months after the incorporation of company

Foreign Company

Details required to be submitted to the office by a foreign company as per Section 81 of the Companies Act 2063

S.No.	Details of Information	Time Period for providing information
1	Accounts, Audit Report and Annual Financial Statement Section, 156(1)	Within 6 months of completion of the Fiscal Year
2	Annual financial statements are prepared in accordance with the law of its home country, Audit Report and Director's Report. Section,156(2)	Within 3 months
3	Certified statement from the LP of the liaison office. Section, 156(5)	Within 3 months of completion of the Fiscal Year
4	Amendment or alternation to any documents submitted. Section,155(2)	Within 35 days

1 b) The Bank and financial institution Act, 2073 has provided the legal measures to open branch office of internationally rated foreign bank or financial institution. Yes, it is provide in the section 6 of the Act. It is required following process provided in the Act.

i) **Prior Approval:** Subsection 1

If any internationally rated foreign bank or financial institution desires to open branch office to carry on banking and financial transaction or non-banking financial transaction within Nepal, prior approval of the Rastra Bank should be obtained before opening such branch office.

ii) **Application:** Subsection 2

An application has to be submitted to Rastra Bank along with the **capital and fees** as prescribed by the Rastra Bank.

iii) **Details and documents to be submitted:** Subsection 3

While submitting application pursuant to Sub-Section (2), such foreign bank or financial institution shall have to submit the following details and documents in addition to the details and documents as referred to in Sub-Section (1) of Section 5:-

- Written commitment of the Board of Directors that it will make available on demand of the Rastra Bank the amount necessary for fulfilling its entire liabilities with regard to business activities of its branch of representative or liaison office of concerned foreign bank or financial institution in Nepal,
- Details as to the location of the proposed branch office of the foreign bank or financial institution,
- Details as to the possible office bearers to be engaged in the proposed branch office of the foreign bank or financial institution.

iv) **Inquiry of details and documents and demand thereof:** Subsection 4

The Rastra Bank may, If deems necessary to demand further documents or details while carrying out inquiry to the documents or details submitted pursuant to Sub-Section (3), demand required documents or details from concerned applicant. The Rastra Bank may inquire of the additional documents submitted pursuant to Sub-Section (3) and of the documents asked for submission pursuant to Sub-Section (4).

v) **Grants of Approval**: Subsection 5.

After carrying out such inquiry and deems appropriate Rastra Bank may grant approval to open a branch office in Nepal within **one hundred twenty days after filing of the application**, with or without prescribing any conditions.

vi) **Registration of branch office:** Subsection 6

The foreign bank or financial institution, after obtaining prior approval pursuant to Sub-Section (5), shall have to get registered as the branch office according to the prevailing laws relating to companies.

vii) **Approval to carry on banking and financial transaction**: Subsection 7

The branch office of the foreign bank or financial institution registered shall have to submit an application before the Rastra Bank along with the **following documents and details** as well as the charge or fee as prescribed by the Rastra Bank for approval to carry on baking and financial transaction in Nepal:-

(a) **Registration certificate** of being registered according to the prevailing laws to carry on banking and financial transaction in Nepal as a branch office,

(b) **Letter of approval or consent granted by the Government or central bank or regulating agency** according to the law of concerned country of the foreign bank or financial institution to open branch office of such bank or financial institution in Nepal,

(c) **Details of the discrepancy**, if any, in any matter to be completed by the concerned foreign bank or financial institution under this Act after submission of application before the Rastra Bank for establishment of a branch office of the foreign bank or financial institution or after obtaining approval from the Rastra Bank,

(d) **Other information and documents demanded** by the Rastra Bank.

viii) **Inquiry on application and approval for transaction**: Subsection 8

The Rastra Bank may carry out inquiry over the application received if it deems necessary. After inquiry Rastra Bank may grant approval to such branch office of foreign bank or financial institution for carrying on banking and financial transaction in Nepal **within 90 days** from the date of filing the application.

ix) **Prior Approval may be denied**: Section 7

The Rastra Bank may deny to grant prior approval for open branch office of the foreign bank or financial institution in following circumstances:

(a) If the **name** or **banking and financial transaction** to be carried out by the proposed bank or financial institution is **not found to be appropriate from the point of view of public interests, religion, ethnicity or traditional belief,** etc.,

(b) If the **objective** of the proposed bank or financial institution is **contrary to the prevailing laws**,

(c) If **incorporation** of the proposed bank or financial institution **does not seem to be technically appropriate**,

(d) If study of the **feasibility study report**, details and documents other infrastructures submitted by the proposed bank or financial institution **does not provide a ground to believe** that it may carry on financial transactions **in a healthy and competitive manner**,

(e) If **not all promoters** of the proposed bank or financial institution have **signed** the Memorandum of Association and Articles of Association, also stating their **names, address and number of shares** subscribed by them, in the presence witness and the name and address of the witnesses have not been mentioned,

(f) If **per person share investment limit and share ownership ratio** has **not been found to have been maintained as specified by the Rastra Bank from time to time**,

(g) If it is **found to be inconsistent with the policy relating to incorporation of bank or financial institution and licensing policy** issued by the Rastra Bank,

(h) If **any condition** as prescribed by the Rastra Bank has **not been found to be fulfilled**.

If the Rastra Bank **denies granting prior approval** to the proposed bank or financial institution for any of the reasons referred to above, **information shall be given** to the applicant stating reasons thereof

2. Answer the following questions:

a) Co-operative is a kind of institution where various sectors of local people are integrated by mobilizing the scattered capital and skill of the members thereof to carryout out community based economic social and cultural activities for the development of national economy. State the exemptions and facilities which are provided to the cooperative societies under the Co-operative Act, 2074? **7**

b) Insurance Act, 2049 states that no individual will run or cause to operate an insurance firm without first acquiring a certificate. As a result, anyone interested in conducting insurance business must first obtain a license from the appropriate authority. Answer with concerned provisions the conditions under which the insurance board may impose a restriction on the insurance business under the Insurance Act, 2049. **7**

c) Tina Seth, a professional lawyer, applied for liquidator license in Office. The Office has not responded her application saying that her qualification is not sufficient for the liquidator license. What are the qualifications and requirements to obtain the liquidator license and how Tina can get the license? Answer by referring the provisions of Insolvency Act, 2063. **6**

Answer:

2 a) Section 78 of the Cooperative Act, 2074 prescribes the provision regarding exemption and facilities to cooperative societies. Notwithstanding anything in the Act, Cooperative Society will be entitled to the following exemptions and facilities under the Section 78 of the Act:

i) As per S.78(1) Notwithstanding anything contained in the prevailing law, the Cooperative Society/Association will be entitled to the following exemptions and facilities:
- The cooperative/Association or society shall not be required to have registration pass of any instrument relating to its transaction, other than an instrument relating to immovable property.
- No revenue and stamp fee shall be charged on a document or any kind of instrument related with the purchase of an immovable property in respect of construction of its building.

  However the revenue fee shall be charged on a document or any kind of instrument purchased while carried out its business.

  Accordingly, where immovable properties purchased with exemptions of revenue are disposed without being used shall have to return such exempted revenue charge use to be levied.

ii) No revenue and stamp fee shall be charged on a document or any kind of instrument related to the registration of pledge of or going to pledge by it. Notwithstanding anything contained in the prevailing law, no local tax shall be levied on the reserved fund created by the Cooperative Society as per the Section 68, capital refund protection fund created by the cooperative society as per Section 69 and cooperative promotional fund created by the society as per Section 70 of the Act.

iii) The government of Nepal may, by notification in the Nepal Gazette and pursuant to the prevailing law, exempt fully or partly from chargeable customs tariff or sales tax such machineries, industrial and agro-machines, equipment, spare parts, raw materials, office equipments and means of transport as are imported by an association or society for its use.

iv) The government of Nepal may, by notification in the Nepal Gazette and pursuant to the prevailing law, exempt fully or partly from chargeable excise duty or value added tax the goods produced by any association or society.

v) The government of Nepal may, by notification in the Nepal Gazette and pursuant to the prevailing law, exempt the chargeable export duty the goods produced by any association or society and grant the cash as other industries are entitled to pursuant to the law.

vi) An association or society doing industrial business carrying basic industrial promotional business or some special industry shall also be entitled to such other exemptions, facilities and protection as the industries are entitled to pursuant to the law, in addition to the exemptions mentioned as above.

vii) Government of Nepal, Provincial Government or Local level government organization may grant exemption of any tax fully or partly along with the privileged loan and other financial assistance and facilities, to the backward rural woman, differently able person, bonded labour, landless farmers, unemployed persons, self employed promotional industries and for the development of the labour and skill of self employed industries.

viii) Government of Nepal, may revenue exemption to the seek industries intended to be operated by the workers themselves and provide financial provide financial assistance, or transfer of such industries or grant guarantee to such industries.

ix) The government of Nepal may, by notification in the Nepal Gazette and pursuant to the prevailing law, grant financial facilities or exemption of excise duty value added tax levied on the goods produced by the special rural cooperative, market place, with a view to develop big cooperative scheme by making participation in professional share, construction of basic infrastructure or acquiring land for such infrastructure..

The process of acquiring exemption, facilities and privileges under the provision of the Act shall be as prescribed.

2 b)

i) According to Section 12A of the Insurance Act, 2049, the Insurance Board may impose a ban entirely or partially or may cancel any type of business being operated by the Insurer under the Insurance Business in any of the following circumstances:

(a) If the directives provided by the Board time to time regarding the procedures to be followed by the Insurer during the operation of the Insurance Business has been violated,
(b) If the Insurer provides loan to any corporate body in which any of its Directors or his/her family is working as a Managing Agent or partner or provides guarantee or security of any kind for any loan provided to him/her by others by violating Section 14,
(c) If the Insurer does not provide information to the Board to be provided pursuant to Section 15,
(d) If the Insurer does not maintain the accounts and record, to be maintained pursuant to Section 19,
(e) If the Insurer does not maintain separate accounts and records to be maintained separately pursuant to Section 20,
(f) If the Insurer does not maintain the fund to be maintained by it pursuant to Section 21 or bears liability of one Insurance Business from the fund maintained for another business,
(g) If the Insurer does not maintain the compulsory reserve fund to be maintained by it pursuant to Section 22,
(h) If the Insurer accepts the insurance risk without receiving the insurance premium pursuant to Section 27,
(I) If the Insurer does not re-insure pursuant to Section 28.

ii) Before imposing a ban on the Insurance Business of an Insurer pursuant to Sub-section (1), the Board shall provide a reasonable time-limit to submit clarification to the concerned Insurer clearly stating the reasons for imposing the ban on its Insurance Business.

iii) If the concerned Insurer does not submit its clarification within the time-limit mentioned in Sub-section (2) or the clarification submitted by it is not found to be satisfactory, the Board may impose a ban on the Insurance Business of the concerned Insurer pursuant to Sub-section (1) and shall publish a notice in two major newspapers to be published in Nepal for the information of public in general.

iv) During the time period of a ban on the Insurance Business of any Insurer pursuant to Sub-section (3) such Insurer shall make payment of claims of compensation filed against it as prescribed.

v) If the ban is imposed in the Insurance Business of any Insurer under this section, the Board may, if it finds the evidence submitted by the Insurer within the time-limit by stating that the circumstances for imposing the ban on its business existed no longer to be satisfactory, impose a fine as prescribed and lift the ban.

2 c) Section 64 of Insolvency Act, 2063 has made provisions for obtaining the license.

i) A person who is desirous of obtaining a license pursuant to Sub-section (1) of Section 63 shall make an application, along with the prescribed fee, to the Office in the prescribed format.

ii) A person who makes an application pursuant to Sub-section (1) shall meet the following conditions:

- Have completed the age of thirty five years;
- Being a member of the prescribed professional association;
- Having acquired at least bachelor's degree in commercial law, commerce, management, accounts or any other prescribed subject from a recognized university;
- Having abode in the State of Nepal;
- Being competent to carry on insolvency practice under this Act.

iii) On receipt of an application under Sub-section (1), the Office shall, if it considers appropriate to issue a license to carry on the insolvency practice, issue the license in the prescribed format.

iv) The license issued pursuant to Sub-section (3) shall be renewed prescribed.

3. Answer the following questions:

a) After the seventh Constitution promulgation three tiers of government system has been applied in Nepal. This system bears an impact on every sector of corporate life and among them the industrial sector is one. Accordingly, the industrial administration has been transferring in the federal to province level. Concerning the industry registration, how the Industrial Enterprise Act, 2076 has managed the industry registration provision in the Federal and Provincial level simultaneously? State the concerned legal provisions provided under the Act. **7**

b) Define the cooling off period for the engagement team members and what are the restrictions on activities during the cooling off period to the engagement team member in an audit according to the code of ethics of members of ICAN. **7**

c) What do you mean by predicate offence? What offences are included as predicate offence under the Asset (Money) Laundering Prevention Act, 2064? **6**

Answer

3 a) Obviously, the industrial administration has been transferring through federal to provincial level after the promulgation of the Constitution of Nepal. Such transferring has been carried out through Industrial Enterprise Act, 2076. Section 4 has provided on the matter of the provision relating to registration of industries. In accordance with the provision mentioned in the section 4, the registration provision has been as follows in the federal vis-à-vis provincial level.

Application: Subsection 1

A person, firm or company that intends to establish any of the following industries under this Act shall make an application to the Department (of Industry in Federal Level) for registration in such a form and accompanied by such documents as prescribed:

- an industry mentioned in Schedule-1 that requires permission;
- an industry established with foreign investment;
- an industry related to any matter set forth in Schedule-5 of the Constitution of Nepal;
- an industry that falls under the jurisdiction of two or more Provinces;
- an industry related to academic consultancy services on diplomatic affairs.

Application through electronic means: Subsection 5

The details or documents to be attached with an application to be made under subsection (1) may also be submitted through electronic means (online), and the relevant documents may be authenticated by a digital signature.

Interim industry administration: Subsection 3

Notwithstanding anything contained in subsection (2), the Federation shall carry out acts relating to the administration of industries including the registration, renewal and regulation of the industries subject to registration, renewal and regulation by the Provincial Government until the concerned Provincial Government makes law on such industries.

Limitation on particular industries establishment and operation: Subsection 4

Notwithstanding anything contained in subsections (1) and (2), industries generating atomic energy, radio-active materials, and industries related to atomic energy and uranium-based energy.

Information to submit remain details or documents: Subsection 6.

When examining an application received under subsection (1), it appears that any required details and documents are not submitted, the industry registration body shall immediately inform the applicant to submit such details or documents within a maximum period of ninety days.

Rejection of registration: Subsection 7

If the applicant fails to submit the details or documents demanded under subsection (6) or it does not appear that the procedures under this Act or the rules framed under this Act are met, the industry registration body may, by setting out the reasons, reject the application for industry registration. If decision is made to reject, it shall give written information thereof, setting out the reasons, to the concerned applicant within five days after the decision.

Provincial industrial administration: Subsection 2

The concerned Provincial Government shall carry out acts relating to the administration of industries including the registration, renewal and regulation of industries other than the industries under sub section (1). Provided that, permission shall be obtained in the industry as prescribed in schedule-1 in the case of an industry requiring permission.

Application to the industry registration body of concern province: Sub section 8

A person, firm or company that intends to establish an industry other than an industry mentioned in subsection (1) shall make an application to the industry registration body of the concerned Province for registration of the industry, accompanied by such details and documents as provided in the Provincial law.

3 b) Code of Conduct of the Institute of Chartered Accountants of Nepal has defined the cooling off period to the professional accountants as follows:

i If the individual acted as the engagement partner for seven cumulative years, the cooling-off period shall be five consecutive years.

ii. Where the individual has been appointed as responsible for the engagement quality control review and has acted in that capacity for seven cumulative years, the cooling-off period shall be three consecutive years.

iii. If the individual has acted as a key audit partner other than in the capacities set out as above (i) & (ii) for seven cumulative years, the cooling-off period shall be two consecutive years.

If the professional accountant has provided the services in a combination of key audit partner roles, then the cooling off period will be as follows:

i. If the individual acted in a combination of key audit partner roles and served as the engagement partner for four or more cumulative years, the cooling-off period shall be five consecutive years.

ii. Subject to paragraph R540.16(a), if the individual acted in a combination of key audit partner roles and served as the key audit partner responsible for the engagement quality control review for four or more cumulative years, the cooling-off period shall be three consecutive years.

iii. If an individual has acted in a combination of engagement partner and engagement quality control review roles for four or more cumulative years during the time-on period, the cooling-off period shall:

   a) As an exception to paragraph R 540.15 be five consecutive years where the individual has been the engagement partner for three or more years; or
   b) Be three consecutive years in the case of any other combination.

iv. If the individual acted in any combination of key audit partner roles other than those addressed in paragraphs R540.14 to R540.16, the cooling-off period shall be two consecutive years.

Service at a Prior Firm

R540.18 In determining the number of years that an individual has been a key audit partner as set out in paragraph R540.5, the length of the relationship shall, where relevant, include time while the individual was a key audit partner on that engagement at a prior firm.

Shorter Cooling-off Period Established by Law or Regulation

R540.19 Where a legislative or regulatory body (or organization authorized or recognized by such legislative or regulatory body) has established a cooling-off period for an engagement partner of less than five consecutive years, the higher of that period or three years may be substituted for the cooling-off period of five consecutive years specified in paragraphs R540.11, R540.14 and R540.16(a) provided that the applicable time-on period does not exceed seven years.

Restrictions on Activities During the Cooling-off Period

R540.20 For the duration of the relevant cooling-off period, the individual shall not:

(a) Be an engagement team member or provide quality control for the audit engagement;

(b) Consult with the engagement team or the client regarding technical or industry-specific issues, transactions or events affecting the audit engagement (other than discussion with the engagement team limited to work undertaken or conclusion reached in the last year of the individual's time on period where this remains relevant to the audit)

(c) Be responsible for leading or coordinating the professional services provided by the firm or a network firm to audit client, or overseeing the relationship of the firm or a network firm with the audit client; or;

(d) Undertake any other role or activity referred to above with respect to the audit client, including the provision of non - assurance services that would result in the individual

(e) Having significant or frequent interaction with senior management or those charged with governance,

3 c) A predicate offences is **a crime that is a component of a more serious crime**. For example, producing unlawful funds is the primary offence and money laundering is the predicate offence. The term "predicate offence" is usually used to describe money laundering or terrorist financing activities.

A predicate offense – or predicate crime – refers to a crime which is a component of a larger crime. In a financial context, the predicate offense would be any crime that generates monetary proceeds. The larger crime would be money laundering or financing of terrorism.

Section 2ad has not defined but designated the predicate offence as provided in the annex of the Money Laundering (Prevention) Act, 2064. Pursuant to the annex, the predicate offence as categorized in the act is as follows:

i) **Any offence under the prevailing laws**

- Participation in an organized criminal group and illegal or racketeering,
- Disruptive (terrorist) act and terrorism,

- Trafficking in human being and migrant smuggling in any form,
- Any kinds of sexual exploitation including the child sexual exploitation,
- Illicit trafficking in narcotic drugs and psychotropic substances,
- Illicit trafficking in arms and ammunition,
- Illicit trafficking in stolen and other goods,
- Corruption and bribery,
- Fraud,
- Forgery,
- Counterfeiting of coin and currency,
- Counterfeiting and piracy of products or imitation, illegal copy or theft of products,
- Environmental crime,
- Murder, grievous bodily injury,
- Kidnapping, illegal restraint or hostage-taking,
- Theft or rubbery,
- Smuggling (including custom, excise and revenue),
- Tax (including direct and indirect),
- Extortion,
- Piracy,
- Insider Dealing and Market Manipulation in securities or commodities ,
- Ancient monument conservation,
- Forest, National park and wild animals conservation,
- Money, banking, finance, foreign exchange, negotiable instruments, insurance, cooperatives,
- Black marketing, consumer protection, competition, supply,
- Election,
- Communication, broadcasting, advertising,
- Transportation entrepreneurship, education, health, medicine or forgery in foreign employment,
- Firm, partnership, company, association,
- Real estate and property,
- Lottery, gambling, donation,
- Citizenship, immigration and passport.

ii) Offence of terrorist financing pursuant to section 4,

iii) Any other offence as designated by the Government of Nepal by publishing a notice in the Nepal Gazette, or

iv) An offence under a law of a foreign State, in relation to act or omission under paragraph (1), (2) or (3), which had they occurred in Nepal, would have constituted an offence.

4. Answer the following questions:

a) The paid-up capital of JHI Private Limited is Rs. 10 Crores in the form of 7,00,000 Equity Shares of Rs. 100 each and 3,00,000 Preference Shares of Rs 100 each. Morning Star Private Limited is holding 3,00,000 Equity Shares and 3,00,000 Preferences Shares in JHI Private Limited. State with reason, whether JHI Private Limited is subsidiary of Morning Private Limited? **8**

b) Salme Hydropower Limited has issued IPO to the public on 22 September 2022 and listed in NEPSE on 02 October 2022. As per Security Registration and Issues Regulation, 2073 all listed companies have to published quarterly report in daily national newspaper and one copy of such report with signature shall submit to SEBON and NEPSE. State the contents that have to be mentioned in quarterly report as per the rules. **7**

Answer

4 a) According to Section 2(e) of Companies Act, 2063 "Subsidiary Company" means any company controlled by a holding company. Under section 142 (1) states that, a holding company may control its subsidiary company as follows:

i) By holding direct or indirect control over the formation of the board of directors;

ii) By holding majority shares of the company.

Section 142 (2) says, if any company becomes a subsidiary company of any other subsidiary company, the former company shall also be a subsidiary company of the holding company controlling the later company.

Under section 142 (3) the shares of a company are subscribed by any agent on behalf of the holding company or its subsidiary company or that the right to appoint directors of such company is exercised by any person nominated on behalf of the holding company or its subsidiary company, the conditions mentioned in Sub-section (1) shall be deemed to have been fulfilled. However, that while determining a holding company and a subsidiary company, the shares possessed in the following circumstances shall not be recognized for this purpose:

i) In cases where any company is entitled to exercise any power on the basis of holding debentures or a trust deed on the issue of debentures or having subscribed shares;

ii) In cases where a company lending credit has accepted the shares by way of security.

It is to be noted that Preference share capital will also be considered if preference shareholders have same voting rights as equity shareholders.

In the instant case, JHI Pvt. Ltd. is having paid-up capital of Rs. 10 Crores in the form of 7,00,000 Equity Shares of Rs. 100 each and 3,00,000 Preference Shares of Rs. 100 each. Morning Star Pvt. Ltd. is holding 3,00,000 Equity Shares and 3,00,000 Preference Shares in JHI Private Limited.

As in the given problem it is not clear that whether Preference Shares are having voting rights or not, it can be taken that there is no voting right with these shares. On the basis of provisions of Section 2(e) with section 65 (e) and facts of the given problem, Morning Star Pvt. Ltd. is holding 3,00,000 Equity Shares of total equity paid up share capital of JHI Pvt. Ltd. Therefore, as Morning Star Pvt. Ltd. does not exercise or controls unless by holding direct or indirect control over the formation of the board of directors' u/s 142 (1) (a) or by holding majority shares u/s 142 (1) (b) in JHI Pvt. Ltd., So, JHI Pvt. Ltd. is not subsidiary of Morning Star Pvt. Ltd.

4 b) Each listed company shall publish quarterly report in the national media and also should load the data in the NEPSE & SEBON online system so that each stakeholder should have knowledge on the company and its progress and current status. Following contents should be required to make the quarterly report for the publication for a listed company as per the schedule 14 of the Security Registration and Issue Regulation, 2073:

i) Financial statement:

- Quarterly financial statement including the balance sheet, profit or loss account and the quarterly financial statement should be comparable with the previous year same quarter financial statement. This financial statement should be based on the provisional financial statement and should be prepared considering all possible facts and figures in every quarter and the figures should be comparable in each quarter so that the investor can analyses the financial information as per their requirement.
- Along with the financial report, a details of number of shares hold by the related parties of the company is also shown in the report. Related parties including their name and share holding along with their ratio of holding also be mentioned in this report.
- There should also include the financial ratio like earning per share, PE ratio, net worth per share, return on assets and return on equity

ii) Management Analysis

- Management shall include the current status of the company saying whether the company has started commercial operation or will start within the date or any further analysis of the company should be mentioned in this section.

iii) Legal proceeding:

- The report should also disclose whether there is any legal case regarding. All legal cases and litigation should be disclosed in this report.

5. Answer the following questions: **(3×5=15)**

a) According to the Labour Act, 2074,Hiring Foreign Nationals is not open to the employer. However in certain cases, employer can employ foreign nationals by fulfilling the required legal process. State those conditions where an employer is allowed to employ foreign nationals.

b) Point out the matters shall be audited by the Auditor General in view of propriety in accordance with Audit Act, 2075.

c) Certain customers of a commercial Bank have made an application that the commercial bank is in a problematic condition. State the circumstances in which banks or financial institutions will be deemed problematic as per the Nepal Rastra Bank Act 2058.

Answer

5 a) Section 22 of the Labour Act, 2074 prescribes the provision regarding the conditions where an employer are permitted for hiring foreign nationals. According to it, the foreign national can only be hired if local skill sets are not available for the job. The New Labor Act also provides provisions on work permit for certain entities, the language of employment agreement, repatriation of salary and terms and condition of service etc.

General Provisions: No foreign nationals can be engaged in work without having obtained the work permit from the Department. Prior to engaging a foreign national in work, the entity must publish an advertisement in national level Daily Newspaper to fill the vacant posts by Nepali citizens. If no application is submitted or if no local skill set is available for any work after the vacancy publication foreign national can be hired for the work with the approval of Labor Department.

Work Permit for technicians for short period (Section 24): Technicians engaged for less than three (3) months to carry out repairing of any machinery or installing new technology or similar casual work may be provided work permit simply by recording in the Labor Department.

Employment Agreement: As per the New Labor Act, 2074 no foreign national can be engaged in work without the employment agreement which should be entered into either in language understandable by such foreign national or in English language. Unless otherwise provided in the agreement, the employment agreement continues for three years.

Repatriation of Income: The foreign nationals can repatriate their income in convertible foreign currency.

Work Permit Exemption Section (Section 24): The foreign nationals having diplomatic immunity or the foreign nationals who are exempted from work permit under the treaty or agreement entered into with Nepal government are exempted from work permit requirement.

5 b) In accordance with section 9 of the Audit Act, 2075 the matters to be audited by the Auditor General in view of propriety:

i) The Auditor General shall, as required, audit the following matters in view of the propriety thereof:

- If it is seen that any expenditure, though it confirms to the authorization, has been made unreasonably or in a manner to cause loss and damage to the national property, with respect to such expenditure and its authorization,
- With respect to any grant of national property whether movable or immovable or underwriting of revenue or any lease, permit, license or rights relating to mining, forest, hydropower etc. and all authorizations issued in a manner to abandon any revenue or national property, whether movable or immovable,
- With respect to the subject-matters of various financial transactions including contracts and agreements relating to public works, repair and maintenance, procurement and supply, consultancy service, service delivery, public expenditure and revenue mobilization.

ii) The Auditor General may, if he or she deems it appropriate, examine, in accordance with the recognized principles of accounting, as to whether or not any official within his or her scope of competence has borne financial accountability.

iii) The Auditor General may not include in his or her report minor items of irregular amounts or other items deemed not to be significant and important in view of their propriety.

5 c) Under Section 86B of Nepal Rastra Bank Act, 2058, Nepal Rastra Bank will declare any commercial bank or financial institution problematic by providing written notice to it when Nepal Rastra Bank is convinced that the following conditions are prevailing in any commercial bank or financial institution:

a. In case any action against the interest of the depositors, shareholders, creditors or general public is evident,
b. In case of not fulfillment of any financial liabilities or not having probalility to do that or not payment of due amount,
c. In case of insolvency or going t be insolvent or facing material financial difficulties,
d. In case of non-compliance with or breach or the Nepal Rastra Bank Act, prevailing law related to bank and financial institution, other prevailing law, terms of licenses or regulation, directives or order of bank,
e. In case it is evident that the license has been obtained on the basis of submitting false, fraudulent, wrong document or data,
f. In case of inability to maintain the capital fund as per Nepal Rastra Bank Act, prevailing law related to bank and financial institution and directives issued by the bank at time to time.
g. In case of the initiation of legal proceedings for liquidation or resolution r insolvency of any commercial bank or financial institution under the prevailing law,
h. In case of undue delay in the process of voluntary liquidation where such proceeding has been initiated,
i. For the commercial bank or financial institution established with the joint venture of the foreign commercial bank or financial institution, while such foreign commercial bank or financial institution is insolvent or liquidator is appointed for the liquidation or the license of such commercial bank or financial institution is terminated under the provision of the law or respective country or transaction is banned either fully or partially or where it is evident that operation of banking transaction is done in association with such commercial bank or financial institution, or
j. If the Nepal Rastra Bank is convinced that commercial bank or financial institution is unable t pay its due or can make negative effect in its liability or duties, which it has to perform.

6. Write short notes on the followings:

a) Mention the grounds to cancel license of an institution violating directives issued under the Act Relating to Institutions Acting as Financial Intermediary, 2055. **4**

b) State punishment thresholds on commission of avail or provide credit, facility or discounts beyond the authority obtained or limit sanctioned under of the Banking Offence and Punishment Act, 2064. **3**

c) Highlight the license procedures to carry on Foreign Exchange in accordance with the Foreign Exchange (Regulation) Act, 2019. **3**

Answer

6 a) Section 19 of the Act states the Power to Cancel License:

i) In case any Society violates the directives issued under Section 18, the Bank may issue a warning to it to correct its mistakes, or impose a bank on any of its functions. In case any society violates such directives for three times, or takes any of the following actions, the Bank may suspend or cancel its license.

- In case the Society stops working as a financial intermediary.
- In case the Society misappropriates its funds, or does not use such funds for purposes for which they have been received.

- In case the Society does not comply with the directives issued by the Bank to introduce reforms or make any special arrangement in respect to any of its functions and activities by prescribing a time limit for that purpose.
- In case the Society fails to renew itself under the 1977 Registration of Association Act and Section 7 of this Act.

ii) The Bank may, if it so deems necessary before issuing an order of cancellation of license under Sub-Section (1), have necessary nquiries or investigations conducted in that connection.

iii) Before cancelling a license under Sub-Section (1), the Bank shall provide the concerned Society with an opportunity to submit its explanations.

6 b) Section 15(2) has been provided while avail or provide credit, facility or discounts beyond the authority obtained or limit sanctioned. If anyone commits such offence specified under the section 7(d) he/she will be punished with the fine and imprisonment as stipulated on the basis of claimed amount and depending upon the degree of offence committed.

Claim Amount	**Imprisonment**	**Fine**	**Compensation (Recovering claim Amount)**
Up to 10 lakhs	up to 1 year	As per claim amount	As per claim amount
10- 50 lakhs	2-3 years	As per claim amount	As per claim amount
50 - 100 lakhs	3-4 years	As per claim amount	As per claim amount
100 - 1000 lakhs	4-6 years	As per claim amount	As per claim amount
1000 - 5000 lakhs	6-8 years	As per claim amount	As per claim amount
5000 - 1 Arab	8-10 years	As per claim amount	As per claim amount
Above 1 Arab	10-12 years	As per claim amount	As per claim amount

6 c) The License procedures, pursuant to the section 3, to be obtained to carry on foreign exchange transaction, are as follows:

i) A person, firm, company or body who intends to carry on the foreign exchange transaction shall obtain the license from the Bank.

ii) A person, firm, company or body who intends to carry on the foreign exchange transaction shall make an application, accompanied by the details specified by the Bank, to the Bank to obtain the license.

iii) If an application is made pursuant to Sub-section (1), the Bank shall make necessary inquiry into the matter on the basis of the specified criteria and may, if it considers appropriate, issue the license to the concerned person, firm, company or body to carry on the foreign exchange transaction. In so issuing the license, the Bank may also specify the type and limit of the foreign exchange to be transacted, the period for carrying on the transaction and other necessary terms.

iv) The Bank may, from time to time, give necessary order or directive to the licensee in relation to the regularization and management of the foreign exchange transaction. It shall be the duty of the licensee to abide by such an order or directive.

v) The licensee bank shall pay to the Bank such annual fees and deposits as may be prescribed by the Bank. The Bank may cancel or suspend the license of the licensee who fails to pay the annual fees and deposits so prescribed.

vi) If any person, firm, company or body applies for an provisional (Patake) license to carry on the foreign exchange transaction, the Bank may issue the provisional license to such a person, subject to this Section.

Examiner's Commentary on Students' Performance in December 2022 Examinations

Paper 1: Advanced Financial Reporting

List of Questions	Specific Comments on the Performance of the Students
Question no. 1	Most of the students attempted correctly, however confused on calculation of Deferred Tax, Retained Earning, Long term Borrowing Parts.
Question no. 2	a. Most of the students were confused on Time Period for Calculation of SAR Liability. b. Most of the students were confused on Calculation of PV of loan.
Question no. 3	a. Confused on Hedge Accounting. b. Bonus Question is well Attempted and scored good
Question no. 4	All questions are attempted well except question no e. Students were not conceptually cleared on these questions.
Question no. 5	a) Very little preparation b) Confused with finance ware.
Question no. 6	a) Confused on valuation of non-current asset as on 1^{st} Kartik b) Confused on treatment for factory Shed previously directs charged to P/L.

Paper 2: Advanced Financial Management

List of Questions	Specific Comments on the Performance of the Students
Question no. 1	In part (b) of the question students were not able to answer the question by making NPV=0 In part (c) students did not explained properly the correct method of risk analysis in capital budgeting.
Question no. 2	a. Most Students did not answer the question correctly. b. Most of the students were not able to compute gain or loss to share holder on exchange of share.
Question no. 3	Answered correctly, but some students wrongly used spot buying and selling rate.
Question no. 4	All theories are not specifically answered.
Question no. 5	a. Most of the students wrongly treated the direct contribution to overhead by parent company. b. Most of the students answered correctly.
Question no. 6	a. Answered correctly. b. Answered correctly, but some made mistakes in computing Actual return.

Paper 3: Advanced Auditing

List of Questions	Specific Comments on the Performance of the Students
Question no. 1	a. NSA 402 is quoted and explained by only few students. b. Though types and threats are properly given, explanation part seemed weak in majorities of students.
Question no. 2	a. Objectives of EOM is not clear in majorities of the students. b. Only few left to write the conclusion.
Question no. 3	a. Lack of conclusion in about 50% cases. b. NSA 450/320 is quoted and explained by few students.
Question no. 4	a. Majorities of the students do not answer well.
Question no. 5	a. Fairly done. b. NSA 315 is not explained by many students. c. Too general answer.
Question no. 6	Satisfactory performance.

Paper 4: Corporate Laws

List of Questions	**Specific Comments on the Performance of the Students**
Question no. 1	a. Most of the students failed to maintain the legal provision and time period to submit various documents under various sections. b. Most of the students did not answer properly.
Question no. 2	a. Satisfactory performance b. No adequate preparation of Insurance Act, 2049. c. Most of the students failed to explain the question.
Question no. 3	a. Very few students answered this question correctly. Students are unaware about the three tire of Government system for the registration of industry. b. The cooling off period is defined by very few students. c. Most of the students defined predicate offence in general.
Question no. 4	a. Answered by majority of the students. b. Overall performance of the students is satisfactory.
Question no. 5	a. Most of the students attempted this question with well preparation. b. Majority students referred the correct legal provision. c. No adequate preparation of Nepal Rasta Bank Act was found.
Question no. 6	a. Most of the students are not aware about the Act and could not answer the question properly. b. Not attempted by majority of the students. c. Attempted by most of the students.