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# THE CHARTERED ACCOUNTANT

JOURNAL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA



## Centre of Excellence - Ready to Take off

- 59<sup>th</sup> Annual Function of ICAI at New Delhi on February 4, 2009 at 3:00 p.m.
- Succession Planning in Family Managed Business
- An Introduction to Excel Solver – An Optimization Tool
- XBRL – A CFO's Perspective

Celebrating 60<sup>th</sup> Year of Excellence

Volume 57 No. 08 February 2009

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## THE SATYAM FIASCO

The energy giant Enron was billed America's most innovative company till a massive accounting fraud brought its downfall in 2001. In 2009, the more or less same story has unfolded in India at its fourth largest IT company Satyam Computer Services with its promoter B. Ramalinga Raju confessing to country's largest-ever corporate fraud of Rs. 7,136 crore by cooking the company's books for years to inflate profit and revenue figures. The revelations about this massive con-job have shocked India Inc, Indian capital markets, regulators and auditors fraternity across the globe. The episode has cast a shadow over the credibility of corporate governance mechanism, role of independent directors, regulatory framework and auditing profession in the country.

The timing of all this could not have been worse – India is reeling under the impact of global economic turmoil and its stock market was just showing signs of responding positively to Government moves to stimulate economy. Although Satyam episode is not a system failure and an aberration, still, it poses a danger of domestic and overseas investors losing confidence in Indian corporate governance and related oversight mechanisms. This scenario calls for urgent short-term as well as long-term steps and measures to restore and sustain confidence of various stakeholders in India. The broad three-pronged confidence building approach should be – 'To save Satyam from going the Enron way', 'To strictly and swiftly punish all the guilty,' and 'To fine-tune and tighten regulatory and monitoring framework to avert a repeat of Satyam'.

Government's speedy actions of appointing a new board comprising ace entrepreneurs and professionals and launching probes on various fronts are welcome, but are seen only as a small consolation when compared to huge expectations of anxious stakeholders. The ultimate success lies in speedy delivery of results on all the related fronts. All those guilty of negligence or connivance in this episode deserve exemplary punish-

ment. The Institute of Chartered Accountants of India too has moved fast to assess the performance gap, if any, in the statutory audits of the corporate and is committed to punish those found wanting. It has already constituted a High Powered Committee to look into the matter, in sync with a concerted drive by various Government agencies and regulators like Securities and Exchange Board of India and Reserve Bank of India to bring the guilty to book in a time-bound manner. While the Committee is on the job, it may be worthwhile to note that "regulation and maintenance of the status and standard of the professional qualifications of members of the Institute" is one of the important functions to be discharged by the Council. To discharge

this function, the Council, for decades, has in place a four-pillar mechanism viz. 'standard setting', 'continuing professional education', 'supervision' and 'disciplinary', and has constituted various boards and committees for the purpose.

It is important to note that the composition of all the standard setting Boards/Committees as well as the Financial Reporting Review Board, the Peer Review board, the Quality Review Board as well as the Disciplinary Committee and Board of Discipline ensures representation to a cross section of stakeholders such as the Government, the regulators, viz., Reserve Bank of India, the SEBI, the Insurance Regulatory and Development Authority; industry, academics, etc. One must remember that the concept of professional skepticism is the mainstay of auditing, and that, in turn depends on the professional judgement of the auditor.

In the present situation, the greatest danger to Indian companies comes not from the unmasking of Satyam's fraud but from any failure to deal robustly with all the shortcomings that allowed it to happen. Of course, the corporate credibility is a foundational must for any emerging market economy pursuing high growth.

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ICAI Bhawan, Post Box No.7100, Indraprastha Marg,  
New Delhi-110002. Tel: + 91 (11) 39893989.  
E-mail: journal@icai.org, website: www.icai.org

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**Cover:** Photograph of the Centre of Excellence at Hyderabad which is proposed to commence its activities very soon to enhance the excellence of members and students.

## Dear Esteemed Colleagues,

Change is the only thing that is constant. It is this continuity of change — change with the times that has kept our profession in a leading position in India for decades. As has been well said, ‘continuity gives us roots; change gives us branches, letting us stretch and grow and reach new heights’. It is time for change at the Institute too — a change of guard at the very top. Yes, this is my last message to you as the President of the Institute.

And as I write this, the nation and our profession are grappling with India’s largest-ever corporate fraud of over Rs. 7,000 crores committed at country’s fourth largest IT firm, Satyam, by cooking up the company’s books for years to inflate profit and revenue figures. The irregularities in this high-profile con-job have come as a rude shock to the Institute, indeed to the entire accountancy profession and the society at large. The resultant furore and backlash against regulators and auditors is only natural. But, looking to the facts so far, it doesn’t seem to be a case of a systemic failure, but is more in the nature of an individual aberration. I can only say that we as a professional body are as keen as any one else to get to the bottom of things and the Institute as the regulator of the auditing profession will do everything which is expected of it.

Friends, there is a wrong impression in certain quarters that the Institute is slow in taking deterrent action against defaulting members. On the contrary, the Institute has been most prompt in taking punitive action against its errant members. In fact we have been most stern in punishing members for any violation of the code of conduct. An idea of how severe the Institute can be had from the fact that in the last three years itself, it has awarded punishment to more than 100 members. The Institute has painstakingly tried to ensure adherence to a code of conduct by all its members. Let me reassure you that I and my colleagues in the Council are committed to keep that track record unblemished by giving exemplary punishment to all those who may be found guilty in the Satyam episode after expeditious investigations. We have initiated a range of steps and have embarked on extensive and time-bound investigations, in sync with a concerted drive by various Government agencies and regulators to bring the guilty to book. Our first and foremost task, I need hardly say, is to restore and sustain confidence of the society in our profession.

Our credibility is at stake. It’s time for all our

members to be extra-vigilant while delivering our services and performing our duties, particularly in the backdrop of Satyam fiasco, which might change the relationship between the auditors and the managements in the years to come. We need to re-prove our worth as the backbone of Indian financial system and justify the epithet of being the ‘conscience keeper’ of Indian economy.

The Satyam fraud is a wake-up call to all members to meet the biggest challenge posed to the profession. The society expects that the financial statements once certified by the auditors are true and can be taken at their face value and we must all endeavour to restore that faith in the profession.

## Training to Articled Assistants

The present troubled times also bring into focus the strong need for quality article training, which is the key to a strong accountancy profession. In these times of high expectations, globalization and the fast-increasing number of articled assistants, the practical training of articled assistants has to be taken far more seriously than ever before in order to maintain high standards of probity and excellence. It’s high time that members/principals rose to the occasion and gave extra attention to groom the CA students who work with them into complete professionals of integrity and ethics. Members need to act like mentors, as ‘friend, philosopher and guide’ to the CA students and give them the best training they can. The practical training needs to be meticulously planned and implemented in such a manner that the trainees get exposed to a variety of professional activities, circumstances and business environments.

Let me now share with you some of the other major developments pertaining to our profession over the last one month.

## MoU with CPA Australia Recognizing Each Other’s Qualifications

All through my tenure my earnest endeavour has been to ensure that the international presence of ICAI and Indian Chartered Accountant is more widespread and strong. You would recall that in the month of November, 2008, we had signed a historic MoU with ICAEW recognizing each other’s qualifications. Now an MRA with CPA Australia has also been finalized and by the time this issue of the Journal reaches you, the same would have been signed.

As per the Memorandum of Understanding

reached, members of ICAI who are graduates will be eligible for CPA Australia membership on passing one paper on Business Strategy & Leadership. On the other hand, members of CPA Australia will be eligible for ICAI membership subject to passing two papers on Corporate and Allied Laws and Taxation and two more papers on Advanced Auditing and Professional Ethics and Financial Reporting, if they have not already passed them as part of the CPA Australia programme.

This MRA will open professional opportunities to our members in Australia and this will bring the two countries, India and Australia, closer. Let me further inform you that discussions are on with other Institutes of the world, particularly in Canada, Singapore, CA Australia, Ireland and Scotland and I am quite confident that very soon, we should be in a position to have similar MRAs with many more countries.

As part of our effort to popularize Indian CA qualification in countries of interest to Indian

accounting profession, ICAI's proposals for the institutionalization of the accountancy profession have been well received by Papua New Guinea and the Republic of Djibouti and are under active consideration.

In yet another major capacity and credibility enhancing initiative for members associated with Information Systems Audit, we have formally signed an agreement with Information Systems Audit and Control Association (ISACA). Now our members can freely access and make use of internationally accepted standards, guidelines and procedures of ISACA. It will not only bring increased global credibility, goodwill and acceptability of our DISA qualification in carrying out IS Audits but also facilitate active participation of our members in further research that is being conducted by ISACA

for development of IS Audit standards

However, some other important tasks on my international agenda have remained unfinished. These include formation of Chapters of the Institute at Thailand, Hong Kong, Tanzania and Auckland, but necessary processes for these are on. The project of the 'compilation of a directory of foreign members' and the institution of the Best Chapter Award are also in progress.

## **The Institute's Gift of a Free Accounting Software**

Friends, ours is an accounting Institute and I have always wondered what is the best gift that an accounting Institute like ours could give to the world. Accordingly, I conceived the idea of giving account-



ing software to the world that can be downloaded by anyone anywhere absolutely free of cost. Being an accounting Institute, it is our responsibility to make available all tools that are required in accounting and auditing.

I am glad that we have been able to develop the first version of such accounting software. It has been officially launched and is now freely downloadable from the ICAI website by any user. The software is the first of its kind. It is a web based, easy to use, with the help of which the end users will be able to maintain their accounts online. It can operate as a single user license on a desktop computer for a small timer. If deployed on a web server, it can meet the financial accounting requirements of the corporate sector as well.

The initial version of the software will contain core modules. This software will also serve households that use accounts payable type accounting transactions, managing budgets and simple account reconciliation. Our accounting software would be different from other accounting softwares, as it will be web-based, that will offer the facility of viewing of

accounts online from anywhere/ anytime and having accounts in any currency of the world.

The Institute will be releasing advanced versions of the software from time to time and in due course it will ultimately meet even the most complex and expensive business accounting software requirements which are normally a part of an extensive suite of software often known as Enterprise Resource Planning or ERP software.

I may add that work on developing free downloadable auditing software for small and medium practitioners is also on and we should be in a position to launch it soon.

### Accountancy Museum

You would recall that I had envisaged an accountancy museum with a rare collection of objects of historic and heritage value from the point of view of the accountancy profession in India. Today, I am delighted to inform you that this museum is ready, and will be open for all of you by the time you read this issue.

The museum presents rare and historic images (evidence of the oldest balance sheet in human civilization), and documentary evidence of the evolution of accountancy in India. The items on display include the minutes of Indian Accountancy Board (responsible for the birth of the Institute), first gold medals of R.A. final and CA final examinations, first annual report of the Council, our own first balance sheet, rare photographs and so on. It will also showcase very unique images including documents that have been acquired from the British Museum, London, and other private collectors from India as well as abroad. I am sure this museum will serve as a great source of learning, inspiration and professional pride for all of us.

### Digital Library

I am happy to inform that all the five Regional Council Libraries and the Central Council Library of the Institute have been brought on an 'Enterprise Library Software', facilitating access to all libraries simultaneously. This facility will also provide links to online journals, e-books, articles from *The Chartered Accountant* journal, library security deposit rules, library services for members & students, photographs available in the library, recent additions and SAFA books & publications available in the library and much more. Log-in facility for members and students will provide search and access to user account with the additional facilities

like alerts etc. It will also facilitate easy and speedy correspondence with the library on a regular basis. This e-Library is accessible from e-Library link hosted on [www.icaai.org](http://www.icaai.org).

### Portal for Members

With a view to facilitate better networking among practicing members and to ensure optimum utilization of their services and expertise, an exclusive portal has been launched for them wherein the practicing members can offer one area of their service that may be availed of by other practicing members. The portal will cater to both the overburdened members who are looking for specialized helping hands among our fraternity as well as those who are looking for professional opportunities. This portal offers an easily accessible and mutually beneficial contact point for the entire CA community. I foresee a great boost in networking and professional opportunities for members in practice through this portal. Let's remember that 'coming together is a beginning, staying together is progress, and working together is success'.

### Centres of Excellence

In my first communication to you in the March, 2008 issue, I had shared with you my dream of having Centres of Excellence throughout the country to make the CA 'a world class, matchless professional'. I am happy to say that as part of that drive, a Centre of Excellence in Hyderabad is being inaugurated later this month i.e. on 31<sup>st</sup> January, 2009. This will be a Centre of Excellence with a difference and it will offer residential courses and programmes for members, particularly the senior ones, with a view to transforming them into the best available, multi-dimensional professionals. This Centre will offer opportunity to members, both in practice and industry, to enhance their competitive competence and communication skills as well as their practical skills and professional and leadership abilities.

You will be happy to know that work on Centre of Excellence in Jaipur is continuing apace. Further, we have also acquired land for a Centre of Excellence in Bangalore.

### Convergence with International Ethical Standards

As part of our drive to continue to benchmark ourselves against the best available global practices and explore the tremendous opportunities on the horizon, we have adopted a new Code of Ethics which

is in line with the IFAC Code of Ethics. I am sure this move will go a long way in boosting the stature and brand of Indian CAs and help in his/her transformation into a 'Global Chartered Accountant'. Across the world, it will also help showcase Indian accountancy profession at a higher pedestal of professional excellence. In a related move, our Committee on Ethical Standards has been reoriented and re-organized as 'Ethical Standards Board' to facilitate greater transparency and participation of other stakeholders – ministries, regulators etc, in the relevant standard-setting process.

## Examination Results Set Welcome Trends

The results of Common Proficiency Test (Dec. 2008) and Chartered Accountancy Final Examination (Nov. 2008) have been excellent and have set some welcome new trends.

A total of 34,251 students (38.37%), including 11,588 girls cleared the CPT out of a total of 89,253 who appeared for it. The analysis of CPT results over the years shows that since 14<sup>th</sup> September, 2006 when the new scheme of CPT was introduced, within a period of about 27 months, about 3.8 lakh students have opted for CA Course out of which more than 1.55 lakh students have passed the CPT examination. Thus, there has been a substantial increase in number of students as compared to years 2001-2005 when an average of 35,000 students used to get enrolled for articleship. There is also an increase in the number of girl students opting for CA course — 30.96% (27,637) of total 89,253 students who took the latest CPT were girls. Moreover, the performance of girls has also been better than that of boys with an impressive pass percentage of 42% as against 37% of their male counterparts.

In the CA Final examination, 20.27% (2961) of 14,606 students who appeared for both groups have passed while 18.76% of a total of 6588 students cleared Group I and 21.13% of a total 9235 have passed Group II. A welcome trend is that there has been an increase of more than 25% in the number of students appearing for the Final examination as compared to November, 2007. The percentage of female students too has continued to rise over a period of time. Out of total 30,399 students that appeared for Group-1, Group-II & Both Groups in November, 2008, the number of female students was 7189, i.e., 23.64% of the total students as compared to 23.04% in May, 2008. Not only that, female students also continue to excel in their performance in CA examination and they

have bagged two out of the first five positions.

I congratulate all those who have passed the examination. My special compliments to the rank holders.

## Initiatives for Students

You would appreciate that all through my tenure, I have tried to ensure that CA students and their welfare get special attention in ICAI's overall scheme of things and they are provided with an enabling environment that helps them not only in their academic pursuits but in the development of their overall personality as well. As part of that mission, it has been decided to develop sports/gymnasium and health check-up facilities for students at every branch of ICAI. This, I am sure, will prove to be very beneficial to them. The facilities so developed can also be made available to members as is being done for computer labs.

Further, with a view to giving a distinct identity to CA students and to inculcate a sense of belonging among them, it has been decided to give a face-lift to the dress prescribed for them. Now, CA students will be encouraged to wear a blazer of a colour slightly different from the blue recommended for members with a prescribed lapel pin sported thereon. The lapel pins, whose photographs were published in January, 2009 issue of the journal, have been made available at all the decentralized offices of ICAI and are meant to be given free to the students at the time of their registration itself.

## I Bid Adieu...

Friends, as I prepare to pass the baton of ICAI leadership on to my successor, I can modestly say that many of my initiatives have borne fruit. You will, I hope, agree that ICAI is today a more robust, developed, energetic and futuristic organization. I am happy to recall that during the year when I had the privilege of leading the onward march of ICAI, it has not only grown bigger and better but has also paved the way for a brighter tomorrow for the profession. Barring the unfortunate Satyam episode, there has been a phenomenal rise in the status, prestige and image of ICAI in the public eye.

When I took over the reins of the ICAI, I had a mission within the ultimate vision of excellence and I am proud to say that we have accomplished most of that mission. ICAI has hit several milestones and overcome several challenges with the spirit of a true partner in nation building. Friends, I have tried to go faster, and have tried to speed things up.

When I look at the infrastructure, the Centres of Excellence at Hyderabad, Jaipur and Bangalore are taking shape, whereas the process of acquisition of land for Centres of Excellence at Guwahati, Mussoorie, Chennai, Noida and Ernakulam is going on.

The branches are the extended arms of the Institute and in order to strengthen these branches a number of steps have been taken to ensure better infrastructure. Out of total 118 branches, 63 branches have their own buildings; construction is on at 14 branches; and the process of acquiring land is on in at least 18 branches. Further, each of the branches is being provided with a generator set. Seventy-three of them have their own websites. Six overseas chapters also have their own websites. The e-mail facility that was started during this year has been made use of by more than 58,000 members and students.

During the year, as many as 111 branches and 4 Chapters have got their own computer labs besides 16 computer labs at regional headquarters for imparting top rate information technology training to students as well as members. At the same time, the process of setting up more computer labs and expanding the capacity of the existing labs and starting the advanced information technology training for final course students is on. These labs, besides imparting training to the students and to members who are not computer savvy, have also helped in conducting the on-line examination for CPT. Now the plan is to hold CPT examination on-line every month starting from the month of March, 2009.

The three-month residential programmes for students have been started at Faridabad and at Jaipur, but, as indicated above, the Institute will soon be in a position to start this programme at other places also including at IIM Indore.

The Board of Studies has been expanded and subject-wise departments have started working. My desire was to bring it to completion during my tenure, but because of the delay in the construction of the Noida building, it is likely to take another six months. I am hopeful that this process will be completed next year and we will be in a position to have a full-fledged Board of Studies having specialized wings for each of the subjects.

The launch of Accounting Technician Course and granting Accounting Technician certificates to students who could not pass the CA final examination, conducting examination on alternate days to make examination schedules less stressful for stu-

dents, and holding convocations to help forge a bond of camaraderie among new members were some of the new initiatives which we were able to accomplish during this year.

In tune with the emerging requirements of globalized economy and the need for specialized professionals and also as a futuristic move, we have been able to start 10 certificate courses in various spheres this year. The response of the members to each of these courses has been very encouraging. I am quite confident, that over a period, the Institute will be in a position not only to run all these courses in all major cities, but also come out with many more certificate courses.

To ensure that the students that we produce have an all-round development, various initiatives were taken during the year by organizing extra curricular activities. These include the National Debate competition, National Sports competition, National Cultural competition and creating health awareness. Many more of such activities need to be started for the all-round development of the students.

Similar activities for members have helped in creating a bond not only among them, but among their families as well. This year 2008-09 which is being celebrated as the Diamond Jubilee Year, a special focus was put on reaching out to the society and many initiatives were taken including a host of programmes. As part of this effort, the Institute was able to invite the top leadership of the country like the Hon'ble Prime Minister, Hon'ble Corporate Affairs Minister, Hon'ble Finance Minister, Hon'ble Deputy Chairman, Rajya Sabha and a host of Governors, Union Ministers, Chief Ministers and other dignitaries. Besides, we launched ICAI National Service Scheme to contribute our mite to socially relevant areas and to bring the profession much closer to the society.

Besides, as part of our social responsibility, we made significant progress in giving our support to the Government, both Central and State, in public finance and Government accounting. I am confident that in the years to come, our core competence in these areas will go a long way in ensuring better management of public finances and improving transparency in Government accounting.

An area which is very close to my heart is the creation of professional avenues and opportunities for members who have qualified the ISA course. I must admit that despite my best efforts, much progress could not be made except the signing of MoU with ISACA. This, I believe, will help com-

plete this process. But we need to do a lot more here, which include providing hands-on experience in a live environment with the service users. There is also a need to bring close proximity between such qualified members and users of ISA service.

As the premier accounting Institute, it is our responsibility to carry out research on accounting and related subjects. Though some initiatives were taken in this direction during the year, I must admit that the progress has not been as much as I wanted it to be. There is an urgent need to identify research scholars and encourage them to work in the area. ICAI needs to come out with research documentation one after the other so that it becomes one of the leading institutions in fundamental research. We also need to do research in teaching accountancy and related subjects through distance education.

On the front of creating a sense of belonging and making the CA fraternity a close knit family, various steps were taken during the year. These include increased communication by providing e-mail facility, improved website, updated information and improved on-line payment system. These efforts have certainly helped in bringing back many of those members who have not renewed their membership but there are still a large number of persons, who were members at one time, but have not renewed membership. We need to do a lot more on this account so that we can say with pride that each person who has qualified as a Chartered Accountant from this Institute is a member of the Institute. Besides, there is still a lot of scope in improving the behavioural response in the service to be provided by the Institute to its members and the students.

I believe that with every rising sun, you rejoice at a journey that has begun. And with every setting sun,

you rejoice at the victories that you have achieved and the paths that you paved for victories the next day. We have indeed come a long way, but I must admit that I have not been able to accomplish as much as I wanted to. There are still miles to go, still many more promises to keep. As such, these accomplishments cannot be final. The pursuit of ultimate excellence is an ever-going journey for the Institute and the profession. I am sure my successors will not only finish the unfinished agenda but also take up new ones, set new goals, make fresh starts in newer areas and achieve newer milestones in times to come.

Friends, all this would not have been possible without the active support of my colleagues in the Central Council, Regional Councils, branches and officers and staff of ICAI, who, more often than not, have burnt midnight oil with me, sometimes working as late as 3 AM. I humbly and sincerely thank all of them. I also express my gratitude towards past presidents and other well wishers for their encouragement and support.

As I sign off as President of ICAI, I feel overwhelmed by the affection showered on me and the confidence reposed by all of you in me. This has been the source of my strength and has energized me to work aggressively for the cause of the profession. And it has earned for me a unique relationship with all of you and with all our students, something that I will cherish for the rest of my life.

Adieu!



— CA. Ved Jain

New Delhi, January 27, 2009



*Back home*

**'ICAI President with President of India' – An Amusing Anecdote**

When I saw in the January 2009 issue of our journal, the photograph of our Institute's President with President of India, I recalled a very humorous incident when our Institute's President in 1974-75 (late Mr. N.C. Krishnan) called on the then President of India Mr. Fakhruddin Ali Ahmed for an 'At Home' tea-party hosted by the latter in honour of the visiting foreign delegates attending the Commonwealth Conference organised by our Council to celebrate our Silver Jubilee. As I recall, we were instructed beforehand about the protocol at such official functions whereby each person had to introduce himself and then shake hands with the President of India. Later when the Institute's President introduced himself as 'N.C. Krishnan, President of Institute of Chartered Accountants of India', Mr. Ahmed, tongue firmly in cheek, said: "Oh, my, your designation is longer than mine : I am only the President of India". The entire gathering burst into laughter and since

Mr. Ahmed was himself grinning, we were reassured that we were not breaching the protocol for such official functions.

— CA. Bansi S. Mehta, Past President, ICAI

**New Year Greeting with a Difference!**

The January 2009 issue of The Chartered Accountant journal deserves heartfelt appreciation for offering a treat to the eyes and minds of its 1,86,000 readers by way of artistic New Year greeting and insightful content. The very cover page of the issue inspires us to lead the New Year shining and blooming as bright as the sunflowers. The strong message which flows from the cover page of this edition is the year 2009 being the 'Sunflower year for the profession' with its fraternity of professionals converging together as the partners in Nation Building to offer their services in the larger interest of the economy.

— Sumit Kr. Dhanuka, CA Final Student, Mumbai

My heartiest congratulations to President CA. Ved Jain for having put in place a perfect system of delivering the journal timely. The January 2009 issue of the journal reached us exactly on 1st Jan 2009, carrying New Year wishes of the Institute to every member and reader with a difference. The cover page of the journal with Sunflower carrying ICAI logo depicts a joyous wish for each member and student in 2009. I admire the Journal as a highly professional and informative journal.

— CA. (Dr.) N.A. Charantimath, Hubli

I am a regular reader of the journal and congratulate the ICAI for bringing out yet another highly informative and attractive issue for the month of January 2009. I found the article 'Companies Bill 2008 – Accounts & Audit' as particularly informative and useful, especially for CA students. It was inspiring and refreshing to read, know and understand the meaning of the ICAI motto 'Ya Esa Suptesu Jagarti'. The advertisement with the punch line: 'A Cut Above the Rest, Indian Chartered Accountants Are Best' too was morale booster for many like us.

— Chiragkumar R. Patel, C.A Final Student, Ahmedabad

**MoU With Bhartiya University**

I congratulate the ICAI for entering into agreement with Bhartiya University for MBA course for both members and students. This step will go a long way in the broadening the horizons of ICAI members and CA students and facilitate more professional opportunities for them.

— CA. Jatin Nigam

**Pro-Students Initiatives Welcome**

It is a welcome move to recognise the students who could not pass final CA examination to award accounting technician certificate. It will certainly boost their morale and their services will certainly add value to the accounting profession. So far as changes in scheme of CA course is concerned, frequent changes should be avoided.

— CA. P. K. Agrawal, Maihar

I would like to thank ICAI for taking various initiatives for the benefit of CA students. One day gap after every exam is really benefiting the students. Further, the quality of question papers has also improved. To further help students to better prepare for examinations, the institute should come out with special preparatory DVDs which should also include answer papers of the first three rank holders in all the papers.

— V. Venkata Siva Kumar

**For the Attention of Readers**

Readers' attention is specifically invited to fact that the views and opinions expressed or implied in *The Chartered Accountant* journal are the views and opinions of the authors only, and not those of the ICAI. The ICAI bears no responsibility of any sort whatsoever in case of an action taken by any reader based on any article published in the journal.

**Write to the Editor**

'Information is Power' and our ever-evolving profession needs more and more of that today than ever before. Do you have any relevant points to make, experiences to share, and views to spread among the CA fraternity? If yes, e-mail us at [eboard@icai.org](mailto:eboard@icai.org) or write to: The Editor, The Journal Section, ICAI Bhawan, C-1, Sector 1, Noida (U.P.) 201 301.

- Editor



ICAI President CA. Ved Jain with other dignitaries at the Jain temple at Shri Mahaveerji, Rajasthan during a two-day residential programme organised on 3<sup>rd</sup> and 4<sup>th</sup> January, 2009.



ICAI President CA. Ved Jain lays the foundation stone of Meerut branch building in the presence of ICAI Vice President CA. Uttam Prakash Agarwal; Central Council members CA. Anuj Goyal, CA. Manoj Fadnis, CA. Akshay Kumar Gupta, CA. Kashi Khandelwal, CA. Shanti Lal Daga, CA. Jaydeep N. Shah; CIRC Chairman CA. Sudhir Bhansali and other dignitaries on 13<sup>th</sup> January 2009.

ICAI President CA. Ved Jain with Chief Minister of Chhattisgarh Dr. Raman Singh at the inauguration of 29<sup>th</sup> regional conference of Central India Regional Council of ICAI on 23<sup>rd</sup> January 2009 at Raipur.



ICAI President CA. Ved Jain with Former Union Minister Mr. Ram Naik and ICAI Vice President Uttam Prakash Agarwal at the ICAI Awards function organised from 23<sup>rd</sup> to 25<sup>th</sup> January 2009 at Mumbai.

# POINT OF REVENUE RECOGNITION ON IAS (US) AND AS (ICAI)

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Revenue recognition refers to a set of accounting rules that governs how a company accounts for its sales. If only cash counted, revenue reporting would not pose any risk of misleading investors. But the accrual concept allows companies to book revenue before receiving cash. Because of this, Revenue Recognition has become a significant concept. The primary issue in accounting for revenue is to determine when to recognize revenue. This article attempts to provide practical guidance on how to recognize revenue as per International Accounting Standards and Indian Accounting Standards.

## Revenue under International Accounting Standard - 18

It defines revenue as a gross inflow of economic benefits during a specific period arising from ordinary activities of an enterprise when the inflows result in an increase in equity, other than increases relating to contributions from equity participants.

### Sale of Goods

Revenue from the sale of goods shall be recognized when the following condi-

tions have been satisfied :

- (a) The entity has transferred to the buyer the significant risks and rewards arising from the ownership of goods;
- (b) The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- (c) The amount of revenue can be measured reliably;
- (d) It is probable that economic benefits associated with



— CA. S.P. Santhanam  
*(The author is a member of the Institute. He can be reached at santhanam\_sp@rediffmail.com)*

Under International Accounting Standard 18, if the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognized. If an entity retains only an insignificant risk of ownership, the transaction is a sale, and revenue is recognized.

- the transaction will flow to the entity; and
- (e) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

The assessment of when an entity has transferred the significant risks and rewards of ownership to the buyer requires an examination of the circumstances of the transaction. In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer. This is the case for most retail sales. In other cases, the transfer of risks and rewards of ownership occurs at a different time from the transfer of legal title or the passing of possession.

If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognized. An entity may retain a significant risk of ownership and rewards in a number of ways. Given below are the examples of such situations :

- (a) When the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;
- (b) When the receipt of revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of goods;
- (c) When goods are shipped subject to installation and the installation forms a significant part of the contract which has not yet been completed by the entity; and
- (d) When the buyer has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

If an entity retains only an insignificant risk of ownership, the transaction is a sale, and revenue is recognized.

For example, a seller may retain the legal title to the goods solely to protect the collectibility of the amount due. In such a case, if the entity has transferred the significant risks and rewards of ownership, the transaction is a sale and revenue is recognized.

Another example of an entity retaining only an insignificant risk of ownership is a retail sale in which

a refund is offered if the customer is not satisfied. Revenue in such cases is recognized at the time of sale provided the seller can reliably estimate future returns and recognizes a liability for returns based on previous experience and other relevant factors.

Revenue is recognized only when it is probable that the economic benefits associated with a transaction will flow to the entity. In some cases, this may not be probable until the consideration is received or until an uncertainty is removed. For example, it may be uncertain that a foreign governmental authority will grant permission to remit the consideration from a sale in a foreign country. When the permission is granted, the uncertainty is removed and revenue is recognized. However, when an uncertainty arises about the collectibility of an amount already included in revenue, the uncollectible amount or the amount in respect of which recovery has ceased to be probable is recognized as an expense, rather than as an adjustment of the amount of revenue originally recognized.

Revenue and expenses that relate to the same transaction or other event are recognized simultaneously; this process is commonly referred to as the matching of revenues and expenses. Expenses, including warranties and other costs to be incurred after the shipment of goods, can normally be measured reliably when other conditions for the recognition of revenue have been satisfied. However, revenue cannot be recognized when the expenses cannot be measured reliably; in such circumstances, any consideration already received for the sale of goods is recognized as a liability.

## Recognition of Revenue under International Accounting Standard - 18

Revenue comprises the fair value of the consideration received or receivable for the sale of goods and services in the ordinary course of the entity's activities. Revenue is shown as the net of value-added tax, returns, rebates and discounts and after eliminating sales within the group.

The entity recognizes revenue when the amount of revenue can be reliably measured. It is possible that future economic benefits will flow to the entity when specific criteria have been met for each of the en-

Under International Accounting Standard 18, the entity recognizes revenue when the amount of revenue can be reliably measured. The amount of revenue is not considered to be reliably measurable until all contingencies relating to the sale have been resolved.

tity's activities as described below. The amount of revenue is not considered to be reliably measurable until all contingencies relating to the sale have been resolved. The entity bases its estimates on historical results, taking into consideration the type of customer, the type of transaction and the specifics of each arrangement.

**(a) Sales of Goods – Wholesale**

For instance, the entity manufactures and sells a range of footwear products in the wholesale market. Sales of goods are recognized when the entity has delivered products to the wholesaler, who has full discretion over the channel and price to sell the products, and there is no unfulfilled obligation that could affect the wholesaler's acceptance of the products. Delivery does not occur until the products have been shipped to the specified location, the risks of obsolescence and loss have been transferred to the wholesaler, and either the wholesaler has accepted the products in accordance with the sales contract or the acceptance provisions have lapsed, or the entity has objective evidence that all criteria for acceptance have been satisfied.

Footwear products are often sold with volume discounts, and customers have a right to return faulty products in the wholesale market. Sales are recorded on the basis of the price specified in the sales con-

tracts, net of the estimated volume discounts and returns at the time of sale. Accumulated experience is used to estimate and provide for discounts and returns. The volume discounts are assessed on the basis of anticipated annual purchases.

**(b) Sales of Goods – Retail**

For instance, a group operates a chain of retail outlets for selling shoes and other leather products. Sales of goods are recognized when a group sells a product to the customer. Retail sales are usually in cash or by credit card. The policy of entity may be to sell its products to the retail customer with a right to return within prescribed. Accumulated experience is used to estimate and provide for such returns at the time of sale.

**(c) Sale of Goods in Beverage Industry**

The point of Revenue recognition will be when there is persuasive evidence that an arrangement exists, the delivery of products has occurred, the sales price is fixed or determinable, and collectibility is reasonably assured. Generally, in this industry revenue is recognized when the title of products is transferred to bottling partners, resellers or other customers. The title is usually transferred upon shipment of goods or on their receipt at their customers' locations, as determined by the specific sales terms of each transaction.

Case	Whether Seller has transferred risks & rewards	Whether Seller has relinquished managerial involvement	Point of revenue recognition
Transferring title with delivery of goods under an unconditional sale arrangement	Y	Y	At the time of transfer of goods
Transferring title with delivery of goods, in an agency arrangement.	N	N	At the time when agent's right to return goods is relinquished and/or agent has generated third party revenue
Where goods are transferred, but the seller retains the title for credit protection purposes	Y	Y	At the time of transfer of goods. Credit risk is not a significant risk of ownership

Under Indian Accounting Standards, a key criterion for determining when to recognize revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration.

Case	Whether Seller has transferred risks & rewards	Whether Seller has relinquished managerial involvement	Point of revenue recognition
Where goods are transferred, but at the same time the sale is unconditional; sale price is not fixed until the buyer takes delivery of goods	Y	Y	At the time of transfer of goods
Where the buyer and seller enter in a layaway sales arrangement.	N	N	At the time the buyer takes delivery of goods
Where the buyer and seller enter into a bill and hold sale arrangement	Y	Y	At the time the buyer takes the title provided the conditions for a bill and hold sale are met.
Where the buyer takes delivery of goods, and payment is made subject to satisfactory installation	N	N	At the time the installation and inspection is complete
Where the buyer takes delivery of goods, but the seller guarantees product performance outside of normal warranty provisions	It will depend on facts and circumstances	It will depend on facts and circumstances	At the time the seller is no longer exposed to significant risk and has no further performance obligation
Where the buyer takes delivery of goods, but the seller guarantees product performance within normal warranty provisions	Y	Y	At the time the buyer takes delivery of goods
Where the buyer takes delivery of goods but the seller continues to share in certain benefits.	It will depend on facts and circumstances	It will depend on facts and circumstances	At the time the seller has relinquished right to significant benefits
Where the seller transfers goods to the buyer, and the seller has an obligation to repurchase goods	N	N	No sale is recognized, as substantially all the risks and rewards are retained

In a C.I.F. contract, the determination of whether the property in the goods passes to the buyer depends entirely on whether the seller has parted with the control over the disposal of the goods. It is not an unconditional contract.

Case	Whether Seller has transferred risks & rewards	Whether Seller has relinquished managerial involvement	Point of revenue recognition
Where the seller transfers goods to the buyer, and the seller has an option to repurchase goods at an amount below their fair value	N	N	At the time the seller relinquishes purchase option

## Recognition of Revenue under Indian Accounting Standards and Indian GAAP

### Revenue under Indian Accounting Standard - 9

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of its goods, from the rendering of services, and from the use by others of enterprise's resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or any other consideration.

### Sale of Goods

It may be noted that the criteria laid in the standard may involve recognizing a transaction as 'sale' even though no sale has taken place in the legal sense of the term, *i.e.*, before the title in the goods is transferred from the seller to the buyer under the provisions of the law governing such a transaction (Sale of Goods Act in our country). The criteria laid down in the standard are based on the consideration of substance over form, *i.e.*, if in substance, a sale has taken place, it should be recognized in the accounts, irrespective of whether or not the legal title in the goods has been transferred.

The requirements contained in AS 9 are in consonance with accrual basis of accounting, substance over form, going concern, prudence etc., laid down in AS 1. For instance, the recognition of revenue at a time when the significant risks and rewards of ownership in goods are transferred is in itself a man-

ifestation of substance over form. In other words, if there is no legal transfer of property, of the goods sold, but significant risks and rewards of ownership in such goods are transferred, revenue can be recognized as per AS 9.

A key criterion for determining when to recognize revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where the transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognized at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass from one party to the other at a time that is different from the time when actual ownership passes.

There are many factors *e.g.*, intention of the parties for retaining the shipping documents, any explicit term in the contract signifying control over the goods etc., which should be considered before deciding whether there has been a transfer of property in the goods or transfer of significant risks and rewards of ownership in the goods. Since these factors may differ from case to case, it is not practicable to lay down any specific rule (s) in this regard, which would be applicable in all situations.

In case of short production cycle items, the determination of whether the transfer of property has actually taken place or significant risks and rewards of ownership in the goods have been transferred to the buyer will have to take into account the legal provisions and the actual facts and circumstances of the case, respectively.

Therefore, in such situations, whether transfer of property or transfer of all significant risks and rewards of ownership take place before the delivery of all the documents under the contract, is a question of fact to be determined keeping in view the circumstances of each case.

For deciding whether significant risks and rewards of ownership in the goods have been transferred to the buyer, the following factors should be taken into consideration :

- (a) The right of the seller to stop goods in transit.
- (b) Incidence of loss of goods in transit, i.e., the one who bears the loss of goods in transit.

It may be mentioned that apart from the above factors, there can be other factors specifically mentioned in the terms and conditions of the contract that indicate whether or not significant risks and rewards of ownership in the goods have been transferred.

- (c) The legal transfer of property in the goods will have to be determined on the basis of the facts and circumstances of each case.

### Revenue Recognition for Exports on CIF Basis

CIF Contract is a contract to :

- (a) ship, at the port of shipment, goods of the description contained in the contract,
- (b) procure contract of affreightment under which goods will be delivered at the destination contemplated in the contract,
- (c) arrange for insurance upon terms current in the trade, which will be available to the buyer,
- (d) make out proper invoice, and
- (e) tender these documents to the buyer, so that he can obtain delivery of goods on arrival or get paid for their loss in transit.

In a c.i.f. contract, the determination of whether the property in the goods passes to the buyer depends entirely on whether the seller has parted with the control over the disposal of the goods. It is not an unconditional contract because in commercial parlance, c.i.f. presumes an undertaking by the seller to do something more, namely, to put the goods on a ship and this postpones the passing of property until the goods are shipped by the seller. But the

presumption that the property passes on shipment is a presumption about the intention of the parties, and may be excluded either by the express terms of the contract or by other circumstances [section 19(3) of the Sale of Goods Act]. For example, the presumption is rebutted where the seller reserves the right of disposal of the goods until certain conditions laid down in the contract are fulfilled. Until such time, the property in the goods does not pass on to the buyer. Since, on shipment, the goods pass out of the physical possession of the seller, his intention to reserve the right of disposal is usually evidenced by his treatment of the bill of lading. For instance, if the seller endorses the bill of lading in a bank and hands it over to his agent not to be delivered to the buyer until the goods are paid for, then the seller has shown his intention to retain the disposal of the goods under his control (*Mehta v. Heureux, A.I.R. 1924 Bom. 422; Mohanlal V. Krishna 1928 30 Bom. L.R.415*). Therefore, the question whether the property in the goods passes on to the buyer under a c.i.f. contract, before the latter receives all the documents under the contract, is a question of fact, which is to be determined keeping in view the circumstances of each case.

With regard to the question whether all significant risks and rewards of ownership have been transferred to the buyer and that the seller retains no effective control of the goods transferred to a degree usually associated with ownership, even though the property in goods has not been transferred, before the documents under the c.i.f. contract are tendered to the buyer, is, once again, a question of fact. For instance, retention of the bill of lading merely to protect the collectibility of the amount due, where all other aspects of c.i.f. contract have been fulfilled properly, would indicate that significant risks and rewards of ownership have been transferred to the buyer. Although, in c.i.f. contract, the buyer is in effect the insurer and the risk *prima facie* attaches to him as and after shipment of goods, yet it is subject to the condition of tendering the shipping documents, including the insurance policy, as contemplated by the contract or as per the terms of trade.

Under International Accounting Standard 18, revenue from fixed-price contracts for delivering design services is recognized under the percentage-of-completion method. Under this method, revenue is generally recognized on the basis of the services performed to date as a percentage of the total services to be performed.

## Revenue Recognition from Sale of Goods before Delivery thereof. i.e., Revenue Recognition for Short Production Cycle Items

**Section 23 (1) of the Sale of Goods Act, 1930, states:**

*"Where there is a contract for the sale of unascertained or future goods by description and goods of that description and in a deliverable state are unconditionally appropriated to the contract, either by the seller with the assent of the buyer or by the buyer with the assent of the seller, the property in the goods thereupon passes to the buyer. Such assent may be expressed or implied, and may be given either before or after the appropriation is made."*

Thus, if it is legally sustainable that property in the goods has been transferred as per the aforesaid provisions of law, performance should be regarded as having been achieved for the purpose of compliance with AS 9.

The question whether all significant risks and rewards of ownership have been transferred to the buyer and that the seller retains no effective control of the goods transferred to a degree usually associated with ownership, is a question of fact. For this purpose, factors such as who will bear the loss in case the goods are destroyed while they are in the custody of the seller, the risk of loss in transit, the rights of the unpaid seller etc., will have to be considered in each case of sale.

In case of short production cycle items, the determination of whether the transfer of property has actually taken place or significant risks and rewards of ownership in the goods have been transferred to the buyer will have to take into account the legal provisions and the actual facts and circumstances of the case, respectively, as discussed here.

### Illustrated Policy of Revenue Recognition

Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection. Revenue from the sale of goods is recognized when the goods are dispatched

from the factory / stock points to customers. Sale of products is recognized when the products are shipped from the factory/stock points to the customers. All Income and Expenses are accounted generally on accrual basis, with the exception of interest from customers, rebates from suppliers, and claims recoverable from the Government of India (GOI) on account of buffer stocking which are accounted on receipt basis in view of the uncertainty of their collection. Certain recoverable expenses are accounted on sanction / settlement basis as indicated in the schedules. A sale is inclusive of Price Concession / difference receivable from Central / State Government.

### Issue

1.-What should be the manner of disclosure of excise duty in the presentation of revenue from sales transactions (turnover) in the statement of profit and loss?

### Consensus

2.-The amount of turnover should be disclosed in the following manner on the face of the statement of profit and loss :

Turnover (Gross)	XX
Less: Excise Duty	XX
Turnover (Net)	XX

Financial analysts and other users of financial statements, sometimes, require the information related to turnover gross of excise duty as well as net of excise duty for a meaningful understanding of financial statements. However, some enterprises disclose turnover net of excise duty while others disclose turnover at gross amount. Accordingly, Interpretation issued by ICAI requires disclosure of turnover gross of excise duty as well as net of excise duty on the face of the statement of profit and loss.

### Revenue Recognition of Contract under International Accounting Standard 18

Revenue from time and material contracts, typically from delivering design services, is recognized at the contractual rates as labour hours are delivered and

Accounting Standard (AS) 7, issued by the Institute of Chartered Accountants of India, is applicable in respect of the service contracts for project management, and technical and consultancy services relating to construction of an asset or a combination of assets, undertaken by a company.

direct expenses incurred.

Revenue from fixed-price contracts for delivering design services is recognized under the percentage-of-completion (POC) method. Under this method, revenue is generally recognized on the basis of the services performed to date as a percentage of the total services to be performed.

Revenue from fixed-price contracts for delivering transportation services is generally recognized in the period the services are provided, using a straight-line basis over the term of the contract. If circumstances arise that may change the original estimates of revenues, costs or extent of progress toward completion, then the estimates are revised. These revisions may result in increase or decrease in estimated revenues or costs, and are reflected in income in the period in which the circumstances that give rise to the revision become known by management.

Contract costs are recognized when incurred. When the outcome of a construction contract cannot be estimated reliably, contract revenue is recognized only to the extent of contract costs incurred that are likely to be recoverable. When the outcome of a construction contract can be estimated reliably and it is likely that the contract will be profitable, contract revenue is recognized over the period of the contract. When it is likely that the total contract costs will exceed the total contract revenue, the expected loss is recognized as an expense.

The Entity uses the 'percentage of completion method' to determine the appropriate amount to recognize in a given period. The stage of completion is measured by reference to the contract costs incurred up to the balance sheet date as a percentage of total estimated costs for each contract. Costs incurred in the year in connection with future activity on a contract are excluded from contract costs for determining the stage of completion. They are presented as inventories, pre-payments or other assets, depending on their nature.

The Entity presents as an asset the gross amount due from customers for contract work for all contracts in progress for which costs incurred *plus* recognized profits (less recognized losses) exceed progress bill-

ings. Progress billings not yet paid by customers and retentions are included within 'trade and other receivables'.

The Entity presents as a liability the gross amount due to customers for contract work for all contracts in progress for which progress billings exceed costs incurred *plus* recognized profits (less recognized losses).

## Revenue Recognition of Contract under Indian Accounting Standards

Accounting Standard (AS) 7, issued by the Institute of Chartered Accountants of India, is applicable in respect of the service contracts for project management, and technical and consultancy services relating to construction of an asset or a combination of assets, undertaken by a company.

In case of other service contracts not covered by the above, companies can recognize revenue as per Accounting Standard (AS) 9 on 'Revenue Recognition', issued by the Institute of Chartered Accountants of India.

Where no formal contract has been signed, a company can recognize revenue if it can be reliably measured on the basis of the memorandum of understanding or otherwise, provided there is no significant uncertainty as to its ultimate collection.

The policy to recognize revenue in the case of lump sum service contracts, in proportion of actual costs of the work performed to latest estimated total costs of the work, or in proportion to work estimated to have been executed, whichever is less, may be proper if the said costs and the physical progress are more or less *in tandem*. Where they are not, the matter requires special consideration. In such cases the manner of revenue recognition can be arrived at after proper investigation of the extent of work accomplished. However, profit should not be recognized unless the work has progressed to a reasonable extent, say 20 to 25 per cent of the work has been completed. If physical progress is 25 per cent or above, profit can be recognized as a proportion based on the latest estimates of the total cost and total revenue.

The recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method. In this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period.

In this method, contract revenue is recognized as revenue in the statement of profit and loss in the accounting periods in which the work has been performed. Contract costs are usually recognized as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate has been performed. However, any expected excess of total contract costs over total contract revenue for the contract is recognized as an expense.

When the outcome of a construction contract cannot be estimated reliably :

- (a) Revenue can be recognized only to the extent of contract costs incurred of which recovery is probable; and
- (b) Contract costs are to be recognized as an expense in the period in which they are incurred.

During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be that the enterprise will recover the contract costs incurred. Therefore, contract revenue is recognized only to the extent of costs incurred that are expected to be recovered. As the outcome of the contract cannot be estimated reliably, no profit is recognized. However, even when the outcome of the contract cannot be estimated reliably, it may be that the total contract costs will exceed the total contract revenue. In such cases, any expected excess of total contract costs over total contract revenue for the contract is recognized as Contract costs recovery of which is not probable are recognized as an expense immediately.

### Disclosure of Accounting Policies

The following are illustrations of accounting policy disclosures :

Revenue from fixed price construction contracts is recognized on the percentage of completion meth-

od, measured by the percentage of labour hours incurred up to the reporting date to estimated total labour hours for each contract.

Revenue from cost *plus* contracts is recognized by the recoverable costs incurred during the period *plus* the fee earned, measured by the proportion that costs incurred up to the reporting date bear to the estimated total costs of the contract.

### Revenue Recognition of Amounts Receivable on Completion of Performance Guarantees.

A company is following a policy of recognizing income, net of guarantees / warranties in a situation where the company is giving performance guarantees in respect of the assets so constructed. It is to be noted that where the company receives amounts in respect of performance guarantee against bank guarantees, the same is treated as advance. Recognition of revenue pertaining to guarantees/warranties would depend upon uncertainty of collectibility which, in turn, would depend upon the facts and circumstances of each case. Thus, in case it is estimated on the basis of factors such as the past experience involved etc., then it is not unreasonable to expect ultimate collection. The revenue pertaining to the performance guarantee may be recognized on receipt of the relevant amount. However, in case the uncertainty relating to collectibility arises subsequently, it would be appropriate to make a separate provision in this regard.

The term 'Contingency' has been defined in para 3.1 of Accounting Standard (AS) 4 on 'Contingency and Events Occurring After the Balance Sheet Date', issued by the Institute of Chartered Accountants of India :

*"A contingency is a condition or situation the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence of one or more uncertain future events."*

The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote. On the basis of the above, amount of guarantees issued by banks on behalf of the company against counter-indemnity should be disclosed as contingent liabilities. □

## Issue of spares and stores to dredgers

**The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.**

### A. Facts of the Case

1. A public sector undertaking, under the Ministry of Shipping, Road Transport and Highways, was incorporated on 29<sup>th</sup> March, 1976 under the Companies Act, 1956. The main objective of the company is to provide integrated dredging services to all major and minor ports, Indian Navy, fishing harbours and other maritime organisations.
2. The dredging activities are carried out by ocean going dredgers, self-propelled or dumb dredgers. As compared to any other ocean going vessel, the dredger has got a much greater amount of machinery installed. The trailer dredgers have almost twice the amount of machinery fitted as compared to an ocean going ship of the same size. Most of the time, dredgers operate in various types of soils and sandy waters which affect the outer surface of hull plates as well as the internal plates of the hopper, which in turn, results in wear and tear of hull and other soil touching parts/equipments. These dredgers would normally be working 24 hours a day continuously for a period of about 3 weeks when the machinery will be stopped for undertaking preventive maintenance. Such continuous usage of the machinery in the shallow and sandy waters of the port causes heavy wear and tear necessitating periodic repairs in a dry dock and also the consumption of spares and stores.
3. The querist has informed that the spares used are machinery spares in nature as these spares are intended to be utilised on the fixed assets, i.e., dredgers. The procurement of these spares is need-based and against the specific requirement indicated by Masters/Chief Engineer on board of the dredgers through an indent. Such spares are replacements for parts worn out during usage of the machinery. Thus, replacement may take place at the next following maintenance period or during the next following dry dock of the dredger. Till such time, the spares so procured may generally be delivered on board the particular dredger or sent to the Central Warehouse at Visakhapatnam. In the latter case, the value of the spares is treated as inventory till the time of issue to the dredgers. These spares do not increase the future benefits from the existing assets (dredgers and other crafts) beyond their previously assessed standard of performance. These spares are procured to keep up the original functioning of the machinery on board the dredger.
4. The querist has mentioned that the cost of initial spares, i.e., the spares purchased along with the dredgers is capitalised. The cost of spares and stores purchased subsequently during the operation/repair of the dredgers is charged off as operational expenditure.
5. The current fleet of the company includes dredgers, tugs, survey launches and other ancillary crafts like barges, pontoons, etc. The above crafts are depreciated at the rate of 7% under straight line method (SLM), as provided in Schedule XIV to the Companies Act, 1956. The residual value of 2% is carried in the books as Written Down Value. Presently, the company owns 12 dredgers, out of which 9 dredgers have been depreciated to 98%. All these dredgers are in operation and all these crafts are expected to have a further useful life of at least 5 to 10 years.
6. During the course of audit of accounts for the year 2006-07, the Comptroller and Auditor General of India (C&AG) (PDCA& MAB, Hyderabad) issued a provisional comment on accounting of stores and spares issued to dredgers. The accounting policy 4(a) in respect of spares and stores and the provisional comment 4(a) on this accounting policy of the company along with the company's reply are reproduced below:
 

*Accounting Policy*

“4. Operational Expenses

(a) Spares & Stores:

Spares and stores and lubricants delivered to the crafts during the year acknowledged by the Master/CEO are charged to revenue. Provision is made for the material delivered to crafts upto 31st March in respect of which acknowledgements are not received.”

*Comment of Government Audit*

“4(a) This is understated by Rs. 99.16 crore due to failure to account for the stores and spares which were acknowledged by Masters of the vessels and lying on board the dredgers as on 31 March, 2007. This has resulted in overstatement of consumption of stores and spares for the year by Rs. 29.91 crore and prior period consumption by Rs. 72.25 crore and understatement of net profit after prior period adjustments by Rs. 99.16 crore. There is a need to change the accounting policy so that it is not in conflict with Ac-

counting Standard (AS) 2, 'Valuation of Inventories'."

*Reply of the company*

"The accounting policy in respect of spares and stores has been consistently followed since inception and the same policy is being followed by other companies in similar business. The accounting policy needs to be viewed in the background of the dredging and shipping industry.

The company is meeting dredging requirements of various major and minor ports in India. Practically, it becomes very difficult to maintain/monitor the suggested method of spares/stores on board the vessel keeping in view the difficulties involved.

Some of the important factors that need to be considered in this regard include:

- (a) Dredgers are manned by floating officers and crew whose skills are highly specialised and confined to dredging operations. They are not accustomed to record keeping, except insofar as it may be necessary to operate the dredger (navigation and dredging).
- (b) Floating personnel are continuously changing (3 months on and 2 months off) as per the rules applicable to them and every time there are necessary handing over/taking over formalities.
- (c) Dredgers operate most of the time in sea. They require minimum spares on board all the time.
- (d) Spares supplied on board the dredgers are exposed to sea conditions and therefore, deteriorate at comparatively faster rate.
- (e) Sometimes spares required by a dredger due to urgency may have to be supplied from another dredger.
- (f) Estimating value of spares on board on a particular date will be impractical as these spares may have been carried for several years.

Because of the above factors, the shipping industry is following this specific policy of charging spares as and when delivered.

The value of inventories amounting to Rs. 99.16 crore appears to be based on the Management report furnished by Dredge Masters. The figures so arrived are not authenticated/supported by necessary documentary evidence, i.e., invoice giving cost, taxes, duties, cost of bringing it to its present location, etc. Besides, the proposed change, if implemented, would seriously distort the

true and fair view of the current year profitability.

It is further submitted that AS 2 is not applicable to the subject spares as AS 2 specifically excludes machinery spares in connection with items of fixed assets and therefore, the question of any conflict with AS 2 does not arise. Hence, Audit is requested to drop the Comment."

Further, in respect of the discussions with C&AG (PDCA & MAB Hyderabad), the querist has informed that it was also submitted that such procurement of spares and stores do not satisfy any of the following conditions to capitalise:

- (a) enhance the life of the dredger, or
  - (b) increase the previously assessed standard of performance, or
  - (c) it results in reduction of cost of production.
7. According to the querist, the subsequent procurement of spares and stores has been only to maintain the normal functioning of the dredger. In view of this position, the cost of such procurement is to be expensed in the year of its incurrence. Further, as per the querist, this accounting treatment is in accordance with Accounting Standard (AS) 10, 'Accounting for Fixed Assets', and also with the rationale of the opinions issued by the Expert Advisory Committee of the Institute of Chartered Accountants of India. Besides this, the querist has mentioned that the accounting policy is in line with the industry practice.
  8. The querist has mentioned that after considerable discussions, the C&AG (PDCA & MAB, Hyderabad), agreed to the contentions of the company that it does not fall within the scope of AS 2 and revised the earlier Provisional Comment 4(a) stating that the accounting treatment of the company is not in consonance with AS 10 and forwarded the revised Comment 4(a) to C&AG, New Delhi along with other comments. The querist has provided the Revised Provisional Comment 4(a) along with the company's reply for the perusal of the Committee, the relevant extracts of which are reproduced as below:

*Comment of Government Audit*

"Profit and Loss Account

B. Expenditure on:

Operations (Schedule X)

Spares	and	Stores	—
Rs. 4534.97 lakh			

- 4(a) (i) This includes spares valuing Rs. 9.86 crore issued to three dredgers which have a residual life. The spares should have been

capitalised in accordance with Accounting Standard (AS) 10, 'Accounting for Fixed Assets' and depreciated over the remaining life period of these dredgers. Failure to do so resulted in overstatement of consumption by Rs. 9.86 crore, understatement of Gross Block to the same extent, understatement of depreciation by Rs. 1.38 crore and profit for the year by Rs. 8.48 crore.

- (ii) This also includes spares worth Rs. 35.49 crore issued to remaining dredgers with no residual life. The value of these spares should have been capitalised and then charged off to Profit and Loss Account through depreciation account. This has resulted in overstatement of consumption by Rs. 35.49 crore and understatement of Gross Block and depreciation to the same extent.
- (iii) Such incorrect charging-off of spares issued to dredgers in the past but not consumed and lying on board the dredgers as on 31st March, 2007 has led to understatement of Gross Block by Rs. 72.25 crore. Due to adopting an accounting policy which is not in consonance with AS 10, the Gross Block is not being properly accounted for. There is a need to change the accounting policy No. 4(a) relating to issue of spares and stores so that it is not in conflict with AS 10."

*Reply of the company*

"...For ready reference, we are furnishing below the particular accounting policies adopted by various similar companies in the industry:

*A Ltd.*

Accounting policy No.7 (e) –

7. Valuation of stocks:

(e) Store/spares including paints, etc. are charged to revenue as consumed when directly issued to ships. Items of stores/spares, which cannot be delivered immediately are shown under stores/spares in transit and are cleared on receiving acknowledgement from the ship. However, all items of stores/spares purchased within last 3 months of the financial year, for which acknowledgement are not received, are treated as stock and valued at lower of cost or realisable value.

*B Ltd.*

Accounting policy No. (i) (ii)

- (i) Operating expenses:
- (ii) Stores and spares delivered on board the ships and rigs are charged to revenue.

*C Ltd.*

Accounting policy No.(g)

- (g) Stores and Spares:

Stores and spares purchased are directly issued to ships and the value of such purchases is charged to the expenses account as consumed.

Further to above, we would like to reiterate that the values indicated cannot be authenticated/supported by necessary documentary evidence, such as, invoice giving cost, taxes, duties, cost of bringing it to its present location in respect of each item of the spare and its present condition on board the dredger as required to pass necessary accounting entries in the books.

In view of this, we are unable to vouch for the correctness of various figures stated in the modified provisional comments, viz.,

- (a) Rs. 9.86 crore in respect of the three dredgers which have a residual life,
- (b) Spares worth Rs. 35.49 crore issued to remaining dredgers with no residual life, and
- (c) Rs. 72.25 crore purported to have been incorrectly charged off of spares issued to dredgers in the past..."

9. The querist has informed that the revised comment along with other comments was discussed and clarified at C&AG's office, New Delhi. The C&AG's office has dropped the above comment subject to the company's assurance that the subject Provisional Comment will be referred to the Institute of Chartered Accountants of India for its expert opinion. Further, the querist has mentioned that in this connection, the company has relied on the earlier opinions of the Expert Advisory Committee on the subject published in various volumes of Compendium of Opinions, viz., Query No. 13 of Volume XX, Query No. 32 of Volume XX, Query No. 37 of Volume XX, and Query No. 22 of Volume XXIII.

**B. Query**

10. In view of the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (i) Whether the accounting practice followed by the company, viz., for charging off spares to expenditure as and when these are issued to dredgers, as per the facts and circumstances, is in accordance with the provisions of AS 10.
- (ii) If not,
  - (a) whether such subsequent procurement of spares and stores needs to be capitalised and depreciated over the remaining life period of the dredgers as opined by the C&AG Audit.
  - (b) whether such procurement of spares and stores also needs to be capitalised in respect of dredgers with no residual life. Whether these spares and stores should

be capitalised and then charged off to the profit and loss account through depreciation account as opined by C&AG Audit. (The querist has invited reference to the earlier opinion of the Expert Advisory Committee published as Query No. 3 of Volume XXIII of the Compendium of Opinions.)

### C. Points considered by the Committee

11. The Committee notes the following paragraph of Accounting Standard (AS) 2, 'Valuation of Inventories', which states as below:

"4. Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, 'Accounting for Fixed Assets'."

12. The Committee also notes the following paragraphs of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', which state as below:

"8.2 Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset and their use is expected to be irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item."

#### "12. Improvements and Repairs

12.1 Frequently, it is difficult to determine whether subsequent expenditure related to fixed asset represents improvements that ought to be added to the gross book value or repairs that ought to be charged to the profit and loss statement. Only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity."

**"23. Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance."**

13. On the basis of the paragraphs of AS 2 and AS 10 reproduced above, the Committee notes

that for accounting purposes, there are generally two types of machinery spares. The first type are those machinery spares which cannot be used in connection with a particular/specific item of a fixed asset and whose use is not irregular, and are considered as inventories and accordingly need to be accounted for as per the principles enunciated in AS 2. The second type of machinery spares are those which can be used only in relation to a specific item of a fixed asset and whose use is expected to be irregular, and they should be accounted for as per AS 10. Such spares are commonly known as capital spares/insurance spares.

14. The Committee notes from paragraph 8 of the Facts of the Case that whereas the Government Audit (New Delhi) has given its opinion on the basis that the machinery spares in question are capital spares, the accounting treatment followed by the company is based on the consideration that the spares are of the nature of inventory except in the instance of initial spares purchased at the time of the purchase of the dredgers itself. The Committee also notes from paragraph 6 that the Government Audit (Hyderabad) also appears to consider the machinery spares of the nature of inventory. The Committee further notes that the Facts of the Case do not contain information to decide whether the machinery spares are of the nature of capital spares keeping in view the requirements of paragraph 8.2 of AS 10. The Committee is, therefore, of the view that the company should first decide whether the spares are of capital nature or of the nature of inventory keeping in view the requirements of the aforesaid paragraph of AS 10. It is also possible that some machinery spares may be of capital nature while others may not be of that nature, i.e., these may be of the nature of inventory, e.g., in case of spares which can be used by different dredgers and, therefore, not specific to an item of fixed asset as contemplated in paragraph 8.2 of AS 10. In the absence of the facts, the opinion of the Committee hereinafter deals with both the situations, namely, if the spares are of capital nature and in case the spares are of the nature of inventory.

*In case the spares are of capital nature*

15. Machinery spares of the nature of capital spares/insurance spares are to be capitalised separately, whether purchased along with the principal fixed asset, i.e., the dredgers, or purchased subsequently. The Committee notes that at present the company capitalises the initial spares, i.e., those purchased with the dredgers, and charges to revenue those spares which are purchased subsequently. In this respect, the Committee reiterates that in case the spares

purchased by the company are capital spares, these are to be capitalised whenever these are purchased. As per the requirements of AS 10, capital spares purchased along with the dredgers should be depreciated on a systematic basis over a period not exceeding the useful life of the dredger to which they relate. In case of capital spares purchased subsequently, depreciation should be charged on a systematic basis over a period not exceeding the balance/remaining useful life of the particular dredger to which the spares relate. On the date the capital spare is actually put to use, i.e., it replaces the worn out part in the corresponding dredger, the written down value of the capital spare at that date is immediately written off to the profit and loss account. This is done as the replacement of the spare does not increase the future benefits from the existing dredger beyond its previously assessed standard of performance.

16. In case of spares purchased subsequently in relation to dredgers whose residual life has expired, the Committee notes that as per the accounting treatment given in AS 10, the cost of capital spares should be amortised on a systematic basis over a period not exceeding the useful life of the principal asset, i.e., the particular dredger. Thus, where the useful life of the dredger has expired, i.e., it has been completely depreciated in the books, the Committee is of the view that capital spares, should be first capitalised and then charged to the statement of profit and loss through depreciation in the year of purchase itself. The Committee also notes that this accounting treatment is in consonance with the view expressed by the Committee in its earlier opinion published in Compendium of Opinions, Volume XXIII, Query No.3.

*In case the spares are of the nature of inventory*

17. The Committee notes from paragraph 8.2 of AS 10 reproduced in paragraph 12 above that the machinery spares of the nature of inventory are usually charged to the profit and loss statement as and when consumed. The Committee notes that the company is treating the machinery spares as of the nature of inventory and are charging the same to the profit and loss account when these are *issued for consumption*. The Committee also notes the accounting policies of certain companies quoted by the querist in paragraph 8 of the Facts

of the Case, wherein the spares are being treated as of the nature of inventory and are considered to be consumed when issued for consumption. The Committee is of the view that a spare can be considered as consumed when issued from store in an event the spare is to be immediately used against a specific breakdown of the relevant component of the dredger. However, in case the spares are ordinarily issued to a dredger awaiting breakdown in the dredger, it indicates that spares are lying on the dredgers as inventory. In the latter case, it is imperative for the company to have an appropriate system of inventory management and control on the dredger in case the spares are material in amount. The difficulties indicated by the company in paragraph 6 of the Facts of the Case do not override the requirements of the Standards. What it indicates is the lack of proper system of accounting for spares of the nature of inventory.

18. The Committee is also of the view that in case the company considers the machinery spares of the nature of inventory, the same should be treated as such even if purchased initially along with dredgers. For this purpose, the value of the spares may have to be estimated on a reasonable basis.

#### D. Opinion

19. On the basis of the above, the Committee is of the following opinion in respect of the issues raised by the querist in paragraph 10 above:
- (i) As per the facts and circumstances of the given case, the current accounting practice of the company of charging off spares to expenditure as and when these are issued to dredgers is not in accordance with the provisions of AS 10.
  - (ii) (a) If the spares are of capital nature and purchased subsequently, these need to be capitalised and depreciated systematically over the remaining useful life of the particular dredger in whose connection these are purchased and expected to be used as discussed in paragraph 15 above.
  - (b) In case the spares are of capital nature and where the life of the particular dredger is over, the same should be charged to the profit and loss account through depreciation as discussed in paragraph 16 above. □

1. The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2. The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in twenty five volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
3. Recent opinions of the Committee are available on the website of the Institute at URL: [http://www.icai.org/category.html?c\\_id=146](http://www.icai.org/category.html?c_id=146)

# SERVICE TAX PLANNING IN CONSTRUCTION INDUSTRY – ROLE OF FINANCE MANAGER

In construction industry, some times service tax planning becomes critical in participating bidding process and in risk analysis of a bid. Since the profit margin will be marginal and varies from 3% to 10% depending upon various factors in respect of construction industry, some times service tax element may change the profit margin. Hence service tax planning is essential to choose a suitable option for payment of service tax and in turn minimizing the service tax cost. In this process, Finance Manager plays a decisive role. This article delves further into the concept.

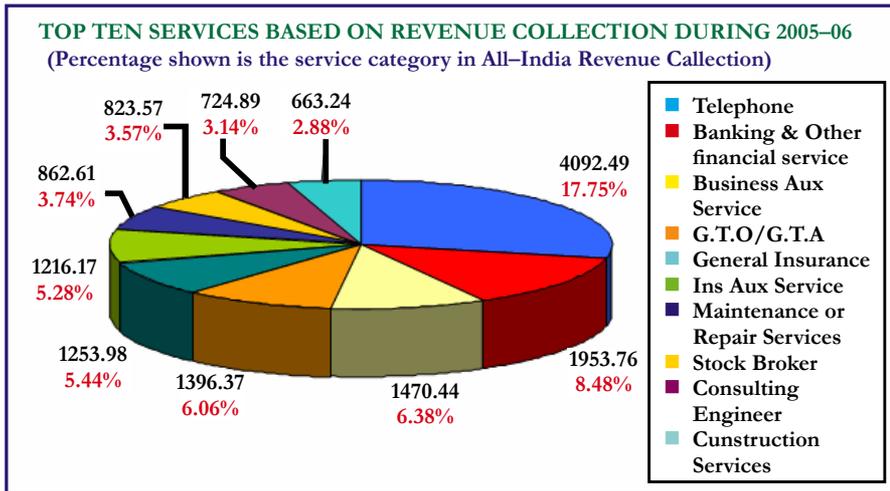
**R**apid industrial growth in India has resulted in need for simultaneous expansion and strengthening of the infrastructure facilities such as power, water, bridges, roads, ports, railways, sewerage, oil & gas, buildings, irrigation etc. The Indian Construction Industry is riding on the high growth

economy and it is evident from high growth rate in terms of turnover and profits of Indian Construction Corporate Sector year by year during the past four years. Construction Industry is one of the major contributors to the revenue collection through Service Tax to the Central Government as per the following performance report of the Director General (Service Tax) for the year 2005-06.



— CA. S. Ranga Swamy  
(The author is a member of the Institute. He can be reached at rangaswamy\_singa@yahoo.co.in)

Consulting engineer means any professionally qualified engineer or any body corporate or any other firm who, either directly or indirectly, renders any advice, consultancy or technical assistance in any manner to a client in one or more disciplines of engineering.



for Erection, Installation and Commissioning activity

o Composite Contract/ Works Contract for Erection, Commissioning and Installation involving both supply of material such as plant, machinery, equipment or structures and labour/ services for erection, commissioning and installation of the same.

- Consultancy Contracts

### Types of Contracts

The Contracts entered into by the Construction industry can be broadly classified under the following heads:

- Turn-Key Contracts or EPC Contracts
- Civil Works Contracts
  - o Contract for civil works providing labour or service
  - o Contract for Supply of material such as cement, steel, fixtures etc. for civil/ structural work
  - o Composite Contract/Works Contract involving both supply of materials such as cement, steel, fixtures etc. and labour/services for execution of civil / structural work
- Erection Contracts
  - o Contract for Erection, Installation and Commissioning providing labour or service for execution of -
    - Electrical Works
    - Instrumentation Works
    - Mechanical Works
    - Fabrication Works
  - o Contract for Supply of material such as plant, machinery, equipment or structures
- Contracts for Designing and Drawings
- Contracts for Testing and Inspection
- Contracts for Hiring of Equipments
- Contracts for Renting of Immovable Property
- Repairs and Maintenance Contracts
- Other contracts or miscellaneous service contracts as given below:
  - Labour supply
  - Material transportation
  - C & F services
  - Material unloading and storage

### Stages in Levy of Service Tax on Construction Services

The various services related to the construction industry have been brought into service tax net in the following stages:

#### 1. Consulting Engineers w.e.f. 7-7-1997

Definition from 7-7-1997 to 9-9-2004

**Consulting engineer** means any professionally qualified engineer or an engineering firm who, either directly or indirectly, renders any advice, consultancy or technical assistance in any manner to a client in one or more disciplines of engineering.

**Taxable service** means any service to a client by a

Taxable service means any service to any person, by a consulting engineer in relation to advice, consultancy or technical assistance in any manner in one or more disciplines of engineering including the discipline of computer hardware engineering. (The word ‘client’ has been replaced with the words ‘any person’)

consulting engineer in relation to advice, consultancy or technical assistance in any manner in one or more disciplines of engineering.

*Definition from 10-9-2004 to 30-4-2006*

**Consulting engineer** - There is no change in the definition.

**Taxable service** means any service to a client by a consulting engineer in relation to advice, consultancy or technical assistance in any manner in one or more disciplines of engineering *but not in the services of computer hardware engineering or computer software engineering.*

*Definition from 1-5-2006 to 31-5-2007*

**Consulting engineer** means any professionally qualified engineer or any body corporate or any other firm who, either directly or indirectly, renders any advice, consultancy or technical assistance in any manner to a client in one or more disciplines of engineering.

**Taxable service**-There is no change in the definition of ‘taxable service’.

*Definition w.e.f. 1-6-2007 to 15-5-2008*

**Consulting engineer** -There is no change in the definition since 1-5-2006.

**Taxable service** means any service to a client by a consulting engineer in relation to advice, consultancy or technical assistance in any manner in one or more disciplines of engineering *including the discipline of computer hardware engineering but excluding the discipline of computer software engineering.*

Consequently computer hardware engineering consultancy will be leviable to service tax and computer software engineering services shall continue to be out of service tax net.

*Definition w.e.f. 16-5-2008*

**Consulting engineer** -There is no change in the definition since 1-5-2006.

**Taxable service** means any service to any person, by a consulting engineer in relation to advice, consultancy or technical assistance in any manner in one or more disciplines of engineering including the discipline of

computer hardware engineering. (The word ‘client’ has been replaced with the words ‘any person’)

**Explanation:-** For the purpose of this sub-clause, it is hereby declared that services provided by a consulting engineer in relation to advice, consultancy or technical assistance in the disciplines of both computer hardware engineering and computer software engineering shall also be classified under this sub-clause.

### **Departmental Clarifications and Judicial decisions**

- It covers all services rendered in the capacity of a professional engineer and includes structural engineering works or civil/ mechanical/ electrical engineering works or relating to construction management.
- Service provided by consulting engineers in relation to computer software is exempted from tax *vide* Notification No. 4/99, dated 28-2-1999. However w.e.f. 16-5-2008 software engineering has also been included in taxable service.
- Survey/Inspection for the purpose of issuing certificates under any authority of law would not be covered.
- Insurance surveying and loss assessment services would not be covered.
- Madras High Court has held that valuer of plant and machinery is also covered.
- Cess paid towards the import of technology is exempt from tax.
- No deduction in respect of reimbursable expenses by consulting engineer w.e.f. 19-4-2006
- In *Daelim Industrial Co. vs CCE-2003 STT 438* it was held that a works contract on turnkey basis is not a consultancy contract. A contract can not be vivisected and part of it subjected to tax.
- In *Metzeler Automotive Profile vs CCE(2005) STT 830* it was held that designing, developing, manufacture and sale of tools cannot be termed as service provided by consulting engineer.

The IIT and IIM could not be called a commercial concern and were not liable to pay service tax on fees collected by them for campus interviews during the period prior to 1-5-2006. For the period from 1-5-2006, it has been clarified that decision should be taken after taking into account of all material facts on case to case basis.

- In *Bharat Fritz Werner vs DCCE(2007) 6 STT 382 (CESTAT)*, it was held that mere supervision, inspection and training is not consulting engineer service.
- Scientific and technical consultancy service has been brought into tax net w.e.f. 16-7-2001. In *CCE Vs MRF Ltd. [2005] 1 STT 80 (Chennai-CESTAT)*, it was held that any service rendered prior to 16-7-2001 which is classifiable as scientific and technical consultancy service cannot be taxed under 'Consultancy engineer's service'.

## 2. Manpower recruitment and supply agency w.e.f. 7-7-1997

*Definition from 7-7-1997 to 15-06-2005*

**Manpower recruitment agency** means any commercial concern engaged in providing any service, directly or indirectly, in any manner for recruitment of manpower, to a client.

**Taxable service** means any service to a client, by a manpower recruitment agency in relation to the recruitment of manpower in any manner.

*Definition w.e.f. 16-6-2005*

**Manpower recruitment or supply agency** means any commercial concern engaged in providing any service, directly or indirectly, in any manner for recruitment or supply of manpower, temporarily or otherwise, to a client.

**Taxable service** means any service to a client, by a manpower recruitment or supply agency in relation to the recruitment or supply of manpower, temporarily or otherwise, in any manner.

*Amendment w.e.f. 1-5-2006*

**Manpower recruitment or supply agency** - The words 'commercial concern' were replaced by the words 'any person'.

*Insertion of Explanation w.e.f. 1-6-2007 to the taxable service*

**Explanation:** - For the removal of doubts, it is hereby declared that for the purpose of this sub-clause, recruitment and supply of manpower includes services

in relation to pre-recruitment screening, verification of the credentials and antecedents of the candidates and authenticity of documents submitted by the candidate.

*Amendment to the Act for replacement of the word 'client' w.e.f. 16-5-2008*

**Taxable service** - W.e.f. 16-5-2008 the word 'client' has been replaced with the words 'any person'.

### **Departmental Clarifications and opinions**

- No service tax in case employees hired directly without intermediary
- The IIT and IIM could not be called a commercial concern and were not liable to pay service tax on fees collected by them for campus interviews during the period prior to 1-5-2006. For the period from 1-5-2006, it has been clarified that decision should be taken after taking into account of all material facts on case to case basis.
- Academic institutions recruiting their students for industrial establishments on receipt of payment fall within the scope of the definition of manpower recruitment agency.
- In CBEC's FAQs, the department has clarified that service tax is not levied on the amount received by the labour contractor as it is for the execution of work and not for employment of manpower.

## 3. Architects w.e.f. 16-10-1998

**Architect** means any person whose name is, for the time being, entered in the register of architects maintained under section 23 of the Architect Act, 1972 (20 of 1972) and also includes any commercial concern engaged in any manner, whether directly or indirectly, in rendering services in the field of architecture.

**Taxable service** means any service to a client, by an architect in his professional capacity, in any manner. (W.e.f. 16-5-2008 the word 'client' has been replaced with the words 'any person')

### **Departmental Clarifications and opinions**

- The work of architect starts from providing

Real estate consultant means a person who renders in any manner, either directly or indirectly, advice, consultancy or technical assistance, in relation to evaluation, conception, design, development, construction, implementation, supervision, maintenance, marketing, acquisition or management, of real estate.

appropriate advice keeping in view the requirements of the client at the preliminary stage of initial sketches, specifications and drawing of plans, and consist of providing detailed drawings, approval of the drawings from the concerned authorities, supervision at each stage of construction and till the point when the completion certificate is obtained from the authorities.

- Architect providing service like surveyor would be liable to pay service tax on such services.

#### 4. Interior Decorators w.e.f. 16-10-1998

**Interior decorator** means any person engaged, whether directly or indirectly, in the business of providing by way of advice, consultancy, technical assistance or in any other manner, services related to planning, design or beautification of spaces, whether man-made or otherwise and includes a landscape designer.

**Taxable service** means any service to a client by an interior decorator in relation to planning, design or beautification of spaces, whether man-made or otherwise, in any manner. (W.e.f. 16-5-2008 the word 'client' has been replaced with the words 'any person')

##### *Departmental Clarifications and opinions*

- Vaastu/Feng Shui consultants are covered
- Services by art directors of films and others who render services of design etc., for setting up temporary structures/settings for shootings etc., do not attract the service tax levy as such interior decoration has no permanency and only temporary in nature.

#### 5. Real Estates Agents/Consultants w.e.f. 16-10-1998

**Real estate agent** means a person who is engaged in rendering any service in relation to sale, purchase, leasing or renting of real estate and includes a real estate consultant.

**Real estate consultant** means a person who renders in any manner, either directly or indirectly, advice, consultancy or technical assistance, in relation to evaluation, conception, design, development, construction,

implementation, supervision, maintenance, marketing, acquisition or management, of real estate.

**Taxable service** means any service to a client, by a real estate agent in relation to real estate. (W.e.f. 16-5-2008 the word 'client' has been replaced with the words 'any person')

##### *Departmental Clarifications and opinions*

- Comprehensive services to real estate developers and promoters in respect of evaluation of a real estate scheme/project by conducting techno-economic studies, providing feasibility reports and helping in marketing real estate projects also covered.
- Any advice with regard to housekeeping and selection of security agency is covered under real estate consultancy services as it is for maintenance of property.
- Any advice on the mode of finance for the acquisition of real estate also covered under real estate consultancy services.
- Advocates preparing sale and purchase deed are excluded.
- Advocates carrying out search of title to property are also excluded.

#### 6. Erection, Commissioning and Installation w.e.f. 1-7-2003

*From 1-7-2003 to 9-9-2004*

**Commissioning and installation** means any service provided by a commissioning or installation agency in relation to commissioning or installation of plant, machinery or equipment.

**Commissioning and installation agency** means any agency providing service in relation to commissioning or installation.

**Taxable service** means any service to a customer by a commissioning and installation agency in relation to commissioning or installation.

*Scope enlarged w.e.f. 10-9-2004*

Services related to erection have also been included.

Erection involves civil works which would otherwise fall under the category of construction service. However in case of a composite contract for erection, commissioning and installation, civil works relating to erection, commissioning and installation, the erection charges would be taxed as part of this category of service.

*Scope enlarged w.e.f. 16-6-2005*

The scope of taxable service has been enlarged by inclusion of services of installation of-

- a) electrical and electronic devices, including wirings or fittings therefor; or
- b) plumbing, drain laying or other installations for transport of fluids; or
- c) heating, ventilation or air-conditioning including related pipe work, duct work and sheet metal work; or
- d) thermal insulation, sound insulation, fire proofing or water proofing; or
- e) lift and escalator, fire escape staircases or travelers; or
- f) such other similar services;

*Scope enlarged w.e.f. 1-5-2006*

Erection, Commissioning or Installation of structures whether fabricated or not is also added.

*Amendment to the Act for replacement of the word 'customer' w.e.f. 16-5-2008*

**Taxable service** - W.e.f. 16-05-2008 the word 'customer' has been replaced with the words 'any person'.

**Departmental Clarifications and opinions**

- Originally erection service was not covered, but included w.e.f. 10-09-2004.
- Activity of installation means the act of putting an equipment, machinery or plant into its place and making it ready for use. The activity of installation starts after erection which refers to the putting up of civil structures. Commissioning of a plant would mean operationalising an installed plant/machinery/equipment.
- In case of turnkey contract, the contract is indivisible and no separate value can be assigned to Commissioning or Installation. In such cases, no service tax is payable on material and goods supplied. However, if service provider

is unable to show breakup of commissioning and installation charges, service tax will be leviable on consolidated amount.-CBEC Circular No.59/8/2003, dated 20-06-2003.

- Putting up a water tank, piping, electrical wiring etc., not be covered till amendment made w.e.f 10-09-2004.
- Installing a booster pump, air conditioner, water filter, water heater etc., were covered w.e.f. 01-07-2003.
- Erection involves civil works which would otherwise fall under the category of construction service. However in case of a composite contract for erection, commissioning and installation, civil works relating to erection, commissioning and installation, the erection charges would be taxed as part of this category of service.
- As per Notification No. 19/2003-ST, dated 21-8-2003, service provider can opt to pay service tax on 33% of the gross amount charged which shall include the value of the plant, machinery, equipment, parts and any other material sold by the commissioning or installation agency during the course of providing commissioning or installation service subject to condition that he does not avail benefit under Notification No. 12/2003-ST, dated 20-6-2003 which provides exemption for cost of goods and materials sold to the receiver of such services. It has not barred for availment of Cenvat Credit.
- The above notification has been amended vide Notification No. 12/2004-ST, dated 10-09-2004 and barred for availment of Cenvat Credit on inputs or capital goods. However Cenvat Credit of input services can be availed.
- Further the Notification No. 12/2004-ST, dated 10-9-2004 has been rescinded w.e.f 1-3-2006 and Notification No.1/2006-ST, dated 01-3-2006 has been issued. As per this notification service provider can opt to pay service tax

on 33% of the gross amount charged which includes the value of the plant, machinery, equipment, parts and any other material sold by the commissioning and installation agency, during the course of providing erection, commissioning or installation service. Now service provider cannot avail any cenvat credit at all apart from the benefit under Notification No.12/2003-ST, dated 20-6-2003.

**7. Management, maintenance or repair w.e.f. 1-7-2003**

*Definition from 1-7-2003 to 15-5-2005*

**Maintenance or repair** means any service provided by

- (i) any person under a maintenance contract or agreement or
- (ii) a manufacturer or any person authorized by him in relation to maintenance or repair or servicing of goods or equipment, excluding motor vehicle.

**Taxable service** means any service to a customer, by a person in relation to maintenance or repair.

*Scope enlarged w.e.f. 16-5-2005*

- The definition ‘maintenance or repair’ is expanded to include (i) maintenance or management of immovable properties and (ii) reconditioning or restoration of any goods or equipment excluding motor vehicle.
- The services in relation to goods or equipment need not be provided under a ‘maintenance contract or agreement’. It will suffice if such services are provided under a ‘contract or agreement’.

*Scope enlarged w.e.f. 1-5-2006*

- The word ‘Management’ was inserted before the title “Maintenance or repair”
- Definition is further expanded to include management, repair or maintenance of all properties whether immovable or not.

**Taxable service** means any service to a customer, by a person in relation to management, maintenance or repair.

*Explanation inserted w.e.f. 1-6-2007*

**Management, maintenance or repair-** As per

*Explanation* inserted ‘Goods’ includes computer software.

*Explanation inserted w.e.f. 16-5-2008*

**Management, maintenance or repair-** As per *Explanation* inserted ‘properties’ includes information technology software.

*The substituted statutory definition w.e.f. 16-5-2008*

**Management, maintenance or repair** means any service provided by,-

- (i) any person under a contract or an agreement; or
- (ii) a manufacturer or any person authorized by him,

in relation to,—

- (a) management of properties, whether immovable or not;
- (b) maintenance or repair of properties, whether immovable or not; or
- (c) maintenance or repair including reconditioning or restoration, or servicing of any goods or equipment, excluding motor vehicle;

*Explanation:-* For the removal of doubts, it is hereby declared that for the purpose of this clause (a) ‘goods’ includes computer software; (b) ‘properties’ includes information technology software.

**Taxable service** means any service **to any person**, by any person in relation to management, maintenance or repair.

*Departmental Clarifications and opinions*

- To attract service tax under this category, the contract or agreement need not necessarily be a maintenance contract/agreement. The contract or agreement may be in writing or oral. Generally as per commercial parlance the contract is in writing.
- Maintenance is to keep a machine, building etc. in a good condition by periodical checking and servicing or repairing.
- Restoration refers to bringing back to original state by rebuilding, repairing and painting.
- Repair refers to restoring to good condition after damage or wear.

- Service means ‘provision of what is necessary for installation and maintenance of machine etc. or operation’ or a ‘periodic routine maintenance of motor vehicle etc.’ or ‘assistance or advice given to customers after sale of goods’.
- Maintenance/repair of computers, computer systems/ peripherals are taxable w.e.f. 9-7-2004 since the exemption notification No.20/2003-ST, dated 21-8-2003 has been withdrawn.
- Since 16-06-2005 immovable properties such as roads, airports, railways, buildings, parks, electrical installations and the like are covered.
- Services provided by the manufacturer or authorized dealer during warranty period also covered.

### 8. Technical inspection and certification w.e.f. 1-7-2003

**Technical inspection and certification** means inspection or examination of goods or process or material or immovable property to certify that such goods or process or material or immovable property qualifies or maintains the specified standards, including functionality or utility or safety or any other characteristic or parameters but does not include any service in relation to inspection and certification of pollution levels.

**Taxable service** means any service to any person, by a technical inspection and certification agency, in relation to technical inspection and certification.

*Scope enlarged w.e.f. 16-5-2008*

Scope enlarged to include ‘certification of IT software’ services

### 9. Technical testing and analysis w.e.f. 1-7-2003

**Technical testing and analysis** means any service in relation to physical, chemical, biological or any other scientific testing or analysis of goods or material or any immovable property but does not include any testing or analysis service provided in relation to human beings or animals.

**Taxable service** means any service to any person, by a technical testing and analysis agency, in relation to technical testing and analysis.

*Explanation inserted w.e.f. 1-5-2006 to the definition technical testing and analysis*

**Explanation:-** For the removal of doubts, it is hereby declared that for the purposes of this clause ‘tech-

nical testing and analysis’ includes testing and analysis undertaken for the purpose of clinical testing of drugs and formulations; but does not include testing or analysis for the purpose of determination of nature of diseased condition, identification of a disease, prevention of any disease or disorder in human beings or animals

*Scope enlarged w.e.f. 16-5-2008*

Scope enlarged to include ‘testing and analysis of IT software’ services

### Departmental Clarifications and opinions

- Services in relation to water quality testing by Government owned State or District Level Laboratory are exempted w.e.f. 1-3-2006
- Service by a Clinical Research Organization approved to conduct clinical trials by the Drugs Controller General of India, in relation to testing and analysis of newly developed drugs, including vaccines and herbal remedies, on human participants so as to ascertain the safety and efficacy of such drugs on human participants is exempted

### 10. Construction Service w.e.f. 10-9-2004

*Definition from 10-9-2004 to 15-6-2005*

**Construction service means—**

- (a) construction of a new building or a civil structure or a part thereof; or
- (b) repair, alteration or restoration of, or similar services in relation to, building or civil structure

which is—

- (i) used, or to be used, primarily for; or
- (ii) occupied, or to be occupied, primarily with; or
- (iii) engaged, or to be engaged, primarily in,

commerce or industry, or work intended for commerce or industry, but does not include road, airport, railway, transport terminal, bridge, tunnel, long distance pipeline and dam.

**Taxable service means** any service to any person, by a commercial concern in relation to construction service.

*Scope enlarged w.e.f. 16-6-2005*

The title of service was changed to ‘commercial or

industrial construction service' and the scope of Construction service has been enlarged by including

- construction of pipeline or conduits (Earlier definition specifically excludes long distance pipeline)
- repair, alteration, renovation or restoration of, or similar service in relation to pipeline or conduits
- completion and finishing services such as glazing, plastering, painting, floor and wall tiling, wall covering and wall papering, wood and metal joinery and carpentry, fencing and railing, construction of swimming pools, acoustic applications or fittings and other similar services, in relation to building or civil structure.
- renovation of building or civil structure (Earlier clause did not cover 'renovation')

*Amendment w.e.f. 1-5-2006 to taxable service*

**Taxable service** means any service to any person, **by any person** in relation to commercial or industrial construction service. The words 'commercial concern' were replaced by the words 'any person'.

*Departmental Clarifications and opinions*

- Construction of port or other port is exempted from levy of service tax w.e.f. 16-6-2005 vide Notification No. 16/2005-ST, dated 7-6-2005. This notification was rescinded by Notification No. 26/2007-ST, dated 22-5-2007. However the exemption is now extended by Notification No. 25/2007-ST, dated 22-5-2007 w.e.f. 1-6-2007 in relation to execution of works contract.
- In case of multi purpose buildings such as residential *cum* commercial construction, tax is leviable in case such immovable property is treated as a commercial property under the local/municipal laws.
- If the contract for commercial complex is a single contract and the construction of road is not recognized as a separate activity as per the contract, then service tax would be leviable on gross amount charged including value of roads.
- Constructions for use of Educational, Religious, Charitable, Health, Sanitation, or Philanthropic purposes are not covered.

- If primary use is residential, then the construction should not be taxable even if some minor part use of the premises is for shops or commercial establishments.
- Post construction completion and finishing services, if undertaken as an isolated or stand alone contract are taxable.
- As per Notification No. 15/2004-ST, dated 10-9-2004 service provider can opt to pay service tax on 33% of the gross amount charged including the value of material cost subject to condition that he does not avail credit of duty paid on input or capital goods and also benefit under Notification No. 12/2003-ST, dated 20-6-2003 which provides exemption for cost of goods and materials sold to the receiver of such services. However Cenvat Credit on input services can be availed.
- The above notification has been rescinded w.e.f. 1-3-2006 and Notification No.1/2006-ST, dated 1-3-2006 has been issued. Now service provider cannot avail any cenvat credit at all apart from the benefit under Notification No.12/2003-ST, dated 20-6-2003. The gross amount charged shall include the value of goods and materials supplied or provided or used by the provider of such construction service. This exemption shall not apply where only completion and finishing services provided in relation to building or civil structure.

### **11. Site formation and clearance, excavation and earth moving and demolition w.e.f. 16-6-2005**

**Site formation and clearance, excavation and earthmoving and demolition** includes,—

- (i) drilling, boring and core extraction services for construction, geophysical, geological or similar purposes; or
- (ii) soil stabilization; or
- (iii) horizontal drilling for the passage of cables or drain pipes; or
- (iv) land reclamation work; or
- (v) contaminated top soil stripping work; or
- (vi) demolition and wrecking of building, structure or road,

but does not include such services provided in rela-

tion to agriculture, irrigation, watershed development and drilling, digging, repairing, renovating or restoring of water sources or water bodies;

**Taxable service** means any service to any person, by any other person, in relation to site formation and clearance, excavation and earthmoving and demolition and such other similar activities.

#### *Departmental Clarifications and opinions*

- Services of site formation and clearance, excavation and earthmoving and demolition provided in the course of construction of roads, airports, railways, transport terminals, bridges, tunnels, dams, ports or other ports are excluded.
- The definition is inclusive and the activities specifically mentioned are indicative and not exhaustive. Prior to construction of buildings, factory or any civil structure, activity of mining or laying of cables or pipes, preparation services of site formation and clearance, excavation and earthmoving or levelling are normally undertaken for a consideration to make the land suitable for such activities. Such services include blasting and rock removal work, clearance of undergrowth, drilling and boring, overburden removal and other development and preparation services of mineral properties and sites, and other similar excavating and earthmoving services.

#### **12. Dredging Services w.e.f. 16-6-2005**

**Dredging** includes removal of material including, silt, sediments, rocks, sand, refuse, debris, plant or animal matter in any excavating, cleaning, deepening, widening or lengthening, either permanently or temporarily, of any river, port, harbour, backwater or estuary.

**Taxable service** means any service to any person by any person in relation to dredging.

#### *Departmental Clarifications and opinions*

The definition of dredging is an inclusive definition and the activities specified are only indicative and not exhaustive. Taxable service covers dredging which is generally undertaken for removal of material such as silt, sediments, rocks etc. of rivers, ports, harbour, backwater or estuary for providing adequate draught for ships and other vessels and to maintain shipping channel and dredging in any other cases does not attract service tax.

#### **13. Survey & Map-making Services w.e.f. 16-6-2005**

**Survey and map-making** means geological, geophysical or any other prospecting, surface, sub-surface or aerial surveying or map-making of any kind, but does not include survey and exploration of mineral.

**Taxable service** means any service to any person, by any other person, other than by an agency under the control of, or authorized by, the Government, in relation to survey and map-making.

#### *Departmental Clarifications and opinions*

- Survey and map-making covers geological, geophysical, geochemical and other prospecting services by studying the properties of the earth and rock formation and structures. It also includes services providing information on sub-surface earth formations by different methods such as seismographic, gravimetric, magnetometric methods or other sub-surface surveying methods. Further it covers surface surveying, services of gathering information on the shape, position or boundaries of a portion of earth's surface by methods such as transit, photogrammetric or hydrographic, for the purpose of preparing maps. It also includes surveying or collection of data by satellites.
- Map-making consists of preparation or revision of maps of all kinds such as topographic, hydrographic, roads, planimetric, cadastral, city maps etc., using various information sources. However survey and map-making services rendered by an agency under the control of the Government or authorized by the Government, such as 'Survey of India' are specifically excluded and are outside the scope of this service.

#### **14. Cleaning Services w.e.f. 16-6-2005**

**Cleaning activity** means cleaning, including specialized cleaning services such as disinfecting, exterminating or sterilizing of objects or premises, of -

- commercial or industrial buildings and premises thereof; or
- factory, plant or machinery, tank or reservoir of such commercial or industrial buildings and premises thereof,

but does not include such services in relation to agriculture, horticulture, animal husbandry or dairying.

**Taxable service** means any service to any person, by

any other person, in relation to cleaning activity.

**Departmental Clarifications and opinions**

- Residential premises are not covered
- No exemption in service tax if the service provider or recipient is a Government Department or Agency.
- Fumigation of godowns storing food grains like wheat and paddy are not covered.
- When service provider undertakes fumigation or disinfecting activity, the materials chemicals or pesticides are consumed and not sold. Gross amount including the value of such materials is the taxable value.

**15. Construction of Complex w.e.f. 16-6-2005**

**Construction of complex** means—

- (a) construction of a new residential complex or a part thereof; or
- (b) completion and finishing services in relation to residential complex such as glazing, plastering, painting, floor and wall tiling, wall covering and wall papering, wood and metal joinery and carpentry, fencing and railing, construction of swimming pools, acoustic applications or fittings and other similar services; or
- (c) repair, alteration, renovation or restoration of, or similar services in relation to, residential complex;

**Residential complex** means any complex comprising of—

- (i) a building or buildings, having more than twelve residential units;
- (ii) a common area; and
- (iii) any one or more of facilities or services such as park, lift, parking space, community hall, common water supply or effluent treatment system located within a premises and the layout of such premises is approved by an authority under any law for the time being in force, but does not include a complex which is constructed by a person directly engaging any other person for designing or planning of the layout, and the construction of such complex is intended for personal use as residence by such person.

*Explanation.*—For the removal of doubts, it

is hereby declared that for the purposes of this clause,—

- (a) "personal use" includes permitting the complex for use as residence by another person on rent or without consideration;
- (b) "residential unit" means a single house or a single apartment intended for use as a place of residence.

**Taxable service** means any service to any person, by any other person in relation to construction of complex.

**Departmental Clarifications and opinions**

- Common area of a Residential Complex includes roads, staircases and other similar areas where residents of the residential complex have easement rights and may also contain other facilities such as market or shopping complex, schools, security, banks, gymnasium, health club, sports facilities, power back up and the like.
- In the case of *K.Raheja Development Corpn. vs State of Karnataka (2005)2 STT 178* the Supreme Court had clarified that the activities undertaken by builders for construction of flats/buildings for one or on behalf of the prospective customers for consideration in cash or deferred payment is covered under works contract and not under sale. The department clarified that such estate builders are covered under definition of service provider for construction of complex service.
- Where a builder, promoter or developer engages the contractor for construction of residential complex, the contractor shall be liable to pay service tax. In case no contractor is engaged and the job of construction is undertaken by the builder, promoter or developer himself by engaging labourers for his own occupation or renting purpose or selling purpose service tax is not leviable.
- As per Notification No. 18/2005-ST, dated 7-6-2005 service provider can opt to pay service tax on 33% of the gross amount charged which include the value of goods and materials supplied or provided or used subject to condition that he does not avail credit of duty paid on inputs or capital goods used and also benefit under Notification 12/2003-ST, dated 20-6-2003 towards cost of goods and materials sold. This

exemption shall not apply where only completion and finishing services provided in relation to residential complex. However Cenvat Credit on input services can be availed.

- The above notification has been rescinded w.e.f 01-03-2006 and Notification No.1/2006-ST, dated 01-3-2006 has been issued. Now service provider cannot avail any cenvat credit at all apart from the benefit under Notification No. 12/2003-ST, dated 20-6-2003.

### 16. Renting of immovable property w.e.f. 1-6-2007

**Renting of immovable property** includes renting, letting, leasing, licensing or other similar arrangements of immovable property for use in the course or furtherance of business or commerce but does not include -

- (i) renting of immovable property by a religious body or to a religious body or
- (ii) renting of immovable property to an educational body, imparting skill or knowledge or lessons on any subject or field, other than a commercial training or coaching center.

*Explanation:-* For the purpose of this clause, “for use in the course of furtherance of business or commerce” includes use of immovable property as factories, office buildings, warehouses, theatres, exhibition halls and multiple-use buildings.

**Taxable service** means any service to any person in relation to renting of immovable property for use in the course of furtherance of business or commerce.

**Explanation 1** – For the purposes of this sub-clause, ‘immovable property’ includes-

- i) building and part of a building and the land appurtenant thereto
  - ii) land incidental to the use of such building or part of a building
  - iii) the common or shared areas and facilities relating thereto and
  - iv) in case of a building located in a complex or an industrial estate, all common areas and facilities relating thereto, with such complex or estate but does not include
- a) vacant land solely used for agriculture, aquacul-

ture, farming, forestry, animal husbandry, mining purposes

- b) vacant land, whether or not having facilities clearly incidental to the use of such vacant land
- c) land used for educational, sports, circus, entertainment and parking purposes and
- d) building used solely for residential purposes and buildings used for the purposes of accommodation, including hotels, hostels, boarding houses, holiday accommodation, tents, camping facilities.

**Explanation 2** - For the purposes of this sub-clause, immovable property partly for use in the course or furtherance of business or commerce and partly for residential or any other purposes shall be deemed to be immovable property for use in the course or furtherance of business or commerce.

#### **Departmental Clarifications and opinions**

- A property tax (land or building tax) is exempted and service recipient eligible to deduct property tax.
- Amount deducted by lessee for maintenance while making payment of rent is includible
- In case service tax is paid on construction service it can be covered under input service for providing out put service of renting and eligible to avail cenvat credit

### 17. Execution of Works Contract w.e.f. 1-6-2007

**Taxable service** means any service to any person, by any other person in relation to the execution of a works contract, excluding works contract in respect of roads, airports, railways, transport terminals, bridges, tunnels and dams, is a taxable service.

**Explanation-** For the purposes of this sub-clause, **Works Contract** means a contract wherein, -

- (i) transfer of property in goods involved in the execution of such contract is leviable to tax as sale of goods, and
- (ii) such contract is for the purposes of carrying out, -
  - (a) erection, commissioning or installation of plant, machinery, equipment or structures, whether pre-fabricated or otherwise, instal-

lation of electrical and electronic devices, plumbing, drain laying or other installations for transport of fluids, heating, ventilation or air-conditioning including related pipe work, duct work and sheet metal work, thermal insulation, sound insulation, fire proofing or water proofing, lift and escalator, fire escape staircases or elevators; or

- (b) construction of a new building or a civil structure or a part thereof, or of a pipeline or conduit, primarily for the purposes of commerce or industry; or
- (c) construction of a new residential complex or a part thereof; or
- (d) completion and finishing services, repair, alteration, renovation or restoration of, or similar services, in relation to (b) and (c); or
- (e) turnkey projects including engineering, procurement and construction or commissioning (EPC) projects;

**Departmental Clarifications and opinions**

- Contracts which are treated as works contract for the purpose of levy of VAT/Sales Tax shall also be treated as works contract for levying service tax.
- In case the service provider opts for composition scheme under VAT/Sales Tax, then the value for goods and services will not be available separately as VAT/Sales Tax will be levied on composite value. The onus to prove the value of the goods involved will be on the service provider. Hence separate records are to be maintained for materials and services.
- In case the service provider does not opt for composition scheme under VAT/Sales Tax and pays VAT/Sales Tax on goods identification method, then the value adopted for the purposes of payment of VAT/Sales Tax will be accepted for allowing deductions towards the goods sold during the execution of the contract.
- Value of materials supplied by recipient of services is not includible for composite scheme
- Cenvat credit on capital goods and input services is allowed

- The service provider can exercise the option under the Works Contract Composition Scheme contract wise but once the said option is exercised with respect to a particular contract, the said opinion cannot be withdrawn.
- Unless the services satisfy the criterion laid down in the provisions of service tax law, it cannot be held as Works Contract even if it is to be treated as Works Contract in terms of VAT/Sales Tax.

**18. Design Service w.e.f. 1-6-2007**

**Design Services** includes services provided in relation to designing of furniture, consumer products, industrial products, packages, logos, graphics, websites and corporate identity designing and production of three dimensional models.

**Taxable service** means any service to any person, by any other person in relation to design services, but does not include service provided by-

- (i) an interior decorator referred to in sub-clause (q); and
- (ii) a fashion designer in relation to fashion designing referred to in sub-clause (zv); and the term "service provider" shall be construed accordingly.

**19. Supply of tangible goods service w.e.f. 16-5-2008**

It covers supply of tangible goods including machinery, equipment and appliances for use, without transferring right of possession and effective control of such goods.

**Departmental Clarifications and opinions**

- Excavators, wheel loaders, dump trucks, crawler carriers, compaction equipment, cranes etc., offshore construction vessels & barges, geo-technical vessels, tug and barge flotillas, rigs and high value machineries are supplied for use, with no legal right of possession and effective control. Transaction of allowing another person to use the goods, without giving legal right of possession and effective control, not being treated as sale of goods, is treated as service.
- Supply of tangible goods for use leviable to VAT/Sales Tax as deemed sale of goods, is not covered under the scope of proposed service.

## Service Tax Planning

The project works can be classified based on price into the following contract types or combination thereof:

- Time-and-materials contracts which reimburse the contractor for direct labour and direct material costs.
- Unit-price contracts provide payment to the contractor based on the amount of units worked.
- Fixed-price contracts usually have a constant price associated with them. They are not typically subject to adjustment because of increasing construction costs.
- Cost-type contracts may be cost without fee or cost *plus* fee. In case of cost without fee, the contractor recoups its cost. In case of cost plus fee, the contractor receives payment for its costs *plus* a fixed fee. The fee is usually based on a profit margin. The fee may be based on variables such as total expected costs, uncertain in estimating costs, risk of the project, economic conditions, etc. The costs of a contract should never exceed its net realizable value because in that case the contract is not financially feasible. If accumulated costs exceed net realizable value during the term of the contract, a loss should be recognized immediately.

In case the contract consist the price inclusive of taxes, the service tax element becomes one of the major cost element among the various components of cost. The service tax cost can be minimized through proper tax planning in construction industry. The Finance Manager would play a key role in the process of risk analysis of bids and service tax planning. The Finance Manager has to exercise a suitable option for payment of service tax considering the various factors of the project work or contract. In respect of the following services option is available to pay service tax treating them either as separate and independent service or under the works contract service in case they satisfy the criterion laid down under *Explanation* to the section 65(105) (zzzza) for works contract—

- Erection, commissioning or installation service [section 65(105) (zzd)]
- Commercial or industrial construction service [section 65(105) (zzq)]

- Construction of complex service [section 65(105) (zzzh)]

The following options are available for arriving service tax liability as per provisions of the service tax law.

### (A) In case of a separate Supply Contract

Supply contract is a contract for sale of goods and hence service tax is not applicable. In case service is also provided as incidental to supply of material and such service value is also included in sale value for sales tax purpose, then service tax is not payable on such service. Service Tax is not leviable when Sales Tax/VAT paid. Imposition of service tax and sales taxes being constitutionally mutually exclusive and sales tax has been paid on the cell phone SIM cards, service tax is not imposable. (Idea Mobile Communications Ltd.-2006(4)STR 132-Trib-Bang.)

### (B) In case of a separate Service Contract

- Pay service tax @12.36% and avail cenvat credit capital goods and input services used in execution of such service contract. In case any materials are used or sold incidental to carry the work under service contract such material value may be deducted from taxable value. In case material is sold and not deducted from taxable value, excise duty credit on such material (except LDO, HSD and petrol) can be availed. Deduction is not available in respect of goods consumed during provision of service. For example, in case of pest control service the material such as chemicals used in providing such service.
- Notification No. 12/2003-ST, dated 20-6-2003 provides that if the amount charged includes value of goods and materials sold, service tax shall not be payable on value of goods and materials sold. There should be documentary evidence for such value of materials sold. This exemption is available only if cenvat credit of such material is not taken. In case credit was taken, service provider should pay amount equal to the credit before effecting sale of such goods.

### (C) In case of Composite Contract which is divisible or Separate Contracts issued on split basis for supply portion and service portion for a project work

In a composite contract, if supply portion and service

portion is identifiable and billed separately any of the following options can be availed for payment of service tax. For instance, in case of a contract for supply, erection, installation and commissioning of machinery, the contractor may identify supply portion and service portion specifying the values separately in the contract or separate contracts may be issued for supply portion and service portion on split basis.

(a) Option I- Payment of Tax on Service portion only @12.36%

Pay service tax at normal rate 12.36% on gross amount charged less the value of transfer of property in goods involved including VAT/Sales Tax under rule 2A of Service Tax (Determination of Value) Rules, 2006. In this case CENVAT Credit of service tax on input services and excise duty credit on capital goods can be availed and there is no restriction on availment of excise duty credit on any inputs used in execution of the said contract. Separate records are to be maintained for materials and services.

(b) Option II- Payment of Tax on both Material portion and Service portion @12.36%

Pay @12.36% on 100% gross bill value including material value and avail cenvat credit on inputs, input services and capital goods including on materials of supply portion. In this case cenvat amount will not be considered as part of cost.

(c) Option III- Payment of Tax on 33% value of Material and Service portion

Pay @12.36% on 33% of the bill value including value of material by availing abatement on 67% of bill value. In this case cenvat credit on inputs, capital goods and input services will not be available.

(d) Option IV- Payment of Tax under Works Contract Composition Scheme @4.12%

Pay an amount equivalent to 4.12% of the gross amount charged less VAT/Sales Tax paid on transfer of property in goods involved in the execution of the works contract under Works Contract (Composition Scheme for Payment of Service Tax) Rules, 2007. In this case CENVAT Credit of duty on inputs used in relation to the said works contract is not available. However the assessee is allowed to avail of the CENVAT credit of duty on capital goods and service tax on various input services used in relation to the said works contract. Once the option is exercised it cannot be withdrawn for a particular contract.

**(D) In case of Composite Contract which is indivisible**

In case of Composite Contract which is inclusive of both supply portion and service portion and billing is indivisible, then the options II, III and IV given in above para (C) are only available.

The net effect of service tax liability is given in the following tables based on the above options and considering the material/labour portions in a contract –

**Table-1 In case a contract consists of 75% Material Portion and 25% Service Portion**

Particulars	Value Rs.	Option-I	Option-II	Option-III	Option-IV
Supply Portion	750	0.00	92.71	30.59	30.90
Service Portion	250	30.89	30.89	10.20	10.30
<b>Total</b>	<b>1000</b>	<b>30.89</b>	<b>123.60</b>	<b>40.79</b>	<b>41.20</b>
<b>Less : Cenvat Credit</b>					
Inputs	92	0	92	0	0
Capital Goods	2	2	2	0	2
Input Services	10	10	10	0	10
<b>Total Cenvat Credit</b>	<b>104</b>	<b>12</b>	<b>104</b>	<b>0</b>	<b>12</b>
<b>Service Tax Liability</b>		<b>18.89</b>	<b>19.60</b>	<b>40.79</b>	<b>29.20</b>

**Table-2 In case a contract consists of 67% Material Portion and 33% Service Portion**

Particulars	Value Rs.	Option-I	Option-II	Option-III	Option-IV
Supply Portion	670	0.00	82.81	27.33	27.60
Service Portion	330	40.79	40.79	13.46	13.60
<b>Total</b>	<b>1000</b>	<b>40.79</b>	<b>123.60</b>	<b>40.79</b>	<b>41.20</b>
<b>Less : Cenvat Credit</b>					
Inputs	82	0	82	0	0
Capital Goods	2	2	2	0	2
Input Services	14	14	14	0	14
<b>Total Cenvat Credit</b>	<b>98</b>	<b>16</b>	<b>98</b>	<b>0</b>	<b>16</b>
<b>Service Tax Liability</b>		<b>24.79</b>	<b>25.60</b>	<b>40.79</b>	<b>25.20</b>

**Table-3 In case a contract consists of 50% Material Portion and 50% Service Portion**

Particulars	Value Rs.	Option-I	Option-II	Option-III	Option-IV
Supply Portion	500	0.00	61.80	20.39	20.60
Service Portion	500	61.80	61.80	20.39	20.60
<b>Total</b>	<b>1000</b>	<b>61.80</b>	<b>123.60</b>	<b>40.78</b>	<b>41.20</b>
<b>Less : Cenvat Credit</b>					
Inputs	61	0	61	0	0
Capital Goods	2	2	2	0	2
Input Services	21	21	21	0	21
<b>Total Cenvat Credit</b>	<b>84</b>	<b>23</b>	<b>84</b>	<b>0</b>	<b>23</b>
<b>Service Tax Liability</b>		<b>38.80</b>	<b>39.60</b>	<b>40.78</b>	<b>18.20</b>

**Table-4 In case a contract consists of 40% Material Portion and 60% Service Portion**

Particulars	Value Rs.	Option-I	Option-II	Option-III	Option-IV
Supply Portion	400	0.00	49.44	16.32	16.48
Service Portion	600	74.16	74.16	24.47	24.72
<b>Total</b>	<b>1000</b>	<b>74.16</b>	<b>123.60</b>	<b>40.79</b>	<b>41.20</b>
<b>Less : Cenvat Credit</b>					
Inputs	49	0	49	0	0
Capital Goods	2	2	2	0	2
Input Services	25	25	25	0	25
<b>Total Cenvat Credit</b>	<b>76</b>	<b>27</b>	<b>76</b>	<b>0</b>	<b>27</b>
<b>Service Tax Liability</b>		<b>47.16</b>	<b>47.60</b>	<b>40.79</b>	<b>14.20</b>

**The following assumptions have been made for the workings given in above tables :**

- Excise duty credit on inputs has been worked out @14.42% on cost of direct purchases being 85% of the sales and such purchases have been made through cenvat invoices.
- Cenvat credit on input services has been worked out @4.12%.
- Cenvat on capital goods has been estimated as Rs.2/- per Rs.1000/- of the total value.

The Finance Manager has to consider the following points which were emerged from the above analysis during the process for selection of a suitable option for service tax payment.

- In case of Turnkey Projects or EPC Contracts or Composite Contract of Civil Construction Activity or Composite Contract of Erection, Installation and Commissioning Work which contains composite rates without breakup of material and labour, the Option IV is simple and beneficial by payment of service tax @4.12% under Works Contract Scheme.
- In respect of Composite Contract which is divisible and consists of material portion more than 67% and service portion less than 33%, the Option-I is beneficial.
- In case material portion is less than 67% and service portion is more than 33% then the Option-IV is beneficial.
- Hence it is advisable to give breakup of supply portion and service portion in a contract to take a suitable option for payment of service tax.
- The scope of the contract is also to be defined accurately by using the relevant words like supply, erection, commissioning, installation, testing, inspection, construction etc. specifying for electrical, mechanical or civil works of plant, equipment, machinery, structures, buildings etc. rather loosely.
- Generally material portion will be more than 67% in composite contract of erection, commissioning and installation since it contains supply of plant, machinery, equipment or structure and hence option I is beneficial by taking the value of service portion only.
- Normally the civil construction contract will be composite and indivisible. In this case the option IV (works contract composition scheme) is advantageous.
- In case of Long-Term Projects/Contracts it is advisable to insert a clause in the terms and conditions of the contract price as “service tax extra” to avoid the disputes due to frequent changes in the provisions of service tax law.

### **Conclusion**

Selection of service tax payment option varies from one contract to another contract and one project activity to another project activity. It is difficult to frame one formula which is suitable to all situations. It is depending upon so many factors such as type of contract, type of service or activity, type of project, purchases through cenvat invoices, deploying own assets or hiring of equipments at project site etc. Some times service tax planning becomes critical in participating bidding process and in risk analysis of a bid. Since the profit margin will be marginal and varies from 3% to 10% depending upon various factors in respect of construction industry, some times service tax element may change the profit margin. Hence service tax planning is essential to choose a suitable option for payment of service tax and in turn minimizing the service tax cost. In this process, Finance Manager plays a decisive role. □

# TRANSFER PRICING— SOME ISSUES



There are many MNCs in India, which by their ability to influence the price chargeable in the transactions entered with their related entity, try to shift the revenue to that country where the consequential tax impact on such transaction is minimal. This process of charging the differential price in respect of the related party transactions for transferring of revenues to the tax beneficial state is termed as Transfer Pricing, which poses grave challenge to Government. This article discusses some issues related to Transfer Pricing in Indian context.

India opened its doors for globalisation in the year 1991 and has seen a tremendous positive results across all the Indian sectors ever since. Many Multinational companies (MNC) have set up their subsidiaries etc. in India to exploit the Indian market using highly efficient, productive and cost-effective resources of India. However, there are many MNCs that by their ability to influence the price chargeable in the transactions entered with their related entity are trying to shift the revenue to that country (state) where the consequential tax impact on such transaction is minimal. This process of charging the differential price in respect of the related party transactions for transferring of revenues to the tax benefi-

cial state is termed as *Transfer Pricing*. This *transfer pricing* mechanism poses a grave challenge to Government revenue authorities all over the world. As such, all such related party transactions had to be put under Government scanner to scrutinize the price charged in such transactions.

In India, till the previous year 2001-02, there was only section-92 under Income Tax Act, 1961 (the Act), dealing specifically with cross border transactions. Under this section an adjustment could be made to the profits of a

resident arising from a business carried on between the resident and a non-resident, if it appeared to the Assessing Officer that owing to the close connection between them, the course of business was so arranged so as to produce less than expected profits to the resident. It



—CA. Rohit Garg  
(The author is a member of the Institute. He can be reached at rohit.garg@icai.org)

The very basic requirement of ‘international transaction’ is that one of the parties to the relevant transaction must be a non-resident. However, if both the parties to the relevant transaction are non-residents, then also such a transaction would be taxable under this provision provided such a transaction does have any impact or connection on Indian resident.

was under the Finance Act, 2001 (w.e.f 01.04.2002) wherein the Finance Minister proposed to tax the *Transfer Pricing* issue specifically by substituting the existing section 92 with a new section and inserting the new sections- 92 A to 92 F under the Act. The memorandum explaining the Finance Bill stated the intention of introducing the new sections as under:

“...The increasing participation of multi-national groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multi-national group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intragroup transactions, thereby, leading to erosion of tax revenues.

Under the existing section 92 of the *Income-tax Act*, which was the only section dealing specifically with cross border transactions, an adjustment could be made to the profits of a resident arising from a business carried on between the resident and a non-resident, if it appeared to the Assessing Officer that owing to the close connection between them, the course of business was so arranged so as to produce less than expected profits to the resident. Rule 11 prescribed under the section provided a method of estimation of reasonable profits in such cases. However, this provision was of a general nature and limited in scope. It did not allow adjustment of income in the case of non-residents. It referred to a "close connection" which was undefined and vague. It provided for adjustment of profits rather than adjustment of prices, and the rule prescribed for estimating profits was not scientific. It also did not apply to individual transactions such as payment of royalty, etc., which are not part of a regular business carried on between a resident and a non-resident. There were also no detailed rules prescribing the documentation required to be maintained.

With a view to provide a detailed statutory framework which can lead to computation of reasonable, fair and

*equitable profits and tax in India, in the case of such multinational enterprises, the Act has substituted section 92 with a new section, and has introduced new sections 92A to 92F in the Income-tax Act, relating to computation of income from an international transaction having regard to the arm's length price, meaning of associated enterprise, meaning of international transaction, computation of arm's length price, maintenance of information and documents by persons entering into international transactions, furnishing of a report from an accountant by persons entering into international transactions and definitions of certain expressions occurring in the said sections”.*

Before going further, it is worth noting here that the regulatory framework of taxing the *Transfer Pricing* comprises:

- A. Provisions under section 92 to 92F of the Act.
- B. Penalty provisions under sections 271(1) (c), 271AA, 271BA, 271G.
- C. Provisions of *Income Tax* rules contained under Rule 10A to Rule 10D of the *Income Tax Rules, 1962*(the Rules).
- D. *CBDT* circulars and notifications thereof.

## Section 92

### Computation of income from International Transaction having regard to arms length price

Section 92 lays down that:

1. any income or expense or interest
2. arising out of an ‘*International Transaction*’<sup>1</sup>
3. shall be computed having regard to its ‘*arm’s length price*’<sup>2</sup>

This section further states that if in an international transaction, two or more associated enterprises<sup>3</sup> enter into a mutual agreement or arrangement for:

- i. the allocation or apportionment of, or

<sup>1</sup>‘International Transaction’ is defined under section 92B of the Act.

<sup>2</sup>‘Arm’s length price’ is the price used for computation of value thereof in a transaction between two or more unrelated parties.

<sup>3</sup>‘Associated Enterprises’ is defined under section 92 A of the Act.

A transaction would not be considered to be an international transaction even if it has been entered into between two associated enterprises, one of them being the non resident, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money but it doesn't have any impact/bearing on profits, income, losses, or assets of such enterprises.

ii. any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, or contributed by, any such enterprise shall be determined having regard to the arms length price of such benefit, service or facility.

It is evident from the above provision that its not only the income which arises in an international transaction between associated enterprises is going to be governed by the Act, rather it also includes any expense or interest which arises thereof.

Let us take an example to understand this provision;

Suppose, there are two enterprises, A in USA and B in India, which are associated enterprises<sup>4</sup>. Both entered into a mutual agreement whereby A would carry out some research in USA for the benefit of both the enterprises and the research expenses which would be incurred thereof will be apportioned between A and B in the ratio of 3:2 respectively. In this case as per the above provision, the B's share in the research expenses would be calculated with regard to *arm's length price* of the research expenses and not on the basis of the actual research expenses incurred.

This section further lays down that provisions of this section shall not apply in a case where the computation carried out having regard to *arm's length price* has the effect of reducing the income chargeable to tax or increasing the loss, as the case may be, computed on the basis of entries made in the books of account in respect of the previous year in which the international transaction was entered into. In simple words, *the provisions of section 92 shall not be applicable if it is prejudicial to the interest of the revenue.*

Its now imperative to understand the concept of 'International Transaction' and 'Associated Enterprises' before going ahead.

## Section 92A

### Meaning of Associated Enterprise

**92A.** (1) For the purposes of this section and sections

92, 92B, 92C, 92D, 92E and 92F, associated enterprise, in relation to another enterprise, means an enterprise

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

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

(2) [For the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year,]

(a) one enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise; or

(b) any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises; or

(c) a loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise; or

(d) one enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise; or

(e) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise; or

(f) more than half of the directors or members

<sup>4</sup> Refer note 3 above.

In order to understand the transfer pricing mechanism, one should be crystal clear about the different relationships, which give the status between two or more enterprises that of the associated enterprises in relation to an International Transaction.

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| <p>of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or</p> <p>(g) the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or</p> <p>(h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or</p> <p>(i) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or</p> <p>(j) where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or</p> <p>(k) where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or</p> <p>(l) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of</p> | <p>individuals; or</p> <p>(m) there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.</p> <p>Let us analyse the above provisions of section 92A in detail.</p> <p>As per section 92A (1), Associated Enterprise, means an enterprise</p> <p>(a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or</p> <p>(b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.</p> <p>On a plain reading of above provision, it comes out that mere participation in the management or control or capital of the other enterprise is sufficient to establish a relationship of Associated Enterprises. It was construed as such since sub section (2) of section 92A starts with the wordings:</p> <p><i>“Two enterprises shall be deemed to be associated enterprises if, at any time during the previous year .....</i>”</p> <p>However, Finance Bill 2002 makes an amendment in the above wordings of Section 92A(2) which reads as under:</p> <p><i>“For the purposes of sub section (1) of section 92A, two enterprises shall be deemed to be associated enterprises, if at any time during the previous year.....”</i></p> <p>It can now be seen that after amendment mere participation in the management or control or capital of the other enterprise will not be sufficient. It should also satisfy any of the criteria as mentioned under sub section (2) of section 92A of the Act. Even the memorandum explaining the Finance Bill 2002, clear-</p> |
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ly brings about this intention by stating as under:

*“The existing provisions contained in section 92A of the Income-tax Act provide as to when two enterprises shall be deemed to be associated enterprises.*

*The Finance Act, 2002 has amended sub-section (2) of section 92A to clarify that where any of the criteria specified in sub-section (2) is fulfilled; two enterprises shall be deemed to be associate enterprises.”*

Sub section (2) of section 92A is very wide in its connotation and it tries to cover as much possible relationship that may happen. It lays down the various types of relationship between two enterprises so as to call them associated enterprises. Such relationship can broadly be classified as under:

Capital Basis	Management Basis	Control Basis
1. One enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise.	5. More than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise	3. Loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise
2. Any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises.	6. More than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons	4. One enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise

Capital Basis	Management Basis	Control Basis
		7. The manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights
		8. Ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise
		9. The goods or articles manufactured or processed by one enterprise, are sold

Capital Basis	Management Basis	Control Basis
		to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise
		10. Where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual
		11. Where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative
		12. Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals
		13. There exists between the two enterprises, any relationship of mutual interest, as may be prescribed

If we closely look at the relationship mentioned under item 10 to 12, we could easily interpret that such relationship is mainly applicable in Indian context only.

Let us now, understand each of the above relationship with the help of illustration(s):

*1. One enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise*

It is to be noted here that in this clause, emphasis is on *voting power*. Therefore, it is imperative here to list out the types of instruments of an entity, which would provide the holder of such an instrument *voting power* in that entity. Following are the main instruments, which provide *voting power* to its holder:

- a) Equity Share.
- b) Convertible Preference Share (after its conversion into equity shares)

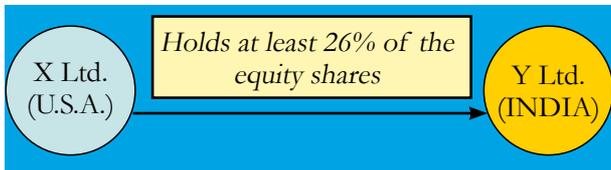
However, clarification is required that whether convertible preference share holders would get right of voting before their conversion into equity shares or not?

Further, it is important here to understand the importance of specified percentage of 26%. For this we have to look into the provisions of sub-clause (c) of sub section (2) of section 189 of Companies Act, 1956 which is as under:

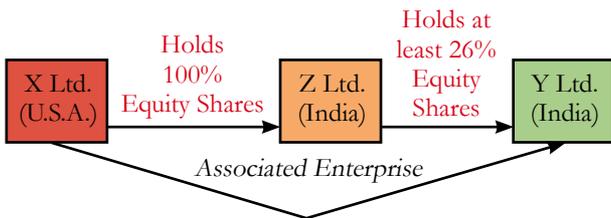
*“(2) A resolution shall be a special resolution when....*

*.... (c) the votes cast in favour of the resolution (whether on a show of hands, or on a poll, as the case may be) by members who, being entitled so to do, vote in person, or where proxies are allowed, by proxy, are not less than three times the number of the votes, if any, cast against the resolution by members so entitled and voting.”*

Therefore, if an entity is holding at least 26% of the voting power of other entity, then no special resolution in such other entity can be passed without the assent of the first mentioned enterprise. For e.g., X Ltd is based in U.S.A. and Y ltd. is based in India. Y Ltd. has equity share capital of Rs.10,00,000 comprising 1,00,000 equity shares of Rs.10 each. Now, if X Ltd. holds at least 26% of the equity shares, i.e., 26,000 equity shares or more, then by applying the above relationship criteria, X Ltd. and Y Ltd. are associated enterprises.

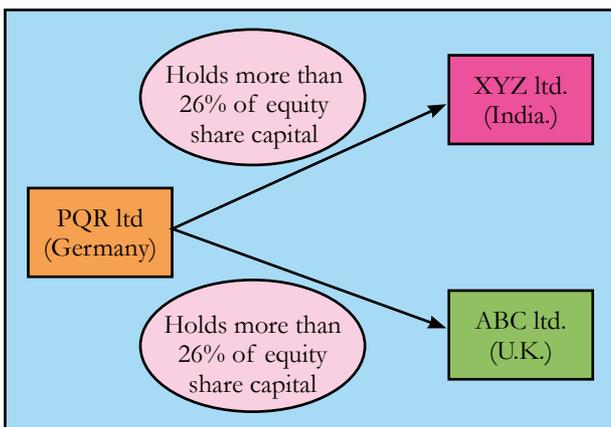


Further, in above case, suppose Z ltd. in India is a wholly owned subsidiary of X ltd, U.S.A. and Z ltd. holds at least 26% of the equity share capital of the Y ltd., then X ltd. and Y ltd. would also be termed as associate enterprises since X ltd. indirectly holds 26% or more of the equity share capital of Y ltd.



2. Any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises.

Suppose, ABC ltd. is in U.K. and XYZ ltd. is in India. Now, there is one more company called PQR ltd. in Germany, which holds, directly or indirectly, more than 26% of equity share capital in ABC ltd. as well as in XYZ ltd. By virtue of above-mentioned relationship, in this case ABC ltd. and XYZ ltd. would be termed as Associated Enterprises.



3. Loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise.

Under this clause, it is important to note here that the term 'loan' has been used. It is imperative to interpret the term 'loan' now. 'Loan' here refers to secured loan as well as to unsecured loans also because in both the cases it is the amount of loan advanced that would give a right to control in other entity.

It is interesting to note here that lender of the loan can be any 'enterprise', i.e., it can even be a bank or financial institution also. An ironical situation can easily arise here, e.g., X ltd. in India starts up a new export business in India. Now to set up such business it takes a loan from a bank 'B' based in France for purchasing the requisite assets. At the end of the year, Balance Sheet of X ltd. is as under:

Balance Sheet of X ltd. as on .....

Liabilities	Amount	Assets	Amount
<u>Unsecured Loan</u>		<u>Assets</u>	
Loan from bank 'B'	50,000	Building	45,000
<u>Current Liabilities</u>		Machinery	20,000
Creditors	25,000	Bank	10,000
<b>Total</b>	<b>75,000</b>	<b>Total</b>	<b>75,000</b>

It is very clear by looking at the above balance sheet here that the loan advanced by the bank 'B' constitutes more than 51% of the book value of the assets of the enterprise. Hence, by applying the above mentioned provision in this case, X ltd. and bank 'B' would also be termed as associated enterprises even though no such intention of controlling the business of X ltd persists with bank 'B'.

4. One enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise.

In this clause, if an enterprise guarantees more than ten percent of the total borrowings of the other enterprise, then such enterprises would be termed as associated enterprises in relation to each other.

For e.g. have a look at the following balance sheet of X ltd (India):

Balance Sheet of X ltd. as on ...

Liabilities	Amount	Assets	Amount
<u>Unsecured Loan</u>		<u>Assets</u>	
Loan from bank 'B'	50,000	Building	45,000
<u>Current Liabilities</u>		Machinery	20,000
Creditors	25,000	Bank	10,000
<b>Total</b>	<b>75,000</b>	<b>Total</b>	<b>75,000</b>

**Notes to accounts:**

Y ltd. in U.S.A. has given the performance guarantee to bank 'B' in respect of loan of Rs.50, 000 to the extent of Rs.20, 000.

In the above case, since Y ltd had furnished the guarantee to the tune of 40% of the borrowings of X ltd., hence by virtue of the above clause, X ltd. and Y ltd. would be termed as associated enterprise.

This is the clause wherein even if two enterprises do not have any business connection between them, then also they would be termed as associated enterprises just because one of the entity has furnished guarantee on behalf of the other enterprise to the lender of the borrowings. It is to be noted that, practically, it is a general phenomenon that parent company provides guarantees in respect of borrowings of their group company as the lender insists for that.

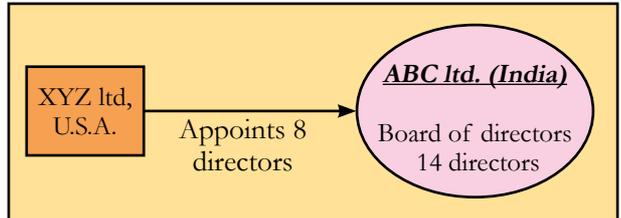
However, it is worthwhile to mention here that the guarantee that is mentioned in this clause refers to performance guarantee provided by first mentioned enterprise on behalf of the other enterprise. Therefore, if the first mentioned enterprise provides the counter guarantee in respect of the performance guarantee of the other enterprise, then these two enterprises would not be termed as associated enterprises.

*5. More than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise*

This is one of the main clauses that establish relationship between two or more enterprises as associated enterprises on the basis of the management of one of these entities. As we all know that it is board of directors in case of company or the governing board in case of an entity other than company, which is primarily concerned with the management of such company, or entity as the case may be. It is good to hold two enterprises as associated enterprises if any one of them appoints the directors or members of the board of directors or governing board as the case may be in respect of the other enterprise since such an act would place the first mentioned enterprise in an authoritative position in respect of other enterprise.

Further, it is to be noted that the law holds two enterprises as associated enterprises even if one of them appoints one of the executive director or member, as the case may be, of the other enterprise since executive director (or member) is wholly engaged in the day to day affairs of the enterprise and is vested substantially with decision making power for running the affairs of the enterprise smoothly. Hence, if one enterprise appoints such executive director (or member) of other enterprise, then it indirectly attains an authoritative position in such other enterprise.

For example, out of the total strength of 14 directors of board of directors of ABC ltd, India, 8 directors are being appointed by the XYZ ltd., U.S.A. Since, in this case XYZ ltd. has appointed more than half of the board of directors of ABC ltd., then by virtue of the above clause, these two enterprises would be deemed as associated enterprises.

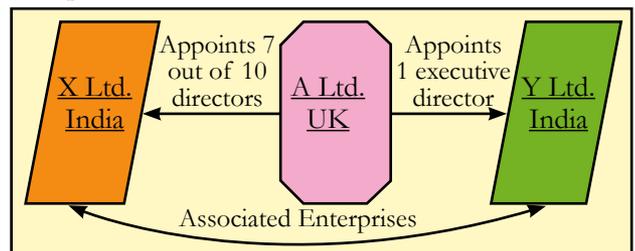


It is imperative to note here that this clause holds two enterprise as associated enterprises only when more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise. Hence it is the actual appointment of director(s) or member(s), as the case may be, of one enterprise by the other enterprise which gives rise to the relationship of associated enterprises rather than if one enterprise has got only the power to appoint the director(s) or member(s), as the case may be, of the other enterprise.

*6. More than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons*

Under this clause, the indirect relationship of associated enterprises between two enterprises has been built up provided more than half of the directors or a member of the governing board, or one or more of the executive directors or members of the governing board of the two enterprises have been appointed by the same person(s).

For example, A ltd. U.K. appoints 7 out of 10 directors of X ltd. India and 1 executive director of Y ltd. India, then in this case, by applying the aforementioned clause X ltd. and Y ltd. would be held as associated enterprises.



*7. The manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights*

Under this clause, if the business of one enterprise is *wholly dependent* on the use of know-how, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, of which the other enterprise has *exclusive rights*, then in that case such enterprise would be considered as associated enterprises.

It is imperative here to interpret the words ‘wholly dependent’ and ‘exclusive rights’ used in this clause in the context in which it has been used.

**‘Wholly Dependent’:** If we look at the dictionary meaning of the word ‘wholly’, it means complete and that of ‘dependent’ it means reliant. Hence the phrase ‘wholly dependent’ means the ‘complete reliance’. In the context of above clause, it means that the business activity of one enterprise is completely reliant on the use of know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature of the other enterprise. The main issue that arises here is that suppose in case of an enterprise, which is carrying on five different activities, and in respect of one of such activity it has to place reliance on the know-how of the other foreign enterprise. Now, question here is whether in this case also these two enterprises would be considered as Associated Enterprises even though the first mentioned enterprise is reliant on the other foreign enterprise’s know how only in respect of its one activity. The answer to this question would be based on the fact whether such an activity in respect of which know how of the other foreign enterprise has been used is the ‘Primary’ activity or not of the first mentioned enterprise. It is only in this case when such activity constitutes ‘Primary’ or main activity of an enterprise, the enterprises would be termed as associated enterprises. The logic behind such reasoning is that it is a normal phenomenon of a business enterprise that it uses know-how etc. of other enterprise and in turn it has to pay some consideration to such other enterprise. So, if that would be the case which the law intends to capture under this clause then there would be numerous of entities that would be considered to be the associated enterprises. But that is not the intention

of the law. Different courts in various case laws have also upheld this view.

**‘Exclusive Right’:** The dictionary meaning of the word ‘exclusive’ is *sole* and that of ‘right’ is *entitlement*. Hence, in the context of the above clause it means that the know-how, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, which is the subject matter in the current clause, should be under the name of the enterprise or if it has been acquired from any other person then its use must be under the control of the entity so that the entity should be solely entitled to exercise its right over that business or commercial rights and it is that entity’s sole discretion to decide how, when and by whom to exercise such right.

One more issue, which is to be answered here, is whether provisions of this clause are also applicable in case of enterprise carrying on ‘profession’ using the trademark or patent of any other foreign enterprise. This issue is debatable.

However, author is of the view that the provision of this clause is not applicable in case of enterprise carrying on profession. On a plain reading of the provision of the above clause, it seems that this clause is applicable in respect of an enterprise carrying on business activity because of the following wordings used in this clause:

*“.....or business carried out by one enterprise.....”*

So, the issue here is whether the term business includes profession also or not. As per section 2(13) of the Income Tax Act, 1961:

*“business includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture;”*

While section 2(36) defines profession as under:

*“profession” includes vocation;*

It can be seen that business includes carrying on of an activity, which is in the nature of trade, commerce or manufacture. While profession includes vocation. The dictionary meaning of vocation is career or profession, which involves talent or natural ability of some person(s). Therefore, it is very clear that the above clause is not applicable to an enterprise carrying on a profession since it does not involve any activity that is in the nature of trade, commerce or manufacture. Also, it defeats the purpose of law if we apply this provision in respect of profession also since the language of the clause clearly indicates that there must be use of some

‘...business or commercial right’ which is mainly used by an entity which is carrying on any business activity of the nature of trade, commerce or manufacture.

*8. Ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise*

Under this clause, two enterprises would be considered to be Associated Enterprises if:

- Ninety per cent or more of the *raw materials and consumables*
- required for the *manufacture or processing* of goods or articles carried out by one enterprise
- are *supplied* by the other enterprise, or by persons specified by the other enterprise
- *and the prices and other conditions* relating to the supply are influenced by such other enterprise

An analysis of the above provisions makes it very clear that this clause is applicable only in respect of those enterprise(s), which require raw materials and consumables for the purpose of manufacturing or processing of goods or articles.

Hence this clause is not applicable on those enterprise(s) whose business activity doesn't involve manufacturing or processing of goods and articles.

This clause also mentions that the supply of such material to the first mentioned could be made either directly by the other enterprise or by the person(s) as specified by such other enterprise. In other words, such other enterprise can direct some person(s) also to supply such material to the buyer of the material.

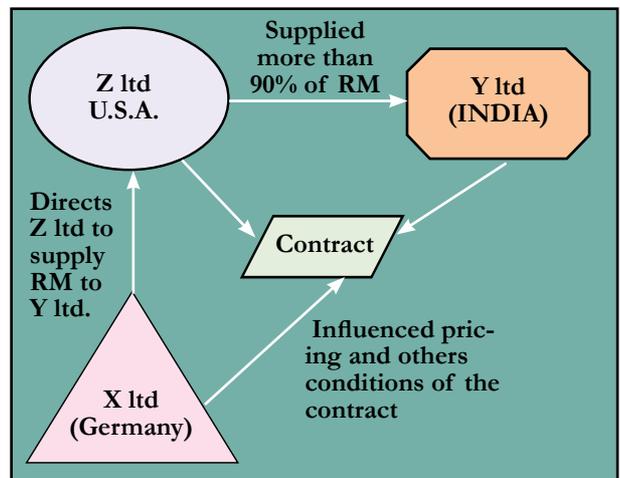
Further, one more important requisite of this clause is that the prices and other terms and conditions relating to the agreement between two enterprises in respect of supply (or purchase) of raw materials, has been *influenced* by the supplier if he is making the supply of raw materials and consumables directly to the purchaser or if it has directed some other enterprise to supply such raw materials or consumables. It is to be noted that the term used here is ‘influenced’ which according to the author means actual fixation of prices and other terms and conditions relating to the contract of supply of raw material or consumables by such other enterprise

is irrelevant. The provisions of this clause would get attracted even if such other enterprise has only influenced the price and other conditions of the contract.

*It is to be noted here that at least 90% criteria as envisaged under this clause is to be applied exclusively in respect of raw materials and consumables<sup>5</sup>.*

For example, X ltd. in Germany has entered into a contract with Y ltd. India for the supply of raw materials to be used by the later for the processing of its goods and articles. Further, pricing and others terms and conditions relating to such contract has been substantially determined by X ltd. In the year 2007-08, out of the total requirement of one lac tonnes of raw materials of Y ltd, X ltd supplied 95,000 tones of raw material thereof. Therefore, by virtue of the provision of the above clause, in the instant case X ltd. and Y ltd. would be considered to be associated enterprises.

Suppose, in the above example if there is another company Z ltd. in U.S.A. and X ltd. directs Z ltd. to supply the required raw material to Y ltd and the pricing and other terms and conditions relating to such supply is being influenced by X ltd., then also in this case X ltd. and Y ltd. would be held as associated enterprises by virtue of the above clause.



*9. The goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise*

This is one of the clauses, whereby two enterprises would be considered as associated enterprises even if none of them has any stake in each other enterprise. It holds the relationship of associated enterprises on the business transaction only. Under this clause, if:

<sup>5</sup>This view has been held under the Guidance Note issued by the ICAI in this regard.

- The goods or articles *manufactured* or processed by one enterprise
- are *sold* to the other enterprise or to persons specified by the other enterprise
- and the *prices and other conditions* relating thereto are influenced by such other enterprise

This clause is similar to the previous clause except in this case instead of purchase contract in respect of raw material and consumables, there would be a sale contract of goods and articles produced by one enterprise to other.

It is interesting to note here that under this clause, unlike the previous clause, no minimum percentage requirement is envisaged. Now, if we make a literal interpretation of this clause, it poses an absurd issue in front of us because in the absence of any minimum requirement, every sale of goods or articles produced by one enterprise to any person(s) would be covered by this clause. Hence, instead of giving the literal interpretation to the provisions of this clause whereby the purpose of this clause gets defeated, we need to give the constructive meaning to the provisions so that the intention of the law gets intact. So author is of the view that in the current clause, it would be a case whereby all or 100% of the goods or articles produced by one enterprise is sold to the other enterprise. In other words, there is only one buyer in respect of goods or articles produced by an enterprise. It is only under this situation when an enterprise would be in a position to exercise control over the other enterprise, which is the intention of the law.

*10. Where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual*

This clause is self-explanatory whereby it has been provided that in case two enterprises are under the common control of an individual or his relative or jointly by such individual and his relative, then in that case such enterprises would be considered as Associated Enterprises.

For example, X ltd. in France and Y ltd. in India are under the control of Mr. Ram and his family members, then by applying the above clause, X ltd and Y ltd. would be considered as Associated Enterprises.

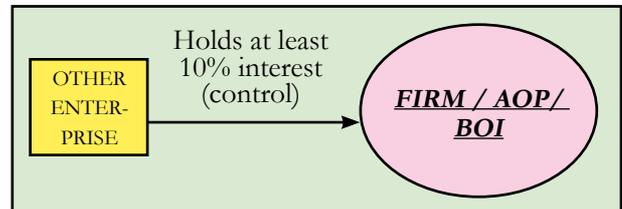
*11. Where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or*

*jointly by such member and his relative*

This clause is similar to the previous clause except that this clause is applicable in case of HUF. Under this clause, two enterprises would be held as associated enterprises if one of such enterprises is under the control of one HUF and the other enterprise is under the control of any individual member of such HUF or the relative of such member or jointly by such member and his relative. It is to be noted here that in this case individual member can be any member of the HUF; it need not necessarily be the Karta of such HUF. This clause is applicable in the Indian context only since concept of HUF is prevalent in India only.

*12. Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals*

This is the only clause under which one enterprise has to be either a firm or association of persons or body of individuals. Under this clause, if one enterprise holds at least ten percent interest in such firm or AOP or BOI, then these two would be held as associated enterprises.



**What is meant by ‘at any time during the previous year’?**

Before concluding the discussion on section-92A, it is important to interpret the phrase ‘at any time during the previous year’ used in the beginning of sub-section (2) of section 92. This phrase has got a lot of significance in determination of the timing when two enterprises would be considered to be associated enterprises. It means that if at any point of time during the previous year, any of the clauses of section 92A(2) is applicable in respect of two or more enterprises, then such enterprises would be considered to be associated enterprises *in respect of that previous year only*. It means further that transactions between two enterprises would not be chargeable to tax under this Act in any previous year simply because such enterprises were considered to be the associated enterprises in the earlier years. Hence, *it can be concluded here that criteria as prescribed under section-92A (2) needs to be applied/checked in respect of two enterprises separately for each of the previous year, irrespective of their relationship in the earlier*

years, in order to consider two or more enterprises as associated enterprises.

## Section 92B

### Meaning of International Transaction

(1) For the purposes of this section and sections 92, 92C, 92D and 92E, international transaction means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

(2) A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be a transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the rele-

vant transaction are determined in substance between such other person and the associated enterprise.

### Analysis

As per sub section (1) of section 92, International transaction means a transaction between:

- a) two or more associated enterprises,
- b) either or both of whom are non-residents,

in the nature of

- i. purchase, sale or lease of tangible or intangible property, or
- ii. provision of services, or
- iii. lending or borrowing money, or
- iv. any other transaction

having a bearing on the

- i. profits,
- ii. income
- iii. losses ,or
- iv. assets

of such enterprises, **and** shall include

a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or ex-

pense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

On making analysis of the above provisions it is pretty much clear that the very basic requirement of 'international transaction' is that one of the parties to the relevant transaction must be a non-resident. However if both the parties to the relevant transaction are non-residents, then also such a transaction would be taxable under this provision provided such a transaction does have any impact or connection on Indian resident, otherwise it would simply be a transaction between two non-residents which won't be taxable under the Act.

Further, section provides that after being determined the relationship and residential status of the enterprises as associated enterprises and at least one of them as non-resident respectively, then the transaction being entered between such parties would be considered as international transaction if it is in the nature of:

- i. purchase, sale or lease of tangible or intangible property, or
- ii. provision of services, or
- iii. lending or borrowing money

It is to be noted that all the above transactions needs to have an impact on either

- i. profits,
- ii. income
- iii. losses, or
- iv. assets

of such enterprises.

However, this sub section provides further flexibility by stating that any other transaction, not covered under above nature of transactions, would still be considered to be an international transaction if such transaction does have an impact on profits, income, losses or assets of such enterprises.

Conversely, we can say that a transaction would not be considered to be an international transaction even if it has been entered into between two associated enterprises, one of them being the non resident, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money but it doesn't have any impact/bearing on profits, income, losses, or assets of such enterprises.

This section further provides that apart from all of the above nature of transactions, following shall still be considered to be an international transaction:

- a mutual agreement or arrangement between

- two or more associated enterprises
- for the allocation or apportionment of, or
- any contribution to,
- any cost or expense
- incurred or to be incurred
- in connection with a benefit, service or facility
- provided or to be provided to
- any one or more of such enterprises.

Sub section (2) of the section 92 B provides a deeming fiction by stating that for the purposes of sub section (1), a transaction entered into by an enterprise with a person other than an associated enterprise shall be deemed to be a transaction entered into between two associated enterprises, if

- *there exists a prior agreement* in relation to the relevant transaction between such other person and the associated enterprise, or
- *the terms of the relevant transaction are determined in substance* between such other person and the associated enterprise.

Let's understand the provision of this sub section with the help of an example, say

X ltd. in India and Y ltd in U.K. are associated enterprises. Now, there is one more enterprise Z ltd. in Malaysia with which X ltd entered into a transaction of lending the money. However, there exists a prior agreement between Y ltd. and Z ltd. in respect of such transaction. Hence, by virtue of sub section 2 of section 92B such a transaction would be considered to have been entered into between two associated enterprises.

It is worth to be noted here that sub section (2), provides deeming fiction of associated enterprises between two enterprises for the purpose of sub-section (1) only. It means, if the nature of transaction between two unassociated enterprises is one which is being mentioned under the sub section (1), then for the purpose of such transaction only such unassociated enterprises would be considered to be associated enterprise provided the conditions as envisaged under sub section (2) is fulfilled in respect of such transactions.

### Conclusion

It is evident from the aforesaid discussion that in order to understand the transfer pricing mechanism, one should be crystal clear about the different relationships, which give the status between two or more enterprises that of the associated enterprises in relation to an International Transaction

## CIRCULARS/NOTIFICATIONS

### Significant Circulars/Notifications issued during the month of December, 2008

#### DIRECT TAXES

##### I. Circulars

###### 1. Circular No. 10/2008, dated 5-12-2008

The Central Board of Direct Taxes has through this circular clarified the meaning of the expression “fish or fish products” used in rule 6DD(e)(iii) so as to include ‘other marine products such as shrimp, prawn, cuttlefish, squid, crab, lobster etc.’.

This circular also clarifies the definition of “producers of fish or fish products” so as to include besides the fishermen, any headman of fishermen, who sorts the catch of fish brought by fishermen from the sea, at the sea shore itself and then sells the fish or fish products to traders, exporters etc.

It has been further clarified that the above exception will not be available on the payment for the purchase of fish or fish products from a person who is not proved to be a ‘producer’ of these goods and is only a trader, broker or any other middleman, by whatever name called.

###### 2. Circular No. 11/2008, dated 19-12-2008

Through this circular the Central Board of Direct Taxes has clarified the implications arising from the amendment made in section 2(15) by the Finance Act, 2008. This circular clearly lays down that the newly added proviso to section 2(15) is not applicable in respect of the first three limbs of section 2(15) i.e., where the purpose of the trust or institution is relief to the poor, education and medical relief, even if it incidentally involves carrying on of commercial activities.

However, the said proviso shall apply to those entities whose purpose is advancement of any other object of general public utility i.e. the fourth limb of the definition of charitable purpose contained in section 2(15). Hence, such entities will not be eligible for exemption under section 11 or under section 10(23C) of the Act if they carry on commercial activities.

For details visit:

<http://law.incometaxindia.gov.in/TaxmannDit/Display-Page/dpage1.aspx?md=1>

##### II. Notifications

###### 1. Notification No. 111/2008 (S.O. 2959(E)) [F.NO. 133/91/2008-TPL], dated 23-12-2008

The Central Board of Direct Taxes has, through this notification, notified the Income-tax (Eleventh Amendment) Rules, 2008. These Amendment rules have amended Rule 114E and Form No.61A relating to furnishing of Annual Information Return. The AIR is now required to be furnished to Director of Income-tax (Central Information Branch) instead of Commissioner of Income-tax (Central Information Branch).

For details visit:

<http://law.incometaxindia.gov.in/TaxmannDit/Display-Page/dpage1.aspx?md=31>

#### INDIRECT TAXES

##### EXCISE

##### I. Notifications

###### 1. Notification No. 48/2008 – Central Excise (N.T.), dated 05.12.2008

The formula given for calculation of CENVAT credit in proviso to clause (a) of Rule 3(7) of CENVAT Credit Rules, 2004 has been modified from “Fifty percent of [X multiplied by {(1 + BCD/400) multiplied by (CVD/100)}]” to “Fifty percent of [X multiplied by {(1 + BCD/200) multiplied by (CVD/100)}]”

For details visit: <http://www.cbec.gov.in/excise/cx-act/notfns-2k8/cent48-2k8.htm>

###### 2. Notification No. 50/2008 – Central Excise (N.T.), dated 31.12.2008

Clause (i) of Rule 6(6) of CENVAT Credit Rules, 2004 has been substituted by a new clause so as to extend the benefit of availing full CENVAT credits on input when the final product is despatched without payment of duty “to a developer of a special economic zone for their authorised operations” also.

For details visit: <http://www.cbec.gov.in/excise/cx-act/notfns-2k8/cent50-2k8.htm>

##### II. Circulars

###### 1. Circular No 880/18/2008-CX, dated 22 -12 - 2008

The CBEC issued this Circular for determination of the value of the excisable goods for the purposes of charging central Excise Duty in respect of industrial units located in Jammu & Kashmir and availing VAT remission vide SRO 91 dated 16.03.06.

For details visit: <http://www.cbec.gov.in/excise/cx-circulars/cx-circulars-08/880-2008-cx.htm>

##### CUSTOMS

##### I. Circulars

###### 1. Circular No. 20/2008-Customs, dated 02.12.2008

Vide this circular it has been issued to explain the changes in Customs (Compounding of Offences) Rules, 2005 and guidelines in this regard.

1. The compounding amount prescribed under Rule 5 of the Rules has been revised downwards. A new proviso has been inserted in this rule, which provides that if a person has, in respect of same goods, committed offences falling under more than one category, i.e., Sl.No.1 to 8 of the table specified in this rule and where amount of duty evasion or amount of drawback or exemption from duty, or amount of market value of the goods is same for all such offences, then the compounding amount, in such cases, shall be the amount determined for the offence for which a higher compounding amount has been prescribed.

2. Further, in rule 4, a new provision has been added, whereby it has been provided that an applicant should pay duty, penalty, and interest before submission of application for compounding. Correspondingly, the Application Form has also been amended by inserting Sl.No.12A so as to ensure that the compounding of offences shall not be allowed unless the aforesaid duty, penalty and interest thereon are paid by the applicant.
3. Further, it was decided by the Board that compounding of offences should not be allowed where there are demonstrable contradictions, inconsistencies or incompleteness in the case. Accordingly, in the guidelines issued for compounding of offences under Customs and Central Excise Acts vide Circular No.54/2005-Cus dated 30.12.2005, the following additional guidelines shall be added:
 

“3(v): Any person who has applied for compounding of offence in a case, where there are apparent contradictions or inconsistencies or incompleteness.”
4. Further, in order to make best use of compounding of offence scheme, all persons against whom prosecution is initiated or contemplated, should be informed separately in writing, the offer of compounding.

For details visit: <http://www.cbec.gov.in/customs/cs-circulars/cs-circulars08/circ20-2k8-cus.htm>

### 2. Circular No. 21/2008-Customs, dated 18-12-2008

As there has been greater concern about sub-standard toys containing toxic and poisonous materials being imported into the country, the Board reiterates that import of all pre-packaged commodities, inter alia, import of toys in packaged form, shall be subjected to compliance of all the provisions of the Standards of Weights and Measures (Packaged Commodities) Rules, 1977. It may also be ensured that import of toys or similar imported packaged commodities is not allowed clearance for home consumption unless such pre-packaged toys carry the mandatory declarations as specified in the DGFT's above mentioned notification. In case, it is found that the importers are unable to fulfill the requirement of mandatory declarations under Rule 6 before clearance by Customs for home consumption, the imported goods shall either be confiscated absolutely or allowed re-export only as well as necessary penal action taken against the importer for non-compliance with the existing legal provisions as applicable on import of goods.

For details visit: <http://www.cbec.gov.in/customs/cs-circulars/cs-circulars08/circ21-2k8-cus.htm>

### 3. Circular No. 22/2008-Customs, dated 19.12.2008

This Circular has been issued to clarify para 4.4 of circular no. 24/2007-Customs, dated 02.07.2007 which provide that all applications involving a refund of duty and/or interest of Rs. 5 lakh or more shall be subject to pre-audit as per the existing practice.

This circular clarifies that the pre-audit of all refund claims

will be conducted by the Assistant/Deputy Commissioner (Audit), in the Commissionerate Headquarters Office. Thereafter, the Assistant/Deputy Commissioner of Group/Division will pass an order-in-original in respect of the claim. Thereafter, the orders-in-original passed in this regard shall be subjected to review by the Commissioner concerned.

For details visit: <http://www.cbec.gov.in/customs/cs-circulars/cs-circulars08/circ22-2k8-cus.htm>

## SERVICE TAX

### I. Notifications

#### 1. Notification No. 33/2008-ST, dated 7.12.2008

The CBEC vide this Notification has amended Notification No. 41/2007 ST dated 06.10.2007, which exempts certain specified taxable services received by an exporter and used for export of goods.

- i) The general condition that “the said goods have been exported without availing drawback of service tax paid on the specified services under the Customs, Central Excise Duties and Service Tax Drawback Rules, 1995” has been dispensed with and accordingly the prescribed form for claiming refund has also been modified.
- ii) In the case of Services provided by a commission agent, located outside India, and engaged under a contract or agreement or any other document by the exporter in India, to act on behalf of the exporter, to cause sale of goods exported by him, “the restriction of refund of service tax to actual amount of service tax paid or service tax calculated on two percent of FOB value of export goods, whichever is less” has been increased to actual amount of service tax paid or service tax calculated on ten percent of FOB value of export goods, whichever is less”.
- iii) One more service provided by a clearing and forwarding agent in relation to export goods exported by the exporter has been exempted vide this notification subject to fulfilment of conditions specified therein.

For details visit: [http://www.servicetax.gov.in/servtax\\_notfnns\\_idx.htm](http://www.servicetax.gov.in/servtax_notfnns_idx.htm)

### II. Circulars

#### 1. Circular No. 106/2008-ST, dated 11.12.2008

This Circular has been issued to clarify the following points in respect of refund of service tax paid under notification No. 41/2007 – ST dated 6.10.2007:

- i) Refund of service tax paid to manufacturer exporter not registered with central excise.
- ii) Actual payment of service tax by exporter claiming exemption and document evidencing payment of service tax.
- iii) Disposal of refund claim within thirty days.

For details visit: <http://www.servicetax.gov.in/st-circulars.htm>

## LEGAL DECISIONS<sup>1</sup>

### Direct Taxes

Section 2(24) read with Section 28 of the Income-tax Act, 1961 — Income [Assessment Years 1985-86 to 1995-96]

*Burden of proving the source or the category under which the receipts should be classified is on the assessee, and any receipt will be treated as income unless the assessee shows that it comes under an exemption*

Swami Premananda @ Premkumar v Commissioner of Income Tax, Tiruchirapalli and another (MAD), 16 December 2008

The petitioner, who headed an Ashram, accumulated properties, both movable and immovable. His premises were raided and in pursuance of which assessment orders were passed.

*The Court held that in the instant case, the assessee ran an ashram where he gave spiritual teaching and conducted discourses. The donations received from abroad were to help him in his activities. There is nothing to show that the remittances were received by the assessee as the custodian of the Trust. Merely his ipse dixit will not suffice. Firstly, the Trust came in to existence only in 1994 whereas the donations had been coming in from 1985; the assessee deposited them in his account and dealt with them as if they were his properties, the release deeds are neither duly stamped nor registered and hence there can be*

*no valid transfer of imsmovable properties; there is evidence aliunde that the Trust had no money on the date on which it came into existence where these movable and immovable properties were available even before the said date. So the amounts that came in must be assessed as his income in the absence of satisfactory proof that it must be assessed in another's hands. Therefore, the amounts received by the assessee constituted income since it was profits and gains arising out of his vocation, profession or business. It is for the assessee to show that these receipts received by him are exempt from tax. Hence, the burden of proving the source or the category under which the receipts should be classified is on the assessee, and any receipt will be treated as income unless the assessee shows that it comes under an exemption.*

*The petitions were disposed of.*

Section 4 read with Section 2(24) of the Income-tax Act, 1961 - Income – Chargeable as [Assessment Years 1987-88 and 1988-89]

*Income earned by the offender would be an income liable for assessment*

Commissioner of Income Tax, Erode v K. Thangamani (MAD), 05 December 2008

The assessee is engaged in tax consultancy and audit work. During search, it was revealed that the assessee had been claiming and receiving income tax refunds by filing bogus TDS certificates along with return of income prepared by him even in the names of non-existent persons. The same was treated as “professional income” by the department. The Tribunal held that the entire refunds collected illegally by the assessee could under no circumstances be his income.

*The High Court held that the assessee having acquired income by unethical manner or by resorting to*

*acts forbidden by law, cannot be heard to say that the State cannot be a party to such sharing of ill-gotten wealth. In case of allowing such income to escape the tax net would be nothing but a premium or reward to a person for doing an illegal trade. In the event of taxing the income of only those who acquired the same through legal manner, the tendency of those who acquired income by illegal means would increase. It is not possible for the income tax authorities to act like police to prevent the commission of unlawful acts but it is possible for the tax machinery to tax such income. During such process strict rules of evidence are not*

<sup>1</sup>These cases have been compiled and contributed by [www.windlaw.com](http://www.windlaw.com). Readers are invited to send their comments on the selection of cases and their utility at [board@icai.org](mailto:board@icai.org). For the convenience of readers full text of these cases have been hosted on the website of the institute at the link: [http://www.icai.org/post.html?post\\_id=967&c\\_id=59](http://www.icai.org/post.html?post_id=967&c_id=59)  
Edited by Journal Section, ICAI.

*applicable to the income tax authorities. That piece of evidence which are not sufficient in ordinary legal proceedings to prove a particular fact would be sufficient for the tax officials to assess the income of an individual.*

*The High Court further held that Income tax Act considers the income earned legally as well as tainted income alike. Even if the assessee was prosecuted by Law Enforcing authorities for commission of*

*offence, the income earned by the offender still would be an income liable for assessment. It is not a defence in such cases that the State is also becoming a party to the illegal act by sharing the booty. The Tribunal committed a serious error by holding that the booty received by the assessee can under no circumstances be the income of the assessee.*

*The appeals were allowed.*

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Section 17(3) read with Section 4 of the Income-tax Act, 1961 — Salary - Profits in lieu of salary [Assessment Years 2003-04 and 2004-05]

*Amounts received by way of compensation for not being offered the job on the basis of gender discrimination were in the nature of capital receipts*

**Commissioner of Income Tax v Rani Shankar Mishra (DEL), 12 December 2008**

The assessee had applied for a job in the Voice of America which was a state owned broadcasting agency. The assessee was informed that she had cleared the competitive test, but, she was never offered the job. A class action suit had been filed before the United States District Court. The assessee received her share out of US\$ 508 million which was given to the entire class of 1100 claimants. The Commissioner of Income -tax had categorically found as a fact that there was no employer-employee relationship between the assessee and the Voice of America or the United States Government. Consequently, the Commissioner of Income-tax (Appeals) concluded that the said amount received by the assessee cannot fall within the concept of “salary”. The tribunal also noted the factual position that the assessee was, in fact, never offered the job. Consequently, the only conclusion that could be

arrived at with regard to the nature of the amount received by the assessee was that it was not offered as a part of or arising out of the employment of the assessee. The amount was received by the assessee by way of compensation for not having been offered the job with the Voice of America. The allegation was, as noted above, that she alongwith about 1100 other women had been discriminated against on the ground of sex and had not been offered jobs by the Government agency.

*The Court held that the amounts received by the assessee were in the nature of capital receipts because the amount was received by way of compensation for not being offered the job on the basis of gender discrimination.*

*The appeals were dismissed.*

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Section 92CA read with Section 10A of the Income-tax Act, 1961 — Transfer Pricing Officer – Reference to [Assessment Year 2003-04]

*Transactions of the assessee with its associated enterprises satisfy the arm’s length test*

**Philips Software Centre Private Limited, Bangalore v Assistant Commissioner of Income Tax, Bangalore (ITAT- Bang.), 26 September 2008**

The assessee was engaged in providing software development services to its overseas affiliates and had various international transactions. The software developed by the assessee was used in house by the associated enterprises and was integrated by the associated enterprises in the software components and hardware manufactured outside India. The complete package of the hardware and software manufactured was sold in the open market by the associated enterprises.

The assessee conducted a transfer pricing study substantiating that its international transactions were at arm’s length. The assessee filed its return of income. Subsequently, assessment proceedings were initiated under section 143(3)/143(2). The case of the assessee was also referred to the Additional Director of Income Tax (Transfer Pricing). The Transfer Pricing Officer (IPO) passed an order under section 92CA, proposing a transfer pricing adjustment of after

arriving at a mean margin of the comparable companies @ 21.14%.

The Tribunal observed that since the basic intention behind introducing the transfer pricing provisions is to prevent shifting of profits outside India, and the assessee is claiming benefit under section 10A, the transfer pricing provisions ought not to be applied to the assessee; (ii) Circular No.14/2001 issued by the CBDT is binding upon the TPO; (iii) there was no infirmity in the TP Study conducted by the assessee, and the TPO erred in disregarding the same for the purpose of computing framing the assessment and making the transfer pricing adjustment; (iv) The TPO or the A.O. needs to satisfy and communicate to the taxpayer the relevant clause under section 92C(3) which has been triggered by the assessee, which has necessitated the application of provisions of the transfer pricing provisions. Since this was not demonstrated to the assessee, the transfer pricing order is void; (v) The TPO erred in conducting a fresh study for the purpose of passing his order, which is not in conformity with the provisions of Rule 10B(4) and 10D(4); (vi) The TPO erred in disregarding the most appropriate method adopted by the assessee in the TP Study, and

also in using the Prowess data base. The TPO did not provide any reason for deviating from the TP Study in respect of these matters; (vii) the TP Study cannot be ignored by the TPO, in the absence of any deficiency or insufficiency; (viii) for the purpose of comparability, companies with even a single rupee of transactions with associated enterprises cannot be considered as comparables; (ix) adjustment needs to be made to the margins of the comparables to eliminate differences on account of different functions, assets and risks. More specifically, adjustment needs to be made for: (a) Differences in risk profile; (b) Difference in working capital position; (c) Differences in accounting policies; (x) The TPO has grossly erred in 'normalising' the profits of super profit companies. Such companies should have been excluded from the list of comparables; (xi) proviso to section 92C(2) provides a standard deduction of 5% to the taxpayers.

The transactions of the assessee with its associated enterprises satisfy the arm's length test. The comparables selected by the TPO should not be considered for the purpose of comparability analysis.

The appeal was allowed.

Section 143 read with Section 158BC of the Income-tax Act, 1961 — Assessment

*Provisions of section 143(2) though it is a procedural one is mandatory and the Assessing Officer is bound to follow that, if the Assessing Officer decide to determine the undisclosed income of the assessee*

**Zeus Air Services Private Limited, Mumbai and another v ACIT, Mumbai and another (ITAT-Mum.), 13 October 2008**

The assessee-company is an IATA approved agent carrying on business of Cargo clearing & forwarding. During search, the assessee made declaration of the undisclosed income of Rs.2.95 crore while giving the statement under section 132(4). However, when the return was filed, the assessee only declared the income of Rs.10 lakh. The Assessing Officer issued the notice under sections 142(1) and 143(2) on 27-06-2001 to the assessee for determining the undisclosed income as declared by the assessee in the block return as well as seized material and documents in consequence of the search action under section 132. The contention of the assessee was that even, in the case of block

assessment framed under section 158BC, the provisions of section 143(2) is mandatory including the limitation provided for issuing the notice in the said section.

*The Tribunal observed that as the Assessing officer failed to issue notice within the period of 12 months from the end of the month in which the assessee filed the block return, there is fitter on the power of the Assessing Officer to make the assessment. Hence, the assessment made by the Assessing Officer is null and void.*

The appeal was allowed.

Section 275 read with Section 271B of the Income-tax Act, 1961 — Penalty — Bar of Limitation for imposing Penalties [Assessment Year 2000-01]

*Interpretation of the provisions of Section 275(1)(c)*

**Subodh Kumar Bhargava v Commissioner of Income Tax (DEL), 26 November 2008**

The assessee was liable to get his accounts audited by an accountant and to furnish the report of such audit in the prescribed form duly signed and verified by such an accountant before 31st day of October of the assessment year. The assessee neither got his accounts audited nor did he file the audited report before the Assessing Officer. The assessee filed his return of income on 22.06.2000. The return was processed under Section 143(1) on 14.03.2002. It was not subjected to assessment under Section 143(3). On 31.07.2003, a show cause notice was issued. By an order dated 17.02.2004, the Assistant Commissioner imposed penalty. According to the assessee since the penalty proceedings had been initiated on 31.07.2003, the penalty order could have been passed within six months thereof, i.e., by 31.01.2004. Therefore, the order was passed on 17.02.2004 was time barred.

*The High Court held that:*

*There are two periods of limitation prescribed under sub-clause (c) of Section 275(1). The first period relates to those category of cases where action for the imposition of penalty has been initiated in the course of "some" proceedings. In such a situation, the period of limitation prescribed is upto the end and including the financial year in which such proceedings are completed. The second part of Section 275(1) (c) pertains to all cases falling under clause (c). This is so because the action for imposition of penalty is contemplated in both parts. Penalty can only be imposed under Chapter XXI by following the procedure prescribed in Section 274. Thus, in any eventuality, before an order imposing a penalty can be passed, the assessee has to be heard or has to be given a*

*reasonable opportunity of being heard. This can only happen when action for imposition of penalty is initiated and the assessee is put to notice with regard to such action so that he may present his point of view in opposition to such action. The only difference between the first part and the second part is that while in the first part, the action for imposition of penalty is initiated in the course of some other proceedings, under the second part, "the other" proceedings are of no relevance and the only thing to be considered is the point of time as to when the action for imposition of penalty is initiated.*

*The instant case undoubtedly falls under Section 275(1)(c) and, that too, under the second part thereof. Therefore, the period of limitation during which an order imposing a penalty could have been passed would be a period of six months beginning from the end of the month in which the action for imposition of penalty was initiated. The show cause notice under Section 274 read with Section 271B was issued on 31.07.2003. Since that happened to be the end of the month also, the period of six months would have to be reckoned from that date. That would take to 31.01.2004. Thus, the penalty order could have been passed on any date upto and including 31.01.2004. The penalty order came to be passed on 17.02.2004, which would be hit by the bar of limitation.*

*Therefore, the tribunal was not right in law in its interpretation of the provisions of Section 275(1)(c) and was wrong in holding that the penalty order passed on 17.02.2004 under Section 271B was within the period of limitation prescribed under the Act.*

*The appeal was allowed.*

## Indirect Taxes

### Excise & Customs

Section 35L of the Central Excise Act, 1944 – Supreme Court – Appeals to

*Disposal of appeals by mere reference to decisions without analyzing the special features of each case, is not proper*

*Commissioner of Central Excise, Bangalore v Srikumar Agencies etc. (Supreme Court), 27 November 2008*

The issue involved in the present case was whether printing on package is merely incidental or primary.

*The Supreme Court observed that since the factual position has not been analysed in detail, disposal of appeals by mere reference to decisions, was not the proper way to deal with the appeals. The CEGAT also does not appear to have dealt with the*

*relevance and applicability of I.T.C. Ltd. v. Collector of Central Excise, Madras (JT 1998 (8) SC 527) on which strong reliance has been placed. The CEGAT ought to have examined the cases individually and the articles involved. By clubbing all the cases together and without analyzing the special features of each case disposing of the appeals in the manner done was*

*not proper. In the circumstances, the impugned judgments in each case were set aside and the matter was remitted to CEGAT presently known as 'CESTAT'*

*to deal with by the appropriate Bench. In view of the aforesaid order no answer was made to the reference.*

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**Section 111 of the Customs Act, 1962 - Confiscation of improperly imported goods, etc**

*Customs authorities are liable to return the entire sale proceeds without deducting therefrom the duty but subject to deduction of fine and penalty with interest*

**Shabir Ahmed Abdul Rehman v Union of India, Mumbai and others (MUM.), 3 December 2008**

The issue before the Court was whether during the pendency of an appeal filed against the confiscation order, the customs authorities could sell the confiscated gold and when it is ultimately held that the petitioner is entitled to redemption of the confiscated gold, whether the sale proceeds could be returned after deducting the customs duty from the sale proceeds.

*The High Court observed that handing over the confiscated gold immediately after serving the order of confiscation itself was improper. In any event after receiving letter from the petitioner, the customs authorities ought to have stopped the auction sale of the confiscated gold. However, the gold was sold during the pendency of the appeal filed by the petitioner before Commissioner (Appeals).*

*Since the petitioner was seeking redemption of the confiscated gold, he could not escape payment of fine and penalty. In fact, the petitioner offered to pay fine and penalty. As regards payment of duty is concerned, duty would be payable only if the gold was actually allowed to be redeemed. In the instant case, what were being given were the sale proceeds and not the gold as such. In such a case, the question of paying duty in respect of the sale proceeds would not arise.*

*Therefore, the customs authorities were liable to return the entire sale proceeds without deducting therefrom the duty but subject to deduction of fine and penalty imposed by the Commissioner (Appeals) with interest.*

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**Section 112 read with Section 111 of the Customs Act, 1962 - Penalty for improper importation of goods, etc.**

*A person charged with mis-declaration is entitled to know the ground on the basis whereof he would be penalized and is entitled to a proper hearing*

**Kothari Filaments and Another v Commissioner of Customs (Supreme Court), 16 December 2008**

Appellant No.2 is a proprietary concern of Appellant No.1, which is importer of various items. During search and seizure it was found that the Appellant has misdeclared certain goods. A show cause notice was issued. The Appellants contended that their foreign supplier had sent the goods by mistake, which was accepted by the exporter. However, the goods were confiscated and penalty was imposed.

*The Supreme Court held that:*

*The statutory authorities under the Act exercise quasi-judicial function. By reason of the impugned order, the properties could be confiscated, redemption fine and personal fine could be imposed and in the event an importer was found guilty of violation of the provisions of the Act. In the event, a finding as regards violation of the provisions of the Act is arrived at; several steps resulting in civil or evil consequences*

*may be taken. The principles of natural justice, therefore, were required to be complied with.*

*The Commissioner of Customs either could not have passed the order on the basis of the materials which were known only to them, copies whereof were not supplied or inspection thereto had not been given. He, thus, could not have adverted to the report of the overseas enquiries. A person charged with mis-declaration is entitled to know the ground on the basis whereof he would be penalized. He may have an answer to the charges or may not have. But there cannot be any doubt whatsoever that in law he is entitled to a proper hearing which would include supply of the documents. Only on knowing the contents of the documents, he could furnish an effective reply.*

*The appeal was allowed.*

### Service Tax

Rule 3 of the Service-tax Rules, 1994 read with Rule 3 of the Central Excise Rules, 2002 – Appointment of Officials

*Where Revenue failed to satisfy that signatories to the review order were authorized authorities, the act of review was ab initio void and non est*

**Commissioner of Central Excise Customs and Sales Tax, Bhubaneswar-II v Ores India Private Limited (CES-TAT-Kolkata), 24 October 2008**

The present appeal has been filed pursuant to review and authorization by a Committee which comprised of officers without being validly appointed by appropriate Notification in the Official Gazette to act as Chief Commissioners of Central Excise. The Revenue failed to produce copies of Notifications in the Official Gazette for perusal by the Bench.

*vested with the powers of review and any other functions under the Service Tax Law, and failed to satisfy that the signatories to the Review Order were authorized Authorities notified according to the procedure known to law to perform the functions of the Reviewing Authority, the act of review was ab initio void and non est.*

*The Tribunal held that since the Committee was not* The appeal was dismissed.

### Sales tax / VAT

Section 9 read with Section 3 and Section 6 of the Central Sales-tax Act, 1956 - Levy and collection of tax and penalties [Assessment Year 2000-01]

*Once the sales fell under Section 3(a), then under Section 9(1), tax has got to be collected by the State from which the movement of the goods commenced*

**A and G Projects and Technologies Limited v State of Karnataka (Supreme Court), 11 December 2008**

The appellant is engaged in execution of electrical works contracts and a registered dealer both under the Karnataka Sales Tax Act, 1957 and the Central Sales Tax Act, 1956. The appellant filed its return of turnover contending that the second and the third sales were subsequent sales; hence, the appellant claimed exemption from tax for such sales under Section 6(2) of the CST Act. Relying on the proviso to Section 9(1) of the CST Act, the AO held that the State of Karnata-

taka was competent to levy the tax.

*The Supreme Court held that once the sales fell under Section 3(a), then under Section 9(1), tax has got to be collected by the State from which the movement of the goods commenced. The plea of subsequent sales effected during the movement of the goods stood specifically rejected. The proviso to Section 9(1) of the CST Act 1956 is not applicable.*

*The appeal was allowed.*

Section 61 read with Section 36 of the Bombay Sales Tax Act, 1959 read with Section 9 of the Central Sales-tax Act, 1956 – High Court – Reference to

*Question of law, reference to High Court*

**Sales Tax Maharashtra v Ghatge Patil Industries Limited, Kolhapur (BOM), 27 November 2008**

The Respondent is carrying on business of manufacture and sale of cast iron castings, engineering goods, and automobiles parts. The assessee received an order from 'B', a Government of India undertaking and selling bulldozers and earth movers. 'B' placed an order with the assessee for supply of clutch assembly and various other assemblies. They had agreed to supply certain imported parts, such as discs and bearings imported by them and requested the assessee to insert the same in the assembly during the process of

manufacture. These parts were referred as "assistance material" which were supplied free of cost. The Commissioner came to the opinion that insertion in the assembly by the assessee company before delivery of the assembly should form part of assessment value. Thus, he concluded that there was evasion of excise duty and accordingly issued a show cause notice. The assessee contended that the assistance material which was supplied to the assessee company was not liable to tax as they were supplied free of cost and the finished

goods qua the company were not open to liability. The raw material used in manufacture of the finished goods was liable to be considered for the entire value of the finished goods and tax ought to have been determined on that basis. Application under section

61(1) for reference was rejected by the Tribunal.

*The High Court observed that the application filed under Section 61(2) deserves to be allowed. The Maharashtra Sales Tax Tribunal was directed to submit the statement of case and refer the question of law.*

**Section 3D of the Uttar Pradesh Trade Tax Act, 1948 — Levy of trade tax on purchase of sales of certain goods**

*As paddy and rice are considered to be the separate commodities, paddy husk cannot be treated to be rice husk*

**Commissioner of Trade Tax, Uttar Pradesh v S. S. Ayodhya Distillery and Others (Supreme Court), 2 December 2008**

The respondents operate their manufacturing units by using Paddy Husk as fuel in their respective factories. The issue before the Supreme Court whether Paddy Husk and Rice Husk connote the same commodity.

*The Supreme Court held that as paddy and rice are considered to be the separate commodities, paddy husk cannot be treated to be rice husk. When a paddy is dehusked, it becomes paddy husk and when the rice is dehusked, it becomes rice husk.*

*There are two other aspects of the matter which cannot be lost sight of. If something is included in the Schedule which is non-existent, no tax can be levied thereupon. Furthermore, if there is a doubt or dispute as to whether paddy husk or the rice husk denotes the same commodity or not, the benefit thereof shall be given to the assessee. Furthermore, it is not the case of the appellant that the respondent extracts any oil out of 'paddy husk'.*

*The appeals were dismissed.*

**Other Acts**

**Arbitration**

**Section 3 read with Section 34 of the Arbitration and Conciliation Act, 1996 – Receipt of Written Communications**

*If a written communication is delivered to the addressee personally at his place of business, it shall be deemed to have been received by him on the day it was delivered*

**Kailash Rani Dang v Rakesh Bala Aneja and Another (Supreme Court), 12 December 2008**

A partnership deed was executed between 'S' since deceased, his son and the appellant, cousin of 'S'. The shares in the partnership were also delineated therein. On dispute the Arbitrator called the parties to file papers. The appellant dispatched her statement of claim to the Arbitrator as well as to S. The receipt of this statement was acknowledged by S, who addressed a letter to the appellant for the supply of certain documents, failing which it would not be possible for him to file a reply to the statement of claim. An *ex parte* order was passed as S failed to appear before the arbitrator. The order was sent to S through registered post. But, S refused to accept the letter which was endorsed by the postman. Accordingly the appellant file an application for execution of the award. At this stage S filed an Application under Order 21 Rule 26 of the CPC seeking a stay of the execution proceedings, and denying any

knowledge of the passing of the Award.

*The Supreme Court observed that a bare perusal of the aforesaid provisions would reveal that if a written communication is delivered to the addressee personally at his place of business, it shall be deemed to have been received by him on the day it was delivered. The statement of the postman becomes extremely relevant wherein he deposed that on the first day S had not been present in the business premises but on the next day he had refused to receive the communication even when tendered to him which fact had been endorsed by him on the envelope which had then been returned to the sender. Therefore, by virtue of sub-clause (a) of Section 3 (1) read with Section 3(3), a presumption that the document had indeed been delivered is writ large on the facts of the case. In the*

*present case, no misconduct has been alleged against the arbitrator. There is no flaw in the conduct of the arbitration proceedings. The order of the High court was therefore set aside*

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### Section 11 of the Arbitration and Conciliation Act, 1996 — Appointment of Arbitrator

*For appointment of an arbitrator it is important that the arbitration agreement was in existence*

**Speech and Software Technologies (India) Private Limited v Neos Interactive Limited (Supreme Court), 5 December 2008**

The applicant, an Indian company filed an application under Section 11(6) to appoint a former Chief Justice of the High Court as sole arbitrator and to refer the disputes to him, which have arisen between the applicant and the respondent, a foreign company during the course of execution of services.

*The Supreme Court observed that exercise of power under Section 11(6) is judicial power. The preliminary matters to be considered by the court are: (1) existence of arbitration agreement; (2) territorial jurisdiction; (3) whether there are live issues to be referred to the arbitrator; and (4) whether application is filed within the period of limitation prescribed by the law.*

*If the court finds that the arbitration agreement does not exist or is rescinded then the prayer for referring the dispute to the arbitrator will have to be rejected.*

*The Supreme Court further held that the Services Agreement had not ceased to exist and the applicant was entitled to invoke the arbitration clause contained in that agreement indicating that disputes existed between the parties. The application was also well within the time prescribed by law. There was no manner of doubt that dispute were existing between the parties relating to the execution of the Services Agreement, which were arbitrable.*

*The application was allowed.*

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### Banking Laws

Section 138 read with Section 141 of the Negotiable Instruments Act, 1881 - Dishonor of cheque for insufficiency, etc. of funds in the account

*Issuance of notice would not by itself give rise to a cause of action but communication of the notice would*

**Harman Electronics Private Limited and Another v National Panasonic India Limited (Supreme Court), 12 December 2008**

The appellants and respondent entered into a business transaction. The appellant is a resident of Chandigarh. He carries on business in Chandigarh. The cheque in question admittedly was issued at Chandigarh. The Complainant also has a branch office at Chandigarh although his Head Office is in Delhi. The cheque was presented at Chandigarh. The cheque was dishonoured also at Chandigarh. The complainant - respondent issued a notice upon the appellant asking him to pay the amount from New Delhi. The notice was served upon the respondent at Chandigarh. On failure on the part of the appellant to pay the amount within a period of 15 days from the date of communication of the letter, a complaint petition was filed at Delhi.

*The Supreme Court held that it is one thing to say that sending of a notice is one of the ingredients for maintaining the complaint but it is another thing to say*

*that dishonour of a cheque by itself constitutes an offence. Issuance of notice would not by itself give rise to a cause of action but communication of the notice would. A Court derives a jurisdiction only when the cause of action arose within his jurisdiction. The same cannot be conferred by any act of omission or commission on the part of the accused. A distinction must also be borne in mind between the ingredient of an offence and commission of a part of the offence. While issuance of a notice by the holder of a negotiable instrument is necessary, service thereof is also imperative. Only on a service of such notice and failure on the part of the accused to pay the demanded amount within a period of 15 days thereafter, commission of an offence completes. Giving of notice, therefore, cannot have any precedent over the service. Therefore, the Delhi High Court has no jurisdiction to try the case.*

*The appeal was allowed.*

Section 138 read with Section 118 and Section 139 of the Negotiable Instruments Act, 1881 - Dishonor of cheque for insufficiency, etc. of funds in the account

*A presumption is not in itself evidence, but only makes a prima facie case for a party for whose benefit it exists*

**Kumar Exports v Sharma Carpets (Supreme Court), 16 December 2008**

The defence of the appellant was that he had agreed to purchase woolen carpets from the respondent and had issued the cheques by way of advance however, the respondent did not supply the carpets. According to the respondent he had sold woolen carpets to the appellant and in discharge of the said liability the appellant had issued two cheques, which were ultimately dishonored. In support of his case the respondent produced the carbon copy of the bill. There was no endorsement made by the respondent accepting the correctness of the contents of the bill and the appellant neither signed it.

*The Supreme Court observed that in order to determine the question whether offence punishable under Section 138 is made out against the appellant, it will be necessary to examine the scope and ambit of pre-*

*sumptions to be raised as envisaged by the provisions of Sections 118 and 139 of the Act. In a suit to enforce a simple contract, the plaintiff has to aver in his pleading that it was made for good consideration and must substantiate it by evidence. Section 118 provides certain presumptions to be raised. The reason for these presumptions is that, negotiable instrument passes from hand to hand on endorsement and it would make trading very difficult and negotiability of the instrument impossible, unless certain presumptions are made. The presumption is a matter of principle to facilitate negotiability as well as trade. Section 118 of the Act provides presumptions to be raised until the contrary is proved. A presumption is not in itself evidence, but only makes a prima facie case for a party for whose benefit it exists.*

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Section 22 of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 - Procedure and Powers of the Tribunal and the Appellate Tribunal

*Right of an appeal is a substantive right*

**A. K. Kamarudeen v Bank of India, Chennai and others (MAD), 18 November 2008**

The issue before the Court was whether the Tribunal was justified in passing an order calling applications for hearing arguments on the point of maintainability without having taken note of application filed for direction to panel valuer to produce the notes of proceedings and to summon the panel valuer of the respondent Bank who has valued the property.

*The High Court observed that the procedure adumbrated under the Act cannot be derailed in any manner. Since the Tribunal is not bound by the provisions of CPC, 1908 but guided by the principles of natural justice, on the basis of equity and fair play, the Court directed the Tribunal to take up all applications and to dispose of the same on merits to prevent aberration of justice.*

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Section 22 of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 - Procedure and Powers of the Tribunal and the Appellate Tribunal

*It is always open to the borrower and guarantor to join together to challenge a common order passed by DRT*

**S. Srinivasan v Karnataka Bank Limited, Tirupur and others (MAD), 8 December 2008**

The petitioner, Managing Director of the Company under liquidation, filed an application to transpose the company as the second appellant. The Tribunal rejected the application mainly on the ground that the cause of action for filing appeal is different from the cause of action of the Company, though it has been

accepted that the Company can file a separate appeal against the order passed by Tribunal.

*The High Court observed that it is always open to the borrower and guarantor to join together to challenge a common order passed by the Tribunal, the borrower having granted loan by the Bank and guarantor having*

given guarantee with regard to the loan. Accordingly, directions were issued to the Tribunal to transpose the

Company as second appellant.  
The petition was disposed of.

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Section 18 read with Section 13 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 read with Section 19 of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 – Appellate Tribunal – Appeal to

*Where the tribunal has failed to exercise its jurisdiction, the High Court can certainly entertain the petition under article 227 of the Constitution*

**Majestic Furnishing Company Limited, Chennai v Oman International Bank, Mumbai and others (MAD), 18 Nov 2008**

The Registry raised a query as to the maintainability of the appeal on the plea that as per convention, the appellant was supposed to file the appeal before the Debt Recovery Tribunal, Mumbai where the appeal filed by the first respondent Bank was still pending. On the same day, the office returned the appeal papers with further endorsement that the jurisdiction falls with that of the Debt Recovery Tribunal, Mumbai, which passed an order to hand over the possession of the applicant's assets. In view of the same, the appeal papers were returned with further endorsements that according to the prevailing practices and procedures followed by the tribunal and also in view of Sec.19(1)(a) and (b) of the Recovery Of Debts Due To Banks And Financial Institutions Act, 1993,

the tribunal does not have the jurisdiction to entertain the application.

*The High Court held that when an appeal is filed before the tribunal and if any question arises as to its jurisdiction to entertain the same, a query has to be raised and the appellant is to be asked to answer that query. When the appellant persists that the tribunal has got jurisdiction because of certain set of facts and wants the matter to be argued before the tribunal, the tribunal should give an opportunity to the appellant to substantiate their claim. When the tribunal has failed to exercise its jurisdiction, High court can certainly entertain the petition under article 227 of the Constitution.*

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### Trade Mark

Section 18 read with Section 9 and Section 11 of the Trade Marks and Merchandise Act, 1958 Application for Registration

*Issue relating to ownership of trademark*

**World Wide Brands Inc., Gurgaon v Central Wearhouse, Bangalore and another (MAD), 10 December 2008**

The petitioner-company claimed to have owned and used the trade mark "Camel Collection", "Camel Collection and device of camel", "Camel Trophy" etc., and claimed to have owned around 1395 trade marks registration world over and their use is prior in time to that of the respondent. The appellate Board found that there is no dispute that the petitioner had registered its trade mark "Camel" brand in various forms either as a word mark or with device mark in various countries.

*of registrations. When there is a specific finding that the petitioner had totally failed to produce any evidence with regard to the commercial publicity either in the magazines or otherwise the appellant mark in India, the contention relating to transborder reputation should be negated. Even relating to the advertisement, it is seen that the petitioner had produced two calendars, which are in Spanish Language and were not in circulation in India and the same cannot be relied upon for the purpose of advertisements of camel brand cigarettes in India. Challenge to the registration of the trade marks "camel collection" in favour of the respondent to be contrary to Sections 9, 11(a), 11(e) and 18(1) liable to be rejected.*

*The High Court held that excepting the fact that the exhibits bear the there is absolutely no evidence placed either before the registering authority or the appellate Board, as to how the petitioner became the owner of the trade mark, except producing some list*

*The petitions were dismissed.*

## DISCIPLINARY CASE

*Summary of a disciplinary case - Council of the Institute of Chartered Accountants of India Vs. Shri Raj Kumar N Iyer<sup>1</sup> (Chartered Accountant Reference No. 2 of 2003) decided on 18.10.2004 by the Bombay High Court under Section 21(6) of the Chartered Accountants Act, 1949.*

### Facts of the case:

The I.T.O., Mumbai (Complainant) filed a complaint against Shri Raj Kumar N. Iyer, Chartered Accountant (Respondent) under Section 21 of the Chartered Accountants Act, 1949 (Act) to the Institute of Chartered Accountants of India (Institute) alleging, inter alia, that the Respondent filed a duly signed and certified tax audit report in the case of M/s Elsans, Mumbai (Elsans) for the assessment year 1995-96 in Forms 3CB & 3CD on 26th October, 1995 without the Balance Sheet, Profit & Loss Account as annexures to Form 3CD as required under Section 44AB of the Income Tax Act. During the Survey under Section 133A of the Income Tax Act conducted on 31.10.95, no books of account for Accounting year 1994-95 were found at the office of the Elsans. The Respondent, in response to query by the ITO, admitted on 31st October, 1995 that the assessee firm did not properly maintain the books of account as mentioned in the Audit Report, and the books of account were not caused to be generated through the computer. As the books of accounts were not generated through the computer, it was stated by the Respondent that (i) it was not possible to furnish Trading Account, Profit & Loss Account and Balance-Sheet, (ii) the opinion given in 3CB, that, the accounts give true and fair view in respect of Balance-sheet, Trading Account, Profit & Loss Account for the year ended 31st March, 1995 was not correct, and (iii) the audit report should be treated as incorrect. Hence, the Respondent gave false certificate in Form 3CB & 3CD despite the non-completion of audit in order to save his client from the proceedings of penalty under Section 271B of Income Tax Act.

The Council of the Institute prima facie opined that the Respondent was guilty of professional and/or other misconduct and referred the case to the Disciplinary Committee for enquiry. During the proceedings before the

Disciplinary Committee, the Respondent pleaded guilty under Regulation 15(2) of the Chartered Accountants Regulations, 1988. The Disciplinary Committee on perusal of the documents on record, upon recording the deposition of the witnesses and on recording the plea of Respondent under Regulation 15(2) and after hearing of the submissions made by the Respondent came to the conclusion that the Respondent was not guilty of professional misconduct within the meaning of Clause (7) of Part I of the Second Schedule to the Act. However, held that he was guilty of professional misconduct within the meaning of Clause (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 read with Sections 21 and 22 of the Act.

The Council after giving opportunity of being heard to the respondent concurred with the finding of the Disciplinary Committee and recommended to the High Court that the Respondent be reprimanded. As required under Section 21(5) of the Act, the matter was referred to the Bombay High Court with the recommendations of the Council.

### Decision of the Hon'ble Court:

*The Hon'ble Court observed that despite service, the Respondent had chosen not to appear and admitted his guilt before the Disciplinary Committee. The Hon'ble Court further observed that there is nothing on record that the respondent was accused of professional misconduct in past. The court was of the view that since the respondent admitted guilt, he deserves lenient punishment.*

*On overall consideration of the entire material, the Hon'ble Court accepted the recommendation of the Council that the Respondent was guilty of professional misconduct within the meaning of Clause (8) of Part I Second Schedule to the Chartered Accountants Act, 1949 read with Sections 21 and 22 of the said Act, and ordered that the Respondent be reprimanded.*

<sup>1</sup>For full text of the Judgment please see Institute's publication viz. Disciplinary Case Vol.VIII, Part I, p. 875. For the convenience of readers full text of this case has been hosted on the website of the institute at the link: [http://www.icai.org/post.html?post\\_id=967&c\\_id=59](http://www.icai.org/post.html?post_id=967&c_id=59)

# SUCCESSION PLANNING IN FAMILY MANAGED BUSINESS WITH SPECIAL ATTENTION TO MANAGEMENT OF SIBLING RIVALRY



India being a nation of strong family and social values and a country where the system of joint family still flourishes, every practising member of our Chartered Accountant fraternity has to be an advisor, consultant, mentor, legal counsellor or sergeant-at-arms to a family owned business where the first generation is planning to hand over the torch to the second generation of incumbents either presently or at some time in future. This article provides some guiding tips for succession planning in family-managed businesses.

All parents would love to realize the utopian dream of a perfect family business that has its own by-laws, sacred cows, cherished beliefs, myths, rules and roles and every member abides by them. But seldom is it realized.

No matter what class (social as well as economic stratum) do they belong to, what education do they get (in schools or outside), what manner they are brought up in (by negligent, wanton parents or doting, affectionate, caring ones), adult sibling ri-

valry is the omnipresent pain that all parents of our times have to bear with in their lifetime. This is particularly true of those who have put their children in the family business with the ambition of building up a big business empire. Invariably, they miss out on paying attention to the operational efficacy and psychological stability of sibling relationships.

The sad fact is that in many family business environments, nothing could be worse. Often, the sentiment is more like “he’s my brother and I don’t want to stand him for another second.” Sibling relationships are more



— CA. Lavanya Gupta  
*(The author is a member of the Institute. She can be reached at lavanya\_9@yahoo.com)*

Not all families work well together. Quite often sibling rivalry impairs development. Jealousy, personal agendas and the weakness of father or mother allows things to deteriorate in family relationships as a result of the pending succession. Some families become totally dysfunctional as a result of continued differences.

likely to be described as "competitive," "humiliating," and "hurtful".

Who can forget the brouhaha caused in our media when two brothers fought over the legacy left behind by their father in the form of the largest private sector enterprise of the country, with businesses in energy and materials value chain? The genesis of the battle was traceable to ownership and control issues. The waging war cooled only with the subtle intervention of their mother and the division of the group industries between the two brothers. The case brings out the importance of succession planning in family run businesses and involves issues like corporate governance, control, and ownership.

The primary cause for the problems of the kind mentioned above is poorly understood principles and dynamics of sibling partnerships. If the business relationship between the brothers is rooted in misperceptions and misunderstandings on the part of parents as well as the siblings themselves, which it invariably is, then its consequences will adversely impact the peace of the family as well as the smooth working of the business.

Our role as advisors to the first generation of business owners—that is parents—should be sound and wholesome, because a lot depends on how they handle the situation by taking measures to nip the vice of rivalry in the bud before it adversely affects both the prosperity of business and the peace at home/family.

The dynamics of sibling rivalry in children can be explained as springing from the following :

- need for the parents' attention,
- countering parental favouritism,
- assertion of individualism and/or dominance,

In the case of adult siblings thrown aboard the same business ship, several other factors also need to be assessed :

- leadership succession to the competent and capable among the siblings,
- reward structure for sibling co-workers--both

monetary and non-monetary desire of siblings to acquire personal wealth and pursuit of material possessions.

Not all families work well together. Quite often sibling rivalry impairs development. Jealousy, personal agendas and the weakness of father or mother allows things to deteriorate in family relationships as a result of the pending succession. Some families become totally dysfunctional as a result of continued differences. That is not to say that there aren't families that handle succession without a problem and everything works out smoothly. Many, however, are able to do so mainly because they consciously plan well in advance about succession related issues. Take, for example the case of Michel Stone Ltd., Manchester or our own Bajaj Group of Industries. In both these cases, ownership transition from one generation to another was well thought out in advance and the necessary steps taken to ensure its implementation. . In both cases, , their owner manager Tom Hill and Chairperson Rahul Bajaj, placed the children in the organisation to utilize their strategic potential, ensure their commitment to success of **business first**, determine the shareholding patterns upfront and ensure extensive successor training.

What needs to be stressed is that passing the torch is not that complicated, though execution may be a bit difficult. As family mentors, the following guiding principles should be conveyed to the concerned parties for setting up succession plans so that the pitfalls can be avoided :

- Whenever a son or daughter is introduced to the business, it is essential that she/he be told clearly what is expected of her/him while working for the family business. Expectations should be established and communicated up front so that each family member knows his role in the organizational structure and does not have any grievances regarding the same. Specific job descriptions might also be laid out if needed.
- It should be hammered into the minds of every incumbent that **Business needs should come first**. This implies that their primary fo-

Whenever a son or daughter is introduced to the business, it is essential that she/he be told clearly what is expected of her/him while working for the family business. Expectations should be established and communicated up front so that each family member knows his role in the organizational structure and does not have any grievances regarding the same.

cus should be on the long-term health of the business. An accountability structure should be made up front and each sibling must be groomed to fit into it. They have to remember that one rotten apple spoils all the apples in a basket. If one sibling is allowed to take things out of the way or put personal goals ahead of the business as a whole, others will follow suit and nothing can be as bad for the business.

- Develop a family code of conduct, rules and bye-laws, doctrines that would serve as decision-making and operational guidelines for one and all. Create a set of agreements that will determine how he will make decisions, communicate with others, and resolve conflicts. They will also know how to hold each other accountable, how to represent one another to the senior managers and employees and all outsiders. If required, a trusted outside advisor could be brought in to facilitate debate and discussions.
- Create an agreement upon the Leadership Model to be followed. Make sure that the sibling whom you wish to entrust with leadership qualities has the requisite character. Parental favouritism should not be allowed to prejudice this decision because the health of the business rests on this ONE BIG DECISION. You may wish to get outside opinion on leadership skills and leadership development of your children. (You are too close to make unbiased judgments). A leadership education and training programme could be made compulsory for the incumbents.
- Establish official family compensation programmes for paying family members according to their position. There should be complete transparency in the remuneration package to family members; its absence could prove a major source of conflict. Develop a comprehensive Family Business Employment Policy. This policy will cover everything from the criteria by which members of the next

generation become eligible for employment in the family business, to compensation, bonus, and perk structures, to behaviours and attitudes expected on the job. Promoting agreements on these sensitive issues ahead of time will serve to minimize future disagreements. Establish a framework for dealing with family performance issues without any exception.

- Engage in Family Strategic Planning to determine a “shared vision” of your future together. Every incumbent will have his own ideas about the growth and direction of business. Conflicting views on this need to be resolved ahead of time to ensure prosperity of the business. If any member has any personal dreams, attempt should be made to fit these within the family business strategy.
- Provide assurance that your Estate Plans are in order. On many occasions the tragedy of an untimely death intestate or without appropriate estate planning can create subsequent challenges in family business circles. Having your estate plans in order will provide peace of mind regarding your sibling’s affairs and the impact it could have on the business.
- Agree upon an acceptable Exit Strategy. It is because at some point of time one or more siblings will want to exit the business.

Apart from these steps, parents should be told that there is a psychological aspect that needs to be clarified to each of the siblings involved with the business. They should be well-conversed with the fact that effective sibling partnerships will not happen by default. It requires a good deal of effort to promote this effectiveness. Each sibling has to be appraised of the fact that he/she has to rise above sibling rivalry. The following tips could prove useful for them :

- Subordinate your personal needs to the greater good of the business. As a successor, recognize that you will be taking on the stewardship responsibility of the business. The business represents more than what it can do for you. Many employees and their families, vendors,

and an entire community depend on a relationship with your business.

- Recognize the contribution each of your siblings makes. Every business is a team work. Do not try to put up a one-man show just to satisfy your ego or the urge to dominate. Work as a sibling unit to develop as a self-directed and self-governing team. Remember that unity is strength.
- Focus on your opportunities, not on what you're not getting. Nobody likes a whiner, especially when they are the entitled brat child of a business owner. Recognize that the opportunities you have are uncommon and be humble.
- Learn to communicate and handle conflict with your siblings effectively. The absence of communication to keep peace is not effective. You must learn to navigate conflict successfully. It builds confidence in your ability to function effectively as a team. You may need to set provisions for breaking a deadlock.
- Keep your in-laws from becoming out-laws. Most of what occurs in a sibling partnership must stay in the business to protect naturally supportive and hypersensitive spouses from over-reaction to everyday heated discourse between siblings.

The first generation of business owners should be apprised of the fact that even if they do everything right to complete the family business succession without a hitch, it might happen that their sons or daughters are just incapable of accepting the responsibility on his/her shoulders or that their personal materialistic goals are too big to allow them to make right decisions for the family and its business. If that happens, then the owners have to look for other options. These options range from promoting someone capable or competent, or bringing in a CEO from the outside, or selling the business. In this context, the CEO succession planning controversy at one of India's largest pharmaceutical company was quite heated as to how and why promoter and CEO believed in running the business professionally and handed over the company's management to an independent professional (and a non-family member), amidst stiff opposition from family members. This professional then transformed a small Indian pharmaceutical company into a research based global pharmaceutical major.

It is true that a large number of circumstances need to be discussed and analyzed for each business before the first generation makes the final decision about the right kind of person for passing on the baton. Don't sacrifice your relationship with your child but don't be held hostage to your own DNA either. It is easier said than done... but it is a reality that parents have to face and we as chartered accountants hold not only a fiduciary responsibility to the client and the business involved, but to the society as a whole to do our best to advise the best course of action for ongoing success of a business enterprise. □

# XBRL – A CFO’s PERSPECTIVE



XBRL (Extensible Business Reporting Language) is a novel and speedy way of communication of business and financial data which is of immense utility to governments, regulators, capital markets and other stakeholders. As the whole world seems to be moving towards XBRL and IFRS, finance professionals need to begin learning about both at the earliest. Singapore, Japan, Australia and many European countries have already mandated the use of XBRL for their statutory filings. In U.S., large corporations started doing their filings in XBRL from 2008 and the rest of the corporate world will do so in 2009. More and more countries are expected to follow suit sooner than later. This article provides an overview of XBRL.

One of the offshoots of the rapid globalization of the world economies is the desire for prompt and accurate company information. With unprecedented growth in the size of corporations, businesses have to change the way they communicate. While speed, accuracy and

timeliness are expected from finance professionals in their reporting, the amount of information that they have to handle in bringing out meaningful management reports is mind-boggling. Increased economic, market and regulatory pressures require Senior Management to reassess how one of their most important, but in many ways most routine, busi-



— CA. S.R. Viswanathan  
*(The author is a member of the Institute working as CFO, NeoClarus, Hyderabad. He can be reached at singhikv@gmail.com)*

It is estimated that large corporations on an average use more than 800 spreadsheets to prepare financial statements for regulatory reporting and filing purposes. Use of XBRL significantly reduces the effort and at the same time improves internal controls over financial reporting.

ness processes— reporting of business information— is performed.

### XBRL – A New Tool

XBRL (Extensible Business Reporting Language) is a tool that looks set to satisfy the requirements for speedy and accurate financial reporting. It is a way of electronic communication of business and financial results and is of immense utility to capital markets and investing community. It has been developed by an international non-profit consortium of organizations and Government agencies. It is an open standard which means users can get free, things which they would otherwise have had to buy and also they are not locked on to a specific vendor.

### Old Methods Yield Way to the New

The conventional methods of preparing financial reports in spreadsheets, templates and word documents involve huge amount of manual work and are also susceptible to errors. In these methods, manual and automated processes are combined for consolidating data for analysis and reporting. Problems crop up when reporting has to be done in a different jurisdiction, or there are changes, even of the tiniest kind. It is estimated that large corporations on an average use more than 800 spreadsheets to prepare financial statements for regulatory reporting and filing purposes. Use of XBRL significantly reduces the effort and at the same time improves internal controls over financial reporting.

### The Working of XBRL

XBRL works through a process called “Tagging”, which provides a distinct tag for each and every individual item of data. This is computer readable. Computers read the XBRL data intelligently; they select, analyze, store and exchange data with other computers and present it in a number of ways for users. Tagging also allows data entered in one application to be interpreted, analyzed and reused across systems, platforms, business units, applications and organizations. The result is a complete automation of financial reporting business process, which is accurate, reliable, cost effective and interactive.

### Taxonomies

XBRL works by assigning a name to every item in a financial statement and a definition of relationship be-

tween those items. This list, which is called “Taxonomy” enables companies to tag their data and produce statements in XBRL. A “Taxonomy” is a description and classification system for concepts. An XBRL taxonomy is a particular way to describe and classify reporting concepts. XBRL represents each concept as an element with a name.

### Pictorial Depiction of XBRL

The XBRL US GAAP taxonomy describes and classifies elements representing US GAAP reporting



concepts. XBRL taxonomies are electronic, machine-readable dictionaries, consisting of many linked files containing thousands of elements linked to each other. The XBRL US GAAP taxonomy is based on US GAAP and is intended for SEC registrants who file financial reports prepared in accordance with US GAAP. The XBRL US GAAP has a broad and deep coverage of financial reporting concepts (over 10,000 elements) including all US GAAP and SEC financial statement disclosure requirements.

### Extensions

If there is any element that is not present in XBRL taxonomy, it can be created by what is called “extension”. The taxonomy’s breadth and size minimizes the effort required to create extensions to meet specific reporting needs.

All countries that have adopted XBRL have published their own list of taxonomies which would help bring in a huge amount of standardization in the way financial statements are presented. To provide flexibility, even when a general ledger account of a corporation does not fit into the standard taxonomy, it can create “extensions”.

### Verification of XBRL Document

Tagging of the financial statement is done by mapping each individual line in the financial statement to a term in the US GAAP XBRL vocabulary as published by XBRL International. A user does this with an XBRL instance creation tool. Once the XBRL document has been created, other tools can be used to validate the

XBRL works by assigning a name to every item in a financial statement and a definition of relationship between those items. This list, which is called ‘Taxonomy’ enables companies to tag their data and produce statements in XBRL. A ‘Taxonomy’ is a description and classification system for concepts.

document before distribution of the financial statements to regular users.

### Uses of XBRL and its Advantages

XBRL can be applied to a wide range of business and financial data. It can handle

- Internal and external financial reporting of corporations;
- Reporting to all types of regulators – tax and financial authorities, banks and Governments;
- Loan applications, reports, and credit risk assessments.

The main advantages of XBRL are :

- Handling large volume of data speedily;
- Reducing the incidence of manual interventions and errors;
- Automatic checking of data/ information;
- Flexibility: allows reports to be compiled in different forms.

All the above result in savings in costs while ensuring greater speed and accuracy. According to the CFO of a large corporation, use of XBRL resulted in 17% savings in time (more than 200 man hours) required for filing their 10-Q reports with SEC, while concurrently strengthening the process controls. And this is only for the first year. As users become familiar with the use of XBRL, savings from using XBRL will grow considerably in subsequent years.

### Who Can Use XBRL?

XBRL can handle different languages and accounting standards. Its flexibility enables it to be adapted to meet different requirements. XBRL can be used by

- Investors
- Analysts
- Regulators/ Government Agencies
- Financial Institutions
- Company Managements
- Accountants and auditors

XBRL automates data collection. Data from different companies/ divisions with different accounting sys-

tems can be assembled quickly, economically and efficiently. Once data is gathered in XBRL, different types of reports using varying subsets of the data can be produced with minimum effort. The Finance Department of a Corporation can quickly generate reliable internal management reports, financial reports for publication, tax and other regulatory filings as well as reports for banks and lenders. XBRL offers significant potential benefits for internal reporting. By extending the appropriate GAAP taxonomy to link with management reporting structures, a company can bridge external reporting systems and internal management reporting, thereby providing real-time financial and management information that can be disseminated to any user at any level. Data handling cannot only be automated, thereby eliminating time consuming and error prone processes but can also be checked by XBRL for accuracy.

### XBRL & IFRS

International Accounting Standards Board (IASB) is developing a taxonomy that reflects International Financial Reporting Standards (IFRS). National XBRL jurisdictions will modify/ extend this taxonomy to reflect their local accounting standards. Once IFRS is adopted by more countries of the world, efficiency and comparability of financial statements will be greatly improved. As the benefits of using XBRL become more and more evident, the use of XBRL for analyzing, comparing, and filing financial information is going to become widespread.

Let us look at some of the countries that have mandated the use of XBRL

## Global Status of XBRL Mandate



## The Indian Scenario

In India the ICAI has taken steps to embrace XBRL and set up a general purpose taxonomy for commercial and industrial enterprises, based on Indian accounting standards and corporate laws. It will follow it up by setting up the taxonomy for financial sector companies. The ICAI has been assigned the Indian jurisdiction of XBRL International as a result of which the ICAI will be the Indian entity which will encourage the development and adoption of XBRL in India and will represent the Indian interest at the international level. The Ministry of Corporate Affairs and the various regulators, namely, RBI, SEBI and IRDA are part of the group constituted by the ICAI in this regard and are supporting the Institute in this initiative.

The ICAI has also taken up the task of development of general purpose XBRL taxonomy for commercial and industrial companies. This taxonomy, which is based on the requirements of the Indian accounting standards and various Indian corporate laws, has been finalized. This move is expected to give corporates a taste of the XBRL and address their concerns, if any. Subsequent to the development of general purpose taxonomy, the ICAI would take up the development of taxonomy for the financial sector, specifically banks and non-banking financial companies.

Reserve Bank of India (RBI) is about to launch Basel II reporting system by using XBRL through the existing Online Returns Filing System (ORFS). RBI has introduced XBRL filing for few returns like Form A under section 42(2) of RBI Act with the objective of eliminating the need for paper based data submission. This also obviates the necessity for submission of multiple copies of the same returns to various departments of RBI, thus simplifying the process.

## Step Forward

As the whole world seems to be moving towards XBRL and IFRS, finance professionals should begin learning about both at the earliest. Singapore, Japan, Australia and many European countries have already mandated the use of XBRL for their statutory filings. In U.S., large corporations started doing their filings in XBRL from 2008 and the rest of the corporate world will do so in 2009. More and more countries are expected to follow suit sooner than later. Most organizations wait for external regulations to drive them towards any new initiative like XBRL. Forward looking organizations will plan for early implementation of reporting by XBRL and thereby improve the quality of their reporting – both internal and external.

NeoClarus is one the early entrants in the XBRL field and provides customized solutions for filings in XBRL. To know more about what NeoClarus offers, visit it at [www.neoclarus.com](http://www.neoclarus.com).

*(The author acknowledges valuable information on XBRL by authors Eric E Cohen & Neil Hannon and John Stantial which has been used in this article) □*

# REAL ESTATE INVESTMENT TRUSTS

Real Estate Investment Trusts (REITs) are publicly traded companies which invest in and manage portfolios of commercial properties or mortgage loans. For the individual investor, they represent one of the few ways, and arguably the most practical way, to invest in real estate that was once the exclusive domain of the very wealthy and the institutions. The article explores the concept in Indian context.



Today, there are Real Estate Investment Trusts (REITs) that invest in just about every type of commercial property in existence: apartment buildings, regional malls, neighbourhood shopping centres, office complexes, industrial parks, health care facilities, hotels,

warehouses, hospitals, etc. These REITs invest on an all cash basis, with modest borrowings from Financial Institutions i.e. doing leveraging. Interest Rate Arbitrage enhances the yield to

the investors. They buy properties directly or through joint ventures with other investors. Some develop properties, some just buy existing real estate.

REITs can be either public or private enterprises. Public REITs are open to the general public and are listed on one of the major securities exchange. Private REITs are generally restricted to parties that REIT management wants as co-owners or perhaps just to institutional investors i.e. units.

REITs are set up as corporations or business trusts. In recent years, most have been established as corporations because the laws governing corporations are generally more uniform and



— CA. Nilesch Choudhary and CA. Navnit Choudhary

*(The authors are member of the Institute associated with Real Estate sector. They can be reached at [navnitchoudharyaaaaa@rediffmail.com](mailto:navnitchoudharyaaaaa@rediffmail.com))*

The key difference between REITs and other public companies is how they are taxed. In three simple words: “THEY ARE NOT”. They are not taxed at the federal level and in most cases not at the state level too. Most of the profits made by REITs are distributed to shareholders, who then pay the tax bill.

established than those governing trusts. The corporate REIT issues stock, while the business trust issues shares of beneficial interest.

The key difference between REITs and other public companies is how they are taxed. In three simple words: “THEY ARE NOT”. They are not taxed at the federal level and in most cases not at the state level too. Most of the profits made by REITs are distributed to shareholders, who then pay the tax bill. Other public companies are taxed on their profits. If they payout any dividend to shareholders, then the shareholders are responsible for paying taxes on these dividends. That results in double taxation. The benefit of taxation is given to REITs so as to keep it under the same footing with Mutual Fund.

The reason of putting money in REITs is to enjoy the benefits of Real Estate Sector by putting a small chunk of savings and have a very hassle free investments.

#### Issues at Hand:

- Time and expertise required for selection of properties and builder.
- Stamp Duty Payment, Registration and visiting government offices a number of times.
- Limitation of down payments to bank.
- Build diversified portfolio across cities to hedge the risk.
- Earn high return with low risk investments

#### Choose the Right REIT for Investment

Before investing in any REITs, it is important to remember the importance of sticking to the basics. This means that one should not be overly concerned with the recent track of the individual REIT sectors or, for that matter, with the results recorded by any individual REITs. This is very much true that the stock performance is important in evaluating any public company, but just because a company's stock may have posted a 50% annual return each of the last two years does not mean it will do so again next year.

In any decision-making process, one needs to follow a disciplined approach of determining investment objectives and risk tolerance and matching those results with the appropriate REIT or REITs.

While evaluating individual REITs, preference should be given to those REITs that have some or all of the following characteristics:

- Self Administered
- Self Managed
- Fully Integrated
- High Quality Assets
- Geographic & Asset Focus
- Track Record
- Management Experience
- Promoter's Contribution

#### REITs In India

In exercise of the powers conferred by section 30 read with sections 11 and 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992), the Securities and Exchange Board of India has made the Regulations on Real Estate Investment Trusts, namely 'Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2008'.

In accordance to the provisions of the draft guidelines, no person other than real estate investment trust can make a public offer or seek listing of units whereas no person other than real estate investment management company can manage real estate investment schemes.

The units of every scheme shall be listed immediately after the date of allotment of units and not later than six weeks from the date of closure of the scheme on each of the stock exchanges as mentioned in the offer document.

Every scheme for which authorisation is requested shall appoint an independent property valuer (the “Principal Valuer”). The Principal Valuer shall value all the real estate held under the scheme, on the basis of a full valuation with physical inspection in respect of the site of the real estate and an inspection of the building(s) and facilities erected thereon once a year, and in any event, for the purposes of issuance of new units. The Principal Valuer shall also submit a valuation report on real estate to be acquired or sold by the scheme or where new units are offered by the scheme or in any other circumstances as may be specified by the Board.

In India, as of now, the concept of REITs is not recognized. However, a similar structure of REITs can be designed and worked under the Real Estate Fund routed through Venture Capital Fund. Indian Venture Fund will be regulated by Securities and Exchange Board of India (Venture Capital Fund) Regulations 1996.

The valuation methodology shall follow the "Valuation Standards on Properties" published from time to time by the concerned Indian Institute or the International Valuation Standards issued from time to time by the International Valuation Standards Committee.

A real estate investment management company shall take all reasonable care to ensure that the net asset value per unit of a scheme is calculated as and when an annual valuation report is issued by the principal valuer for the relevant period, and that such net asset value shall be published in the annual report and disclosed to unit holders at such frequency as specified by the Board.

The scheme shall distribute to unit holders as dividends each year an amount not less than 90 % of its annual net income after tax.

In India, as of now, the concept of REITs is not recognized. However, a similar structure of REITs can be designed and worked under the Real Estate Fund routed through Venture Capital Fund. Indian Venture Fund will be regulated by Securities and Exchange Board of India (Venture Capital Fund) Regulations 1996.

A "**Venture Capital Fund**" under the SEBI Regulations means:

A fund established in the form of a trust or a company including a body corporate and registered under these regulations which:

- (i) has a dedicated pool of capital;
- (ii) raised in a manner specified in the regulations; and
- (iii) invests in accordance with the regulations.

The Term "**Venture Capital Undertaking**" means a domestic company

- (i) whose shares are not listed on a recognised stock exchange in India;
- (ii) which is engaged in the business for providing services, production or manufacture of article or things or does not include such activities or sectors which are specified in the negative list by the Board with the approval of the Central Government by notification in the Official Gazette in this behalf.

Real Estate has been removed from the negative list.

## Investment Conditions and Restrictions

### Minimum investment in a Venture Capital Fund:

(1) A venture capital fund may raise monies from any investor whether Indian, Foreign or non-resident Indian by way of issue of units.

(2) No venture capital fund set up as a company or any scheme of a venture capital fund set up as a trust shall accept any investment from any investor which is less than five lakh rupees, provided the investors who are (a) employees or the principal officer or directors of the venture capital fund, or directors of the trustee company or trustees where the venture capital fund has been established as a trust; or (b) the employees of the fund manager or asset management company.

Each scheme launched or fund set up by a venture capital fund shall have firm commitment from the investors for contribution of an amount of at least rupees five crores before the start of operations by the venture capital fund.

### Investment conditions and restrictions:

All investment made or to be made by a venture capital fund shall be subject to the following conditions, namely:-

(a) venture capital fund shall disclose the investment strategy at the time of application for registration;

(b) venture capital fund shall not invest more than 25% corpus of the fund in one venture capital undertaking;

(c) venture capital fund may invest in securities of foreign companies subject to such conditions or guidelines that may be stipulated or issued by the Reserve Bank of India and the Board from time to time.

(d) shall not invest in the associated companies; and

(e) venture capital fund shall make investments as enumerated below :

(i) at least 66.67% of the investible funds shall be invested in unlisted equity shares or equity linked instruments of venture capital undertaking.

(ii) Not more than 33.33% of the investible funds may be invested by way of subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed.

In view of the above, out of the total income of the Venture Capital Fund (VCF), only that part of the income of the SEBI registered VCF which is derived from the qualifying Venture Capital Undertaking (as per the definition under section 10(23FB) of the Income-tax Act, 1961) will be exempt from tax under section 10(23FB) and the balance amount which is not tax exempt would be subject to taxation under the general provisions of the Income-tax Act, 1961.

**Prohibition on listing:** No venture capital fund shall be entitled to get its units listed on any recognised stock exchange till the expiry of three years from the date of the issuance of units by the venture capital fund.

**Prohibition on inviting subscription from the public:** No venture capital fund shall issue any document or advertisement inviting offers from the public for the subscription or purchase of any of its units.

**Private placement:** A venture capital fund may receive monies for investment in the venture capital fund through private placement of its units.

**Changes in the placement memorandum to be intimated to the board:**

#### Taxation of VCF Fund

- (i) Only such income of a VCF which is earned from investments in VCUs, which operate within the identified sector will be exempted from tax under the provisions of section 10(23FB) of the Income-tax Act, 1961 (ITA).
- (ii) Those VCUs which do not operate in the specified sectors and other non VCUs will be outside the purview of section 10(23FB) of the ITA.

In view of the above, out of the total income of the Venture Capital Fund (VCF), only that part of the income of the SEBI registered VCF which is derived from the qualifying Venture Capital Undertaking (as per the definition under section 10(23FB) of the ITA) will be exempt from tax under section 10(23FB) and the balance amount which is not tax exempt would be subject to taxation under the general provisions of the Income-tax Act, 1961.

Further, as far as taxation of the investors in a VCF are concerned, pursuant to section 115U, only the income which is exempt under section 10 (23FB) would retain the same character when distributed to investors. The taxability of income received from a VCF on investments made in companies which are not operating in the prescribed sectors, will be dealt with under the general provisions of the Income-tax law.

**Where the VCF is organized as a trust, the provi-**

**sions regarding the taxation of trusts would apply, which are discussed hereunder:**

#### a) Organization as a Specific Trust

As per Income-tax Act, 1961, a trust is not a separate taxable entity. Where the trust is specific, i.e. the beneficiaries are identifiable with their shares being determinate, the trustee is assessed as a representative assessee and tax is levied and recovered from him in like manner and to the same extent as it would be leviable upon and recoverable from the person represented by him. The tax authorities can alternatively raise an assessment on the beneficiaries directly, but in no case can tax be collected twice over. While the income tax officer is free to levy tax either on the beneficiary or on the trustee in his capacity as representative assessee, as per section 161 of the ITA, it must be done in the same manner and to the same extent that it would have been levied on the beneficiary, i.e., qua the beneficiaries. Thus in a case where the trustee is assessed as a representative assessee, he would generally be able to avail of all the benefits/deductions etc. available to the beneficiary, with respect to that beneficiaries share of the income. There is no further tax on the distribution of income from a trust. Hence, where the trustee pays tax at the trust level in his representative capacity, there would be no question of taxation of income upon further distribution.

To summarise the Income-tax provision in India, fund which is a SEBI registered VCF would be taxed in the following manner w.e.f. April 1, 2007:

**a.** In respect of investments made in the eight specified businesses, the VCF will be exempted from tax on its income and the investors would be subjected to tax under the provisions of section 115U of the ITA as and when they receive the income from the VCF. The character of the income would remain the same;

**b.** In respect of investments made by the VCF which do not qualify for the exemption under section 10(23FB) of the ITA, the trust should not be subjected to tax due to the provisions of section 63 or 161 of the ITA, whichever applicable. The investors should be assessable to tax on the income earned by the trust. □

# THE ADVENT OF REAL ESTATE MUTUAL FUND – BROADENING INDIA'S CAPITAL MARKET

A new investment product called Real Estate Mutual Fund (REMF) is emerging in India, which will make it easier for the average investors to invest their hard-earned money in real estate. The entry of real estate funds in the already over-heated realty market is bound to cause quite a stir. The article provides an overview of the concept in Indian context.

One sector that has assumed growing importance in the liberalized Indian economy is that of real estate. Growth in real estate has been fuelled by an expanding economy, rising urbanization and improved transparency. Foreign investments in India have seen a steady rise of 40%-45% per year; Indian financial institutions too have stepped up their investments. The combined investment from both along with significant investments from corporate houses has pumped in billions.

Real estate investment in

India lures heavy weight investors with its lucrative returns. It is estimated that such investments in developed countries would fetch a return of 3% to 4%, whereas these fetch 12% to 15% in India.

## Introduction

Today, the Indian economy is growing at a good pace and the real estate sector is growing even faster. Eventually, more and more money is chasing a limited quantity of high-quality property.

This makes real estate potentially one of the best investment opportunities out there. But



– CA. Saurabh Gupta\* and Anuj Arora\*\*

(\*The author is member of the Institute. He can be reached at [sgupta7@gmail.com](mailto:sgupta7@gmail.com). \*\*The author is a Company Secretary. He can be reached at [anujarora\\_cs@yahoo.co.in](mailto:anujarora_cs@yahoo.co.in))

REITs are also investment vehicles dealing in real estate. Like REMFs, they too are close-ended schemes and listed on stock exchanges. But there are big technical differences between the two. First, a REIT is mandated to distribute at least 90 per cent of the gains it makes in a year to its unit-holders. Second, a REIT can invest only in finished projects and not in the ones that are under construction.

high prices and transaction costs make it difficult for an average investor to take bets on this fast-growing sector.

How often have you stared at a gleaming skyscraper in a tony locality in your town and wished you could afford to buy a house there? If you have ended up sighing wistfully and walking away, here's some good news. Now, you may easily be able to own a small portion of a very swanky address.

Fortunately, a new investment product called Real Estate Mutual Fund (REMF) is emerging, which will make it easier for the average investor to invest his or her hard-earned money in real estate.

The entry of real estate funds in the already over-heated realty market is bound to cause quite a stir. A slew of real estate funds, promoted by Indian and foreign financial institutions are scouring the real estate market for properties with assured returns to invest in.

Globally, REMFs are also known as Real Estate Investment Trusts (REITs). The essential difference between a REIT and a mutual fund is that investments made in REIT are traded in real estate stocks and not invested in the stock of companies. It provides a heavier liquidity than MF's. With strong fundamentals in the property market and improved transparency, REMFs are expected to provide an attractive alternate investment vehicle and deepen India's growing Capital Market.

### Working of REMF

Since the product is at a very basic stage in India, it makes sense to look at international markets where a similar product -- the Real Estate Investment Trust (REIT) -- is quite popular. In the US alone, there are hundreds of publicly traded REITs (just like we trade in shares or mutual fund units) with several hundred billion dollars in assets.

An REIT by its very nature will buy, develop and maintain property both for sale and rent, and share profits with those who invest in such funds. Let us assume your REMF collects Rs 500 crore (Rs 5 billion) and invests Rs 200 crore (Rs 2 billion) out of it (40 per cent of the collections) in 40 flats costing Rs 5 crore (Rs 50 million) each. If you have invested Rs 10,000

in this fund, then your share out of the appreciation and rental income of these flats would be 0.0002 per cent. Like our regular mutual funds, real estate funds will also charge fees for administrative and management expenses.

### REMF Vs REIT

REITs are also investment vehicles dealing in real estate. Like REMFs, they too are close-ended schemes and listed on stock exchanges. But there are big technical differences between the two.

**First**, a REIT is mandated to distribute at least 90 per cent of the gains it makes in a year to its unit-holders. **Second**, a REIT can invest only in finished projects and not in the ones that are under construction.

Hence, it earns its major chunk from rental income. "While REITs help you earn only a regular income, REMFs give you capital appreciation too.

Securities Exchange Board of India (SEBI) guidelines mandate REMFs to invest at least 35 per cent in completed and ready-to-use properties. They do, in that sense, resemble REITs to an extent and can, in fact, invest this portion in Reits.

REITs and REMFs run simultaneously in many countries across the world, especially in developed markets like that of the US. India is set to follow that path as SEBI has shown enough intent to allow the launch of both products.

### Spreading of Risk

REMFs are being developed in India along similar lines. They will offer the same general advantages that mutual funds offer to investors: namely diversification and lower transaction costs.

REMFs enable the retail investor to invest in real estate, which till now has been the preserve of the few with deep pockets. These also bring more money into the market.

One indirect benefit is that it paves the way for cleaning the system. The real-estate industry has traditionally been plagued by a lack of transparency in its working and speculative in nature. With the entry of REMF, builders will be hard-pressed to develop quality projects and leeway for sub-standard construction

Currently, the Securities and Exchange Board of India (SEBI), the market regulator that approves such schemes in India, is in the process of examining the REMF and is especially concerned about developing sound valuation norms for the funds. There are real-estate funds, which have been approved, but these are venture capital funds, targeted at high net-worth individuals or institutions.

practices will be considerably reduced. Real estate funds are expected to acquire real estate assets with quality blue chip tenants and focus on growing urban development markets.

## Launch of REMF

Currently, the Securities and Exchange Board of India (SEBI), the market regulator that approves such schemes in India, is in the process of examining the product and is especially concerned about developing sound valuation norms for the funds.

There are real-estate funds, which have been approved, but these are venture capital funds, which are targeted at high net-worth individuals or institutions. For example the HDFC Property Fund has a minimum investment of Rs 5 crore. However, it's only a matter of time before REMF's are opened to retail investors. This will not only provide a promising new investment vehicle but also help develop the nation by channeling savings into much needed housing and commercial projects.

The timing is also quite opportune as the real estate markets are experiencing strong headwinds coming from the sub-prime bruised West with IPO markets in a slumber and debt almost dried up. Hopefully, REMFs should help in:-

- Unlocking and churning of capital by developers selling the stabilized assets to REMF's;
- Creating an alternative investment portfolio for small investors / households who do not have the technical ability and the means to directly invest in the Real Estate sector;
- Catalyzing a sophisticated and liquid market for mortgage backed securities; and
- Mobilizing retail funds for assets through a regulated institutional route.

## SEBI Has Introduced Guidelines for Real Estate Mutual Funds

The 10th Five-Year Plan has proposed that SEBI would regulate the real estate mutual funds in India. These can be invested in real estate in India directly or indirectly. SEBI would introduce the REMFs as closed ended units and list in stock markets.

As per an earlier guideline by SEBI, the NAV of REMFs were required to be disclosed daily but a recent proposal of a quarterly disclosure of NAV is drawing serious speculations from the realty segment.

**Real Estate Mutual Fund Scheme** means a scheme of mutual fund, established in the form of a trust, which invests directly or indirectly in real estate assets or other permissible assets.

## Who Can Set Up REMF?

- An existing mutual fund may launch a scheme, if it has an adequate number of key personnel and directors having adequate experience in real estate.
- People who have been dealing in real estate for at least for five years, and also fulfill the eligibility criteria specified by SEBI for Mutual Funds.

## Investment in REMF

There are certain restrictions on Investments in REMF

- Every real state mutual fund scheme shall invest at least thirty five per cent of the net assets of the scheme directly in real estate assets.
- Subject to the above, every scheme shall invest-
  - at least seventy five per cent of the net assets of the scheme in-
    - real estate assets;
    - equity shares or debentures of companies dealing in real estate assets or undertaking real estate development projects,[whether listed on a recognized stock exchange in India or not;
    - and the balance in other securities;

Unless otherwise disclosed in the offer document, no mutual fund shall, under all its REMF schemes, invest more than thirty per cent of its net assets in a single city.

No mutual fund shall, under all its REMF schemes, invest more than fifteen per cent of its net assets in the real estate assets of any single real estate project. For the purposes of this regulation, "single real estate project" means a project by a builder in a single location within a city.

No mutual fund shall, under all its REMF schemes, invest more than twenty five per cent of the total is-

No mutual fund shall, under all its REMF schemes, invest more than fifteen per cent of its net assets in the real estate assets of any single real estate project. For the purposes of this regulation, "single real estate project" means a project by a builder in a single location within a city.

sued capital of any unlisted company.

No mutual fund shall invest more than fifteen per cent of the net assets of any of its REMF schemes in the equity shares or debentures of any unlisted company.

No scheme shall invest in -

- any unlisted security of the sponsor or its associate or group company ;
- any listed security issued by way of preferential allotment by the sponsor or its associate or group company;
- any listed security of the sponsor or its associate or group company, in excess of twenty five per cent of the net assets of the scheme.
- No mutual fund shall transfer real estate assets amongst its schemes.
- No mutual fund shall invest in any real estate asset which was owned by the sponsor or the asset management company or any of its associates during the past five years or in which the sponsor or the asset management company or any of its associates hold tenancy or lease rights.

### Real Estate Valuer

"Real Estate Valuer" means a qualified valuer of real estate assets who has been accredited by a credit rating agency registered with the Board.

### Other Conditions for REMF Schemes

- Every scheme shall be close-ended and its units shall be listed on a recognized stock exchange, provided the redemption of a scheme may be done in a staggered manner.
- The units issued by a scheme shall not confer any right on the unit holders to use the real estate assets held by the scheme and any provision to the contrary in the trust deed or in the terms of issue shall be void.
- The title deeds pertaining to real estate assets held by a scheme shall be kept in safe custody with the custodian of the mutual fund.
- No scheme shall undertake lending or housing finance activities.
- All financial transactions of a scheme shall be routed through banking channels and they shall not be cash or unaccounted transactions.

### Valuation of Real Estates Assets and Declaration of Net Asset Value

The real estate assets held by a scheme shall be valued

- at cost price on the date of acquisition; and
- at fair price on every ninetieth day from the day of its purchase in accordance with the specified norms.
- The asset management company, its directors, the trustees and the real estate valuer shall ensure that the valuation of assets held by a real estate mutual fund scheme are done in good faith, in accordance with the norms specified and that the accounts of the scheme are prepared in accordance with accounting principles specified.
- The net asset value of every real estate mutual fund scheme shall be calculated and declared at the close of each business day on the basis of the most current valuation of the real estate assets held by the scheme and accrued income thereon, if any.

### Duties of Asset Management Company (AMC)

Without prejudice to the provisions of regulation 21, the AMC of a mutual fund having schemes shall appoint a suitable number of qualified key personnel with relevant experience, before undertaking investment management of real estate assets of a scheme.

- AMC may appoint advisors to advise it on acquisitions or proposed acquisitions of real estate assets.
- AMC shall exercise due care while appointing a real estate valuer for valuing the real estate assets held by the real estate mutual fund scheme and shall ensure that there is no conflict of interest.
- AMC shall lay down an adequate system of internal controls and risk management.
- AMC shall put in place systems to ensure that all financial transactions are done through banking channels and exclude transactions in cash or unaccounted transactions.
- AMC shall exercise due diligence in the maintenance of the assets of a real estate mutual fund scheme and shall ensure that there is no avoidable deterioration in their value.

The REMFs, once introduced in the country, are expected to bring in more liquidity and heighten the organization level of the emerging real estate market in India. REMFs are to be introduced in India following their success stories in some major economies like US, the UK, Japan, South Korea, Singapore, and Hong Kong.

- AMC shall ensure that the real estate assets held by a real estate mutual fund scheme are adequately insured against impairment, damage or destruction.
  - AMC shall ensure that the cost of maintenance and insurance of real estate assets is within reasonable limits and that no funds of the scheme are utilized for the development of such assets.
  - AMC shall ensure that a real estate valuer certifies compliance on an annual basis.
  - AMC shall ensure that no real estate valuer continues with the valuation of particular real estate asset for more than two years and that no such valuer values the same asset for a period of at least three years thereafter.
  - AMC shall record in writing the details of its decision making process for buying or selling real estate assets together with the justifications for such decisions and forward the same to its trustees periodically.
  - AMC shall ensure that investments of funds of the real estate mutual fund scheme are not made contrary to the provisions of this chapter and the trust deed.
- in real estate assets on a continuous basis.
  - The trustees shall monitor whether due diligence is exercised by the asset management company in managing investments.
  - The trustees shall review the market price of the units during the year and shall recommend proportionate buy back of units from unit holders, if the units are traded at steep discount to the net asset value.
  - The magnitude of discount shall be disclosed in the offer document.
  - The trustees shall ensure that only permissible investments are made by the asset management company.
  - The trustees shall ensure that all financial transactions of the real estate mutual fund scheme are made only through banking channels and that systems are in place to exclude cash and unaccounted transactions.
  - The trustees shall lay down the required criteria for empanelment of real estate brokers.
  - The trustees shall lay down the broad procedure for the asset management company for transacting real estate assets
  - The trustees shall require the asset management company to set up such systems and submit such reports to trustees as may be necessary for them to effectively monitor the performance and functioning of the real estate mutual fund schemes.
  - The trustees shall include a confirmation on compliance in their half yearly reports made to the Board.

## Usage of Real Estate Assets of a Real Estate Mutual Fund Scheme

The AMC may let out or lease out the real estate assets held by the scheme if the term of such leasing or letting does not extend beyond the period of maturity of the scheme.

Where real estate assets are let out or leased out, the AMC shall diligently collect the rents or other income in a timely manner.

Real estate assets held by a scheme may be let out to the sponsor, AMC or any of their associates, at market price or on commercial terms, provided that not more than 25% of the total rental income of the scheme shall be derived from assets so let out.

## Duties of Trustees

- The trustees shall ensure that the asset management company has the necessary expertise, internal control systems and risk management mechanism to invest and manage investments

## Conclusion

The REMFs once introduced in the country are expected to bring in more liquidity and heighten the organization level of the emerging real estate market in India. REMFs are to be introduced in India following their success stories in some major economies like US, the UK, Japan, South Korea, Singapore, and Hong Kong. These shall lessen the tax burden on entities by exempting corporate and capital gains tax. □

# THE FINANCE LINKAGE OF SUPPLY CHAIN MANAGEMENT

There's a positive correlation between supply chain execution and financial performance. Making that linkage has proved to be challenge for the practitioners all over the world. This article offers a practical way to successfully accomplish this task. The article explores that critical link between supply chain performance and business performance and demonstrates how supply chain metrics can be coordinated and linked to corporate financial metrics. There is a clear and direct link between how effectively supply chain activities are executed and how well the business performs.

The concept of the supply chain, with its emphasis on linkages among all of the value-adding activities in the chain, emerged in the early 1980s when U.S. and Japanese manufacturing firms began adopting the just-in-time concept. Many company leaders still have a traditional vision of supply chain and do not always realize the opportunities that the different actions of the Supply Chain could bring to the bottom line of their company. But business executives have started exploring that effective supply chain management (SCM) can help boost a firm's performance. In particular, they have recognized that SCM can pro-

vide a distinctive and sustainable competitive advantage and improved profitability on the four dimensions of competitiveness—cost, quality, response time, and flexibility (Presutti and Mawhinney, 2007). The term *supply chain management (SCM)* was coined by consultant Keith Oliver, of strategy consulting firm 'Booz Allen Hamilton' in 1982. SCM being a relatively new term crystallizes concepts about integrated business planning that have been espoused by logistics experts, strategists, and operations research practitioners as far back as the 1950s (Shapiro, 2002). According to the Council of Supply Chain Management Professionals (CSCMP), SCM "encompasses the planning and management



— Dr. Ashwani Kumar

(The author is Director GNA Institute of Management and Technology Phagwara. He can be reached at [marshallgoldsmith@rediff.com](mailto:marshallgoldsmith@rediff.com))

The supply chain process plays a critical role in determining the level of profitability on a company. The more efficient and productive the supply chain process is, the greater the profitability of the company. Conversely, the less efficient and less productive, the higher the supply chain costs and lower the profitability. Supply chain management (SCM) has the potential to improve the three key drivers of financial performance – growth, profitability, and capital utilization.

*of all activities in sourcing and procurement, conversion, and all logistics management activities. Importantly, it also includes coordination and collaboration with channel partners, which can be suppliers, intermediaries, third-party service providers and customers. In essence, SCM integrates supply and demand management within and across companies.”*

### **Brief Literature Review**

Over the past few years, researchers have attempted to show the impact of supply chain management on corporate financial performance.

Timme and Timme (2000), Roberts (2002) and Ellram and Baohong (2002) have described the financial supply chain and the impact of effective supply management on a firm's cash flows. Vickery *et al.* (2004) have considered the impact of just-in-time operations on financial performance, the relationship between total quality management practices and business performance, and the effect of supply chain disruptions on wealth. According to them, "...any management actions must have an impact on key customer service dimensions, and it is this enhanced customer service that then engenders financial performance. Managers should not expect supply chain integration to directly impact firm financial performance."

Robert Colman (2004) in a major study by Deloitte Consulting of 600 companies in 22 countries concluded that the most effective firms have adopted a process view of their supply chains, rather than a functional view. The Deloitte study found that end-to-end approach enabled them to optimize the supply chain process across the entire organization and generate significant profit and returns. In other words, effective supply chain integration has a significant impact on financial performance. Another significant study undertaken by Andraski and Jack (2003), explored the financial benefits of collaborative planning, forecasting, and replenishment (CPFR) for several companies, including Procter & Gamble, Wal-Mart, Sara Lee, and Nabisco. The study found that sales increased 12 per cent on average from lower stock-out losses, improved promotional planning, and increased service

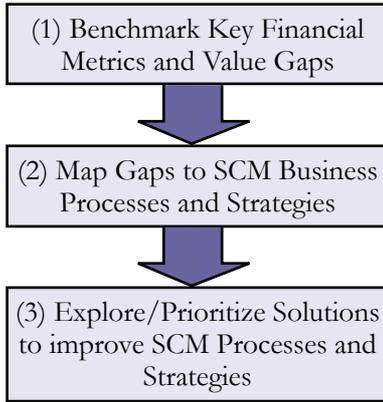
levels. Inventory and related expenses decreased 20 to 40 per cent as a result of lower safety stock because of greater confidence in the forecasting and planning process, and there was a 3.5 to 7.5 per cent decrease in production capital requirements as a result of better scheduling.

According to Coyle *et al.* (2003) "the supply chain process plays a critical role in determining the level of profitability on a company. The more efficient and productive the supply chain process is, the greater the profitability of the company. Conversely, the less efficient and less productive, the higher the supply chain costs and lower the profitability. Supply chain management (SCM) has the potential to improve the three key drivers of financial performance – growth, profitability, and capital utilization. Despite SCM's potential, relatively few companies utilize SCM as a tool to drive financial performance (Timme and Timme, 2000). Failure to make the financial-SCM connection is driven by several factors. Firstly, many executives continue to view SCM merely as a tactical back-room cost-center activity. Therefore, consequently, they fail to fully recognize SCM's tactical and strategic use for managing financial performance (Bob Carbo, 2002). It needs top-down organizational alignment to achieve best SCM performance. Secondly, most SCM professionals are not conversant with the language of finance. Hence, they lack the ability to link SCM to key financial metrics and to understand coherently how SCM drives financial performance. Thirdly, SCM drives performance throughout the organization. Therefore, SCM strategic and tactical decisions cannot be made in a vacuum. Yet most SCM scorecards and analyses initiatives are incomplete, as they are not from an enterprise-wide perspective. Decisions on items such as modes of transportation, sourcing, and replenishment are often based solely on operating expenses – and many times not even total SCM operating expenses – and omit the impact on inventory, warehousing requirements, and possible stock-out losses. If an enterprise-wide perspective is not adopted, the real value of SCM will not be achieved (Timme and Timme, 2003).

## Making a Financial-SCM Connection

According to Randy Meyers (1997), the top-down organizational alignment approach comprises three steps:

**Figure 1: Top-Down Approach to Making Financial SCM Connection**



### Step 1: Calculate Value of Gaps in Key Financial Metrics

SCM enables key financial metrics such as inventory days, percentage cost of goods sold, and revenue growth. The values of the gaps may be based on historical performance, benchmarks from competitors and industry aggregates. These value gaps can be measured using a variety of value-based financial measures such as free cash flow, economic profit, and stock price and become effective means to communicate to the organization the need for change and the potential value of improved SCM.

### Step 2: Link Gaps in Financial Metrics to SCM Business Processes and Strategies

Gaps in financial metrics are driven by unique company factors such as sales mix, pricing strategies, and outsourcing. The next step in the top-down approach is to link gaps in financial metrics to SCM-related business processes and strategies. A gap in profitability related to percentage cost of goods sold, for example, can be mapped to an SCM-related process such as distribution and logistics, which, in turn, is linked to a key activity such as warehouse management. Warehouse management is related to tasks such as receiving, put-away, pick, pack, and ship, and to key performance indicators (KPIs) such as labor costs, average time per pick, and pick accuracy. This mapping provides a better understanding of the cause-and-effect relationships between SCM business activities and financial performance.

### Step 3: Map SCM Initiatives to Financial Performance Gaps

The information provided in previous steps is used as the basis for exploring solutions that optimize the SCM-related business processes and strategies. The potential gaps in SCM-related business processes and strategies may be:

- Forecasting
- Demand planning
- Procurement
- Production planning
- Order fulfillment
- Distribution and logistics

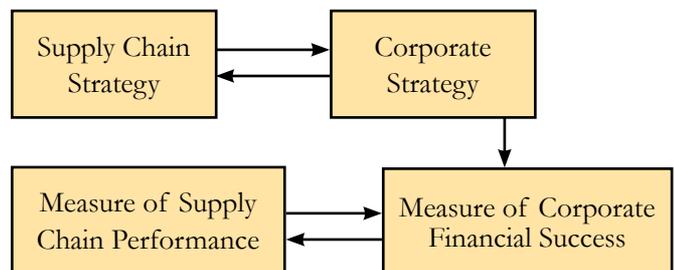
These gaps are used to explore SCM solutions such as:

- Collaborative planning, forecasting and replenishment (CPFR)
- Strategic network optimization
- E-procurement
- Advanced planning
- Vendor-managed inventory and
- Strategic outsourcing

This provides a logical approach for identifying specific areas of opportunity, estimating the monetary benefits and understanding the critical success factors and risks of SCM solutions. Though financial performance gaps cannot be completely eliminated through improvements in SCM business processes and strategies yet it can make a significant contribution for many companies.

To measure the impact of supply chain activities on business performance, a clear-cut alignment between business strategy and supply chain strategy is needed (Figure 2). Business executives need to understand the relationship between the firm's operational metrics with the financial performance metrics. The goal of supply chain strategy is to strike a balance between efficiency and responsiveness that result in strategic fit with the competitive strategy.

**Figure 2: Relationship Matrices**



Another component of SCM used by firms to optimize profits is revenue management. Revenue management (RM) uses differential pricing to better match supply and demand and increase supply chain profits. Traditionally, firms have changed the availability of

assets to match supply and demand. RM aims to reduce supply/demand imbalance by using pricing as a lever. A big advantage of using revenue management is that a change in pricing is much easier to reverse as compared an investment in supply chain assets. When used properly, revenue management increases firm profits while leaving valuable customers more satisfied through greater asset availability (Chopra and Meindl, 2003).

### The Supply Chain Financial Impact

One of the greatest challenges companies face today is delivering a competitive return to shareholders. Customer demands, competition, labor costs and operating environment volatility often drive down return on capital (ROC). This demands the generation of sufficient profits in relation to the size of the shareholders' investment to assure and sustain the investment in a company (Burt *et al.*, 2003). If the returns are too low, the stockholders engage themselves in personal arbitrage switchover to other companies, lowering the stock value and possibly the stage for financial disaster such as takeover or bankruptcy. The most popular tool for measuring overall supplies chain performance is the strategic profit model. The main advantage of

this model is that it aggregates many other measures into one common measure of return on assets (ROA). ROA indicates how well each part of the supply chain, and the entire supply chain itself is using its resources. A company's ROA is a financial performance metric that is used as a benchmark to compare management and company performance to that of other companies. This model indicates the relationships among various measures. It also indicates the supply chain effectiveness, supply chain efficiency, and asset deployment and utilization. The supply chain process plays a significant role in determining the level of profitability in a company. An efficient and productive supply chain is the source of greater profitability of the company. The strategic profit model shown in figure indicates the financial relationship between supply chain management and ROA. The supply chain effectiveness impacts the sales level and the supply chain efficiency affects the total cost of the company. The level of inventory held throughout the internal supply chain determines the assets held for inventory. The order processing time and the lead time affects the average collection period from debtors and cash assets. Finally, the supply chain decisions regarding distribution and logistics impact fixed assets.

**Figure 3: Return on Assets**

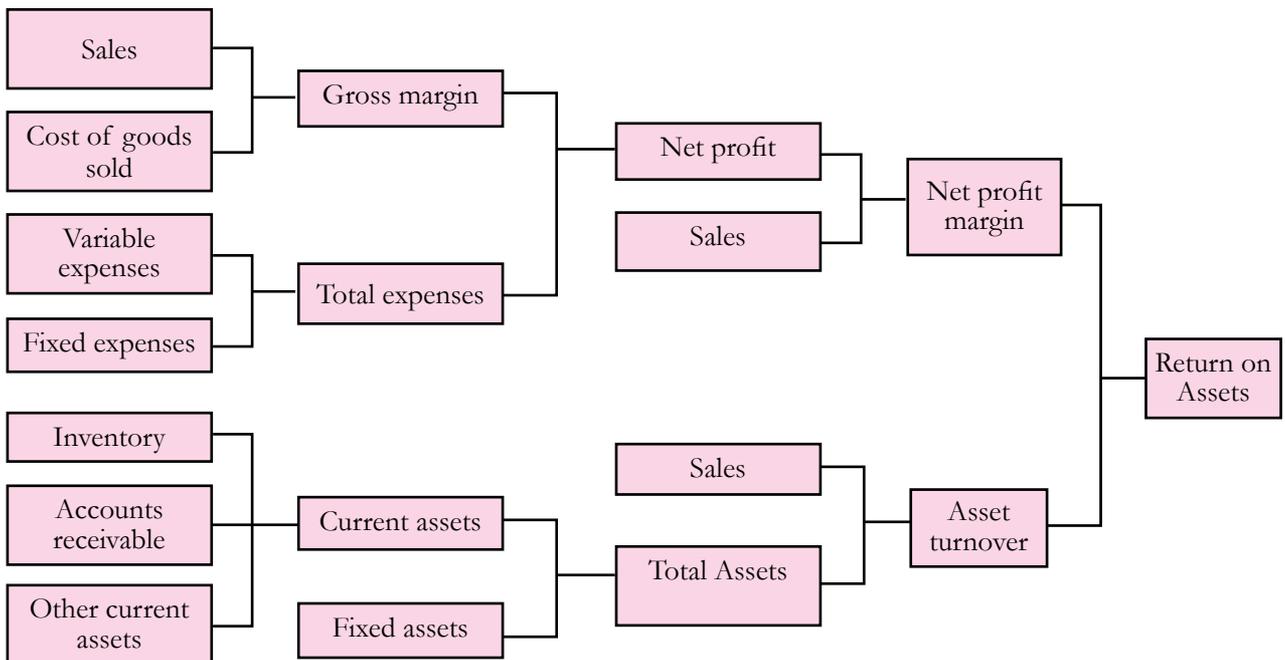
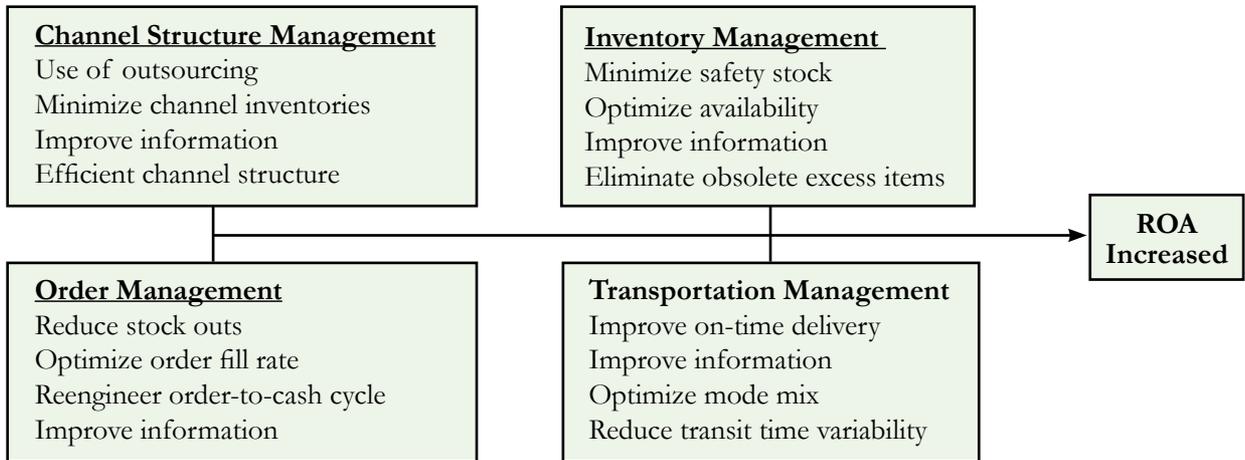


Figure 3 shows the calculation of ROA as the division of net profit margin by the asset turnover. Higher the net profit margin for a given level of asset turnover, higher the ROA. Alternatively, the lower the asset turnover for a given level of net profit margin, the

higher the ROA. Figure 4 shows the supply chain strategic areas affecting return on assets. The decisions regarding channel structure management, order management, inventory management, and logistics management jointly affect the level of assets employed or the level of profitability.

**Figure 4: Supply Chain Decisions and ROA**



(Source: Coyle et al., 2003)

*Channel structure management* is the key enabler of increased ROA through the use of outsourcing, channel inventories, information systems and efficient channel structure. Outsourcing induces lower supply chain costs; reduction in assets and increased sales thereby increasing ROA. *Inventory management decisions* that reduce inventory and optimize inventory location reduce the investment in the inventory asset. Such decisions require analysis of sales data and inventory levels by location readily available by information system. *Effective order management* besides reducing supply chain costs increases sales. Reduction in stockouts implies sufficient inventory available to meet demand and make the sale. Optimizing the order fill rate implies a reduction in order processing time and reduces the average collection period from debtors. Reduction in order processing time along with reduction in credit period to customers, reduce accounts payable and the cost of capital required to fund accounts payable. All such reductions in time prove helpful in improving ROA. Finally, by lowering transit time through *effective transport management*, a seller can differentiate its product by lowering the buyer’s inventory and stockout costs. This differentiation produces potential for increased sales and increased profits. Modal mix optimization lowers the transportation cost by utilizing a lower cost method of transportation that does not increase costs above the savings.

### Key Performance Drivers and Their Outcomes

Balanced scorecard (BSC) developed by Kaplan and Norton (1996) is another linkage approach incorporating EVA and the SCOR model. This tool identi-

fies “performance drivers” and “outcomes measures.” The elements of the SCOR model are important supply chain-related performance drivers, while the corporate performance metrics represent important outcomes. Understanding the link between performance objectives and outcomes measures is fundamental to achieving improved financial performance.

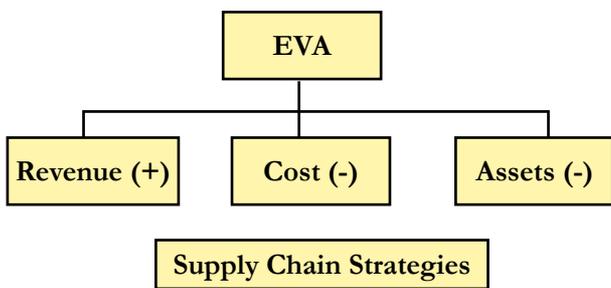
BSC is an instrument to measure the performance of the overall supply chain to meet the requirements of end customer. It not only operates at different levels but also integrates the different levels to meet the objectives of the supply chain. This approach incorporates both financial and operating performance measures to be used at all levels of the supply chain. At each level the BSC addresses four key performance areas: (1) financial, (2) customer, (3) business process, and (4) learning and growth. Within each of these areas, key objectives are identified that are driven by the objectives and strategies of the next higher level in the scorecard hierarchy; specific performance measures associated with the objectives, performance targets, and initiatives to achieve the targets are then developed.

### Economic Value Added

EVA, developed by Stern Stewart, is recognized as a comprehensive measure of value creation. It is concerned with implementing a new framework for decision-making rather than questioning existing strategies or formulating new ones ([www.sternstewart.com](http://www.sternstewart.com)). EVA as a financial performance measure comes closer than any other to capture the true economic profit of an enterprise (Prober, 2000). Put most simply, EVA is net operating profit minus an appropriate charge for the opportunity cost of all capital invested in an enterprise. *As such, EVA is an*

estimate of true "economic" profit, or the amount by which earnings exceed or fall short of the required minimum rate of return that, shareholders and lenders could get by investing in other securities of comparable risk. According to William and John (2007), revenue, costs, and assets have been recognized as true drivers of EVA (Figure 5). By understanding the EVA drivers, managers become more aware of the impact of innovation, cost reductions, technology improvements, and capital base reductions on value creation. As such, the EVA drivers align nicely with the performance drivers in the supply chain.

**Figure 5: EVA Components and the Supply Chain**



An EVA orientation forces a firm to define its supply chain broadly. It is also a method of changing corporate priorities and behavior throughout a company, right down to the shop floor. EVA not only includes the traditional activities of the supply chain like purchasing and inventory management with their impact on costs and assets, but also upstream activities like product design that may impact EVA's revenue element. A major study undertaken by Aberdeen Group (2001) found that integrating the firm's product development efforts with a supplier's engineering department through e-design technology may reduce time-to-market cycles by 10-15 per cent. This real-time collaboration contributed to cost reductions by minimizing redesign time and uncovering opportunities for standardization. Since responsiveness of a supply chain and cost control are key factors in market success, effective supply chain management on the upstream side of the chain may increase a firm's revenue through larger market share while lowering costs. The profitability and value creation elements in the supply chain are generally under the firm's control. Better management of the supply chain has a major impact on revenue growth, cost reduction, and asset turnover. The cost of capital however is determined by outside forces and management has little control over this. Therefore, an efficient and effective management of its supply chain is one of the keys to boost EVA.

### The SCOR Model

SCOR model developed by Supply Chain Council, has emerged as the most popular methodology for benchmarking and measuring improvements in supply chain performance. The SCOR model is used as a tool to demonstrate the relationship between SCM and overall financial performance. The model identifies the need for corporate level objectives, strategies, and business plans as the starting point for identifying best practices, processes, concepts and tools. It is a framework to help companies move towards agility with the help of performance metrics. Table 1 contains the Level 1 strategic supply chain performance metrics. These metrics contain performance attributes that have a direct impact on the internal facing as well as the downstream portion of the supply chain. For example, supply chain objective consistent with customer needs is "perfect order fulfillment" based on reliability in delivery performance, on-time delivery and orders shipped to schedule. High performance here can help the firm establish a sustainable competitive advantage leading to increases in revenue through capturing greater market share. This activity will have a positive impact on the revenue component of EVA. Similarly the internal-facing Level 1 metrics impact the cost and assets components of EVA.

The following are the performance attributes as per Level 1:

1. Supply chain delivery reliability
2. Supply chain responsiveness
3. Supply chain flexibility
4. Supply chain costs and supply chain asset management efficiency.

**Table 1: SCORcard Performance Metrics**

SCOR Level 1 - Strategic Supply Chain Metrics	Performance Attributes					
	Customer-Facing			Internal-Facing		
	Reliability	Responsiveness	Flexibility	Cost	Assets	
Perfect Order Fulfillment	●					Revenue
Order Fulfillment Cycle Time		●				
Upside Supply - Chain Flexibility			●			
Upside Supply - Chain Adaptability			●			Cost
Downside Supply - Chain Adaptability			●			
Supply Chain Management Cost				●		Assets
Cost of Goods Sold				●		
Cash-to-Cash Cycle Time					●	
Return on Supply Chain Fixed Assets					●	
Return on Working Capital					●	

(Source: Supply Chain Council)

SCOR Level 2 defines 26 core process categories that are possible components of a supply chain. These processes can be used by organizations to configure

or re-configure their actual or ideal operations. A company may have a different supply chain for each product. The first step is to create a physical layout of the supply chain and then choose the relevant SCOR Level 2 process elements. At this step a company knows about the information inputs required and the outputs expected. Along with the process elements other factors like performance attributes in cycle time, cost, service/quality and assets, the metrics associated with each of the performance attributes, the best practices in the industry also have to be considered (Altekar, 2005).

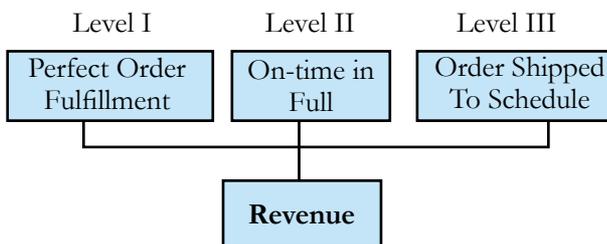
### Linkages in Action

A linkage may be established to support an overall corporate financial metric (EVA) by leveraging the SCOR supply chain metrics. While using economic value-added as the measure of overall financial performance, the nodes that the SCOR model process provides for linking the supply chain metrics to corporate financial goals, may be identified. The focus is on the components of EVA typically under a firm's control — revenue, costs, and assets.

### The Revenue Component

Starting with the development of the SCM objectives and strategies, Figure 6 shows the relationship between the SCOR model metrics and the revenue component of EVA of a company.

**Figure 6: Revenue Component of EVA**



Improved customer satisfaction is one of the strategies for increasing revenue and the SCOR model provides the process to prioritize and select the most significant supply chain support strategies and performance indicators to achieve this goal. For example, one of the SCOR model's key attributes is "perfect order fulfillment". Perfect order fulfillment and "on-time, in full," are critical metrics in industries operating in a just-in-time environment. The number of processes that support on-time, in full can prove to be significant. SCOR Level 3 provides the information required for successfully planning and setting goals for supply chain improvements. It outlines the decomposition process to ensure that the efforts of

those who impact the Level 1 perfect order fulfillment goal are properly focused. In these cases, one of the Level 3 performance indicators chosen is "orders shipped to schedule," an important component of the perfect order.

Goal setting at each of the levels in the SCOR model plays a major role in establishing the level of effort and creativity required to achieve the goal through continuous process improvement initiatives. The performance attributes and associated level 3 metrics are shown below.

**Table 2: Performance Attributes and Associated Level 3 Metrics**

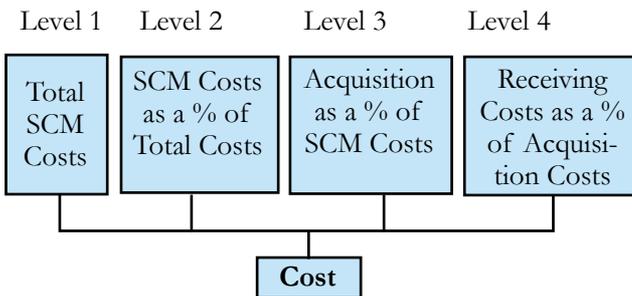
Performance Attribute	Metric
• Reliability	% schedules generated and changed within supplier lead time
• Responsiveness	Average release cycle of changes
• Flexibility	Average days per schedule change
	Average days per engineering change
• Cost	Product management & planning costs as a per cent of product acquisition cost
• Assets	Return on Supply Chain Assets

### The Cost Component

Figure 5 shows the further linkage of SCOR model process to metrics in support of the cost component of EVA. In the example, the SCOR model identifies Total Supply Chain Management Costs as the Level 1 objective with supporting metrics in Levels 2-4. The total "Supply Chain Strategic Cost Management" objective based on the structured approach to cost reduction is the sum of the costs of a number of significant functional operations. This approach varies according to the stage of the product life cycle. With this reason, organizations have begun to consider cost reduction initiatives that include both upstream and downstream members of their supply chains. The concept of total cost of ownership has become the right choice of SCM managers. It requires an organization to identify and measure costs beyond the standard unit price, transportation and tooling while evaluating supply chain performance. The main focus of supply chain management is to reduce total supply chain management costs. There is great leverage associated with this metric because a rupee saved on transaction costs is an additional rupee contribution

to profit-boosting EVA. The decomposition to Levels 3 and 4 isolates supply management-related activities that are not included in the actual expenditures for goods and services. The example shows product acquisition costs as a Level 3 metric. Those costs may include salaries for all those involved in the purchasing process and other transaction costs. For example, one of those costs relates to the receiving activities, a component of acquisition costs. This is a Level 4 metric in the model. The goal is to focus on those factors that will most effectively support the improvement in the EVA cost element.

**Figure 7: Cost Component of EVA**



**The Asset Component**

One of the model’s key performance attributes is to provide just the right amount of assets to meet requirements. A number of factors such as capital utilization, cash velocity, inventory turns, and cycle time reduction have been discovered affecting the level of assets employed by a firm to deliver value to the market. A right balance of assets improves the “cash-to-cash cycle time” metric of the model. To have a positive impact on EVA, the firm needs to minimize the asset levels used to deliver that value.

The planning level of the SCOR model focuses on identifying a balance of supply chain resources necessary to meet supply chain requirements.

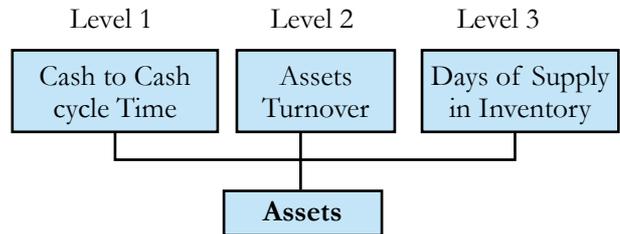
Figure 7 identifies cash-to-cash cycle time as a Level 1 metric. It denotes the length of the time taken to convert cash outflows for raw materials, labour etc. into cash inflows. It is calculated as follows:

$$\begin{aligned}
 \text{Cash-to-cash cycle time} = & \text{Avg. days of Inventory} + \\
 & \text{Avg. days of sales} \\
 & \text{outstanding} \\
 & - \text{Average payment period for material}
 \end{aligned}$$

Cash-to-cash cycle time is directly impacted by asset turnover (for example, raw material inventory) at Level 2, which itself is impacted by the days of supply in inventory at Level 3. Management wanting to improve EVA through the asset component can use the

cash-to-cash cycle time metric to focus attention on asset turnover by setting objectives for days of supply in inventory. An inventory reduction helps in increasing turnover at a consistent level of sales.

**Figure 7: Asset Component of EVA**



Ultimately, these actions are reflected in a reduction in cash-to-cash cycle time. Finally, the asset component of EVA is reduced assuming no offsetting increases in asset levels. Thus, like the first two EVA components, the asset component is clearly linked to the overall measure of corporate financial performance. The benefits of the hierarchical mapping process described for the revenue, cost, and asset components of EVA are significant. The process helps to tie the goals and strategies at the operational level to a measure of overall organizational performance that demonstrates the impact on shareholder value. The SCOR model provides the hierarchical framework.

The overall performance measure of EVA provides the link to shareholder value. An attempt has been made to demonstrate the link between the SCOR model performance attributes and metrics and overall corporate performance something that the model itself does not do. The modern globalized businesses are experimenting with Balance Score Card (BSC), SCOR Model and EVA for establishing financial linkages of supply chain management.

**Conclusion**

Organizations can take several important steps to help establish the link between effective supply chain management and improved financial performance. Top management along with supply chain professionals must commit to developing an understanding of how supply chain performance can impact financial performance. Everyone responsible for managing supply chain activities must be aware of the financial performance metrics so that decisions made at the operational level are linked to financial outcomes. The present article is an attempt in this direction. The SCOR model construct has been used to identify key supply chain metrics that link directly to the three key elements of EVA—revenue, costs, and assets. □

## RESERVATIONS ON REVERSE MORTGAGE



In the normal mortgage finance, when a borrower repays a loan, the loan component decreases with a simultaneous increase in the equity portion, during the tenure of loan. As against this traditional method of financing against mortgage, in reverse mortgage, the mortgagor can get lump sum or partial sum with annuity mechanism for a specified period. The article broadly delves into this emerging concept in India.



There has been a significant increase in the longevity of human life the world over. In India, the population of senior citizens is nearly 7.5 cr to 8 cr; most of them have to encounter many kinds of difficulties because of insufficient financial resources. In particular, the cost of good health care, which is an essential component of their expenses, is spiraling and they find it difficult to cope with it. Their problems are compounded by the fact that India lacks a properly set up social security system for its people.

The main anxiety of retired people centres on how to maintain their standard of living and life style with lower monthly pay packets. They need adequate cash flow stream to supplement their pension or interest on deposits or other sources of income to meet their financial needs.



— CA. R.S. Raghavan

(The author is a member of the Institute. He can be reached at [rsraghavan007@yahoo.co.in](mailto:rsraghavan007@yahoo.co.in))

When a person retires, usually a house owned by him is his sole solid security, with a lot of sentimental and emotional attachment to it. In the Indian tradition, normally younger generation takes care of the needs of their parents, though

As the reverse mortgage loan is a new concept in India, the associated issues on taxation are not yet fully settled, and are still being debated by the authorities concerned. Being a capital receipt arising out of a capital asset, payment is exempted from income tax.

one can find exceptions to it, as the joint family system has given way to nuclear families.

Despite the polluted environment and artificial as well as organic growth process of vegetables and fruits, chances of a person being healthy in the advanced age are quite less. However, with the advancement of medical sciences, one can prolong the life expectancy up to 75 or 80 years, even enduring with some sort of ailment, disorder, etc. But this involves cost and money, which is hard in the post retirement era. In this scenario, a win-win situation can be thought of provided the house property is leveraged to the advantage of the owner. If a house is fully owned by a retiree, then the free hold property can be used as a reservoir of fund through "Reverse Mortgage". The cash-starved senior citizen should obviously be permitted to enjoy fruits of his labour put in during his prime time, by encashment of the additional value created in the immovable property, at least during his older days, in which it may not be possible for him to be very productive.

### What is Reverse Mortgage?

In the normal mortgage finance, when a borrower repays a loan, the loan component decreases with a simultaneous increase in the equity portion, during the tenure of loan. As against this traditional method of financing against mortgage, in reverse mortgage, the mortgagor can get lump sum or partial sum with annuity mechanism for a specified period.

The lender makes a periodical or regular payment, inclusive of lump sum amount if so desired, to the property owner; thus the flow of fund is reversed. As time passes, the equity portion reduces because the loan component increases with future cash flows, thereby slowly and steadily extinguishing the equity portion of a customer to nil.

In the traditional mortgage, if a party buys a property for Rs 10.00 lakhs, the borrower is required to bring in his margin of Rs 2.50 lakhs (equity) and with the borrowed sum of Rs 7.50 lakhs (loan), the property is purchased. As the borrower commences to repay the loan with interest, the loan portion comes down gradually, thereby increasing the equity portion of the

party on the assumption that the property value does not come down. Once the loan is closed, the liability to the lender is extinguished and the borrower exclusively owns the property without any encumbrances.

Extending the same analogy, in the reverse mortgage, in respect of a marketable property, say of the value of Rs 10.00 lakhs, if a borrower aged above 60 years wants some cash flow out of it, he can subject the property owned by him to reverse mortgage and avail some loan, say Rs 5.00 lakhs at one go or by way of annuity through periodical installments on monthly or quarterly basis. As the owner/borrower is not required to repay the loan amount, due to application of interest over a period of time, the loan component would increase, thereby reducing his equity portion in the property. At the end of the agreed period or at the time of the demise of the borrower/owner or vacation of the premises permanently, the lender can subject the property for sale, realize the proceeds, appropriate the dues outstanding and return the balance to the owner/legal heir, as the case may be. Lenders may also stipulate that the Equity to Value Ratio (EVR) should not normally come down below 10%.

### Salient Features

Some of the salient features of the innovative scheme, prevalent in western countries and gaining prominence now in India, are detailed below:

1. Without losing ownership but simultaneously enjoying the right of possession, the house is mortgaged to the lender, viz. a Housing Finance Company or a bank, in return for a lump sum amount or annuity mode of cash inflow or a combination of both for a specified period of 10, 15, or 20 years.
2. The residual life of the property should be more than the tenure of the loan at least by five years and the age of the borrower should be above 60 years.
3. The borrower should be the owner of the residential property with clear and marketable title deeds. As long as the property in question has a good marketable title and is in good condition, the lender need not look for credit worthiness, re-

Indian law makes it mandatory for children and relatives to take care of parents in their old age. Under this law, Maintenance Tribunals would soon be set up for making a demand on the legal heirs of senior citizens to pay a certain sum, say Rs. 10,000 or so per month for their maintenance.

paying capacity, etc as there is no servicing of the loan, and the loan is self liquidating in nature.

4. After availing the loan, during the passage of time, the equity portion comes down and loan component increases due to application of interest.
5. Depending on the age profile of the owner of the house, some percentage of the value of the property can be availed as loan, as follows.

Age Profile	Eligible amount as a percentage on the value of the property
60 – 65	40 %
66 – 70	50 %
71 – 75	55 %
Above 75	60 %

6. The lender has a safety net in the sense that the amount lent is lower than the market value, which would be on the rise in future.
7. On the borrower vacating / leaving the property once for all, caused by death or otherwise, subject to covenant and the spouse occupying the house, the property is sold with the loan with its interest component. If there is a residual amount, it is given to the legal heirs of the owner / lender.
8. The borrower or legal heir can pay the outstanding dues to the lending institution without selling the house at any point of time, as provided in the covenant between the lender and borrower / owner.
9. Spouse can be taken as a co-obligent, if the borrower so desires. This would help in continuance of the reverse mortgage loan arrangement after the death of the borrower, subject to the spouse satisfying other covenants in the loan agreement.
10. Commercial property is not eligible for the Reverse Mortgage Loan. In addition, use of the facility for speculative, unlawful trading and business purposes is not permitted. In this regard, end use of the loan proceeds should be ensured by the lender. The loan proceeds can be utilized by the owner/borrower for any lawful purposes, such as paying medical expenses, repairing property, settling any institutional dues, or supplementing the post-retirement income.
11. The loan can be closed through pre-payment without attracting any penalty / charges.
12. There is a mechanism for revaluation of the property after five-year intervals and re-setting the loan amount being paid periodically.
13. As the borrower will remain the owner of the property, he/she is required to pay tax, insurance premium and maintain the property in good condition.
14. The loan shall become due and payable only when the last surviving borrower dies or sells the property or permanently moves out of the house (for more than one year)
15. The National Housing Bank, the apex body on the subject matter of residential property loan matters, seeks to refinance the banks or financial institutions to extend reverse mortgage loan to senior citizens.
16. As a social comfort to the senior citizens, the N H B also provides guarantee to senior citizen borrowers towards the obligations of the lenders to make regular payments over the agreed period in the loan arrangement.
17. The borrower or legal heirs shall be given the first right to settle the loan outstanding with up-to-date interest, without resorting to sale of the property in question.
18. All reverse mortgage loan products may carry a clear and transparent “no negative equity” or “non-recourse” guarantee. That is, the borrowers will never owe more than the net realizable value of the property, provided the covenants of the loan have been met.

### Tax Angle

As the reverse mortgage loan is a new concept in India, the associated issues on taxation are not yet fully settled, and are still being debated by the authorities

The Reverse Mortgage Loan can be considered a partial substitute for a Social Security Scheme for senior citizens owning unencumbered immovable property. Since they are not required to repay the loan during their life time or the tenure of the loan, there is no requirement for income proof to qualify for the facility.

concerned. Being a capital receipt arising out of a capital asset, payment is exempted from income tax. The sale of the property attracts the related capital gains tax. However, the element of profit embedded in the financial deal cannot be ignored. The borrower is not said to be in receipt of any sort of income, as one of the condition for the facility is that the owner / borrower should necessarily stay in the house. But in case the owner incurs any sort of expenditure on repair or upkeep of the property, the same is eligible for reduction in the computation of income under the Income Tax act.

In terms of section 47 of the Income Tax Act 1961, amended through the Budget for the financial year 2008-09, Reverse Mortgage scheme has been included in the category of exempted transactions, such as gift, inheritance, etc of a capital asset. This implies that no capital tax will be imposed on the reverse mortgage transaction. Moreover, the amount received as loan either in lump sum or in installments in a transaction of reverse mortgage will not be chargeable to tax.

On the demise of the owner/borrower, the legal heir may clear the loan by selling the property. This should be considered as the cost of property for the legal heir. Taxation for the lender should also be settled in an equitable manner. There are certain grey areas in the whole deal as far as taxation is concerned.

## Other Issues

The Reverse Mortgage Loan scheme throws up some other issues, which need to be clearly understood before formulating the scheme. These are detailed below:

- a. After closure of the first reverse mortgage loan, can the owner/borrower, if he is found to be of sound health, be given a second reverse mortgage loan?
- b. If a borrower owns more than one house, can a second mortgage loan on a different property be considered for him/her?
- c. Can a second mortgage loan by a legal heir, who is above 60 years, be considered?
- d. Should there be any stipulation for the maximum age of the property in question? (say the

age of property should not be over fifty years or so).

- e. As the period of loan is for a long term, there should be an interest re-set clause every three years on a mutually agreed terms depending in the prevailing and expected interest rate scenario.
- f. As both the lender and the owner of the property have insurable interest, joint meeting of the insurance charges should be specifically incorporated in the reverse mortgage agreement.
- g. There should be a clause in the covenants of the reverse mortgage agreement regarding the treatment to be meted out to the gifted / willed property (before the mortgage) and about gifting or giving through will property that is already reverse mortgaged, so that lenders' interest is protected in both cases.
- h. A force major clause should also be incorporated in the reverse mortgage agreement to take care of unforeseen situations arising from the acquiring of the property by the Government or through any operation of law.
- i. A properly worded foreclosure clause should be incorporated in the loan agreement.
- j. As the reverse mortgage scheme is a new concept. A clause may be incorporated to allow rescinding of the contract by either party, by mutual consent, during the operational period of the reverse mortgage scheme.
- k. Indians are generally sentimental and may be likely to leave property to their children as a mark of their love and affection for them. This has to be addressed in the reverse mortgage agreement, as no family would like to lose the property enjoyed by them during their lifetime, when the loan closure date comes up.

There is a need to have a model agreement of reverse mortgage, developed by the National Housing Bank, as it comes under its jurisdiction, or a reputed Housing Development Finance Company, so that it takes care of the interest of the borrower, lender and also the family members consisting of legal heirs, to avoid ambiguity and heartburns, particularly when the borrower is no more.

The scheme has the inbuilt social objective of helping the needy old age people and lessening their dependency on their children. But because of conventional thinking, it is yet to gain momentum, which is clear from the availment status and lukewarm response to it till now. Nevertheless, primary lending institutions, such as banks and housing finance companies offer Reverse Mortgage loans to needy people

All said and done, the Primary Lending Institutions, viz banks, housing finance companies, reserve their discretion to offer the Reverse Mortgage Loan, which is a new concept.

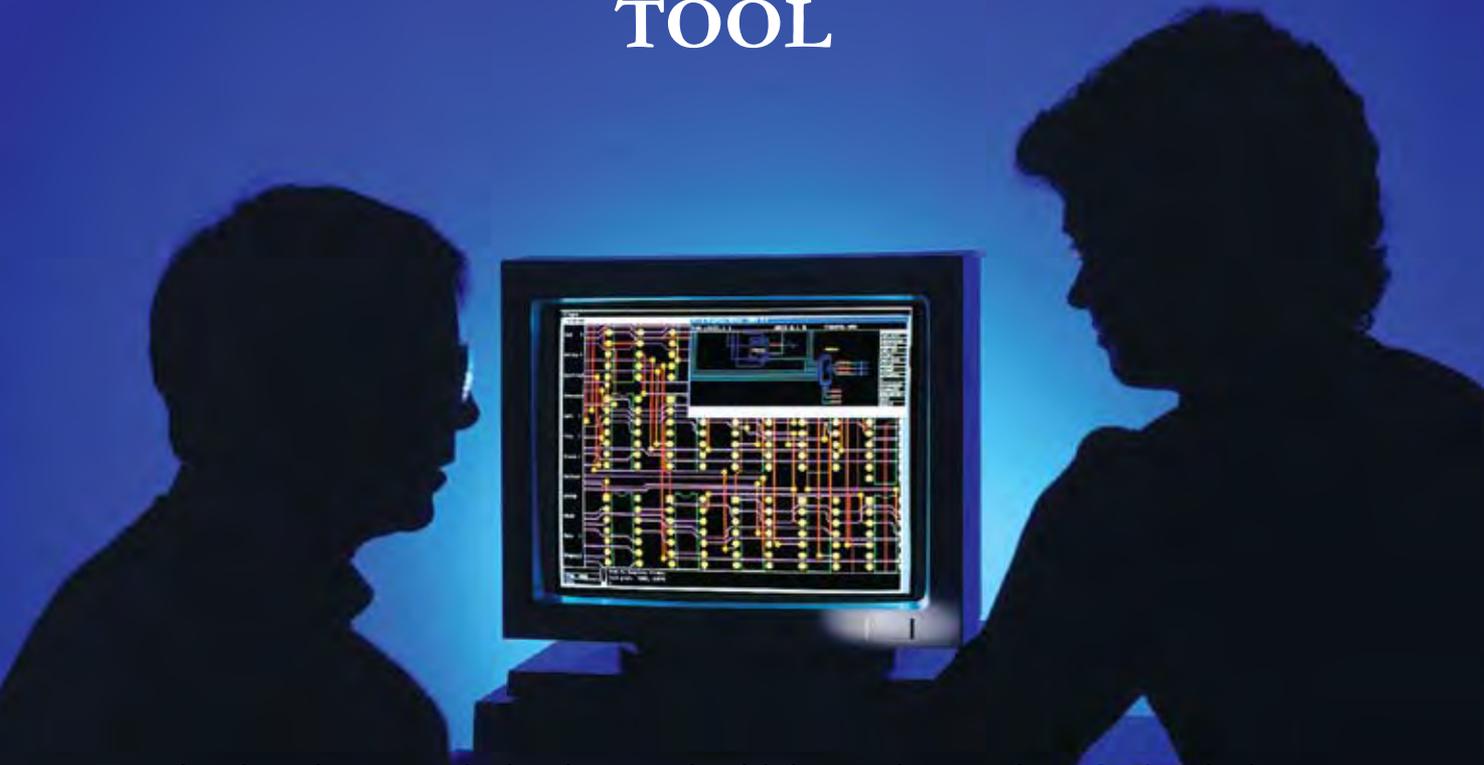
## Conclusion

The Reverse Mortgage Loan can be considered a partial substitute for a Social Security Scheme for senior citizens owning unencumbered immovable property. Since they are not required to repay the loan during their life time or the tenure of the loan, there is no requirement for income proof to qualify for the facility. The loan amount depends primarily on the age of the property owner, value of the property, and the prevailing interest rates.

Considering the traditional and conventional thinking of Indians with regard to taking care of elders in the family, the concept of Reverse Mortgage may not find many takers. Bankers too may feel wary about the implications of the recent law of "The Maintenance and Welfare of Parents and Senior citizens Act," which was passed in the parliament in late 2007. The law makes it mandatory for children and relatives to take care of parents in their old age. Under this law, Maintenance Tribunals would soon be set up for making a demand on the legal heirs of senior citizens to pay a certain sum, say Rs. 10,000 or so per month for their maintenance. There is a chance that the Maintenance and Welfare Law may dissuade some senior citizens from availing the Reverse Mortgage Loan facility. But with changing times, the idea of reverse mortgage is bound to catch on in our country.

The reverse mortgage concept has been introduced in India only recently and presently only few banks and financial institutions offer the Reverse Mortgage Loan Schemes. Many other lenders are still in the process of finalizing such schemes by ironing out some of the issues. As the concept is rather new, there will always be some grey areas to be sorted out and fine-tuned in the course of time. □

# AN INTRODUCTION TO EXCEL SOLVER – AN OPTIMIZATION TOOL



Excel solver is an optimization tool which can be used to find solution or make decision on real life business problems, where we want to arrive at decision either based on maximum or minimum value of something. For example profit, cost, return on investment etc. Using Excel Solver is easy and simple. It can be used to answer problems which otherwise seems difficult or time consuming. This article provides an insight into this tool.

**M**icrosoft Excel Solver is an optimisation tool, inbuilt provided into Excel. This tool can be used to solve practical business problems like ‘optimum product mix problems’, ‘transportation or distribu-



— CA. Liyakatali Lal

*(The author is a Member of the Institute. He can be reached at liyakatali\_lal@in.com)*

tion problems’, ‘capital Budgeting problems’, ‘financial planning problems’, ‘retirement planning problems’, and ‘workforce scheduling problems’. Using Excel Solver is easy and simple. It can be used to answer problems which otherwise seem difficult or time consuming.

See below listed illustrative problems:

A	Type of problem	Example
	Optimum product mix	How can a large FMCG company determine the monthly product mix at their Mumbai plant that maximizes their profit with use of limited resource?
B	Transportation or Distribution	If XYZ Textile Ltd produces textile at three different locations and distribute to four outlets, how can they minimize the cost of meeting demand for them?
C	Capital Budgeting (Selection of project)	Software Ltd would like to undertake 10 projects that will require capital and labour for the next few years. They do not have enough resources for all projects; which ones they should undertake?
D	Financial Planning	How should I allocate my investment portfolio among Govt. bond, blue chip stocks, speculative stocks and short term deposits?

In all the above situations, we want to find the “best” way to do something i.e. we want to either maximize or minimize values of certain cells in a worksheet to achieve our objective. Microsoft Office Excel Solver tool helps us answer all such optimization problems. The best way to understand how to use Solver is to look at some detailed examples

An optimization model has three parts: target cell, changing cells, and the constraints.

1. The target *cell* represents the objective or goal. We want to either minimize or maximize the amount in the target cell. In our examples

Example	Maximise or minimise	Target cell
FMCG Company – Product Mix	Maximise	Profit

XYZ Textile Ltd	Minimise	Distribution cost
Software Ltd – Project	Maximise	Net present value (NPV)
Investment planning	Maximise	Annual return

2. The changing *cell* represents cells that we can change or adjust to optimize the target cell. In our examples

Example	Changing cell
FMCG Company – Product Mix	Qty of each product produce during the month
XYZ Textile Ltd	Qty produce at each plant and shipped to each outlet
Software Ltd – Project	Which project to be selected
Investment planning	Amount of money invested in each asset class

3. The list of problem *Constraints* in our examples

Example	Changing cell
FMCG Company – Product Mix	Product mixes don't use more resource than available; Qty should not be more than demand.
XYZ Textile Ltd	Don't ship more than plant capacity; outlet receive Qty what they need
Software Ltd – Project	Projects can't use more capital and labour than available
Investment planning	Minimise risk and fixed % in speculation stock

To install Solver, click the Microsoft Office Button, click Excel Options, and click Add-Ins. In the Manage box at the bottom of the window, select Excel Add-ins, and click Go. Check the Solver Add-in in the Add-Ins box, and click OK. After Solver is installed, you can run Solver by clicking Solver in the Data tab. Figure 1 shows the Solver parameters dialog box.

Navigation to Excel Solver tool:

Excel2007: Office Button >> Excel Options >> Add-Ins >> In Manage box select Excel Add-Ins >>

Go >> Check Solver Add-in >> OK. After installation go to Data tab in ribbon >> Solver

Excel2003: Tool >> Add-Ins >> Check Solver Add-in >> OK. After installation Tool >> Solver

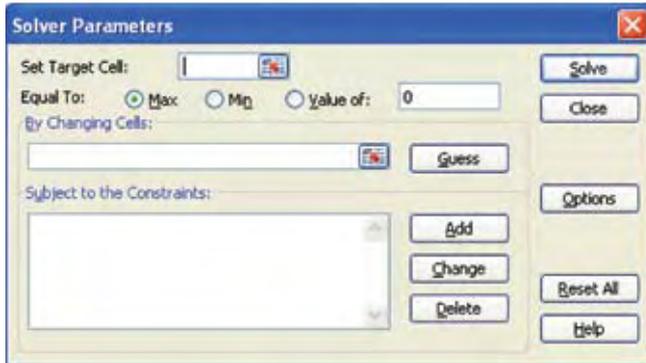


Figure 1 : Solver parameters dialog box

After we have input the target cell, changing cells, and constraints, what does Solver do? To understand this we need to know some background in Solver terminology. Any specification of the changing cells that satisfies the model's constraints is known as a feasible solution. In our example of FMCG company product mix that satisfies the following three conditions would be a feasible solution:

1. Does not use more raw material or labour than is available
2. Does not produce more of each product than is demanded
3. Does not produce a negative amount of any product

Essentially, Solver searches all feasible solutions and finds the one that has the "best" target cell value (the largest value for maximum optimization, the smallest for minimum optimization). Such a solution is called an optimal solution. Some Solver models have no optimal solution and some have a unique solution. Other Solver models have multiple (actually, an infinite number of) optimal solutions.

### A. Determine the Optimal Product Mix:

#### How can I determine the monthly product mix that maximizes profitability?

Companies often need to determine the Qty of each product to produce on a monthly basis. In its simplest form, the product mix problem involves how to determine the amount of each product that should be produced during a month to maximize profits. Product mix must usually adhere to the following constraints:

1. Product mix can't use more resources than are

available.

2. We can't produce more than its demand, because the excess production is wasted (for example, a perishable drug).

Let's solve the following example of the product mix problem. Say we work for a FMCG company that produces six different products at their plant. Production of each product requires.

	A	B	C	D	E	F	G
1	Product Name	P	Q	R	S	T	U
2							
3	Demand	1300	750	1250	980	1000	850
4	Qty Produce	150	160	170	180	190	200
5	Labour (Qty pu)	7	8	4.8	5.2	2.5	3.25
6	RM (Qty pu)	4.25	3.6	1.5	0.85	0.6	1.3
7	Sale price (pu)	14.50	12.00	8.50	9.00	6.25	3.75
8	Variable cost (pu)	7.75	7.60	3.90	3.45	1.85	2.00
9	Profit contribution	6.75	4.40	4.60	5.55	4.40	1.75
10							
11	Total Profit	4,684				Available	
12						Available	
13	Labour used	5207	<=	5500			
14	RM used	1995.5	<=	2000			

Figure 2 : Feasible solution (not optimum) fits constraints

How can this company maximize its monthly profit, within the labour, material and demand constraints?

If we knew nothing about Excel Solver, we would attack this problem by constructing a worksheet to track profit and resource usage associated with the product mix. Then we do trial and error to vary the product mix to optimize profit within the given constraints. We can use Solver in process only at the trial-and-error stage i.e. Solver is an optimization tool that performs the trial-and-error search.

In solving the product mix problem we need to compute the resource usage and profit associated with given product mix. An important function **SUMPRODUCT** can be used to calculate this. The SUMPRODUCT function multiplies corresponding values in cell ranges and returns the sum of those values. Each cell range used in a SUMPRODUCT evaluation must have the same dimensions i.e. we can use SUMPRODUCT with two rows or two columns, but not with one column and one row.

Let's try to compute our resource usage. Our usage is calculated as "(Labour Qty of P \* Qty produce of P) + (Labour of Q \* Qty of Q) + ... (Labour of U \* Qty of U)", we could compute usage in tedious fashion as =B4\*B5+C4\*C5+D4\*D5+E4\*E5+F4\*F5+G

4\*G5 or by using =SUMPRODUCT(B4:G4,B5:G5). Similarly, raw material usage could be computed as =B4\*B6+C4\*C6+D4\*D6+E4\*E6+F4\*F6+G4\*G6 or by =SUMPRODUCT(B4:G4, B6:G6). Entering formula in traditional fashion for six products is time-consuming. Imagine how long it would take if we are working with a company that produced 50 products.

We can now identify the three components of our product mix solver model:

1. Target cell - Our goal is to maximize profit in cell B11 computed by formula as =SUMPRODUCT(B4:G4,B9:G9) .
2. Changing cells - The Qty produced of each product (listed in the cell range B4:G4)
3. Constraints - We have the following constraints:
  - Do not use more of labour or raw material than available i.e. values in cells B13:B14 (used) must be less than or equal to the values in cells D13:D14 (available).
  - Do not produce more of a drug than its demand i.e. values in the cells B4:G4 (produced) must be less than or equal to the value in cell B3:G3 (demand).
  - We can't produce a either partial or negative Qty of any product.

Now enter the target cell, changing cells and constraints into Solver. Then click the Solve button to find a profit maximizing product mix. Solver parameter dialog box will look like

Click the Options button in the Solver Parameters dialog box. Check Assume Linear Model box and Assume Non-Negative box as shown below. Click OK.

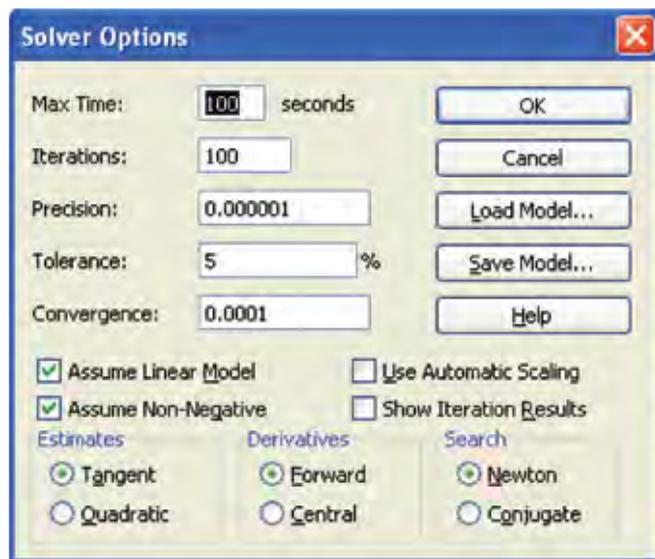


Figure 4 : Solver option settings

Checking the Assume Non-Negative box ensures that changing cell assumes a non-negative value. We checked the Assume Linear Model box because this is a linear problem. Essentially, a Solver model is linear under the following conditions:

1. The target cell is computed by adding together the terms in form (changing cell) \* (constant)
2. Each constraint is evaluated by adding together the terms in form (changing cell) \* (constant).

Since our product mix problem is a linear model, why should we care?

1. If a Solver model is linear and we select Assume Linear Model, Solver is guaranteed to find the optimal solution to the Solver model. If a Solver model is not linear, Solver may or may not find the optimal solution.
2. If a Solver model is linear and we select Assume Linear Model, Solver uses a very efficient algorithm (the simplex method) to find the model's optimal solution. If a Solver model is linear and we do not select Assume Linear Model, Solver uses a very inefficient algorithm (the GRG2 method) and might have difficulty finding the model's optimal solution.

After clicking OK in the Solver Options box, we return to the main Solver parameter dialog box, shown earlier in Figure 3. When we click Solve, Solver calcu-

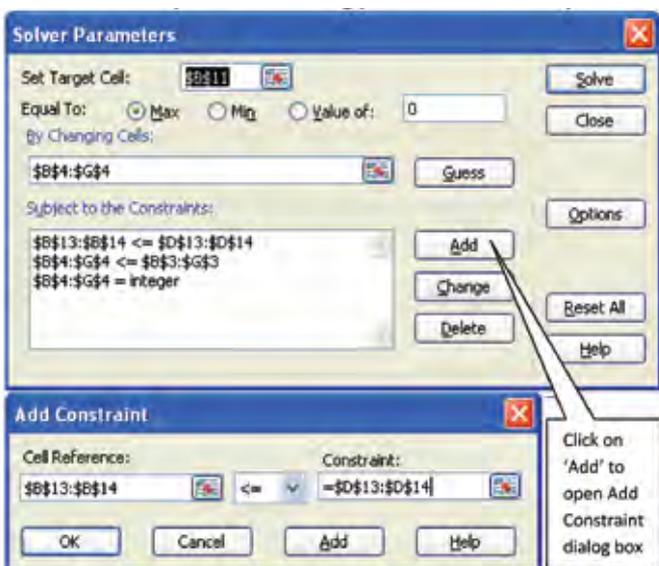


Figure 3 : Final dialog box for product mix problem

lates an optimal solution (if one exists) for our product mix problem. An optimum solution calculated in Figure 5.

	A	B	C	D	E	F	G
1	Product Name	P	Q	R	S	T	U
2							
3	Demand	1300	750	1250	980	1000	850
4	Qty Produce	0	0	1	576	1000	0
5	Labour (Qty pu)	7	8	4.8	5.2	2.5	3.25
6	RM (Qty pu)	4.25	3.6	1.5	0.85	0.6	1.3
7	Sale price (pu)	14.50	12.00	8.50	9.00	6.25	3.75
8	Variable cost (pu)	7.75	7.60	Available	3.45	1.85	2.00
9	Profit contribution	6.75	4.40	4.60	5.55	4.40	1.75
10							
11	<b>Total Profit</b>	<b>7,601</b>					
12			Available				
13	Labour used	5500	<=	5500			
14	RM used	1091.1	<=	2000			

Figure 5 : Optimum solution of product mix within constraint

Our FMCG Company can maximize profit of 7,601 by producing 1 unit of R, 576 units of S and 1000 units of T. We can be sure that with our limited resources and demand, there is no way to make more than 7,601.

**Is it necessary that Solver model always have a feasible solution?**

The answer is “No”. Say, in our example demand for each product must be met. Demand constraint will change from B4:G4 <= B3:G3 to B4:G4 >= B3:G3. Solver result gives message as ““Solver could not find a feasible solution”. This message means that with our limited resources, we can't meet demand for all products.

**What if Solver result gives the message as “The set cell values do not converge”?**

Let's see what happens if we allow unlimited demand for each product, delete demand constraint and we allow negative Qty to be produced, clear the Assume Negative box. When we click Solve, Solver returns the message "Set Cell Values Do Not Converge". This means that our model has an error.

**B. Transportation or Distribution Problems:**

Many companies manufacture products at different locations (Supply point) and ship their products to customers (Demand points). A question then is, what is the least expensive way to produce and ship products to customers and still meet demand? This type of problem is called a *transportation problem*. A transportation problem is a linear model with the following specifications:

1. Target cell - Minimize total shipping and dis-

tribution cost

2. Changing cells - The Qty produced at each supply point and shipped to each demand point
3. Constraints - The Qty shipped from each supply point can't exceed plant capacity. Each demand point must receive its required demand. Also, each changing cell must be non negative and an integer number (Partial Qty cannot be shipped)

If XYZ Textile Ltd produces textile at three different locations and distribute to four outlets, how can they minimize the cost of meeting demand for them?

Let's now solve the following example of the Transportation problem.

	A	B	C	D	E	F	G	H
1	SHIPMENT COST (per unit):							
2		Wholesale Outlet						
3	Factories	W1	W2	W3	W4	Capacity (Units)		
4	Factory1	4.00	2.50	3.20	1.80	12000		
5	Factory2	2.75	1.80	2.00	3.80	10000		
6	Factory3	3.25	2.50	3.80	6.00	15000		
7	Demand (Units)	9500	7000	8000	12500			
8								
9	SHIPMENT QTY:							
10		Wholesale Outlet				Sent (Units)	Capacity (Units)	
11	Factories	W1	W2	W3	W4			
12	Factory1	4500	5000	2500	0	12000	<=	12000
13	Factory2	0	2000	0	8000	10000	<=	10000
14	Factory3	5000	0	5500	4500	15000	<=	15000
15	Received (Units)	9500	7000	8000	12500			
16		>=	>=	>=	>=			
17	Demand (Units)	9500	7000	8000	12500			
18								
19	Total Shipment Cost		136,850					

Figure 6 : Feasible solution (not optimum) within constraints

We can now identify the three components of Transportation Solver model:

1. Target cell - Our goal is to minimise Total shipment cost in cell C19 computed by using formula =SUMPRODUCT(B4:E6,B12:E14) or can also be calculated in tedious fashion as =B4\*B12+C4\*C12+D4\*D12+E4\*E12+B13\*B5+C13\*C5+D13\*D5+E13\*E5+B14\*B6+C14\*C6+D14\*D6+E14\*E6.

[Note: The SUMPRODUCT function can multiply corresponding element in two separate rectangle (both rectangle are of the same size) and add together the product.]

2. Changing cells - The Qty produced at each supply point (Factories) and shipped to each demand point (Outlet), (listed in the cell range B12:E14).
3. Constraints - We have the following constraints:
  - Do not ship from each Factory more than plant capacity i.e. values in cells F12:F14 (Sent) must be less than or equal to the values in cells H12:H14 (capacity).

- Demand from each of warehouse outlet must be met i.e. values in the cells B15:E15 (received) must be more than or equal to the value in cell B17:E17 (demand).
- We can't ship either partial or negative Qty of any product i.e. value in cell B12:E14 should be an integer.

Now enter the target cell, changing cells and constraints into Solver. Then click the Solve button to find a minimum shipment cost. Solver parameter dialog box will look like



Figure 7 : Final solver dialog box for Transportation problem

Our transportation problem is a linear Solver model because our target cell is created by adding together the terms in form (changing cell)\*(constant) and both our supply and demand constraints are created by comparing the sum of changing cells to a constant. Thus, Click Options and check the Assume Linear Model and Assume Non-Negative boxes. Finally Click Solve, Solver will calculate an optimal solution (if one exists) for our transportation problem. An optimum solution calculated in Figure 8.

	A	B	C	D	E	F	G	H
1	SHIPMENT COST (per unit):							
2		Wholesale Outlet						
3	Factories	W1	W2	W3	W4	Capacity (Units)		
4	Factory1	4.00	2.50	3.20	1.80	12000		
5	Factory2	2.75	1.80	2.00	3.80	10000		
6	Factory3	3.25	2.50	3.80	6.00	15000		
7	Demand (Units)	9500	7000	8000	12500			
8								
9	SHIPMENT QTY:							
10		Wholesale Outlet				Sent (Units)	Capacity (Units)	
11	Factories	W1	W2	W3	W4			
12	Factory1	0	0	0	12000	<=	12000	
13	Factory2	0	1500	8000	500	<=	10000	
14	Factory3	9500	5500	0	0	<=	15000	
15	Received (Units)	9500	7000	8000	12500			
16		>=	>=	>=	>=			
17	Demand (Units)	9500	7000	8000	12500			
18								
19	Total Shipment Cost							86,825

Figure 8 : Optimum solution for transportation problem that fits constraints

The minimum shipment cost of meeting demand of XYZ Ltd is 86,825 derived by supplying 9500 units from Factory3 to W1, 8000 units from Factory2 to W3 and so on...

### C. Capital Budgeting Problems:

Many companies like to know which new products to develop or which projects to be undertaken, i.e. one want to undertake projects that contribute the greatest net present value (NPV), subject to limited resources (usually capital and labour). The Solver feature in Microsoft Office Excel can help to make such decisions.

Let's look at this problem, Software Ltd would like to undertake 10 projects that will require capital and labour for the next 2 years. They do not have enough resources for all projects; which ones should they undertake?

	A	B	C	D	E	F	G	H
1	Do = 1				Capital Reqd		Labour Reqd	
2	Don't = 0			NPV	Year 1	Year 2	Year 1	Year 2
3	1	Project 1	1053		422	198	130	125
4	0	Project 2	1033		175	287	158	103
5	1	Project 3	926		153	207	75	78
6	0	Project 4	668		299	236	73	87
7	1	Project 5	1069		315	270	142	158
8	0	Project 6	973		104	301	138	101
9	1	Project 7	670		227	238	73	61
10	0	Project 8	933		174	131	86	118
11	1	Project 9	763		306	159	56	72
12	0	Project 10	966		238	272	149	89
13								
14			Used		1423	1072	476	494
15					<=	<=	<=	<=
16			Available		1500	1800	850	700
17								
18	Total NPV of selected projects					4,481		

Figure 9 : Data to decide which project to undertake - Capital budgeting problem

Problems where either we want to do or don't do something can be solved by using binary changing cells. A binary changing cell always equals 0 or 1. Where 1 = Do the project and 0 = don't do the project. For this we need to add constraint by selecting changing cell and then choose bin from the list in the Add Constraint dialog box.

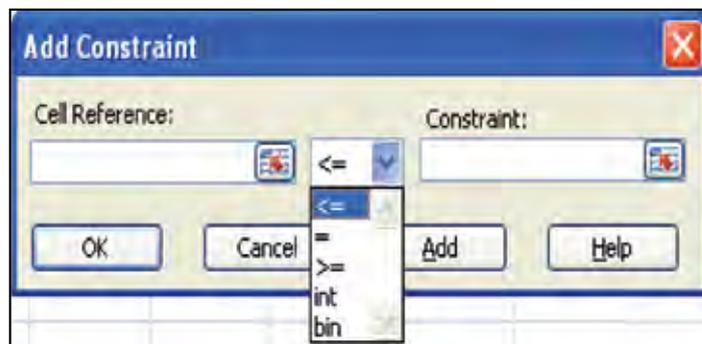


Figure 10 : Add constraint box with option of bin = Binary & int = Integer

Now, let us solve this problem, by identify the three components of capital budgeting model:

1. Target cell - Our goal is to maximise Total NPV in cell E18 computed by using formula =SUMPRODUCT(A3:A12,C3:C12), this formula only picks up NPV of project with 1 in column A and doesn't consider NPV with 0 in column A. It can also be calculated in tedious fashion by multiplying binary variable in column A with NPV values in column C, every row wise and adding together for all projects to arrive at total NPV figure.

2. Changing cells - We look for a 0 or 1 binary changing cell for each project (listed in A3:A12). Here, 1 = Do the project and 0 = don't do the project.

3. Constraints - We have the following constraints:

- Do not use capital and labour more than available in each year i.e. values in cells E14:H14 (Used) must be less than or equal to the values in cells E16:H16 (Available). Used capital and labour is computed by using formula =SUMPRODUCT(\$A\$3:\$A\$12, E3:E12) and copy from E14:H14 (\$ sign is used for absolute cell referencing).
- Values of changing cell listed in A3:A12 should be Binary.

After entering the target cell, changing cells and constraints into Solver. Solver parameter dialog box will look like



Figure 11 : Final solver dialog box with constraint

Since our model is linear, we will also check the Assume Linear Model and Assume Non-Negative boxes under Option. Finally Click Solve, Solver will calculate an optimal solution for our capital budgeting problem. An optimum solution calculated in Figure 12.

	A	B	C	D	E	F	G	H
1	Do = 1				Capital Reqd		Labour Reqd	
2	Don't = 0		NPV		Year 1	Year 2	Year 1	Year 2
3	1	Project 1	1053		422	198	130	125
4	1	Project 2	1033		175	287	158	103
5	1	Project 3	926		153	207	75	78
6	0	Project 4	668		299	236	73	87
7	0	Project 5	1069		315	270	142	158
8	1	Project 6	973		104	301	138	101
9	1	Project 7	670		227	238	73	61
10	1	Project 8	933		174	131	86	118
11	0	Project 9	763		306	159	56	72
12	1	Project 10	966		238	272	149	89
13								
14			Used		1493	1634	809	675
15					<=	<=	<=	<=
16			Available		1500	1800	850	700
17								
18	Total NPV of selected projects				6,554			

Figure 12 : Optimum solution - maximum NPV with-in constraint

Software Ltd. can obtain maximum NPV of 6,554 by selecting project 1-3, 6-8 and 10.

#### D. Financial Planning:

The Solver feature in Microsoft Office Excel can be used as a powerful tool for analyzing financial planning problems like how much money I need to save for retirement? Or how should I allocate my investment portfolio among Govt. bond, blue chip stocks, speculative stocks and short term deposits?

Let's look at the example in Figure 13, we have total fund of 20 Lakhs to invest in among 4 options within following constraints:

- Weighted average risk factor not to exceed 25
- Amt in speculative stocks should not exceed 20% of total amount invested
- At least 2 Lakhs to be invested in short term deposits
- Investment in any option should be whole number i.e. fraction of rupee cannot be invested in any option.

	A	B	C	D	E	F	G	H
1	Type of Investment	Expected Return (Pa)	Risk Factor (0 - 100)	Investment Amount	Annual Return		Total fund available	
2	Govt. Bond	11%	12	450,000	49,500		=D6*20%	
3	Blue chip stocks	15%	24	900,000	135,000			
4	Speculative stocks	23%	48	370,000	85,100	<=	400,000	
5	Short term deposits	8%	9	280,000	22,400	>=	200,000	
6				2,000,000	292,000	<=	2,000,000	
7		=SUMPRODUCT(C2:C5,D2:D5)/SUM(D2:D5)						
8	Weighted Average risk factor	24		<=	25		=SUM(E2:E5)	

Figure 13 : Feasible solution (not optimum) for Investment decision within given constraints

We can now identify the three components of Investment problem:

1. Target cell - Our goal is to maximise Annual Return in cell E6 computed as =SUM(E2:E5).
2. Changing cells - The Investment amount in each option (listed in the cell range D2:D5).
3. Constraints - We have the following constraints:
  - Total investment amt value in cell D6 not to exceed total fund available i.e. 20 Lakhs.
  - Weighted average risk factor computed in cell C8 (=SUMPRODUCT(C2:C5, D2:D5)/SUM(D2:D5) not to exceed 25.
  - Amt in speculative stocks i.e. value in cell D4 not more than value in cell G4 (20% of total amount invested)
  - Investment in Short term deposits in cell D5

should be at least 2 Lakhs.

- Investment amount in cell range D2:D5 should be an integer.

After entering the target cell, changing cells and constraints into Solver. Solver parameter dialog box will look like

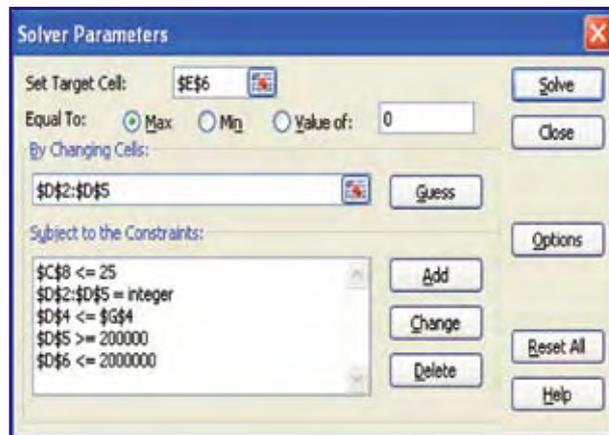


Figure 14 : Final solver dialog box with all constraints for Investment decision

In this financial planning problem, our model is non-linear as the relationship that each constraint should be in form (changing cell) \* (constant) is not satisfied in case of Risk factor constraint, where we have used division to calculate weighted average. We will only check the Assume Non-Negative boxes under Option. Finally Click Solve, Solver will calculate an optimal solution for our financial planning (Investment) problem. An optimum solution calculated in Figure 15.

	A	B	C	D	E	F	G	H
1	Type of Investment	Expected Return (Pa)	Risk Factor (0 - 100)	Investment Amount	Annual Return		Total fund available	
2	Govt. Bond	11%	12	383,334	42,167		=D6*20%	
3	Blue chip stocks	15%	24	1,016,666	152,500			
4	Speculative stocks	23%	48	400,000	92,000	<=	400,000	
5	Short term deposits	8%	9	200,000	16,000	>=	200,000	
6				2,000,000	302,667	<=	2,000,000	
7		=SUMPRODUCT(C2:C5,D2:D5)/SUM(D2:D5)						
8	Weighted Average risk factor	25		<=	25		=SUM(E2:E5)	

Figure 15 : Optimum solution within constraints for Investment planning

Maximum annual return of 302,667 can be obtained by investing 383,334 in Govt. bond, 1,016,666 in Blue chip stocks, 4 Lakhs in Speculative stocks and 2 Lakhs in Short term deposits.

**Conclusion:**

Excel solver is an optimization tool which can be used to find solution or make decision on real life business problems, where we want to arrive at decision either based on maximum or minimum value of something. For example profit, cost, return on investment, etc. □

## A PEEP INTO THE PAST

Continuing with our series of contents having nostalgic value, published herewith are details of some events which took place between 1970 and 80, for the information of the members.

### Meeting of International Coordination Committee for the Accountancy Profession

The International Coordination Committee for the Accountancy Profession held its 6<sup>th</sup> Plenary Session at the premises of the Institute in New Delhi between 14<sup>th</sup> and

16<sup>th</sup> February, 1977, which was attended by representatives of 11 leading countries. This was an event of considerable importance to the profession as it gave final shape to the constitution of the International Federation of Accountants (IFAC), which came into existence at the 11<sup>th</sup> International Congress later held in Munich.



*(Photograph taken on the occasion of the meeting of the International Coordination Committee for the Accountancy Profession at New Delhi on February 14-16, 1977.)*

### Formation of IFAC

Representatives of more than 50 nations attending the 11<sup>th</sup> International Congress of Accountants in Munich (West Germany) signed an agreement for establishment of International Federation of Accountants (IFAC), an organization with a potential membership of more than 100 accounting bodies in over 70 countries. The purpose of this new professional society of accountants was to develop a coordinated international accountancy profession with harmonized standards. The broad objective of the Federation was, besides arranging for International Congresses, to initiate, co ordinate and guide efforts that have as their goal the achievement of international technical, ethical and educational guidelines for the accountancy profession. It was decided that International Committee on Accounting Standards (IASC) will continue to issue pronouncements on international accounting standards. It was also decided to locate the permanent secretariat of the Federation at New York, and that the affairs of the Federation will be managed by the 15-member Council. It is a matter of great pride that India was elected as member of the Council for two successive 5-year terms, and Shri B.L. Kabra, the then president of ICAI, was elected as one of the Vice-Presidents of IFAC.



*Shri B. L. Kabra, President, signing on behalf of the Institute an Agreement constituting International Federation of Accountants at Munich, West Germany on 7<sup>th</sup> October, 1977.*

At the time of formation, the tentative work programme of the IFAC includes development of guidelines for international auditing practices, establishment of a minimum code of international professional ethics and development of international guidelines for professional education. To implement the work programme, the council of the IFAC constituted seven committees dealing with Auditing, Education, Ethics, Management Accounting, Regional Organization, International Congress and Planning. □

## Enhancing Audit Quality

*Given below are some of the common non-compliances observed by the Financial Reporting Review Board (FRRB) during review of general purpose financial statements of certain enterprises and auditors' reports thereon. These have been published for the information of members, both in practice and industry, so that they observe the highest level of best practices.*

### Schedule VI to The Companies Act, 1956

1. As per the requirements of Schedule VI to Companies Act, 1956 the interest received has to be shown under the head 'Other income'. Some enterprises show interest received as deduction from interest paid in the Schedule to the profit and loss account regarding 'Interest and Financial charges', which is contrary to the requirements of Schedule VI to Companies Act, 1956.
2. As per the requirements of Schedule VI to the Companies Act, 1956, insurance is required to be shown separately from taxes whereas some enterprises do not disclose tax and insurance separately but disclose them as one figure, which is contrary to the requirements of Schedule VI to the Companies Act, 1956.
3. Schedule VI to the Companies Act, 1956 requires 'Repairs to buildings' to be disclosed separately from 'Repairs to machinery'. In few cases, the enterprises disclose only one figure of 'Repairs to assets' in the financial statement. This is not as per the requirements of Schedule VI to the Companies Act, 1956.
4. Part II of Schedule VI to the Companies Act, 1956, requires the amount of income from investments has to be shown as classified into income from trade investments and other investments. Some enterprises bifurcate the same into income from current investments and long-term investments, which is contrary to the requirements of Schedule VI to the Companies Act, 1956.
5. As per Part I of Schedule VI of the Companies Act, 1956 (Vertical Form) it is required to show on the face of the Balance Sheet the following under the head 'Fixed Assets' on the Application of Funds side of the Balance Sheet:

Gross Block  
Less: Depreciation

Net Block

Capital work-in-progress

Some enterprises merge the aforesaid details under schedule and do not show the required details on the face of the Balance Sheet itself, which is contrary to the requirements of Schedule VI to the Companies Act, 1956.

6. As per Part I of Schedule VI of the Companies Act, 1956 (Vertical Form), it is required to show on the face of the Balance Sheet the following under the head 'Current Assets, Loan and Advances' on the Application of Funds side of the Balance Sheet:
  - a) Inventories
  - b) Sundry debtors
  - c) Cash and Bank balances
  - d) Other Current Assets, and
  - e) Loans and Advances

Some enterprises merge the aforesaid details under schedule and do not show the required details on the face of the Balance Sheet itself, which is contrary to the requirements of Schedule VI to the Companies Act, 1956.

7. As per Part I of Schedule VI of the Companies Act, 1956 (Vertical Form), it is required to show on the face of the Balance Sheet the following under the head 'Current Liabilities and Provisions' on the Application of Funds side of the Balance Sheet as:
  - a) Liabilities
  - b) Provisions

Some enterprises merge the aforesaid details under schedule and do not show the required details on the face of the Balance Sheet itself, which is contrary to the requirements of Schedule VI to the Companies Act, 1956.

## 100% I-T Waiver for SEZs set up under Parent Companies

In a move that will significantly ease the tax burden on India's biggest information technology companies, the government has decided to amend the law relating to tax exemption for units operating out of Special Economic Zones (SEZs). SEZs set up by IT majors like Infosys, Wipro and Tata Consultancy Services (TCS) under the parent companies will soon be able to enjoy 100% tax exemption on profits on a par with those set up as separate entities. Prime Minister Manmohan Singh, who is also handling the Finance Ministry, has agreed to change the relevant norms under the Income-tax Act, a Commerce Department official has said. The Finance Ministry will soon issue a notification changing rules under Section 10AA (7) of the Income-tax Act, which will allow all SEZ units to be treated as separate entities and thus be eligible for 100% tax exemption on profits for the first five years of operation.

[www.epaper.timesofindia.com](http://www.epaper.timesofindia.com)

## SEBI Makes it Mandatory to Disclose Details of Shares Pledged by the Promoters

To enhance the disclosure requirements, SEBI Board, in its meeting held on January 21, 2009, decided to make it mandatory on the part of promoters (including promoter group) to disclose the details of pledge of shares held by them in listed entities promoted by them. Such disclosures shall be made as and when the shares are pledged ("event based disclosure") as well as by way of periodic disclosures. Necessary steps to amend the relevant regulations and the listing agreement are being taken. Details of pledge of shares and release/ sale of "pledged shares" shall be made to the company and the company shall in turn inform the same to the public through the Stock Exchanges

[www.sebi.gov.in](http://www.sebi.gov.in)

## AEC wants 10-year Tax Rebate for Nuclear Power Plants Beyond 2010

Nuclear power plants that come into operation after 2010 may still be able to enjoy ten-year tax holiday if a recommendation by the Atomic Energy Commission (AEC) is accepted by the Government. AEC has sought tax relief on income from power generation business to be extended to companies that start nuclear power generation before March 31, 2020. As per the current provision in the Income-tax Act, income arising from power generation is exempt from tax for 10 years if the units begin operation between April 1, 1993 and March 31, 2010.

[www.economictimes.indiatimes.com](http://www.economictimes.indiatimes.com)

## 1,550 PF Trusts May Lose I-T Benefits

Over 1,550 Private Provident Fund Trusts run by Indian companies could lose their income tax benefits in less than three months time. These private trusts enjoy tax benefits on the basis of their affiliation to the Employees Provident Fund Organisation (EPFO) through temporary relaxations granted by it. The deadline for getting recognised by the Government as an exempted fund under EPFO expires on March 31, 2009. The Finance Ministry had mandated in 2006 that Private Provident Trusts should obtain exemption under the EPF Act within a year from the labour ministry if they wanted to continue enjoying tax benefits under the Income-tax Act.

[www.economictimes.indiatimes.com](http://www.economictimes.indiatimes.com)

## Returns To Be Filed By Banks: RBI Clarification

The Reserve Bank of India on January 20, 2009 has clarified that scheduled commercial banks have to file the returns 'Statements showing interest rates of commercial banks for credit limits over Rs. 2 lakh' and 'IBS-reporting of derivatives transactions'. Consequently, the number of returns banks have to submit to the Reserve Bank of India will be 225. It had prepared and published two lists of returns – one list of returns to be submitted to the Reserve Bank and the other list of returns not to be submitted to the Reserve Bank.

[www.rbi.org.in](http://www.rbi.org.in)

## Buyback Candidates Face SEBI Check on Financial Position

The Government is planning to ask the Securities and Exchange Board of India (SEBI) to check the financial position of all companies which have announced buyback of their equity, but have deferred the scheme or have not started it as yet. The scope of the exercise will be one year to begin with and then extended further. The study will not only check the reserves position but will also try to find out the "real surplus" available with the companies to fund the buyback programmes. It will also ascertain whether the companies concerned have made any other provisions for such funding. The ratio of book value to the share price will be a good measure to check the real asset position of the company.

[www.business-standard.com](http://www.business-standard.com)

## Companies Bill Provision Could Be Reviewed

The Ministry of Corporate Affairs (MCA) would consider amending some of the key provisions in the new Companies Bill, 2008, which is currently before the Standing Committee on Finance. The move comes in view of the biggest accounting fraud to have occurred in the country's corporate history with the revelations made by Satyam Computer Service. According to an MCA official, in most likelihood the provision related to the aspect of corporate governance and corporate valuation are going to be revisited. All these provisions would be made stricter so that no company would be in a position to bypass them, he added.

[www.financialexpress.com](http://www.financialexpress.com)

### **China Overtakes Germany as World's Third-Largest Economy**

China has taken Germany's spot as the world's third largest economy after the United States and Japan, statistics released on Wednesday 14 January 2009. Beijing's National Statistics Office released corrected figures for the year 2007, revising the Gross Domestic Product (GDP) growth upwards from 11.9 per cent to 13 per cent, the largest increase since 1993. Total GDP figures were revised upwards by 777.6 billion yuan (\$113.8 billion), or 3.1 per cent, to 25.73 trillion yuan, thereby overtaking Germany's output, experts said.

[www.timesofindia.indiatimes.com](http://www.timesofindia.indiatimes.com)

### **US Economy May Shrink 1.5% in 2009**

Economists slashed forecasts for US growth in 2009 and projected Federal Reserve policy makers won't be able to start raising interest rates until 2010, according to a monthly Bloomberg News survey. The world's largest economy will contract 1.5 per cent this year, a half percentage point more than projected last month, according to the median of 59 forecasts in the survey taken from January 5 to January 12. The slump will push inflation below what some Fed officials consider price stability, the survey showed.

[www.business-standard.com](http://www.business-standard.com)

### **IMF Would need another \$150 bn to Help Fight Crisis**

The International Monetary Fund (IMF) may need another \$150 billion to help counter the hit to emerging markets and poorer countries from a worsening global economic downturn, Managing Director Dominique Strauss-Kahn said. The IMF Chief, in an interview in Washington, also chided European leaders for failing to grasp the depth of the coming slump in their region, creating the risk of social upheaval. The fund will make a "significant" increase in its \$1.4 trillion projection of global financial losses and writedowns, he added.

[www.financialexpress.com](http://www.financialexpress.com)

### **BOE Cuts Rate To Lowest Since Bank's Creation in 1694**

The Bank of England (BOE) cut the benchmark interest rate to the lowest since the central bank was founded in 1694 as policy makers tried to prevent the credit squeeze from deepening Britain's recession. The Monetary Policy Committee, led by Governor Mervyn King, trimmed the bank rate by a half point to 1.5%. The result matched the median forecast of 60 economists in a Bloomberg News survey. The pound rose against the euro and the dollar. The reduction limits the central bank's scope to keep fighting the recession with its main policy tool. That may spur King to cooperate with Prime Minister Gordon Brown to inject money into the economy and the financial system through so-called quantitative easing. The European Central Bank has cut its key interest rate by 1.75 percentage points to 2.5% since early October, and may reduce it again next week.

[www.financialexpress.com](http://www.financialexpress.com)

### **IASB Proposes Additional Disclosures for Investments in Debt Instruments**

The International Accounting Standards Board (IASB) on 23 December 2008 published for public comment proposals to require entities to provide additional disclosures on all investments in debt instruments, other than those classified in the fair value through profit or loss category. The proposed amendments follow discussions with participants in a series of public round-table meetings on the global financial crisis organised by the IASB and the US Financial Accounting Standards Board (FASB). The IASB believes that the proposed disclosures would allow greater comparability between investments in debt instruments held with and by different entities, and so enhance investors' confidence in the financial markets. The FASB is making similar disclosure proposals.

[www.iasb.org](http://www.iasb.org)

### **2009 to Be Bellwether Year for Financial Reporting**

Fitch Ratings predicts that 2009 will be a pivotal year for accounting, particularly in terms of fair value measurement and standards convergence. The credit-ratings service has published a report on the global outlook for accounting and financial reporting this year. One major issue it predicts will be going-concern evaluations. As companies prepare their annual financial statements, a pressing question is how best to justify a going-concern basis, given the doubts some have about their ability to refinance. Impairment of debt investments and the lack of clear-cut rules on the subject have pitted some issuers against their auditors, the report noted.

[www.webcpa.com](http://www.webcpa.com)

### **CBN, SEC, Others Urged To Sanction Erring Auditors**

Financial regulators have been urged to sanction auditors who present wrong statements about their companies, so as to enforce good corporate governance. The regulators are the Central Bank of Nigeria (CBN), the Securities and Exchange Commission (SEC) and the Nigerian Stock Exchange (NSE). The call was the crux of deliberations by the National Accounting Standards Board (NASB) in Lagos recently. According to a communiqué issued by the board, any auditor who gives a clean bill of health to a company and is found to have manipulated the reports should be sanctioned.

[www.thenationonline.ng.com](http://www.thenationonline.ng.com)

### **Broker-Dealer Auditors Need to Register with PCAOB**

The Public Company Accounting Oversight Board (PCAOB) said the financial statements of non-public broker-dealers now need to be certified by PCAOB-registered auditing firms. The registration applies to financial statements for fiscal years ending after December 31, 2008. Registration of auditors of the private broker-dealers had not been required in the past as the result of an order by the Securities and Exchange Commission. However, the SEC order has now expired, and the commission is not likely to extension the exemption given recent criticism of its lax regulation of the markets. To apply for registration with the PCAOB, a firm must complete an electronic application form at [www.pcaobus.org/registration](http://www.pcaobus.org/registration) and pay an application fee. Under the Sarbanes-Oxley Act and PCAOB rules, the board must, within 45 days after receiving an application and application fee, either approve the application, request additional information from the applicant, or provide a notice of hearing to determine whether to approve the application.

[www.webcpa.com](http://www.webcpa.com)

### **IASC Foundation Publishes IFRS Taxonomy 2009**

The International Accounting Standards Committee (IASC) Foundation on 12 January 2009 announced the release of the near final version of the IFRS Taxonomy 2009 for public comment. The IFRS Taxonomy 2009 is a translation of International Financial Reporting Standards (IFRSs) as issued at 31 December 2008 into XBRL (eXtensible Business Reporting Language), a language that is used to communicate information between businesses and other users of financial information. The specific characteristics of XBRL allow companies, regulators, investors, analysts and others using the IFRS Taxonomy 2009 with easier filing, access to and comparison of financial data. Interested parties are invited to access the near final version of the IFRS Taxonomy 2009 and submit comments by 12 March 2009.

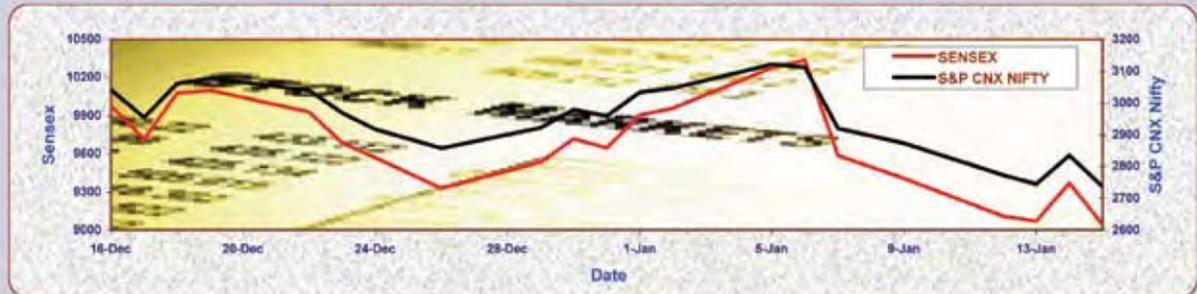
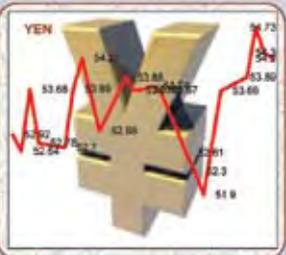
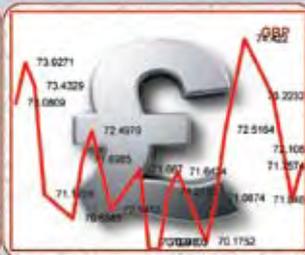
[www.iasb.org](http://www.iasb.org)

### **Banks Team Up To Avoid Future Losses**

Banks are increasingly keen to share sensitive risk information with their rivals, albeit anonymously, as lenders try to limit damage from debtors' defaults, fraud and other hazards in the future. The international banking industry is also working to create common methods on how to report risk, after the turmoil of the past year exposed flaws in their control systems and procedures, blamed for spectacular writedowns and cases of fraud. The Risk Analysis Service (RAS), which provides data on more than 1 trillion euros' (893 million pounds) worth of global banks' exposure to debtors, said the number of participants had increased by around a quarter in the past year, adding it expected the current number to double over the next year. Meanwhile, mathematicians from technology corporation IBM are helping analyse 34 billion euros of losses collected by the Operational Riskdata eXchange Association (ORX) in an effort to create better safeguards against operational losses.

[www.tiscali.co.uk/news](http://www.tiscali.co.uk/news)

## Economic Indicators



## Selected Indicators

Item	Unit/Base	2008						
		Dec. 28	Nov. 21	Nov. 28	Dec. 5	Dec. 12	Dec. 19	Dec. 26
Cash Reserve Ratio	per cent	7.50	5.50	5.50	5.50	5.50	5.50	5.50
Bank Rate	Per cent per annum	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Prime Lending Rate	Per cent per annum	12.75-13.25	13.00-13.50	13.00-13.50	12.50-13.25	12.50-13.25	12.50-13.25	12.50-13.25
Deposit Rate	Per cent per annum	8.25-9.00	8.75-10.50	8.50-10.50	8.50-10.00	8.50-10.00	8.50-10.00	8.50-10.00
Call Money Rate (Low/High)	Per cent per annum	6.00/8.55	3.00/9.84	4.00/7.75	4.00/7.00	3.00/6.20	3.05/6.75	4.00/6.60

Note : Readers are Invited to contribute write-ups or any relevant and interesting piece of information for this feature at [eboard@icai.org](mailto:eboard@icai.org).

## ACCOUNTANT'S BROWSER

“PROFESSIONAL NEWS & VIEWS PUBLISHED ELSEWHERE”

Index of some useful articles taken from Periodicals/Newspapers received during December 2008 – January 2009 for the reference of Faculty/Students & Members of the Institute.

### 1. ACCOUNTING

Accounts & Audit: Accounting for Real Estate by T.P. Ghosh. *Corporate Professionals Today*, Dec. 16-31, 2008, pp. 764-770.

Accounts & Audit: IFRSs: Growing Opportunities in India by A.L. Saini. *Corporate Professionals Today*, Dec. 16-31, 2008, pp. 573-580.

Accounts, Audit & the Companies Bill by Gautam Nayak. *BCAJ*, Dec. 2008, pp. 353-354.

Analyzing the German Accounting Triad – “Accounting Premium” for IAS/IFRS & U.S. GAAP vis-à-vis German GAAP? by Jurgen Ernstberger & Oliver Vogler. *The International Journal of Accounting*, Vol. 43, 2008, pp. 339-386.

Breaking the Link with a University Education in the Creation of a Chartered Accountant: The ICAS Story by Elizabeth Gammie & Linda Kirkham. *The British Accounting Review*, Vol. 40, 2008, pp. 356-375.

The British Accounting Review – Characteristics of Papers Submitted & Accepted, 1997 to 2006. *The British Accounting Review*, Vol. 40, 2008, pp. 289-296.

Carbon Trading : Accounting & Reporting Issues by J. Bebbington & C.L. Gonzalez. *European Accounting Review*, Vol.17/4, 2008, pp. 697-717.

Corporate Reporting of Intellectual Capital: Evidence From UK Companies by Ludmila Striukova etc. *The British Accounting Review*, Vol. 40, 2008, pp. 297-313.

Discovery-Learning Classroom Case on Accounting Data Transmission Systems by David R. Fordham. *Journal of Information Systems*, Fall 2008, pp. 103-122.

Do Accounting Standards Matter? An Exploratory Analysis of Earnings Management Before & After IFRS Adoption by Thomas Jeanjean & Herve Stolowy. *J. Account. Public Policy*, Vol.27, 2008, pp. 480-494.

Does Convergence of Accounting Standards Lead to the Convergence of Accounting Practices? A Study from China by Songlan Peng etc. *The International Journal of Accounting*, Vol. 43, 2008, pp. 448-468.

Investigation of Compliance with

International Accounting Standards by Listed Companies in the Gulf Cooperation Council Member states by Bader Al-Shammari, etc. *The International Journal of Accounting*, Vol.43, 2008, pp. 425-447.

Modelling an Object-oriented Accounting System with Computer-aided Software Engineering by Alan S. Levitan etc. *Journal of Information Systems*, Fall 2008, pp. 123-139.

Role of Change Agents & Imitation in the Diffusion of an Idea: Charge & Discharge Accounting by Michael John Jones. *Accounting & Business Research*, Vol.38/5, 2008, pp. 355-371.

Role of a Crisis in Reshaping the Role of Accounting by Alnoor Bhimani. *J. Account. Public Policy*, Vol.27, 2008, pp. 444-454.

### 2. AUDITING

Auditing for Compliance by Susan Burch. *Internal Auditor*, Dec. 2008, pp. 53-59.

Discretionary Accruals & Auditor Behaviour in Code-Law Contexts: An Application to Failing Spanish Firms by Laura Arnedo Ajona. *European Accounting Review*, Vol.17/4, 2008, pp. 641-666.

Firm Characteristics & Audit Committees Complying with ‘Best Practice’ Membership Guidelines by Elizabeth A. Rainsbury etc. *Accounting & Business Research*, Vol.38/5, 2008, pp. 393-408.

Introducing Students to the Integrated Audit with “Auditing Alchemy, Inc.” by Ulric J. Gelinis etc. *Journal of Information Systems*, Fall 2008, pp. 151-170.

Practical Aspects of Branch Audits of Banks by V.S.K. Murthy. *Corporate Professionals Today*, Dec. 16-31, 2008, pp. 771-776.

### 3. ECONOMICS

Global Warming & Corporate Disclosures in India: A Comparative Analysis with Companies from France, Germany, the UK, Japan & Canada by Bikki Jaggi etc. *Indian Accounting Review*, June 2008, pp. 1-17.

Macroeconomic & Monetary Developments Mid-term Review 2008-09: 1. The Real Economy. *RBI Bulletin*, Nov. 2008, pp. 1891-1998.

### 4. INSURANCE

Riding on Health Insurance: Multi-tiered Protection for Comprehensive Coverage by Somil Nagpal. *IRDA Journal*, Nov. 2008, pp. 14-16.

### 5. INVESTMENT

Cross-Border Mergers & Acquisition-Addressing the Taxation Issues from an Indian Perspective by Sayaantan Gupta. *Corporate Professionals Today*, Dec. 16-31, 2008, pp. 525-532.

Indian Capital Market: A Study of BSE – 30 Companies by Sanjay J. B h a y a r. *DIAS Technology Review*, Oct.2007-March 2008, pp. 30-39.

Revised concept Paper on Regulation of Valuation Professionals. *Company Law Journal*, Vol.4, 2008, pp. 103-125.

### 6. MANAGEMENT

Corporate Disclosure, Cost of Capital & Reputation: Evidence from Finance Directors by Seth Armitage & Claire Marston. *The British Accounting Review*, Vol.40, 2008, pp. 314-336. Delivering on the Promise of Non-profits by Jeffrey L. Bradach etc. *Harvard Business Review*, Dec. 2008, pp. 88-97.

Developing Trust in Business Relationships: Years to Build, Seconds to Destroy by Karl Smith. *Accountancy SA*, Dec. 2008-Jan.2009, pp. 22.

Is Earned-Leave Encashment a part of “Basic Wages” under Provident Fund Act? by B. Shanmugasundaram. *Consolidated Commercial Digest*, 1.12.2008, pp. 511-515.

Reinventing Your Business Model by Mark W. Johnson. *Harvard Business Review*, Dec. 2008, pp. 50-59.

Relevance of Traditional Management Accounting in the Public Sector by Monir Zaman Mir & Bikram Chatterjee. *Indian Accounting Review*, June 2008, pp. 60-74.

### 7. TAXATION & FINANCE

Principles of Natural Justice: Taxation Laws of Appointing Special Auditor by S.M. Jain. *Consolidated Commercial Digest*, 1.12.2008, pp. 516-526.

Transfer Pricing & Intangible Planning by Robert E. Ackerman. *Asia-Pacific Tax Bulletin*, Nov.-Dec. 2008, pp.437-443.

Transfer Pricing Reform by Andrew Casley & Susan Forrest. *CAPJ*, Dec.(ist) 2008, pp. 9-20. □

Full Texts of the above articles are available with the Central Council Library, ICAI, which can be referred on all working days. For further inquiries please contact on 011-23370154 or by e-mail at [library@icai.org](mailto:library@icai.org)

## Important Announcement

### New Scheme of Education and Training

#### Accounting Technician Course (ATC)

- **To become an Accounting Technician.....**
  - Enrol for Common Proficiency Test (CPT) after passing Class 10 examination
  - Pass 10+2 examination and CPT
  - Enrol for Accounting Technician Course (ATC)
  - Successfully complete 9 months of Study Course
  - Successfully complete Orientation Course of one week spanning over 35 hours and covering topics, such as, personality development, communication skills, office procedures, business environment, general commercial knowledge, etc
  - Successfully complete Information Technology Training (ITT) or Computer Training Programme
  - Pass Group I of Integrated Professional Competence Examination (IPCE)
  - Group I is composed of four papers –
    - (i) Accounting
    - (ii) Business Laws, Ethics and Communication
    - (iii) Cost Accounting and Financial Management
    - (iv) Taxation
  - Successfully complete one year work experience under a chartered accountant in practice or in industry
  - Get ATC Certificate
  - Designate as Accounting Technician

#### Accounting Technician Certificate for Old Students

Such old students who have passed both groups of Intermediate Examination or Professional Education – II Examination or Professional Competence Examination and have completed the prescribed period of articled training will be eligible for grant of Accounting Technician Certificate on making an application to this effect. The application can be submitted online by visiting [www.icai.org](http://www.icai.org).

- **To become a Chartered Accountant after becoming Accounting Technician.....**
  - Enrol in Group II of Integrated Professional Competence Course (IPCC) and register as Articled Assistant for a period of 3 years
  - Pass Group II of IPCC
  - Appear in Final Examination during last 6 months of 3 years of articled training
  - Pass both the Groups of Final examination
  - Complete remaining period of articled training, if applicable

- Successfully complete the Course on General Management and Communication Skills
- Get Final Examination Certificate
- Enrol as a member of ICAI and designate as “Chartered Accountant”

#### ● **TO QUALIFY AS A CHARTERED ACCOUNTANT.....**

- Enrol for Common Proficiency Test (CPT), after passing Class 10 examination
- Pass 10+2 examination and CPT
- Enrol for Group I or Group II or both Group I and Group II of IPCC
- Group I is composed of four papers
  - (i) Accounting
  - (ii) Business Laws, Ethics and Communication
  - (iii) Cost Accounting and Financial Management
  - (iv) Taxation
- Group II is composed of three papers
  - (i) Advanced Accounting
  - (ii) Auditing and Assurance
  - (iii) Information Technology and Strategic Management
- Successfully complete 9 months of Study Course
- Successfully complete Information Technology Training (ITT) or Computer Training Programme
- Appear and pass Group I or both Groups of Integrated Professional Competence Examination (IPCE)
- Register as Articled Assistant for a period of 3 years, on passing either Group I or both Groups of IPCC
- Appear in IPCC Final Examination during last 6 months of 3 years of articled training
- Pass Group I as well as Group II of Final Examination
- Complete remaining period of articled training, if applicable
- Successfully complete the Course on General Management and Communication Skills
- Get IPCC Final Examination Certificate
- Enrol as a member of ICAI and designate as “Chartered Accountant”

*Resolve to be a master of change rather than a victim of change*

## New IPCC vs. Existing PCC – A Guide to the Students

Under the new scheme an option has been given till June 30, 2009 to existing CPT passed students and to those who appeared in the CPT examination held on December 14, 2008 to choose between PCC and new IPCC. Those students who have passed CPT and are not so far got registered for articles and those who pass CPT examination held on December 14, 2008 (of which result is likely to be declared on January 16, 2009) are free and eligible to get registered under the new scheme of IPCC after declaration of CPT result without articles registration. All such students getting registered for IPCC on or before January 31, 2009 shall be eligible to sit in the new IPCC examination scheduled for November, 2009 as they shall complete 9 months of study by that time.

The following table will clarify the difference between the existing Professional Competence Course (PCC) and the newly launched Integrated Professional Competence Course (IPCC):

	<b>PCC (PCC and Articleship on or before January 31, 2009)</b>	<b>IPCC (Get registered for IPCC without articleship)</b>
PCC/IPCC – Examination Due	November 2010	November, 2009

Result of PCC / IPCC Examination	January, 2011	January, 2010
Registration of Articleship under IPCC	NA	January, 2010
Completion of Articleship under PCC/IPCC	June, 2012	January, 2013
Final Examination Due	November, 2012	November, 2012
Result of Final Examination	January, 2013	January, 2013

If the students intend to choose the new IPCC it will be advisable to get registered immediately after the result of CPT and before January 31, 2009 so that they would be eligible to sit in November, 2009 examination.

### Transitional Provisions

Detailed transitional provisions have been made to address the various issues that would be faced by Intermediate, PE-II and PCC students. Students are advised to refer to Institute's website [www.icai.org](http://www.icai.org);

## Corporate Laws Committee Certificate Course on Valuation

While appreciating the need of the profession in the global service market, the Institute has launched a Certificate Course on Valuation. The overall goal of this course is to build skills and improve quality and confidence of our members in carrying out valuation assignment. The valuation is the epicenter of financial decision-making and this course provides the framework for business valuation and gives practical advice on using the framework to value a business. It is balanced between lectures, presentations, cases and dissertations. The Course has the vision to empower and position our members, as leaders in the global service market. The Course has started at Delhi, Mumbai and Chennai and will be launched in Kolkata and Bangalore shortly. The responses received from the members are over-whelming. The students who have cleared their CA Final examination can also join this course. Eminent faculties from IITs, IIMs, Universities and leaders in profession and industry are sharing their experience with the participants. Details of this course are available at [http://www.icai.org/post.html?post\\_id=3428&c\\_id=266](http://www.icai.org/post.html?post_id=3428&c_id=266). This Course is an intensive and comprehensive package and no member can afford to miss this opportunity. Integrating the basic understanding of the term 'value' with the new perspectives, the Course runs through the key approaches of valuation discovering the underlying assumptions of various models and their applications in live cases. Indeed, this course is a capacity building measure for the profession.

## Ethical Standards Board

The Council, at its 283<sup>rd</sup> meeting held on December 18-20, 2008, decided to rename the Committee on Ethical Standards (CES) as "**Ethical Standards Board**" (ESB) with immediate effect.

The new email-id of the Board is- [esb@icai.org](mailto:esb@icai.org) in place of [ces@icai.in](mailto:ces@icai.in).

*Make failure your teacher, not your undertaker*

## CHARTERED ACCOUNTANTS STUDENTS BENEVOLENT FUND

The Board of Trustees of the Chartered Accountants Students Benevolent Fund have decided to launch a special scheme for financial assistance to the students who are currently undergoing articled training in accordance with the Chartered Accountants Regulations, 1988 and are poor and needy but meritorious requiring financial assistance to pursue the chartered accountancy course.

To begin with, a sum of Rs.1000/- per month will be granted as financial assistance to about 100 students.

The eligibility criteria for obtaining financial assistance from CASBF would be as under :-

- i) Passed 10+2 examination with a minimum of 70 per cent marks
- ii) Passed Common Proficiency Test of ICAI in the first attempt
- iii) Currently undergoing articled training as per CA Regulations
- iv) Annual income of both parents from all sources be not more than Rs.1.50 lakhs.

The above criteria can be relaxed in deserving cases.

Physically challenged students will however be given preference.

Students who are needy, poor but meritorious and are fulfilling the above criteria may come forward to avail this opportunity from the Chartered Accountants Students Benevolent Fund and may send their request in the prescribed form, duly completed, to the Member Secretary at the following address so as reach on or before 20<sup>th</sup> February 2009. The form can be downloaded from [www.icai.org](http://www.icai.org) or can be had from Institute.

Students suffering from serious medical ailments may also apply for one time lump sum financial assistance, along with supporting prescriptions/documents/original bills etc. The Board of Trustees will consider each such case on merit basis and decide at their discretion the amount of financial assistance to be granted.

The Member Secretary

Chartered Accountants Students Benevolent Fund  
C/o The Institute of Chartered Accountants of India  
ICAI Bhawan, Indraprastha Marg, New Delhi-110002.

01<sup>st</sup> January, 2009

President

## Committee on Information Technology

### ERP Course on Microsoft Dynamics NAV

The Committee has started offering ERP Courses for members and students (final/article ship completed) of the Institute to enable them to offer value added services in the field of ERP Consulting as Functional Consultants in the finance domain considering their rich experience in accounting/finance/business/legal requirements, which are in increasing demand today. These courses are also suitable for Members in Industry where ERP applications are implemented/being implemented.

This ERP Initiative includes, training programmes on Microsoft **NAV Dynamics (Delhi-January 30, Chennai-February 06)**. This course is being offered through OEM vendors giving twin benefits of convenient timing and discounted course fees. Further details are available on the Institute website at [www.icai.org](http://www.icai.org) under Members →Courses.

Please contact 011-30210619/621 or [erp@icai.org](mailto:erp@icai.org) for further details/clarifications/registration.

### Forthcoming Practical Workshops

City	Workshop Theme	Date
Mumbai	SOX	January 31
Delhi	SOX	February 14
Chennai	ACL & IDEA	February 14
Chennai	Security Audit Tools in Desktop Environment – Level 1	February 28

Further details, workshop brochures & registration form are available at [www.icai.org](http://www.icai.org) under events. Workshop registration is on first-come-first-served-basis on receipt of duly filled in form with workshop fee. Please contact 011-30210619/ 621 or [isadelhi@icai.org](mailto:isadelhi@icai.org) for further details/assistance/registration.

*Thou shalt not be a victim. Thou shalt not be a perpetrator. Above all, thou shalt not be a bystander*

## Auditing and Assurance Standards Board Outstanding Exposure Drafts (Issued by AASB)

Exposure Draft	Comment Due by
Revised Standard on Auditing (SA) 610, "Using the Work of Internal Auditors" (Published in the January, 2009 issue of the Journal) <a href="http://icai.org/resource_file/14324Annexure3-171208.pdf">http://icai.org/resource_file/14324Annexure3-171208.pdf</a>	March 1, 2009
Standard on Auditing (SA) 450, "Evaluation of Misstatements Identified During the Audit" (Published in the January, 2009 issue of the Journal) <a href="http://icai.org/resource_file/14323Annexure2-171208.pdf">http://icai.org/resource_file/14323Annexure2-171208.pdf</a>	March 1, 2009
Revised Standard on Auditing (SA) 320, "Materiality in Planning and Performing an Audit" (Published in the January, 2009 issue of the Journal) <a href="http://icai.org/resource_file/14322Annexure1-171208.pdf">http://icai.org/resource_file/14322Annexure1-171208.pdf</a>	March 1, 2009
Standard on Auditing (SA) 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements" (Published in the November, 2008 issue of the Journal) <a href="http://www.icai.in/resource_file/13531Annexure%201.pdf">http://www.icai.in/resource_file/13531Annexure%201.pdf</a>	December 31, 2008
Revised Standard on Auditing (SA) 210, "Agreeing the Terms of Audit Engagements" (Published in the November, 2008 issue of the Journal) <a href="http://www.icai.in/resource_file/13530Annexure%202.pdf">http://www.icai.in/resource_file/13530Annexure%202.pdf</a>	December 31, 2008
Revised Standard on Auditing (SA) 402, "Audit Considerations Relating to an Entity Using a Third Party Service Organisation" (Published in the October, 2008 issue of the Journal) <a href="http://www.icai.in/post.html?post_id=3239">http://www.icai.in/post.html?post_id=3239</a>	December 1, 2008
Standard on Auditing (SA) 265, "Communicating Deficiencies in Internal Control" (Published in August, 2008 issue of the Journal) <a href="http://www.icai.in/resource_file/7835announ1489.pdf">http://www.icai.in/resource_file/7835announ1489.pdf</a>	September 30, 2008
Revised Standard on Auditing (SA) 500, "Considering the Relevance and Reliability of Audit Evidence" (Published in the August, 2008 issue of the Journal) <a href="http://www.icai.in/resource_file/8370announ1491.pdf">http://www.icai.in/resource_file/8370announ1491.pdf</a>	September 30, 2008
Note: Though, for the benefit and information of the interested readers, and exposure draft shall continue to be hosted on the website of the AASB even after its last date for comments has expired, no comments thereon, after the expiry of the said date, would be considered by AASB, as the case ,may be.	
An exposure draft would be removed from the AASB's website when the final standard is issued or if the project is dropped.	

*Life is what happens to you while you're busy making other plans*

## INVITATION FOR RESEARCH PROPOSALS

Research Committee invites applications for Research Projects from members and others for carrying out research in the field of accounting and other affiliated fields for e.g. accounting for chain departmental stores, accounting in health care industry, accounting for electricity generation and distribution companies, accounting in aviation industry, accounting for shipping companies, management control systems, approaches to social cost-benefit analysis in the Indian context, etc. The Committee would provide financial support for the approved Research Projects.

### The Eligibility Criteria

- (a) The applicant must be a member of the Institute of Chartered Accountants of India with a research aptitude having at least 10 years of post-qualification experience either in the practice of the profession or as an employee with a reputed manufacturing/service organisation; or
- (b) The applicant must be holding a post-graduate degree from a recognised University or an institute of national repute and must have at least 10 years research and/or teaching experience;

Applications from persons having an experience less than as stated above may also be considered on the basis of merit.

### The Evaluation Criteria

Only those research proposals will be accepted that result in formulation of guidance material in the form of Technical Guide, Studies, Monographs for the members of the Institute in accounting and allied areas, such as the following:

- the issues on which no accounting standards are available or

- the issues that may arise in the implementation of accounting standards and other pronouncements in the industry-specific situations.

### Duration

The duration of research project should not exceed 3 months from the date of the approval of the research proposal unless a longer period is otherwise justified.

### Documents to be submitted with the research proposal

The proposal should be accompanied by a

- Complete bio-data including experience in the relevant field of interest.
- Synopsis of the project explicitly specifying the objective, scope and issues that would be addressed in the final proposed document. It should also contain a justification for the proposal and the detailed chapter plan.

The proposal should also indicate the estimated expenditure and expected honorarium for this purpose. The amounts in this regard would be remitted on the final acceptance of the draft by the Research Committee.

Research proposals complete in all respects should be sent to the Secretary, Research Committee, at the following address:

The Institute of Chartered Accountants of India,

ICAI Bhawan, Post Box No.7100,

Indraprastha Marg, New Delhi

E-mail: [research@icai.org](mailto:research@icai.org), Telephone: 011-30110458



## SCHOOL OF DISTANCE EDUCATION BU-ICAI JOINT EDUCATION PROGRAMME



**BHARATHIAR UNIVERSITY**  
State University  
Accredited with "A" Grade by NAAC  
Coimbatore – 641 046, Web: [www.b-u.ac.in](http://www.b-u.ac.in)

**THE INSTITUTE OF CHARTERED  
ACCOUNTANTS OF INDIA**  
(Set up under an Act of Parliament)  
New Delhi, Web: <http://www.icaai.org/>

BHARATHIAR UNIVERSITY (BU) & THE INSTITUTE OF CHARTERED  
ACCOUNTANTS OF INDIA (ICAI) have entered in to a Memorandum of Understanding to of-  
fer the following courses:

Under Graduate Course (UG)		Post Graduate Course (PG)	
B.B.A	B.Com.	M.Com.	M.B.A

Under the distance education mode the above courses are exclusively meant for qualified Chartered Accountants and for those who are undergoing Chartered Accountancy Course.

- For the purpose of award of the degree the total marks secured both in CA programme and UG/PG programme chosen by the candidate under this arrangement will be counted together.
- Exemptions in appearing from certain subjects in UG/PG examinations will also be provided both to the qualified Chartered Accountants and for those who have completed their Intermediate/PE II/ PCC/Final programme.
- For eligibility, course fee and cost of application and prospectus you can visit Bharthiar University website [www.b-u.ac.in](http://www.b-u.ac.in). and/or ICAI website [www.icaai.org](http://www.icaai.org)
- Admission for the programme will be made up to 31st March 2009. For those who are getting admission up to 31.03.2009, examination would be conducted during the month of January 2010.
- The application form can also be downloaded from the University website [www.b-u.ac.in](http://www.b-u.ac.in) and/or [www.icaai.org](http://www.icaai.org) under the heading BU-ICAI joint education programme. While submitting the filled-in application, a Demand Draft/Bank of India challan for Rs.100/- towards the cost of the application form in favour of **The Director, School of Distance Education, Bharathiar University payable at Coimbatore** should be enclosed.

Duly filled in application along with the enclosures can be sent to **The Co-ordinator, BU-ICAI Joint Programme, Administrative Building 1<sup>st</sup> floor, Bharathiar University, Coimbatore – 641 046 superscribed on the envelop as "Application for BU-ICAI Programme"**.

**Co.ordinator, BU-ICAI Joint Programme, Bharathiar University, Coimbatore - 46**  
Phone: 0422 – 2428400, e-mail : [gs\\_fin@yahoo.co.in](mailto:gs_fin@yahoo.co.in)

### CLASSIFIEDS

**4691** Wanted CA from all over India in all cities as partners, interested CA can contact on: (Mob): 9870229618/ 022- 25363548 or e-mail to: [smosantosh@rediffmail.com](mailto:smosantosh@rediffmail.com)

**4692** Delhi based CA firm requires fresh or experienced Chartered Accountants. Candidates should have audit or taxation experience. Contact M/s. D. G. & Co, 403 Pratap Chambers, Gurudwara Road, Karol Bagh, New Delhi-05, Ph no. 011-28751295, email: [dgco@airtelmail.in](mailto:dgco@airtelmail.in)

**4693** Experienced Chartered Accountant from

Industry now holding COP is available as External Quality control Reviewer/Advisor for firms of CAs with corporate clients at Chennai/Hyderabad. Response to [psmswamy@rediffmail.com](mailto:psmswamy@rediffmail.com)

**4694** Required Chartered Accountants on partnership/assignment/retainership/sub-contract/employment basis, semi-qualified and articulated assistants(for all major cities/district centers). Apply box: 4693, C/o: The Institute of Chartered Accountants of India, ICAI Bhawan, C-1, Sector-1, Noida-201301.

*As long as you live, keep learning how to live*

## Announcement on General Amnesty for Restoration of Names from Register of Members

01<sup>st</sup> January, 2009

A General Amnesty Scheme for retrospective restoration of Membership effective from the date of removal due to non-payment of Membership fee was launched by the Council and announcement to this effect was issued on 13<sup>th</sup> May, 2008 and the same was hosted on [www.icai.org](http://www.icai.org) and published in the Journal. This scheme provided an opportunity for such members whose names stood removed as on 13<sup>th</sup> May, 2008 due to non-payment of membership to apply for retrospective restoration of Membership on payment of membership fee for the entire period of removal and a restoration fee of Rs. 1000/-. This scheme was valid till 31<sup>st</sup> December, 2008. However, the Certificate of Practice will be issued from prospective date.

Some of the Members whose membership was active as on 13<sup>th</sup> May, 2008 but their membership was removed in the past at any point of time due to non-payment of membership fee made representations for enlarging the scope of the scheme so as to cover even such members whose name was removed in the past but have got their membership restored before the launch of the General Amnesty Scheme for giving retrospective effect of revival of membership for such period which was earlier not taken into account for the purpose of restoration of membership.

On consideration of the representations, the Council has decided to enlarge the scope of the General Amnesty Scheme so as **to cover even such members whose name stood removed in the past at any point of time due to non-payment of Membership Fees but were active members as on 13<sup>th</sup> May, 2008, [i.e. the date from which General Amnesty Scheme was implemented]** on payment of membership fee as was payable during the relevant period on making a request in the relevant form i.e. Form 9 and payment of restoration fee of Rs. 1000/-. The scale of membership fee as applicable from time to time is as given below: -

Effective from	Associate	Fellow
1 <sup>st</sup> April, 2008	*Rs.600	**Rs.1,800
1 <sup>st</sup> April, 2000	Rs.300	Rs.900

1 <sup>st</sup> April, 1996	Rs.225	Rs.700
1 <sup>st</sup> April, 1991	Rs.150	Rs.400
1 <sup>st</sup> April, 1986	Rs.100	Rs.275
1 <sup>st</sup> April, 1982	Rs.80	Rs.200
1 <sup>st</sup> April, 1976	Rs.60	Rs.125
1 <sup>st</sup> April, 1975	Rs.45	Rs.110
1 <sup>st</sup> April, 1964	Rs.28	Rs.83

\*Rs.450 where an Associate member has attained the age of 65 years as on 1st April, 2008.

\*\*Rs.1300 where a Fellow member has attained the age of 65 years as on 1st April, 2008.

The Council further decided to extend the validity of the scheme from 31<sup>st</sup> December, 2008 to 31<sup>st</sup> March, 2009 to enable all such members whose membership status was active or not as on 13<sup>th</sup> May, 2008 to take full advantage of the General Amnesty Scheme in its true sense.

The Council clarified that the retrospective restoration will be only in respect of membership of the Institute and the Certificate of Practice will be issued only from prospective date i.e. the date on which the Form 6 and the fee is received in the Institute. The Form 6 can be downloaded from [www.icai.org](http://www.icai.org) and the payment can be made online through link "Online payment & services".

Such members desirous of availing the opportunity are invited to apply for retrospective restoration of membership in Form 9 which can be downloaded from [www.icai.org](http://www.icai.org) and the payment can be made online through link "Online payment & services".

For any clarification or more details, please contact the concerned decentralised office of the Institute or the Head Office over phone No. 011-30110426/ 30110553/ 30110535 or email to [mss@icai.in](mailto:mss@icai.in)

*No one can make you feel inferior without your consent*

## Launching of the Certificate Course on Enterprise Risk Management

The Internal Audit Standards Board under the aegis of the Council of the Institute of Chartered Accountants of India recognizing the need of enterprise risk management in the complex and dynamic environment in which the modern day enterprises operate, has decided to launch Certificate Course on Enterprise Risk Management.

### Objectives of the Course

The primary objective of this Course is to impart the necessary technical knowledge and expertise and build upon the skill sets of the members of the Institute to play a leading and value adding role in various aspects of Enterprise Risk Management and develop it as another of their areas of core competence. The objectives of the Course therefore are:

- Disseminating knowledge on the theory and practice of ERM.
- Reflect current risk management thinking and practices and how they impact contemporary business enterprises.
- Enhancing the role of chartered accountants in the area of ERM.
- Building up ERM as a core competence area of chartered accountants.

### Course Duration

The total duration of the course is 200 hours spread over 6 weekends, divided as follows:

Self study	: 100 hours
Class room teaching	: 50 hours
E-learning	: 30 hours
Case study preparation and presentation	: 20 hours

### Fees

Rs. 28,090/- (including applicable service tax) per delegate only, payable at the time of Registration.

### Course Contents

#### Module I: Understanding the Concept of Risk and Enterprise Risk Management

- Defining Risk
- Different Types of Risks
- Value Maximisation – Converting Risks into Opportunities
- Defining Enterprise Risk Management
- Benefits of Enterprise Risk Management System
- Limitations of Enterprise Risk Management System
- Objectives of an Enterprise Risk Management System
- Components of Enterprise Risk Management System

#### Module II: Establishing a Risk Strategy

- Implementing Enterprise Risk Management
- Portfolio Theory in Enterprise Risk Management
- Identifying the Event

- Responsibility of the Management
- Responsibility of Those Charged with Governance
- Developing and Documenting a Risk Management Policy
- Creating Risk Aware Culture

#### Module III: Undertaking Risk Assessments

- Risk Assessment Techniques
- Assessing the Cost of Risk
- Risk Categorisation – H, M & L
- Assessing the Risk Likelihood and Severity
- Risk-based Decision Making

#### Module IV: Implementing Risk Response Strategy

- Setting the Risk Appetite
- Treatment of Risk – tolerance, transfer, terminate
- Controlling the Risk
- Reducing the Risk Likelihood
- Disaster Recovery Planning
- Business Continuity Planning

#### Module V: Risk Reporting

- Techniques for Evaluating the Enterprise Risk Management System
- Role of the Internal Audit in Enterprise Risk Management
- Reporting on Enterprise Risk Management System
- Role of ERM in Strengthening Corporate Governance
- Meeting the Stakeholders Expectations Through ERM

#### Module VI: Case Studies

Having regard to the professional and personal preoccupations of the participants, the Course is designed as a balanced mix of class room teaching, E-learning as well as self study.

### Pilot Batch

The pilot batch of this Course is tentatively scheduled from the end of February, 2009/ March, 2009 at Delhi.

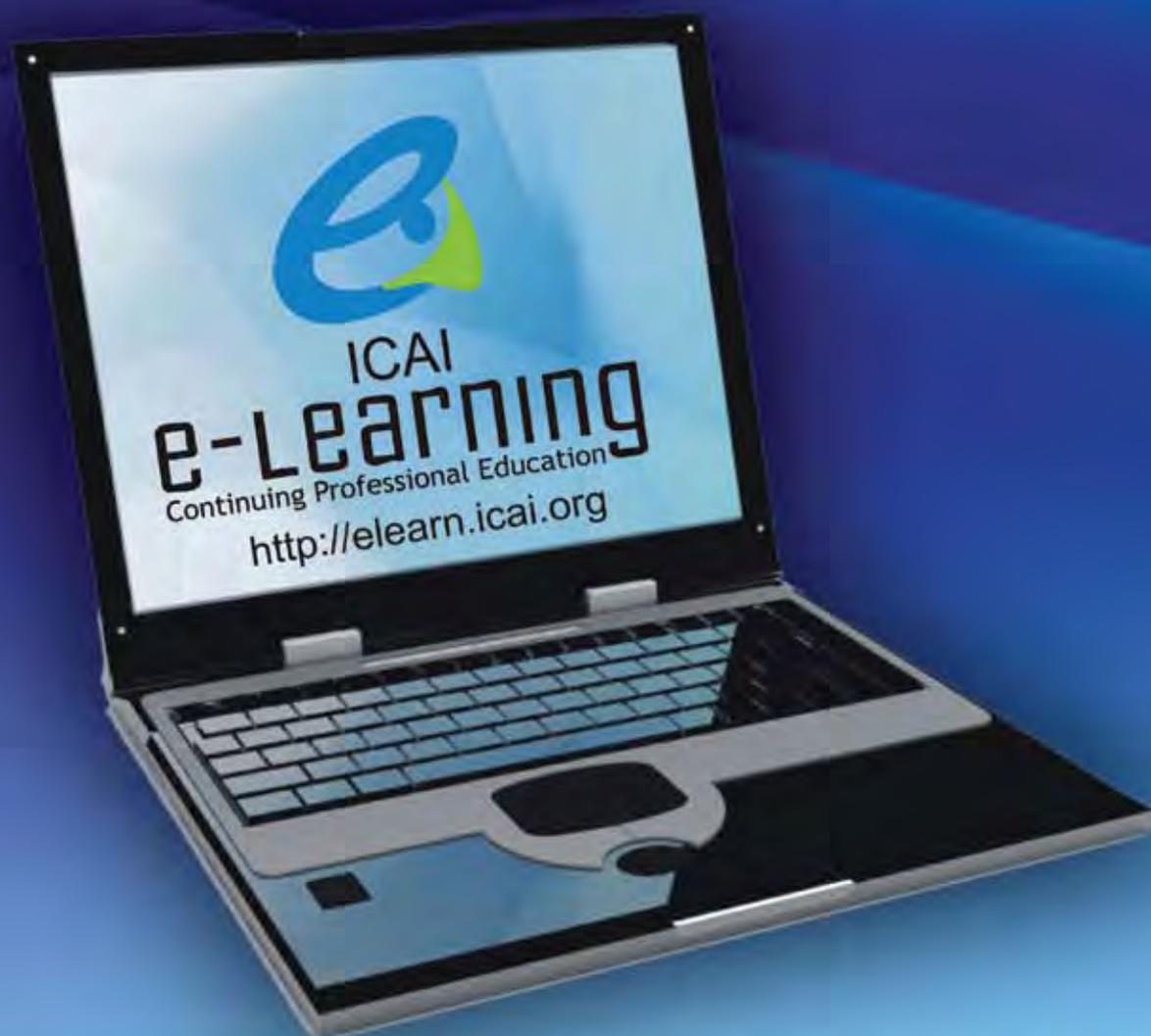
**This Course is being launched on January 28, 2009. The registration for the course would also start from January 28, 2009.**

### Further Details & Assistance

Secretary, Internal Audit Standards Board  
Internal Audit Standards Board Secretariat  
The Institute of Chartered Accountants of India  
ICAI Bhawan, C-1, Sector-1,  
NOIDA-201301  
Tel.: 0120-3054845,  
Fax.: 0120-3054848,  
Email: [cia@icai.org](mailto:cia@icai.org), [auditing@icai.org](mailto:auditing@icai.org)

*When anger rises, think of the consequences*

# ICAI launches its e-Learning Portal and e-learning course on Service Tax



Welcome to the world of e-Learning. We trust that you will enjoy the experience of learning from the comfort of your home or office and will continue to come back to the portal for more. Do share your experience with us and with your colleagues and friends. In case of any clarification, kindly contact **CA. K. Raghu**, Chairman, Continuing Professional Education Committee at [cpeinfo@icai.org](mailto:cpeinfo@icai.org).

ICAI has always been striving to provide better learning opportunities to its members and students. The challenge is to make these learning opportunities available to members across the country in a convenient and empowered manner. The learning materials and modules help members adapt to environmental changes in business, thereby giving them a cutting edge advantage in their work delivery.

With the Unstructured CPE Learning Activities made mandatory from 1st January 2008, there was a need to implement learning opportunities using technology and the Internet to provide members with a learning experience that is professional and at their own convenience. This has led to the introduction of the e-Learning initiative by the Continuing Professional Education Committee that provides members with the opportunity to:

- Keep abreast with current information in all core areas
- Familiarise themselves with new subject content related to Professional Development

**Avail 6 Hours CPE Credits for Service Tax e-learning course**

## ICAI e-Learning Initiative

In a progressive and technology driven world, ICAI recognising this reality is driven by its commitment to provide its members and students with quality learning in a convenient manner, is proud to launch its first e-Learning course.

ICAI has planned a series of e-Learning courses that will provide members with quality content and learning through well produced multi-sensory learning techniques in the convenience of their homes or offices.

Some of the other topics that will be covered through this e-learning initiative are:

- Fringe Benefit Tax
- IFRS
- BASEL II
- SOX
- Foreign Direct Investments
- Transfer Pricing
- Investment Banking
- Treasury Management
- Due Diligence

Course Fee:  
Rs. 500/-

ICAI has ensured that state-of-the-art technology, high production values and an elegant set design will provide an interactive learning experience.

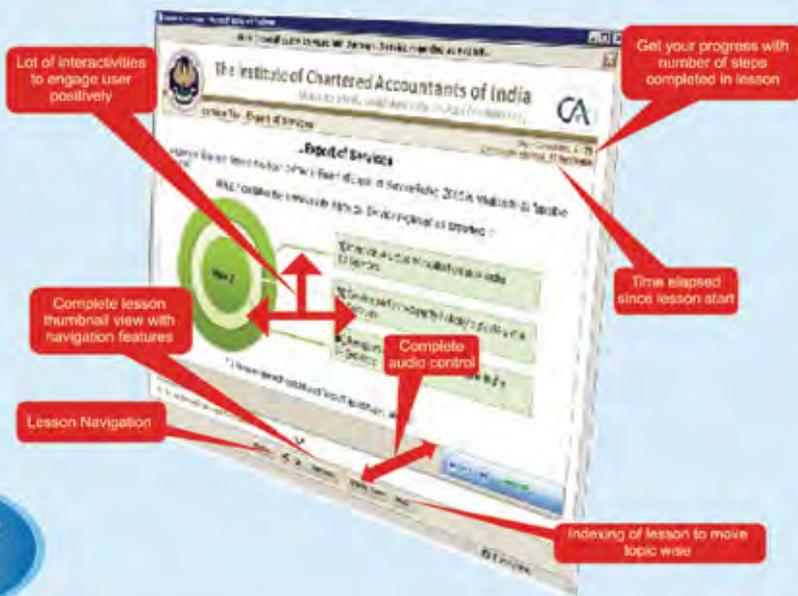
### e-Learning Course on Service Tax

Service Tax is here to stay and the Government of India has consistently brought more and more businesses and professionals under the Service Tax umbrella. Being informed, up-to-date and empowered with a detailed understanding of the Service Tax Act and its impact on business, consultants and professional service providers is of utmost importance and hence ICAI has launched "Service Tax" as its first learning module.

### Coverage of e-Learning Course on Service Tax

No effort has been spared to ensure that the content of this e-learning course on Service Tax is comprehensive and up-to-date. The major topics covered in the course are:

- Introduction to Service Tax
- Applicability of Service Tax
- Service Tax Rate Structure
- Export of Services
- Import of Services
- Classification of Services
- Valuation of Services
- Assessment
- Rectification of Mistakes
- Penalty
- Refund of Service Tax
- Service Tax Procedural Aspects under Service Tax Rules, 1994
- Cenvat Credit Rules, 2004
- Quiz



### Get registered at ICAI e-Learning

- Send a DD/Cheque at PAR to the Institute favouring The Secretary, ICAI payable at New Delhi to the Secretary, CPE Committee, ICAI Bhawan, Post Box no. 7100, Indrapratha Marg, New Delhi-110002
  - Pay online by going to <http://elearn.icai.org/epayments>
- On receipt of the payment by the CPE Committee, the Committee will provide you a "Redeem Code" to create your account on e-Learning Portal.

### Creating an Account

- On your web browser, just go to the link: <http://elearn.icai.org>
- Click the button "Create New Account..."
- At the account creation page, fill all your relevant details along with the provided "Redeem Code".
- Click the button "Submit"
- Your account has been created successfully.
- Now click the button "Return to Login" to go to your e-Learning account.



Continuing Professional Education Committee  
The Institute of Chartered Accountants of India  
ICAI Bhawan, Indraprastha Marg, Post Box. No. 7100, New Delhi - 110 002, India  
Website: [www.icai.org](http://www.icai.org) E-mail: [cpesec@icai.org](mailto:cpesec@icai.org) Tel: +91 11 3011 0451

## Result of the Writing Competition

The results of the writing competition organised by the Board of Studies of the ICAI have been announced. The names of the prize winners in all three categories are given below:

### 1. Why to become a Chartered Accountant

1.	CA. S. Balan , Pune	First Prize
2.	CA. Parizad Minoor Master, Mumbai	Second Prize
3.	CA. Shashank Bhube, Mumbai	Consolation Prize
4.	Ms. Richa Modi, Kolkata	Consolation Prize

### 2. How services of a Chartered Accountant help?

1.	CA. Jyotsna Yadav, New Delhi	First Prize
2.	CA. Rahul Kumar, Gurgoan	Second Prize
3.	CA. S. Indra Kumar, Calicut and Ms. Rafat Jahan, NRO	Third prize (to be shared)

### 3. Catchy Slogan

1.	Mr. Rushabh Chandrakant Mehta, Ahmedabad	First Prize
2.	Mr. Manish Dutt	Second Prize
3.	CA. Niranjan Hiremath	Third Prize

Letter of appreciation will be sent to following participants:

1.	CA. Mahadevan N.V, Thrissur
2.	Ms. Hyma Venkatesan, Chennai
3.	Ms. Chhaya M. Kothari, Vapi (W)

4.	CA. Rajesh Kumar Modi, Mumbai
5.	CA. Rambabu Mantry, Siliguri
6.	Ms. Shivakriti Kapoor, Kanpur
7.	Ms. Garima Agarwal, Jodhpur
8.	Ms. Binal M. Saiya, Mumbai
9.	Ms. C. Jayanthi, Chennai
10.	Ms. Epla Virmani, Delhi
11.	Mr. Vinit D. Gada, Mumbai
12.	CA. K. Sharada
13.	Ms. Vaidya Urvi K., Rajkot
14.	CA. Rishab Jain, Chennai
15.	CA. R.J. Khandelwal, Pune
16.	CA. Arman G. Nagori, Ahmedabad
17.	Ms. Archana J. Bhatt, Surat
18.	Mr. R. Saravanan, Chennai
19.	Mr. Sahil Khajuria,
20.	Mr. Ullal Kartik Rohithashwa, Mangalore
21.	Ms. V. Aruna, Chennai
22.	Ms. Mahak Kala, Jaipur
23.	Mr. Kaushik Venkatraman,
24.	Mr. Hrushit T. Shah, Ahmedabad

Director of Studies

## Empanelment of Faculty for the Course on Enterprise Risk Management

Considering the contemporary relevance of the Enterprise Risk Management in the complex and dynamic environment in which the modern day enterprises operate, and need to provide the members necessary skills in this regard, the Internal Audit Standards Board of the Institute of Chartered Accountants of India proposed to launch Certificate Course on Enterprise Risk Management. The broad course contents are as follows :

- Understanding the Concept of Risk and Enterprise Risk Management
- Establishing a Risk Strategy
- Undertaking Risk Assessments
- Implementing Risk Response Strategy
- Risk Reporting
- Case Studies

The total duration of the course is 200 hours spread over 6 weekends, divided as follows:

Self study	: 100 hours
Class room teaching	: 50 hours
E-learning	: 30 hours
Case study preparation and presentation	: 20 hours

The Board is presently preparing a panel of experts to act as faculty for this course across the country. The honorarium to the experts would be made as per rules of the Institute in this regard. The persons who are interested are requested to send their Resume to the Secretary, Internal Audit Standards Board at the following address at the earliest:

The Secretary, Internal Audit Standards Board, The Institute of Chartered Accountants of India,  
ICAI Bhawan, Post Box. No. 36, C-1, Sector- 1, Noida- 201301.  
E-mail: [cia@icai.org](mailto:cia@icai.org); [auditing@icai.org](mailto:auditing@icai.org), Phone: (0120) 3054845

*Learning acquired in youth is an inscription on stone*

## Empanelment of Faculties for the In-house Executive Development Programmes being conducted by the CPE Committee of ICAI

The Continuing Professional Education Committee (CPEC) of the Institute of Chartered Accountants of India organizes specialized In-house Executive Development Programmes for the officials of various leading corporates of the country on diverse topics which broadly include:

1. International Financial Reporting System (IFRS)
2. Service Tax
3. Income-tax
4. Customs
5. Central Excise & CENVAT
6. Transfer Pricing
7. Due Diligence
8. US GAAP
9. Preparation of Financial Statements
10. Tax Audit
11. Other subjects relating to Chartered Accountancy Profession

The CPE Committee is in the process of finalizing a

panel of Experts to act as faculty for In-house Executive Development Programme across the country. The persons who have more than 3 years of experience in the relevant area and who have delivered lectures at various forums are eligible for the Panel of Experts.

The persons who are interested to be associated with the Institute of Chartered Accountants of India as Resource Persons are requested to send/e-mail their resume to Dr. M.S. Turan, Additional Director (CPE and CMII) at the following address :

The Institute of Chartered Accountants of India  
ICAI BHAWAN.

I.P. Marg, New Delhi –110 002.

E-Mail: [cpehours@icai.org](mailto:cpehours@icai.org), [cpeadmin@icai.org](mailto:cpeadmin@icai.org)

T.No. 011-30110438,451,536

It would be appreciated if the resume including all details regarding qualification, experience, areas of specialization, contact address, etc. is sent at the earliest, preferably within one month.

Chairman,  
CPE Committee of the ICAI  
New Delhi

## Certificate Course on Forensic Accounting and Fraud Detection using IT and CAATs

The Council of the Institute of Chartered Accountants of India, recognizing the need for Forensic Accounting and Fraud Detection, in the emerging economic scenario, has decided to launch this Certificate Course on Forensic Accounting and Fraud Detection using IT and CAATs.

Forensic Accounting and Fraud Detection specialisation is in increasing demand considering increasing incidents of cyber crimes and frauds detection. It is the practice of utilizing accounting, auditing, CAATs/ Data Mining Tools, and investigative skills to detect fraud/mistakes.

Learning Outcomes

- Assessment of the damages
- Fact finding to see whether fraud/ embezzlement has taken place

- Collection of evidences
- Investigating and analyzing financial evidences

### Course Duration

100 hours spread over 6 weekends.

### CPE Hours

The CPE credit of 20 Hours will be given to the participants.

### Course Fees

Rs.25,000/- per delegate payable Online or by DD/ Pay-Order drawn in the favour of "The Secretary, ICAI" payable at Delhi.

**Further Details and Registration Form for the course are available on the web-site of the**

*A weak man has doubts before a decision, a strong man has them afterwards*

Institute under the heading Courses Offered by the Institute at the link [http://icai.org/post.html?post\\_id=3859](http://icai.org/post.html?post_id=3859)

Course Mail id:- [cc.fafd@icai.in](mailto:cc.fafd@icai.in)

**National Course Director**

CA. Atul C. Bheda, Chairman, Committee on IT, ICAI

E-mail: [bhedaac@mtnl.net.in](mailto:bhedaac@mtnl.net.in),

Mobile Number 9323323667

**Further Details & Assistance**

ICAI Course Coordinator	Course Coordinator for Mumbai Batch	Nodal Officer
<b>Mrs. Indu Arora</b>	<b>Mrs. Srabani Kapoor</b>	<b>Mr.Amit Gupta</b>
Secretary, Committee on IT, ICAI	Sr.Faculty, ICAI Mumbai	Sr.EO, CIT, ICAI
E-Mail: <a href="mailto:indu@icai.org">indu@icai.org</a>	E-mail:- <a href="mailto:kapoor@icai.org">kapoor@icai.org</a>	E-mail:- <a href="mailto:amitgupta@icai.org">amitgupta@icai.org</a>
Tel: 011-30210619/621, 9350799910	Tel: 022-39802911, 9321239894	Tel: 011-30210619/ 621

### Attention Old Students Accounting Technician Certificate

The Institute has launched a new scheme of education – Integrated Professional Competence Course (IPCC) providing for registration to Group I/Accounting Technician or Group II or all Groups.

The new scheme of education provides that a student who has passed the erstwhile Intermediate Examination or First Examination or was exempted from passing First Examination or Professional Education - II Examination or Professional Competence Examination in its entirety and has completed the prescribed period of practical training will be eligible for grant of Accounting Technician Certificate.

Interested students who have passed Intermediate Examination or other Examination as explained above and have completed prescribed period of practical training are invited to exercise their option for grant of Accounting Technician Certificate by making an application to this effect. For more details and online submission of application, please visit [www.icai.org](http://www.icai.org)

[V. Sagar]  
Joint Secretary (MSS)

22<sup>nd</sup> January, 2009

### OFFICE OF THE COMPTROLLER AND AUDITOR GENERAL OF INDIA 10, BAHADUR SHAH ZAFAR MARG, NEW DELHI 110002 Empanelment of Chartered Accountant firms for the year 2009-2010

Applications are invited **online** from the firms of Chartered Accountants who intend to be empanelled with this office for the year 2009-2010 for appointment as auditors of Government Companies/Corporations.

The format of application along-with the detailed instructions regarding the documents to be furnished will be available on our website: [www.cag.gov.in](http://www.cag.gov.in) from **1<sup>st</sup> January 2009 to 16<sup>th</sup> February 2009**.

The last date for the receipt of **specified documents** in this office is **27<sup>th</sup> February 2009**.

Only the firms who apply online and send the specified documents to this office by the due dates will be considered for empanelment.

Sd/-  
(K P Sasidharan)  
Principal Director (Commercial)

*If you do not hope, you will not find what is beyond your hopes*

The Institute of Chartered Accountants of India  
takes pride in announcing the opening of  
*Accountancy Museum*

The Accountancy Museum has been conceptualized as an assemblage to trace the origin and growth of the accountancy profession itself – how accountancy evolved in India and in the world.

The Museum aims to narrate the story of origin and growth of bookkeeping, and its evolution by showcasing rare, historical and important artifacts, images, manuscripts and documents. Beginning with the primers of accountancy exercises in Sumerian civilization (circa 8000 BC), its state in ancient India through *Kautilya's Arthashastra* (4<sup>th</sup> century BC) and other later Vedic texts, accountancy practices during Delhi Sultanate and Mughal Empire, and its gradual sophistication during the Company and then British rule in India, the Museum goes on to narrate the rationality behind the birth of the Institute.

Among many rare and historic items on display, the Museum has presented images of world's first and India's first coins, balance sheets as old as 1929, image of the members and minutes of the proceedings of the Indian Accountancy Board, first balance sheet of our Institute, first report of the Council, first RA Final Examination and CA Final Examination Gold Medals, Income & Expenditure Account of the Indian Accountancy Board of 1935 and the report of the Accountancy Expert Committee.

All are invited to take a tour to the Museum.

Date of Inauguration : Monday, February 2, 2009, 12:30 PM  
Visiting hours : 10.30 AM to 1.00 PM and 1.30 PM to 05.00 PM (Monday to Friday)  
Venue : ICAI Bhawan, C-1/Sector-1, NOIDA 201301



The President and members of the Council of

**THE INSTITUTE OF CHARTERED  
ACCOUNTANTS OF INDIA**

Cordially invite you to the institute's

**59<sup>th</sup>**  
Annual  
Function

**Date & Time:** Wednesday, 4th Feb.'09, 3.00 pm

**Venue:** Convention Hall, Hotel Ashok, New Delhi

*A coward gets scared and quits. A hero gets scared, but still goes on*

**National Conference at Indore**  
**Organized by Continuing Professional Education Committee**  
**Hosted by Indore Branch of CIRC of ICAI**

<b>Theme</b>	Leveraging knowledge to serve diverse demand
<b>Date &amp; Time</b>	Saturday 21 <sup>st</sup> and Sunday 22 <sup>nd</sup> , February, 2009 at 09.30 am to 06.00 pm
<b>Venue</b>	Dhirubhai Ambani Auditorium, Daly College, Indore
<b>Inaugural Session</b>	Key Note Address by President, ICAI Special Address by Kr. Sumer Singh, Director, The Daly College Business School, Indore
<b>Topics to be Discussed</b>	<b>Speakers</b>
Internal Audit -Tool for Value Addition & Internal Control and Financial Reporting with special reference to Forensic Accounting	<b>Session Chairman :</b> CA. K. Raghu, Central Council Member <b>Speakers:</b> CA. Nagesh Pinge & CA. Arjit Chakraborty
Issues in Corporate Taxation Landmark Judgements in Income Tax Act, 1961	<b>Session Chairman :</b> Shri Manoj Sarkar, Central Council Member <b>Speakers:</b> CA. Manish Dafria CA. Chythanya K.K., Bangalore
Key Note Address on GST 2010, Road ahead Stock Market behaviour and Investors' strategy, Issues related to VAT	<b>Session Chairman :</b> CA. Ashok Chandak, Past President, ICAI <b>Speakers:</b> CA. Rajendra Goyal, CA. P.D. Nagar
Evolution of Hindu Law and Tax Aspects NRI Taxation All about TDS under Income Tax Act, 1961	<b>Session Chairman :</b> CA. R. Bupathy, Past President, ICAI <b>Speakers:</b> CA. Nitin Hegde, CA. Girish Ahuja
<b>Cultural Evening and Dinner on 21<sup>st</sup> February, 2009 at 07 pm onwards</b>	
<b>CPE Hours</b>	12 Hours for the Members of the ICAI
<b>Delegate Fees</b>	ACA: Rs. 1,500; FCA: Rs. 1,700; Students: Rs. 1,000; Others: Rs. 1,700
<b>Conference Chairman</b>	CA. K. Raghu, Central Council Member & Chairman CPE Committee (Mob.: 09341219091)
<b>Conference Director</b>	CA. Manoj Fadnis, Central Council Member (Mob.: 9302217716)
<b>Conference Co-Chairperson</b>	CA. Kemisha Soni, Chairperson, Indore Branch of CIRC of ICAI (Mob. : 9302166885 / 9826049594)
<b>Conference Secretary</b>	CA. Aseem Trivedi, Secretary, Indore Branch (Mob. : 9893627530)
For Registration & further details, please contact Email - <a href="mailto:indore@icai.org">indore@icai.org</a>	Indore Branch of CIRC of ICAI, Plot No. 19B, Scheme No. 78, Indore-452010 Phone : 0731-3254900, 4298198, 4227962

# INTRODUCTION TO STRESS MANAGEMENT

Stress is not necessarily something bad – it all depends on how we take it. The stress of exhilarating, creative successful work is beneficial while that of failure, humiliation or infection is detrimental. Negative stress is what we feel when we think we have lost control over events. There are very many proven skills that we can use to manage stress. This article discusses the concept.



A lot of research has been conducted into 'stress' over the last hundred years. Some theories about it are now settled and accepted; others are still being researched and debated.

## Definitions

Hans Selye was one of the founding fathers of research on stress. He stated in 1956 that "stress is not necessarily something bad – it all depends on how we take it. The stress of exhilarating, creative successful work is beneficial while that of failure, humiliation or infection is detrimental."

Since then, a great deal of further research has been

conducted on the subject, and new ideas have come to light. Stress is now viewed as a "bad thing", with a range of harmful biochemical and long-term effects. These effects have rarely been observed in positive situations.

The most commonly accepted definition of stress is that stress is a condition or feeling experienced when a person perceives that "demands exceed the personal and social resources the individual is able to mobilize." In short, it is what we feel when we think we have lost control over events.

## Managing Stress

There are very many proven skills that we can use to manage stress. These help us to re-



— CA. Sachinder Garg  
*(The author is a member of the Institute. He can be reached at [casaching@yahoo.com](mailto:casaching@yahoo.com))*

Sometimes we are not able to change our environment -- may be because we do not have the power to change a situation, or where we are about to give an important performance. Imagery is a useful skill for relaxing in these situations. By imagining a pleasant and relaxing scene, we can objectively see reduction in the stress in our body.

main calm and effective in high-pressure situations, and help us avoid the problems of longterm stress. Some of the techniques that we can use to manage stress are described below :

## 1. Imagery

**Mental Stress Management:** Sometimes we are not able to change our environment -- may be because we do not have the power to change a situation, or where we are about to give an important performance. Imagery is a useful skill for relaxing in these situations.

Imagery is a potent method of stress reduction, especially when combined with physical relaxation methods like deep breathing.

We all are aware of how particular environments can be very relaxing, while others can be intensely stressful. The principle behind the use of imagery in stress reduction is that we can use our imagination to recreate and enjoy a situation that is very relaxing. The more intensely we imagine the situation, the more relaxing the experience will be.

By imagining a pleasant and relaxing scene, we can objectively see reduction in the stress in our body. By imagining an unpleasant and stressful situation, we can feel the increase of stress in our body.

To relax with imagery, we need to imagine a warm, comfortable, safe and pleasant situation, and enjoy it in our imagination.

## 2. Anger Management

**Channelling Anger into Performance:** People experience anger in many different ways and for many different reasons. What makes us angry may only mildly irritate one of our colleagues, and have little or no effect on another one. This subjectivity makes anger difficult to understand and deal with. So anger management focuses on managing our response (rather than specific external factors). By learning to manage our anger, we can develop techniques to expel negative responses and emotions before they cause us serious stress, anxiety and discomfort.

Given below is the 11-step approach to help us direct

our anger constructively rather than destructively :

### Step 1: Acknowledge that we have a problem managing anger

It is a known truth that we cannot change what we don't acknowledge. So it is important that we accept that anger is a roadblock to our success.

### Step 2: Use our support network

If anger is a problem, let the people who matter in our life know about the changes we are trying to make. They can be a source of motivation and their support will help to prevent us from lapsing into old behaviour patterns.

### Step 3: Use anger management techniques to interrupt the anger cycle

- Pause
- Take deep breaths
- Tell ourselves that we can handle the situation
- Stop negative thoughts

### Step 4: Use empathy

If another person is the cause of our anger, try to see the situation from his or her perspective. We need to remind ourselves that we have to be objective: to realize that everyone makes mistakes, and it is through mistakes that people learn how to improve.

### Step 5: Laugh at ourselves

Humour is often the best medicine. We need to learn to laugh at ourselves and not take everything too seriously.

If we feel tempted to kick the photocopier, we have to think how silly we would look, and thus see the humour in our inappropriate expression of anger.

### Step 6: Relax

Angry people are often the ones who let little things bother them. If we learn to calm down we will realize that there is no need to get uptight and we will experience fewer bouts of anger.

### Step 7: Build trust

Angry people can be cynical. They believe that oth-

People experience anger in many different ways and for many different reasons. What makes us angry may only mildly irritate one of our colleagues, and have little or no effect on another one. This subjectivity makes anger difficult to understand and deal with. So anger management focuses on managing our response (rather than specific external factors).

ers do things on purpose to annoy or frustrate them. If we can build trust in people we will be less likely to become angry with them when something does go wrong and more likely to attribute it to anything other than malicious intent.

### Step 8: Listen

Miscommunication contributes to frustration and mistrust. The better we listen to what a person is saying, the better we will be able to find a resolution that does not involve an angry response.

### Step 9: Be assertive

We need to remember that the word is assertive, NOT aggressive. When we are angry it is often difficult to express ourselves properly. If we learn to assert ourselves and let others know our expectations, boundaries, issues, and so on, we will have better chances of interpersonal success.

### Step 10: Live each day as if it is our last

This saying may have been overused, but it still holds true. Life is short, and it is much better to spend it positively than negatively. We have to realize that if we spend all our time getting angry, we will miss out on the many joys and surprises that life has to offer.

### Step 11: Forgive

To ensure that the changes we are making go really deep down into us, we need to forgive the people that have angered us. It is true that it is not easy to let go of past hurts and resentments but the only way to move past our anger is to let go of these feelings and start afresh.

These 11 steps form a comprehensive plan to control inappropriate and unproductive anger. And the sooner we begin the better for us. Anger and stress are highly correlated and the effects of stress on the body are well documented.

## 3. Physical Relaxation Techniques

### Deep Breathing, PMR and the Relaxation Response:

Physical relaxation techniques are as effective as

mental techniques in reducing stress. In fact, the best relaxation is achieved by using physical and mental techniques together.

The following three useful physical relaxation techniques can help reduce muscle tension and manage the effects of the fight-or-flight response on our body.

#### (a) Deep Breathing:

Deep breathing is a simple, but very effective method of relaxation. It is a core component of everything from the "take ten deep breaths" approach to calming someone down, right through to yoga relaxation and Zen meditation. It works well in conjunction with other relaxation techniques such as Progressive Muscular Relaxation, relaxation imagery and meditation to reduce stress.

#### (b) Progressive Muscular Relaxation:

Progressive Muscular Relaxation (PMR) is useful for relaxing our body when our muscles are tense.

The idea behind PMR is that we tense up a group of muscles so that they are as tightly contracted as possible, and hold them in this state for a few seconds. Then, we relax the muscles slowly and slowly, so that we are as relaxed as possible.

By tensing our muscles we can relax our muscles more than if we tried to relax them.

We can experiment with PMR by forming a fist, and clenching our hand as tightly as we can for a few seconds. Then we relax our hand to its previous tension, and then consciously relax it again so that it is as loose as possible. We can easily feel deep relaxation in our hand muscles.

#### (c) The Relaxation Response:

This we can do by following the steps given below :

- Sit quietly and comfortably.
- Close our eyes.
- Start by relaxing the muscles of our feet and then work up our body relaxing muscles.
- Focus attention on our breathing.

“Deep Breathing,” “Progressive Muscular Relaxation,” and the steps leading to the “Relaxation Response” are three good techniques that can help to relax our body and manage the symptoms of the fight-or-flight response.

- Breathe in deeply and then let our breath out. Count our breaths, and say the number of the breath as we let it out (this to keep our mind engaged, and avoid getting distracted).

“Deep Breathing,” “Progressive Muscular Relaxation,” and the steps leading to the “Relaxation Response” are three good techniques that can help to relax our body and manage the symptoms of the fight-or-flight response.

#### 4. Building Self-Confidence

##### Develop the self-confidence we deserve!

Self-confident people inspire confidence in others: their audience, their peers, their bosses, their customers, and their friends. Gaining the confidence of others is one of the key ways in which a self-confident person finds success.

The good news is that self-confidence can really be acquired and built on. And, whether we are working on our own self-confidence or building the confidence of people around us, it is well-worth the effort! All other things being equal, self-confidence is often the single ingredient that distinguishes a successful person from someone less successful.

Our level of self-confidence can show in many ways: in our behaviour, our body language, the manner in which we speak or what we say, and so on. Given below is a comparison between confident behaviour with behaviour associated with low self-confidence.

Self-Confident	Low Self-Confidence
Doing what we believe to be right, even if others mock or criticize us.	Governing our behaviour on the basis of what other people think.
Being willing to take risks and go the extra mile to achieve better things.	Staying in our comfort zone, fearing failure and avoid taking risks.
Admitting our mistakes and vowing to learn from them.	Working hard to cover up mistakes and praying that we can fix the problem before anyone detects it.

Waiting for others to congratulate us on our accomplishments.	Extolling our own virtues as often as possible to as many people as possible.
Accepting compliments graciously.	Dismissing compliments offhandedly.

We can see from the comparison that low self-confidence can be self-destructive; it often manifests itself as negativity. Self-confident people are generally more positive – they believe in themselves and their abilities, and they also believe in living life to the full.

#### 5. Laughter

Adopting a humorous view towards happenings in life can take the edge off everyday stress. Not being too serious or in a constant alert mode helps maintain the equanimity of mind and promote clear thinking. Being able to laugh stress away is the smartest way to ward off its effects.

A sense of humor also allows us to perceive and appreciate the incongruities of life and provides moments of delight. The emotions we experience directly affect our immune system. Positive emotions can create neurochemical changes that buffer the immunosuppressive effects of stress.

##### What laughter can do against stress and its effects

- Laughter lowers blood pressure and reduces hypertension.
- It provides good cardiac conditioning, especially for those who are unable to perform physical exercise.
- It reduces stress hormones.
- Laughter cleanses the lungs and body tissues of accumulated stale air as it empties more air than it takes in.
- It increases muscle flexion, relaxation and fluent blood circulation in body.
- It boosts immune function.
- Laughter triggers the release of body's natural painkillers.
- It produces a sense of well-being. □

## Standard on Internal Audit (SIA) 12 Internal Control Evaluation

The following is the text of the Standard on Internal Audit (SIA) 12, *Internal Control Evaluation*, issued by the Institute of Chartered Accountants of India. The Standard should be read in the conjunction with the “Preface to the Standards on Internal Audit”, issued by the Institute.

In terms of the decision taken by the Council of the Institute at its 260<sup>th</sup> meeting held in June 2006, the following Standard on Internal Audit shall be recommendatory in nature in the initial period. The Standard shall become mandatory from such date as may be notified by the Council in this regard.

### Introduction

1. The purpose of this Standard on Internal Audit is to establish standards and provide guidance on the procedures to be followed by the internal auditor in evaluating the system of internal control in an entity and for communicating weaknesses therein to those charged with governance.

### Nature, Purpose and Types of Internal Controls

2. Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met. “Internal Control System” means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management’s objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls

are well designed and properly operated. Internal control system consists of interrelated components as follows:

- Control (or Operating) environment.
- Risk assessment.
- Control objective setting.
- Event identification.
- Control activities.
- Information and communication.
- Monitoring.
- Risk response.

3. The system of internal control must be under continuous supervision by management to determine that it is functioning as prescribed and is modified, as appropriate, for changes in environment. The internal control system extends beyond those matters which relate directly to the functions of the accounting system and comprises:

- a. “control environment” means the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity. The control environment has an effect on the effectiveness of the specific control procedures

and provides the background against which other controls are operated. Factors reflected in the control environment include:

- The entity’s organisational structure and methods of assigning authority and responsibility (including segregation of duties and supervisory functions).
  - The function of the board of directors and its committees, in the case of a company or the corresponding governing body in case of any other entity.
  - Management’s philosophy and operating style.
  - Management’s control system including the internal audit function, personnel policies and procedures.
  - Integrity and ethical values.
  - Commitment to competence.
  - Human resource policies and practices.
- b. “control activities” (or procedures) which means those policies and procedures in addition

to the control environment which management has established to achieve the entity's specific objectives. Control activities include approvals, authorizations, verifications, reconciliations, reviews of performance, security of assets, segregation of duties and controls over information systems.

4. Internal controls may be either preventive or detective. Preventive controls attempt to deter or prevent undesirable acts from occurring. They are proactive controls that help to prevent a loss. Examples of preventive controls are separation of duties, proper authorization, adequate documentation and physical control over assets. Detective controls attempt to detect undesirable acts. They provide evidence that a loss has occurred but do not prevent a loss from occurring. Examples of detective controls are reviews, analyses, variance analyses, reconciliations, physical inventories and audits.

5. Internal controls are generally concerned with achieving the following objectives:

- Transactions are executed in accordance with management's general or specific authorisation.
- All transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with the applicable accounting standards, other recognised accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets.
- Assets and records are safeguarded from unauthorised access, use or disposition.

- Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.
- Systems and procedures are effective in design and operation.
- Risks are mitigated to a reasonable extent.

6. Internal control is a process. Internal control can be expected to provide only reasonable assurance, not absolute assurance. Internal control is geared to the achievement of objectives. Internal control is effected by people and not by policy manuals and forms alone.

### Inherent Limitations of Internal Controls

7. Internal control systems are subject to certain inherent limitations, such as:

- Management's consideration that the cost of an internal control does not exceed the expected benefits to be derived.
- The fact that most internal controls do not tend to be directed at transactions of unusual nature. The potential for human error, such as, due to carelessness, distraction, mistakes of judgement and misunderstanding of instructions.
- The possibility of circumvention of internal controls through collusion with employees or with parties outside the entity.
- The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.
- Manipulations by management with respect to transactions

or estimates and judgements required in the preparation of financial statements.

### Role of the Internal Auditor in Evaluating Internal Controls

8. **The Internal auditor should examine the continued effectiveness of the internal control system through evaluation and make recommendations, if any, for improving that effectiveness.** However, the internal auditor is not vested with management's primary responsibility for designing, implementing, maintaining and documenting internal control. Internal audit function adds value to an organization's internal control system by bringing a systematic, disciplined approach to the evaluation of risk and by making recommendations to strengthen the effectiveness of risk management efforts. **The internal auditor should focus towards improving the internal control structure and promoting better corporate governance.** The role of the internal auditor encompasses:

- Evaluation of the efficiency and effectiveness of controls;
- Recommending new controls where needed – or discontinuing unnecessary controls;
- Using control frameworks; and
- Developing control self-assessment.

9. The internal auditor's evaluation of internal control involves:

- determining the significance and the sensitivity of the risk for which controls are being assessed;
- assessing the susceptibility to misuse of resources, failure to attain objectives regarding ethics, economy, efficiency and effectiveness, or failure to fulfil

accountability obligations, and non-compliance with laws and regulations;

- identifying and understanding the design and operation of relevant controls;
- determining the degree of control effectiveness through testing of controls;
- assessing the adequacy of the control design; and
- reporting on the internal control evaluation and discussing the necessary corrective actions.

10. The broad areas of review by the internal auditor in evaluating the internal control system, *inter alia*, are:

- Mission, vision, ethical and organizational value-system of the entity;
- Personnel allocation, appraisal system, and development policies;
- Accounting and financial reporting policies and compliance with applicable legal and regulatory standards;
- Objective of measurement and key performance indicators;
- Documentation standards;
- Risk management structure;
- Operational framework;
- Processes and procedures followed;
- Degree of management supervision;
- Information systems, communication channels; and
- Business Continuity and Disaster Recovery Procedures.

11. **The internal auditor should obtain an understanding of the significant processes and internal control systems sufficient to plan**

**the internal audit engagement and develop an effective audit approach. The internal auditor should use professional judgment to assess and evaluate the maturity of the entity's internal control. The internal auditor should obtain an understanding of the control environment sufficient to assess management's attitudes, awareness and actions regarding internal controls and their importance in the entity.** Such an understanding would also help the internal auditor to make a preliminary assessment of the adequacy of the accounting and internal control systems as a basis for the preparation of the financial statements and of the likely nature, timing and extent of internal audit procedures. The internal auditor assesses the 'as-is' internal control system within the organization.

12. **The internal auditor should obtain an understanding of the internal control procedures sufficient to develop the audit plan.** In obtaining this understanding, the internal auditor would consider knowledge about the presence or absence of control procedures obtained from the understanding of the control environment, business processes and accounting system in determining whether any additional understanding of control procedures is necessary. **The internal auditor should understand and document the design and operations of internal controls to evaluate the effectiveness of the control environment.** The important procedures to be adopted by the internal auditor for this purpose include:

- Narratives
- Flowcharts
- Questionnaires

13. When obtaining an understanding of the business processes, accounting and internal control systems to plan the audit, the internal auditor

obtains a knowledge of the design of the internal control systems and their operation. For example, an internal auditor may perform a "walk-through" test that is, tracing a few transactions through the accounting system. When the transactions selected are typical of those transactions that pass through the system, this procedure may be treated as part of the tests of control.

14. **The internal auditor should consider the following aspects in the evaluation of internal control system in an entity:**

- **Ascertaining whether the entity has a mission statement and written goals and objectives.**
- **Assessing risks at the entity level.**
- **Assessing risks at the activity (or process) level.**
- **Completing a Business Controls Worksheet for each significant activity (or process) in each function or department with documentation of the associated controls and their degree of effectiveness (partial or full); prioritizing those activities (or processes) which are most critical to the success of the function or department.**
- **Ensuring that all risks identified at the entity and function or department level are addressed in the Business Controls Worksheet along with the consolidated documentation of the operating controls.**
- **Ascertaining from the Business Controls Worksheet, those risks for which no controls exist or existing controls are inadequate. This process is the stage of 'controls gap' analysis.**

## Segregation of Duties

15. Segregation of duties is critical to effective internal control; it reduces the risk of both erroneous and inappropriate actions. **The internal auditor should ensure that in general, the approval function, the accounting/reconciling function, and the asset custody function is separated among employees of the entity. When these functions cannot be separated due to small department size, the internal auditor should ensure that a detailed supervisory review of related activities is in practice, as a compensating control activity.**

## Control Activities for Information Technology

16. In a computer information systems environment, the objectives of tests of control do not change from those in a manual environment; however, some audit procedures may change. The internal auditor may find it necessary, or may prefer, to use computer-assisted audit techniques. The use of such techniques, for example, file interrogation tools or audit test data, may be appropriate when the accounting and internal control systems provide no visible evidence documenting the performance of internal controls which are programmed into a computerised accounting system. There are two broad categories of information systems controls - general controls and application controls. *General Controls* apply to all information systems-mainframe, minicomputer, network, and end-user environments. *Application Controls* are designed to cover the processing of data within the application software.

**17. While evaluating the information technology controls in a system-driven environment, the internal auditor should determine whether the entity, *inter alia*, uses:**

- encryption tools, protocols, or similar features of soft-

**ware applications that protect confidential or sensitive information from unauthorized individuals;**

- **back-up and restore features of software applications that reduce the risk of permanent loss of data;**
- **virus protection software; and**
- **passwords that restrict user access to networks, data and applications.**

18. The nature, timing and extent of the procedures performed by the internal auditor to obtain an understanding of the internal control systems will vary with, among other things:

- Size and complexity of the entity and of its information system.
- Materiality considerations.
- Type of internal controls involved.
- Nature of the entity's documentation of specific internal controls.
- Internal auditor's assessment of inherent risk.

19. Ordinarily, the internal auditor's understanding of the internal control systems significant to the audit is obtained through previous experience with the entity and is supplemented by:

- a. inquiries of appropriate management, supervisory and other personnel at various organisational levels within the entity, together with reference to documentation, such as procedures manuals, job descriptions, systems descriptions and flow charts;
- b. inspection of documents and records produced by the accounting and internal control systems; and
- c. observation of the entity's ac-

tivities and operations, including observation of the organisation of computer operations, personnel performing control procedures and the nature of transaction processing.

## Test of Controls

20. Tests of control are performed to obtain audit evidence about the effectiveness of the:

- a. design of the internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements;
- b. operation of the internal controls throughout the period; and
- c. cost of a control *vis a vis* the benefit obtained from the same.

21. Tests of control normally include:

- Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
- Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- Re-performance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- Testing of internal control operating on specific computerised applications or on the overall information technology function, for example, access or program change controls.

22. **Based on the results of the**

tests of control, the internal auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the internal auditor concluding that the assessed level of control risk needs to be revised. In such cases, the internal auditor would modify the nature, timing and extent of planned substantive procedures.

**23. The internal auditor should consider whether the internal controls were in use throughout the period.** If substantially different controls were used at different times during the period, the auditor would consider each separately. A breakdown in internal controls for a specific portion of the period requires separate consideration of the nature, timing and extent of the audit procedures to be applied to the transactions and other events of that period. The internal auditor would obtain audit evidence as to the nature, timing and extent of any changes in the entity's accounting and internal control systems since such procedures were performed and assess their impact on the auditor's intended reliance.

### Monitoring Internal Audit Findings

**24. The internal auditor should identify internal control weaknesses that have not been corrected and make recommendations to correct those weaknesses. The internal auditor should document the rationale in deciding which audit recommendations should be followed up on and when, in contrast with recommendations where no follow-up is needed. The internal auditor should also inquire from the management and document that either audit recommendations have been effectively implemented or that senior man-**

**agement has accepted the risk of not implementing the recommendations.**

### Communication of Continuing Internal Control Weaknesses

**25. When internal controls are found to contain continuing weaknesses, the internal auditor should consider whether:**

- Management has increased supervision and monitoring;
- Additional or compensating controls have been instituted; and/or
- Management accepts the risk inherent with the control weakness.

**26. The internal auditor should evaluate identified control deficiencies and then determine whether those deficiencies, individually or in combination, are significant deficiencies or material weaknesses. The auditor should communicate significant deficiencies and material weaknesses to management and those charged with governance.** This communication includes significant deficiencies and material weaknesses identified and communicated to management and those charged with governance in prior audits but not yet remediated.

**27. Some examples of common weaknesses in internal controls are:**

- Corporate philosophy is understood but not written exposing it to misinterpretation.
- Organizational roles and responsibilities are not explicitly defined.
- Lack of performance appetite and understanding of the entity's appetite for risk taking.
- Management or board of directors do not receive the

right information at the right time.

- Disincentives exist which lead employees to behave in a dysfunctional manner.

**28. As a result of obtaining an understanding of the internal control systems and tests of control, the internal auditor may become aware of weaknesses in the systems. The internal auditor should make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the internal control systems, which have come to the internal auditor's attention.** The communication of material weaknesses to management would ordinarily be in writing, as part of the internal audit report. However, if the internal auditor judges that oral communication is appropriate, such communication would be documented in the audit working papers. It is important to indicate in the communication that only weaknesses which have come to the internal auditor's attention as a result of the audit have been reported and that the examination has not been designed to determine the adequacy of internal control for management purposes.

**29. The internal auditor in his report to the management, should provide:**

- A description of the significant deficiency or material weakness in internal control.
- His opinion on the possible effect of such weakness on the entity's control environment.

### Effective Date

**30. This Standard on Internal Audit is applicable to all internal audits commencing on or after \_\_\_\_\_. Earlier application of the SIA is encourage. □**

## Standard on Internal Audit (SIA) 13 Enterprise Risk Management

The following is the text of the Standard on Internal Audit (SIA) 13, *Enterprise Risk Management*, issued by the Institute of Chartered Accountants of India. The Standard should be read in the conjunction with the “*Preface to the Standards on Internal Audit*”, issued by the Institute.

In terms of the decision taken by the Council of the Institute at its 260<sup>th</sup> meeting held in June 2006, the following Standard on Internal Audit shall be recommendatory in nature in the initial period. The Standard shall become mandatory from such date as may be notified by the Council in this regard.

### Introduction

1. The purpose of this Standard on Internal Audit is to establish standards and provide guidance on review of an entity’s risk management system during an internal audit or such other review exercise with the objective of providing an assurance thereon. This Standard applies where the internal auditor has been requested by the management to provide such an assurance on the effectiveness of its enterprise risk management system.

2. Enterprise risk management enables management to effectively deal with risk, associated uncertainty and enhancing the capacity to build value to the entity or enterprise and its stakeholders. Internal auditor may review each of these activities and focus on the processes used by management to report and monitor the risks identified.

### Risk and Enterprise Risk Management

3. Risk is an event which can prevent, hinder, fail to further or otherwise obstruct the enterprise in achieving its objectives. A business risk is the threat that an event or action will adversely affect an enterprise’s ability to maximize stakeholder value and to achieve its business objectives. Risk can cause financial disadvantage, for example, additional costs or loss of funds or assets. It can result in dam-

age, loss of value and /or loss of an opportunity to enhance the enterprise operations or activities. Risk is the product of probability of occurrence of an event and the financial impact of such occurrence to an enterprise.

4. Risk may be broadly classified into strategic, Operational, Financial and Knowledge. *Strategic Risks* are associated with the primary long-term purpose, objectives and direction of the business. *Operational Risks* are associated with the on-going, day-to-day operations of the enterprise. *Financial Risks* are related specifically to the processes, techniques and instruments utilised to manage the finances of the enterprise, as well as those processes involved in sustaining effective financial relationships with customers and third parties. *Knowledge Risks* are associated with the management and protection of knowledge and information within the enterprise.

### Process of Enterprise Risk Management and Internal Audit

5. Enterprise Risk Management is a structured, consistent and continuous process of measuring or assessing risk and developing strategies to manage risk within the risk appetite. It involves identification, assessment, mitigation, planning and implementation of risk and developing an appropriate risk response policy. Manage-

ment is responsible for establishing and operating the risk management framework.

6. The Enterprise Risk Management process consists of Risk identification, prioritization and reporting, Risk mitigation, Risk monitoring and assurance. Internal audit is a key part of the lifecycle of risk management. The corporate risk function establishes the policies and procedures, and the assurance phase is accomplished by internal audit.

### Role of the Internal Auditor in Relation to Enterprise Risk Management

7. The role of the internal auditor in relation to Enterprise Risk Management is to provide assurance to management on the effectiveness of risk management. **Due consideration should be given to ensure that the internal auditor protects his independence and objectivity of the assurance provided.** The role of the internal auditor is to ascertain that risks are appropriately defined and managed.

8. The scope of the internal auditor’s work in assessing the effectiveness of the enterprise risk management would, normally, include:

- (a) assessing the risk maturity level both at the entity level as well as the auditable unit level;
- (b) assessing the adequacy of and

compliance with the risk management policy and framework; and

- (c) for the risks covered by the internal audit plan:
- (i) Assessing the efficiency and effectiveness of the risk response; and
  - (ii) Assessing whether the score of the residual risk is within the risk appetite.

9. The extent of internal auditor's role in enterprise risk management will depend on other resources, internal and external, available to the board and on the risk maturity of the organisation. **The nature of internal auditor's responsibilities should be adequately documented and approved by those charged with governance. The internal auditor should not manage any of the risks on behalf of the management or take risk management decisions. The internal auditor should not assume any accountability for risk management decisions taken by the management.** Internal auditor has a role only in commenting and advising on risk management and assisting in the effective mitigation of risk.

10. The internal auditor has to review the structure, effectiveness and maturity of an enterprise risk management system. In doing so, he should consider whether the enterprise has developed a risk management policy setting out roles and responsibilities and framing a risk management activity calendar. **The internal auditor should review the maturity of an enterprise risk management structure by considering whether the framework so developed, *inter alia*:**

- a) protects the enterprise against surprises;
- b) stabilizes overall performance with less volatile earnings;
- c) operates within established risk appetite;

- d) protects ability of the enterprise to attend to its core business; and
- e) creates a system to proactively manage risks.

**11. The internal auditor should review whether the enterprise risk management coordinators in the entity report on the results of the assessment of key risks at the appropriate levels, which are, *inter alia*:**

- Risk management committee
- Enterprise Business and Unit heads
- Audit Committee

### Internal Audit Plan and Risk Assessment

12. The internal auditor will normally perform an annual risk assessment of the enterprise, to develop a plan of audit engagements for the subsequent period. This plan will be reviewed at various frequencies in practice. This typically involves review of the various risk assessments performed by the enterprise (e.g., strategic plans, competitive benchmarking, etc.), consideration of prior audits, and interviews with a variety of senior management. It is designed for identifying internal audit key areas and, not for identifying, prioritizing, and managing risks directly for the enterprise. **The internal audit plan, which should be approved by the audit committee, should be based on risk assessment as well as on issues highlighted by the audit committee and senior management. The risk assessment process should be of a continuous nature so as to identify not only residual or existing risks, but also emerging risks. The risk assessment should be conducted formally at least annually, but more often in complex enterprises. To serve this objective, the internal auditor should design the audit work plan by aligning it with the objectives and risks of the enter-**

**prise and concentrate on those issues where assurance is sought by those charged with governance.**

13. The risk review process to be carried out by the internal auditor provides the assurance that there are appropriate controls in place for the risk management activities and that the procedures are understood and followed. Effective enterprise risk management requires a monitoring structure to ensure that the risks are effectively identified and assessed and that the appropriate mitigation plans are in place.

14. The review process conducted by internal auditors will help to determine, *inter alia*:

- a) whether the adopted measures result in what was intended;
- b) whether the procedures adopted and information gathered for undertaking the assessment were appropriate; and
- c) Further, improved knowledge would help in reaching better decisions and identifying the lessons to improve future assessment and management of risks.

**15. The internal auditor should submit his report to the Board or its relevant Committee, delineating the following information:**

- Assurance rating (segregated into High, Medium or Low) as a result of the review;
- Tests conducted;
- Samples covered; and
- Observations and recommendations.

### Effective Date

16. This Standard on Internal Audit is applicable to all internal audits commencing on or after \_\_\_\_\_. Earlier application of the SIA is encouraged. □

## Revised Standard on Auditing (SA) 530\* Audit Sampling

Standard on Auditing (SA) 530 (Revised), “Audit Sampling” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, which sets out the authority of SAs.

### Introduction

#### Scope of this SA

1. This Standard on Auditing (SA) applies when the auditor has decided to use audit sampling in performing audit procedures. It deals with the auditor’s use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample.

2. This SA complements SA 500 (Revised)<sup>2</sup>, which deals with the auditor’s responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. SA 500 (Revised) provides guidance on the means available to the auditor for selecting items for testing, of which audit sampling is one means.

#### Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

### Objective

4. The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

### Definitions

5. For purposes of the SAs, the following terms have the meanings attributed below:

- (a) Audit sampling (sampling) – The application of audit procedures to less than 100% of items within a population of audit

relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

- (b) Population – The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
- (c) Sampling risk – The risk that the auditor’s conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:
- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.
- (d) Non-sampling risk – The risk

that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. (Ref: Para. A1)

(e) Anomaly – A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

(f) Sampling unit – The individual items constituting a population. (Ref: Para. A2)

(g) Statistical sampling – An approach to sampling that has the following characteristics:

- (i) Random selection of the sample items; and
- (ii) The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling.

(h) Stratification – The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

(i) Tolerable misstatement – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. (Ref: Para. A3)

\*Earlier known as SA 530 (AAS 15), “Audit Sampling”.

<sup>1</sup>Published in the July, 2007 issue of the Journal.

<sup>2</sup>The Auditing and Assurance Standards Board has issued the Exposure Draft of Revised SA 500, “Considering the Relevance and Reliability of Audit Evidence”, which was published in August, 2008 issue of the Journal for public comments.

- (j) Tolerable rate of deviation – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

## Requirements

### Sample Design, Size and Selection of Items for Testing

6. When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. (Ref: Para. A4-A9)

7. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. (Ref: Para. A10-A11)

8. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. (Ref: Para. A12-A13)

### Performing Audit Procedures

9. The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.

10. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. (Ref: Para. A14)

11. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details. (Ref: Para. A15-A16)

### Nature and Cause of Deviations and Misstatements

12. The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of

the audit procedure and on other areas of the audit. (Ref: Para. A17)

13. In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

### Projecting Misstatements

14. For tests of details, the auditor shall project misstatements found in the sample to the population. (Ref: Para. A18-A20)

### Evaluating Results of Audit Sampling

15. The auditor shall evaluate:

- (a) The results of the sample; and (Ref: Para. A21-A22)
- (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. (Ref: Para. A23)

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## Application and Other Explanatory Material

### Definitions

#### Non-Sampling Risk (Ref: Para. 5(d))

A1. Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognise a misstatement or deviation.

#### Sampling Unit (Ref: Para. 5(f))

A2. The sampling units might be physical items (for example, cheques listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances) or monetary units.

#### Tolerable Misstatement (Ref: Para. 5(i))

A3. When designing a sample, the

auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality, as defined in SA 320 (Revised),<sup>3</sup> to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

### Sample Design, Size and Selection of Items for Testing

#### Sample Design (Ref: Para. 6)

A4. Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

A5. When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling. In fulfilling the requirement of paragraph 8 of SA 500 (Revised), when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

A6. The auditor's consideration of the purpose of the audit procedure, as required by paragraph 6, includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements. For example, in a test of details relating

<sup>3</sup>The Auditing and Assurance Standards Board has issued Exposure Draft of Proposed Standard on Auditing (SA) 320 (Revised), "Materiality in Planning and Performing an Audit" which has been published in the January, 2009 issue of the Journal and has also been hosted on the website of the Institute for public comments.

to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a misposting between customer accounts does not affect the total accounts receivable balance. Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

A7. In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size. For example, if the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls. Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

A8. In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate. Appendix 1 provides further discussion on stratification and value-weighted selection.

A9. The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

#### **Sample Size** (Ref: Para. 7)

A10. The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the

risk the auditor is willing to accept, the greater the sample size will need to be.

A11. The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. Appendices 2 and 3 indicate the influences that various factors typically have on the determination of sample size. When circumstances are similar, the effect on sample size of factors such as those identified in Appendices 2 and 3 will be similar regardless of whether a statistical or non-statistical approach is chosen.

#### **Selection of Items for Testing** (Ref: Para. 8)

A12. With statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. With non-statistical sampling, judgment is used to select sample items. Because the purpose of sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.

A13. The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection. Each of these methods is discussed in Appendix 4.

#### **Performing Audit Procedures** (Ref: Para. 10-11)

A14. An example of when it is necessary to perform the procedure on a replacement item is when a cancelled cheque is selected while testing for evidence of payment authorisation. If the auditor is satisfied that the cheque has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined.

A15. An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost.

A16. An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

#### **Nature and Cause of Deviations and Misstatements** (Ref: Para. 12)

A17. In analysing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

#### **Projecting Misstatements** (Ref: Para. 14)

A18. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

A19. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

A20. For tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole. SA 330<sup>4</sup> provides guidance when deviations from controls upon which the auditor intends to rely are detected.

#### **Evaluating Results of Audit Sampling** (Ref: Para. 15)

A21. For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating

<sup>4</sup>SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 17 and A41.

the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

A22. In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

A23. If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

- Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or
- Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

## Material Modifications to ISA 530, "Audit Sampling"

SA 530 (Revised), "Audit Sampling" does not contain any modifications *vis-à-vis* ISA 530.

### Appendix 1

(Ref: Para. A8)

#### Stratification and Value-Weighted Selection

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate. This Appendix provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

##### Stratification

1. Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

2. When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

3. The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population. For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide

to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

4. If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

##### Value -Weighted Selection

5. When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units. One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes. This approach may be used in conjunction with the systematic method of sample selection (described in Appendix 4) and is most efficient when selecting items using random selection.

### Appendix 2

(Ref: Para. A11)

#### Examples of Factors Influencing Sample Size for Tests of Controls

The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

Factor	Effect On Sample Size	
1. An increase in the extent to which the auditor's risk assessment takes into account relevant controls	Increase	The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased).
2. An increase in the tolerable rate of deviation	Decrease	The lower the tolerable rate of deviation, the larger the sample size needs to be.
3. An increase in the expected rate of deviation of the population to be tested	Increase	The higher the expected rate of deviation, the larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
4. An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population	Increase	The greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
5. An increase in the number of sampling units in the population	Negligible effect	For large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence.

### Appendix 3

(Ref: Para. A11)

#### Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

Factor	Effect On Sample Size	
1. An increase in the auditor's assessment of the risk of material misstatement	Increase	The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.
2. An increase in the use of other substantive procedures directed at the same assertion	Decrease	The more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be.

Factor	Effect On Sample Size	
3. An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population	Increase	The greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.
4. An increase in tolerable misstatement	Decrease	The lower the tolerable misstatement, the larger the sample size needs to be.
5. An increase in the amount of misstatement the auditor expects to find in the population	Increase	The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population. Factors relevant to the auditor's consideration of the expected misstatement amount include the extent to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures.
6. Stratification of the population when appropriate	Decrease	When there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.
7. The number of sampling units in the population	Negligible effect	For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures).

## Appendix 4

(Ref. Para. A13)

### Sample Selection Methods

There are many methods of selecting samples. The principal methods are as follows:

- (a) Random selection (applied through random number generators, for example, random number tables).
- (b) Systematic selection, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50<sup>th</sup> sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random

number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

- (c) Monetary Unit Sampling is a type of value-weighted selection (as described in Appendix 1) in which sample size, selection and evaluation results in a conclusion in monetary amounts.
- (d) Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last

entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

- (e) Block selection involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample. □

## Revised Standard on Auditing (SA) 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures<sup>1</sup>

*Standard on Auditing (SA) 540 (Revised), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services<sup>2</sup>”, which sets out the authority of SAs.*

### Introduction

#### Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor’s responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315<sup>3</sup> and SA 330<sup>4</sup> and other relevant SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

#### Nature of Accounting Estimates

2. Some financial statement items cannot be measured precisely, but can only be estimated. For purposes of this SA, such financial statement items are referred to as accounting estimates. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias. (Ref: Para. A1-A11)

3. The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome

of one or more transactions, events or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different, and is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. For example, the applicable financial reporting framework may require fair value measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as “marketplace participants” or equivalent) in an arm’s length transaction, rather than the settlement of a transaction at some past or future date.<sup>5</sup>

4. A difference between the outcome of an accounting estimate and the amount originally recognised or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

#### Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

#### Objective

6. The objective of the auditor is to obtain sufficient appropriate audit evi-

dence whether in the context of the applicable financial reporting framework:

- (a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and
- (b) related disclosures in the financial statements are adequate.

### Definitions

7. For purposes of the SAs, the following terms have the meanings attributed below:

- (a) **Accounting estimate** – An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where this SA addresses only accounting estimates involving measurement at fair value, the term “fair value accounting estimates” is used.
- (b) **Auditor’s point estimate or auditor’s range** – The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management’s point estimate.
- (c) **Estimation uncertainty** – The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.
- (d) **Management bias** – A lack of neutrality by management in the

<sup>1</sup>Hitherto known as AAS 18, “Audit of Accounting Estimates”.

<sup>2</sup>Published in the July, 2007 issue of the Journal.

<sup>3</sup>SA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”. Published in February, 2008 issue of the Journal.

<sup>4</sup>SA 330, “The Auditor’s Responses to Assessed Risks”. Published in February, 2008 issue of the Journal.

<sup>5</sup>Different definitions of fair value may exist among financial reporting frameworks.

preparation and presentation of information.

- (e) **Management's point estimate** – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.
- (f) **Outcome of an accounting estimate** – The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

## Requirements

### Risk Assessment Procedures and Related Activities

8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by SA 315,<sup>6</sup> the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates: (Ref: Para. A12)

- (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. (Ref: Para. A13-A15)
- (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. (Ref: Para. A16-A21)
- (c) How management makes the accounting estimates, and an understanding of the data on which they are based, including:

(Ref: Para. A22-A23)

- (i) The method, including where applicable the model, used in making the accounting estimate; (Ref: Para. A24-A26)
- (ii) Relevant controls; (Ref: Para. A27-A28)
- (iii) Whether management has used an expert; (Ref: Para. A29-A30)
- (iv) The assumptions underlying the accounting estimates; (Ref: Para. A31-A36)
- (v) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and (Ref: Para. A37)
- (vi) Whether and, if so, how management has assessed the effect of estimation uncertainty. (Ref: Para. A38)

9. The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time. (Ref: Para. A39-A44)

### Identifying and Assessing the Risks of Material Misstatement

10. In identifying and assessing the risks of material misstatement, as required by SA 315<sup>7</sup>, the auditor shall evaluate the degree of estimation un-

certainty associated with an accounting estimate. (Ref: Para. A45-A46)

11. The auditor shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks. (Ref: Para. A47-A51)

### Responses to the Assessed Risks of Material Misstatement

12. Based on the assessed risks of material misstatement, the auditor shall determine: (Ref: Para. A52)

- (a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and (Ref: Para. A53-A56)
- (b) Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances. (Ref: Para. A57-A58)

13. In responding to the assessed risks of material misstatement, as required by SA 330,<sup>8</sup> the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate: (Ref: Para. A59-A61)

- (a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate. (Ref: Para. A62-A67)
- (b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether: (Ref: Para. A68-A70)
  - (i) The method of measurement used is appropriate in the circumstances; and

<sup>6</sup>SA 315, paragraphs 5-6 and 11-12.

<sup>7</sup>SA 315, paragraph 24.

<sup>8</sup>SA 330, paragraph 5.

(Ref: Para. A71-A76)

- (ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework. (Ref: Para. A77-A83)
- (c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: Para. A84- A86)
- (d) Develop a point estimate or a range to evaluate management's point estimate. For this purpose: (Ref: Para. A87-A91)
  - (i) When the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. (Ref: Para. A92)
  - (ii) When the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. (Ref: Para. A93-A95)

14. In determining the matters identified in paragraph 12 or in responding to the assessed risks of material misstatement in accordance with paragraph 13, the auditor shall consider whether specialised skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence. (Ref: Para. A96-A101)

### **Further Substantive Procedures to Respond to Significant Risks**

### **Estimation Uncertainty**

15. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of SA 330,<sup>9</sup> the auditor shall evaluate the following: (Ref: Para. A102)

- (a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate. (Ref: Para. A103-A106)
- (b) Whether the significant assumptions used by management are reasonable. (Ref: Para A107-A109)
- (c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so. (Ref: Para. A110)

16. If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate. (Ref: Para. A111-A112)

### **Recognition and Measurement Criteria**

17. For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence whether the following are in accordance with the requirements of the applicable financial reporting framework:

- (a) management's decision to recognise, or to not recognise, the accounting estimates in the financial statements; and (Ref: Para. A113-A114)

- (b) the selected measurement basis for the accounting estimates. (Ref: Para. A115)

### **Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements**

18. The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated. (Ref: Para. A116-A119)

### **Disclosures Related to Accounting Estimates**

19. The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. (Ref: Para. A120-A121)

20. For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. (Ref: Para. A122-A123)

### **Indicators of Possible Management Bias**

21. The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates. (Ref: Para. A124-A125)

### **Written Representations**

22. The auditor shall obtain written representations from management whether management believes significant assumptions used by it in making accounting estimates are reasonable. (Ref: Para. A126-A127)

<sup>9</sup>SA 330, paragraph 20.

## Documentation

23. The audit documentation shall include:

- (a) The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and
- (b) Indicators of possible management bias, if any. (Ref: Para. A128)

## Application and Other Explanatory Material

### Nature of Accounting Estimates (Ref: Para. 2)

A1. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific. The Appendix to this SA discusses fair value measurements and disclosures under different financial reporting frameworks.

A2. Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.
- Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as "observable" in the context of a fair

value accounting estimate.

- Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.
- Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.

A3. For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.
- Fair value accounting estimates for which a highly specialised entity-developed model is used or for which there are assumptions or inputs that cannot be observed in the marketplace.

A4. The degree of estimation uncertainty varies based on the nature of the accounting estimate, the extent to which there is a generally accepted method or model used to make the accounting estimate, and the subjectivity of the assumptions used to make the accounting estimate. In some cases, estimation uncertainty associated with an accounting estimate may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be made.

A5. Not all financial statement items requiring measurement at fair value, involve estimation uncertainty. For example, this may be the case for some financial statement items where there is an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur, in which case

the existence of published price quotations ordinarily is the best audit evidence of fair value. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

A6. Additional examples of situations where accounting estimates, other than fair value accounting estimates, may be required include:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long term contracts.
- Financial Obligations / Costs arising from litigation settlements and judgments.

A7. Additional examples of situations where fair value accounting estimates may be required include:

- Complex financial instruments, which are not traded in an active and open market.
- Share-based payments.
- Property or equipment held for disposal.
- Certain assets or liabilities acquired in a business combination, including goodwill and intangible assets.
- Transactions involving the exchange of assets or liabilities between independent parties

without monetary consideration, for example, a non-monetary exchange of plant facilities in different lines of business.

A8. Estimation involves judgments based on information available when the financial statements are prepared. For many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The auditor is not responsible for predicting future conditions, transactions or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management.

### **Management Bias**

A9. Financial reporting frameworks often call for neutrality, that is, freedom from bias. Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result). The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

A10. Management bias can be difficult to detect at an account level. It may only be identified when considered in the aggregate of groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, in making such judgments there may be no intention by management to mislead the users of financial statements. Where,

however, there is intention to mislead, management bias is fraudulent in nature.

A11. Certain entities such as, Central/ State governments and related government entities (for example, agencies, boards, commissions) may have significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement at fair value or other current value bases, or a combination of both. Often specialised assets held do not generate cash flows and do not have an active market. Measurement at fair value therefore ordinarily requires estimation and may be complex, and in some rare cases may not be possible at all.

### **Risk Assessment Procedures and Related Activities** (Ref: Para. 8)

A12. The risk assessment procedures and related activities required by paragraph 8 of this SA assist the auditor in developing an expectation of the nature and type of accounting estimates that an entity may have. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to identify and assess the risks of material misstatement in relation to accounting estimates, and to plan the nature, timing and extent of further audit procedures.

### **Obtaining an Understanding of the Requirements of the Applicable Financial Reporting Framework** (Ref: Para. 8(a))

A13. Obtaining an understanding of the requirements of the applicable financial reporting framework assists the auditor in determining whether it, for example:

- Prescribes certain conditions for the recognition,<sup>10</sup> or methods for the measurement, of accounting estimates.
- Specifies certain conditions that permit or require measurement at a fair value, for example, by referring to management's in-

tentions to carry out certain courses of action with respect to an asset or liability.

- Specifies required or permitted disclosures.

Obtaining this understanding also provides the auditor with a basis for discussion with management about how management has applied those requirements relevant to the accounting estimate, and the auditor's determination of whether they have been applied appropriately.

A14. Financial reporting frameworks may provide guidance for management on determining point estimates where alternatives exist. Some financial reporting frameworks, for example, require that the point estimate selected be the alternative that reflects management's judgment of the most likely outcome<sup>11</sup>. Others may require, for example, use of a discounted probability-weighted expected value. In some cases, management may be able to make a point estimate directly. In other cases, management may be able to make a reliable point estimate only after considering alternative assumptions or outcomes from which it is able to determine a point estimate.

A15. Financial reporting frameworks may require the disclosure of information concerning the significant assumptions to which the accounting estimate is particularly sensitive. Furthermore, where there is a high degree of estimation uncertainty, some financial reporting frameworks do not permit an accounting estimate to be recognised in the financial statements, but certain disclosures may be required in the notes to the financial statements.

### **Obtaining an Understanding of How Management Identifies the Need for Accounting Estimates** (Ref: Para. 8(b))

A16. In preparing the financial statements, management has the responsibility to determine whether a transaction, event or condition gives rise to

<sup>10</sup>Most financial reporting frameworks require incorporation in the balance sheet or income statement of items that satisfy their criteria for recognition. Disclosure of accounting policies or adding notes to the financial statements does not rectify a failure to recognise such items, including accounting estimates.

<sup>11</sup>Different financial reporting frameworks may use different terminology to describe point estimates determined in this way.

the need to make an accounting estimate, and that all necessary accounting estimates have been recognised, measured and disclosed in the financial statements in accordance with the applicable financial reporting framework.

A17. Management's identification of transactions, events and conditions that give rise to the need for accounting estimates is likely to be based on:

- Management's knowledge of the entity's business and the industry in which it operates.
- Management's knowledge of the implementation of business strategies in the current period.
- Where applicable, management's cumulative experience of preparing the entity's financial statements in prior periods.

In such cases, the auditor may obtain an understanding of how management identifies the need for accounting estimates primarily through inquiry of management. In other cases, where management's process is more structured, for example, when management has a formal risk management function, the auditor may perform risk assessment procedures directed at the methods and practices followed by management for periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary. The completeness of accounting estimates is often an important consideration for the auditor particularly accounting estimates relating to liabilities.

A18. The auditor's understanding of the entity and its environment obtained during the performance of risk assessment procedures, together with other audit evidence obtained during the course of the audit, assist the auditor in identifying circumstances, or changes in circumstances, that may give rise to the need for an accounting estimate.

A19. Inquiries of management about changes in circumstances may include, for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

A20. During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. SA 315 provides guidance when the auditor identifies a material weakness in the entity's risk assessment processes.

*Considerations Specific to Smaller Entities*

A21. Obtaining this understanding for smaller entities is often less complex as their business activities are often limited and transactions are less complex. Further, often a single person, for example the owner-manager, identifies the need to make an accounting estimate and the auditor may focus inquiries accordingly.

**Obtaining an Understanding of How Management Makes the Accounting Estimates** (Ref: Para. 8(c))

A22. Management is responsible for establishing financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:

- Selecting appropriate accounting policies and prescribing

estimation processes, including appropriate estimation or valuation methods, including, where applicable, models.

- Developing or identifying relevant data and assumptions that affect accounting estimates.
- Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary.

A23. Matters that the auditor may consider in obtaining an understanding of how management makes the accounting estimates include, for example:

- The types of accounts or transactions to which the accounting estimates relate (for example, whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions).
- Whether and, if so, how management has used recognised measurement techniques for making particular accounting estimates.
- Whether the accounting estimates were made based on data available at an interim date and, if so, whether and how management has taken into account the effect of events, transactions and changes in circumstances occurring between that date and the period end.

*Method of Measurement, Including the Use of Models* (Ref: Para. 8(c)(i))

A24. In some cases, the applicable financial reporting framework may prescribe the method of measurement for an accounting estimate, for example, a particular model that is to be used in measuring a fair value estimate. In many cases, however, the applicable financial reporting framework does not prescribe the method of measurement, or may specify alternative methods for measurement.

A25. When the applicable financial re-

porting framework does not prescribe a particular method to be used in the circumstances, matters that the auditor may consider in obtaining an understanding of the method or, where applicable the model, used to make accounting estimates include, for example:

- How management selects a particular method considering the nature of the asset or liability being estimated.
- Whether the entity operates in a particular business, industry or environment in which there are methods commonly used to make the particular type of accounting estimate.

A26. There may be greater risks of material misstatement, for example, in cases when management has internally developed a model to be used to make the accounting estimate or is departing from a method commonly used in a particular industry or environment.

*Relevant Controls* (Ref: Para. 8(c)(ii))

A27. Matters that the auditor may consider in obtaining an understanding of relevant controls include, for example, the experience and competence of those who make the accounting estimates, and controls related to:

- How management determines the completeness, relevance and accuracy of the data used to develop accounting estimates.
- The review and approval of accounting estimates, including the assumptions or inputs used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services (for example, in the case of a large finan-

cial institution, relevant segregation of duties may include an independent function responsible for estimation and validation of fair value pricing of the entity's proprietary financial products staffed by individuals whose remuneration is not tied to such products).

A28. Other controls may be relevant to making the accounting estimates depending on the circumstances. For example, if the entity uses specific models for making accounting estimates, management may put into place specific policies and procedures around such models. Relevant controls may include, for example, those established over:

- The design and development, or selection, of a particular model for a particular purpose.
- The use of the model.
- The maintenance and periodic validation of the integrity of the model.

*Management's Use of Experts* (Ref: Para. 8(c)(iii))

A29. Management may have, or the entity may employ individuals with, the experience and competence necessary to make the required point estimates. In some cases, however, management may need to engage an expert to make, or assist in making, them. This need may arise because of, for example:

- The specialised nature of the matter requiring estimation, for example, the measurement of mineral or hydrocarbon reserves in extractive industries.
- The technical nature of the models required to meet the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements at fair value.
- The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate.

*Considerations specific to smaller entities*

A30. In smaller entities, the circumstances requiring an accounting estimate often are such that the owner-manager is capable of making the required point estimate. In some cases, however, an expert will be needed. Discussion with the owner-manager early in the audit process about the nature of any accounting estimates, the completeness of the required accounting estimates, and the adequacy of the estimating process may assist the owner manager in determining the need to use an expert.

*Assumptions* (Ref: Para. 8(c)(iv))

A31. Assumptions are integral components of accounting estimates. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates include, for example:

- The nature of the assumptions, including which of the assumptions are likely to be significant assumptions.
- How management assesses whether the assumptions are relevant and complete (that is, that all relevant variables have been taken into account).
- Where applicable, how management determines that the assumptions used are internally consistent.
- Whether the assumptions relate to matters within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and how they conform to the entity's business plans and the external environment, or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).
- The nature and extent of documentation, if any, supporting

the assumptions.

Assumptions may be made or identified by an expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management's assumptions.

A32. In some cases, assumptions may be referred to as inputs, for example, where management uses a model to make an accounting estimate, though the term inputs may also be used to refer to the underlying data to which specific assumptions are applied.

A33. Management may support assumptions with different types of information drawn from internal and external sources, the relevance and reliability of which will vary. In some cases, an assumption may be reliably based on applicable information from either external sources (for example, published interest rate or other statistical data) or internal sources (for example, historical information or previous conditions experienced by the entity). In other cases, an assumption may be more subjective, for example, where the entity has no experience or external sources from which to draw.

A34. In the case of fair value accounting estimates, assumptions reflect, or are consistent with, what knowledgeable, willing arm's length parties (sometimes referred to as "marketplace participants" or equivalent) would use in determining fair value when exchanging an asset or settling a liability. Specific assumptions will also vary with the characteristics of the asset or liability being valued, the valuation method used (for example, a market approach, or an income approach) and the requirements of the applicable financial reporting framework.

A35. With respect to fair value accounting estimates, assumptions or inputs vary in terms of their source and bases, as follows:

- (a) Those that reflect what marketplace participants would use in pricing an asset or liability developed based on market data obtained from sources inde-

pendent of the reporting entity (sometimes referred to as "observable inputs" or equivalent).

- (b) Those that reflect the entity's own judgments about what assumptions marketplace participants would use in pricing the asset or liability developed based on the best information available in the circumstances (sometimes referred to as "unobservable inputs" or equivalent). In practice, however, the distinction between (a) and (b) is not always apparent. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

A36. The extent of subjectivity, such as whether an assumption or input is observable, influences the degree of estimation uncertainty and thereby the auditor's assessment of the risks of material misstatement for a particular accounting estimate.

*Changes in Methods for Making Accounting Estimates* (Ref: Para. 8(c)(v))

A37. In evaluating how management makes the accounting estimates, the auditor is required to understand whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates. A specific estimation method may need to be changed in response to changes in the environment or circumstances affecting the entity or in the requirements of the applicable financial reporting framework. If management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method is more appropriate, or is itself a response to such changes. For example, if management changes the basis of making an accounting estimate from a mark-to-market approach to using a model, the auditor challenges whether management's assumptions about the marketplace are reasonable in light of economic circumstances.

*Estimation Uncertainty* (Ref: Para. 8(c)(vi))

A38. Matters that the auditor may consider in obtaining an understanding of whether and, if so, how management has assessed the effect of estimation uncertainty include, for example:

- Whether and, if so, how management has considered alternative assumptions or outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate.
- How management determines the accounting estimate when analysis indicates a number of outcome scenarios.
- Whether management monitors the outcome of accounting estimates made in the prior period, and whether management has appropriately responded to the outcome of that monitoring procedure.

***Reviewing Prior Period Accounting Estimates*** (Ref: Para. 9)

A39. The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

A40. The review of prior period accounting estimates may also assist the auditor, in the current period, in

identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's attitude of professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

A41. A retrospective review of management judgments and assumptions related to significant accounting estimates is also required by SA 240 (Revised).<sup>12</sup> That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls. As a practical matter, the auditor's review of prior period accounting estimates as a risk assessment procedure in accordance with this SA may be carried out in conjunction with the review required by SA 240 (Revised).

A42. The auditor may judge that a more detailed review is required for those accounting estimates that were identified during the prior period audit as having high estimation uncertainty, or for those accounting estimates that have changed significantly from the prior period. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A43. For fair value accounting estimates and other accounting estimates based on current conditions at the measurement date, more variation may exist between the fair value amount recognised in the prior period financial statements and the outcome or the amount re-estimated for the purpose of the current period. This is because the measurement objective for such accounting estimates deals with perceptions about value at a point in time, which may change

significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that would be relevant to identifying and assessing risks of material misstatement. For example, in some cases obtaining an understanding of changes in marketplace participant assumptions which affected the outcome of a prior period fair value accounting estimate may be unlikely to provide relevant information for audit purposes. If so, then the auditor's consideration of the outcome of prior period fair value accounting estimates may be directed more towards understanding the effectiveness of management's prior estimation process, that is, management's track record, from which the auditor can judge the likely effectiveness of management's current process.

A44. A difference between the outcome of an accounting estimate and the amount recognised in the prior period financial statements does not necessarily represent a misstatement of the prior period financial statements. However, it may do so if, for example, the difference arises from information that was available to management when the prior period's financial statements were finalised, or that could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed.

**Identifying and Assessing the Risks of Material Misstatement**

**Estimation Uncertainty** (Ref: Para. 10)

A45. The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:

- The extent to which the accounting estimate depends on

judgment.

- The sensitivity of the accounting estimate to changes in assumptions.
- The existence of recognised measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty).
- The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
- The availability of reliable data from external sources.
- The extent to which the accounting estimate is based on observable or unobservable inputs.

The degree of estimation uncertainty associated with an accounting estimate may influence the estimate's susceptibility to bias.

A46. Matters that the auditor considers in assessing the risks of material misstatement may also include:

- The actual or expected magnitude of an accounting estimate.
- The recorded amount of the accounting estimate (that is, management's point estimate) in relation to the amount expected by the auditor to be recorded.
- Whether management has used an expert in making the accounting estimate.
- The outcome of the review of prior period accounting estimates.

**High Estimation Uncertainty and Significant Risks** (Ref: Para. 11)

A47. Examples of accounting estimates that may have high estimation uncertainty include the following:

- Accounting estimates that are highly dependent upon judgment, for example, judgments

<sup>12</sup>SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph 32(b)(ii).

about the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future.

- Accounting estimates that are not calculated using recognised measurement techniques.
- Accounting estimates where the results of the auditor's review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.
- Fair value accounting estimates for which a highly specialised entity-developed model is used or for which there are no observable inputs.

A48. A seemingly immaterial accounting estimate may have the potential to result in a material misstatement due to the estimation uncertainty associated with the estimation; that is, the size of the amount recognised or disclosed in the financial statements for an accounting estimate may not be an indicator of its estimation uncertainty.

A49. In some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may, therefore, preclude recognition of the item in the financial statements, or its measurement at fair value. In such cases, the significant risks relate not only to whether an accounting estimate should be recognised, or whether it should be measured at fair value, but also to the adequacy of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the high estimation uncertainty associated with them (see paragraphs A120-A123).

A50. Where the auditor determines

that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities.<sup>13</sup>

A51. In some cases, the estimation uncertainty of an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. SA 570<sup>14</sup> establishes requirements and provides guidance in such circumstances.

### **Responses to the Assessed Risks of Material Misstatement** (Ref: Para. 12)

A52. SA 330 requires the auditor to design and perform audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement in relation to accounting estimates at both the financial statement and assertion levels.<sup>15</sup> Paragraphs A53-A115 focus on specific responses at the assertion level only.

### **Application of the Requirements of the Applicable Financial Reporting Framework** (Ref: Para. 12(a))

A53. Many financial reporting frameworks prescribe certain conditions for the recognition of accounting estimates and specify the methods for making them and required disclosures. Such requirements may be complex and require the application of judgment. Based on the understanding obtained in performing risk assessment procedures, the requirements of the applicable financial reporting framework that may be susceptible to misapplication or differing interpretations become the focus of the auditor's attention.

A54. Determining whether management has appropriately applied the requirements of the applicable financial reporting framework is based, in part, on the auditor's understanding of the entity and its environment. For example, the measurement of the fair value of some items, such as intangible assets acquired in a business combina-

tion, may involve special considerations that are affected by the nature of the entity and its operations.

A55. In some situations, additional audit procedures, such as the inspection by the auditor of the current physical condition of an asset, may be necessary to determine whether management has appropriately applied the requirements of the applicable financial reporting framework.

A56. The application of the requirements of the applicable financial reporting framework requires management to consider changes in the environment or circumstances that affect the entity. For example, the introduction of an active market for a particular class of asset or liability may indicate that the use of discounted cash flows to estimate the fair value of such asset or liability is no longer appropriate.

### **Consistency in Methods and Basis for Changes** (Ref: Para. 12(b))

A57. The auditor's consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is considered arbitrary. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to a financial statement misstatement or be an indicator of possible management bias.

A58. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.

<sup>13</sup>SA 315, paragraph 28.

<sup>14</sup>Revised SA 570, "Going Concern" has been published in the December, 2008 issue of the Journal. Revised SA 570 is applicable for audits of financial statements for periods beginning on or after April 1, 2009.

<sup>15</sup>SA 330, paragraphs 5-6.

**Responses to the Assessed Risks of Material Misstatements** (Ref: Para. 13)

A59. The auditor’s decision as to which response, individually or in combination, in paragraph 13 to undertake to respond to the risks of material misstatement may be influenced by such matters as:

- The nature of the accounting estimate, including whether it arises from routine or non-routine transactions.
- Whether the procedure(s) is expected to effectively provide the auditor with sufficient appropriate audit evidence.
- The assessed risk of material misstatement, including whether the assessed risk is a significant risk.

A60. For example, when evaluating the reasonableness of the allowance for doubtful accounts, an effective procedure for the auditor may be to review subsequent cash collections in combination with other procedures. Where the estimation uncertainty associated with an accounting estimate is high, for example, an accounting estimate based on a proprietary model for which there are unobservable inputs, it may be that a combination of the responses to assessed risks in paragraph 13 is necessary in order to obtain sufficient appropriate audit evidence.

A61. Additional guidance explaining the circumstances in which each of the responses may be appropriate is provided in paragraphs A62-A95.

*Events Occurring Up to the Date of the Auditor’s Report* (Ref: Para. 13(a))

A62. Determining whether events occurring up to the date of the auditor’s report provide audit evidence regarding the accounting estimate may be an appropriate response when such events are expected to:

- Occur; and

- Provide audit evidence that confirms or contradicts the accounting estimate.

A63. Events occurring up to the date of the auditor’s report may sometimes provide sufficient appropriate audit evidence about an accounting estimate. For example, sale of the complete inventory of a superseded product shortly after the period end may provide audit evidence relating to the estimate of its net realisable value. In such cases, there may be no need to perform additional audit procedures on the accounting estimate, provided that sufficient appropriate evidence about the events is obtained.

A64. For some accounting estimates, events occurring up to the date of the auditor’s report are unlikely to provide audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at the balance sheet date and therefore may not be relevant to the measurement of the fair value accounting estimate. Paragraph 13 identifies other responses to the risks of material misstatement that the auditor may undertake.

A65. In some cases, events that contradict the accounting estimate may indicate that management has ineffective processes for making accounting estimates, or that there is management bias in the making of accounting estimates.

A66. Even though the auditor may decide not to undertake this approach in respect of specific accounting estimates, the auditor is required to comply with SA 560.<sup>16</sup> The auditor is required to perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of

the financial statements and the date of the auditor’s report that require adjustment of, or disclosure in, the financial statements have been identified<sup>17</sup> and appropriately reflected in the financial statements.<sup>18</sup> Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions or events, the auditor’s work under SA 560 is particularly relevant.

*Considerations specific to smaller entities*

A67. When there is a longer period between the balance sheet date and the date of the auditor’s report, the auditor’s review of events in this period may be an effective response for accounting estimates other than fair value accounting estimates. This may particularly be the case in some smaller owner-managed entities, especially when management does not have formalised control procedures over accounting estimates.

*Testing How Management Made the Accounting Estimate* (Ref: Para. 13(b))

A68. Testing how management made the accounting estimate and the data on which it is based may be an appropriate response when the accounting estimate is a fair value accounting estimate developed on a model that uses observable and unobservable inputs. It may also be appropriate when, for example:

- The accounting estimate is derived from the routine processing of data by the entity’s accounting system.
- The auditor’s review of similar accounting estimates made in the prior period financial statements suggests that management’s current period process is likely to be effective.
- The accounting estimate is based on a large population of

<sup>16</sup>Standard on Auditing (SA) 560, “Subsequent Events” has been published in January, 2009 issue of the Journal. Revised SA 560 is applicable for audits of financial statements for periods beginning on or after April 1, 2009.

<sup>17</sup>SA 560 (AAS19), paragraph 4. See footnote 16.

<sup>18</sup>SA 560 (AAS19), paragraph 5. See footnote 16.

items of a similar nature that individually are not significant.

A69. Testing how management made the accounting estimate may involve, for example:

- Testing the extent to which data on which the accounting estimate is based is accurate, complete and relevant, and whether the accounting estimate has been properly determined using such data and management assumptions.
- Considering the source, relevance and reliability of external data or information, including that received from external experts engaged by management to assist in making an accounting estimate.
- Re-calculating the accounting estimate, and reviewing information about an accounting estimate for internal consistency.
- Considering management's review and approval processes.

*Considerations specific to smaller entities*

A70. In smaller entities, the process for making accounting estimates is likely to be less structured than in larger entities. Smaller entities with active management involvement may not have extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Even if the entity has no formal established process, it does not mean that management is not able to provide a basis upon which the auditor can test the accounting estimate.

*Evaluating the method of measurement* (Ref: Para. 13(b)(i))

A71. When the applicable financial reporting framework does not prescribe the method of measurement, evaluating whether the method used, including any applicable model, is appropriate in the circumstances is a matter of professional judgment.

A72. For this purpose, matters that the auditor may consider include, for example, whether:

- Management's rationale for the method selected is reasonable.
- Management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method.
- The method is appropriate in the circumstances given the nature of the asset or liability being estimated and the requirements of the applicable financial reporting framework relevant to accounting estimates.
- The method is appropriate in relation to the business, industry and environment in which the entity operates.

A73. In some cases, management may have determined that different methods result in a range of significantly different estimates. In such cases, obtaining an understanding of how the entity has investigated the reasons for these differences may assist the auditor in evaluating the appropriateness of the method selected.

*Evaluating the use of models*

A74. In some cases, particularly when making fair value accounting estimates, management may use a model. Whether the model used is appropriate in the circumstances may depend on a number of factors, such as the nature of the entity and its environment, including the industry in which it operates, and the specific asset or liability being measured.

A75. The extent to which the following considerations are relevant depends on the circumstances, including whether the model is one that is commercially available for use in a particular sector or industry, or a proprietary model. In some cases, an entity may use an expert to develop and test a model.

A76. Depending on the circumstances, matters that the auditor may also consider in testing the model include, for example, whether:

- The model is validated prior

to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:

- The model's theoretical soundness and mathematical integrity, including the appropriateness of model parameters.
- The consistency and completeness of the model's inputs with market practices.
- The model's output as compared to actual transactions.
- Appropriate change control policies and procedures exist.
- The model is periodically calibrated and tested for validity, particularly when inputs are subjective.
- Adjustments are made to the output of the model, including in the case of fair value accounting estimates, whether such adjustments reflect the assumptions marketplace participants would use in similar circumstances.
- The model is adequately documented, including the model's intended applications and limitations and its key parameters, required inputs, and results of any validation analysis performed.

*Assumptions used by management* (Ref: Para. 13(b)(ii))

A77. The auditor's evaluation of the assumptions used by management is based only on information available to the auditor at the time of the audit. Audit procedures dealing with management assumptions are performed in the context of the audit of the entity's financial statements, and not for the purpose of providing an opinion on assumptions themselves.

A78. Matters that the auditor may consider in evaluating the reasonableness of the assumptions used by management include, for example:

- Whether individual assumptions appear reasonable.
- Whether the assumptions are interdependent and internally consistent.
- Whether the assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.
- In the case of fair value accounting estimates, whether the assumptions appropriately reflect observable marketplace assumptions.

A79. The assumptions on which accounting estimates are based may reflect what management expects will be the outcome of specific objectives and strategies. In such cases, the auditor may perform audit procedures to evaluate the reasonableness of such assumptions by considering, for example, whether the assumptions are consistent with:

- The general economic environment and the entity's economic circumstances.
- The plans of the entity.
- Assumptions made in prior periods, if relevant.
- Experience of, or previous conditions experienced by, the entity, to the extent this historical information may be considered representative of future conditions or events.
- Other assumptions used by management relating to the financial statements.

A80. The reasonableness of the assumptions used may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the financial reporting framework may require it to do so. Although the extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions.
- Review of written plans and other documentation, including, where applicable, formally approved budgets, authorisations or minutes.
- Inquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report.
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments.

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that assumptions reflect those used by marketplace participants.

A81. Matters that the auditor may consider in evaluating the reasonableness of assumptions used by management underlying fair value accounting estimates, in addition to those discussed above where applicable, may include, for example:

- Where relevant, whether and, if so, how management has incorporated market specific inputs into the development of assumptions.
- Whether the assumptions are consistent with observable market conditions, and the characteristics of the asset or liability being measured at fair value.
- Whether the sources of market-participant assumptions are relevant and reliable, and how management has selected the assumptions to use when a number of different market participant assumptions exist.
- Where appropriate, whether and, if so, how management considered assumptions used in, or information

about, comparable transactions, assets or liabilities.

A82. Further, fair value accounting estimates may comprise observable inputs as well as unobservable inputs. Where fair value accounting estimates are based on unobservable inputs, matters that the auditor may consider include, for example, how management supports the following:

- The identification of the characteristics of marketplace participants relevant to the accounting estimate.
- Modifications it has made to its own assumptions to reflect its view of assumptions marketplace participants would use.
- Whether it has incorporated the best information available in the circumstances.
- Where applicable, how its assumptions take account of comparable transactions, assets or liabilities.

If there are unobservable inputs, it is more likely that the auditor's evaluation of the assumptions will need to be combined with other responses to assessed risks in paragraph 13 in order to obtain sufficient appropriate audit evidence. In such cases, it may be necessary for the auditor to perform other audit procedures, for example, examining documentation supporting the review and approval of the accounting estimate by appropriate levels of management and, where appropriate, by those charged with governance.

A83. In evaluating the reasonableness of the assumptions supporting an accounting estimate, the auditor may identify one or more significant assumptions. If so, it may indicate that the accounting estimate has high estimation uncertainty and may, therefore, give rise to a significant risk. Additional responses to significant risks are described in paragraphs A102-A115.

*Testing the Operating Effectiveness of Controls* (Ref: Para. 13(c))

A84. Testing the operating effectiveness of the controls over how management made the accounting esti-

mate may be an appropriate response when management's process has been well-designed, implemented and maintained, for example:

- Controls exist for the review and approval of the accounting estimates by appropriate levels of management and, where appropriate, by those charged with governance.
- The accounting estimate is derived from the routine processing of data by the entity's accounting system.

A85. Testing the operating effectiveness of the controls is required when:

- (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls over the process are operating effectively; or
- (b) Substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.<sup>19</sup>

#### *Considerations specific to smaller entities*

A86. Controls over the process to make an accounting estimate may exist in smaller entities, but the formality with which they operate varies. Further, smaller entities may determine that certain types of controls are not necessary because of active management involvement in the financial reporting process. In the case of very small entities, however, there may not be many controls that the auditor can identify. For this reason, the auditor's response to the assessed risks is likely to be substantive in nature, with the auditor performing one or more of the other responses in paragraph 13.

#### *Developing a Point Estimate or Range* (Ref: Para. 13(d))

A87. Developing a point estimate or a range to evaluate management's point estimate may be an appropriate response when, for example:

- An accounting estimate is not derived from the routine processing of data by the accounting system.

- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective.
- The entity's controls within and over management's processes for determining accounting estimates are not well designed or properly implemented.
- Events or transactions between the period end and the date of the auditor's report contradict management's point estimate.
- There are alternative sources of relevant data available to the auditor which can be used in making a point estimate or a range.

A88. Even when the entity's controls are well designed and properly implemented, developing a point estimate or a range may be an effective or efficient response to the assessed risks. In other situations, the auditor may consider this approach as part of determining whether further procedures are necessary and, if so, their nature and extent.

A89. The approach taken by the auditor in developing either a point estimate or a range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a preliminary point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, where possible, a point estimate.

A90. The ability of the auditor to make a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and

assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value).

A91. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- Further developing management's consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions.
- Employing or engaging a person with specialised expertise to develop or execute the model, or to provide relevant assumptions.
- Making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

#### *Understanding Management's Assumptions or Method* (Ref: Para. 13(d)(i))

A92. When the auditor makes a point estimate or a range and uses assumptions or a method different from those used by management, paragraph 13(d)(i) requires the auditor to obtain a sufficient understanding of the assumptions or method used by management in making the accounting estimate. This understanding provides the auditor with information that may be relevant to the auditor's development of an appropriate point estimate or range. Further, it assists the auditor to understand and evaluate any significant differences from management's point estimate. For example, a difference may arise because the auditor used different, but equally valid, assumptions as compared with those used by management. This may reveal that the accounting estimate is highly sensitive to certain assumptions and therefore subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of

<sup>19</sup>SA 330, paragraph 8.

a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

*Narrowing a Range* (Ref: Para. 13(d)(ii))

A93. When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate (the auditor's range), paragraph 13(d)(ii) requires that range to encompass all "reasonable outcomes" rather than all possible outcomes. The range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit. The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated.

A94. Ordinarily, a range that has been narrowed to be equal to or less than the amount lower than the materiality level for the financial statements as a whole determined for purposes of assessing risks of material misstatement and designing further audit procedures<sup>20</sup> is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly in certain industries, it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk. Additional responses to significant risks are described in paragraphs A102-A115.

A95. Narrowing the range to a position where all outcomes within the range are considered reasonable may be achieved by:

- (a) Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur; and
- (b) Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.

**Considering whether Specialised Skills or Knowledge are Required** (Ref: Para. 14)

A96. In planning the audit, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the audit engagement.<sup>21</sup> This may include, as necessary, the involvement of those with specialised skills or knowledge. In addition, SA 220 requires the engagement partner to be satisfied that the engagement team, and any auditor's external experts, collectively have the appropriate capabilities, competence and time to perform the audit engagement.<sup>22</sup> During the course of the audit of accounting estimates the auditor may identify, in light of the experience of the auditor and the circumstances of the engagement, the need for specialised skills or knowledge to be applied in relation to one or more aspects of the accounting estimates.

A97. Matters that may affect the auditor's consideration of whether specialised skills or knowledge is required include, for example:

- The nature of the underlying asset, liability or component of equity in a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments).
- A high degree of estimation uncertainty.
- Complex calculations or specialised models are involved, for example, when estimating fair values when there is no observable market.

lised models are involved, for example, when estimating fair values when there is no observable market.

- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice is inconsistent or developing.
- The procedures the auditor intends to undertake in responding to assessed risks.

A98. For the majority of accounting estimates, even when there is estimation uncertainty, it is unlikely that specialised skills or knowledge will be required. For example, it is unlikely that specialised skills or knowledge would be necessary for an auditor to evaluate an allowance for doubtful accounts.

A99. However, the auditor may not possess the specialised skills or knowledge required when the matter involved is in a field other than accounting or auditing and may need to obtain it from an auditor's expert. SA 620<sup>23</sup> establishes requirements and provides guidance in determining the need to employ or engage an auditor's expert and the auditor's responsibilities when using the work of an auditor's expert.

A100. Further, in some cases, the auditor may conclude that it is necessary to obtain specialised skills or knowledge related to specific areas of accounting or auditing. Individuals with such skills or knowledge may be employed by the auditor's firm or engaged from an external organisation outside of the auditor's firm. When such individuals perform audit procedures on the engagement, they are part of the engagement team and accordingly, they are subject to the requirements in SA 220.

A101. Depending on the auditor's understanding and experience of working with the auditor's expert or those

<sup>20</sup>The Exposure Draft of SA 320 (Revised), "Audit Materiality" has been published in January, 2009 issue of the Journal. The last date for sending the comments is March 1, 2009.

<sup>21</sup>SA 300, "Planning an Audit of Financial Statements", paragraph 7(e).

<sup>22</sup>Paragraph 10 of the existing SA 220 (AAS 17), "Quality Control for Audit Work", issued in July, 1999 states "Any delegation of work to assistants would be in a manner that provides reasonable assurance that such work will be performed with due care by persons having the degree of professional competence required in the circumstances". The Standard is being revised in the light of the corresponding International Standard.

<sup>23</sup>SA 620 (AAS 9), "Using the Work of an Expert", paragraph 2. The Standard is being revised in the light of the corresponding International Standard.

other individuals with specialised skills or knowledge, the auditor may consider it appropriate to discuss matters such as the requirements of the applicable financial reporting framework with the individuals involved to establish that their work is relevant for audit purposes.

**Further Substantive Procedures to Respond to Significant Risks** (Ref: Para. 15)

A102. In auditing accounting estimates that give rise to significant risks, the auditor's further substantive procedures are focused on the evaluation of:

- (a) How management has assessed the effect of estimation uncertainty on the accounting estimate, and the effect such uncertainty may have on the appropriateness of the recognition of the accounting estimate in the financial statements; and
- (b) The adequacy of related disclosures.

**Estimation Uncertainty**

*Management's Consideration of Estimation Uncertainty* (Ref: Para. 15(a))

A103. Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. One possible method used by management is to undertake a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies with different assumptions. Even for accounting estimates measured at fair value there can be variation because different market participants will use different assumptions. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterised as a range of outcomes by management, such as "pessimistic" and "optimistic" scenarios.

A104. A sensitivity analysis may demonstrate that an accounting estimate is not sensitive to changes in particular assumptions. Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor's attention.

A105. This is not intended to suggest that one particular method of addressing estimation uncertainty (such as sensitivity analysis) is more suitable than another, or that management's consideration of alternative assumptions or outcomes needs to be conducted through a detailed process supported by extensive documentation. Rather, it is whether management has assessed how estimation uncertainty may affect the accounting estimate that is important, not the specific manner in which it is done. Accordingly, where management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for, how it has addressed the effects of estimation uncertainty on the accounting estimate.

*Considerations specific to smaller entities*

A106. Smaller entities may use simple means to assess the estimation uncertainty. In addition to the auditor's review of available documentation, the auditor may obtain other audit evidence of management consideration of alternative assumptions or outcomes by inquiry of management. In addition, management may not have the expertise to consider alternative outcomes or otherwise address the estimation uncertainty of the accounting estimate. In such cases, the auditor may explain to management the process or the different methods available for doing so, and the documentation thereof. This would not, however, change the responsibilities of management for the preparation and presentation of the financial statements.

*Significant Assumptions* (Ref: Para. 15(b))

A107. An assumption used in making an accounting estimate may be deemed to be significant if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate.

A108. Support for significant assumptions derived from management's knowledge may be obtained from management's continuing processes of strategic analysis and risk management. Even without formal

established processes, such as may be the case in smaller entities, the auditor may be able to evaluate the assumptions through inquiries of and discussions with management, along with other audit procedures in order to obtain sufficient appropriate audit evidence.

A109. The auditor's considerations in evaluating assumptions made by management are described in paragraphs A77-A83.

*Management Intent and Ability* (Ref: Para. 15(c))

A110. The auditor's considerations in relation to assumptions made by management and management's intent and ability are described in paragraphs A13 and A80.

**Development of a Range** (Ref: Para. 16)

A111. In preparing the financial statements, management may be satisfied that it has adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks. In some circumstances, however, the auditor may view the efforts of management as inadequate. This may be the case, for example, where, in the auditor's judgment:

- Sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.
- It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate, for example, where the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances.
- It is unlikely that other audit evidence can be obtained, for example, through the review of events occurring up to the date of the auditor's report.
- Indicators of management bias in the making of accounting estimates may exist.

A112. The auditor's considerations in determining a range for this purpose are described in paragraphs A87-A95.

## Recognition and Measurement Criteria

*Recognition of the Accounting Estimates in the Financial Statements* (Ref: Para. 17(a))

A113. Where management has recognised an accounting estimate in the financial statements, the focus of the auditor's evaluation is on whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable financial reporting framework.

A114. With respect to accounting estimates that have not been recognised, the focus of the auditor's evaluation is on whether the recognition criteria of the applicable financial reporting framework have in fact been met. Even where an accounting estimate has not been recognised, and the auditor concludes that this treatment is appropriate, there may be a need for disclosure of the circumstances in the notes to the financial statements. The auditor may also determine that there is a need to draw the reader's attention to a significant uncertainty by adding an Emphasis of Matter paragraph to the auditor's report. SA 706<sup>24</sup> establishes requirements and provides guidance concerning such paragraphs.

*Measurement Basis for the Accounting Estimates* (Ref: Para. 17(b))

A115. With respect to fair value accounting estimates, some financial reporting frameworks presume that fair value can be measured reliably as a prerequisite to either requiring or permitting fair value measurements and disclosures. In some cases, this presumption may be overcome when, for example, there is no appropriate method or basis for measurement. In such cases, the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.

## Evaluating the Reasonableness

## of the Accounting Estimates, and Determining Misstatements

(Ref: Para. 18)

A116. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an accounting estimate that differs from management's point estimate. Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. Where the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range.

A117. Where management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude based on the audit evidence that the accounting estimate is misstated as a result of an arbitrary change by management, or may regard it as an indicator of possible management bias (see paragraphs A124-A125).

A118. SA 450<sup>25</sup> provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of:

- Misstatements about which there is no doubt (factual misstatements).
- Differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inap-

propriate (judgmental misstatements).

- The auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (projected misstatements).

In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult or impossible.

A119. Evaluating the reasonableness of accounting estimates and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing an accounting estimate recognised in the financial statements.

## Disclosures Related to Accounting Estimates

*Disclosures in Accordance with the Applicable Financial Reporting Framework* (Ref: Para. 19)

A120. The presentation of financial statements in accordance with the applicable financial reporting framework includes adequate disclosure of material matters. The applicable financial reporting framework may permit, or prescribe, disclosures related to accounting estimates, and some entities may disclose voluntarily additional information in the notes to the financial statements. These disclosures may include, for example:

- The assumptions used.
- The method of estimation used, including any applicable model.
- The basis for the selection of the method of estimation.
- The effect of any changes to the method of estimation from the prior period.

<sup>24</sup>At present, there is no separate Standard on Auditing (SA) corresponding to International Standards on Auditing (ISA) 706, "Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor's Report". However, the concept of 'emphasis of matter paragraph' has been discussed in SA 700, "The Auditor's Report on Financial Statements". The Standard is being revised in the light of the corresponding International Standard. The Auditing and Assurance Standards Board will issue the Exposure Draft of SA 706 corresponding to ISA 706 in the near future.

<sup>25</sup>The Exposure Draft of SA 450, "Evaluation of Misstatements Identified during the Audit", has been published in January, 2009 issue of the Journal. The last date for sending the comments is March 1, 2009.

- The sources and implications of estimation uncertainty.

Such disclosures are relevant to users in understanding the accounting estimates recognised or disclosed in the financial statements, and sufficient appropriate audit evidence needs to be obtained about whether the disclosures are in accordance with the requirements of the applicable financial reporting framework.

A121. In some cases, the applicable financial reporting framework may require specific disclosures regarding uncertainties. For example, some financial reporting frameworks prescribe:

- The disclosure of key assumptions and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities. Such requirements may be described using terms such as “Key Sources of Estimation Uncertainty” or “Critical Accounting Estimates”.
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
- The disclosure of information regarding the significance of fair value accounting estimates to the entity’s financial position and performance.
- Qualitative disclosures such as the exposures to risk and how they arise, the entity’s objectives, policies and procedures for managing the risk and the methods used to measure the risk and any changes from the previous period of these qualitative concepts.
- Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity’s key management personnel, including credit risk,

liquidity risk and market risk.

**Disclosures of Estimation Uncertainty for Accounting Estimates that give Rise to Significant Risks** (Ref: Para. 20)

A122. In relation to accounting estimates having significant risk, even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved. The auditor’s evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see related discussion in paragraph A95).

A123. In some cases, the auditor may consider it appropriate to encourage management to describe, in the notes to the financial statements, the circumstances relating to the estimation uncertainty. SA 705<sup>26</sup> provides guidance on the implications for the auditor’s report when the auditor believes that management’s disclosure of estimation uncertainty in the financial statements is inadequate or misleading.

**Indicators of Possible Management Bias** (Ref: Para. 21)

A124. During the audit, the auditor may become aware of judgments and decisions made by management which give rise to indicators of possible management bias. Such indicators may affect the auditor’s conclusion as to whether the auditor’s risk assessment and related responses remain appropriate, and the auditor may need to consider the implications for the rest of the audit. Further, they may affect the auditor’s evaluation of whether the financial statements as a whole are free from material misstatement, as discussed in SA 700<sup>27</sup>

A125. Examples of indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.
- Use of an entity’s own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
- Selection or construction of significant assumptions that yield a point estimate favourable for management objectives.
- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

**Written Representations** (Ref: Para. 22)

A126. SA 580<sup>28</sup> discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognised or disclosed in the financial statements may include representations:

- About the appropriateness of the measurement processes, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.
- That the assumptions appropriately reflect management’s intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- That disclosures related to accounting estimates are complete and appropriate under the applicable financial reporting framework.
- That no subsequent event requires adjustment to the ac-

<sup>26</sup>At present, there is no separate Standard on Auditing (SA) corresponding to International Standard on Auditing (ISA) 705, “Modifications to the Opinion in the Independent Auditor’s Report”. However, the concept of ‘modified audit report’ has been discussed in SA 700, “The Auditor’s Report on Financial Statements”. The Standard is being revised in the light of the corresponding International Standard. The Auditing and Assurance Standards Board will issue the Exposure Draft of SA 705 corresponding to ISA 705 in the near future.

<sup>27</sup>Hitherto known as SA 700 (AAS 28), “The Auditor’s Report on Financial Statements”. The Standard is being revised in the light of the corresponding International Standard.

<sup>28</sup>Standard on Auditing (SA) 580 (Revised), “Representations by Management” has been published in the October, 2008 issue of the Journal. Revised SA 580 is effective for audits of financial statements for periods beginning on or after 1st April, 2009.

counting estimates and disclosures included in the financial statements.

A127. For those accounting estimates not recognised or disclosed in the financial statements, written representations may also include representations about:

- The appropriateness of the basis used by management for determining that the recognition or disclosure criteria of the applicable financial reporting framework have not been met (see paragraph A114).
- The appropriateness of the basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework, for those accounting estimates not measured or disclosed at fair value (see paragraph A115).

**Documentation** (Ref: Para. 23)

A128. Documentation of indicators of possible management bias identified during the audit assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate, and in evaluating whether the financial statements as a whole are free from material misstatement. See paragraph A125 for examples of indicators of possible management bias.

**Material Modifications to ISA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"**

**Deletions**

1. Paragraph A11 of the Application Section of ISA 540 deals with the application of the requirements of ISA 540 to the audits of public sector entities regarding significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement at fair value or other current value bases, or a combination of both. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other

Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even non-public sector entities, may have significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement. Accordingly, the spirit of erstwhile A11, highlighting the fact that in case of certain entities, there may be a requirement of estimation at fair value in case of specialised assets, has been retained.

**Appendix**

(Ref: Para. A1)

**Fair Value Measurements and Disclosures Under Different Financial Reporting Frameworks**

The purpose of this appendix is only to provide a general discussion of fair value measurements and disclosures under different financial reporting frameworks, for background and context.

1. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist.

2. Definitions of fair value may differ among financial reporting frameworks, or for different assets, liabilities or disclosures within a particular framework. For example, Accounting Standard (AS) 30<sup>29</sup> defines fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing par-

ties in an arm's length transaction". The concept of fair value ordinarily assumes a current transaction, rather than settlement at some past or future date. Accordingly, the process of measuring fair value would be a search for the estimated price at which that transaction would occur. Additionally, different financial reporting frameworks may use such terms as "entity-specific value," "value in use," or similar terms, but may still fall within the concept of fair value in this SA.

3. Financial reporting frameworks may treat changes in fair value measurements that occur over time in different ways. For example, a particular financial reporting framework may require that changes in fair value measurements of certain assets or liabilities be reflected directly in equity, while such changes might be reflected in income under another framework. In some frameworks, the determination of whether to use fair value accounting or how it is applied is influenced by management's intent to carry out certain courses of action with respect to the specific asset or liability.

4. Different financial reporting frameworks may require certain specific fair value measurements and disclosures in financial statements and prescribe or permit them in varying degrees. The financial reporting frameworks may:

- Prescribe measurement, presentation and disclosure requirements for certain information included in the financial statements or for information disclosed in notes to financial statements or presented as supplementary information;
- Permit certain measurements using fair values at the option of an entity or only when certain criteria have been met;
- Prescribe a specific method for determining fair value, for example, through the use of an independent appraisal or specified ways of using discounted cash flows;
- Permit a choice of method for determining fair value from among several alternative methods (the criteria for selection

<sup>29</sup>AS 30, "Financial Instruments: Recognition and Measurement".

may or may not be provided by the financial reporting framework); or

- Provide no guidance on the fair value measurements or disclosures of fair value other than their use being evident through custom or practice, for example, an industry practice.

5. Some financial reporting frameworks presume that fair value can be measured reliably for assets or liabilities as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable. Some financial reporting frameworks may specify a fair value hierarchy that distinguishes inputs for use in arriving at fair values ranging from those that involve clearly “observable inputs” based on quoted prices and active markets and those “unobservable inputs” that involve an entity’s own judgments about assumptions that marketplace participants would use.

6. Some financial reporting frameworks require certain specified adjustments or modifications to valuation information, or other considerations unique to a particular asset or liability. For example, accounting for investment properties may require adjustments to be made to an appraised market value, such as adjustments for estimated closing costs on sale, adjustments related to the property’s condition and location, and other matters. Similarly, if the market for a particular asset is not an active market, published price quotations may have to be adjusted or modified to arrive at a more suitable measure of fair value. For example, quoted market prices may not be indicative of fair value if there is infrequent activity in the market, the market is not well established, or small volumes of units are traded relative to the aggregate number of trading units in existence. Accordingly, such market prices may have to be adjusted or modified. Alternative sources of market information may

be needed to make such adjustments or modifications. Further, in some cases, collateral assigned (for example, when collateral is assigned for certain types of investment in debt) may need to be considered in determining the fair value or possible impairment of an asset or liability.

7. In most financial reporting frameworks, underlying the concept of fair value measurements is a presumption that the entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Therefore, in this case, fair value would not be the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale. On the other hand, general economic conditions or economic conditions specific to certain industries may cause illiquidity in the marketplace and require fair values to be predicated upon depressed prices, potentially significantly depressed prices. An entity, however, may need to take its current economic or operating situation into account in determining the fair values of its assets and liabilities if prescribed or permitted to do so by its financial reporting framework and such framework may or may not specify how that is done. For example, management’s plan to dispose of an asset on an accelerated basis to meet specific business objectives may be relevant to the determination of the fair value of that asset.

**Prevalence of Fair Value Measurements**

8. Measurements and disclosures based on fair value are becoming increasingly prevalent in financial reporting frameworks. Fair values may occur in, and affect the determination of, financial statements in a number of ways, including the measurement at fair value of the following:

- Specific assets or liabilities, such as marketable securities or liabilities to settle an obligation under a financial instrument, routinely or periodically “marked-to-market”.
- Specific components of equity, for example when account-

ing for the recognition, measurement and presentation of certain financial instruments with equity features, such as a bond convertible by the holder into common shares of the issuer.

- Specific assets or liabilities acquired in a business combination. For example, the initial determination of goodwill arising on the purchase of an entity in a business combination usually is based on the fair value measurement of the identifiable assets and liabilities acquired and the fair value of the consideration given.
- Specific assets or liabilities adjusted to fair value on a one-time basis. Some financial reporting frameworks may require the use of a fair value measurement to quantify an adjustment to an asset or a group of assets as part of an asset impairment determination, for example, a test of impairment of goodwill acquired in a business combination based on the fair value of a defined operating entity or reporting unit, the value of which is then allocated among the entity’s or unit’s group of assets and liabilities in order to derive an implied goodwill for comparison to the recorded goodwill.
- Aggregations of assets and liabilities. In some circumstances, the measurement of a class or group of assets or liabilities calls for an aggregation of fair values of some of the individual assets or liabilities in such class or group. For example, under an entity’s applicable financial reporting framework, the measurement of a diversified loan portfolio might be determined based on the fair value of some categories of loans comprising the portfolio.
- Information disclosed in notes to financial statements or presented as supplementary information, but not recognised in the financial statements. □

**Smile Please**

The phone bill was exceptionally high and the head of the house called a family meeting on a Saturday morning...after breakfast...

Man: This is unacceptable. You have to limit the use of the phone, I do not use this phone, and I use the one at the office.

Wife: Same here, I hardly use this home telephone as I use my work telephone.

Son: Me too, I never use the home phone. I always use my company mobile.

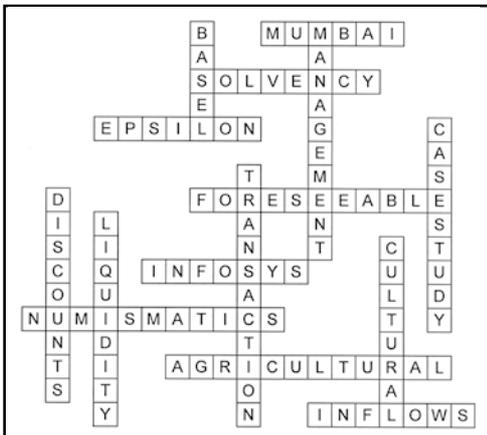
Maid: So - what is the problem? We all use our work telephones!!

**OUT OF THE BOX**

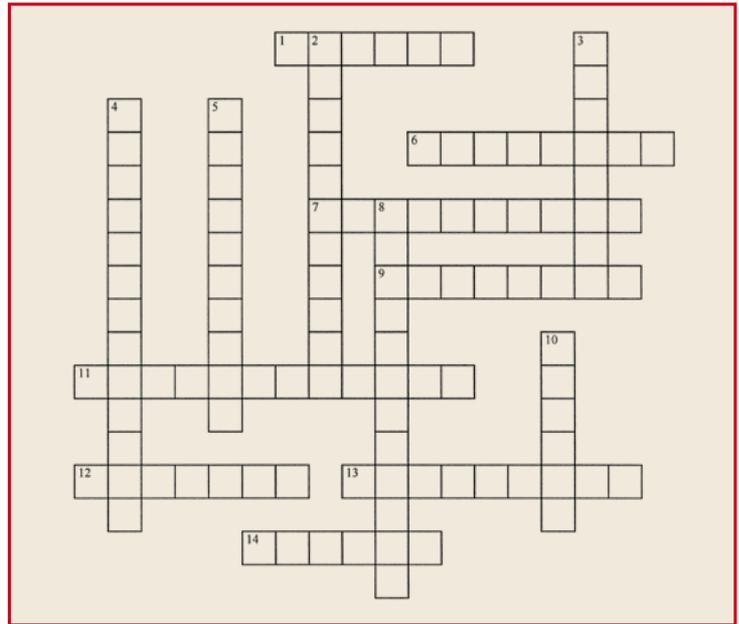


*I lost simply because as a reflex action I ran all the way...to the bank!*

**Crossword 031 - Solution**



**CROSSWORD 032**



Note:- The above crossword related to 'Management Strategy' has been contributed by CA. T. Muralidhara Kalkura, Chennai.

**ACROSS**

1. A group of companies/firms to control prices. (6)
6. Selling complementary products as a single package is called \_\_\_\_\_ Strategy. (8)
7. Removal of layers of management. (10)
9. One of the oldest adages - '\_\_\_\_\_ is always right'. (8)
11. Corporations expend much energy on identifying their Core \_\_\_\_\_. (12)
12. The strategy for the final days of a company. (3,4)
13. Immediate sale of all assets after acquisition is called Asset \_\_\_\_\_. (9)
14. A necessary part of any strategy. (6)

**DOWN**

2. Author of *My Years with General Motors*. (6,5)
3. If we call Acquisition is old paradigm then the new one is Strategic \_\_\_\_\_. (8)
4. The process of altering a product's place in its market. (13)
5. Top managers setting the best ones considered valuable contribution. (10)
8. Akio Morita, Sony's Former Chairman had invented this phrase, 'Global \_\_\_\_\_'. (12)
10. A Method of managing multinationals is \_\_\_\_\_ Management. (6)

**Note:** The first ten correct entries from the members will be awarded one hour CPE Credit. The entries, along with name, membership no. and contact details shall be sent by post to: The Editor, The Chartered Accountant, ICAI Bhawan, C-1, Sector 1, Noida - 201 301.