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THE CHARTERED ACCOUNTANT

JOURNAL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

ICAI-ICAEW MoU

HERALDS NEW ERA OF PROFESSIONAL TIES

- Exchange Differences: Schedule VI – AS 11
- Overhauling the Indian Banking – Basel II Accord
- The Credit Crisis of 2008: Causes, Consequences and Implications for India
- Limited Liability Partnership
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Celebrating 60th Year of Excellence

Volume 57 No. 06 December 2008
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G-20 Summit and India

The G-20 summit, called to ponder over the worst financial crisis in over 70 years, had many takers for India's three point emphasis— on the need for a 'global oversight' and greater say for developing countries in the global financial system; need to ensure that prospects of emerging economies do not suffer; and the need to avoid the protectionist tendencies. The six-point action plan mooted at the G-20 summit also reflected the spirit of Indian stand on tackling the crisis, particularly the concern voiced by Prime Minister Dr. Manmohan Singh that the financial meltdown had exploded into a systemic crisis requiring a coordinated approach by world leaders. The broad plan included short-term action such as fiscal stimulus to boost domestic demand, restarting world trade talks, and expanding financial stability forum to emerging economies. It also agreed to long-term steps such as reforming the International Monetary Fund.

Leaders of the G-20 made all the right noises on the need for greater transparency, regulation and international cooperation despite inevitable gaps in perception between major players— the US, Europe and developing countries. But those who looked upon G-20 summit as the 'next Bretton Woods'– The Historic talks after World War II that led to a dollar-led new world economic order, are of course disappointed at its rather innocuous and non-concrete conclusion. It is now obvious that the West will not countenance a new power structure beyond the G-7, whose heads still don't seem to see anything wrong in the BRIC group not having legitimate say in global economic affairs.

Prime Minister Dr. Manmohan Singh was forthright in campaigning for 'inclusivity' and greater say for developing countries, particularly India, in the global financial system. India, as a $1 trillion economy, has indeed a vital stake in the stability of the international economic and financial system. The prevailing global crisis has reinforced the need to have a new and more inclusive order of global oversight. India's viewpoint that such a global oversight is a must to put in place an 'early warning mechanism' should be taken and acted upon seriously by the world leaders, particularly since the World Bank and IMF have virtually failed to provide such a mechanism. As a common regulation framework on global scale is too ambitious, India has rightly pitched for common prudential and regulatory standards for all financial institutions in the world and a convergence of accounting standards to prevent collapse of global financial institution. Of course there should not be overregulation, but there must be some way by which countries can have global oversight with commonly accepted regulatory and prudential standards overseen by national regulators. It is welcome that the G-20 summit supported an action plan to reform the multilateral financial institutions and agreed to establish supervisory colleges for major cross-border financial institutions but what remains a matter of concern is that it fell short of announcing major regulatory breakthroughs.

The second point of India's stress at the G-20 meeting had been that the developing countries that are able to drive economic growth, particularly BRIC, should not suffer in the period in which the world grapples with the economic crisis. This meant that resources should be made available to such countries so that they can continue to grow and drive economic growth. It is good that the G-20 has agreed to help shore up liquidity in developing world.

Thirdly, as has been rightly pointed out by Finance Minister P Chidambaram, the crisis should not be an excuse for the countries to go into a protectionist cocoon. Without the free flow of goods, services and capital, the world cannot recover and get back to the path of growth. It was indeed heartening to note the G-20 unity on the need to desist from trade protectionism and complete the Doha Round of talks.

In the current scenario, global markets needed their political leaders to send out a signal of confidence and the G-20 summit probably has done enough to assuage fears. But the point of concern is that no mechanism exists to oversee the economic action plan agreed by world leaders at the summit. It is also not quite clear yet as to whether the incoming US administration was wholly on board with what the George W. Bush's team agreed at the meeting. As such, perhaps the more critical meeting will be the one scheduled for April 30, 2009— that's were the fine print will be discussed. India should aim to be an influential voice of emerging economies at that meeting.

— Editorial Board
ICAI- Partner in Nation Building

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Cover: ICAI, ICAEW sign MoU

TOTAL CIRCULATION: 1,86,000
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Dear Esteemed Colleagues,

I am writing this page just after the conclusion of the three-day International Conference on *Accounting Profession - Shining Bridge Between Global Economies* held in the pink city of Jaipur as part of the ongoing Diamond Jubilee celebrations of the Institute. It was a memorable assembly of highly admired experts in the field, besides the leaders in trade and industry. The conference focused on topical issues like governance, financial engineering, regulatory compliance, value creation and corporate social responsibility. The conference also offered a good opportunity to the participants to enhance their knowledge and widen their vision.

This conference was organized to coincide with the meetings of the Board of South Asian Federation of Accountants (SAFA) and Board of Confederation of Asian Pacific Accountants (CAPA) in which representatives from more than 30 countries participated. This helped in achieving a global reach for India's chartered accountancy profession. The leaders of the accountancy profession from the various parts of the world could see the competence level of the chartered accountancy profession in India. The conference was very well attended. An idea of the success of the conference can be gauged from the fact that more than 3000 delegates including more than 200 delegates from abroad participated in it. And it was addressed by more than 40 learned speakers including more than 15 speakers from abroad.

Historic MoU with ICAEW recognizing each other's qualifications

Friends, I have always wondered why the Indian Chartered Accountancy course, despite being so comprehensive and so tough as compared to any other chartered accountancy course of the world, is not recognized by other accounting bodies of the world. Accordingly, immediately after assuming the office of the President of the Institute in February, 2008, I started working on this issue.

ICAI President CA. Ved Jain with Union Minister for Corporate Affairs Mr. P.C Gupta and Deputy President, ICAEW Mr. Martin Hagen after signing of MoU between ICAI and ICAEW in Jaipur on November 20, 2008.

I am glad to inform you that my efforts in this direction have started showing results. I, on behalf of the Institute of Chartered Accountants of India, signed a memorandum of understanding (MoU) on 20th November, 2008 at Jaipur with Mr. Martin Hagen, Deputy President of the Institute of Chartered Accountants in England & Wales (ICAEW), who specially flew down from London for this purpose. Hon'ble Union Minister of Corporate Affairs Shri Prem Chand Gupta witnessed this historic development. As per the memorandum of understanding reached, members of ICAI with two years of post-qualification experience will be eligible for ICAEW membership on passing ICAEW's one paper on Case Study. However, members with less than two years experience will be required to pass two additional papers i.e. Business Change and Business Reporting. The members of ICAEW who are trained in public practice will be eligible for ICAI membership subject to passing ICAI's four papers on Taxation; Law, Ethics & Communication;

Information Technology & Strategic Management; and Auditing & Assurance. Details and the procedure have been published elsewhere in this issue of the journal and are also available on the Institute's website. In the era of globalization, the coming together of two largest chartered accountancy bodies in the world heralds a new era for the accountancy profession. This agreement will facilitate mobility of members across the borders. It goes without saying that the signing of this MoU is a recognition of the high level of the education and training which a student of ICAI undergoes before he becomes a full-fledged member of it.

Convocation Ceremony at Mumbai and Delhi

I am delighted to inform you that we have recently initiated the practice of organizing convocation for new Chartered Accountants. The first such convocation for the Western Region was held on 9th November, 2008 at Mumbai and the second convocation for the Northern Region was held on 16th November, 2008 at Delhi, where I handed over Membership Credentials to more than 1200 young torch bearers of the profession. It was heartening to feel the sense of pride and camaraderie among the new entrants to the profession. I am sure this new practice will in time become a tradition and will flourish in days to come and will strengthen professional bonding, sense of belongingness to the Institute and also help in brand building.

National Cultural and Sports Competitions

To create awareness among school students about the choice of their career and encourage them to join CA course, a national debate competition is going on for students of Class XI and Class XII in different parts of the country. I am happy to inform you that so far this national debate competition has been held at more than 55 branches in the country in which more than 12,000 students of 600 schools have participated. The feedback which I have received from the branches is very encouraging. This debate competition has helped the Institute to reach out not only to the students, but also to their parents and teachers, besides sensitizing the students on various contemporary issues on which the debate is being held.

Continuing this process further and in order to encourage CA students to take part in extra-curricular activities, it has been decided to organize a National Cultural Competition in various streams such as dance, drama, music - vocal and instrumental, etc. at each of our branches. Similarly, to encourage sports activities amongst CA students, it has been decided to organize a National Sports Competition (carom, chess, tennis, badminton, table tennis, etc.) at each of our branches. This competition will be open to all CA students including CPT students. Winners at the branch level will participate in the competition at the regional level and thereafter at the national level. I hope you will agree that encouraging cultural and sports activities among CA students will go a long way in helping them to develop an all round personality. It will also show to the world that CA students do not lag behind in these areas. And possibly in the years to come, many of our students and members will bring laurels to the Institute by excelling in cultural and sports activities.

Three-months Residential Programme for Students

I am glad to tell you that a major milestone achieved this year has been the starting of the three months' residential programme on Soft Skills Development for CA students. The first two batches of this programme were conducted with the help of National Institute of Financial Management, Faridabad, benefiting 107 Chartered Accountancy students. Encouraged by the response, the third Soft Skills Development programme is scheduled to start from December 1, 2008 at Jaipur. The venue of this programme is the LNM Institute of Information Technology, Jaipur, which is spread over 100 acres and has a calm and serene academic environment. Among other things, it will also help in enlarging the geographical spread of the programme. It would be my endeavour to replace the present 15-day General Management and Communications Skills course by this 3-months residential programme so that all students are able to reap its benefit.

May I also inform you that work on the ICAI's

own residential Centre of Excellence at Jaipur, the foundation stone of which was laid in September, 2008, is going on and I am confident that this Centre of Excellence will become operational by next year. This will help us in making the 3-month residential course mandatory for all CA students before they are admitted as members of the Institute.

Residential Course for Senior Members at Hyderabad

The aforementioned three-month residential programme for students and newly qualified members was started to groom chartered accountants into a class of matchless professionals. However, at the same time there is a pressing need to ensure that senior members who did not have the opportunity of undergoing such a residential course, both in industry and practice, also have an opportunity to enhance their competitive competence and communication skills as well as their practical skills and professional and leadership abilities. Accordingly, it has been decided to start residential programmes of short duration for senior members as well and to have a Centre of Excellence for them. I am very happy to inform you that the ICAI's first such Centre of Excellence is going to be inaugurated at Hyderabad by the end of December, 2008. This Centre of Excellence at Hyderabad is spread over about three acres of land and is being equipped to have world-class facilities for holding a top level residential programme. This Centre of Excellence at Hyderabad has been conceptualized to be a landmark in the field of education and training, a learning and research hub for accountancy in India, and also a centre to help formulate economic and financial policies. In the Diamond Jubilee year of its service to the nation, this will indeed be yet another feather in the ICAI's cap.

Revamped Online Payment System

It has been our constant endeavour to improve the functioning of the systems in the Institute to suit modern-day requirements. As part of this process, the online payment system of the Institute has been totally revamped to facilitate easy and real time online payments towards membership fees, enrollment of members, registration of students, registration for examination, ordering of publications, registration for conferences/seminars, registration for e-learning courses, donations if any and many other services being offered by the Institute. I may assure you that the new online services portal is highly reliable and user-friendly payment gateway.

Need to fulfil CPE Requirements

As you know, the main objective of the Continuing Professional Education (CPE) requirements, which are mandatory for all members of the Institute with effect from 1st January 2008, is to enhance the skills and capabilities of the professionals. Tremendous efforts are being put to fulfill this objective of CPE by organizing a series of programmes in different areas of professional and related activities for the benefit of members. During the period 1st January, 2008 to 10th November this year, the total number of CPE hours generated has been a mammoth 7,65,000. Even more encouraging is the fact that out of the total membership of 69,582 holding Certificate of Practice (excluding the senior members and members residing abroad) around 14,000 members have already completed the minimum requirement of 20 CPE hours in the calendar year 2008 much before the stipulated time. I congratulate all such members for completing the CPE requirements so enthusiastically.

However, I am concerned about a large number of members who have apparently not taken the CPE requirements seriously. It is disturbing to note that despite the fact that first calendar year 2008 of the rolling three-year period 2008-2010 is nearing its close, many members are yet to initiate the process of acquiring CPE hours for 2008. I appeal to all such members to complete CPE Credit requirement for the calendar year 2008 and plan their work schedules for 2009 in such a manner that they complete the CPE requirements comfortably throughout the year instead of making a last minute rush for the same in the last months. Completing the CPE Credit requirements hurriedly, just for the sake of it, is hardly desirable. This defeats the very purpose of the CPE and is not in the interest of the profession.

You could verify the number of CPE credit hours earned by you through the CPE Portal,

www.cpeicai.org. In case, you find any discrepancy in the actual number of CPE hours earned by you and those appearing on the CPE Portal, please contact the concerned Programme Organising Unit. Your suggestions for inclusion of some newer topics/areas under the CPE Programmes will always be welcome.

Revival of Lapsed Membership

Friends, as you may have noticed, the Institute has taken several initiatives to bring all its members closer to it. I find that names of many members stand struck off due to non-receipt of fees. This could be due to non-receipt of communication from ICAI consequent upon change of address etc. Realizing the importance of the fact that the CA qualification is a coveted qualification, having been acquired after hard work and passing through rigorous system of examinations, the Council has approved an Amnesty Scheme to enable such members whose membership stands cancelled as on 13.05.2008 due to non-payment of membership fees, to get their membership restored with retrospective effect upon payment of membership fee for the entire period of removal and submission of Form 9. This scheme is currently in force and will remain valid up to 31st December, 2008. It is satisfying for me to note that this scheme has evoked a very encouraging response and about 1000 members have already availed themselves of the facility of the retrospective restoration of their membership. I urge all the remaining professionals whose name has got removed from the ICAI membership list due to non-payment of membership fee to benefit from the Amnesty Scheme. All such members can visit www.icai.org and click the link 'Restore Your Membership' for online submission of Form '9'. May I also request you to help in identifying such members whose names stand struck off and pass on this message to them! Your help can be crucial because this message will otherwise not reach them as they do not receive the journal.

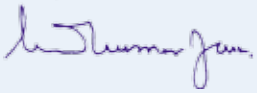
CAs are the Best Internal Auditors.

Internal audit is an area where CAs are by far the best professionals available. The independence, integrity, transparency, accountability, skill, competence and ability which chartered accountants possess are best suited for internal audit. A CA's flair to grasp the intricacies of an entity gives him an edge in the area of internal audit. The ability to deal with numbers and the skills acquired during the course of practical work experience puts a chartered accountant way ahead of others to carry out the internal audit. To further enhance this competence, the Institute has come out with the Standards on Internal Audit and has set up an Internal Audit Standards Board. This will further enhance the visibility of chartered accountants and at the same time ensure top quality work being done by the chartered accountants.

Forensic Accounting

Forensic Accounting encompasses the use of accounting/auditing, investigative skills, data mining and the use of the computer as an audit tool. Chartered accountants, with their sound grounding in accounting/auditing, are the most appropriate professionals to offer forensic accounting and fraud detection services. Realizing this, a Certificate Course on Forensic Accounting and Fraud Detection is being started. The course will help members in acquiring investigative skills required to uncover corporate/business frauds, measure result damage and provide support/counsel by applying accounting and auditing principles for the detection of frauds. The details of this course are available on the Institute website. Meanwhile, work on starting a Certificate Course on Corporate Governance as well as a Certificate Course on Enterprise Risk Management is going on and I will be sharing more details of it in my next communication.

Friends, a number of other initiatives are also underway that are meant to add to the capacity, capabilities and skills of our professionals with the overall objective of making them the best in the world. I look forward to receiving your guidance and help in achieving this objective.



CA. Ved Jain
New Delhi, November 25, 2008

READERS WRITE

Good Contemporary Articles

It is heartening to come across a story on corporate environment management in the June 2008 issue of *The Chartered Accountant*. Environment management is a means by which companies and governmental departments act to identify their impacts on the environment and improve their performance in this area, and encourage their suppliers, customers and partners to do the same. Environmental issues impact both our personal as well as corporate health.

I appreciate the ICAI's efforts for publishing articles on such a pertinent issue, and I wish all success for its succeeding exclusives.

– Shri Amar Singh, MP (Rajya Sabha)

Congrats for the engrossing article on *Corporate Governance* published in November issue of the Journal, dripping with *dharma* needed for corporate *karma*. All that corporate czars need to do is to read to become the breed to start encouraging value innovation. It is not at all easy to dress a vast literature with past blenders and still impress in such a blending article of management & spirituality.

– CA. M Sivaraman, Chennai

Admiration for ICAI Initiatives

Innovative Steps

I appreciate the initiatives taken up by the Institute like the e-learning courses, tie-ups with management universities, new certificate courses in Forex & Treasury Management, Derivatives, IFRS, etc. Integrity and commitment towards the profession and keeping up the high standards can be the contribution of each member to the profession and the Institute. I feel extremely proud to be a member of the esteemed Institute.

I find a great visionary in the President of our Institute.

– CA. Pradip Kaodkar, Goa

Members' Helpdesk: Excellent Initiative

I really appreciate Members' Helpdesk, a recent initiative. I congratulate our President for such an innovative initiative. Use of internet will increase the speed of communication between the Institute and its members and also among members. I have really benefited from this Helpdesk. Firm-name approval normally takes about one and a half month besides postal delays, but I got my firm's name approved within 3 days. Credit goes to this Helpdesk. I would also like to appreciate the timely responses to my queries from the authorities concerned.

– CA. Vinayak A. Aamale-Patil, Nashik

Quality Articleship

I do agree with the President that practical training of articles must be taken more seriously, and that there has been a three-fold increase in the enrolment for articleship since 200-05. Under the present system of CPT, plus 2 students with 17 years of age lack basic theoretical knowledge and reasonable maturity to do audit. PE-II should be part of CA curriculum and not an entry requirement.

– CA. M.C Joseph, Kochi

Innovative Courses

I am very happy to know that our institute has started certificate courses in Forex & Treasury Management and Derivatives. It is necessary for us to understand international finance and money market. The article on corporate finance was very educative. I am really proud that a street has been named *Auditors Street* in Salem and it is one more milestone of recognition.

– CA. Kaushalendra Pandey, Kanpur

Attractive Cover Page

I am happy to see our Journal carrying a beautiful cover page. Please try to incorporate more case studies on finance banking and economy so that we may be benefited more.

– CA. Neelesh Gupta, Shahdol

Use of Unstructured Learning Activities

The unstructured CPE learning activities introduced by the Institute is one of the best steps for members in industry for fulfilling CPE Credits and benefitting from it.

– CA. N. Syed Nafiz Ahamed, Chennai

Build CA Parks!

My idea for celebrating the Diamond Jubilee year in a fitting manner would be by establishing CA parks the way we have IT parks.

– CA. R. Suresh, Pondicherry

Write to the Editor

'Information is Power' and our ever-evolving rofession 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/nadeem@icai.org or write to: The Editor, The Journal Section, ICAI Bhawan, C-1, Sector 1, Noida (U.P.) 201 301.

- Editor

CA. Ved Jain, President ICAI, Appointed on Board of IFAC

CA. Ved Jain, the President of Institute of Chartered Accountants of India (ICAI), has been appointed as a Member on the Board of International Federation of Accountants (IFAC) for a term of 3 years from 13th November 2008. The announcement regarding this prestigious appointment was made during the IFAC Council meeting held on 12th-13th November 2008 at Rome, Italy. His appointment to the board of IFAC is a recognition of his qualifications, technical skills and competence.

IFAC, the global organisation for the accountancy profession, works with its 138 members and 20 associates in 123 countries and jurisdictions to protect the public interest by encouraging high quality practices by the world's accountants. ICAI is one of the members of IFAC. IFAC members and associates, which are primarily national professional accountancy bodies, represent 2.5 million accountants employed in public practice, industry, commerce, government, and academia.

CA. Ved Jain is a rank holder in both CA Inter and CA Final. A Triple Bachelors Degree Holder, he has done his Bachelors of Science from Punjab University in 1973. A true follower of Continuous Professional Education, after completing his Chartered Accountancy in 1973, for the love of the subject he did his Bachelors of Arts in Economics in 1979. Thereafter, he completed his Law Bachelors Degree in 1980 from Delhi University. A Fellow Member of ICAI with more than three decades of standing, CA. Ved Jain was elected to the Central Council of ICAI for the first time in 2004 and thereafter in 2007.

CA. Ved Jain, 55, who took over as the President of ICAI for the year 2008-2009 on February 5, 2008, is actively associated with regional accountancy bodies as well. He is on the Board of Confederation of Asian and Pacific Accountants. He is also on the board of the South Asian Federation of Accountants (SAFA) Assembly.

He is also a member of the National Advisory Committee on Accounting Standards constituted by the Ministry of Corporate Affairs, Govt. of India. He is also a member of the Governing Body of National Institute of Public Finance and Policy besides being part of a number of other high level committees constituted in national economic interest.

CA. Ved Jain, who has steered the ICAI to new heights both nationally and internationally, has already been making significant contributions as a member of the Developing Nations Committee of the IFAC since January 2008.❑

ICAI president CA. Ved Jain gives Certificate of Practice to a newly qualified Chartered Accountant at the first convocation of Northern India Regional Council of ICAI organised in New Delhi on 16th November 2008. More than 1200 newly qualified CAs were conferred with credentials at the convocation.

ICAI President CA. Ved Jain addresses the gathering at the Diamond Jubilee conference on 'Challenges of Change -- Always Ahead' organised by Bombay Chartered Accountants Society on 8th November 2008 in Mumbai.

ICAI President CA. Ved Jain with Karnataka Chief Minister Shri B. S. Yediyurappa (Centre) after a meeting to discuss the issues related to Public Finance at Karnataka Bhawan, New Delhi on 17th November, 2008. Chairman of Committee on Public Finance of ICAI CA. Subodh Kumar Agrawal, central council members CA. K. Raghu and CA. Jaydeep N. Shah were also present on the occasion.

ICAI President CA. Ved Jain, ICAI Vice President CA. Uttam Prakash Agarwal, Justice K.K Tated of Bombay High Court, Chairman WIRC of ICAI CA. B.M Agarwal, Chairman NIRC of ICAI CA. Sudhir Agarwal, Central Council Members Jaydeep N. Shah, CA. Sanjeev Maheshwari, CA. R.S. Adukia and other dignitaries at the first convocation of Western India Regional Council of ICAI, organised in Mumbai on 9th November 2008.

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

MoU Between ICAI and ICAEW

Heralds New Era of Professional Ties

In a major move to expand the professional horizons of Indian Chartered Accountants, the Institute of Chartered Accountants of India has signed a Memorandum of Understanding (MoU) with the Institute of Chartered Accountants in England & Wales, which *inter alia* provides for Recognition and Examination arrangements between the two Institutes. The MoU is effective from December 01, 2008.

This agreement would facilitate mobility of members across the borders and further strengthen the ties between India and Great Britain. The MoU entails membership of Institute without license to practice. General practice rights excluding auditing rights would be available.

Existing members of ICAI, in good standing and with two years post qualification experience (availing credit of prior learning) will be eligible for ICAEW membership on passing of only one paper of ICAEW on Case Study. The ICAI members with less than two years experience (not availing credit for prior learning) will be required to appear additional papers in Business Reporting (T1) and Business Change (T2) along with Case Study. They will also be required to pursue the structure training in ethics. There is no additional requirement of undergoing any additional training experience requirements or take any other examinations. The procedure/steps to be followed to become ICAEW member is given in **Chart 1** on next page.

Registration with ICAEW would require documents such as Personal Details, Proof of active ICAI membership, Proof of Good standing, Confirmation of work experience and Registration fee. ICAI members with no adverse disciplinary findings made against them and those who have confirmed their compliance with the CPD requirements of ICAI will only be eligible for the arrangement.

On the other hand, members of ICAEW who are trained in public practice will become eligible for ICAI membership subject to passing ICAI's examination papers for the special modules of Auditing & Assurance; Law, Ethics & Communication; Information Technology & Strategic Management; and Taxation.

Members of the ICAI who join the ICAEW will be eligible for an ICAEW practicing certificate on the same basis as ICAEW members. Similarly, members of the ICAEW who join the ICAI will have general practice rights, excluding audit rights in India.

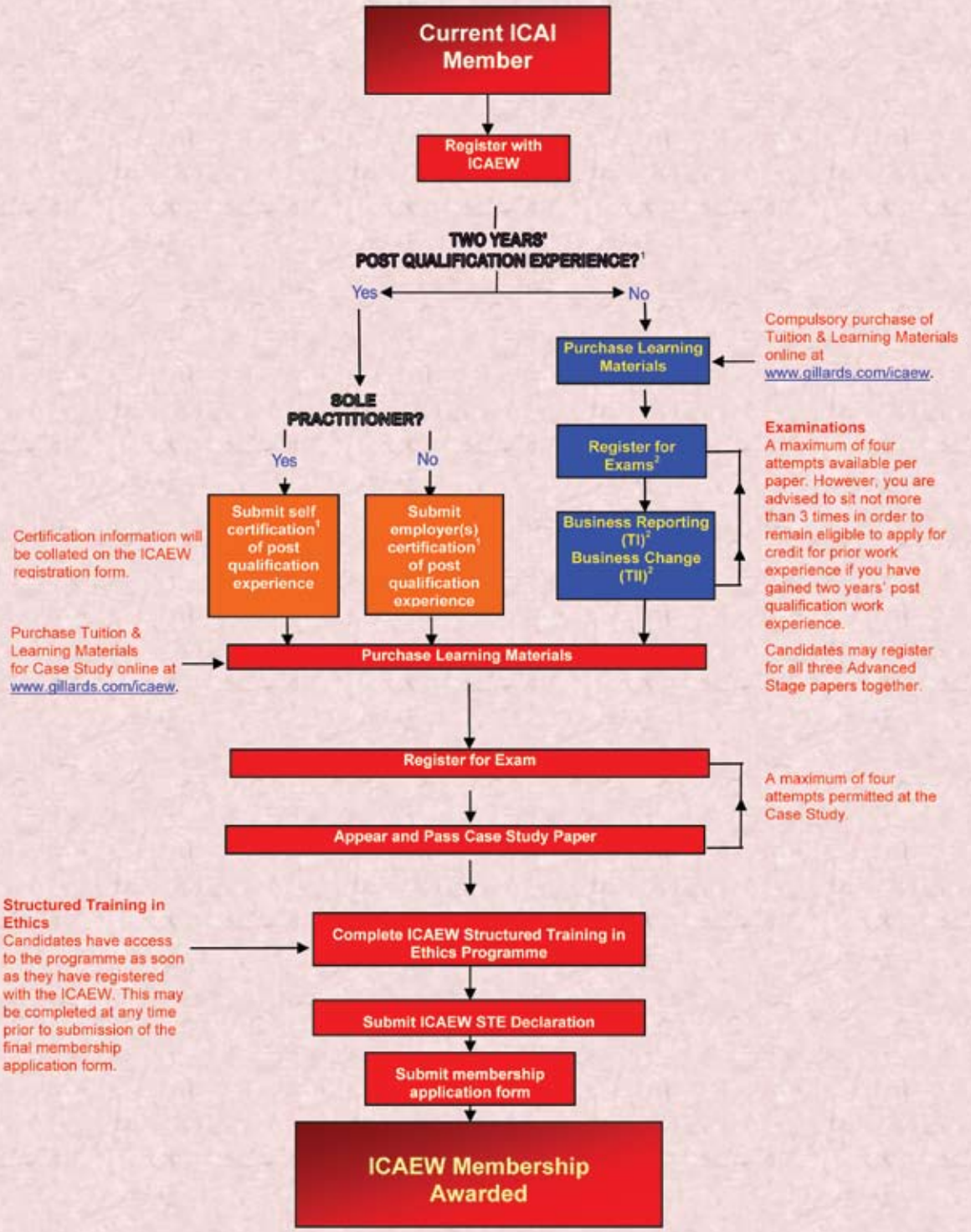
A maximum of four attempts are permitted per paper of Technical Integration Business Change and Technical Integration Business Reporting papers. However, one is advised to sit no more than 3 times in order to remain eligible to apply for credit for prior work experience if you have gained two years' post qualification work experience.

A maximum of four attempts are permitted for the Case Study. Pass marks are 50% in the Technical Integration and Case Study papers.

There is a four-week period between the latest deadline for registering for an examination and the examination date.

For further details visit ICAI website www.icai.org or email at icaewmra@icai.in.

Chart – 1
Steps for ICAI Member to Become an ICAEW Member



[1] Certification of post qualification experience is given on the basis of experience meeting the aims and learning outcomes of the ICAEW's Technical Integration Business Reporting and Business Change Technical Integration papers.
[2] Exam centres available at the British Council administered by ICAI. Please our website www.icaew.com for set dates.

EXCHANGE DIFFERENCES: SCHEDULE VI – AS 11

One of the recent controversies that has arisen is the accounting treatment of Exchange Differences on foreign currency loans used to acquire fixed assets from outside India in light of the Instruction contained in Schedule VI to the Companies Act, 1956 vis-à-vis Accounting Standard (AS) 11- 'The Effects of Changes in Foreign Exchange Rates' prescribed by the Central Government under Companies (Accounting Standard) Rules, 2006 notified vide notification dated 7th December, 2006.

The devaluation of the Indian rupee on 6th June, 1966, brought several problems in its wake. One such problem arose out of the consequential enhancement in the liability of an Indian businessman who had imported plant and machinery from abroad the consideration for which had been fixed in terms of a foreign currency and which had not been fully discharged by the date of devaluation. Question arose as to how this increase in liability has to be (a) accounted for in the books of account of the businessman, and (b) taken into account for purposes of certain allowances available under the Income-tax Act, 1961?


— CA. Kamlesh Vikamsey* & CA. Dharini Shah**

(The author is Past President of the ICAI and President CAPA. **The author is a member of the ICAI. They can be reached at kamlesh@khimjikunverji.com)*

Soon after the currency devaluation of 1966, the Institute of Chartered Accountants of India (ICAI) issued a statement indicating the manner in which the effects of devaluation should be shown in the accounts. It said:

"6.1 The council is of the opinion that, to the extent to which repayment obligations in respect of fixed assets purchased prior to devaluation remain outstanding as on 6th June, 1966 (except those

covered by forward exchange contracts), the additional cost of repayment in terms of rupees should be considered as enhancing the cost of the corresponding asset purchased. In cases where identification of the assets which have been purchased out of foreign funds is not possible, some reasonable method of allocation would have to be adopted."

A few years later, the currencies of a large number of countries came to be "floated" in foreign exchange markets leaving the exchange rates to be determined from day-to-day by market forces. Also, the Indian rupee was delinked from the pound sterling and its rates of exchange in relation to other currencies came to be determined by the Government on the basis of exchange rates of a selected "basket" of foreign currencies.

The Legislature reacted to the situation created by the devaluation of 1966 by effecting two amendments:

- The first legislative provision enacted to meet the situation was the insertion of section 43A in the Income-tax Act, 1961.
- The second statutory provision was an amendment to Schedule VI of the Companies Act, 1956 (herein after referred to as "the Act"), in the form of a balance-sheet prescribed for companies. In the third column setting out "the instructions in accordance with which assets should be made out", the following instruction (herein after referred to as "said instruction") was inserted against "fixed assets" at the very top of the form:

"Where the original cost aforesaid and additions and deductions thereto, relate to any fixed asset which has been acquired from a country outside India, and in consequence of a change in the rate of exchange at any time after the acquisition of such asset, there has been an increase or reduction in the liability of the company, as expressed in Indian currency, for making payment towards the whole or a part of the cost of the asset or for repayment of the whole or a part of moneys borrowed by the company from any person, directly or indirectly in any foreign currency specifically for the purpose of acquiring the asset (being in either case the liability existing immediately before the date on which the change in the rate of exchange takes effect), the amount by which the liability is so increased or reduced during the year, shall be added to, or, as the case may be, deducted from the cost, and the amount arrived at after such addition or deduction shall be taken to be the cost of the fixed asset.

Explanation 1 : This paragraph shall apply in relation to all balance-sheets that may be made out as at the 6th day of June, 1966, or any day thereafter and where, at the date of issue of the notification of the Government of India, in the Ministry of Industrial Development and Company Affairs (Department of Company Affairs), G. S. R. No. 129, dated 3rd day of January, 1968, any balance-sheet, in relation, to which this paragraph applies, has already been made out and laid before the company in annual general meeting, the adjustment referred to in this paragraph may be made in the

ICAI has, considering the fact that there was a difference in the treatment/ recognition of exchange differences on imported fixed assets as provided in Schedule VI and as provided in AS 11 (2003), stated that, pending amendment to Schedule VI by the Central Government, any company adopting the treatment as provided in Schedule VI will still be considered to be complying with AS 11 (2003) for the purpose of section 211 of the Act. Accordingly, the auditor of the company should not qualify his report in this regard under section 227(2) of the Act. The Central Government has *vide* the Rules stated that the accounting treatment for exchange difference in respect of imported fixed assets contained in Schedule VI to the Act should not be followed.

first balance-sheet made out after the issue of the said notification.

Explanation 2.-In this paragraph, unless the context otherwise requires, the expressions "rate of exchange", "foreign currency" and "Indian currency" shall have the meanings respectively assigned to them under sub-section (1) of section 43A of the Income-tax Act, 1961 (43 of 1961), and Explanation 2 and Explanation 3 of the said sub-section shall, as far as may be, apply in relation to the said paragraph as they apply to the said sub-section (1)"

Thus the said instruction states that any change, on account of change in rate of exchange ***(herein after referred to as "exchange difference")***, in the liability of the company for making payment towards the cost of the fixed asset acquired from outside India ***(herein after referred to as "imported fixed assets")*** or for repayment of moneys borrowed in any foreign currency specifically for the purpose of acquiring such assets, shall be added to or, as the case may be, deducted from the cost of such fixed asset ***(herein after referred to as "accounting treatment of exchange difference in respect of imported fixed assets").***

The ICAI had provided for a similar accounting treatment in AS 11- 'The Effects of Changes in Foreign Exchange Rates' which was originally introduced in 1994

Subsequently, ICAI revised AS 11 in March 2003. The revised AS 11 (2003), did not require the adjustment of exchange differences in the carrying amount of the fixed assets, in the situations envisaged in Schedule VI referred to herein above. As per revised AS 11 (2003), such exchange differences are required to be recognised in the statement of profit and loss since it is felt that this treatment is conceptually preferable to that required in Schedule VI and is in consonance with the international position in this regard.

However, ICAI had *vide* an Announcement published in 'The Chartered Accountant', November 2003, page 497 stated as under:

"It may be mentioned that the Institute has decided to take up this aspect with the Government to consider the same in the revision of Schedule VI to the Companies Act, 1956. It may be noted that where requirement of an accounting standard is different from the applicable law, the law prevails. Accordingly, a requirement of an accounting standard is not applicable to the extent it is in conflict with the requirement of the relevant law. Thus, pending the amendment, if any, to Schedule VI to the Companies Act, 1956, in respect of the matter, a company adopting the treatment described in paragraph 2 above will still be considered to be complying with AS 11 for the purposes of section 211 of Act. Accordingly, the auditor of the company should not assert non-compliance with AS 11 (2003) under section 227 (3) (d) of the Act in such a case and should not qualify his report in this regard on the true and fair view of the state of the company's affairs and profit or loss of the company under section 227(2) of the Act."

Thus the ICAI has, considering the fact that there was a difference in the treatment/recognition of exchange differences on imported fixed assets as provided in Schedule VI and as provided in AS 11 (2003), stated that, pending amendment to Schedule VI by the Central Government, any company adopting the treatment as provided in Schedule VI will still be considered to be complying with AS 11 (2003) for the purpose of section 211 of the Act. Accordingly, the auditor of the company should not qualify his report in this regard under section 227(2) of the Act.

Later, the Central Government notified Companies (Accounting Standards) Rules, 2006 ***(herein after referred to as "the Rules")*** *vide* Notification dated 7th December, 2006 whereby the Central Govern-

Honourable Supreme Court has held that the prescribed AS 22, to the extent it requires recognizing deferred tax liabilities/ assets in the Financial Statements, is only a gap filling exercise. The Central Government has not exceeded its authority in adopting prescribed AS 22 in exercise of section 642(1)(a). Prescribed AS 22 is not inconsistent with/ contrary to any of the provisions of Companies Act including Schedule VI. Hence prescribed AS 22 should be mandatorily followed by all companies.

ment prescribed accounting standards 1-7 and 9-29 as recommended by ICAI ***[herein after referred to as "prescribed AS ___(relevant number)"].***

These Rules were notified by the Central Government in exercise of powers conferred under section 642(1)(a) read with sections 211(3C) and 210A(1).

As per the Rules, every company and its auditor(s) shall comply with the Accounting Standards in the manner specified in Annexure to those Rules in preparation of General Purpose Financial Statements.

Further para4 of Part I of the Annexure to the Rules state that Accounting Standards, which are prescribed, are intended to be in conformity with the provisions of applicable laws. However, if due to subsequent amendments in the law, a particular accounting standard is found to be not in conformity with such law, the provisions of the said law will prevail and the financial statements shall be prepared in conformity with such law.

As regards the accounting treatment of exchange differences in respect of imported fixed assets, the following foot note is contained in prescribed AS 11 under para13 – "Recognition of Exchange Differences"-

"It may be noted that the accounting treatment of exchange differences contained in this Standard is required to be followed irrespective of the relevant provisions of Schedule VI to the Companies Act, 1956."

Thus the Central Government has *vide* the Rules stated that the accounting treatment for exchange difference in respect of imported fixed assets contained in Schedule VI to the Act should not be followed.

{It is interesting to note that the Central Government has not attempted to make similar amendment in the Income-tax Act, 1961 like it had done originally in 1968.Hence section 43A of the Income-tax Act, 1961 continues on the statute book}.

Issue

The issue which has arisen consequently is - **Whether a company should follow Schedule VI or the prescribed AS 11 in accounting for exchange difference in respect of imported fixed assets?**

{It is interesting to note that this controversy exists only in case of accounting for exchange difference in respect of imported fixed assets not in case of indigenous fixed assets which have been acquired out of Foreign Currency External Commercial Borrowings (ECBs)}

Discussion

A question which was before Honourable Supreme Court in case of **J. K. Industries Ltd. v. Union of India [2008] 297 ITR 176** in the context of prescribed AS 22- 'Accounting for taxes in income' to the extent it requires recognizing deferred tax liabilities/ assets in the Financial Statements

"Whether Accounting Standard 22 (AS 22) entitled 'accounting for taxes on income' insofar as it relates to deferred taxation is inconsistent with and ultra vires the provisions of the Companies Act, 1956, ('the Companies Act'), the Income-tax Act, 1961 ('the I. T. Act') and the Constitution of India ?"

The judgement of Honourable Supreme Court is a very detailed one. We have reproduced hereunder some extracts of the judgement which are relevant to the issue under consideration (Emphasis supplied wherever considered necessary):

"Section 211(1) requires the balance-sheet to be in the form set out in Part I of Schedule VI "or as near ***thereto as circumstances admit". The said phrase "or as near thereto as circumstances admit" allows adoption of improved techniques in the presentation of accounts to shareholders.*** *It is important to note that the information which is required to be given to shareholders pursuant to Schedule VI should be given in a manner which they will understand and which must give a "true and fair" view of the company's affairs as also it must give a proper picture of the company's profits (losses) for the relevant year. By the Companies (Amendment) Act, 1999, sub-sections (3A), (3B) and (3C) as well as a proviso thereto stood inserted in section 211 of the Companies Act with effect from October 31, 1998, in order to provide for*

The issue which needs to be addressed is whether prescribed AS 11 should be followed in accounting for exchange difference in respect of imported fixed assets or Schedule VI should be followed? What is mandatory-prescribed AS 11 or Schedule VI? This controversy needs to be set right by the Central Government or else companies may choose to follow different accounting treatment of exchange difference in respect of imported fixed assets.

compliance of Accounting Standards by companies in the preparation of profit and loss account and balance-sheet. By virtue of the said amendment, Accounting Standards are required to be prescribed by the Central Government in consultation with the NAC established under section 210A. Until the NAC is established and Accounting Standards are prescribed by the Central Government, the Accounting Standards specified by the Institute shall be followed by all the companies. In the present case, the NAC has been established. In the present case, by the impugned notification dated December 7, 2006, the Accounting Standards have been prescribed by the Central Government. In the present case, by the impugned notification, AS 22 earlier specified by the Institute has been adopted by the Central Government in the form of a rule. Therefore, vide the impugned notification, AS 22 stands prescribed by the Central Government in consultation with NAC which has been established under section 210A of the Companies Act…

> *Under section 211(1) every balance-sheet of a company has to comply with the following requirements:*
>
> *(i) It must give "true and fair" view of the affairs of the company at the end of the financial year;*
>
> *(ii) it must be in the form set out in Part I of Schedule VI or as near thereto as circumstances admit ; and*
>
> *(iii) it must give regard to the general instructions for preparation of balance-sheet under the heading "Notes".*
>
> *Similarly, section 211(2) of the Companies Act requires that every profit and loss account of a company must give a "true and fair" view of the profit or loss of the company for the financial year and comply with the requirements of Part II of Schedule VI so far as they are applicable thereto.*
>
> *It may be noted that the balance-sheet prescribed by Part I of Schedule VI has to be in the form of a proforma. However, the Companies Act does not prescribe a proforma of profit and loss account. Part I of Schedule VI prescribes a proforma of balance-sheet. Part II of Schedule VI only prescribes the particulars which must be furnished in the profit and loss account. Therefore, as far as possible, the profit and loss account must be drawn up according to the requirements of Part II of Schedule VI.* ***It is important to note that section 211 read with Part I and Part II of Schedule VI prescribes the form and contents of balance-sheet and profit and loss account.*** *However, section 211(1), inter alia, states that every balance-sheet of a company shall subject to the provisions of that section, be in the form set out in Part I of Schedule VI. The words "subject to the provisions of this section" would mean that every sub-section following sub-section (1) including sub-sections (3A), (3B) and (3C) shall have an overriding effect and consequently every profit and loss account and balance-sheet shall comply with the Accounting Standards.* ***Therefore, implementation of the Accounting Standards and their compliance are made compulsory and mandatory by the aforestated sub-sections (3A), (3B) and (3C).*** *The insertion of the concept of "true and fair" view in place of "true and correct" has been made to do away with the view that accounts should disclose arithmetically accuracy.* ***Adherence to the disclosure requirements as per Schedule VI is subservient to the overriding requirement of "true and fair view" as regards the state of affairs.*** *Therefore, the annual financial statements should convey an overall fair view and should not give any misleading information or impression... Further, the information to be disclosed should be in consonance with the fundamental accounting assumptions and commonly accepted accounting policies. ..In this regard it may be noted that under section 227(3)(d) it is the duty of the auditor, to state in his audit report whether the*

The judgement of Honourable Supreme Court in case of *J.K. Industries (supra)* is distinguishable since in that case Honourable Supreme Court was concerned with the matter of application of "Recognition & Measurement principles" provided by prescribed AS 22 and that they had held that the "Disclosure Principles" of Schedule VI are subservient to the overriding requirement of "True & Fair view".

> *profit and loss account and the balance-sheet complies with the Accounting Standards referred to in section 211(3C). Before introduction of sub-sections (3A), (3B) and (3C) in section 211 (with effect from October 31, 1998), these Standards were not mandatory. Therefore, the companies were then free to prepare their annual financial statements, as per the specific requirements of section 211 read with Schedule VI. However, with the insertion of sub-sections (3A), (3B) and (3C) in section 211 the profit and loss account and the balance-sheet have to comply with the Accounting Standards. For this purpose the expression "Accounting Standards" shall mean the standards of accounting recommended by the Institute as may be prescribed by the Central Government in consultation with NAC on Accounting Standards. Thus, the Accounting Standards are prescribed by the Central Government.* ***Thus, the Accounting Standards prescribed by the Central Government are now mandatory qua the companies and non-compliance with these Standards would lead to violation of section 211 inasmuch as the annual accounts may then not be regarded as showing a "true and fair view".*** *(Paras14 -17 on pages 219-222 of 297 ITR)*

The Honourable Supreme Court went on to discuss on the following question-

> *"Whether the Central Government, which is the rulemaking authority, has overridden the Companies Act, 1956, either by exceeding its authority in adopting AS 22 or by making provisions inconsistent with sections 209 and 211 read with Part I and Part II of Schedule VI to the Companies Act as alleged by the appellants."*

The Honourable Supreme Court held that the impugned rule which adopts AS 22 neither suffers from the vice of excessive delegation nor is the said rule incongruous/inconsistent with the provisions of the Companies Act, 1956 for the following reasons:

> *"In the present case, we are required to consider the scope of section 642(1), which refers to the power of the Central Government (rulemaking authority) to make rules vis-a-vis section 641, which states that subject to the provision of the section, the Central Government may, by notification in the Official Gazette, alter any of the regulations, rules, forms, tables and other provisions contained in any of the Schedules to the Companies Act (including Schedule VI). This aspect is of some importance.* ***Section 642 is in addition to the powers conferred by section 641, therefore, the two sections form part of the same scheme. However, the scope of section 641 is different from the scope of section 642.*** *Power to alter any provision of the Schedules and the power to carry out gap filling exercise are both entrusted to the Central Government. The expression "in addition" to in section 642 indicates that both the above sections constitute one scheme. However, section 642 enables the Central Government to provide details and, therefore, under section 642 the rules contemplated refers to gap filling exercise."* (Para71 on page 269 of 297 ITR)

> *"Therefore, power to make subordinate legislation is derived from the enabling Act and it is a fundamental principle of law which is self evident that the* ***delegate on whom such power is conferred has to act within the limitations of the authority conferred by the Act.*** *It is equally well settled that rules made on matters permitted by the Act in order to supplement the Act and not to supplant the Act, cannot be held to be in violation of the Act.* ***A delegate cannot override the Act either by exceeding the authority or by making provisions inconsistent with the Act.*** *(See Britnell v. Secretary of State for Social Security [1991] 2 All ER 726 (HL) at 730)."* (Para72 on page 270 of 297 ITR)

"Applying the tests laid down in the aforesaid judgement to the present case, it may be noted that, in this case, we are concerned only with the existence and the extent of the powers given to the Central Government to make rules, both for altering the Schedules to the Companies Act as well as to fill in details. ***Power to alter the Schedule as well as power to fill in details are two distinct powers. However, both the powers are entrusted to the same delegate, namely, the Central Government.*** *Further, as stated above, sections 641 and 642 form part of the same scheme, hence, it cannot be said that merely because the impugned notification has been issued under section 642 and not under section 641 the said notification is exhaustive of the powers given to the Central Government to frame rules under the aforestated two sections. Moreover, in the present case, section 642(1) begins with the expression in addition to the powers conferred by section 641, therefore, one has to read section 641 as an additional power given to the Central Government to make rules, in addition to its power to alter the Schedule by making appropriate rules under section 641. There is one more way of looking at the arguments. The Companies Act has been enacted to consolidate and amend the law relating to companies and certain other associations. Under section 211(3A) Accounting Standards framed by the National Advisory Committee on Accounting Standards constituted under section 210A are now made mandatory. Every company has to comply with the said standards. Similarly, under section 227(3)(d), every auditor has to certify whether the profit and loss account and balance-sheet comply with the accounting standards referred to in section 211(3C). Similarly, under section 211(1) the company accounts have to reflect a "true and fair" view of the state of affairs. Therefore, the object behind insistence on compliance with the A.S. and "true and fair" accrual is the presentation of accounts in a manner which would reflect the true income/profit. One has, therefore, to look at the entire scheme of the Companies Act.* ***In our view, the provisions of the Companies Act together with the rules framed by the Central Government constitute a complete scheme.*** *Without the rules, the Companies Act cannot be implemented. The impugned rules framed under section 642 are a legitimate aid to construction of the Companies Act as contemporanea expositio. Many of the provisions of the Companies Act, like computation of book profit, net profit etc. cannot be put into operation without the rule"* (Para76 on page 271 of 297 ITR)

"In the present case also even under the rules impugned herein AS 22, which is made mandatory, provides an internal legitimate aid to the meaning of the words in the Companies Act, including Schedule VI, namely, liability, provision for taxes on income, book profit, net profit, depreciation, amortization etc. Therefore, it cannot be said that the impugned rules framed under section 642(1) constitute an act on the part of the rulemaking authority, namely, the Central Government, in exercise of its powers under section 642(1) of the Companies Act. In our view, the impugned rule/notification is valid. It has nexus with the matters entrusted to the Central Government to be covered by the appropriate rules. Therefore, in our view, the impugned rule is valid as it has nexus with the statutory functions entrusted to the Central Government which is the rulemaking authority under the Act...The scheme of the Companies Act indicates that Accounting Standards are made mandatory. They have to be followed by the auditors. They have to be followed by the companies. The Accounting Standards provide discipline. They provide harmonization of concepts. They provide harmonization of accounting principles. In the past, when Accounting Standards were not mandatory, various companies used to follow alternate system of accounting. This led to overstatement of profits. Therefore, the said Standards have now been made mandatory. In our view, it is the statutory function given to the Central Government to frame Accounting Standards in consultation with the National Advisory Committee on Accounting Standards (NAC) under section 211(3C). It is not necessary for the Central Government to adopt in every case the Accounting Standards issued by the Institute. Nothing prevents the Central Government from enacting its own Accounting Standards which may not be in

consonance with the Standards prescribed by the Institute. Similarly, nothing prevents the Central Government from adopting the Standards issued by that Institute as is the case in the present matter. ***Therefore, in our view, the impugned rule is valid as it has nexus with the statutory functions entrusted to the rulemaking authority, namely, the Central Government"*** (Para79 on page 273 of 297 ITR)

The Honourable Supreme Court then went on the next point -

"(b) Whether the impugned rule is incongruous/contrary to sections 209 and 211 read with the provisions of Part I and Part II of Schedule VI to the Companies Act, 1956, and whether the said rule seeks to modify the essential features of the Companies Act?"

and held as under-

"Therefore, in our view, rules framed under section 641 followed by the rules framed under section 642(1) shall continue to be rules subordinate to the Companies Act though for the purposes of construction, they are to be treated as forming part of the same scheme. (Para100 on page 283 of 297 ITR)

"Applying the above test to the present case, we are now required to interpret the words "the amount of charge for Indian income-tax on profits" in clause 3(vi) in Part II of Schedule VI to the Companies Act. Similarly, we are required to interpret the words "current liabilities and provisions" in the form of balance-sheet in Part I of Schedule VI to the Companies Act. Part III of the said Schedule defines the words "provision" as well as "reserve".

As stated above, the form of balance-sheet is prescribed by Part I of Schedule VI. The Act does not prescribe a proforma of profit and loss account. However, Part II of Schedule VI prescribes the particulars which must be furnished in a profit and loss account. As far as possible, the profit and loss account must be drawn up according to the requirements of Part II of Schedule VI. As stated above, section 211(1) emphasizes "true and fair" view in place of true and correct view of accounting. As stated above, the legislative policy is to obliterate the difference between the accounting income and the taxable income. As stated above, the accounting income/book profit is the real income. Therefore, section 211(1) emphasizes the concept of "true and fair" view. As stated above, it is a standalone consideration. It is the controlling element underlying the scheme of sections 209, 211 and 227. ***However, as stated above, the Companies Act does not deal with recognition, measurement and disclosure. As stated above, how much amount should be recognized in respect of a specific matter is not covered by section 209(3)(b). Recognition, measurement and disclosure are the three items which can only be done by way of Accounting Standards and not by the provisions of the Companies Act.*** *This aspect is important because under section 642(1) the Central Government is empowered to carry out ancillary/subordinate legislative functions which is also fictionally called as power to fill up the details. Under section 211(1), Parliament has laid down the controlling consideration in presentation of balance-sheet and profit and loss account by companies and it has thereafter conferred discretion on the Central Government to work out details within the framework of that policy."* (Paras118-119 on page 286 of 297 ITR)

"The words "tax expense" in paragraph 9 under conservative system of accounting were confined to current tax. However, with paragraph 9 of AS 22 coming into force, the words "tax expense" now include both current tax and deferred tax. This inclusion became necessary because of developments not only in concepts but also in accounting practices. This inclusion becomes necessary if one has to go by the paradigm shift from historical costs accounting to fair value principles. In our view, with the insertion of the words "true and fair" view in section 211, which is the requirement in the matter of presentation of the balance-sheet and the profit and loss account the rulemaking authority was entitled to include the concept of deferred tax in tax expense. It may be stated that under clause 3(vi) of Part II, Schedule VI the charge for tax on profit is contemplated. The provision for liability for taxation

is contemplated by the said clause. Paragraph 9 of AS 22 merely provides for a liability which arises on account of timing difference as explained hereinabove. As stated above, it is known on the balance-sheet date. One has to therefore consider the matching principle and fair valuation principles as important concepts in accrual accounting. Further, as stated above, recognition and measurement is not covered by the provisions of the Companies Act, therefore, one has to read the provisions of the Companies Act along with the impugned rule which adopts AS 22 as recommended by the Institute" ." (Para 126 on page 290 of 297 ITR)

"In our view, paragraph 9 of AS 22 merely represents a gap filling exercise, therefore, there is no merit in the contention advanced on behalf of the appellants that AS 22 is inconsistent with the provisions of the Companies Act including Schedule VI. It proceeds on the principle that every transaction has a tax effect. The words "true and fair" view in section 211(1) connotes the widest law making powers and, in that context, we hold that the impugned rule adopting AS 22 is intra vires as the said rule is incidental and/or supplementary to the specific powers given to the Central Government to make rules, particularly when such power is given to fill in details. The word "supplementary" means something added to what is there in the Act, to fill in details for which the Act itself does not provide. It is something in the sense that is required to implement what is there in the Act. [See Daymond v. South West Water Authority [1976] 1 All ER 39 (HL). There is no merit in the contention advanced on behalf of the appellants that the impugned rule seeks to modify the essential features of the Companies Act. The rules made on matters permitted by the Act to supplement the Act cannot be held to be in violation of the Act. [See Britnell v. Secretary of State (for Social Security) [1991] 2 All ER 726 (HL)].

When the power to make rules is limited to particular topics and if that rule falls within the ambit of that topic, namely, taxes on income in the present case, it cannot be said that the rule is inconsistent with the provisions of the Act. As stated above, the Act and the rules form part of the composite scheme. The provisions of sections 205, 209 and 211 can be put into operation only if the Act and the rules are read together. In the present case, in our view, the impugned rule constitutes a legitimate aid to construction of the provisions of the Companies Act." (Para 136 on page 294 of 297 ITR)

"…In the present case, as stated above, measurement and recognition methods are not the items under the Companies Act. Methods of recognition and measurements are talked about by the provisions of the Companies Act. Recognition and measurement of various items of revenue expenses etc. stand covered only by the Accounting Standards. Therefore, it cannot be said that the said standards are contrary to the provisions of the Companies Act…" (Para137 on page 295 of 297 ITR)

Thus Honourable Supreme Court held that the prescribed AS 22, to the extent it requires recognizing deferred tax liabilities/ assets in the Financial Statements, is only a gap filling exercise. The Central Government has not exceeded its authority in adopting prescribed AS 22 in exercise of section 642(1)(a). Prescribed AS 22 is not inconsistent with/ contrary to any of the provisions of Companies Act including Schedule VI. Hence prescribed AS 22 should be mandatorily followed by all companies.

However it may be noted that the present issue relating to prescribed AS 11 is distinguishable from that relating to prescribed AS 22 before the Apex Court in the case of *J.K. Industries* (supra) as under:

(a) In case of ***J.K. Industries*** (supra) relating to prescribed AS 22, Schedule VI- Part I requires **disclosure** of Provisions for taxation under the head- 'Current Liabilities and Provisions' in the Balance Sheet and Part II requires **disclosure** of the "amount of charge for Indian Income-tax" in Profit & Loss account, whereas the prescribed AS 22 provides that tax includes current tax as well as deferred tax and requires **recognition** of deferred tax liabilities/assets in the Profit & Loss account & Balance Sheet. Thus AS 22 renders a gap filling exercise in that it gives meaning to and details about "amount of charge for Indian Income-tax", how to measure and recognise such amount

(b) However the said instruction under consideration refers to adjustment of exchange difference in respect of imported fixed assets and mandates that such difference "shall be taken to the cost of the fixed assets". As discussed in the beginning of this article, the insertion of section 43A of the Income-tax Act and the said instruction were made more or less simultaneously to address the issue of extra liability on the companies as a result of the devaluation of Indian Rupee on 6th June, 1966. Apart from the said instruction, there was no change made to the Companies Act for accounting treatment of such exchange difference. Though Schedule VI which is enacted pursuant to section 211(1), provides that the Balance Sheet should be in the form set out in Schedule VI and that it provides for the format of the Balance Sheet, its contents & disclosures, the said instruction mandates **recognition** of exchange difference and it is **not a disclosure requirement.**

The said instruction requires **recognition** of foreign exchange difference in respect of imported assets by reducing / adding the same to/from the cost of the fixed assets in Balance Sheet, whereas the prescribed AS 11 provides for **recognition** of such foreign exchange difference as a revenue item by debiting or crediting the Profit & Loss account. Thus prescribed AS 11 is contrary to and inconsistent with Schedule VI to this extent. It does not render any gap filling exercise.

With this background, the issue which needs to be addressed is whether prescribed AS 11 should be followed in accounting for exchange difference in respect of imported fixed assets or Schedule VI should be followed? What is mandatory-prescribed AS 11 or Schedule VI?

Two views exist-

VIEW 1: AS 11 is mandatory and therefore should be followed for the following reasons-

(a) Power to alter any provision of the Schedules under section 641(1) and the power to carry out gap filling exercise under section 642 are both entrusted with the Central Government. Section

642 is in addition to the powers conferred by section 641, therefore, the two sections form part of the same scheme. The said instruction relating to accounting for exchange difference in respect of imported fixed assets was inserted by the Central Government in 1968 *vide* exercise of its power under section 641. Considering the Scheme of the Act, the subsequent act of the Central Government in prescribing AS 22 and stating, by way of a foot note thereto, that the prescribed AS 22 is required to be followed irrespective of the relevant provisions of Schedule VI implies that the Central Government has, thereby impliedly, exercised its' power under section 641(1) of altering Schedule VI to that extent. Considering the Scheme of the Act, this subsequent act of the Central Government is well within its powers and as such the said instruction should not be followed after coming into force of prescribed AS 11

(b) Even if it is argued that there is no Implied exercise of power under section 641(1), as held by Honourable Supreme Court in case of *J.K. Industries (supra)*, since the two powers, namely power to alter Schedule VI & power to make Rules, are both delegated to the same authority, namely, the Central Government and are at equal footing, it could be said that the subsequent act of the Central Government under section 642 prescribing a treatment contrary to the said instruction would prevail and that the said instruction should not be followed after the coming into force of prescribed AS 11

VIEW 2: Schedule VI is mandatory and therefore should be followed for the following reasons-

(a) Though power to alter Schedule VI under section 641 and the power to carry out gap filling exercise under section 642 are both entrusted to the Central Government and are part of the same scheme, the scope of section 641 is different from the scope of section 642. The notification prescribing AS 11 is in exercise of power under section 642 (1)(a) read with sections 211(3C) and 210A(1) as expressly mentioned in the said notification and therefore it cannot be said that the Central Government has exercised powers under section 641 to alter Schedule VI.

One cannot imply that the Central Government has exercised its power under section 641 since the foot note to prescribed AS 11 states that *"It may be noted that the accounting treatment of exchange differences contained in this Standard is required to be followed irrespective of the relevant provisions of Schedule VI to the Companies Act, 1956"* and not that the said instruction is omitted.

As such the said instruction is valid and continues and should be followed by a company. This argument is further strengthened by the fact that the said instruction and section 43A of the Income-tax Act, 1961 were brought in almost simultaneously and since section 43A still exists on the statute book, the said instruction also is still effective.

(b) Schedule VI is part of the Act. Though Central Government has been vested with the powers to alter Schedule VI, till such power is exercised to delete the said instruction, the said instruction has authority of Law whereas the prescribed AS 11 is part of the Rules. Hence prescribed AS 11 is subordinate to Schedule VI and as such prescribed AS 11 cannot mandate that the said instruction of Schedule VI be not followed.

The judgement of Honourable Supreme Court in case of *J.K. Industries (supra)* is distinguishable since in that case Honourable Supreme Court was concerned with the matter of application of "Recognition & Measurement principles" provided by prescribed AS 22 and that they had held that the "Disclosure Principles" of Schedule VI are subservient to the overriding requirement of "True & Fair view".

The said instruction being a "Recognition Principle" is on equal footing to "Recognition Principle" prescribed by AS 11. Since the said instruction is part of Schedule VI which is part of the Act and till the time the Central Government exercises its power under section 641 to alter Schedule VI by omitting the said instruction, it could be said to have a superior authority over prescribed AS 11. In other words, the power to alter Schedule VI is equivalent to the power to prescribe Accounting Standards. However, till the time such power to alter Schedule VI is exercised, the provisions of Schedule VI prevail in case of any inconsistency with the prescribed Accounting Standards

To conclude, this controversy needs to be set right by the Central Government or else companies may choose to follow different accounting treatment of exchange difference in respect of imported fixed assets.❑

Treatment of initial quantity of in-process material.

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 private limited company manufactures nickel sheets using the electroforming process. The key plant and machinery for the manufacturing process is an electroplating tank consisting of:

(i) Pure nickel in pellet form, and

(ii) Nickel Sulphamate Solution.

2. The principle of operation is that of electroplating. In electroplating, there are two electrodes dipped in an electrolyte solution (Nickel Sulphamate solution). They are given opposite electric charges; the electrode having positive charge is called Anode and the one having negative charge is called Cathode. When the electric charge is applied, Anode dissolves in the electrolyte and the metal that has dissolved gets deposited on the Cathode. The Anode consists of a perforated titanium basket filled with the nickel pellets. The nickel in the basket dissolves in the nickel sulphamate solution. The Cathode consists of a metal sheet. The nickel that dissolves from the Anode gets deposited on the Cathode, thus the product is ready. In the normal course of operation, whatever nickel is taken away from the Anode is replenished by way of addition of fresh nickel pellets.

3. To get the production started and then to maintain the desired quality of product, it is absolutely essential that the quantity of nickel in the Anodes as well as the quantity and concentration of nickel sulphamate solution be maintained as per the standards. Unless nickel and nickel sulphamate solution is added to the tank the same cannot be put to use.

4. In short, according to the querist, the quantity of initial nickel and nickel sulphamate solution that is put inside a tank stays for the entire operational life of the tank. Hence, the cost of initial nickel and nickel sulphamate solution is treated as capital cost for the purpose of obtaining term loan for buying six new tanks in the financial year 2007-08. Besides the six new tanks added in the financial year 2007-08, the company has twelve old tanks where the cost of initial nickel and nickel sulphamate solution has not been considered as capital cost and the balance stock in the tanks as on the balance sheet date is shown as work-in-progress. As per the querist, this being major addition, management of the company felt it necessary to ascertain as to whether capitalisation of cost of initial nickel and nickel sulphamate solution is proper.

B. Query

5. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

(i) Whether the accounting treatment given by the company to treat the cost of nickel and nickel sulphamate solution in the six new tanks, acquired in the financial year 2007-08, as capital expenditure is correct.

(ii) In case the answer to the above question is in the affirmative, then whether it is necessary to declare the same as a change in the accounting policy for fixed assets, since nickel and nickel sulphamate solution in earlier tanks has not been capitalised.

(iii) In case the answer to (i) above is in the affirmative whether it is possible to transfer the work-in-progress (WIP) to capital asset in respect of earlier 12 tanks in the financial year 2007-08. This, according to the querist, will be done by transferring WIP to fixed assets. If it is possible, the following questions arise:

(a) At which price transfer from WIP to Fixed assets should be made, whether at today's price (carrying cost) or the price at which it was originally purchased, i.e., 1998 price.

(b) Whether depreciation from the date of capitalisation (1998) to date should be considered.

(c) If WIP is transferred at 1998 price, what treatment should be given for the balancing amount (difference between the present WIP value and 1998 price).

(iv) Whether the company can adopt dual accounting policy, i.e., continue to show the nickel and nickel sulphamate solution in the earlier 12

tanks as WIP and capitalise the nickel and nickel sulphamate solution in the new 6 tanks during the financial year 2007-08.

(v) In case the nickel and nickel sulphamate solution, in respect of 12 old tanks, is to be capitalised, whether the Income-tax Department will permit depreciation thereon.

C. Points considered by the Committee

6. The Committee notes the definition of the term 'fixed asset' as given in paragraph 6.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', as reproduced below. The Committee also notes the definition of the term 'inventories' and paragraph 4 of Accounting Standard (AS) 2, 'Valuation of Inventories', which state as follows:

AS 10

"6.1 Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business."

AS 2

"Inventories are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials and supplies to be consumed in the production process or in the rendering of services."

"4. …Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise…"

7. The Committee further notes the definition of 'Work in Process' as contained in the Guidance Note on Terms Used in Financial Statements, issued by the Institute of Chartered Accountants of India, which provides as follows:

"Work in Process includes all materials which have undergone manufacturing or processing operations, but upon which further operations are necessary before the product is ready for sale."

8. The Committee notes from the Facts of the Case that the initial nickel and nickel sulphamate solution put into the tank get consumed in the production process through electroplating and are not held as such for producing the goods, as in the case of fixed assets. The quantity of nickel and nickel sulphamate solution in the tank have to be replenished by way of fresh additions in order to continue the production process and thus, it is only the *quantity* of initial nickel and nickel sulphamate solution that stays in the tank for its entire life and not the one originally put into the tank. Accordingly, the contention of the querist in paragraph 4 above to capitalise the cost of initial nickel and nickel sulphamate solution on this ground is not valid. Thus, the Committee is of the view that the initial nickel and nickel sulphamate solution that are contained in the tank are of the nature of work-in-progress to be disclosed as inventory.

D. Opinion

9. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 5 above:

(i) No, the accounting treatment given by the company to treat the cost of initial nickel and nickel sulphamate solution in the six new tanks, acquired in the financial year 2007-08, as capital expenditure is not correct.

(ii) Since the answer to the above question is not in the affirmative, the answer to this question does not arise.

(iii) Since the answer to (i) above is not in the affirmative, the answer to this question does not arise.

(iv) No, the company cannot adopt dual accounting policy for similar items purchased at different points of time.

(v) Answer to this question does not arise as the cost of nickel and nickel sulphamate solution is not to be capitalised. In any case, as per Rule 2 of the Advisory Service Rules, in accordance with which the Committee replies to the queries received, the Committee does not answer the issues involving legal interpretation of various enactments, such as, the Income-tax Act, 1961.❑

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

OVERHAULING THE INDIAN BANKING – BASEL II ACCORD

Indian banks got exposed to Basel II norms long time ago but these norms are impinging on their balance sheets only now, particularly amid a mad rush to rope in more capital to meet the RBI deadlines. In this phase of harsh realisation, banks have been forced not only to challenge and change their own systems but also of their related parties. This article highlights some of the crude realities of Basel II which Indian banks are realizing in the process of overhauling their systems to become Basel II complaint. It also discusses the operational difficulties which banks are experiencing and the challenges that lie ahead for them to become operationally expedient.

In the good old days of Basel I, capital adequacy rules were homogeneous, non-discretionary and non-judgemental. In the brave new world of Basel II, the focus of capital adequacy determination has shifted from a thumb rule based process to one which is a combination of a convention and opinion emanating from administrative reviews of the bank's capital evaluation process.

— CA . Jyoti Singh* and Ms. Pooja Mirchandani**

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The Basel II by the Basel Committee[1] accord is a flip over of the earlier Basel I norms which India had adopted in 1999. The very much same Basel I now has been revamped into Basel II by the Reserve Bank of India's steering committee in 2005 as follows :

- Basel I had a broad brush approach of non-differentiating between borrowers resulting in banks keeping 8 per cent of loan as capital, whether the borrower was a first class blue chip company with little or no risk, or a third rate company with poor track

[1]The Basel Committee on Banking Supervision provides a forum for regular co-operation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. The Committee's Secretariat is located at the Bank for International Settlements (BIS) in Basel, Switzerland.

Pillar 3 of Basel II purports to enforce market discipline through stricter disclosure requirement. While admitting that such disclosure may be useful for supervisory authorities and rating agencies, the expertise and ability of the general public to comprehend and interpret disclosed information is open to question. Moreover, too much disclosure may cause information overload and may even damage financial position of bank.

record. Basel II has introduced the concept of 5 different risk weights - 20 per cent, 30 per cent, 50 per cent, 100 per cent and 150 per cent. For the highest rated borrower, banks need to keep only 20 per cent of 8 per cent or 1.6 per cent (8x 20 per cent) of the credit exposure as capital. The RBI has retained the higher base level of 9 per cent against world level of 8 per cent. These risk weights apply *in tandem* with credit rating given by our accredited rating agencies who decide the fate of the borrower. If a bank wishes to have pity on an unrated borrower, it can do so by keeping in more risk capital in its warehouse.

- Basel I gave no weightage to availability of security for credit facility which has been given due consideration in the new accord.
- Basel I prescription of allowing banks keep same risk capital irrespective of the maturity profile of the loan has been eroded by Basel II making some distinction between short and long-term loans given by banks.
- Basel I encouraged regulatory arbitrage[2] by cherry picking which has been given no scope in Basel II.
- The risk assessment specific to the bank, disclosures and reporting have been emphasized by Basel II accord through the Pillar 2 and Pillar 3.
- The new dimension of operational risk which had gone unnoticed by Bank of International Settlements (BIS) earlier is now being given its due share of accreditation.

As per the RBI guidelines, Indian banks having foreign branches and foreign banks operating in India had to adopt the regulations under Basel II by March 31, 2008. Except local area banks and regional rural banks, all the other commercial banks will have to migrate to Basel II by March 31, 2009. The Reserve Bank has adopted a three-track approach to capital adequacy regulation in India with the norms stipulated at varying degrees of stringency for different categories of banks given the variations in size, nature and complexity of operations and relevance of different types of banks to the Indian financial sector. Accordingly, commercial banks, which account for a major share in the total assets of the banking system and are Basel II standards compliant, would be on Track I, banks which are Basel I compliant would be on Track II and banks which are in the nature of local community banks would be on Track III. We are a quarter up in the financial year 2008, hence the pertinent questions to raise are-

- Has over enthusiastic RBI which had been adamant on imposing rigorous Basel norms which by far exceed in severity than the ones prescribed by BIS actually succeeded?
- Are our Indian banks actually ready to pose a threatening competition to the global banking giants?

There are too many questions to be raised but the answers are few.

Issues with Implementation

Rising Cost Curve

For Banks, the term 'Non-Performing Assets' rings an alarm bell. NPAs have largely been reduced by provisioning for bad debt or by infusion of capital from Government or other sources. But, with the implementation of Basel II norms, banks appetite for additional capital has increased and they are busy in arranging for capital outside of their own or the Government resources. In ICRA's[3] estimates, Indian banks would need additional capital of up to Rs.120 billion to meet the capital requirement for operational risk. Looking at the asset growth witnessed in the past and the expected growth trend, the capital charge requirement [4]for operational risk will grow by 15-20 per cent annually over three years.

[2]Regulatory arbitrage is where a regulated institution takes advantage of the difference between its real (or economic) risk and the regulatory position. For example, if a bank, operating under the Basel I accord, has to hold 8% capital against default risk, but the real risk of default is lower, it is profitable to securitize the loan, removing the low risk loan from its portfolio. On the other hand, if the real risk is higher than the regulatory risk then it is profitable to make that loan and hold on to it, provided it is priced appropriately.

[3]This estimate has been derived from ICRA 2005 report, analysis of which is based on banks financials till financial year end 2004-05. Hence, it would be advisable to take into account the surge in banks loan portfolios and credit growth post 2006 to revise this gross estimate upwards.

[4]Capital charge for operational risk is equal to the average of 15% of annual positive gross income over the past three years, excluding any year when the gross income was negative. Gross income is defined as net interest income and non-interest income, grossed for any provisions, unpaid interest and operating expenses (such as fees for outsourced services). It should only exclude treasury gains/losses from banking book and other extraordinary and irregular income (such as income from insurance).

New standards are an amalgam of international best practices and call for introduction of advanced risk management system with enterprise level applications. Hence it has become a daunting task to craft the required level of technological architecture, and assemble human skill across an institution undertaking such appraisal and across the industry which is dragging to overhaul itself. Also the managerial cadre has to be properly trained for understanding of critical issues for risk profiling of supervised entities and validating and guiding development of complex IRB models.

Huge implementation cost may also impact profitability for smaller banks who are striving to meet the Basel II standards. The new framework is very complex and difficult to understand. It calls for revamping the entire management information system and allocation of substantial resources. Therefore, it may be out of reach for many smaller banks. As Moody's Investors Services puts it, "It is unlikely that these banks will have the financial resources, intellectual capital, skills and large scale commitment that larger competitors have to build sophisticated systems to allocate regulatory capital optimally for both credit and operational risks."

To top it all, banks may have to keep additional capital, considering the possibility of under estimation of risks and the quality of risk management, as stated in the guidelines.

Lack of Specific Guidelines

When the Bank for International Settlements (BIS) proposed guidelines on the treatment of derivatives and other "trading book" issues, those guidelines ran smack up against provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 in US. Provisions of the new U.S. law, which takes effect October 17, 2008 enable companies to net out transactions between counterparties and across derivative product lines. The affected products include repurchase agreements, credit derivatives, energy derivatives, and interest-rate swaps. BIS provisions — part of the Basel II package of international capital guidelines — take a much more restrictive approach to cross-product netting than do the U.S. bankruptcy law or similar European legislation disallowing such cross netting. Hence the rule makers have themselves built in anomalies within the stipulated regulations resulting in conflicts in the regulatory regime of the country which was used as a framework for designing the global Basel accord and is now our issue of contention. This issue with BIS implementation in US has been mentioned here to describe that issues with BIS are not only with us but with the makers of the rules also. It's not up to these regulators to be telling us from Mount Everest what to do when they themselves are confused about the implementation of their own superseding guidelines.

Above all, these norms provide only broad principles to help banks in developing their Internal Capital Adequacy Assessment Process. However, this situation will offer professional opportunities in the form of consulting contracts for the Chartered Accountant community.

A Mixed Bag of Risks

The guidelines issued on Supervisory Review Process (SRP)[5] of Basel II accord ask banks to make provision for risks relating to credit concentration, liquidity, settlement risk, reputation, strategy, and under-estimation of credit risk that were not specified earlier. Providing an assortment of risks to banks not only makes this daunting task more demoralizing but gives room to all possible errors and assumptions on which the new banking accord is being predestined.

Toppling of Interest Margins

Under the Basel II credit rating is not mandatory but provides huge capital savings to the banks with rated portfolios. In case a bank chooses to keep some of its loans unrated, a provision of a flat risk weight of 150 per cent for credit risk on such loans is imposed. After April 1, 2008 fresh unrated disbursals and renewals greater than Rs.500 million attract a risk weight of 150 per cent. This minimum size will be further reduced to Rs.100 million bringing many more loans within the 150 per cent risk weight bracket from April 1, 2009. Hence by getting loans rated, banks will be able to save capital on loans in the higher rating categories.

A consequence of this mayhem is ruthless competition among banks for highly rated corporate needing lower amount of capital which is now exerting pressure on already thinning interest spread. If a bank has high quality credit exposures, it saves capital on account of credit risk. Conversely, a bank with relatively lower

[5]Supervisory Review Process refers to Pillar II of the Basel II accord. Pillar II requires Regulator to ensure that each bank has sound internal processes in place to assess the adequacy of its capital based on a thorough evaluation of its various risk as identified under the new accord.

An ASSOCHAM Eco Pulse study shows that the financial health of the Indian banking system has improved significantly. For instance, this improvement is vivid in terms of Capital Adequacy Ratio (CAR) during the third quarter of the fiscal 2007-08. In comparison to the mandated limit of CAR of 9 per cent, the average capital adequacy ratio of commercial banks went up to 13 per cent in financial year 2008 from 12 per cent in the previous year.

rated credit exposure has to provide more capital.

Reliability of the New Rating Treaty

Rating is not a pre-condition for a loan sanction or for renewal of working capital facilities. Yet a bank can insist on a rating for the loan before sanction or renewal, as it will help the bank in saving capital as stated above. On the other hand, a company has the option to accept or reject the ratings assigned to it by the rating agencies .Once the rating is approved, a rating letter is issued by the rating agency which is posted on its website and carry in its monthly publications.

Rating is a lagging indicator of the credit risk and the agencies have poor track record in this respect. There is a possibility of rating blackmail through unsolicited rating. Moreover, rating in India is restricted to issues and not issuers. Encouraging rating of issuers would be a challenge. In case of unrated sovereigns, banks and corporate, the prescribed risk weight is 100 per cent, whereas in case of those entities with lowest rating, the risk weight is 150 per cent. This may create incentive for the category of counter parties, which anticipate lower rating to remain unrated.

Alternative Approaches

The new Basel framework provides for alternative approaches for computation of capital requirement of various risks. However, competitive advantage of Internal Ratings Based (IRB)[6] approach is leading to domination of this approach among big banks. Banks adopting IRB approach will be more sensitive than those adopting standardised approach since a small change in degree of risk might translate into a large impact on additional capital requirement for the IRB banks. Thus, IRB banks will avoid taking high-risk loans/ assets on its books. Also banks adopting Standardised Approach will not be equally risk-sensitive and shall have a relatively less capital requirement for the same exposure when compared to IRB banks. This may result in banks on Standardised Approach to be inclined to give loans to high-risk clients, which have been turned down by IRB banks. This paradox shall net result in high-risk assets flowing to banks on Standardised Approach, as they would require lesser risk capital for financing such risky loans than banks on IRB approach. Hence, the system as a whole may maintain lower capital than warranted and become more vulnerable. What we understand is that in quest for perfect standards, the only universally accepted standard has been lost.

Also, developing countries like ours have high concentration of lower rated borrowers. The calibration of IRB has lesser incentives to lend to such borrowers. This, along with withdrawal of uniform risk weight of 0 per cent on sovereign claims, may result in overall reduction in lending by internationally active banks in developing countries and increase their cost of borrowing.

Historical Database

Financial stability as a term came into existence just about 12 years back when the Bank of England first used the term in 1996; this indeed is a major push for FS reporting. Financial stability in the banking system is nothing but evaluating the interdependencies between the individual banks. A large loss in a systemically important bank is more often likely to trigger losses in other banks in the system. The IMF has modelled this by evaluating the Joint Probability of Default (JPoD) of a portfolio of banks, by taking the individual probability of default and modelling the interdependencies using non-parametric copulas. The concept of joint default analysis is also used by Moody's to determine the impact of external support on banks ratings so in a way they are also modelling the interdependencies. The JPoD represents the joint probability of default of all banks in the portfolio given that at least one bank has defaulted in the system and is thus a measure of the Banking Stability Index. The IMF has actually tested this on portfolio of 15 large systemically important banks and has determined that the JPoD for this portfolio has risen almost 10 times from mid 2007 till the present.

[6]Under IRB approach, a bank uses its internal ratings, based on the measurement of unexpected loss (UL) and expected loss (EL) derived from four key variables: probability of default (PD); Loss given default (LGD); exposure at default (EAD); and effective maturity (M). The banks will have to estimate the potential future loss from the exposure and assign risk weights accordingly. The IRB Approach has been further subdivided into Foundation Approach and Advanced Approach. In Foundation Approach, a bank would internally estimate the PD and the regulator would provide the other three variables, whereas in Advanced Approach, the bank would be expected to provide the other three variables as well.

The working Group set up by the Basel Committee to look into implementation issues observed that supervisors may wish to involve third parties, such as external auditors, internal auditors and consultants to assist them in carrying out some or all of the duties under Basel II. The prerequisite is that there should be a rightfully developed national accounting and auditing principles and scaffold, which are in line with the best international practices.

Now if we apply these probability concepts to our systems and plan to calculate these numbers, we see that our Indian Banking System did not have the infrastructure to load such intricate details and numbers in the past and neither did it have the data storage capacity and complicated sturdy systems to perform such operations today. So the entire scenario of calculations and detailed analysis goes for a toss. Not only this, Basel II emphasis on computation of probability of default, loss given default, migration mapping and supervisory validation require creation of historical database, which is a time consuming process and may require initial support from the RBI or large banks which is presently not there.

Willingness for Information Overload

Pillar 3 of Basel II purports to enforce market discipline through stricter disclosure requirement. While admitting that such disclosure may be useful for supervisory authorities and rating agencies, the expertise and ability of the general public to comprehend and interpret disclosed information is open to question. Moreover, too much disclosure may cause information overload and may even damage financial position of bank.

Consequences

From the above analysis, three probable consequences emerge, the ripples of which are already being felt:

- New standards are an amalgam of international best practices and call for introduction of advanced risk management system with enterprise level applications. Hence it has become a daunting task to craft the required level of technological architecture, and assemble human skill across an institution undertaking such appraisal and across the industry which is dragging to overhaul itself. Also the managerial cadre has to be properly trained for understanding of critical issues for risk profiling of supervised entities and validating and guiding development of complex IRB models.
- The additional capital requirement posed by capital adequacy norms leads to large number of banks being forced to turn to capital market with IPOs[7] and FPOs[8] which is a noticeable market trend today. This further has its own impact on the banking structure as it demands for dilution of Government ownership on these banks. Government has already been forced to increase the FDI limit by 74 per cent in banking sector to help these banks raise the required capital.
- These moves in the sector have grown pressure to consolidate domestic banks to make them capable of facing international competition. Given the significant dominance of foreign banks over the domestic counterparts, even after the consolidation of domestic banks the threat of takeover remains if the FDI limit is further relaxed.

Status as on Today

An ASSOCHAM Eco Pulse study has brought out that most Indian banks have improved their capital adequacy ratio in line with the requirements of global Basel II norms, but suggests that they need to do more on international risk management practices in the wake of increasing pressure to bring down Non-Performing Assets (NPAs).

Entitled 'Indian Banks and Basel Accord II', the study shows that the financial health of the Indian banking system has improved significantly. For instance, this improvement is vivid in terms of Capital Adequacy Ratio (CAR) during the third quarter of the fiscal 2007-08. In comparison to the mandated limit of CAR of 9%, the average capital adequacy ratio of commercial banks went up to 13 % in financial year 2008 from 12% in the previous year. Axis bank recorded the maximum increase of up to 16.88% in quarter 3, financial year 2007-08 from 11.83% a year earlier in its CAR. ICICI Bank took the second position with an increase from 13.37% to 15.82% in the current financial year. Other banks which registered a significant rise in CAR include ING Vysya Bank, whose ratio rose to 12.23% over and above 10.70% in the previous year, HDFC Bank from 12.80% to 13.80% and Centurion Bank of Punjab from 10.50% in the previous fiscal to 11.50% in the current fiscal. Punjab National Bank turned the corner by recording an increase in its CAR against a decline in the previous financial year. Its capital adequacy ratio dropped to 12.9% from 13.99% in quarter

[7]Initial Public Offer
[8]Follow on Public Offer

3, 2006-07. However, in quarter 3, 2007-08, it saw an upward trend of 14.04% against 12.90% in the similar period, last fiscal. State Bank of India managed to increase its CAR to 12.28% from 11.86%, in contrast to a decline to 11.86% from 12.49% in the financial year 2006-07. Capital adequacy ratio of Bank of Baroda reached 13.51% at the end of third quarter in the financial year 2007-08 as compared to 12.24% in the corresponding period of the previous year. Hence overall there is an upward trend in CAR of most of dominant public sector banks as they move ahead to meet the Basel II deadline laid down by RBI.

However, few players experienced a decline in their CAR, but they still managed to remain above the 9% limit. Capital Adequacy Ratio of IDBI Bank has decreased to 13.31% from 14.09% at the end of quarter 3 and Union Banks CAR went down to 13.03% from 13.21%.

The study, however, expresses concern over the risk management practices of the banks. It stated that the net Non-Performing Assets of 14 commercial banks, in absolute terms, have increased by 25.70% in the third quarter of current financial year to Rs. 14,166.65 crore from Rs 11,270.32 crore in the previous financial year. Gross NPAs of banks increased by about 14% from Rs. 28,392.58 crore to Rs. 32,129.48 crore. The highest rise of 266% in net NPAs was witnessed in the case of Punjab National Bank in Q3, 2007-08, followed by Centurion Bank of Punjab with an increase by 125%, ICICI Bank (77%), Vijaya Bank (49%), HDFC Bank (37.46%) and State Bank of India (25%).

Conclusion

The working Group set up by the Basel Committee to look into implementation issues observed that supervisors may wish to involve third parties, such as external auditors, internal auditors and consultants to assist them in carrying out some or all of the duties under Basel II. The prerequisite is that there should be a rightfully developed national accounting and auditing principles and scaffold, which are in line with the best international practices. Minimum qualifying criteria for firms should be those that have a devoted financial services or banking division that is appropriately researched and have demonstrated aptitude to respond to training and upgrades required of its own staff to complete the tasks satisfactorily. With the implementation of the new framework, internal auditors may become increasingly involved in various processes, including validation and of the accuracy of the data inputs, review of activities performed by credit functions and assessment of a bank's capital assessment process.❑

TAXATION OF EXPATRIATES

With the fast paced globalisation of the world trade and liberalisation of the Indian economy, the number of persons moving in or out of India in the exercise of their business, profession or employment is constantly on the increase. This article attempts to discuss various taxation concepts and issues related to these expatriates.

Residential Status

As in most of the countries, the liability under the Indian income-tax law is also co-related to the residential status of the concerned tax payer. Section 6 of the Income-tax Act, 1961 creates three categories as far as residential status is concerned.

Resident:

- An Individual is said to be resident in India in any previous year if he is in India for at least 182 days in that year or during that year he is in India for a period of at least 60 days and has been in India for at least 365 days during the four years preceding that year.
- However, the period of 60 days referred to above is increased to 182 days in case of Indian citizens who leave India as members of the crew of an Indian Ship for Indian citizens or persons of Indian origin who, being outside India, come to visit India in any previous year.

— CA. S.P. Santhanam
(The author is a member of the Institute. He can be reached at spsanthanam_ca @yahoo.co.in)

Relevant Case:

[2006] 155 Taxman 326 (AAR - New Delhi)

In case of foreign expatriate working in India, the remuneration received by him, assessable under the head 'Salaries', is deemed to be earned in India if it is payable to him for service rendered in India as provided in section 9(1)(ii) of the Income-tax Act, 1961. The *Explanation* to the aforesaid law clarifies that income in the nature of salaries payable for services rendered in India shall be regarded as income earned in India.

Authority for Advance Rulings, New Delhi

British Gas India (P.) Ltd., In re

Justice Syed Shah Mohammed Quadri, Chairman

And A.S. Narang, Member

AAR No. 725 of 2006

July 31, 2006

Section 6 of the Income-tax Act, 1961 - Residential status - Whether a careful reading of *Explanation (a)* would show that requirement of *Explanation* is not leaving India for employment but it is leaving India for purposes of employment outside India - Held, yes Whether for purpose of *Explanation* an individual need not be an unemployed person who leaves India for employment outside India - Held, yes - Applicant an Indian company deputed its employee 'M' to UK for two years from 1-7-2005 - In financial year 2005-06, 'M' stayed in India for less than 182 days - Whether in view of *Explanation* (a) to section 6(1), 'M' would be considered as non-resident in India for financial year 2005-06, and, therefore, salary received in India for rendering services in UK would not be taxable in India - Held, yes

Facts

The applicant, an Indian company, deputed its one employee 'M' to UK for two years from 1-7-2005. The applicant sought advance ruling on the question as to whether salary income received in India by 'M' from the company for rendering services outside India is taxable in India. The Commissioner relying on section 6(1)(c) commented that in view of the 'M's stay of 88 days in India in the financial year 2005-06, the status of 'M' is that of resident in India. The applicant's case is that since 'M' is a citizen of India and left India for the purpose of employment outside the State, he would be a non-resident if his stay is less than 182 days in that year under *Explanation (a)* to section 6(1) and as 'M' stayed in the year in question for only 88 days, he would be a non-resident.

Held

The word 'non-resident' has not been defined in the Act. There are two requirements of section 6 (1) which defines residence of an individual in India:

(I) If an individual is in India in any previous year for a period or periods amounting in all to 182 days or more; or

(II) If the individual, having within the four years preceding that year been in India for a period or periods amounting in all to 365 days or more, is in India for a period or periods amounting in all to 60 days or more in that year.

Now *Explanation (a)* says, *inter alia*, in the case of an individual being a citizen of India, who leaves India in any previous year for the purpose of employment outside India, in relation to that year he will be resident in India if he is in India for a period or periods amounting in all to 182 days or more.

The contention of the Commissioner that he has been in India for more than 60 days is supported by sub-clause (c) of section 6(1) of the Act but this ignores *Explanation (a)* thereof. For the words 'sixty days', occurring in sub-clause (c), the words 'one hundred and eighty-two days' have been substituted by the *Explanation*. If sub-clause (c) is read in the light of the *Explanation (a)*, it is apparent that the stay of 'M' is less than 182 days (his stay is 88 days in India), therefore, he becomes a non-resident and, thus, the requirement of the tax liability of non-resident for the purpose of definition of 'advance ruling' in section 245N (a) is satisfied. The contention of the department that since he is already in employment and is leaving India on deputation, he cannot be said to leave India for employment, cannot be accepted. A careful reading of *Explanation (a)* would show that the requirement of the *Explanation* is not leaving India for employment but it is leaving India for the purposes of employment outside India. For the purpose of the *Explanation* an individual need not be an unemployed person who leaves India for employment outside India. Therefore, the fact that 'M' was already an employee at the time

The Central Government acting under the authority of Law (Section 90) has entered into DTAAs with more than 60 countries. Such treaties serve the purpose of providing protection to the tax payers from double taxation. As per section 90(2), in relation to an assessee to whom any DTAA applies, the provisions of the Act shall apply only to the extent they are more beneficial to the assessee. The provisions of these DTAAs thus prevail over the statutory provisions.

of leaving India is hardly material or relevant. For all these reasons, 'M' is not a resident in India for the financial year 2005-06.

Thus, salary income received in India by 'M' from Indian company for rendering services outside India is not taxable in India.

Non-Resident

A person who is not a resident in terms of the above provision is a non-resident.

'Person resident outside India' means 'person not resident in India' - 'A person resident outside India' would have to be understood as a person who was not a resident in India. Where a person is resident in India in view of provisions of section 2(p)(iii)(c) and section 2(q) of FERA, he is not entitled to exemption under section 10(4A) - *CIT v. K. Ramullan* [1997] 92 Taxman 122/226 ITR 264 (Ker).

Resident but Not Ordinarily Resident (RNOR)

A person who is otherwise resident would be RNOR if he satisfies any of the following two conditions

- He has not been resident in India in 9 out of 10 preceding previous years.

  or

- He has not been in India for an aggregate period of 730 days or more in the preceding seven previous years. W.e.f. 1.4.2004, the status 'RNOR' has been redefined as follows:- An individual shall be said to be RNOR if he has been a non-resident in India in 9 out of 10 previous years preceding or period amounting to 729 days or less during the seven previous years preceding that year.

Scope of Taxation

Based on the residential status of payer, his tax liability will be as follows:

Residential Status	Taxability of Income
Resident	All income of the previous year wherever accruing or arising or received by him including incomes deemed to have accrued or arisen
Non-Resident	All income accruing, arising to or deemed to have accrued or arisen or received in India
Resident but not ordinary Resident	All Income accruing or arising or deemed to have accrued or arisen or received in India. Moreover, all income earned outside India will also be included if the same is derived from a business or profession controlled or set up in India.

Expatriates Working in India

In case of foreign expatriate working in India, the remuneration received by him, assessable under the head 'Salaries', is deemed to be earned in India if it is payable to him for service rendered in India as provided in section 9(1)(ii) of the Income-tax Act, 1961. The *Explanation* to the aforesaid law clarifies that income in the nature of salaries payable for services rendered in India shall be regarded as income earned in India. Further, from assessment year 2000-01 onwards income payable for the leave period which is preceded and succeeded by services rendered in India and forms part of the service contract shall also be regarded as income earned in India. Thus, irrespective of the residential status of the expatriate employee, the amount received by him as salary for services rendered in India shall be liable to tax in India being income accruing or arising in India, regardless of the place where the salary is actually received. However, there are certain exceptions to the rule which are briefly discussed on next page:

Section	Remarks
10(6) (VI).	Remuneration of an employee of a foreign enterprise is exempt from tax if his stay in India is less than 90 days in aggregate during the financial year: The remuneration received by him as an employee of a foreign enterprise for services rendered by him during his stay in India, provided the following conditions are fulfilled—
	The foreign enterprise is not engaged in any trade or business in India;
	His stay in India does not exceed in the aggregate a period of ninety days in such previous year; and
	Such remuneration is not liable to be deducted from the income of the employer chargeable under this Act;
	This is subject to further relaxation under the provisions of Double Taxation Avoidance Agreement entered into by India with the respective country
10(6) (ii)	Remuneration received by a foreign expatriate as an official of an embassy or high commission or consulate or trade representative of a foreign State is exempt or reciprocal basis
10(6) (viii)	Remuneration from employment on a foreign trip provided the stay of the employee does not exceed 90 days in the financial year
10(6) (xi)	Training stipends received from foreign Government
10(8) & (10(8B)	Remuneration under co-operative technical assistance programme or technical assistance grants agreements.

Special Provisions Relating to Non-Residents

Chapter XIIA of the Income-tax Act deals with special provisions relating to certain incomes of non-residents.

Section	Remarks
115D	Provisions regarding computation of investment income of NRIs.
115E	relates to investments income and long-term capital gains of NRIs, such income being taxed at concession flat rates
115F	capital gain is not chargeable on transfer of foreign exchange assets under certain circumstances
115G	The NRIs need not file their return of income if their total income consist only of investment income or long-term capital gains or both and proper tax has been deducted from this income
115H.	Benefits under this chapter are available even after the assessee becomes a resident.
115I	The provisions of this chapter would not apply if the assessee so chooses

Double Taxation Avoidance Agreement (DTAA)

The Central Government acting under the authority of Law (Section 90) has entered into DTAAs with more than 60 countries. Such treaties serve the purpose of providing protection to the tax payers from double taxation. As per section 90(2), in relation to an assessee to whom any DTAA applies, the provisions of the Act shall apply only to the extent they are more beneficial to the assessee. The provisions of these DTAAs thus prevail over the statutory provisions.

Scope of the provision - In case of conflict between Income-tax Act and provisions of DTAA, provisions of DTAA would prevail over provisions of Income-tax Act. Section 90(2) makes it clear that the Act gets modified in regard to the assessee in-so-far as the agreement is concerned if it falls within the category stated therein - *CIT v. P.V.A.L. Kulandagan Chettiar [2004] 137 Taxman 460/267 ITR 654 (SC).*

The provisions of section 90 prevail over those of sections 4, 5 and 9, and therefore, even where a business connection is established the profits of a company could be free from tax if they are covered by a Double Taxation Agreement - *CIT v. Vishakhapatnam Port Trust [1983] 144 ITR 146 (AP).*

The Double Taxation Avoidance Agreement (DTAA)

shall always prevail even when anomaly is noticed between the provisions of the Act and the provisions of DTAA. Further, in view of section 90(2), the assessee has an option to claim that the provisions of the Act may be made applicable if these are more beneficial to the assessee - *CIT v. Hindustan Paper Corporation Ltd. [1994] 77 Taxman 450 (Cal).*

Tax liability of a person residing in both contracting States - Tax liability arising in respect of a person residing in both contracting States has to be determined with reference to his close personal and economic relations with one or other - *CIT v. P.V.A.L. Kulandagan Chettiar [2004] 137 Taxman 460/267 ITR 654 (SC).*

When foreign assessment is not final - The law requires that an application for double taxation relief should be made on the basis of taxes paid both in India and abroad. Notwithstanding that a foreign assessment has not become final, an application for refund made on the basis of a provisional assessment in the foreign country is not opposed to the provisions of law or the rules made there under -*A.H.M. Allaudin v. Addl. ITO [1964] 52 ITR 900 (Mad.).*

Agreement with Malaysia - In absence of permanent establishment in India in regard to carrying on of business of rubber plantations in Malaysia, business income earned by assessee out of rubber plantations could not be taxed in India - *CIT v. P.V.A.L. Kulandagan Chettiar [2004] 137 Taxman 460/267 ITR 654 (SC).*

In terms of the Treaty wherever any expression is not defined, the expression defined in the Act would be attracted. The definition of 'income' would, therefore, include capital gains. Thus, capital gains derived from immovable property is income and, therefore, the relevant article of DTAA would be attracted - *CIT v. P.V.A.L. Kulandagan Chettiar [2004] 137 Taxman 460/267 ITR 654 (SC).*

Agreement with Mauritius - Circular No. 789, dated 13-4-2000, clarifying that FIIs, etc., which are resident in Mauritius, would not be taxable in India on income from capital gains arising in India on sale of shares is valid and efficacious. Being a circular within the meaning of section 90, it must have the legal consequences contemplated by sub-section (2) of section 90. In other words, the Circular shall prevail even if inconsistent with the provisions of Income-tax Act, 1961 in-so-far as assessees covered by the provisions of the DTAA are concerned. There is no merit in the contention that the delegate of a legislative power cannot exercise the power of exemption in a fiscal statute. Section 90 enables the Central Government to enter into a DTAA with the foreign Government. When the requisite notification has been issued thereunder, the provisions of sub-section (2) of section 90 spring into operation and an assessee who is covered by the provisions of the DTAA is entitled to seek benefits there under, even if the provisions of the DTAA are inconsistent with the provisions of the Act. One cannot accept the contention that the DTAA with Mauritius is *ultra vires* the powers of the Central Government under section 90 on account of its susceptibility to 'treaty shopping' on behalf of the residents of third countries - *Union of India v. Azadi Bachao Andolan [2003] 132 Taxman 373/263 ITR 706 (SC).*

Indian Residents Posted Abroad

Indian residents who have taken up employment in countries with which India has got DTAA are entitled to the benefit of the DTAA entered into by India with the country of employment. Accordingly, their tax liability is decided.

It may also be mentioned here that as per section 9(1)(iii) income chargeable under the head 'Salary' payable by the Government to a citizen of India for services rendered outside India is deemed to accrue or arise in India. However, allowances or perquisites paid or allowed outside India by the Government to a citizen of India for rendering services abroad is exempt from taxation under section 10(7).

Relevant Case

[2007] 158 Taxman 259 (SC)

Supreme Court of India

Ishikawajma-Harima Heavy Industries Ltd

vs.

Director of Income-tax

S.B. Sinha and Dalveer Bhandari, JJ.

Case No. Appeal (Civil) 9 of 2007

January 4, 2007

Section 9 of the Income-tax Act, 1961, read with articles 7 and 12 of the Double Taxation Avoidance Agreement between India and Japan - Income - Deemed to accrue or arise in India - Whether mere existence of business connection may result in income to non-resident assessee from transaction with such a business connection accruing or arising in In-

dia - Held, no - Whether it would be wrong to equate permanent establishment with a business connection, since former is for purpose of assessment of income of a non-resident under a Double Taxation Avoidance Agreement, and latter is for application of section 9 - Held, yes - Whether income arising out of turnkey project executed in India would be assessable in India, only because a non-resident has a permanent establishment - Held, no - Whether for attracting taxing statute, there has to be some activity through permanent establishment and, if income arises without any activity of permanent establishment, even under DTAA, taxation liability in respect of overseas services would not arise in India - Held, yes - Whether in cases where different severable parts of a composite contract are performed at different places, principle of apportionment as recognised by *Explanation 1(a)* of section 9(1)(i), can be applied, to determine which fiscal jurisdiction can tax that particular part of transaction - Held, yes - Whether location of source of income within India would render sufficient nexus to tax income from that source - Held, no - Whether for section 9(1)(vii) to be applicable, it is necessary that services provided by a non-resident assessee under a contract should not only be utilized within India, but should also be rendered in India or should have such a live link with India that entire income from fees as envisaged in article 12 of DTAA becomes taxable in India - Held, yes - Whether thus, for a non-resident to be taxed on income for services, such a service needs to be rendered within India, and has to be a part of a business or profession carried on by such person in India - Held, yes - Whether whatever is payable by a resident to a non-resident by way of fees for technical services would not always come within purview of section 9(1)(vii) but it must have sufficient territorial nexus with India so as to furnish a basis for imposition of tax - Held, yes - Appellant was a company incorporated in Japan and engaged, *inter alia*, in business of construction of storage tanks as also engineering, etc. - It entered into an agreement with 'P' for setting up a Liquefied Natural Gas receiving storage and degasification facility in India - Appellant was to develop, design, engineer and procure equipment, materials and supplies, to erect and construct storage tanks of 5 MMTPA capacity - Contract involved offshore supply and offshore services - Whether since all activities in connection with offshore supply were carried out outside India, amounts received/receivable by appellant from 'P' for offshore supply of equipments, materials, etc., cannot be deemed to accrue or arise in India - Held, yes - Whether since entire services had been rendered outside India and had nothing to do with permanent establishment, amount received/receivable by appellant from 'P' for offshore services was not liable to tax in India - Held, yes

Facts

The appellant is a company incorporated in Japan and is engaged, *inter alia*, in the business of construction of storage tanks as also engineering, etc. It formed a consortium along with various foreign entities including an Indian company. With the said consortium members, it entered into an agreement with 'P' for setting up a Liquefied Natural Gas (LNG) receiving storage and degasification facility in India. The contract envisaged a turnkey project. Role and responsibility of each member of the consortium was specified separately. Each of the members of the consortium was also to receive separate payments. The appellant was to develop, design, engineer and procure equipment, materials and supplies, to erect and construct some storage tanks of 5 MMTPA capacities.

The contract indisputably involved:

(i) Offshore supply,

(ii) Offshore services,

(iii) Onshore supply,

(iv) Onshore services and

(v) construction and erection.

The price was payable for offshore supply and offshore services in US dollars, and for onshore supply as also onshore services and construction and erection partly in US dollars and partly in Indian rupees. Liability to pay income-tax in India of the appellant, being doubtful, an application was filed by the appellant before the Authority for Advance Rulings in terms of section 241Q (1) raising the following questions :

1. Whether the amounts, received/receivable by the appellant from 'P' for offshore supply of equipments, materials, etc., are liable to tax in India under the provisions of the Act and India-Japan Tax Treaty and if taxable, to what extent are the amounts reasonably attributable to the operations carried out in India and accordingly taxable in India ?

2. Whether the amounts received/receivable by the appellant from 'P' for offshore services are chargeable to tax in India under the Act and/or the India-Japan Tax Treaty and if tax-

able, to what extent would amounts received/ receivable for such services be chargeable to tax in India under the Act and/or the India-Japan Tax Treaty?

The contention of the appellant before the Authority was that the contract being a divisible one, it did not have any liability to pay any tax in regard to offshore services and offshore supply. The revenue, on the other hand, contended that the contract being a composite and integrated one, it was so liable.

The Authority ruled that:

- amounts received/receivable by the appellant from 'P' in respect of offshore supply of equipment and materials are liable to be taxed in India under the provisions of the Act and the India-Japan Treaty and in view of the *Explanation 1*(a) to section 9(1)(*i*) and/or article 7(1) read with the Protocol of the India-Japan Treaty, the amount that would be taxable in India is so much of the profit as is reasonably attributable to the operations carried out in India;
- The entire amount received/receivable by the appellant from 'P' for offshore services is liable to be taxed in India both under the provisions of the Act as well as under Indo-Japan Treaty.

On appeal to the Supreme Court:

Held

- The contract in the instant case is a complex arrangement. 'P' and the appellant are not the only parties thereto; there are other members of the consortium who are required to carry out different parts of the contract. The consortium included an Indian company. The fact that it has been fashioned as a turnkey contract by itself may not be of much significance. The project is a turnkey project. The contract may also be a turnkey contract, but the same by itself would not mean that even for the purpose of taxability the entire contract must be considered to be an integrated one so as to make the appellant to pay tax in India. The taxable events in execution of a contract may arise at several stages in several years. The liability of the parties may also arise at several stages. Obligations under the contract are distinct ones. Supply obligation is distinct and separate from service obligation. Price for each of the components of the contract is separate. Similarly offshore supply and offshore services have separately been dealt with. Prices in each of the segment are also different.
- The very fact that in the contract, the supply segment and service segment have been specified in different parts of the contract is a pointer to show that the liability of the appellant there under would also be different.
- The contract indisputably was executed in India. By entering into a contract in India, although parts thereof would have to be carried out outside India that would not make the entire income derived by the contractor to be taxable in India.
- Scope of work is contained in clause 2.1 of Ex. A appended to the contract which includes supply of equipment, materials and facilities. The said exhibit spells out different systems to be set in place. It imposes an obligation on the contractor to supply equipments required therefore. It was to arrange for the engineering services in relation thereto. It was also required to render various other services within India. Ex. D, however, provides for the prices to be paid in respect of offshore supplies and offshore services, onshore supply and onshore services, construction and erection. Payment schedule has also been separately specified in respect of each of the components separately.
- It is not in dispute that title in the equipments supplied was to stand transferred upon delivery thereof outside India on high-sea basis as provided for in clause 22.1. Similarly, clause 13.1 provides for a lump sum contract price, whereas clause 13.3.2 specifically refers to the cost of offshore supplies. The provisions with regard to offshore supplies and offshore services are to be read with the provisions contained in Ex. D which formed the basis of customs duty. Clause 13.4 refers to Ex. D as the basis for price escalation.
- The question of imposition of tax on income arising from a business connection may, thus, have to be considered keeping in view the said factual backdrop.
- Section 9(1)(i) states that income accruing or arising whether directly or indirectly, through

or from any business connection in India shall be deemed to accrue or arise in India. The appellant is a non-resident assessee.

- Section 9 raises a legal fiction, but as regards the contextual interpretation the legal fiction must be construed having regard to the object it seeks to achieve. The legal fiction created under section 9 must also be read having regard to the other provisions thereof.
- The provisions of section 42 of the Income-tax Act, 1922 provide that only such part of income as is attributable to the operations carried out in India would be taxable in India.
- Territorial nexus doctrine, thus, plays an important part in assessment of tax. Tax is levied on one transaction where the operations which may give rise to income may take place partly in one territory and partly in another. The question which would fall for consideration is as to whether the income that arises out of the said transaction would be required to be proportioned to each of the territories or not.
- Income arising out of operation in more than one jurisdiction would have territorial nexus with each of the jurisdictions on actual basis. If that be so, it may not be correct to contend that the entire income 'accrues or arises' in each of the jurisdictions. The Authority has proceeded on the basis that supplies in question had taken place offshore. It, however, has rendered its opinion on the premise that offshore supplies or offshore services were intimately connected with the turnkey project.
- In the instant case, it is only for the purpose of taxability that the terms of the contract are required to be construed. A turnkey contract may involve supply of materials used in the execution of the contract for price as also for use of the materials by works and Labour; but the same may not have any relation with the taxability part of it.
- Tax under the Act has to be assessed under different heads. Income under one head may be subjected to exemption and deductions may be claimed under same head while under another head no tax may be payable at all. Whether a part of the income of the assessee would be taxable or not depends upon the fact of each case. Even there is nothing to prevent the income accruing or arising at the sources.
- The principle of apportionment is also recognized by clause (a) of Explanation 1 to section 9(1)(i). Thus, if submission of the revenue is accepted that the contract is a composite one, then offshore supply would be of equipment designed and manufactured in one territory (Japan), and then sold in another tax territory, leading to division of profits arising in two tax territories, which is not envisaged under Indian taxation law.
- It would give rise to the question as to what would be the meaning of the phrase 'business connection in India'. Mere existence of business connection may not result in income, to the non-resident assessee from transaction with such a business connection, accruing or arising in India.
- In construing a contract, the terms and conditions thereof are to be read as a whole. A contract must be construed keeping in view the intention of the parties. No doubt, the applicability of the tax laws would depend upon the nature of the contract, but the same should not be construed keeping in view the taxing provisions.
- The term 'permanent establishment' has not been defined in the Act. Since the appellant carries on business in India through a permanent establishment, it clearly falls out of the applicability of article 12(5) of the DTAA but within the ambit of article 7 of DTAA. The Protocol of the DTAA discusses about the involvement of the permanent establishment in transactions, in order to determine the extent of income that can be taxed. It is stated that the term 'directly or indirectly attributable' indicates the income that shall be regarded on the basis of the extent appropriate to the part played by the permanent establishment in those transactions. The permanent establishment in the instant case has no role to play in the transaction that is sought to be taxed, since the transaction took place abroad.
- Clause 1 of article 7, thus, provides that if an income arises in Japan (Contracting State), it shall be taxable in that country unless the enterprise carries on business in the other Contracting State (India) through a permanent

establishment situated therein. What is to be taxed is profit of the enterprise in India, but only so much of them as is directly or indirectly attributable to that permanent establishment. All income arising out of the turnkey project would not, therefore, be assessable in India, only because the assessee has a permanent establishment.

- The distinction between the existence of a business connection and the income accruing or arising out of such business connection is clear and explicit. In the instant case, the permanent establishment's non-involvement in transaction in question excludes it from being a part of the cause of the income itself, and thus there is no business connection.
- Article 5.3 provides that a person is regarded as having a permanent establishment if he carries on construction and installation activities in a Contracting State and only if the said activities are carried out for more than six months. The Protocol of India-Japan Tax Treaty also provides that only income arising from activities wherein the permanent establishment has been involved can be said to be attributable to the permanent establishment. It would give rise to two questions, firstly offshore services are rendered outside India; the permanent establishment would have no role to play in respect thereto in the earning of the said income. Secondly, entire services having been rendered outside India, the income arising there from cannot be attributable to the permanent establishment so as to bring within the charge of tax.
- For attracting the taxing statute there has to be some activities through permanent establishment. If income arises without any activity of the permanent establishment, even under the DTAA the taxation liability in respect of overseas services would not arise in India. Section 9 spells out the extent to which the income of non-resident would be liable to tax in India. Section 9 has a direct territorial nexus. Relief under a Double Taxation Treaty having regard to the provisions contained in section 90(2) would arise only in the event a taxable income of the assessee arises in one Contracting State on the basis of accrual of income in another Contracting State on the basis of residence. Thus, if appellant has income that accrued in India and is liable to tax because in its State all residents are entitled to relief from such double taxation payable in terms of Double Taxation Treaty. However, so far as accrual of income in India is concerned, taxability must be read in terms of section 4(2) read with section 9, whereupon the question of seeking assessment of such income in India on the basis of Double Taxation Treaty would arise.
- In cases such as the instant one, where different severable parts of the composite contract are performed at different places, the principle of apportionment can be applied, to determine which fiscal jurisdiction can tax that particular part of the transaction. The said principle helps to determine where the territorial jurisdiction of a particular State lies, and its capacity to tax an event. Applying it to composite transactions which have some operations in one territory and some in others, is essential to determine the taxability of various operations.
- Therefore, the concepts of profits of business connection and permanent establishment should not be mixed up. Whereas business connection is relevant for the purpose of application of section 9, the concept of permanent establishment is relevant for assessing the income of a non-resident under the DTAA. There, however, may be a case where there can be over-lapping of income. The entire transaction having been completed on the high seas, the profits on sale did not arise in India, as had been contended by the appellant. Thus, having been excluded from the scope of taxation under the Act, the application of the double taxation treaty would not arise. The Treaty, however, was taken recourse to by appellant only by way of an alternate submission on income from services and not in relation to tax offshore supply of goods.
- As regards the question of division of taxable income of offshore services parties were *ad idem* that there existed a distinction between onshore supply and offshore supply. The intention of the parties, thus, must be judged from different types of services, different types of prices, as also different currencies in which the prices are to be paid.
- Reading the provision of section 9(1)(vii) (c)

in its plain sense, it can be seen that it requires two conditions which have to be satisfied. The services which are the source of the income, that is sought to be taxed, have to be rendered in India, as well as utilized in India, to be taxable in India. In the instant case, both these conditions are not satisfied simultaneously, excluding that income from the ambit of taxation in India. Thus, for a non-resident to be taxed on income for services, such a service needs to be rendered within India, and has to be a part of a business or profession carried on by such person in India. The appellant in the instant case have provided services to persons resident in India, and though the same have been used in India, the same have not been rendered in India.

- Section 9(1)(vii) whereupon reliance has been placed by the revenue, must be read with section 5, which takes within its purview the territorial nexus on the basis whereof tax is required to be levied, namely (a) resident; and (b) receipt or accrual of income.
- Global income of a resident although is subjected to tax, global income of a non-resident may not be. The answer to the question would depend upon the nature of the contract and the provisions of DTAA.
- What is relevant is receipt or accrual of income, as would be evident from a plain reading of section 5(2). The legal fiction created although in a given case may be held to be of wide import, yet it is trite that the terms of a contract are required to be construed having regard to the international covenants and conventions. In a case of the instant nature, interpretation with reference to the nexus to tax territories would also assume significance. Territorial nexus for the purpose of determining the tax liability is an internationally accepted principle. An endeavour should, thus, be made to construe the taxability of a non-resident in respect of income derived by it. Having regard to the internationally accepted principle and DTAA, it may not be possible to give an extended meaning to the words 'income deemed to accrue or arise in India' as expressed in section 9. Section 9 incorporates various heads of income on which tax is sought to be levied by the Republic of India. Whatever is payable by a resident to a non-resident by way of fees for technical services, thus, would not always come within the purview of section 9(1)(vii). It must have sufficient territorial nexus with India so as to furnish a basis for imposition of tax. Whereas a resident would come within the purview of section 9(1)(vii), a non-resident would not, as services of a non-resident to a resident which are utilized in India may not have much relevance in determining whether the income of the non-resident accrues or arises in India. It must have a direct live link with the services rendered in India. When such a link is established, the same may again be subjected to any relief under DTAA. A distinction may also be made between rendition of services and utilization thereof.
- The provisions of section 9(1) (vii) are plain and capable of being given a meaning. There, therefore, may not be any reason not to give full effect thereto. However, even in relation to such income, the provisions of article 7 would be applicable, as services rendered outside India would have nothing to do with permanent establishment in India. Thus, if any services have been rendered by the head office of appellant outside India, only because they were connected with permanent establishment, principle of apportionment shall apply.
- The Authority has committed an error in this behalf. If services rendered by the head office are considered to be the services rendered by the permanent establishment, the distinction between Indian and foreign operations and the apportionment of the income of the operations shall stand obliterated.
- It would be contrary to the intent and purport of the Double Taxation Convention which is a part of the scheme under the Act.

Therefore, it is held as under:

Regarding Offshore Supply:

- Only such part of income, as is attributable to the operations carried out in India can be taxed in India as contemplated in *Explanation 1(a)* of section 9(1)(i);
- Since all parts of the transaction in question, *i.e.*, the transfer of property in goods as well as the payment, were carried out outside the Indian soil, the transaction could not have been taxed in India;

- The principle of apportionment, wherein the territorial jurisdiction of a particular State determines its capacity to tax an event, has to be followed;
- The fact that the contract was signed in India is of no material consequence, since all activities in connection with the offshore supply are carried outside India, and therefore cannot be deemed to accrue or arise in India;
- There exists a distinction between a business connection and a permanent establishment. As the permanent establishment cannot be said to be involved in the transaction, the provision of section 9 will have no application. The permanent establishment cannot be equated to a business connection, since the former is for the purpose of assessment of income of a non-resident under a Double Taxation Avoidance Agreement, and the latter is for the application of section 9;
- The existence of a permanent establishment would not constitute sufficient 'business connection', and the permanent establishment would be the taxable entity. The fiscal jurisdiction of a country would not extend to the taxing entire income attributable to the permanent establishment;
- There exists a difference between the existence of a business connection and the income accruing or arising out of such business connection;
- Paragraph 6 of the Protocol of the DTAA is not applicable, because, for the profits to be 'attributable directly or indirectly', the permanent establishment must be involved in the activity giving rise to the profits.

Regarding Offshore Services:

- Sufficient territorial nexus between the rendition of services and territorial limits of India is necessary to make the income taxable;
- The entire contract would not be attributable to the operations in India, *viz.*, the place of execution of the contract, assuming the offshore elements forms an integral part of the contract;
- Section 9 (1)(vii) read with Memo cannot be given a wide meaning so as to hold that the amendment was only to include the income of non-resident taxpayers received by them outside India from Indian concerns for services rendered outside India;
- The test of residence, as applied in international law also, is that of the taxpayer and not that of the recipient of such services;
- For section 9(1)(vii) to be applicable, it is necessary that the services should not only be utilized within India, but should also be rendered in India or should have such a "live link" with India that the entire income from fees as envisaged in article 12 of DTAA becomes taxable in India;
- The terms 'effectively connected' and 'attributable to' are to be construed differently even if the offshore services and the permanent establishment are connected;
- Section 9(1)(vii)(c) in the instant case would have no application as there is nothing to show that the income derived by a non-resident company irrespective of where rendered, was utilized in India;
- Article 7 is applicable in instant case, and it limits the tax on business profits to that arising from the operations of the permanent establishment. In the instant case, the entire services have been rendered outside India, and have nothing to do with the permanent establishment, and can thus not be attributable to the permanent establishment and, therefore, not taxable in India;
- Applying the principle of apportionment to composite transactions which have some operations in one territory and some in others, is essential to determine the taxability of various operations;
- The location of the source of income within India would not render sufficient nexus to tax the income from that source;
- If the test applied by the Authority for Advance Rulings is to be adopted, in the instant case too, then it would eliminate the difference between the connection between Indian and foreign operations, and the apportionment of income accordingly;
- The services are inextricably linked to the supply of goods, and it must be considered in the same manner.❑

NOTIFICATIONS/CIRCULARS

Significant Circulars/Notifications during the Month of October, 2008

DIRECT TAXES

I. Notifications

1. Notification No. 96/2008, dated 8-10-2008

The Convention was between the Government of the Republic of India and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on income was notified by the Central Government under section 90 of the Income-tax Act, 1961 in the Gazette of India vide G.S.R. 101(E) dated 1st March, 1990.

Clause (*a*) of paragraph 4 of Article 11 of the said Convention provides the details regarding 'Central Bank' and 'financial institution wholly owned by the Government' in the case of Japan which will not be subject to tax under paragraph 3 of the said Article, in respect of interest arising to it in the other Contracting State.

Sub-clause (*ii*) of clause (*a*) of paragraph 4 of Article 11 refers to Japan Bank for International Cooperation as one of the financial institutions wholly owned by the Government.

By this notification both, the Government of India and the Government of Japan have omitted "Japan Bank for International Co-operation" from sub-clause (*ii*) of clause (*a*) of paragraph 4 of Article 11 and substitute therein "International business unit of Japan Finance Corporation"; This shall be deemed to have taken effect from 1st October, 2008.

2. Notification No. 97/2008, dated 10-10-2008

The Central Board of Direct Taxes has through the Income-tax (7th Amendment) Rules, 2008 substituted Rule 6DD with effect from Assessment year 2009-10.

3. Notification No. 98/2008 [F.NO. 142/12/2008-TPL], dated 22-10-2008

The Central Board of Direct Taxes has through the Income-tax (Eighth Amendment) Rules, 2008 inserted a new Rule 18DDA after rule 18DD, namely "Form of report for claiming deduction under sub-section (11C) of section 80-IB". This rule specifies that the report of an accountant required to be furnished by the assessee along with the return of income, under sub-section 80-IB (11C) shall be in Form No. 10CCBD.

For details visit: http://law.incometaxindia.gov.in/TaxmannDit/DisplayPage/dpage1.aspx?md=31

INDIRECT TAXES

EXCISE

I. Notifications

1. Notification No. 43/2008 CE (NT) dated 06.10.2008

The Notification has inserted two provisos after first proviso to sub-rule 2 and 3 of rule 9 of Central Excise Rules, 2002.

The second proviso lays down that if a person manufacturing Compressed Natural Gas (CNG) [falling under tariff item 2711 29 00 of the of First Schedule to the CETA, 1985 (5 of 1986)], has more than one premises requiring registration (which fall within the jurisdiction of one Chief CCE), he may obtain a single registration for all such premises with any of the CCE. If subsequent to obtaining such registration any additional premises are started, it should be intimated in advance.

The third proviso lays down that if the assessee is registered under the existing provision, he may apply for fresh registration or file amendment to the registration as the case may be, in accordance with provisions of this notification.

For details visit: http://www.cbec.gov.in/excise/cx-act/notfns-2k8/cent43-2k8.htm

2. Notification No.44/2008-Central Excise (N.T.), dated 6th October , 2008

The Central Board of Excise and Customs *vide* this notification made further amendment in the Notification 14/2002-Central Excise (N.T.) dated 08-03-2002: "Provided that the jurisdiction of the Commissioner of Central Excise, under whose jurisdiction a person manufactures Compressed Natural Gas falling under tariff item 2711 29 00 of the of First Schedule to the Central Excise Tariff Act, 1985 and has obtained a single registration for more than one premises in terms of the Notification No. 35/2001-Central Excise (N.T.) dated 26-06-2001, shall also extend to the entire jurisdiction of the concerned Chief Commissioner of Central Excise as specified in Table I for the said manufacturer."

For details visit: http://www.cbec.gov.in/excise/cx-act/notfns-2k8/cent44-2k8.htm

CUSTOMS

I. Circulars

1. Circular No.16/2008-Customs dated 13.10.2008

The Circular has clarified the following points relating to refund of 4% Additional Duty of Customs (4% CVD) and even in some cases relaxing the procedural requirement for expeditious sanction of refund claims:

(i) Time-limit for filing of refund claim;
(ii) Early processing of refund claims;
(iii) Early processing of refund claims;
(iv) Declaration for non-admission of Cenvat Credit;
(v) Payment of ST/VAT by cash or input tax credit;
(vi) Submission of original copy of ST/VAT Challan;
(vii) Unjust enrichment and its Certification by Chartered Accountants;
(viii) Consignment Agents;
(ix) Submission of refund claim for part of goods in a consignment.

For details visit: http://www.cbec.gov.in/customs/cs-circulars/cs-circulars08/circ16-2k8-cus.htm

2. Circular No.17/2008-Customs dated 21.10.2008

The Circular has clarified that import of readymade garments would be subjected to CVD only on the basis of transaction value and not on the basis of retail sale price.

For details visit: http://www.cbec.gov.in/customs/cs-circulars/cs-circulars08/circ17-2k8-cus.htm

OTHER ACTS

SEBI

I. Circulars

1. Cir No.IMD/FII&C/34/2008 dated 20-10-2008

SEBI has reviewed the data submitted by the foreign institutional investors in pursuance of our circular no. 32, dated October 16, 2008. SEBI disapproves of the activity of the foreign institutional investors lending shares abroad. The facility of lending and borrowing has been made available on Indian Exchanges. SEBI is reworking the existing stock exchange offered securities lending and borrowing mechanism, to make suitable changes. The custodians are requested to communicate to their FII constituents the disapproval of SEBI.

For details visit: http://www.sebi.gov.in/circulars/2008/fiicir3408.html

2. MRD/DoP/SE/Cir- 31 /2008, dated 31-10- 2008

The framework for Securities Lending and Borrowing (SLB) was specified vide circular no. MRD/DoP/SE/Dep/Cir- 14 /2007 dated December 20, 2007 w.e.f. April 21, 2008. Pursuant to feedback from market participants and proposals for revision of SLB received from NSE and BSE, the framework is being revised as under:

1. Tenure for SLB may be increased to 30 days from the present 7 days.

2. The SLB tenure of 30 days will result in the need for appropriate adjustments for corporate actions.

3. The time for SLB session may be extended from the present one hour (10 am to 11 am) to the normal trade timings of 9:55 am to 3:30 pm.

4. With regard to risk management in SLB, it is advised that common risk management practices shall be followed by stock exchanges for SLB. It is reiterated that the exchanges should ensure that the risk management framework strikes a balance between ensuring commercial viability of SLB transactions and ensuring adequate and proper risk management. Exchanges should satisfy themselves regarding the adequacy of the risk management system.

5. Exchanges and Depositories are advised to: a) take necessary steps and put in place necessary systems for implementation of the above at the earliest; b) make necessary amendments to the relevant bye-laws, rules and regulations for the implementation of the above; c) issue necessary instructions to the member brokers/clearing members and depository participants and also to disseminate the same on the website.

For details visit: http://www.sebi.gov.in/circulars/2008/cir312008.html

RBI

I. Circulars

1. DNBS (PD) CC. No.131/03.05.002 /2008-2009 dated 29- 10-2008

Taking into consideration, the need for enhanced funds for increasing business and meeting regulatory requirements, it has been decided that Systemically Important Non-Deposit taking Non-Banking Financial Companies (NBFCs-ND-SI) may augment their capital funds by issue of Perpetual Debt Instruments (PDI) in accordance with the guidelines. Such PDI shall be eligible for inclusion as Tier I Capital to the extent of 15% of total Tier I capital as on March 31 of the previous accounting year. The minimum investment in each such issue/tranche by single investor shall not be less than Rs 5 lakh. The amount of funds raised by NBFCs-ND-SI shall not be treated as 'public deposit' within the meaning of clause 2(1)(xii) of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998. The, amount of PDI in excess of amount admissible as Tier I shall qualify as Tier II capital within the eligible limits.

For details visit: http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=4588&Mode=0

LEGAL DECISIONS[1]

Direct Taxes

Section 43A of the Income-tax Act, 1961 — Special Provisions consequential to Changes in rate of Exchange of Currency [Assessment Year 1993-94]

For claiming deduction on account of foreign exchange rate fluctuation factual position is required

Commissioner of Income Tax, Rajkot v. M/s Gujarat Siddhi Cement Ltd. (Supreme Court) 17 October, 2008

The respondent/assessee claimed increased amount as deduction as investment allowance on account of increase in the cost of plant and machinery on account of exchange rate fluctuation. The assessing officer disallowed the claim on the ground that plant and machinery in respect of which there has been increase were installed in the earlier years. On appeal, the Commissioner upheld by the order of the Assessing Officer on the ground that no arguments were advanced and no factual details were furnished regarding the alleged fluctuation on account of foreign exchange rate.

The Supreme Court held that on a bare reading of the provisions of Section 43A(1) the position is clear that it relates to the fluctuation in the previous year in question. If any extra benefit is taken the same has to be taxed in the year when the liability is reduced as provided in terms of Section 41(1)(a) Explanation 2. Therefore, whenever there is fluctuation in any previous year, Section 43A (1) comes into play.

On facts, the Court held that it would be appropriate to grant opportunity to the assessee to establish the factual position relating to fluctuation in foreign exchange rate. The matter was therefore, remitted to the Tribunal to consider whether assessee is justified in claiming deduction in the background of Section 43A(1) as it stood then.

The appeal was disposed of.

Section 80-HH read with Section 80-I of the Income-tax Act, 1961 — Deductions – Profits and gains from newly established industrial undertakings or hotel business in backward areas

Deduction under Sections 80-HH and 80-I is allowable as ship breaking activity gives rise to production of a distinct and different article

Section 195 of the Income-tax Act, 1961 – Deduction at source – Other sums

Usance interest is exempt from payment of income tax if paid in respect of ship breaking activity and thus assessee was not bound to deduct tax at source under section 195(1)

Vijay Ship Breaking Corporation & Ors. v. Commissioner of Income Tax, Ahmedabad (Supreme Court) 1 October, 2008

Issues before the Supreme Court were: (1) Whether appellant-assessee was entitled to deduction under Sections 80-HH and 80-I in respect of ship breaking activity undertaken by it and (2) Whether 'usance interest' partakes of the character of purchase price and, therefore, not liable to deduction at source under Section 195(1).

As regards to deduction under Sections 80-HH and 80-I the Supreme Court held that ship breaking activity gave rise to the production of a distinct and different article. Hence, deduction under Sections 80-HH and 80-I is allowable.

As regards to deduction at source under Section 195(1) the Supreme Court held that usance interest is exempt from payment of income tax if paid in respect of ship breaking activity. The assessee was not bound to deduct tax at source once Explanation-2 to Section 10(15)(iv)(c) stood inserted as TDS arises only if the tax is assessable in India. Since tax was not assessable in India, there was no question of TDS being deducted by the assessee.

The appeals were disposed of.

Section 80-I of the Income Tax Act, 1961 - Deductions - Profits and gains from industrial undertakings after a certain date [Assessment Year 1993-94]

Whether receipt of service charges was or was not directly linked with the manufacturing activity carried out in the industrial undertaking of the appellant

Krishak Bharati Cooperative Ltd. v. Joint Commissioner of Income Tax (Supreme Court) 21 October, 2008

[1]These cases have been compiled and contributed by www.Indlaw.com. Readers are invited to send their comments on the selection of cases and their utility at eboard@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=2583

Edited by Journal Section ICAI

Appellant/assessee is a multi-state Cooperative Society engaged in the business of manufacturing urea and ammonia at its Plant at Hazira. Appellant used to supply ammonia gas through pipe connections from its plant at Hazira directly to the Heavy Water Plant (HWP) of the Heavy Water Board (HWB). The HWP is located next to the appellant's plant. In fact, it is in the precinct of the appellant's plant. In view of an agreement executed between the appellant and HWB, appellant was entitled to be reimbursed for the cost of ammonia manufactured by it and supplied to the HWB and in addition thereto it was also entitled to receive service charges and incentives from HWB. The Commissioner (Appeals) held that since the receipt of service charges was not directly connected or linked with the manufacturing activity carried out in the industrial undertaking of the assessee, the service charges received by the assessee from the activity of producing Heavy Water cannot be considered as the profit derived from its industrial undertaking so as to qualify for deduction under Section 80-I.

The Supreme Court held that prima facie one finds that Hazira Ammonia Extension Plant (HAEP) is an extension of the Ammonia Plant of the appellant then the question which arises is whether the above process constituted manufacturing activity carried out in the industrial undertaking of the appellant. Another feature to be noticed in this regard is that the Department of Atomic Energy entered into an agreement with the appellant to set up HAEP in the premises of the appellant's Ammonia Plant. Hence, the entire scheme was based on the principle of functional interdependence between the two plants.

On the above discussion the judgment of the High Court was set aside and the matter was remitted back to the Tribunal for reconsideration of the matter in accordance with law.

Sections 273A read with Section 139(8) of the Income-tax Act, 1961 — Penalty — Power to Reduce or Waive, in certain cases [Assessment Year 1985-86 to 1989-90]

Late filing of return by itself cannot be the only reason to reject an application for waiver of penalty in case of return filed voluntarily and in good faith

Madhuri, Akola v. Commissioner of Income Tax, Vidarbha Region, Nagpur (BOM) 7 August, 2008

The petitioner is a house wife and earning through the private tuitions. She voluntarily submitted the returns of income in good faith and in response to the general representation by the Deputy Commissioner of Income Tax, that department would be waiving interest and penalty of those who have not filed returns though have assessable income. Returns were duly accepted by Assessing Officer under Section 143(1). However, the petitioner's request for waiver of interest and penalties was rejected.

The High Court held that in the instant case there was no dispute that the return was filed before any demand notice was issued by the department. The returns were admittedly filed late but considering the scheme of Section 273A and as all the ingredients are available, the Assessing Officer ought to have considered the case in view of the scheme and purpose of Section 273A. The reason given by Assessing Officer to reject petitioner's application was insufficient and there was failure to consider all the elements to exercise the power and discretion as contemplated under scheme of the Section 273A. The late filing of return by itself cannot be the only reason to reject the application in case of return filed voluntarily and in good faith like present one, as those were filed even prior to the notice or any such demand.

The petition was allowed.

Section 273A read with Sections 139(8) and Section 217 of the Income Tax Act, 1961 — Penalty — Power to Reduce or Waive, in certain cases [Assessment Year 1984-85 to 1988-89]

Section 273A(1)(a) requires a disclosure of full and true income and not the filing of valid returns in time before issue of notice under Section 139(2) or Section 148

Vasantbhai Jethalal Lathiwala v. Commissioner of Income Tax, Vidarbha Region, Nagpur (BOM) 7 August, 2008

The petitioner is a Karta of HUF. He voluntarily and in good faith pursuant to the assurance given by the Income Tax Department made a full and true disclosure of his income before issuance of any notice. The respondent issued notice under Section 148. The Income Tax Officer charged interest for all the years under Section 139 for late filing of returns and charged interest under Section 217 for nonpayment of advance tax. The Commissioner has rejected the application filed by the petitioner.

The High Court observed that the Commissioner has relied the case of Saberaj Industries vs. F.J.Bahadur

C.I.T., 1995 (127) CTR (Bom) 395 and held that since the returns filed by the assessee on 13/3/1992 were regularised subsequent to issue of notice under Section 148, the precondition of disclosure of income before issue of notice under Section 273A was not fulfilled and thereby not gone into the merits of matter. But the Commissioner failed to consider that in that case returns for three years were true and complete out of eight years returns and therefore, the court refused to interfere with the said order. However, in the instant case the Commissioner, wrongly overlooked the judgment passed in B.R.Sound-N-Music vs. O.P.Bhardwaj and another 1988 (173) ITR 433 passed by this court against which the Special Leave Petition was dismissed by the Supreme Court. In B.R.Sound-N-Music's case (supra) *it is specifically observed that Section 273A(1)(a) requires a disclosure of full and true income and not the filing of valid returns in time before issue of notice under Section 139(2) or Section 148. It is necessary for the commissioner to take into consideration all the material available on the record.*

Hence, the order passed by the Commissioner was quashed and set aside.

Section 37(1) read with Section 145 of the Income-tax Act, 1961 – Business Expenditure – In which year it is allowable [Assessment Year 1998-1999]

Allowability of the sum provided under the head "salaries and wages", pending revision

Central Government Employees Consumer Cooperative Society Limited v. Commissioner of Income Tax (Delhi), 19 September, 2008

The assessee had provided for a sum under the head "salaries and wages", pending revision. The Assessing Officer found that the liability had been provided for in relation to wage revision implemented with effect from 01.07.1997. But, the liability on account of wage revision had not been ascertained and had not accrued during the year which ended on 31.03.1998. The Assessing Officer disallowed it for the assessment year 1998-1999. The assessee placing reliance on Accounting Standard 4 issued by the Institute of Chartered Accountants of India contended that note of significant events occurring after the balance sheet date was required to be taken.

The High Court observed that although the Tribunal took the view that no notification had been issued by the Central Government indicating the approval to Accounting Standard 4 in terms of Section 145(2), the Tribunal discussed the applicability of Accounting Standard 4 itself and concluded that the same was not, in any event, applicable in the facts of the present case. On facts, the Tribunal observed that in the case of the assessee the condition existing on the balance sheet date, i.e., *on 31.03.1998 was, at best, the revision of pay being contemplated with effect from 01.07.1999. The Tribunal further observed that there was no indication of any revision of the pay scales payable by the assessee for the year 01.07.1997 to 31.03.1998. Consequently, the Tribunal returned a finding of fact that the liability itself had been incurred by the assessee only during the financial year 1998-1999. The High Court therefore held that the decision arrived by the Tribunal was correct in law. The appeal was dismissed.*

Section 273 read with Section 215 of the Income-tax Act, 1961— Penalty – False estimate of, or failure to pay, advance tax [Assessment Year 1979-80 and 1980-81]

For imposing penalty, mens rea on the part of assessee would have to be shown

Commissioner of Income Tax, Ahmedabad v. Sarabhai Holdings Pvt. Ltd (Supreme Court), 21 October, 2008

The assessee followed the Mercantile System of Accounting. There was an agreement whereby the assessee agreed to transfer its industrial undertaking and business activity in favour of the assessee's own subsidiary X. The agreement provided for an interest clause, which was agreed at the rate of 11% per annum and that it would be payable on balance sale consideration which would remain unpaid from time to time. X transferred the undertaking to Y and wrote a letter on 15.6.1978 to the assessee proposing modification in terms of payment and requested, *inter alia*, that the interest be charged on deferred sale consideration from 1.7.1979 instead of 1.3.1977. Accordingly, a Resolution dated 30.6.1978 was passed, doing away with the requirement of payment of interest. The assessee claimed waiving of interest as a natural corollary of the Resolution dated 30.6.1978. However, the assessee was asked to pay advance tax. The assessee filed an estimate, showing nil amount of advance tax payable. The Assessing Officer levied interest under Section 215 on a finding that the assessee had failed to pay advance tax. The Assessing Officer also directed

that the penalty proceedings under Section 273(2)(a) and 271(1)(c) should be initiated against the assessee.

The Supreme Court held that the letter dated 15.6.1978 was complied with by X in providing adequate security of the payable amounts, hence, there is nothing to dispute or suspect the genuineness of the transaction. The whole transaction would have to be viewed on that backdrop. In the commercial world, the parties are always free to vary the terms of contract. Merely because by Resolution dated 30.6.1978, the assessee agreed to defer the payment of interest, would not mean that it tried to evade the tax. What is material in the tax jurisprudence is the evasion of the tax, not the beneficial lawful adjustment therefor. Considering the genuine nature of the transaction based on the letter dated 15.6.1978 and the Resolution dated 30.6.1978, it could not be said that the whole transaction was in order to evade the tax.

Further the Supreme Court held that the High Court took the view that the levy of interest under Section 215 and the levy of penalty under Section 273(2)(a) stand on different footings. Indeed, while the levy of interest under Section 215 is automatic, that is not the case with the penalty under Section 273(2)(a), where the mens rea on the part of the assessee would have to be shown to the extent, it has been indicated in the language of the Section, where, therefore, there was some scope for the assessee to justify the estimate given by it and that the penalty could not be inflicted. Indeed, if the assessee proceeded on the basis of Resolution dated 30.6.1978, it has to be held that the assessee had reasonably believed that the income of interest which was written off by the Resolution, could not be added to its income. If it genuinely proceeded under that bonafide impression, then, the High Court was right in writing off the penalty and upsetting the view of the Tribunal.

The appeals were dismissed.

Indirect Taxes

Excise & Customs

Section 28 of the Customs Act, 1962 — Notice for payment of duties, interest etc.

Rule 2(a) of the Interpretative Rules would not be applicable since there is no question of the goods having the essential character of CTVs

Commissioner of Customs, New Delhi v. Sony India Limited (Supreme Court), 23 September, 2008

The issue before the Supreme Court was that whether Rule 2(a) of the Interpretative Rules can be applied, as to whether the benefit of Notification exempting components only will be available, if the product is considered as complete or finished article by virtue of deemed provision of Rule 2(a), and whether the change effected in Explanatory Notes of HSN will give only prospective application or it will be applicable.

The Supreme Court observed that the goods brought in different consignments separately on the basis of valid import licences would not attract the import duty as if they were the finished goods. Rule 2(a) would not be applicable since there is no question of the goods having the essential character of CTVs.

The appeal was dismissed.

Section 108 of the Customs Act, 1962 — Search, Seizure and Arrest - Power to summon persons to give evidence and produce documents

Power to arrest is circumscribed by objective considerations and cannot be exercised on whims, caprice or fancy of the officer

Union of India v. Padam Narain Aggarwal etc. (Supreme Court), 3 October, 2008

In view of non-co-operation by the respondents, complaints were filed by the Custom Authorities for commission of offences punishable under Sections 174 and 175 of the IPC. On knowing this the accused made applications for anticipatory bail before the District and Sessions Court which were dismissed. On appeal, the High Court disposed of the applications by directing the Customs Authorities not to arrest the respondents of any non-bailable offence without ten days prior notice to them.

The Supreme Court observed that the respondents were only summoned under Section 108 for recording of their statements. The High Court was conscious and mindful of that fact. It, therefore, held that applications for anticipatory bail, in the circumstances, were pre-mature. They were, accordingly, disposed of by directing the respondents to appear before the Custom Authorities. The Court, however, did not stop there. It stated that even if the Custom Authorities find any non- bailable offence against the respondents, they shall not be arrested "without ten days prior notice to them. Neither of the above directions

can be said to be legal, valid or in consonance with law. Firstly, the order passed by the High Court is a blanket one as held by the Constitutional Bench of this Court in Gurbaksh Singh Sibbia & Ors. v. State of Punjab, (1980) 2 SCC 565, and seeks to grant protection to respondents in respect of any non-bailable offence. Secondly, it illegally obstructs, interferes and curtails the authority of Custom Officers from exercising statutory power of arrest a person said to have committed a non -bailable offence by imposing a condition of giving ten days prior notice, a condition not warranted by law. The order passed by the High Court to the extent of directions issued to the Custom Authorities was, therefore, liable to be set aside.

The appeal was partly allowed.

Section 2(f) of the Central Excise Act, 1944 — Manufacture

Cutting and slitting of steel sheets and polyester films used for lamination purposes do not amount to manufacture

Commissioner of Central Excise, Mumbai v. M/s Rajpurohit GMP India Ltd. & Ors. (Supreme Court) 14 October, 2008

Section 11A of the Central Excise Act, 1944 - Recovery of duties not-levied or not-paid or short-levied or short-paid or erroneously refunded

Revenue was not justified in invoking the extended period of limitation

Commissioner of Central Excise, Kanpur v. M/s. New Decent Footwear Industries (Supreme Court), 25 September, 2008

In this case, composite appeal filed by the Firm and the partners was partly accepted in the case of partners. Against the Firm the demand was confirmed. The Revenue did not file any appeal against the order passed in favour of "X", the company to whom the Firm was supplying its proucts and the partners. The Tribunal held that the Revenue was not right in invoking extended period of limitation under the proviso to Section 11A.

The Supreme Court held that as the Revenue had accepted the decision in the case of X arising from the same order of the authority in original and there being no change on the facts, the appeal against the respondent firm could not be proceeded with. Further, the Revenue was not justified in invoking the extended period of limitation.

The appeal was dismissed.

Section 37B of the Central Excise Act, 1944 — Instructions to Central Excise Officers

A circular which is contrary to the statutory provisions has really no existence in law

Commissioner of Central Excise, Bolpur v. M/s Ratan Melting & Wire Industries (Supreme Court) 14 October, 2008

The Supreme Court held that Circulars and instructions issued by the Board are no doubt binding in law on the authorities under the respective statutes, but when the Supreme Court or the High Court declares the law on the question arising for consideration, it would not be appropriate for the Court to direct that the circular should be given effect to and not the view expressed in a decision of this Court or the High Court. A circular which is contrary to the statutory provisions has really no existence in law.

Service Tax

Sections 76 read with Sections 77 and 78 of the Finance Act, 1994 read with Section 35F of the Central Excise Act, 1944 — Penalty for failure to pay service tax

For the purpose of arriving at a finding as to undue hardship, the case as a whole should have been considered by the appellate authority

Devi Constructions, Erode v. Commissioner of Central Excise, Salem (MAD), 15 October, 2008

The respondent/appellate authority had directed the petitioner to make the payment of pre-deposit within 30 days for the purpose of enabling the respondent to hear the appeal. The petitioner has not raised any point about the financial hardship and even at the time of hearing the appeal, any such hardship had not been contended. Whether respondent was justified in directing payment of entire service tax due for the purpose of admitting the appeal without by itself considering undue hardship?

The High Court held that for the purpose of arriving at a finding as to undue hardship, the case as a whole should have been considered by the appellate authority. The Appellate Tribunal before passing any interim

order shall consider whether the direction for deposit as pre-deposit condition would cause undue hardship to the person against whom such direction is issued. Such a finding is not available in the impugned order of the respondent, nor did the respondent decide the prima facie *issue. It is not proper on the part of the respondent to come to the* prima facie *conclusion that the petitioner is liable to pay tax for all the works as assessed by the original authority.*

The petition was disposed of.

Sales Tax / VAT

Rule 31B of the Bombay Sales Tax Rules, 1959 — Incentives — Entitlement

An existing unit is entitled to the incentives under the 1993 scheme irrespective of the increase in the production capacity

Commissioner of Sales Tax, Mumbai v. Pec Vee Textile Limited, Wardha (BOM), 13 October 2008

The issue under consideration is whether the Deputy Commissioner of Sales Tax could impose conditions to the effect that the incentives can be availed proportionately to the production of the finished products attributable to the newly acquired fixed assets?

The High Court held that the 1993 scheme as amended in 1994 makes a specific departure from the earlier schemes and provides for availing the incentives not on the proportionate basis but on the total production of the Existing Unit. In these circumstances, imposing conditions for availing the incentives on prorata basis would be contrary to the 1993 scheme of incentives. Therefore, additional investment made by the assessee for modernisation and upgradation of the existing plant did not result in increase in the production capacity of the plant. Merely because an existing unit is entitled to the incentives on acquisition of requisite new fixed assets and merely because the incentives are to be availed on the finished products, it cannot be presumed that the incentives under the 1993 scheme are to be availed on the finished products attributable to the fixed assets newly acquired by the existing unit. Since increase in the production capacity of the existing unit acquiring new fixed assets, is not the criteria for entitlement of incentives under the 1993 scheme, availing the incentives under the 1993 scheme proportionate to the production attributable to the newly acquired fixed assets does not arise at all. Rule 31B does not provide for availing the incentives under the 1993 scheme in proportion to the production attributable to the newly acquired fixed assets. An existing unit is entitled to the incentives under the 1993 scheme irrespective of the increase in the production capacity.

The applications were disposed of.

Other Acts

Arbitration Act

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

Where conditions indicate to existence of an arbitration agreement, matter should be referred to an Arbitrator

M/s. Unissi (India) Pvt. Ltd. v. Post Graduate Institute of Medical Education & Research (Supreme Court), 1 October, 2008

Tender floated by the Respondent/PGI contained an arbitration clause. The appellant gave an offer for the tender which was accepted by the Respondent. Purchase orders were placed and in compliance with the said order, the appellant had supplied equipments. The delivery of equipments was also accepted by the Respondent and the machineries were installed however, no payment was made to the appellant. The Respondent demanded the execution of an agreement containing an arbitration clause on a non-judicial stamp paper duly signed. The appellant signed the agreement and sent it to the Respondent. The Respondent though admittedly received the same, did not send back the agreement to the appellant. It was alleged by the Respondent that no arbitration agreement was executed between the parties and, therefore, question of appointing an Arbitrator could not arise. The Additional District Judge held that it could not be held that the appellant was entitled to ask for appointment of an Arbitrator under Section 11.

The High Court held that the tender documents itself contain an arbitration clause and by reason of acceptance of the tender of the appellant by PGI, it must be held that there was a valid arbitration agreement between the parties.

Further, although no formal agreement was executed, the tender documents indicating certain conditions of contract contained an arbitration clause. Since, an arbitration agreement did exist in the instant case, the matter should be referred to an Arbitrator for decision. Accordingly order passed by the Learned District Judge was set aside.

The appeal was allowed.

Money Laundering

Section 1 of the Prevention of Money Laundering Act, 2002 — Constitutional validity of

Constitutional validity of the Act

Pareena Swarup v. Union of India (Supreme Court) 30 September, 2008

The Appellant filed a writ petition contending that the provisions of the Act are so provided that there may not be independent judiciary to decide the cases under the Act but the Members and the Chairperson are to be selected by the Selection Committee headed by the Revenue Secretary. The Constitutional guarantee of a free and independent judiciary and the constitutional scheme of separation of powers can be easily and seriously undermined, if the legislatures were to divest the regular Courts of their jurisdiction in all matters, entrust the same to the newly created Tribunals. The Respondent placed on record that the suggested actions have been completed by amending the Rules.

The Court observed that it is necessary that the Court may draw a line which the executive may not cross in their misguided desire to take over bit by bit and judicial functions and powers of the State exercised by the duly constituted Courts. While creating new avenue of judicial forums, it is the duty of the Government to see that they are not in breach of basic constitutional scheme of separation of powers and independence of the judicial function. We agree with the apprehension of the petitioner that the provisions of Prevention of the Money Laundering Act are so provided that there may not be independent judiciary to decide the cases under the Act but the Members and the Chairperson to be selected by the Selection Committee headed by Revenue Secretary. Further, as the amended/proposed provisions are in tune with the scheme of the Constitution as well as the principles laid down by this Court, the same is approved and the respondent-Union of India is directed to implement the above provisions.

The writ petition was disposed of.

MRTP

Section 36A of the Monopolies and Restrictive Trade Practices Act, 1969 — Unfair Trade Practice

Section 36A does not apply in a situation where goods are not sold at all

Philips Medical Systems (Cleveland) Inc. v. Indian MRI Diagnostic and Research Limited and Another (Supreme Court), 29 September, 2008

The appellant is a company based in USA engaged in the business of manufacturing and selling of various medical diagnostic equipment. Respondent No. 1 wanted to purchase a Whole Body CT Scanner and held negotiations for the same with the appellant. The First Offer lapsed without being accepted on the expiry of 90 days as import licence was not forwarded by respondent No. 1 within the validity period. A Second Quotation was accepted by respondent No. 1, which was duly endorsed by respondent No. 2. The Letter of Credit (L/C) had been opened for a sum quoted in the first offer instead of the agreed price through the second offer. Respondent No. 2 refused to amend the L/C and wanted the appellant to falsify the shipping documents. The L/C was never encashed by the appellant and was returned to respondent No. 1. Respondent Nos. 1 & 2 filed a complaint before the MRTP Commission. MRTP Commission allowed the complaint and has held the appellant guilty of unfair trade practice and directed to pay compensation.

The Supreme Court held that Section 36A does not apply in a situation where goods are not sold at all. It only applies where goods are sold. Section 36A was really meant to protect consumers against defective goods or goods sold which do not have features or qualities which they were represented to have. Since the appellant did not sell the CT scanner at all to the respondent, Section 36A is not attracted at all.

Per Altamas Kabir, J. :

However, there may be situations where a promise to supply a particular good, which the supplier knew that he was in no position to supply, with a motive of promoting of some other model, as has happened in the instant case, could occur. In such a case a customer may be forced to obtain the same material from some other party and suffer losses in the process. Therfore, even without actual sale of goods, such an act on the part of the supplier could also amount to 'unfair trade practice' and Section 36-A cannot in absolute terms be said not to apply to a situation where goods may not have been sold at all. In fact, such a situation may also be covered even by the provisions of Sub-clause (ii) or (vi) of sub-section (1) of Section 36-A.

The appeal was allowed.

DISCIPLINARY CASE

Summary of a disciplinary case - Council of the Institute of Chartered Accountants of India vs. Shri Vijay R. Ashar[1] (Chartered Accountant Reference No. 4 of 2001) decided on 13.08.2004 by the Bombay High Court under Section 21(6) of the Chartered Accountants Act, 1949.

Facts of the case:

Shri Bharat D. Bhatia , Mumbai (hereinafter referred to as 'Complainant') filed a complaint against Shri Vijay R. Ashar, Chartered Accountant (hereinafter referred to as 'Respondent') under Section 21 of the Chartered Accountants Act, 1949 (the Act) to the Institute of Chartered Accountants of India (Institute) alleging, *inter alia*, that in spite of the reason that the wife of the Respondent is a Director and holding substantial interest (more than 20% shares) in the Jamnadas Rutonsi Pvt. Ltd. (Company), the Respondent accepted the appointment as auditor of the Company for the period from about 1984 to 4th December, 1990. Further, in spite of the clear provision in the guidelines issued by the Institute, the Respondent wilfully and deliberately did not disclose the interest in the aforesaid Company during the entire period when he was the statutory auditor of the Company. It was further alleged that the Respondent had always sought to directly and indirectly exert influence and control over the day-to-day workings of the Company. Soon after his appointment as auditor of the Company, the Company made a fresh Issue of Shares on his advice as a result of which the percentage shareholding of his wife in the Company increased substantially. Therefore, by acting as auditor of the Company and failing to disclose the interest of his wife in the same Company, the Respondent had committed grave and serious breach of the guidelines issued by the Institute.

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. The Disciplinary Committee on perusal of the documents on record, after recording of evidence and hearing of the submissions made by the parties came to the conclusion that the Respondent by not having disclosed his interest in the audit report, had violated Clause (4) of Part I of the Second Schedule of the Act in terms of Section 21 and 22 and that he was not guilty of the second charge that he was exercising his influence over the management of the Company to the detriment of the Complainant. The Disciplinary Committee was also of the opinion that the said violation under Clause (4) of Part I of the Second Schedule was only technical in nature.

The Council on consideration of the report of the Disciplinary Committee alongwith the written representations and also oral submissions of the parties, accepted the Report of the Disciplinary Committee and found that the Respondent was guilty of professional misconduct within the meaning of Clause (4) of Part I of Second Schedule in terms of Section 21 read with Section 22. The Council recommended to the High Court that the Respondent be reprimanded. As required under Section 21(5), the matter was referred to the Bombay High Court with the recommendations of the Council.

The Judgment of the Division Bench of the Bombay High Court comprising of Hon'ble Mr. Justice R.M. Lodha and Hon'ble Mr. Justice J.P. Devadhar is summarized below.

Decision of the Hon'ble Court:

The Hon'ble Court observed that Smt. Dipika V. Asher, wife of the Respondent was examined before the Committee. She admitted that she was the director of the company viz. Jamnadas Rutonsi Pvt. Ltd. and she held initially 90 shares in the year 1984 and thereafter 150 further shares. The Court also observed that it appears that the wife of the Respondent had holding of more than 20% shares in the said company.

The Hon'ble Court further observed that Code of Conduct for the chartered accountants framed by the Institute of Chartered Accountants of India provides that where the partner or relative of the member as a director in the company holds substantial interest, the member may desist from the undertaking audit of the financial statements and/or expression of opinion and if the member feels that his independence is not affected and undertakes the audit of such company, he should disclose such interest in his report while expressing his opinion on the financial statement of such company. The explanation of the Respondent before the Disciplinary Committee was that he was ignorant of the said guidelines. The Court was of the view that the explanation put forth by the Respondent was hardly acceptable. It could not be believed that as a professional chartered accountant in practice, he was not aware of the guidelines and the Code of Conduct framed by the Institute of Chartered Accountants of India.

The Hon'ble Court, accordingly, concurred with the finding recorded by the Disciplinary Committee and accepted by the Council, that the Respondent had violated Clause (4) of Part I of the Second Schedule of the Act. Accordingly, the Court held that the recommendation of the Council that the Respondent be reprimanded is reasonable and rather lenient.

[1]For full text of the Judgment please see Institute's publication viz. Disciplinary Case Vol.VIII, Part I, p. 825

THE CREDIT CRISIS OF 2008: CAUSES, CONSEQUENCES AND IMPLICATIONS FOR INDIA

The ripple effects of global credit crisis has hit world economy hard, triggering global recession. India is no exception to the woes of this financial meltdown as it has led to some credit squeeze and erosion of huge amounts of investor wealth. It, however, is in far more comfortable position than many other nations. This scenario offers an opportunity to India to learn from America's mistakes and take corrective, preventive measures. This article discusses the causes and consequences of the crisis, its impact on India and the lessons that need to be learnt by the country.

To understand the genesis of the current financial meltdown we need to start with the US housing market, a $22.5 trillion major economic driver larger in size than the US stock market. The US housing market witnessed an unprecedented run-up in prices from the mid 1990s until it peaked in mid 2006.[1] Between 1997 and 2006, home prices increased by nearly 85% overall[2] with a per year compound rate of 12% between 2000 and 2005.[3] Ratios of home prices to household incomes were at an all time high and appeared unsustainable. Low interest rates made borrowing money cheap and fueled the rise in home prices. Low inflation, in turn, kept interest rates down during this period, and low unemployment allowed people to feel comfortable taking on more debt. Easy access to cheap credit during a period of very high appreciation in real estate prices meant that builders and real estate speculators made healthy profits. As a re-


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[1]Standard Standard & Poors, Case Shiller Index Website, http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,0,0,2,1,0,0,0,0,0.html, excel file dated August 2008, accessed November 12, 2008.
[2]Report and Recommendations by the Majority Staff of the Joint Economic Committee, "The Subprime Lending Crisis," October 2007, pp. 2 and 3.
[3]Ken Leon, "Industry Surveys Home Building," Standard & Poors. July 3, 2008, p. 9.

It took nearly a year of falling home prices and subsequent mortgage defaults to leak into the larger economy. Lenders with a significant sub-prime loan portfolio were affected first. $56 billion New Century Financial Corporation, one of the largest subprime lenders in the United States, was one of the first banks to fail. Over 150 prime and subprime lenders also failed in 2007.

sult, they continued to build, leading to an oversupply of homes. Building of single family homes peaked in 2005, with 1.7 million single family housing starts that year.[4] Renters saw the amazing appreciation on their neighbor's houses and decided to take the plunge. Home owners, buoyed by the profit they made on their primary homes, bought second homes and vacation homes in large numbers; 12% of all homes purchased in 2007 were vacation homes and 21% were purchased for investment.[5]

Rather than opting for the traditional fixed-rate mortgage, home buyers took on risky adjustable rate mortgages, where the interest rate they paid fell or rose with the interest rate in the economy. Homeowners refinanced their mortgages within a few months of purchase at lower interest rates, and continued to refinance, cashing in the equity that had appreciated on their homes to pay the mortgage or for discretionary spending. The spiral of rising home prices led to increased borrowings that then allowed home owners to spend and consume more than was sustainable, but this underlying weakness was masked as long as home prices appreciated and interest rates stayed low. Refinancing accounted for 66% of the $3.8 trillion in mortgage originations in 2003, and continued to remain high through 2007, at 52% of the $2.4 trillion originations that year.[6] Looking back at that period and the number of refinance and easy credit advertisements that proliferated at the time, it is obvious that the United States was in a massive housing bubble. Unfortunately, it is the hallmark of all epic bubbles that few realize they are in one until it is too late.

The Rise of Subprime

The idea that housing prices would only appreciate caused US banks and mortgage companies to loosen their credit standards and start lending to families with no credit history and only tenuous ability to service their mortgages. Subprime lending, which in the US context meant lending to homeowners with less than stellar credit histories, grew rapidly during the housing bubble and more than tripled from $190 billion in 2001 to $625 billion in 2005.[7] The US Government actively encouraged banks to lend to low income families with the belief that home investment in poor and urban neighborhoods would strengthen weak economies in those areas. Mortgage brokers, many of whom were paid on volume of loans originated rather than on the quality of those loans, sold adjustable rate mortgages to people who did not have the ability to sustain them.

The first death knell for subprime mortgage holders was the increase in oil and commodity prices, which pushed up inflation and the all-important interest rates. In 2006, when the housing bubble burst and home prices stopped their steep ascent and interest rates rose simultaneously, the game was up for many subprime borrowers. Unable to meet higher payments (in some cases a 30% increase in their monthly payment) when their mortgages reset to the higher interest rates, subprime borrowers began defaulting on their mortgages in large numbers. In cases where the home prices dropped, some owed more money than they could obtain from the sale of the house. In these cases, home owners walked away from their debt, leaving the deed to the house with the bank or mortgage company. The US government estimated that starting in March 2007, three million subprime and nonprime mortgages worth $600 billion would reset their interest rates higher by 2010. It conservatively estimated that 2.2 million loans (worth $164 billion) would foreclose.[8] By October 2007 home builders' expectations for the housing market had reached historic lows.[9] By some estimates, the total loss in real estate values since 2006 have exceeded $5 trillion.

Housing bubbles and aggressive lending by financial institutions, followed by increasing interest rates and defaults by borrowers has happened before in the United States, most recently during the Savings and Loan crisis in the mid 1980s. What makes the current crisis unique is its severity and global reach. The

[4]Ibid., p. 4.
[5]Reuters, "Second-Home Sales Accounted for One Third of Transactions in 2007," March 28, 2008, http://www.reuters.com/article/pressRelease/idUS145670+28-Mar-2008+PRN20080328, accessed November 12, 2008.
[6]Kevin Cole, "Industry Surveys, Savings & Loans," Standard & Poors, July 24, 2008, p.2.
[7]"The Subprime Lending Crisis," p. 10.
[8]Ibid., p. 7.
[9]Ibid., p. 5.

The Role of the Run-Up and the Eventual Crash in Real Estate Prices, The Unsustainable Euphoria that Accompanies Bubble Markets, the Securitization of Home Mortgages, and the Low Interest Rate Environment were Factors that Set the Stage for the Financial Meltdown. Nearly Every Entity that was Involved in the Subprime Crisis Bears Some Blame.

crisis spread from the subprime market to engulf the broader mortgage industry and the entire banking industry in the United States, while simultaneously affecting financial institutions in several industries and governments, and threatening to bankrupt the small country of Iceland. To explain why a relatively small sector (subprime mortgages) of the US economy was able to infect the entire globe, we need to first understand what happens to a home mortgage in the United States after a consumer borrows money from a local bank to finance a home purchase.

The US Mortgage Industry

The US mortgage industry has two sub-markets, the primary market (loans between the home buyer and the lender) and the secondary market (loans sold as investments). There are four types of players in the secondary mortgage market, and many companies perform more than one function[10] :

- Originators: local, regional, and national banks and thrifts, mortgage banks, and mortgage brokers
- Aggregators: large mortgage banks, financial firms, investment banks, and government sponsored entities (GSEs)
- Securities dealers: broker/dealers in financial firms and investment banks that specialize in mortgages
- Investors: foreign governments, pension funds, investment banks, banks, hedge funds, GSEs

Prior to the 1990s, originators sold some of their mortgages to Government Sponsored Entities, such as Fannie Mae and Freddie Mac, at a higher price than the loan amount. Because banks were constrained as to the level of debt they carry on their balance sheets, selling mortgages to GSEs allowed them to originate more mortgages to home owners, thereby earning more fees and interest. Fannie and Freddie, because they were implicitly backed by the US Government, could borrow money through the bond market at rates lower than those generally available to commercial banks and thrifts.[11] Fannie was chartered by the US Congress in 1938 after the Great Depression as a way to create a secondary mortgage market, acting as an intermediary between loan originators and investors, thereby injecting liquidity and stability into the home mortgage market. Both Fannie and Freddie, also known as agencies, were further directed by Congress to focus mortgage buying efforts in underserved urban areas and low and middle income buyers.[12] The monthly payments from the homeowners to service their loans were passed on by the local bank to the GSEs. The GSEs would, in turn, aggregate and package mortgages into Mortgage Backed Securities (MBS), guarantee them, and sell them to investors through securities brokers in a process called securitization.

These MBS were considered low risk and were rated highly. Investors, such as foreign governments and other institutions, bought the agency issued securities from brokers under the implicit assumption that these securities were guaranteed by the US government through the GSEs that issued them. This process of securitization allowed investors from all over the world to safely lend money to help finance home purchases in the United States and to earn a modest rate of return for their fixed-income portfolio of investments.

Innovation in Secondary Market

Investment banks that handled the bond sales for the GSEs noticed that there was an enormous appetite for MBS from investors all over the world. Moreover, some investors were willing to take on more risk but demanded higher yields than were available from the MBS issued by GSEs. Investment banks and larger mortgage financing companies looked for ways to enter this growing market and started replicating the role of GSEs, aggregating the loans in addition to simply passing them through their pipelines. They

[10]Barry Nielson, CFA, "Behind The Scenes Of Your Mortgage," Investopedia, A Forbes Digital Company, http://www.investopedia.com/articles/pf/07/secondary_mortgage.asp, accessed November 12, 2008.
[11]Kevin Cole, p. 5.
[12]The charter specifically states that Fannie should "provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing," Federal National Mortgage Association Charter Act, p.1, http://www.ofheo.gov/media/pdf/FNMcharter406.pdf, accessed November 12, 2008.

India has an opportunity to learn from America's mistakes. It should develop secondary markets carefully and thoughtfully, with appropriate regulation, infrastructure, and disclosure requirements. In the primary market, lenders must monitor borrowers' credit histories and track credit scores. India has already experienced some of America's problems.

bought home mortgages from local banks and mortgage originators, picking mortgages based on computerized programs that modeled risk levels. Investments banks took mortgages from various parts of the United States to mitigate the risk; the theory being that even if one area became depressed the other regions would still be good investments. The models became even more sophisticated over time, mixing and matching mortgages from certain cities, neighborhoods, types and lengths of mortgages, types of homes, and prices of homes. The investment banks aggregated the mortgages and then repackaged them into Special Purpose Entities (SPEs)—such as Collateralized Mortgage Obligations (CMOs) and Collateralized Debt Obligations (CDOs)—that varied in risk level. The SPE then sold classes or tranches of its securities to investors.

The investment banks hired credit rating agencies that used their own computer models to assess the risk of the securities in the SPE and then issued ratings. The safest tranches were rated AAA and had lower yields than tranches that bore more risk of default by homeowners. Investment banks made a small profit by selling the different tranches at a higher price than they paid for the mortgages, but these profits added up as the US mortgage market grew into trillions of dollars. From 2001 to 2006, as subprime mortgages took a larger percentage of all mortgages originated, investment banks securitized them as well. In 2005 alone, 81% of subprime mortgages, or $507 billion, were securitized, the vast majority through subprime lenders or through investment banks.[13]

Over time, the investment banks started enhancing the safety of the securities they sold by insuring them or guaranteeing them. Investment banks that floated the SPEs wrote contracts guaranteeing to their investors that they would buy back securities issued by SPEs if the investors could not find a ready buyer for them. In addition, insurance companies, such as AIG and other institutions, offered new products that were designed to protect investors against default risk. These insurance-like products were called Credit Default Swaps (CDS). In return for a regularly paid fee, the insurer would pay the buyer if the SPE (or any other covered entity and its debt) defaulted or had a significant credit event, such as a restructuring or severe downward change to its rating. Payment could be either physical or cash. In a physical settlement, the CDS seller paid the buyer the face value of the debt in exchange for the debt itself. In a cash settlement, the CDS seller paid the buyer the difference between the original value of the debt and the current value after the triggering event. CDS became wildly popular because buyers could hedge against risk without paying money upfront. Indices (such as the Dow Jones CDX) cropped up that expanded the CDS market and allowed freer and more liquid trading.[14] By some estimates about $75 trillion dollars of CDS contracts have been written. CDS were sold to insure against the risk of several entities, not just SPEs, and were bought and sold multiple times. In particular, the insurance giant AIG was, by some accounts, is said to have written CDS contracts worth $450 billion.

Trillions of dollars in privately traded securities were generated in the last decade; all based on the value of US real estate. When the real estate market in the United States started declining and interest rates rose, home owners began defaulting on their loans. The number of foreclosures hit 1.3 million in 2007, a steep 75% increase from the year before, and there have been even more home foreclosures in 2008. When banks keep the loans that they make to homeowners, they often renegotiate terms with them to avoid foreclosure. However, with mortgages being sold to SPEs and GSEs, pooled with other mortgages, securitized, chopped up into tranches, and sold to investors thousands of miles away, renegotiating with homeowners is difficult if not impossible.

The Crisis Spreads

It took nearly a year of falling home prices and subsequent mortgage defaults to leak into the larger economy. Lenders with a significant subprime loan portfolio were affected first. $56 billion New Century Financial Corporation, one of the largest subprime lenders in the United States, was one of the first banks to fail,

[13]Report and Recommendations by the Majority Staff of the Joint Economic Committee, "The Subprime Lending Crisis," October 2007, p. 18.
[14]Mike Jakola, "Credit Default Swap Index Options," Kellogg School of Management, Northwestern University, June 2, 2006, pp. 2-3.

A well-functioning disclosure and regulatory environment, an infrastructure that supports timely, accurate, and clear communications to investors, coupled with an educated investor population, will be able to reap the benefits of mortgage securitization and avoid the worst of the risks. Lastly, following accounting rules, having high quality audits, making timely provisions for bad debts, and writing down impaired assets are all old lessons but even more critical in the new economy.

filing for bankruptcy protection in April 2007. Over 150 prime and subprime lenders also failed in 2007.[15]

By 2008, the MBS themselves started to tarnish. Mortgages had been combined into varying funds, and so it was extremely difficult to gauge which MBS or even which companies were susceptible to the subprime defaults. The value of all MBS became suspect, and just about every financial institution had some MBS on their books. While buyers of credit default swaps were making money, CDS sellers were taking a hit. Soon banks were unwilling to lend to each other because they were not sure if the other bank had a big exposure to subprime loans and CDS. By September 2008, banks stopped lending to each other at even high interest rates. When there is substantial risk of the principal not being returned, a high interest rate is not sufficient inducement for potential lenders to part with their money. The widespread uncertainty froze credit markets, and banks were unable to meet their current obligations. What followed next was an unprecedented and spectacular failure of financial institutions.

Two investment banks that were among the most deeply leveraged in MBS were the first to go. In March 2008, Bear Sterns was rescued by JP Morgan Chase in a deal brokered by the New York Federal Reserve Bank; in September Lehman Brothers, a 158-year old institution, filed for bankruptcy. After Lehman failed, the floodgates opened on insolvencies. Fannie Mae and Freddie Mac, which owned or guaranteed over 50% of the $12 trillion US mortgages, were taken over by the US government. Bank of America stepped in to rescue Merrill Lynch. The US Federal Reserve extended an $85 billion loan to help AIG meet their obligations on all those credit default swaps. That amount has since grown to $150 billion and the eventual amount could be higher. Washington Mutual, in the largest bank failure ever in the United States, was seized by the Federal Deposit Insurance Corporation (FDIC), while Wachovia bank was acquired by Wells Fargo.

Investment banks were vulnerable to the downturn in mortgage values for several reasons. The first was that investment banks, unlike retail banks, do not typically have a lot of capital. They buy and sell, borrow and lend, making money on the transaction and trading fees. They are not allowed to take deposits so they depend on fee-based and trading-based income and on loans to finance purchases and investments. It took three to nine months to securitize the MBS, so when the downturn came, many investment banks were left holding warehoused mortgages that had significantly declined in value or had no market at all. If they had financed the purchase of those mortgages with borrowing, they had to pay back the money they had used to buy mortgages they could no longer sell or securitize, creating a severe and acute cash crunch. Adding to their difficulties, investment banks whose client contracts required them to buy back the CDOs that they had guaranteed scrambled for cash or credit to meet their obligations. Investment banks were also obligated by contract to finance several SPEs. They had planned on raising money with short term instruments such as commercial paper, but their access to such credit dried up when no one was willing to lend to a bank.

The contagion extended to traditional banks that had MBS and CDS on their books as well. When the news spread that banks were in financial difficulties, the loss of confidence caused a run on several institutions, and some in the United States and Europe became insolvent. The ones that were solvent were anxious to sell their MBS to meet their liquidity needs but the MBS started trading at steep discounts, well below the value they would realize if held to maturity. The lack of buyers and the anxiety to sell drove the prices of MBS down very rapidly. Mark-to-market (MtM) accounting rules, which required firms to record the fair market value on assets and liabilities, acted in a pro-cyclical manner to exacerbate the decline in the prices of MBS. John Berlau, director of the Center for Entrepreneurship at the Competitive Enterprise Institute and a free market proponent, likened the MtM rules to a "method of disease transmission,"

[15]Krishna Palepu, Suraj Srinivasan, and Aldo Sesia Jr., "*New Century Financial Corporation*," HBS No. 109-034, (Boston: Harvard Business School Publishing, 2008).

forcing otherwise healthy banks to write down their assets because another, more sickly bank had to dump similar assets in a fire sale. MtM, he argued, was one reason that all MBS were affected by a relatively low rate of mortgage defaults (6.4% versus 40% during the Great Depression).[16] The pro-cyclical effect of MtM, critics say, intensifies the business cycle, fostering economic instability, allowing banks to loan more in the good times, but devastating them in the bad times.[17] Proponents of MtM, including Treasury Secretary Henry Paulson, believe that banks should have the discipline to record their assets at fair value.[18] The debate continues whether mark-to-market was a cause of the crisis or just an accurate barometer of it.

Soon retail banks found that they could not meet the capital adequacy requirements set by regulators as their assets were declining rapidly in value. To meet regulatory requirements, they had to raise capital, but capital was increasingly scarce. With inadequate capital to cover the loans already on their books, banks simply could not loan more money. Since most financial institutions were in the same boat, the entire credit market ground to a halt. Other types of loans, such as corporate short term loans, credit cards, auto loans, and student loans were affected. Municipalities delayed bond issuances in fear that they would not be able to raise needed capital to meet their budgets. Automakers' sales started to plummet because people could not finance new cars. Not surprisingly, the U.S. stock market began a long and unchecked downward slide, eventually losing 40% of its value from October 2007 to October 2008.

Taxpayers to the Rescue

On October 3, 2008, in an attempt to finally stop the panic, the US Congress passed a $700 billion bailout package. The bailout package, officially called the Emergency Economic Stabilization Act (EESA), enabled the Treasury to broadly intervene in private companies in order to purchase their MBS, give them access to capital, and allow them to obtain government loans. The $700 billion could be used to aid the economy in three ways:

1. Provide liquidity to consumer and commercial credit markets and foreclosure intervention
2. Capital Purchases – purchase non-voting equity stakes (preferred stock) in the company in exchange for capital
3. Direct Aid or Loans to Failing Institutions – direct assistance through loans with terms negotiated on a case-by-case basis

In return for the assistance, the Treasury placed restrictions on executive pay, including caps on tax deductibility, limits on incentives that "encourage unnecessary and excessive risks", a ban or limit on severance packages, and the ability in some cases to recoup or clawback compensation already paid out. These pay provisions were in response to the public outcry that the bailout would spend US taxpayer money to rescue companies when their executives pocketed millions of dollars in bonuses, stock awards, and golden parachutes.

The Federal Deposit Insurance Corporation (FDIC) of the US government is also guaranteeing unsecured credit issued by financial institutions for a fee. Ultimately, the US tax payers will be on the hook if these financial institutions default and the US government is forced to make good on its guarantee. Whether the fee charged by the FDIC is adequate to cover this risk will be known only in the future and will depend, in part, on how deep the current recession will last.

Who's to Blame?

We have already discussed the role of the run-up and the eventual crash in real estate prices, the unsustainable euphoria that accompanies bubble markets, the securitization of home mortgages, and the low interest rate environment as factors that set the stage for the financial meltdown. While all this created a nice dry tinder box, who or what set the match to it? Upon review of the suspects, nearly every entity that was involved in the subprime crisis bears some blame.

The US government bears responsibility for the poor oversight and regulation of both the subprime and the CDS market. In particular, the former Federal Reserve Chairman, Alan Greenspan, decided not to regulate the CDS market and has since regretted his decision in testimony before the Congress. A central clearing house and more transparency in what was being bought and sold in the CDS over-the-counter (OTC) market may have helped to avoid the credit

[16]Berlau, John, "Maybe the Banks Are Just Counting Wrong," *The Wall Street Journal*, September 20, 2008, http://online.wsj.com/article/SB122186515562158671.html, accessed November 12, 2008.
[17]JPMorgan, "*Solvency, mark-to-market and insurance*," webpage, http://www.jpmorganchase.com/cm/ContentServer?c=JPM_Content_C&pagename=jpmorgan%2Fam%2FJPM_Content_C%2FGeneric_Detail_Page_Template&cid=1159362822564, accessed November 12, 2008.
[18]Michael Grynbaum, "*Paulson Weighs In on Mark-to-Market Debate*," New York Times DealBook Blog, July 22, 2008, http://dealbook.blogs.nytimes.com/2008/07/22/paulson-weighs-in-on-mark-to-market-debate/, accessed November 12, 2008.

freeze. Subprime lenders, who have very little over sight compared with traditional banks, had strong financial motivations to increase the volume of loan originations, since they made money on each loan they wrote. Because they sold the loans to investment banks, which did not require the same level of underwriting standards as did the GSEs, mortgage brokers had very little motivation to assure the quality of the loans they were making. In addition, the US Congress and politicians from both dominant political parties pressured Fannie Mae and Freddie Mac to increase home ownership by encouraging lending to poorer consumers by relaxing lending norms.

Corporate governance at many of the failed institutions is also suspect for compensation plans that may have encouraged excessive risk taking by executives. In particular, some compensation plans discouraged retail banks and subprime lenders from making timely provisions for the bad loans they were writing. While such provisions may have depressed the stock prices of those firms and hurt the compensation of their executives, this action would have sent appropriate and opportune signals to the markets that subprime loans were not performing well. Sooner discovery of this problem may have isolated the companies that had exposure to subprime loans and prevented the crisis from spreading. Auditors and audit committees for these financial institutions also bear some responsibility for not forcing companies to make provisions for bad loans and to write down impaired assets in a timely manner. While the FAS 157 rule that mandated mark-to-market accounting methods forced a reflection of the sharp decrease in MBS values, it is unclear that MBS and CDS markets are functioning well enough to be good sources of information on security values. Hence, the mark-to-market rule should be re-thought for environments where the market does not function effectively and lacks proper infrastructure.

Credit rating agencies also are accountable in part for the MBS market debacle. SPEs paid the ratings agencies for their securities to be rated. A system where the firm being rated pays for its ratings is rife with conflicts of interest. In particular, when firms play one ratings agency against another (also known as opinion shopping) to get the highest ratings that money can buy, ratings become meaningless. We clearly need more regulation of how ratings agencies do business.

It also appears that credit ratings agencies and financial institutions used flawed models to model risk. They seem to have grossly underestimated the correlation in default events. Large numbers of homeowners tend to default at the same time as each other if home prices decline and interest rates move up simultaneously. This will then lead to financial institutions with MBS on their books defaulting at the same time. This correlation in default events seems to have been underestimated by most players in the market. Thus insurance companies were covering risk that they did not fully comprehend. To make matters worse, investment banks and insurance companies were highly levered. The impact of their risk exposure to the real estate market was amplified by their astronomical leverage levels.

Lax oversight of mortgage brokers and mortgage loan originators allowed consumers with very poor credit histories to borrow large sums they possibly could not afford. The list of exotic or predatory loans widely available to home buyers reads like a litany of bad ideas. Loans with teaser rates (low introductory rates that step up rather rapidly), and "no documentation" loans (also known as "liar loans") where the potential home buyer's financial position was taken on faith, and interest only loans (where borrower payments do not pay down principle) should not have been allowed in the first place.

Implications for India

India is prone to rapid increases in real estate prices, and the use of credit to finance real estate purchases has become very common. In fact, property prices have appreciated much more rapidly during the last ten years in urban India than they have in the United States. This price increase has been fueled by NRI investments, IT professionals buying flats in large numbers, and commercial property buildup to support IT, IT-Enabled Services, and export businesses. With the world economy headed into a recession, the factors that fueled the real estate boom in India may no longer be able to support real estate prices in India. To make matters worse, loans to asset values have been steadily climbing in India as well. If salaries in the Indian IT sector decline in concert with a decline in the United States and European economies, many professionals who are first-time homeowners may default on their home mortgages in India. Private-sector banks that have taken the lead in financing home purchases may be hit the hardest. In India, however, problems in the real estate and banking sector are likely to be contained and are unlikely to impact insurance companies and investment banks, because India lacks a strong secondary mortgage market. Banks in India are also unlikely to witness liabilities from off-balance sheet SPEs.

The real question is, given the recent meltdown in the United States, should India avoid growing a secondary market, or emulate the United States and actively develop a market for MBS and CDS? We believe that the answer is a resounding yes to secondary market development. There are risks to this strategy, as the current crisis so aptly illustrates, but the benefits of a strong secondary market outweigh the risks. The benefits of a broad and deep market for MBS are likely to accrue to millions of current and future homeowners in India and reduce the costs of financing their home purchases. It would be an egregious mistake to draw the inference from America's recent experience that India does not need a well-developed market for MBS or CDS.

India has an opportunity to learn from America's mistakes. It should develop secondary markets carefully and thoughtfully, with appropriate regulation, infrastructure, and disclosure requirements. In the primary market, lenders must monitor borrowers' credit histories and track credit scores. If the mortgage industry can develop a system that regularly and accurately tracks and reports credit scores to lenders, it can lower borrowing costs and make credit available for millions of Indians. The secondary MBS market in the United States worked amazingly well until there was a push from politicians and investment banks to lower credit standards and expand subprime lending, respectively.

Unfortunately, India has already experienced some of America's problems. As in the United States, political pressure on banks to make loans to consumers and businesses with poor credit histories and an obvious inability to service the loans, have resulted in government bailouts paid for by India's tax payers. While India has not seen such bailouts in the home loan industry yet, it is perhaps because the borrowers in the home loan industry have been from the middle class rather than the vote-heavy poor class or the politically-connected wealthy industrialists. Hopefully, such bailouts will not forthcoming if the home loan industry in India is hit by foreclosures. Bailing out homeowners, while appearing to be the compassionate thing to do at the time, in the long run has the effect of destroying the home mortgage market, as such bailouts send the message to homeowners that it is better to default on one's loans than to pay them back. It would be better for regulators to monitor lending practices and eliminate predatory lending to poor and uninformed homeowners.

We also hope that India does not draw the conclusion that nationalizing financial institutions is the solution, given that America has nationalized or invested in several financial institutions. Fannie Mae and Freddie Mac were quasi government agencies to begin with, and yet failed to adequately discharge their fiduciary duties. If anything, to avoid the cycle of making poor quality loans under political pressure and inadequate control systems, leading to non-performing assets a few years later that then need budgetary support from the central government, India should consider privatizing nationalized banks in a phased manner to reduce and eliminate the political pressure to make loans that will never be repaid.

Another lesson from the debacle we are witnessing in America should be that when a few financial institutions get too big, it puts the rest of the economy at a huge risk. Whether these financial institutions are in the private, public, or quasi-public sector, when they grow too large with unchecked growth of consumer loans, they have the ability to take down the whole economy if they fail. Regulation in financial industries, then, should carefully monitor rates of growth in large financial institutions and have some ability to curb growth that becomes unsustainable or that moves beyond market fundamentals. Regulatory over reach in India, however, is a concern. While America needs both more regulation and enforcement, India, in general, needs fewer rules but more effective enforcement.

With economic expansion comes increased responsibility. It is the responsibility of financial institutions to clearly disclose the nature and risks of the financial products that they sell, and the responsibility of the government to insure that regulations are followed. Government, for example, should ensure that credit and risk rating agencies are completely independent and free of conflicts of interest. It should also prohibit predatory lending practices. In return, it is the responsibility of the investors, whether they be the banks of Iceland or a small family saving for retirement in India, to understand exactly what they are buying and the risks involved. A well-functioning disclosure and regulatory environment, an infrastructure that supports timely, accurate, and clear communications to investors, coupled with an educated investor population, will be able to reap the benefits of mortgage securitization and avoid the worst of the risks. Lastly, following accounting rules, having high quality audits, making timely provisions for bad debts, and writing down impaired assets are all old lessons but even more critical in the new economy.❑

LIMITED LIABILITY PARTNERSHIP

The revised "Limited Liability Partnership Bill, 2008" has been passed by the Rajya Sabha in October, 2008 and is likely to be passed by the Lok Sabha too before the end of the current year. The new Bill, when enacted, will provide for an alternative corporate business vehicle that provides the benefits of limited liability but allows its members the flexibility of organising their internal structure as a partnership based on a mutually arrived agreement. This article discusses some of the important provisions of the Bill.

PARTNERS IP

Limited Liability Partnership Bill (LLP Bill), providing for establishment of Limited Liability Partnership (LLP) in our country, was first introduced in the Rajya Sabha by the Minister of Company Affairs on 15th December, 2006. This Bill was referred to Parliamentary Standing Committee. This Committee's Report was presented to Lok Sabha and Rajya Sabha on 27th November, 2007. On the basis of the recommendations of this Committee, some changes were made in LLP Bill of 2006. The revised Bill "LLP Bill, 2008" was introduced in Rajya Sabha on 21st October, 2008. This Bill has been passed by the Rajya Sabha in October, 2008. It will now be placed for approval of Lok Sabha in December, 2008 and may, hopefully, be passed before the end of the current year. It may be noted that the basic structure proposed in LLP Bill – 2006 has been

— CA. P. N. Shah

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The Incorporation Document will have to be signed by two or more partners of LLP. This Document will have to be filed with a statement in the prescribed form signed by an Advocate, a Chartered Accountant, a Company Secretary or a Cost Accountant who is engaged in the formation of LLP and any one of the partners who has signed the Incorporation Document. This statement should state that all the requirements of LLP Act and Rules relating to incorporation of LLP have been complied with.

retained in LLP Bill - 2008 and some changes, as suggested by the Committee, are made in the Bill as passed by Rajya Sabha.

With the growth of the Indian Economy, the role played by our entrepreneurs as well as our technical and professional manpower has been acknowledged world over. The need for traditional partnership concept, with limited liability, was felt in order to enable professional expertise and entrepreneurial initiative to combine, organise and operate in flexible, innovative and efficient manner. Concept of LLP has been accepted in USA, U.K, Australia and other countries. The new Bill, when enacted, will provide for an alternative corporate business vehicle that provides the benefits of limited liability but allows its members the flexibility of organising their internal structure as a partnership based on a mutually arrived agreement. This enactment will come into force on the date of notification to be issued by the central government after the Bill is passed by the Lok Sabha.

Formation of LLP

Any two or more persons can form a LLP for the purpose of carrying on any business, trade, profession, service or occupation. Even a limited company, a foreign company, a LLP, a foreign LLP or a non-resident can be a partner in LLP. Although there is no specific mention, a HUF represented by its Karta can be a partner of LLP. A Co-operative Society or a corporation sole cannot be a partner of LLP. If the number of Partners fall below two, the surviving partner will have to admit at least one more partner within 6 months. If he does not do so, his liability will become unlimited and LLP will be wound up. It may be noted that at least one of the partners in LLP should be a resident in India. Every LLP shall have at least two designated partners who are Individuals. At least one of such designated partner shall be a resident individual. If all partners of LLP are corporate bodies, at least two individuals, who are nominees of corporate bodies, will be designated as designated partners.

A person who has been found to be of unsound mind by a court, who is an undischarged insolvent or who has applied to be adjudicated as an insolvent and his application is pending, cannot be a partner of LLP. There is no mention in the Bill whether a minor can be a partner of LLP. However, it appears that under the General Law a minor can be admitted to the benefits of partnership (*i.e.* LLP).

Every LLP will have to get itself registered with the Registrar of Companies (ROC). For this purpose, the LLP will have to file an Incorporation Document with the ROC of the State in which its Registered Office is situated. Such Incorporation Document shall be in such form as may be prescribed and shall include the following particulars:

(i) Name of LLP

(ii) Proposed business, trade, profession, service or occupation of LLP

(iii) Address of the Registered Office

(iv) Names and Addresses of each of the partners of LLP.

(v) Names and addresses of each of the Designated Partners.

(vi) Such other information as may be prescribed.

The Incorporation Document will have to be signed by two or more partners of LLP. This Document will have to be filed with a statement in the prescribed form signed by an Advocate, a Chartered Accountant, a Company Secretary or a Cost Accountant who is engaged in the formation of LLP and any one of the partners who has signed the Incorporation Document. This statement should state that all the requirements of LLP Act and Rules relating to incorporation of LLP have been complied with. It will be necessary for LLP to deposit the prescribed fees with the ROC. On completion of these formali-

Any two or more persons can form a LLP for the purpose of carrying on any business, trade, profession, service or occupation. Even a limited company, a foreign company, a LLP, a foreign LLP or a non-resident can be a partner in LLP. Although there is no specific mention, a HUF represented by its Karta can be a partner of LLP. A Co-operative Society or a corporation sole cannot be a partner of LLP.

ties, the ROC has to register the document and issue a Registration Certificate within 14 days.

A LLP, upon incorporation, will be treated as a body corporate and will be considered as a legal entity separate from that of its partners. It shall have a common seal and a perpetual succession. Any change in the partners of LLP shall not affect the existence, rights or liabilities of LLP. Every LLP will have to use "LLP" as the last words of its name.

It will be possible for any LLP to change its objects, its name or registered office, to admit new partners or delete the names of partners who have resigned, to make changes in the Designated Partners etc. For this purpose, LLP will have to execute supplementary deed and to file the prescribed particulars with ROC.

The procedure for obtaining the name of LLP is the same as for obtaining the name for a limited company. Application for this purpose is to be made to ROC and the prescribed fee is to be paid. The ROC has to ensure that the name selected by LLP is not identical or too nearly resembles to the name of any other partnership or LLP or a corporate body or a registered trade mark. It may be noted that this particular requirement will be difficult to comply with if the name of LLP is to be compared with the name of any other Partnership Firm all over the country. Firstly, there is no central database for names of partnership firms as the law relating to partnerships is administered by the State Governments. At present, there are several partnership firms with identical names. Therefore, it will be difficult to determine whether there is a partnership firm will identical name in the country.

Any entity (including a Firm), which already has a name similar to the name of a LLP which has been incorporated subsequently, can approach the ROC objecting to the name of LLP. Such application can only be made within 24 months from date of registration of LLP. If ROC is satisfied with the objection, he can direct the LLP to change its name. For this purpose, ROC will have to give hearing to the LLP.

Section 11 of the Companies Act provides that no company, association or partnership consisting of more than 20 persons shall be formed for the purpose of carrying on a business unless it is registered under the Companies Act or is formed in pursuance of some other Indian Law. For banking business, the above restriction applies with reference to 10 or more persons. It may be noted that the LLP Act is a Central legislation. This restriction for number of partners will not apply for carrying on any business, trade, profession, service or occupation if the partnership is registered as LLP. In other words, LLP with more than 20 persons can be formed by Chartered Accountants for carrying on profession as Management Consultants. Similarly, LLP with unlimited number of partners can be formed for carrying on any business or profession.

Relationship of Partners

Upon Registration of LLP, the partners will have to enter into a partnership agreement in writing. This agreement will determine the mutual rights and duties of the partners and their rights and duties in relation to the LLP. Persons who have signed the Incorporation Document as Partners along with other persons can execute this Partnership Agreement. This partnership agreement is required to be filed with ROC and prescribed fees should be paid as provided in the Rules. Whenever there are changes in the terms and conditions of the partnership, LLP has to file the details of the change in the prescribed form with ROC and pay the prescribed fees for the same. If the partnership agreement is executed before registration of LLP, the partners will have to ratify this agreement after incorporation of LLP and file with ROC. Similarly, each partner has to inform the LLP about change of his name or address within 15 days and the LLP has to file notice of such change with ROC within 15 days.

LLP with more than 20 persons can be formed by Chartered Accountants for carrying on profession as Management Consultants. Similarly, LLP with unlimited number of partners can be formed for carrying on any business or profession.

If the partners do not execute the partnership agreement, the relationship between the partners will be governed by the First Schedule to the LLP Bill. This Schedule provides that mutual rights and duties of partners of LLP shall be determined as under in the absence of a written agreement. Even if there is a written agreement, but there is no specific mention about any of the following matters, such matters will be governed by the following provisions:

(i) All the partners of LLP are entitled to share equally in the capital, profits and losses of the LLP.

(ii) The LLP shall indemnify each partner in respect of payments made and liabilities incurred by him in relation to the business of LLP.

(iii) Every partner shall indemnify the LLP for any loss caused to it by his fraud in the conduct of the business of LLP.

(iv) Every partner may take part in the management of the LLP.

(v) No partner shall be entitled to remuneration for acting in the business or management of the LLP.

(vi) No person may be introduced as a partner without the consent of all the existing partners.

(vii) Any matter or issue relating to the LLP shall be decided by resolution passed by a majority in number of the partners, and for this purpose, each partner shall have one vote. However, no change may be made in the nature of business of the LLP without the consent of all the partners.

(viii) Every LLP shall record the decisions taken by it in a minute book within 30 days and keep the minute book at the registered office. It appears that this refers to the decisions as stated in (vii) above.

(ix) Each partner shall render true accounts and full information of all things affecting the LLP to other partner or his legal representatives.

(x) If a partner, without the consent of the LLP, carries on any business of the same nature as and competing with the LLP, he must account for and pay over to the LLP all profits made by him in that business.

(xi) Every partner shall account to the LLP for any benefit derived by him without the consent of the LLP from any transaction concerning the LLP or from any use by him of the property, name or any business connection of the LLP.

(xii) No Partner can expel any partner unless a power to do so has been conferred by express agreement between the partners.

(xiii) All disputes between the partners which cannot be resolved in terms of the LLP agreement shall be referred to Arbitration under the provisions of Arbitration and Conciliation Act, 1996.

Any person may join the LLP as a partner if all partners agree to admit him as a partner. Similarly, a partner will cease to be a partner on his death, retirement or on winding up of the company or LLP which is a partner. It is also provided that if a partner is declared to be of unsound mind or is declared to be insolvent, he will cease to be a partner of LLP. For this purpose, the partners will have to execute a fresh partnership agreement recording the terms and conditions of the partnership with revised constitution. Intimation about admission of new partners or retirement of a partner will have to be given to the ROC in the prescribed from within 30 days.

The partnership agreement may provide for payment of interest on capital of partners or remuneration payable to the partners. Further, the agreement will have to provide the share of each partner in profits or losses of LLP. The conditions relating to payment of interest, remuneration or share in profits or losses can be changed by amendments in the partnership agreement.

The rights of a partner to share profits or losses

A partner of LLP is not personally liable, directly or indirectly, for any debts or obligations of LLP. However, a partner will be personally liable for any liability arising from his own wrongful act or omission. If such liability arises due to wrongful act or omission of any partner, the other partners will not be personally liable for the same.

of LLP are transferable either in whole or in part. Such transfer will not mean that the partner has ceased to be a partner or that the LLP is wound up. Such a transfer will not entitle the transferee or assignee to participate in the management or conduct of the activities of the LLP. Similarly, the transferee will not get right to any information relating to the transactions of LLP.

Limited Liability of Partners

A partner of LLP is not personally liable, directly or indirectly, for any debts or obligations of LLP. However, a partner will be personally liable for any liability arising from his own wrongful act or omission. If such liability arises due to wrongful act or omission of any partner, the other partners will not be personally liable for the same.

Every partner of LLP is the agent of LLP but not of other partners. However, the LLP is not bound by any thing done by a partner in dealing with a third party, if the partner has no authority to act for LLP and the third party is aware of this fact. LLP is liable to meet with the debts or obligations arising during the course of its business, trade, profession, service etc. out of the property of LLP.

Each partner of LLP will have to contribute such amount for the business of the LLP as may be determined by the partnership agreement. The liability of each partner will be limited to the extent of the amount as specified in the partnership agreement.

As stated earlier, at least two partners (Individuals) have to be appointed as Designated Partners. Appointment of such partners will be governed by the partnership agreement. In the event of any vacancy due to death, retirement, or otherwise, LLP has to appoint another partner as a designated partner within 30 days. Particulars of designated partners or changes therein have to be filed with ROC. If LLP does not appoint at least two designated partners or if the number of designated partners falls below two, all partners shall be considered as designated partners. It may be noted that the designated partner has to give consent in writing to the LLP in the prescribed form within 30 days of his appointment. LLP has to file this consent letter with ROC within 30 days of his appointment.

The following will be the obligations of Designated Partners:

(i) They are responsible, on behalf of LLP, for compliance of the provisions of LLP Act and Rules, including filing of any document, return, statement etc. as required by the Act and the Rules.

(ii) They are liable for all penalties imposed on the LLP for any contravention of LLP Act and the Rules.

(iii) Every Designated Partner will have to sign the annual financial statements and annual solvency statement.

(iv) Each Designated Partner will have to obtain a " Designated Partner Identification Number " (DPIN) in the same manner as a Director of a Company has to obtain Director Identification Number (DIN) under sections 266 A to 266 G of the Companies Act.

If any person represents himself or knowingly permits himself to be presented as a partner of any LLP, when he is not such a partner, he will be liable to any person who has on the faith of such representation given credit to the LLP.

Where a LLP or any partner, or employee of the LLP has conducted the affairs of the LLP in a fraudulent manner, then without prejudice to any criminal proceedings, the LLP, its partner or employee shall be liable to any compensation to the person who has suffered any loss or damage by reason of such conduct.

Accounts and Audit

LLP has to maintain such books of account as may be prescribed. Such books may be maintained either on cash basis or accrual basis of accounting. The LLP has to prepare a Statement

Section 56 of the LLP Bill provides that a private limited company registered under the Companies Act can convert itself into LLP. For this purpose, it has to follow the procedure stated in the Third Schedule. Section 57 of the LLP Bill provides that an unlisted public company registered under the Companies Act can convert itself in a LLP. For this purpose, it has to follow the procedure stated in the Fourth Schedule.

of Accounts and a Solvency Statement within a period of six months from the end of the financial year (*i.e.* April to March). These statements have to be signed by the Designated Partners of LLP. The accounts of LLP have to be audited in accordance with the rules as may be made under the LLP Act. The Central Government can exempt any class of LLP from this audit requirement. The statement of Accounts and Solvency Statement have to be filed with ROC in the prescribed form within the prescribed time limit with the prescribed fee.

LLP has to file an annual return with ROC within 60 days of the end of the financial year in the prescribed form with the prescribed fees.

Conversion of Partnership Firm into LLP

An existing Partnership Firm (Firm) can be converted into LLP by following the procedure laid down in the Second Schedule. Broadly stated, this procedure is as under :

(i) A Firm may apply to convert into LLP if and only if the partners of the LLP to which the firm is to be converted, comprise all the partners of the firm and no one else.

(ii) A Firm may apply to convert into LLP by filing with the ROC –

A. a statement by all of its partners in such form and accompanied by such fees as may be prescribed containing the following particulars, namely:–

a) the name and registration number of the firm; and

b) the date on which the firm was registered under the Indian Partnership Act, or any other law and

B. incorporation document and the statement by the advocate, CA., Company Secretary or Cost Accountant who is engaged in the formation of LLP.

(iii) On receiving the documents referred to in clause (ii) above, the ROC shall register the documents and issue a certificate of registration. ROC will have to state the date from which LLP is registered. If the ROC, for any reason, refuses to register the LLP, appeal can be filed to National Company Law Tribunal (Tribunal).

(iv) On and from the date of registration specified in the certificate of registration -

a) LLP by the name specified in the certificate of registration will come into existence.

b) all tangible and intangible properties vested in the firm, all assets, interests, rights, privileges, liabilities, obligations relating to the firm and the whole of the undertaking of the firm shall be transferred to and shall vest in the LLP without further assurance, act or deed;

c) the firm shall be deemed to be dissolved and if earlier registered under the Indian Partnership Act, removed from the records maintained under that Act and

d) LLP shall give information about the above registration to the Registrar of Firms within 15 days in the prescribed from.

(v) If any of the above properties is registered with any authority, the LLP shall, as soon as practicable after the date of registration, take all necessary steps, as required by the relevant authority, to notify the authority, of the conversion and of the particulars of the LLP in such medium and form as the authority may specify.

(vi) All proceedings by or against the firm which are pending in any Court or Tribunal or before any authority on the date of registration may be continued, completed, and enforced

A LLP can be wound up voluntarily. In the alternative, it can be wound up by the National Company Law Tribunal (Tribunal) in various circumstances which include: If LLP decides that it be wound up by the Tribunal, or if for a period of more than 6 months the number of partners of LLP is reduced below two, or if the LLP is unable to pay its debts, or if the LLP has acted against the interests of the sovereignty and integrity of India.

by or against the LLP.

(vii) Any conviction, ruling, order or judgment of any Court, Tribunal or other authority in favour of or against the firm may be enforced by or against the LLP.

(viii) Every agreement to which the firm was a party immediately before the date of registration, whether or not of such nature that the rights and liabilities thereunder could be assigned, shall have effect as from that day as if--

a) the LLP was a party to such an agreement instead of the firm; and

b) for any reference to the firm, there was substituted in respect of anything to be done on or after the date of registration a reference to the LLP.

(ix) All deeds, contracts, schemes, bonds, agreements, applications, instruments and arrangements subsisting immediately before the date of registration relating to the firm or to which the firm is a party, shall continue in force on and after that date as if they relate to the LLP and shall be enforceable by or against the LLP as if the LLP was named therein or was a party thereto instead of the firm.

(x) Every contract of employment shall continue to be in force on or after the date of registration as if the LLP was the employer thereunder instead of the firm.

(xi) Every appointment of the firm in any role or capacity which is in force immediately before the date of registration shall take effect and operate from that date as if the LLP was appointed.

(xii) Any authority or power conferred on the firm which is in force immediately before the date of registration shall take effect and operate from that date as if it was conferred on the LLP.

(xiii) The provisions of clauses (iv) to (xii) above shall apply to any approval, permit or licence issued under any other law to the firm which is in force immediately before the date of registration of the LLP. This will, however, be subject to the provisions of the relevant law under which such approval, permit or licence is issued.

(xiv) Every partner of a firm that has converted into a LLP shall continue to be personally liable (jointly and severally with the LLP) for the liabilities and obligations of the firm which were incurred prior to the conversion or which arose from any contract entered into prior to the conversion.

(xv) If any such partner discharges any liability or obligation referred to above, he shall be entitled (subject to any agreement with the LLP to the contrary) to be fully indemnified by the LLP in respect of such liability or obligation.

(xvi) LLP shall ensure that for a period of twelve months commencing, not later than fourteen days after the date of registration, every official correspondence of the LLP bears the following :

a) a statement that it was, as from the date of registration, converted from a firm to a LLP; and

b) the name and registration number of the firm from which it was converted.

Conversion of a Limited Company into LLP

Section 56 of the LLP Bill provides that a private limited company registered under the Companies Act can convert itself in a LLP. For this purpose, it has to follow the procedure stated in the Third Schedule.

The LLP Act is divided into 14 Chapters. There are 81 sections and Four Schedules. The ROC has been given powers to regulate the working of LLPs. For this purpose, certain documents are required to be filed with ROC and filing fees will have to be paid. As per some procedural provisions of the LLP Act , ROC has power to conduct inspection of documents and call for information from LLP.

Section 57 of the LLP Bill provides that an unlisted public company registered under the Companies Act can convert itself in a LLP. For this purpose, it has to follow the procedure stated in the Fourth Schedule.

The procedure for conversion of a private limited company and an unlisted public limited company into a LLP as provided in the Third and Fourth Schedules being more or less identical, the same is stated below:

(i) A company may apply for conversion into a LLP only if (a) there is no security interest in its assets subsisting or in force at the time of application and (b) all the shareholders of the company and no one else are going to be the partners of the LLP.

(ii) The company shall file with the ROC -

(a) a statement by all the shareholders in the prescribed form accompanied with the prescribed fees the particulars of the name and registration No. of the company and the date on which the company was incorporated.

(b) Incorporation document and the statement by the Advocate, C.A. Company Secretary or Cost Accountant who is engaged in the formation of LLP.

(iii) On receiving the documents referred to in (ii) above, the ROC shall register the documents and issue a certificate of registration. ROC will have to state the date from which LLP is registered.

(iv) Upon such registration, LLP shall inform, within 15 days, the ROC with whom the company was registered about conversion of the company into LLP in the prescribed form.

(v) If the ROC, for any reason, refuses to register the LLP, appeal can be filed before the Tribunal.

(vi) On and from the date of registration specified in the certificate of registration –

(a) LLP by the name specified in the certificate of registration will come into existence.

(b) all tangible and intangible properties vested in the company, all assets, interests, rights, privileges, liabilities, obligations, relating to the company and the whole of the undertaking of the company shall be transferred and shall vest in the LLP without further assurance, act or deed, and

(c) the company shall be deemed to be dissolved and removed from the records of ROC.

(vii) If any of the above properties is registered with any authority, the LLP shall, as soon as practicable, after the date of registration, take all necessary steps as required by the relevant authority to notify the authority of the conversion and of the particulars of the LLP in such medium and from as the authority may specify.

(viii) All proceedings by or against the company which are pending in any Court, Tribunal or any authority on the date of registration may be continued, completed and enforced by or against the LLP.

(ix) Any conviction, ruling, order or judgment of any Court, Tribunal or other authority in favour of or against the company may be enforced by or against the LLP.

(x) Every agreement to which the company was a party immediately before the date of registration of LLP, whether or not of such nature that the rights and liabilities there under could be assigned, shall have effect as form that day as if -

It may be noted that most of the procedural provisions of LLP Act are to be governed by the Rules to be framed by the Central Government. In particular, the form of accounts, form of annual financial statements, solvency statement, auditor's report etc., are to be prescribed by Rules. Let us hope that the Government will publish draft rules for public comments so that practical difficulties can be pointed out before finalising the rules.

(a) the LLP was a party to such agreement instead of the company, and

(b) for any reference to the company, there was substituted in respect of anything to be done on or after the date of registration a reference to the LLP.

(xi) All deeds, contracts, schemes, bonds, agreements, applications, instruments and arrangements subsisting, immediately before the date of registration of LLP, relating to the company or to which the company is a party, shall continue in force on or after that date as if they relate to the LLP and shall be enforceable by or against the LLP as if the LLP was named therein or was a party thereto instead of the company.

(xii) Every contract of employment to which clauses (x) and (xi) above apply, shall continue to be in force on or after the date of registration of LLP, as if the LLP was the employer thereunder instead of the company.

(xiii) Every appointment of the company in any role or capacity which is in force immediately before the date of registration of LLP shall take effect and operate from that date as if the LLP was appointed.

(xiv) Any authority or power conferred on the company which is in force immediately before the date of registration of LLP shall take effect and operate from that date as if the LLP was appointed.

(xv) The provisions of clauses (vi) to (xiv) above shall apply to any approval, permit or licence issued to the company under any other law, which is in force immediately before the date of registration of LLP. This will be subject to the provisions of the law under which such approval, permit or licence is issued.

(xvi) LLP shall ensure that for a period of 12 months commencing not later than 14 days after the date of registration of LLP, every official correspondence of the LLP bears the following -

(a) a statement that it was, as from the date of registration, converted from a company into a LLP.

(b) the name and registration No. of the company.

From provisions of the Third and Fourth Schedules it is not clear as to what treatment should be given to the amount standing to the credit of share capital in the company which is converted into LLP. In the absence of any provision in LLP Bill, it is possible to take the view that the amount of paid-up share capital shall be credited to the capital account of each partner in proportion to his/her shareholding in the company on the date of conversion into LLP. This will apply both to Equity and Preference Capital. So far as credit balances of General Reserve and other reserves are concerned, the same can be retained by LLP or transferred to the Credit of capital or loan account of each equity shareholder in the proportion of his/her shareholding. Whatever treatment is to be given in the accounts should be recorded in the Partnership Agreement.

From the above discussion it will be noticed that a partnership firm, with unlimited liability of partners, can now be converted into limited liability LLP by following the above simplified procedure stated above. Similarly, a private limited company or a closely held unlisted public company can also

LLP Act is silent regarding taxation of LLP under the Income tax Act. Since the basic structure is that of a partnership and the only difference is that the liability of partners is limited, it is possible that under the Income tax Act LLP will be recognised as a 'Firm'. In that case LLP will be taxed at the rate applicable to a 'Firm' and deduction for interest to partners and remuneration to partners will be allowed as provided in section 40 (b) of the Income tax Act.

be converted into a LLP by following this simplified procedure stated above. Such partnership firms and companies, after such conversion, will not be required to comply with the provisions of the Partnership Act or the Companies Act.

Winding Up of LLP

A LLP can be wound up voluntarily. In the alternative, it can be wound up by the National Company Law Tribunal (Tribunal) under the following circumstances:

(i) If LLP decides that it be wound up by the Tribunal.

(ii) If for a period of more than 6 months the number of partners of LLP is reduced below two.

(iii) If the LLP is unable to pay its debts.

(iv) If the LLP has acted against the interests of the sovereignty and integrity of India, the security of the State or Public order.

(v) If the LLP has made a default in filing with ROC the statement of Account and Solvency or annual return for any five consecutive financial years.

(vi) If the Tribunal is of the opinion that is just and equitable that the LLP be wound up.

The Central Government is authorised to make Rules providing for the procedure for winding up and dissolution of any LLP.

Some Procedural Provisions

The LLP Act is divided into 14 Chapters. There are 81 sections and Four Schedules. The ROC has been given powers to regulate the working of LLPs. For this purpose, certain documents are required to be filed with ROC and filing fees will have to be paid. Some of the important procedural provisions of the LLP Act are as under:

(i) ROC has power to conduct inspection of documents.

(ii) ROC has power to call for information from LLP.

(iii) ROC can conduct investigation of the affairs of LLP. Detailed provisions are made in sections 43 to 54 of the LLP Bill.

(iv) The Central Government has power to make Rules for provisions in relation to establishment of place of business by a Foreign LLP in India and for carrying on its business as LLP in India.

(v) The Central Government can notify the provisions of Companies Act which may apply to any LLP.

(vi) The Central Government may make Rules for electronically filing of documents with ROC.

(vii) If there is delay in filing any statement or document with ROC, the same can be filed with default fee of Rs.100 for every day of delay.

(viii) The procedure for reference of matters to the Tribunal as contained in the Companies Act will apply to LLP also.

(ix) LLP Act provides for levy of fine for defaults in filing information, documents, statement, annual return etc. with ROC. This fine can be between Rs.10,000 to Rs.5,00,000.

(x) If any LLP is not carrying on any business or its operations in accordance with LLP Act, the ROC has power under section 75 to strike off the name of such

The concept of LLP is being recognised in our country after a long debate over the past some years. We should welcome it. LLP structure will enable small and medium size organizations and family partnerships to expand as they will be able to admit outsiders with capital or skill as partners. Since the financial liability will be limited, there will be no danger of promoter partners being saddled with the personal liability of outside partners.

LLP from the Register.

(xi) The LLP Act also provides for prosecution of partners or designated partners for certain offences committed under the Act.

(xii) The Central Government has power to make Rules for carrying out the provisions of LLP Act.

(xiii) The Tribunal has been given powers to sanction compromise. Arrangement or Reconstruction of LLPs in sections 60 to 62 of LLP Bill. This will include proposals for merger or demerger of two or more LLPs and compromise with creditors.

(xiv) Central Government is given power to alter the contents of schedules to LLP Act.

(xv) It is provided that till the Tribunal or Appellate Tribunal is contributed the powers of Tribunal shall be exercised by the "Company Law Board" and the powers of Appellate Tribunal shall be exercised by the "High Court".

To Sum Up

The concept of LLP is being recognised in our country after a long debate over the past some years. We should welcome it. LLP structure will enable small and medium size organizations and family partnerships to expand as they will be able to admit outsiders with capital or skill as partners. Since the financial liability will be limited, there will be no danger of promoter partners being saddled with the personal liability of outside partners. Further, there will be no danger of stoppage of business due to non-co-operative attitude of outside partners as LLP is a legal entity with common seal and perpetual succession. One advantage of this structure, in preference to a limited company, is that the partners will have flexibility in the matter of internal working and at the same time their liability will be limited and they will not have to comply with the complicated provisions of Companies Act. Any outsider cannot attach the personal property of the partners for debts due by LLP. He can only proceed against the LLP and recover his dues from the assets of LLP. It may be noted that most of the procedural provisions of LLP Act are to be governed by the Rules to be framed by the Central Government. In particular, the form of accounts, form of annual financial statements, solvency statement, auditor's report etc., are to be prescribed by Rules. Let us hope that the Government will publish draft rules for public comments so that practical difficulties can be pointed out before finalizing the rules. So far as matters relating to accounts and audit are concerned, let us hope that the Government takes the Institute of Chartered Accountants of India into confidence before framing the Rules for this purpose.

LLP Act is silent regarding taxation of LLP under the Income tax Act. Since the basic structure is that of a partnership and the only difference is that the liability of partners is limited, it is possible that under the Income tax Act LLP will be recognized as a 'Firm'. In that case LLP will be taxed at the rate applicable to a 'Firm' and deduction for interest to partners and remuneration to partners will be allowed as provided in section 40 (b) of the Income tax Act. The balance profit which is distributed to partners will be treated as exempt as provided in section 10 (2A). Since there is no distribution of dividend, there will be no dividend distribution tax. For this purpose, we will have to wait for enactment of LLP Act and, thereafter, for consequential amendments in the Income tax Act.❑

THE OPTIONS BACKDATING

In 2006, after the scandals at Enron and WorldCom, 'Options Backdating' rocked the US Corporate world. Heads rolled and the regulator woke up to unveil a new corporate game. 'Options backdating' could not be termed 'illegal' in the US because laws related to this vary from State to State, but everybody is convinced that it is a new kind of Corporate lie. This article explains how the Backdating game was played in the US and how it impacted corporate India.

It is quite well known that a stock option means the right to buy a number of shares of stock at or after a given date in the future, known as the exercise date, and at a given price agreed upon at the time of granting the Option (usually at the current market price (CMP) or about 95% of the CMP). Stock options are normally given during the 'build' phase of a company so that its executives may build the employer company as entrepreneurs and participate in its wealth building exercise. This is a sort of 'Goal Congruence' exercise that the HR managers always dream of. Granting of 'stock options' normally ensures increasing the stock market price of the company's equity over a period of time. On transfer of such stock options the grantee of the option may earn Capital Gains, which are taxable at concessional tax rates, and compare favourably with 'Income from Salaries'. Thus granting stock options is preferred to the granting of other perks or monetary incentives. Being an incentive scheme offered to executives, 'Stock Options' also help the Companies in their 'build' stage to conserve cash and to improve treasury/working capital management, because options are granted as performance based incentives that incur no cash outflow. It is a 'you build, share the growth and you gain' philosophy. Stock options have become extremely popular in the e-Software industry, and the industry leaders — Microsoft, Infosys, Wipro, and recently TCS — have benefited a lot out of this along with their employees. Whereas the value of Stock option does not impact the bottom line, the salaries and bonus paid to the employees do. Stock options stimulate the growth of entrepreneurs and also help in the creation of industry leaders in corporate world.

— CA. E. Srinivasa Charyulu

(The author is a member of the Institute. He can be reached at caonweb@rediffmail.com)

In *Option backdating game*, the corporations resort to the practice of backdating the grant of the option, i.e., the date of the granting

of the option is changed, and the option appears to have been awarded earlier. Instances were brought to light where the option, instead of being based on the stock price when an executive joined the company, was based on an earlier (invariably lower) stock price. "Thus the option is "from that manipulated date of issuance". This implies that an executive is rewarded for the performance of his seniors/ predecessors, which is just not fair. The practice has been considered unethical because the company management started looking 'back over stock price performance and pick the most advantageous date' to award the option. (This is like a Mutual Fund Company advertising that selected pick Stock prices have gone up over last six months and hence if you put your money in its fund it will multiply your money as seen in the graph shown in the pamphlet. Obviously the MF managers are showing others performance as theirs to attract your money!). Thus earnings and taxes were reported wrongly and unfair means were used to window dress accounts and tax filing. Since the exercise is complicated, even revised returns were not filed properly. The practice led investors to believe in a different but false corporate picture, and very rightly invited the wrath of the Regulator and investor public. Assuming the proportions of a scandal, it also affected stock prices in the market. According to a pioneering research published by Prof Narayanan and others (ref: http://sitemaker. umich.edu/options-backdating/home) "Two types of games are possible: Backdating and Forward dating." The researchers thus stated:

Backdating: *If executives report that the options they received were granted on a date before the actual date on which the decision was made, it is called backdating. For example, the company's board of directors decides to grant options to the CEO on June 13, 2006. The executive subsequently reports to the SEC that the options were granted on May 14, 2006. This results in a backdating of about one month.*

Forward dating: *Executives who wish to give their grant date to influence their compensation may not resort to backdating if the company stock price had been falling before the board decision date. In such cases, executives may resort to forward dating to increase their compensation. It works like this:*

Suppose the board meets on June 15 to approve the compensation parameters (essentially, the number of options to be granted). The board intends June 15 to be the grant date and expects the strike price of the options to be the closing stock price on that day. Since the stock price has been falling, the executive decides to wait and see if it goes further down. Suppose the stock price continues to fall till June 22 and then starts rising. On June 24, the executive designates June 22 as the grant date and reports the grant immediately (electronically), thus getting a lower strike price than what prevailed on June 15, and meeting the SEC deadline of reporting within two business days of the grant date. Has any company been targeted for forward dating? The only one we know is Brocade Communications, which forward dated their employee stock options (see WSJ article on July 13, 2006.

How Did the Backdating Disease Spread?

It is reported that over 150 big Corporations (only the tip of the iceberg), which include Apple Computers, McAfree, CNET, United Health group, Broadcade Communications Systems, and Converse Technologies have practiced backdating. The Corporate Library has published that about 51 directors who were common to the 120 out of 150 companies spread the back dating practice by word of mouth! Since in US, the executive salaries over $1 million are not eligible for deduction from employers income, (U/S 162(m) of the IRC since 1993) Options were found a way out, more as a substitute salary package to start with and thereafter were realized as a 'build and gain' management concept to the executive in Software industry, since initially most of them were cash starved but technically highly qualified. Granting shares in place of options has also emerged as a new pay out to tide over controversies. This is due to the introduction of Sarbanes-Oxley in 2002 that was started for cleaning up the Enron pollution in Corporate Governance. The backdating of options has brought to light its 'twin-sin' of 'spring-loading options' which was also not considered illegal in the US. In this, the option delivery date is deliberately scheduled to occur just in advance of the announcement of favourable information such as above (more than expected) estimate earnings! It amounted to scheduling an award based on privileged information and since it is illegal for an executive to buy shares in advance based upon privileged information, it is difficult to reconcile to any logic that spring-loading options are legal. Thus granting of shares rather than options has come to be a safer practice. Granting of shares provides less temptation to manipulate how and when those shares are awarded.

Since in UK and Europe, options have never been important for compensating executives and more recently granting of shares rather than options were found to be more practiced to compensate for performance, the backdating disease seems to have not spread across these countries. But how about the state of affairs in respect of options management in India where Sarbanes has not taken any deep roots? Since Software boom is of recent origin in India and the technology sector has long been an extensive user of stock options across the globe, partly because of the entrepreneurial and high-growth nature of the market in this sector, options have been selectively practiced in India too. Although the culture of options-based pay was hit by the dotcom and technology crash of the early part of 2K in US, 'options use' is more prevalent in the technology sector than in other sectors, even in India. Moreover, the introduction of FBT in India has raised many eyebrows all over and possibly Indian corporate is lured into practicing backdating.

How Do Shareholders View Backdating Game?

It is reported that in the US, shareholders have filed 265 class action lawsuits against more than 70 companies, claiming that they have been defrauded by companies

by misrepresenting their earnings. Insurance companies have shied away from compensating companies as well as their executives in all cases of option backdating. In fact, the backdating scandal has yielded nothing but collective capitalization loss of over $5.1 billion (some put the figure at $8 billion). According to Glass Lewis, a shareholder consultancy firm from San Francisco, the companies that form a part of the scandal, seemed to have incurred penalization of over $10.3 billion including compensation expenditures.

The Indian Scene

Stock options were common in the Indian Software Industry till the entire industrial sector, including the software industry, received a jolt from Fringe Benefit Tax (FBT). The FBT has apparently brought an uneventful taxation. It is a dogmatic approach to levy FBT if a corporate employer provides some perks to his employee and does away with the same if a HUF in business, irrespective of its scale of operations or government/political party, awards the same to its employees. In fact, all these employers are collectively contributing to spiraling inflation in the form of increasing employees' spending/purchasing power. Untimely elections are no less responsible for fueling inflation just like global oil price hike. Sec 49(2AA) of the Income-tax Act deals with taxing Capital Gains. Year of granting the option and year of opting to avail the option have also become important. If the employee exercised the option during 1999-2000, then the perquisite (FMV of the stock at the time of availing the option less acquisition cost incurred at the time of allotment by the employee) is chargeable to tax. Subsequently, no perquisite was assumed in respect of allotment of shares/securities even if employer made it available at concessional rate or with no charges. But, from the Assessment Year 2008-09 onwards, the cost of acquisition at the time of transfer of specified security or sweat equity shall be the fair market value (FMV) which is taken into consideration for computing the value of fringe benefits in the hands of the employer.

On transfer of such shares by the employee, capital gains would be taxable in the year in which shares/securities are transferred and the cost of acquisition is taken as the amount actually paid by the employees at the time of allotment/availing the option. Even if the employee gifts away the securities, there will be Capital Gains that arise in the year of gift and difference in FMV and cost of acquisition by the employee is the taxable gain.

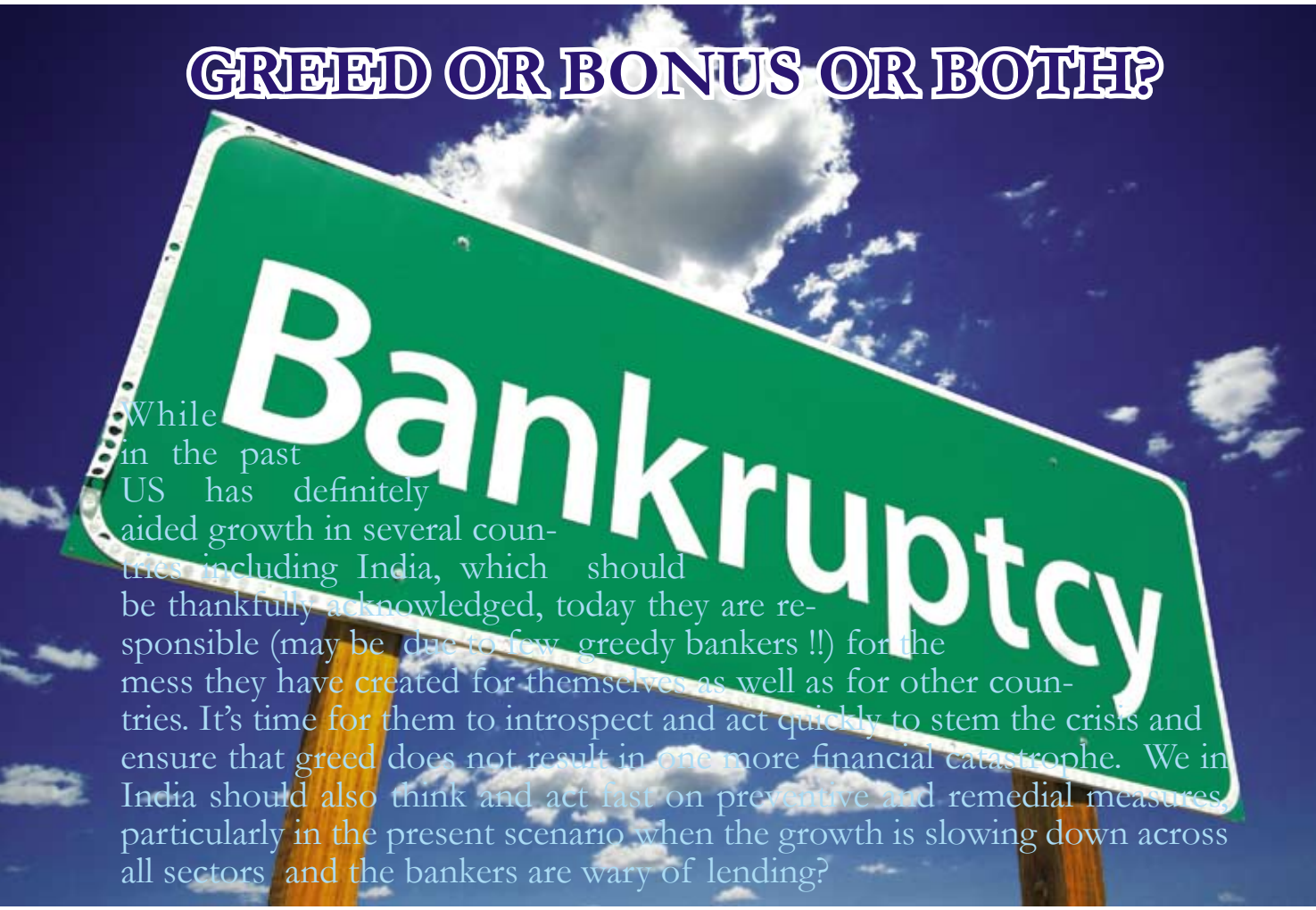
The benefit should flow from employer to his employee in order that employer will be held for FBT at 30%+SC+EC. In this category, among other things, fall specified security/ sweat equity shares allotted or transferred directly or indirectly by the employer free of cost or at concessional rate to his present or former employee. FMV minus amount paid to acquire options thus will be liable to attract the FBT. Thus, for fear of having to shoulder additional burden of 30%+SC+EC, the employer had applied brakes for passing on options to employees from 1/4/2007. This peculiar legal position has prompted some companies to enact the above 'corporate lie,'- that is, backdating, in India too. But this needs verification by the Auditors/SEBI before one can comment on the happenings. Since Sarbanes Oxley Act is not applicable to Indian corporations operating only in India, the possibility of occurrence of backdating among them will be more than in the case of foreign companies operating in India and having employees in India (to whom the foreign company granted/proposes options), which are exposed to Sarbanes. But what about the FBT position if such foreign company grants options to its Indian employees in its foreign shares (holding company) instead of from its Indian subsidiary? Can the Holding company be considered as employer in such cases? Obviously not. Hence, FBT cannot be levied in such cases. But the twist here is that the grantor should not be the employer. If the grantor is employer, it becomes immaterial in which company he grants the options. Thus, for example, if an employer company grants options in shares held by it as investment belonging to another company, such options will attract FBT.

It may be noted in this context that *Circular No.8/2005/29-8-05* clarifies that if an Indian Company carries on business outside India but does not have any employees based in India, it would not be liable to the FBT in India. In such cases stock options to such employees will not be affected by FBT. It is also clarified in Question no. 22 of circular that FBT will apply to foreign companies only if it has employees based in India. FBT will apply, however, to liaison offices of foreign companies in India, if such offices have employees based in India. It must be noted here that exemptions, if any, under Double Taxation Agreements, are only in respect of incomes of the entity and will not be relevant for computing FBT. But Question No 31 of the Circular clarifies that a foreign company having employees based in India, and as per the Article relating to dependent personal services in any treaty, remuneration received by all its employees is not taxable in India. Thus, such foreign companies are not affected by FBT in India.

In the Indian context backdating has no special treatment. To keep the FBT to the minimum is in the interest of employers. So they rarely permit any act that increases their FBT load and at the same time they co-operate with employees in choosing 'dating with options,' which reduces FBT to the minimum. Thus, while granting Stock Options, even employers might act/induce the market in such a manner that the stock market prices of their shares are kept at favourable levels.

The Chartered Accountants need to watch out 'options backdating' and 'options forward dating' incidents among their corporate clients in India and help reduce uncalled for litigation from this exercise and submit revised returns where ever such exercises have occurred . They need to study SEBI/ Company Law regulations too in respect of stock option backdating/forward dating and advise all the concerned parties accordingly.❑

GREED OR BONUS OR BOTH?



While in the past US has definitely aided growth in several countries including India, which should be thankfully acknowledged, today they are responsible (may be due to few greedy bankers !!) for the mess they have created for themselves as well as for other countries. It's time for them to introspect and act quickly to stem the crisis and ensure that greed does not result in one more financial catastrophe. We in India should also think and act fast on preventive and remedial measures, particularly in the present scenario when the growth is slowing down across all sectors and the bankers are wary of lending?

The US financial system is going through air pockets. As the turbulence increases everyday it is essential for us to understand the cause and effect, as the economies of the various countries including India have become or are increasingly becoming inter-dependent. As the US catches a cold (winter has approached) Indians are already affected with sore throats. Before the virus starts spreading, can we look at the reasons and also look at some remedial actions. (May be very obvious!)

We all know that the US economy is consumption driven and that the savings rate is negative. Last week I heard from a banker in India that his friend, who was drawing $ 20,000 per month *plus* bonus, lost his job and he informed him that he has money only to run his family for 1 month! or maximum 2 months.

Today the current account deficit of the US of approx $ 9 trillion (From 1985 till 2008) is funded by various countries including Asia, Middle East and even partly India.

In the past three years, as long as property prices were going up in the US, nobody bothered whether the banker was lending on the same property more than once, whether the tenure was too long, whether the individual income was sufficient to

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Bankers as well as independent broking firms should not be allowed to buy and sell commodities unless it is for a client who is into the similar kind of business and if found by regulatory authorities that the bank has indulged in speculative activity, punitive actions should be taken. Even while entering into Forward, Futures and Options for the clients, there should be checks and balances through regulatory authorities that they cannot do it beyond, let us say, maximum one year of consumption.

repay the mortgage EMI after providing for all his expenses etc.

The investment bankers bundled all these mortgage loans into complex securitised assets coated with derivatives that only few could understand, got the products rated through credit rating agencies and sold them to unwary (supposedly sophisticated) financial institutions such as pension funds, hedge funds, high net worth individuals etc. This innovative process of securitization! continued for more than three years and every body was happy. The investment bankers got their bonus including their Mercs, the credit rating agencies got their fees and the bankers were also happy as they received money for further lending towards consumption.

Countries like India were equally happy since we were also getting money through the FII route and the media was splashing news everyday (perhaps every minute) as to where to invest in the stock market as if the market is only unidirectional. The investment bankers in addition to selling these types of structured products were also into speculative trading in commodities. I fail to understand, when we in the industry after 25 to 30 years of working are unable to predict with any certainty the likely growth in our own industry for the next two years or even perhaps one year, how investment bankers who neither produce nor sell, can predict the future price of oil, lead, zinc etc. and indulge in this type of crazy speculation. They thought that the price can go in only one direction, northward and in the process caused huge damage to the global economy, as the inflation went up due to steep increase in the commodity prices and ultimately the consumer had to pay the price. This spiraling inflation has ultimately IMPACTED THE DEMAND and today most economies are slowing down.

Well we only hope that $700 billon package announced in the US is spent properly with checks and balances, so that the US economy does not slip into recession. The amount of bail out package is almost 75 per cent of the GDP of our country, 80 per cent of the GDP of Australia, higher than that of a few strong European countries and higher than the combined GDP of several African countries. Imagine the multiplier effect that could have happened to the world economy, if this quantum of money was spent for productive purposes rather than buying toxic assets as proposed. Well, if this package does not stimulate the economy, the consequences could be unthinkable.

What should be done to avert this type of man-made catastrophic financial disasters?

First and foremost – The US should provide fiscal stimulus towards savings and introduce certain tax savings instruments for encouraging long-term savings.

There should be checks and balances for lending in any sector. Concentration of risk vs. diversified risk – as a concept is known to all the bankers in the USA but perhaps not practised.

When Lehman fell, I believe their leveraging was in the ratio of 30:1! No management with good corporate governance could have allowed this. The regulatory authorities should have brought in control over this type of lending long time back. How can investment bankers who are not allowed to accept deposits use their own capital for this type of mortgage / leverage lending! While one cannot ban the selling of derivative instruments, people should be properly educated before such products are sold.

With the repeated failure of so many banks, it appears that even for banks, financial leverage is a better way to understand the banks solvency, in addition to the capital adequacy norm. In the capital adequacy norms, capital not only included own funds (Tier I capital) but also loans (Tier II capital). Any loan to qualify for Tier II had to be subordinated to the deposits for repayment and should have a maturity of at least five years. Probable loss in credit portfolio was quantified as 8 per cent and this level was the minimum capital (Tiers I & II) required of any bank. Of the total, Tier II could be 50 per cent *i.e.*, 4 per cent of credit portfolio. RBI has hiked the 'capital' norm from 8 per cent to 9 per cent for banks in India.

Basel II norms refined the above concept, as

As a result of this financial mess, liquidity in India is drying up and the cost of borrowing, particularly for small scale industry is today higher than 20 per cent! If the banks own cost of funding is 13 per cent then they cannot lend it even to blue chip companies for less than 15 per cent! All these actions are already impacting the growth in India.

all loans are not equally risky; some given to blue chip borrowers being safer than others. The quality of borrowers is to be determined by either credit rating agencies or by the bank itself. Further the value of investment could be deducted from loan amount for appraising risk of loss. Besides, banks are required to keep some capital for market risk, *viz.*, dilution in value of investments due to future increase in interest rates and for operational risks, which could arise due to fraud, mismanagement, etc.

While the above logic is sound, in my opinion, the concept of Tier II capital dilutes the meaning of capital. Technically a bank can get into a serious situation if the equity is eroded. Then of course, Tier II capital will still be there to protect depositors, but once a bank becomes insolvent, its assets will fetch a far lower sum on forced sale, thereby endangering the depositors' money also.

Bankers as well as independent broking firms should not be allowed to buy and sell commodities unless it is for a client who is into the similar kind of business and if found by regulatory authorities that the bank has indulged in speculative activity, punitive actions should be taken. Even while entering into Forward, Futures and Options for the clients, there should be checks and balances through regulatory authorities that they cannot do it beyond let us say maximum one year of consumption. The unprecedented rise in commodities prices in the recent past is largely due to speculation and the reason for the recent steep fall is mainly due to winding up of these large positions.

While efficiency should be rewarded and perhaps the reasons for lack of speedier growth in public sector companies and various nationalised banks in India is the absence of reward linked to efficiency, we also cannot operate on two extremes. I don't think the person who designed Nano car would have received the bonus that some of the

All infrastructure projects should be brought under priority sector lending. Of course suitably the limit for priority sector lending should be hiked from 40 per cent so that other priority sector lending does not suffer. As per present RBI guidelines all the infrastructure projects are not considered under 'priority sector.'

middle or even junior level bankers in US (forget the top investment bankers) received in the past two to three years. I do not think they have done any great innovation as compared to the complex design of say a new fuel efficient /alternate fuel car. First, they should deserve and then desire as otherwise we will continue to see these financial debacles. Well I do not think the world can afford to take this type of financial debacle any more! I wonder how many senior citizens in India, who invested in equity mutual funds, lost their money in the recent stock market collapse! And perhaps they may not even live to see the recovery! Investment bankers should understand that they have a larger commitment to the society as they are dealing with public money.

As a result of this financial mess, liquidity in India is drying up and the cost of borrowing, particularly for small scale industry is today higher than 20 per cent! If the banks own cost of funding is 13 per cent then they cannot lend it even to blue chip companies for less than 15 per cent! All these actions are already impacting the growth in India. Unless the rescue package in US and various actions by the European Central Banks work immaculately well and the money starts flowing in again to India, the volatility in rupee would continue and hurt the growth in India. We should not forget the fact India suffers from current account deficit and, therefore, if the inflow from abroad gets choked we will have repercussions on our economy.

Imagine the number of roads and ports which India could have built with even part of this $ 700 billion package which perhaps would have made the investors further richer, as the money would have flowed for productive purpose

While in the past US has definitely aided growth in several countries including India, which should be thankfully acknowledged, today they are responsible (may be due to few greedy bankers !!) for the mess they have created for themselves as well as for other countries. It's time for them to introspect and act quickly to stem the crisis and ensure that greed does not result in one more financial catastrophe. The world cannot take it!

While we want growth we want orderly growth. While we want change we want change for the better.

Finally what should we do in our country in the present scenario where the growth is slowing down across all sectors and the bankers are wary of lending?

Few suggestions which in my opinion are important in the present context :

1. All infrastructure projects should be brought under priority sector lending. Of course suitably the limit for priority sector lending should be hiked from 40 per cent so that other priority sector lending does not suffer. As per present RBI guidelines all the infrastructure projects are not considered under 'priority sector.'
2. Tax free bonds at 7 per cent to 9 per cent with a tenor of 5 years or more should be allowed to be issued directly by public and private sector companies (NTPC, BHEL etc.) which are in the exclusive domain of infrastructure development. Minimum subscription by individuals could be Rs. 1 lakh and maximum cap can also be prescribed.
3. External Commercial Borrowing (ECB) should be allowed to be brought in and used both for redemption of high cost borrowings and for working capital purpose. To ensure that the money does not go to the places other than it is intended for (Stock market etc.) utilization certificate from the bank /CA can be insisted.
4. Reform should be accelerated. While we missed the opportunity of raising money by diluting the Government holding in blue chip public sector companies when the market was on a growth path, we should not again slip. We should not forget the fact that India has revenue deficit, in addition to huge fiscal deficit and current account deficit. Our fiscal obligations keep piling up like tinder on a forest floor for various reasons, which is not healthy. Perhaps even now in certain essential sectors like power, we should-dilute the holdings to provide for growth.❑

Enhancing Audit Quality

With a view to apprise the members of the Institute and others concerned about the major non-compliances observed during the review, the Financial Reporting Review Board (FRRB) compiles such non-compliances from time to time and publishes the same in the Journal. Continuing the same practice, following are the some of the common non-compliances observed by the Board during review of general-purpose financial statements of certain enterprises and auditors' reports thereon:

I Accounting Standards (AS)

AS 2, Valuation of Inventories

1. AS 2, Valuation of Inventories, requires all inventories, including raw materials, packing materials and consumables & stores, to be valued at lower of cost and net realisable value. In few cases, the accounting policy of few enterprises provides that raw materials, packing materials and consumables & stores are valued at the cost/ weighted average cost. In other words, some enterprises do not consider net realisable value in the valuation of raw materials, packing materials and consumables & stores, which is contrary to the requirements of AS 2.
2. Paragraph 26 of the AS 2, dealing with disclosure requires that the financial statements should disclose:
   - the accounting policies adopted in measuring inventories, including the cost formula used; and
   - the total carrying amount of inventories and its classification appropriate to the enterprise.

   Some enterprises do not disclose the method of valuation of inventories i.e. whether FIFO/ LIFO or other method in their accounting policy on Inventories, which is contrary to the requirements of AS 2.

AS 3, Cash Flow Statements

3. As per paragraph 30 of AS 3, Cash Flow Statements, interest paid has to be classified as cash flow from financing activities. Few enterprises have shown interest paid as cash flow from investing activities, which is not as per AS 3.

AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

4. As per AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, prior period items are income or expense which arise in the current period as a result of error or omissions in the preparation of the financial statements of one or more prior periods. Some enterprises have adjusted the Balances/Liabilities that are no longer required relating to earlier years or written off in earlier years under the head prior period adjustments in the profit & loss account, which is contrary to AS 5.

AS 9, Revenue Recognition

5. Accounting Standards Interpretation (ASI) 14, 'Disclosure of Revenue from Sales Transactions' (Re. AS 9, Revenue Recognition) requires that 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

   Some enterprises disclose sales (net of excise duty) on the face of the profit and loss account and the amount of excise duty is shown as deduction from sales in the Schedule to the profit and loss account, which is contrary to the Accounting Standards Interpretation (ASI) 14.

AS 13, Accounting for Investments

6. Paragraph 26 of AS 13, Accounting for Investments, requires that an enterprise should disclose current investments and long-term investments distinctly in its financial statements. Some enterprises classify the investments into two categories, viz., (i) Non-trade (Quoted), and (ii) Unquoted but do not disclose the classification of investment as required by AS 13 either in their Schedule or in the notes to accounts.
7. AS 13, Accounting for Investments, requires provision to be created to recognise a decline, other than temporary, in the value of long-term investments. Some enterprises use the term permanent diminution instead of other than temporary, which is contrary to the requirements of AS 13. It may be noted that there is a difference between 'permanent diminution in the value of investments' and 'other than temporary diminution in value of investments' and normally, no diminution in value of investments may be termed as permanent.

(to be continued……)

Tax-free gratuity ceiling may treble to Rs 10 lakh

In a move that's likely to benefit the salaried, the labour ministry is mulling a proposal to virtually treble the ceiling on tax-free gratuity to Rs 10 lakh from Rs 3.5 lakh now. The ministry has sought comments from workers and employers, and a decision would be taken after considering the views of both sides. If the proposal is cleared, the ministry would urge the finance ministry to hike the tax-free gratuity limit to Rs 10 lakh, government sources said.

CBEC on trail of sugar companies evading excise duty

Sugar mills have come under the Government scanner for alleged excise duty evasion. The Cabinet Committee on Prices (CCP) has asked the Central Board of Excise and Customs to direct its field formations to keep a watch on sugar mills. According to reports, sugar mills have deliberately withheld sale of dismantling buffer stock into the open market or have exported approximately 5 lakh tonnes of sugar without prior approval from the Government of India, for their own benefits & gains. It resulted in excise loss of Rs 500 crore, besides not meeting demand in the domestic market. Sugar commissioners have also been asked to monitor timely release of sugar in the domestic market. Hence, excise officials and sugar commissioners have to work in tandem.

ITTA seeks excise, VAT exemption to import vehicles

With the Government intensifying preparations for the Commonwealth Games, Indian Tourist Transporters Association (ITTA) President has written to the Finance and Commerce Ministries to provide them a one-time exemption from excise duty and VAT under the Export Processing Guarantee Scheme (EPCG) on the purchase of nearly 5,000 vehicles. According to him, this is imperative to ensure their logistical preparedness as they would need to invest around Rs 1,000 crore for these games.

Duty-free shops need local Customs clearance too

The finance ministry has clarified that companies that plan duty-free shops in the country will need to take a separate clearance from local Customs authorities, once their plan is cleared by the Foreign Investment Promotion Board (FIPB). The FIPB's approval is only for the purpose of permitting foreign investment and any such approval does not automatically confer a right on the applicant to open a duty-free shop at any port, an official said. Requisite clearances from the Customs authorities as envisaged in the Customs Act, 1962 are mandatory, the official said.

Telcom firms not to deduct TDS on fee to MTNL, BSNL

In a relief to private telecom players, the Delhi High Court has ruled that no tax will be deducted at source on payments to MTNL and BSNL for interconnection. Telecom companies are required to set up own equipment and infrastructure for operating and maintaining their networks. Interconnection helps complete calls between two networks. Any operator who seeks interconnection from MTNL or BSNL needs to pay a fee fixed by the telecom regulator and the same (payment by private operators to PSUs) is reflected in their receipts for taxation purposes.

Government slaps 5% import duty on iron and steel

The government on 18th November 2008 slapped a 5% import duty on specified iron and steel products and 20% duty on crude soyabean oil in a move aimed at safeguarding the interests of domestic industry. While bringing cheer to the industry, the move is also expected to give a marginal relief to the government revenues as well. The government, which has cut indirect taxes to stimulate the economy in the budget and then later in the financial year including exempting crude oil from import duty has witnessed a downslide in its excise and customs duty collections. The collections declined by 5% in October, 2008.

Attuning company law with other regulatory norms

According to the corporate affairs ministry, the Companies Bill 2008 introduced in parliament recently provides for harmonisation of India's company law framework. What's being envisaged is avoidance of conflict between the Companies Act and various specialised sectoral regulations. The proposed harmonisation, according to the ministry, would enable "sectoral regulators to address their specific roles on the basis of their respective regulatory frameworks in a manner consistent with and complementary to the company law framework."

IFAC Supports Convergence in the Reporting of Financial Instruments

The International Federation of Accountants (IFAC) supports recent moves by the International Accounting Standards Board (IASB) to contribute to greater consistency in financial reporting and to work towards convergence of international standards, an objective which IFAC views as critical to the efficient operation of global capital markets. IFAC believes that the additional guidance given to those applying both accounting and auditing standards relating to fair values has been very valuable and will contribute to the public interest through more consistent application of the standards. This guidance has come from the IASB and the United States Financial Accounting Standards Board, as well as from the International Auditing and Assurance Standards Board in its Staff Audit Practice Alert, *Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment*. IFAC and its independent standard-setting boards are continuing to monitor the impact of the credit crisis and will consider whether further guidance is needed.

www.ifac.org

IFAC Examines Developments in Public Sector Performance Measurement Structures

As part of its mission to serve all professional accountants in business, including those working in the public sector, IFAC's Professional Accountants in Business (PAIB) Committee has conducted a survey to obtain information about the development of financial and non-financial performance measurement and reporting structures in various public sector entities around the world. The results of this survey, contained in the information paper *Developments in Performance Measurement Structures in Public Sector Entities*, will help professional accountants in business, and others who work in the public sector, in evaluating and further improving their own financial and non-financial performance measurement structures. This will enable them to better plan, execute and control their organization's service delivery and to achieve a higher level of accountability. The results will also help IFAC's PAIB Committee to consider specific public sector aspects when developing International Good Practice Guidance for professional accountants in business.

www.ifac.org

IASB and FASB launch consultation on proposed enhancements to the presentation of financial statements

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) on 16 October 2008 published for public comment a discussion paper on financial statement presentation.The discussion paper contains an analysis of the current issues in financial statement presentation and presents the boards' initial thinking on how those issues could be addressed in a possible future format.The discussion paper is open for comment until 14 April 2009.

www.iasb.org

IASB and FASB create advisory group to review reporting issues related to credit crisis

The IASB and FASB on 16 October 2008 announced that they will create a global advisory group comprising regulators, preparers, auditors, investors and other users of financial statements. The advisory group will help to ensure that reporting issues arising from the global economic crisis are considered in an internationally co-ordinated manner.

www.iasb.org

IASB publishes educational guidance on the application of fair value measurement when markets become inactive

The IASB on 31 October 2008 published educational guidance on the application of fair value measurement when markets become inactive. The educational guidance takes the form of a summary document prepared by IASB staff and the final report of the expert advisory panel established to consider the issue. The summary document sets out the context of the expert advisory panel report and highlights important issues associated with measuring the fair value of financial instruments when markets become inactive.

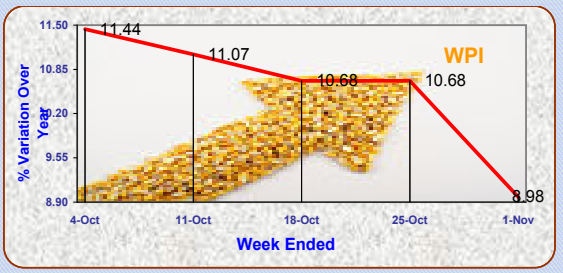
www.iasb.org

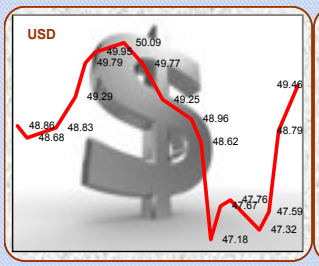
FASB to Issue FSP FAS 140-4 and FIN 46(R)-8

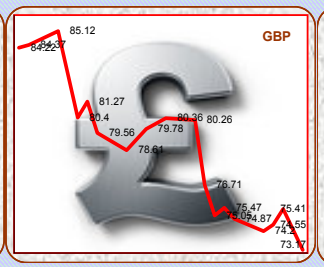
The Financial Accounting Standards Board (FASB) has announced plans to issue final FASB Staff Position (FSP) FAS 140-4 and FIN 46(R)-8, Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities, by December 15, 2008. The document will increase disclosure requirements for public companies for reporting periods that end after December 15, 2008. The purpose of this FSP is to promptly improve disclosures by public entities and enterprises until the pending amendments to FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, and FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, are finalized and approved by the Board. Effective at the end of the first reporting period (interim and annual) after issuance of the FSP for public entities, the FSP amends Statement 140 to require public entities to provide additional disclosures about transfers of financial assets and variable interests in qualifying special-purpose entities. It also amends Interpretation 46(R) to require public enterprises to provide additional disclosures about their involvement with variable interest entities.

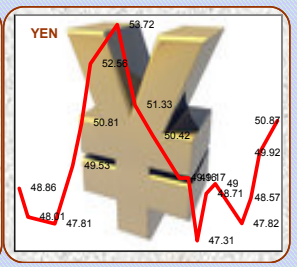
www.fasb.org

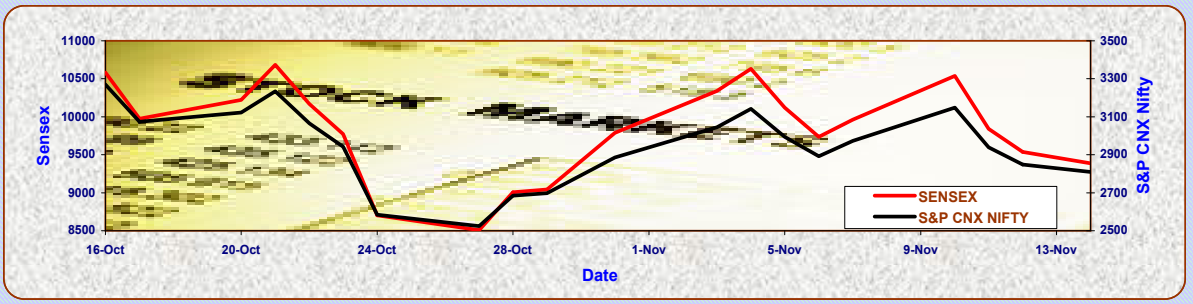
Economic Indicators











Selected Indicators

Item	Unit/Base	2007	2008					
		Nov. 9	Oct. 3	Oct. 10	Oct. 17	Oct. 24	Oct. 31	Nov. 7
Cash Reserve Ratio	per cent	7.00	9.00	9.00	6.50	6.50	6.00	6.00
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	13.75-14.00	13.75-14.00	13.75-14.00	13.75-14.00	13.75-14.00	13.75-14.00
Deposit Rate	Per cent per annum	8.00-9.50	8.75-10.50	8.75-10.50	8.75-10.50	8.75-10.50	8.75-10.50	8.75-10.50
Call Money Rate (Low/High)	Per cent per annum	4.00/8.00	9.00/17.50	5.00/23.00	5.50/11.32	2.00/10.29	4.50/21.00	4.00/21.00

Note : Readers are Invited to contribute write-ups or any relevant and interesting piece of information for this feature at eboard@icai.org.

ACCOUNTANT'S BROWSER

"PROFESSIONAL NEWS & VIEWS PUBLISHED ELSEWHERE"

Index of some useful articles taken from Periodicals/Newspapers received during October-November 2008 for the reference of Faculty/Students & Members of the Institute.

1. ACCOUNTING

Behavioral effects of nonfinancial performance measures: The role of procedural fairness by Chong M. Lau & Antony Moser. *Behavioral Research in Accounting*, Vol.20/2, 2008, pp.55-71.

Effects of moral reasoning on Financial Reporting decisions in a post Sarbanes-Oxlely Environment by James J. Maroney & Roselie E. Mcdevitt. *Behavioral Research in Accounting*, Vol.20/2, 2008, pp.89-110.

IFAC : Bringing balance to the profession by Anuja Ravendran. *Accountants Today*, Oct. 2008, pp.8-10.

IFRS implementation: Auditors training by Uday chitale & Murtuza Vajihi. *BCAJ*, Oct. 2008, pp.67+70.

Lean Accounting: What's it all about? by Frances A. Kenndey & Peter C. Brewer. *The Management Accountant*, Oct. 2008, pp.745-749.

2. AUDITING

Empirical tests of Audit Budget Dynamics by Michael L. Ettredge etc. *Behavioral Research in Accounting*, Vol.20/2, 2008, pp.1-18.

Exploring benford's law – digital analysis with computer assisted Audit tools (CAATs) by Deepjee Singhal & Manish Pipalia. *BCAJ*, Oct. 2008, pp.63-66.

Social Audit: An overview of trends & future possibilities by Aminul Islam. *The Management Accountant*, Oct. 2008, pp. 781-784.

3. ECONOMICS

Lock-in periods: Analysis & anomalies by Ajay chaydgart & Devendra Khatri. *SEBI & Corporate Laws*, Oct. 20-26, 2008, pp. 53-60.

Transfer pricing measures & emerging developing economies by Michael Kobetsky. Asia-Pacific Tax Bulletin, Sep./Oct. 2008, pp.363-377.

4. INVESTMENT

Economics of Mergers & Acquisitions: A study of reliance Industries limited & reliance petroleum limited by D. Raghunatha Reddy & R.N. Arun. *The Management Accountant*, Oct. 2008, pp. 794-801.

Empirical analysis of Stock price volume relationship in Indian stock market by Sarika Mahajan & Balwinder Singh. *Vision*, July-Sep. 2008, pp.1-14.

De-Merger: The growing practice in India by Mayank Chandrakar. *SEBI & Corporate Laws*, Oct. 20-26, 2008, pp.45-52.

5. LAW

Appointment of Arbitrators: Scope & ambit of section 11 (6) of Arbitration & Conciliation Act by V. Gopalan. Company Law Journal, Vol.4, 2008, pp.1-10.

Disclosure of Director's Interest by PR. Raamaanathan. *SEBI & Corporate Laws*, Oct. 20-26, 2008, pp.61-66.

6. MANAGEMENT

B-Schools survey – 2008. *Business India*, Oct. 19, 2008, pp.59-168.

Corporate responsibility, governance & accountability: From self-regulation to co-regulation by Laura Albareda. *Corporate Governance*, Vol. 8/4, 2008, pp.430-439.

Future of Finance by Stathis Gould & Martin Fahy. *The Management Accountant*, Oct. 2008, pp. 750-752.

Exploring the governance agenda of corporate responsibility: Complex Accountability & power in global governance: Issues for global business by Robert O. Keohane. *Corporate Governance*, Vol. 8/4, 2008, pp.361-367.

7. TAXATION & FINANCE

Consumption taxation of supplies of financial services in the Asia-Pacific Region by Lee Burns. *Asia-Pacific Tax Bulletin*, Sep./ Oct. 2008, pp. 352-362.

Germany's new Transfer Pricing rules on transfers of business functions abroad by Peter H. Dehnen & Rosemarie Rhines. *Bulletin for International Taxation*, Nov. 2008, pp.508-512.

Income-tax scrutiny norms by CA. Rajkumar S. Adukia. *ACAJ*, Sep. 2008, pp.381-384.

Indirect taxation on manufacturing concerns by Aditya Bhattacharya & Tanushree pande. *Asia-Pacific Tax Bulletin*, Sep./ Oct. 2008, pp. 378-382.

Need for equal treatment of likes in tax administration by K. Srinivasan. *Corporate Law Adviser*, Oct. (ist), 2008, pp.47-52.

Penal provisions under the Finance Act, 1994 relating to Service Tax by K.P. Sridhara Raman. *Service Tax Journal*, Oct. (ist), 2008, pp.6-9.

Vat treatment of financial Services: Assessment & Policy proposal for developing countries by Pierre-Pascal Gendron. *Bulletin for International Taxation*, Nov. 2008, pp. 494-507.❑

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

A Peep into the Past

Continuing with our series of contents having nostalgic value, reproduced here-in-below is 'A Self Quiz' published in the September 1965 issue of *The Chartered Accountant*, which holds merit even in the current scenario, for the information of the members.

FOR A PRACTISING CHARTERED ACCOUNTANT
A SELF QUIZ

These questions are deliberately thought-provoking. Answers to some of these will provide a searching analysis of the non-technical qualities required for a successful practice -

1. **What are my professional objectives?**

   What do I really want to accomplish in my life-time?

   Have I ever defined my objectives and committed them to writing?

   Have I planned any objectives for my employees?

   Will my employees help me to attain my real proposes?

2. **Am I willing to work at becoming a successful executive, or is it just wishful thinking?**

   Will I sacrifice short-run satisfaction to accomplish my long range objectives?

   Am I willing to live the integrity I profess?

   Am I dedicated to the goals that I have set for myself and my firm?

3. **Have I set worthy objectives for my associates and my employees?**

   Am I sufficiently clear in my own mind as to the functions of my practice?

   Have I allowed my associates and employees to share in establishing the firm's goals, or have I imposed my own will on them?

   Can my employee have faith in me and in our relationship?

4. **Have I set sufficiently high standards of workmanship?**

   Does my staff have the reputation for being aggressive, hard-hitting and maintaining high standards of performance?

   Can and does my staff take pride in being members of the firm?

   Do I insist on performance that gives everyone the feeling that we are moving ahead and getting things done?

   Do I frustrate my staff with indecision, delay, doubts and lack of faith in them?

   Do I have confidence in the ability and willingness of my staff to do a good job?

5. **Do I try to develop the creative potential of each individual in the firm?**

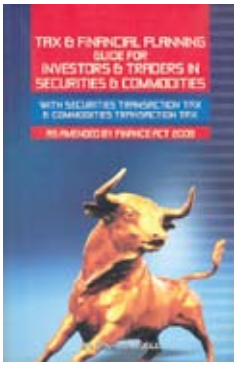
   Do I want to handle all the problems myself, or am I willing to share the management function with my subordinates?

   Am I willing to delegate as much as I can, or do I hold on to certain phases of my job to prove that I am Indispensable?

   Do I try to force my own decisions on my staff or do I let them share in decision-making?

The above Shield was awarded to M/s Tata Iron & Steel Co. Ltd for the year 1958-59 for the Best Presented Accounts at the Annual Meeting held in September 1960.

A PRACTICAL GUIDE FOR INVESTORS & TRADERS IN SECURITIES & COMMODITIES



Title:	Tax and Financial Planning Guide for Investors & Traders in Securities & Commodities
Author:	CA. Samir S. Mogul
Pages:	621
Price:	Rs.595

The book *Tax and Financial Planning Guide for Investors & Traders in Securities & Commodities,* authored by *CA. Samir S. Mogul,* discusses various provisions relating to Securities Transaction Tax and Commodities Transaction Tax under the Indian Income-tax Act, 1961, as amended by the Finance Act, 2008. These discussions have been backed by various case laws as well as notifications, circulars and press releases issued by various statutory authorities. There have also been discussions on how to plan taxes to take advantage of the exemptions and deductions available in the Income-tax Act. Guidelines for Investors as well as Traders and businessmen are also given in this book.

We invest our hard-earned and inherited money including capital, income and savings, in shares, bonds, debentures, mutual funds units, derivatives, and so on, on one hand, and commodities like gold, silver, jewellery, artifacts and other goods/merchandise on the other. Objectives behind investments have always been to make profits and generate revenue from all our assets. In order to maximize our real returns, i.e., after eliminating the effect of inflation, on investments, taxation has to be considered and planned carefully to minimize its impact on investments and returns. Taxation plays a crucial role in the overall returns on any investment or in any trade and hence, it is necessary to understand the fundamentals of taxation. There have been global dramatic changes in past few decades in financial and commodity markets in terms of various volumes, nature, type of assets, values of volatility and so on. Along with it, there have also been a rapid growth in derivatives contracts (options, future and forward contracts) in securities and commodity markets in India over the years, and both the above now account for big share of the total value of transactions.

This book also discusses the impact of changes made by the Finance Act, 2008, especially with regard to the increase in the threshold limit of the exemption from income-tax for individuals, clarifications on reverse mortgage scheme, taxation of securities received under Employees Stock Options Plans (ESOP), changes in tax on distributed profiles by domestic company, among others. The author has given some tax planning tips and strategies in the book which are highlighted with a background shade for the benefit of the readers.

Investors and traders, who are looking for opportunities in derivatives markets for profits, can use this book to understand and take advantage of the tax laws governing securities and commodities. Tax professionals and practitioners would also find this book advantageous. This book can also be used by finance and taxation students and other academicians, who want to acquire a working knowledge of tax laws relating to various financial instruments and commodities.

Eventually, one can say that through this book the author has provided a wide-in-scope guide for investors and traders of all kinds, who may plan their investments and trading activities in financial securities and commodities under the Securities Transaction Tax and Commodities Transaction Tax. This book is recommended to all those investors and traders as a must-read document.❑

Where the Newly Qualified Chartered Accountants are heading in Industry[1]

The Committee for Members in Industry (CMII) of the Institute has successfully organised one more round of Campus Placement Programme during August-September 2008 at Sixteen centers viz. Ahmedabad, Bangalore, Chandigarh, Chennai, Coimbatore, Ernakulam, Hyderabad, Indore, Jaipur, Kanpur, Kolkata, Mumbai, Nagpur, New Delhi, Pune, Surat for those candidates who have qualified in May 2008 examination. In all **3817** candidates had the opportunity to avail this service. The bio-data of these professionals were classified centre-wise and they were given an opportunity to meet 149 interview boards of 77 organisations at Sixteen centres.

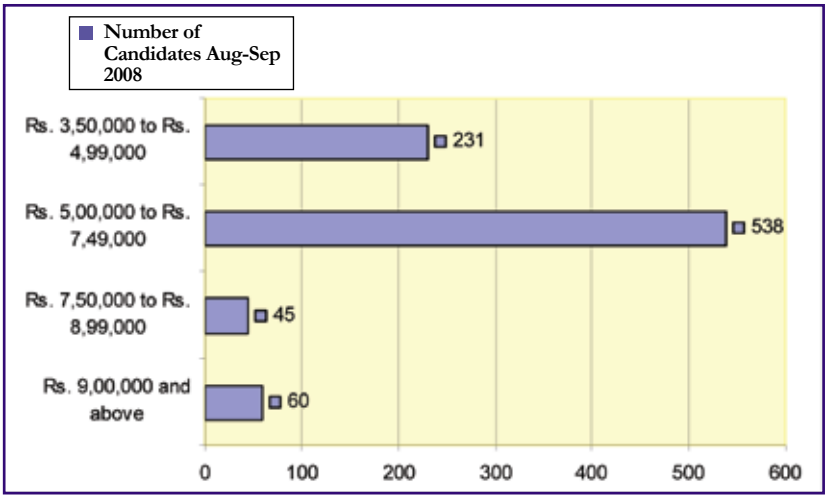
Executive Summary of the Campus Placement Programme

1. Highest salary offered for International posting in the Campus Placement Programme is Rs. 21.00 Lacs per annum.
2. Highest salary offered for domestic posting in the Campus Placement Programme is Rs. 10.61 Lacs per annum.
3. Around 1000 jobs were offered to the candidates who participated in Campus Placement Programme.
4. The average salary offered to the newly qualified Chartered Accountants is about Rs. 6.11 lacs per annum .
5. 77 companies have participated during the Campus Placement Programme.
6. 149 Interview Panels have participated during the Campus Placement Programme.
7. IT Software sector (16.16%) is amongst the highest recruiter of all sectors, but sectors like Mining (8.42%), Banking (7.52%), Financial Services (6.40%), Oil & Gas Refining (5.50%) are the major recruiters.
8. Nineteen new recruiting entities have also joined in the Campus Placement Programme for the first time.
9. The Committee for Members in Industry brought out revised publication on `Quick Review Questions' & `How to face an Interview Board' to enable the candidates to prepare for their Interviews.
10. The committee organised Orientation Programme for candidates to sharpen their soft skills and give updates on the Technical side.

Trends in Salary Packages

In the August-September 2008 Campus Placement Programme the maximum salary offered to Six candidates were Rs. 21.00 lacs per annum for International Posting. For Indian posting the maximum salary offered to Nine candidates were Rs. 10.61 lacs per annum.

The average salary works out to be about Rs. 6.11 lacs per annum. Major details are as below:



Top Five Recruiters during the August-September 2008 Campus Interviews:

S.N.	Company Name	Selected
1	Infosys Technologies Ltd.	84
2	Vedanta	75
3	Tata Sons	48
4	Tata Consultancy Services	46
5	SBI	40

Spreading Wings

There were 19 new entities joined in the Campus Placement Programme for the first time, which included Bharti AXA Life Insurance Company Limited, Container Corporation of India Limited, Johnson & Johnson Limited, IBM Daksh, IBM India Private Limited, Kuwait Resources House, Louis Dreyfus Commodities India Private Limited, Oman Exchange, Tally (India) Private Limited and Tolaram Corporation Private Limited.

For further details kindly visit www.cmii-icai.org.❑

[1] Prepared by the Secretariat of the CMII. Information given is as on 05/11/08 at 1200 hrs
Comments are welcome at placements@icai.org

Competency Mapping for Accountancy Professionals

Last Date of Submission: 15th December, 2008

1 CPE Hour

Preface

The role of an accountant is changing from perspective of the industry. It goes to the credence of the Chartered accountancy profession that its product i.e Chartered accountant members have been able to make their mark felt in the professional dome. The world today is of specific competencies and mapping of such competencies which are ultimately required by the users of members in industry is something which is core to possibly creating a re-alignment of CA profession module. While, the post membership programs reinforce an education already undertaken albeit in specific programs which intending members intend to pursue , it is important to take review of the developments globally and their impact on job market in India. One also sees a steady growth of the members moving to industry and may be returning to licensed practice; this being typically true for the new professional. This could also reflect on the competencies required for members vis-à-vis those in practice and those in industry.

The ongoing structural ramifications in accounting profession taking place world wide would influence the profession and possibly need a sustained response on on-going basis; such issues being of nature which warrant due positioning to be undertaken for the benefit of the membership at large. The issues being timely and requiring threshold reaction are thus needed to be addressed at a shorter notice and hence there is a need for the response of membership to such structural factors.

Institute invites the comments of members in industry to take out time for responding to the Questionnaire as follows for drawing an insight into the competency mapping of the professional traits which are considered to be of foremost important for the members of profession from the view point of industry.

The response would be kept totally confidential and would not be used for another perspective other than to assess the current trends for taking future positions if so warranted. It may also be added that the response stated herein would entitle one for CPE credit of 1 hour.

Members are requested to respond to the below questionnaire either electronically on the homepage of institute's website www.icai.in or submitted in physical form so as to reach us by 15th December 2008 to:

Secretary, Perspective Planning Committee

The Institute of Chartered Accountants of India

Post Box No. 7100, Indraprastha Marg

New Delhi – 110002

Questionnaire

QUESTION 1. Do you work in:

a) Self employed

b) CA firm

c) Industry

d) Others, please specify_____

QUESTION 2. What type of business or organization do you work in?

a) Public Sector

b) Accountancy Firm

c) Other type of Business

d) Career break/ not currently working

e) Others, please specify _____

QUESTION 3. How long ago did you qualify CA?

a) <1 year

b) 1-4 years

c) 4-6 years

d) 6-9 years

e) 9- 19 years

f) + 20 years

QUESTION 4. Are you:

a) Male

b) Female

QUESTION 5. In which of these age groups do you fall?

a) Under 25

b) 25-35

c) 36-45

d) 46-55

e) 56-65

f) Over 65

QUESTION 6. Place of work falls in :

a) North Zone

b) East Zone

c) South Zone

d) West Zone

e) Central Zone

QUESTION 7. Place of work situated in :

a) Metro ((Delhi,Mumbai, Kolkatta ,Chennai, Hyderabad,Bangalore)

b) Non-Metro

QUESTION 8. Do you work:

a) Full time, in a permanent role

b) Part time

c) On a fixed term contract

d) Others, please specify _____

QUESTION 9. In a typical week, how many hours do you spend working, in your office or elsewhere?

a) Upto 20 hours

b) 21-40 hours

c) 41-60 hours

d) 61- 80 hours

e) Above 80 hours

Comments , if any _____

QUESTION 10. What is your current job level?

a) Top Management

b) Middle Management

c) Executive/ Manager

d) Independent/ Partner

e) Accountant

Others, if any _____

QUESTION 11. How many employees work in your organization?

a) 1-20

b) 21-50

c) 50-100

d) 101-500

e) 501-1000

f) 1001-5000

g) More than 5000

Comments, if any _____

QUESTION 12. What is the annual turnover of your organization?

a) Less than 50 crores

b) 50-500 crores

c) 500 crores-1000 crores

d) More than 1000 crore

Comments, if any _____

QUESTION 13. What is your annual emoluments (Cost to Company)?

a) Less than 3 lakh

b) 3- 5 lakh

c) 5-10 lakh

d) 10-20 lakh

e) Above 20 lakhs

Comments, if any _____

QUESTION 14. Is the business income/ salary higher or lower than last year's?

a) Higher

b) Lower

c) Same

Comments, if any _____

QUESTION 15. How long have you been with your current employer/ Firm?

a) Less then 1 year

b) 1-3 year

c) 4- 6 years

d) 7- 10 years

e) More than 10 years

QUESTION 16. Please indicate the main sector in which your organization is involved:

a) Trading

b) Manufacturing

c) Service Sector

d) Others, please specify _____

QUESTION 17. Given the opportunities in the market what according to you are the driving factors for a continued retention in the market?

a) Conducive Environment

b) Good Pay Package

c) Growth Prospects

d) Location

e) Flexi working Hours

f) Brand Equity

g) Others please specify _____

QUESTION 18. What according to you are the most desirable traits of any employee from the employer's perspective and more importantly from an employee with CA as professional background (kindly allocate %)?

a) Ethical Values ____

b) Loyalty ____

c) Hard work ____

d) Dedication ____

e) Professionalism ____

f) Academic Background ____

g) Experience ____

h) Communication skills ____

i) Leadership Skills ____

j) Presentation Skills ____

k) Business Management Skills ____

l) Other , please specify _____

QUESTION 19. How important is it to you to have your employer's involvement in your professional development?

a) Extremely important

b) Very important

c) Quite important

d) Not at all

QUESTION 20. Do you find the current CA curriculum in tune with the Industrial/ Consultancy job requirements in India :

a) Yes

b) No

Comments , if any_____

QUESTION 21. Currently, subjects mix in the final stage of CA program is

Accounting and financial reporting	37.5%
Auditing	12.5%
Law	12.5%
Information Technology	12.5%
Taxation	25%

Do you think that the % classification of subjects as in the current CA curriculum is appropriate from the perspective of an employed ICAI member?

a) Yes

b) No, what should be the appropriate mix?

Accounting and financial reporting	_____%
Auditing	_____%
Law	_____%
Information Technology	_____%
Taxation	_____%

Comments, if any _____

QUESTION 22. Do you think that there is a need of new areas to be included in the current CA curriculum from the industry perspective?

a) Yes, which areas , please specify _____

b) No

Comments, if any _____

QUESTION 23. Do you feel that given the change in the market scenario the focus of studies should be changed from the existing subjects?

a) Yes

b) No

If yes, which areas _____

QUESTION 24. Have you undertaken any post qualification course undertaken by ICAI ?

a) Information System Audit (ISA)

b) Diploma in Insurance and Risk Management (DIRM)

c) International Trade Laws and World Trade Organization (ITL & WTO)

d) Tax Management Course (TMC)

e) Management Accountancy course (MAC)

f) Corporate Management Course (CMC)

g) CPE Course on Computed Accounting and Auditing Techniques (CAAT)

h) ERP course on SAP FICO Module , Oracle 11i, Microsoft Dynamics NAV

QUESTION 25. Do you think that the post qualification courses help you in better job opportunities?

a) Yes

b) No

Comments, if any _____

QUESTION 26. Which factors motivated you for joining the profession?

QUESTION 27. Do you ever feel the competition from other related professionals ?

a) Yes

b) No

Comments, if any_____

QUESTION 28. ICAI has decided to converge with IFRS from April 1, 2011. Are you fully conversant with IFRS ?

a) Yes

b) No

Comments, if any _____

QUESTION 29 Are the functions assigned to you commensurate with your professional expertise?

a) Yes

b) No

Comments, if any _____

QUESTION 30 In addition to ICAI's Continuing professional Education (CPE) program, which are the other sources of Executive Education you have acquired newer skills during last 5 years?

a) Sources :

b) Areas :

QUESTION 31 Kindly give the positive aspects of Chartered accountancy profession?

QUESTION 32 Kindly provide the negative aspects of Chartered accountancy profession?

Question 33 As a possible user of professional services from a Chartered Accountant (eg. You could be a CFO/ Senior Partner, using services of an auditor or having Chartered Accountant associated with you), how would you rate your experience in dealing with them?

a) Dealing with the auditor

b) Dealing with colleagues

Your response is very useful for us.
Thank you for taking time to complete this Questionnaire.

Survey Evaluation

(Please ^appropriate box)

	Excellent	Very Good	Good	Meet Expectation	Below Expectation
1. How would you rate the usefulness of this Survey?	☐	☐	☐	☐	☐

2. Is there anything you can think of which may improve the Questionnaire or any information we should collect through this Questionnaire?

All responses received and the data thereof will be kept STRICTLY CONFIDENTIAL.

Name:

Membership No.

Name of the Organization:

This exercise is being attempted by the Perspective Planning Committee (PPC) of the Institute of Chartered Accountants of India. The Perspective Planning Committee, as the members are aware, has been formed recently to the assess the developments which have been taking place in the service(s) sector and more importantly relating to the accountancy sector so as to initiate and strengthen steps which consolidate and further enhance the distinguish role of the chartered accountancy profession.❑

Changing Profile of Profession in Context with Member Firms

Last Date of Submission: 15th December, 2008

2 CPE Hours

Preface

The advent of globalization and its consequent ramifications are making a subtle transformation in delivery mechanism of the professional services. World over and more importantly in the emerging economies, one sees an innate desire to march toward being bigger. This becomes crucial in context of professions like accountants which traditionally have been sole-practitioners or as small firms with limited number of partners. While there can be no ground to make a case for stating that such firms are inhibited on competency framework; at the same time the on-going reforms and with the limited liability partnership Act in offing with and the users of services also looking for one stop solution on various professionals issues; it makes a cogent ground to draw up synergistic relationship to Grow bigger.

When we talk of growing big in context of professional service providers it could be in the form of consolidations/mergers amongst individual firms, collaborating with others and alike, in order to gain professional competencies needed in the market domain.

The Institute in order to have an insight into the structural dynamics of the profession is coming out with survey to have the perspective of its constituent member firms as to their vision on the emerging paradigm and structural issues relating to profession. It is also a fact that the traditional role of an accountant has now broadened to encompass a wide variety of services. This along with the changing profile of market needs and a renewed thrust on the reporting requirements has brought into a new set of compliance procedures. The compliance systems, while being regulatory in nature have their developmental aspects as well which in process of such compliance, hones up the quality of professional work.

There is no hard core definition of a small and medium practitioner however, traditionally in context of a market like India, small firm would typically signify and create perception of have less than 5 partners and would have smaller number of employees and gross receipts of say Rs.50 lakhs which again may vary depending upon the demographic profile of the firm.

The issue of new trade order and increasing competition from the overseas firms is also a factor which is receiving the attention of the developing economies world over. The importance of the members being equipped with relevant dexterity and augment and strengthening the financial and infrastructural capabilities are being seen as the key drivers for the growth of profession.

This exercise may be attempted by any of the active partners of the firm. However, multiple responses from same firm filled by individual partners will also be accepted.

The ongoing structural ramifications in accounting profession taking place world wide would influence the profession and possibly need a sustained response on on-going basis; such issues being of nature which warrant due positioning to be undertaken for the benefit of the membership at large. The issues being timely and requiring threshold reaction are thus needed to be addressed at a shorter notice and hence there is a need for the response of membership to such structural factors.

In order that the ICAI comes to know of the practitioners perspective/its members in regard to the issues of growing big and the modalities thereof in the changed market scenario would request its member firms to spend some time in responding to the questionnaire below The response would be kept totally confidential and would not be used for another perspective other than to assess the current trends for taking future positions if so warranted. . It may also be added that the response stated herein would entitle the member for CPE credit of 2 hours.

The questionnaire consists of 46 Questions divided into five sections as:

Question 1-11	General Information about your firm
Question 12 -17	Financial Information about your firm
Question 18 -19	Perception on being in Industry vis-à-vis Practice
Question 20 -28	Information on Firms performance
Question 29 - 46	You and ICAI

While answering the questions, please make sure that your replies reflects your individual views as partner/proprietor on behalf of your firm.

The last date for submission of the filled-up questionnaire

is 15th December 2008.

Members are requested to respond to the below questionnaire either electronically on the homepage of institute's website www.icai.in or submitted in physical form so as to reach us by 15th December 2008 to:

Secretary, Perspective Planning Committee

The Institute of Chartered Accountants of India

Post Box No. 7100, Indraprastha Marg

New Delhi – 110002

Questionnaire:

GENERAL INFORMATION ABOUT YOUR FIRM

QUESTION.1 Are you a

a) Sole proprietor

b) Partner

c) Executive at CA firm

d) Others, please specify_____

QUESTION.2 You have been in practice for

a) Less than 3 years

b) 3 years to 5 years

c) 5 years to 10 years

d) 10 years to 20 years

e) Above 20 years

QUESTION.3 Your age is

a) 21-25 years

b) 25-35 years

c) 35-40 years

d) 40-50 years

e) Above 50 years

QUESTION. 4 Are you

a) Male

b) Female

QUESTION.5 You reside at

a) Metro cities (Delhi, Mumbai, Kolkatta ,Chennai, Hyderabad, Bangalore)

b) Non-metro cities

c) Town

QUESTION.6 As on 01-04-2008, you are partner/ executive of firm consisting of

a) Proprietary firm

b) 2 partners

c) 3-5 partners

d) 6-10 partners

e) 11-20 partners

QUESTION. 7 Your firm specialized in (Kindly provide % of total assignments)

a) Accounting _____

b) Internal audit _____

c) Statutory audit _____

d) Concurrent audit _____

e) Indirect taxation _____

f) Direct taxation _____

g) International taxation _____

h) Insurance _____

i) Risk Management _____

j) Merger and Acquisitions _____

k) Management Consultancy _____

l) Others, please specify_____

QUESTION.8 (i) Your majority clients are (kindly give % of total clients and % of gross receipt)

	% clients	% receipts
a) Individuals including proprietary concerns	_____	_____
b) Small Enterprises	_____	_____
c) Medium size industries	_____	_____
d) Large industries	_____	_____
e) Multinational Corporates	_____	_____

Comments, if any _____

(ii) Your Major Clients are from (kindly give % of total clients and % of gross receipt)

	% clients	% receipts
(a) IT Sector	_____	_____
(b) Banking	_____	_____
(c) Financial Services (Insurance, Lending, Mortgaging etc)	_____	_____
(d) Manufacturing	_____	_____
(e) Services	_____	_____
(f) Engineering	_____	_____
(g) Public Sector Units	_____	_____

(h) Others, please specify _____

QUESTION.9 Had you previously been in employment?

a) Yes , for _____ years _____ months

b) No

QUESTION 10 How many professional staff are there in your firm at the financial year ended in 2008?

a) 1-10

b) 10-50

c) 50-100

d) 100-250

e) 250-500

f) 500-1000

g) Above 1000

QUESTION.11 Has your firm gained enough expertise to converge with IFRS by April 2011?

a) Fully expertise has been gained

b) Partial expertise has been gained and confident to be fully convergent.

c) In the process of building up

d) Not yet initiated

Comments, if any _____

FINANCIAL INFORMATION ABOUT YOUR FIRM

QUESTION.12 Annual gross receipts of the firm is:

a) Less than 3 lacs

b) 3 lacs-10 lacs

c) 10 lacs – 20 lacs

d) 20 lacs-50 lacs

e) 50 lacs-1 crores

f) 1 crores – 5 crores

g) 5 crores-10 crores

h) Above 10 crores

Comments, if any _____

QUESTION.13 (a) Firm's gross receipt increased in the current year as compared to last year by:

a) Less than 5 %

b) 5% - 10 %

c) 10% -25%

d) Above 25%

Comments if any _____

(b) Anticipated growth of Firm's gross receipt in the next 5 years is by:

a) Less than 5 %

b) 5% - 10 %

c) 10% -25%

d) Above 25%

Comments, if any _____

QUESTION.14 Have you ever felt that the capital shortage is the one of the impediments for growing your size and quality?

a) Yes

b) No

Comments, if any_____

QUESTION.15 Have you ever seek finance from banks for your profession?

a) Yes

b) No

Comments, if any _____

QUESTION.16 Did you find any difficulty in quoting your fees to the clients for the expert advice given to them?

a) Yes

b) No

Comments, if any _____

QUESTION 17 Do you think CA profession in India and at international level is properly remuneration in context of services provided and time devoted vis-à-vis other professionals ?

a) Yes

b) No

Comments, if any _____

PERCEPTION OF BEING IN INDUSTRY VIS-À-VIS PRACTICE

QUESTION.18a Do you feel that the movement of fresh CA towards industry will affect the profession in practice in the long run?

a) Yes

b) No

QUESTION.18b In your opinion, what steps should be taken in this regard: _____

QUESTION.19a Do you ever find industry more attractive?

a) Yes

b) No

Comments, if any _____

QUESTION. 19b Are you equipped with the industry job?

a) Yes

b) No

Comments, if any _____

INFORMATION OF FIRMS PERFORMANCE

QUESTION.20 Did you ever feel that your small size has been constrained to your professional development.

a) Yes

b) No

QUESTION. 21 What difficulties discourage you for moving ahead with networking, mergers/consolidation with other firms?

(a) Resources (Infrastructure, Competency, Human Resources) limitation

(b) Financial Constraints

(c) Lack of Guidance

(d) Conflict of Interest

(e) Less control over Operations of the firm.

(f) Others, if specify_____

QUESTION.22 What are the mechanism adopted for growing your firm in size and quality?

QUESTION.23 (a) Had you ever tried going for networking?

a) Yes

b) No, go to Question 23 (b)

QUESTION.23 (b) What had prevented you from networking?

QUESTION.24 Will networking of firms benefit your profession?

a) Yes

a) No

QUESTION. 24 (a) If yes, to what extent, do you think networking will help you?

e) Less than 5 %

f) 5% - 10 %

g) 10% -25%

h) Above 25%

QUESTION.24 (b) If no, kindly mention the reason for the same? _____

QUESTION. 25 Do you think networking with other professional will help you in serving your clients better?

a) Yes

b) No

Comments, if any _____

QUESTION.26 Do you feel that the merger/consolidation will increase your profession?

a) Yes

b) No

Comments, if any _____

QUESTION.26 (a) If yes, to what extent, do you think merger/consolidation will help you?

a) Less than 5 %

b) 5% - 10 %

c) 10% -25%

d) Above 25%

QUESTION.26 (b) If no, kindly mention the reason for the same? _____

QUESTION.27 (a) Are you aware, what is Limited Liability Partnership (LLPs)?

a) Yes

b) No, please visit http://en.wikipedia.org/wiki/Limited_liability_partnership

QUESTION 27 (b) Do you think formation of Limited Liability Partnership (LLPs) in India will facilitate professional growth?

a) Yes

b) No

Comments, if any _____

QUESTION. 28 Formation of Multidisciplinary firm with _____ will benefit me the most?

a) Company Secretaries

b) IT Professionals

c) Cost accountants

d) International accountants

e) Tax consultants

f) Advocates

g) Others, please specify _____

YOU and ICAI

QUESTION.29 Do you feel that there should be separate accounting standards for SMEs?

a) Yes

b) No

Comments, if any _____

QUESTION.30 Considering the Indian economy scenario, the contribution of government in promoting the profession is:

a) Average

b) Good

c) Very good

d) Excellent

Comments, if any _____

QUESTION.31 The contribution of ICAI in regulating the profession in India:

a) Average

b) Good

c) Very Good

d) Excellent

Comments, if any _____

QUESTION 32 Is the Quality control system in place in your firm?

a) Yes

b) No

Comments, if any

QUESTION 33 (a) Is your firm already under the Peer review mechanism adopted by ICAI

a) Yes, _____times

b) No

Comments, if any _____

QUESTION 33 (b) Do you have internal mechanism of review of your audits?

a) Yes

b) No

Comments, if any _____

QUESTION 34 (a) In order to grow bigger in size, you would like to work with:

a) Independent proprietor

b) Firm with 2 partners

c) Firm with 3-5 partners

d) Firm with 6-10 partners

e) Firm with 11-20 partners

f) Firm with International networking

g) Others, please specify_____

Comments, if any _____

QUESTION 34 (b)You would like to join the above congregations as a

a) Consultant

b) Partner

c) Executive/Manager

d) Others, please specify

QUESTION 35 Advertising guidelines prescribed for ICAI members in context of the competition to the profession :

a) Are adequate

b) Need to be liberalized further

Comments , if any _____

QUESTION 36 Do you intend for any retirement plan?

a) Yes, major contribution to _____

b) No

QUESTION 37 Do you feel that your firm is equipped for rendering consultancy and other professional work in countries outside India?

a) Yes

b) No

Comments, if any _____

QUESTION 38 What do you perceive to be your core strength for operating in a foreign environment?

QUESTION 39 Professional Indemnity Insurance would be important once LLP comes into place. What are your views on taking such insurance policy?

QUESTION 40. Do you feel that acts like Consumer Protection Act are important for profession like Chartered Accountant dealing with deficiency in service?

a) Yes

b) No

Comments, if any_____

QUESTION 41 Do you think that there is a professional gap between members who have passed recently , say post 2000 era and the earlier members in respect of

(a) Perception for the profession

i) Yes

ii) No

Comments , if any _____

(b) Information Technology

i) Yes

ii) No

Comments , if any _____

(c) Professional opportunities

i) Yes

ii) No

Comments , if any _____

(d) Orientation of professional development

i) Yes

ii) No

Comments , if any _____

QUESTION 42 Your views on steps need to be taken to bridge the professional gap between newer generation members and yester generation members, if so required, in areas of –

(a) Perception for the profession

(b) Information Technology

(c) Professional opportunities

(d) Orientation of professional development

QUESTION 43 Do you think that the demand for profession is increasing?

a) Yes

b) No

Comments, if any _____

QUESTION 44 What are your views on the steps need to be taken to generate numbers of professionals with quality intact as the demand for the profession is increasing?

QUESTION 45 Your views on positioning the image of ICAI in India and outside world- role as a regulator, boundary management of a regulator-

a) If the profession high on education front and less on regulatory front- are we seen more as of an educational institution

b) Need to consolidate value within ourselves for various measures , we undertake

c) Increasing role of other regulators

d) Are we within the boundaries meant for a regulator?

e) Impact of recent developments on its future regulatory profile

Comments, if any _____

QUESTION 46 In the current financial cauldron, what role do you see for the accounting profession in bringing calm and stability in longer perspective?

Your response is very useful for us.

Thank you for taking time to complete this Questionnaire.

Survey Evaluation

(Please ^appropriate box)

1. How would you rate the usefulness of this Survey?	Excellent	Very Good	Good	Meet Expectation	Below Expectation
	☐	☐	☐	☐	☐

2. Is there anything you can think of which may improve the Questionnaire or any information we should collect through this Questionnaire?

All responses received and the data thereof will be kept STRICTLY CONFIDENTIAL.

Name:
Membership No.
Firm Name.

This exercise is being attempted by the Perspective Planning Committee (PPC) of the Institute of Chartered Accountants of India. The Perspective Planning Committee, as the members are aware, has been formed recently to the assess the developments which have been taking place in the service(s) sector and more importantly relating to the accountancy sector so as to initiate and strengthen steps which consolidate and further enhance the distinguish role of the chartered accountancy profession.❑

Guidelines of The Council in the context of use of designation etc and manner of Printing of Letter-heads and visiting cards.

REVISED APPENDIX D to the Code Of Ethics

The Council issued guidelines/directions in the context of use of designation etc. and manner of printing letter-heads and visiting cards, of the President, Vice-President of the Institute, Members of the Council, Chairmen of various Non- Standing Committees of the Institute; Chairmen, other office- bearers and Members of the Regional Councils; Chairmen, other office bearers and Members of the Managing Committees of Branches, which are appearing at Appendix `D' to the Code of Ethics, 2005 issue.

Recently, the Council at its 280th Meeting held on 9th August, 2008 decided to revise the guidelines/directions on visiting cards. The guidelines/directions in full including the revised guidelines/directions on visiting cards are given hereunder:

LETTER-HEADS

1. The Institute will print the letter-heads for President and Vice- President of the Institute with their names, designation and address of the Institute with emblem. In these letter-heads, the President's or Vice-President's personal addresses, including their professional and residential addresses shall not be printed.
2. The Regional Councils and their Branches shall print the letter- heads for official use of the Chairmen of the respective Regional Councils/Branches with their designation, address of the Regional Council/Branch concerned and the Institutes emblem without mentioning their names in the letter-heads. As far as other office-bearers of Regional Councils and Branches are concerned, they should use the common letter-head bearing the name and address of the Regional Council or the Branch, as the case may be, and their designation may be typed below their signatures.
3. It is clarified that no member of the Council or any Regional Council or the Managing Committee of any Branch shall print any letter-head in relation to the position he holds in various Committees or as a member of the Council/Regional Council/Managing Committee, at his cost.

VISITING CARDS

1. The visiting cards will be printed for both the elected and nominated Council members. The visiting cards be also printed for members of Regional Councils and Managing Committees of the branches. The visiting cards will be used only for official work of the Institute. The Head office of the Institute will print the visiting cards for President, Vice-President and Members of Council including Chairman/Vice – Chairman of the Committees of the Council. The offices of Regional Councils and Branches will print the visiting cards for respective Regional Councils and Branches. The members themselves will not print the visiting cards.
2. In the visiting card, the designation viz., President/ Vice-President/Member, Council/Chairman/Vice – Chairman of the respective Committee(s) of the Council/Chairman of the Regional Council/Chairman of the Branch/Vice-Chairman of the Regional Council/Vice-Chairman of the Branch/Secretary of the Regional Council/Secretary of the Branch/ Treasurer of the Regional Council/Treasurer of the Branch/Member of the .... Regional Council/Member of the Managing Committee of .... Branch of .... Regional Council will be used. There will not be any mention of any other designation. Besides the above, Council members who hold the office of Chairman/Vice Chairman of any of the Committees of the Council may mention such position in their visiting cards specifying the name of the Committee concerned and the relevant period for which they are holding such position. If a member of the Council holds Chairmanship/Vice-Chairmanship of more than one Committee of the Council, he may have separate cards printed as above for each such Committees.
3. The full term of the Council/Regional Council/ Branch will be mentioned for example 2007 to 2010. In case of the President/Vice-President/Chairman/ Vice – Chairman of Committees of the Council/ Chairman, Regional Council and Branch/Vice-Chairman, Regional Council and Branch/Secretary, Regional Council and Branch/Treasurer, Regional Council and Branch, the year of Presidentship/Vice-Presidentship/Chairmanship/Vice Chairmanship/ Secretaryship/Treasurership will be mentioned, for example, 2008-2009. The President, Vice- President, Chairman/Vice Chairman of Committees of the Council/ Chairmen of Regional Councils and Branches, Vice-Chairmen of Regional Councils and Branches, Secretary of Regional Councils and Branches and Treasurer of Regional Councils and Branches will use their cards for the year in which they are elected. Cards with the designation/description viz., former/past President, membership of national/international bodies even at personal cost will not be permitted.
4. The address of the Institute in the case of Council members including Chairman/Vice Chairman of Committees of the Council, that of the concerned Regional Council in the case of Regional Council members and that of the concerned Branch in the case of Members of the Managing Committee of the Branch will be printed. The Telephone No., Fax No.

"To achieve the impossible, one must think the absurd; to look where everyone else has looked, but to see what no else has seen"

& E-mail address of the Institute, Member's name, his E-mail identity and Mobile No. in the case of Council Member, those of concerned Regional Council in the case of the Regional Council Member and those of the concerned Branch in the case of Member of Managing Committee of the Branch will be given in the front of the visiting card. However, members of the Council including Chairman/Vice-Chairman of the Committees of the Council, members of the Regional Councils and of Managing Committees of Branches may print either their residential address or office address including telephone/fax no. without mentioning the firm's name on the back of the visiting cards.

5. The visiting cards will be returned to the offices of the Institute as soon as the term of the President and Vice-President, the Membership of the Council/ Chairmanship/ViceChairmanship of respective Committees of the Council/Chairmanship/Vice Chairmanship/Secretaryship/Treasurership/Membership of the Regional Council/Managing Committee of the Branch expires.
6. The number of cards permissible to be printed for the Council member will be initially 500 and thereafter as and when requisition is made. The number of visiting cards permissible to be printed for Chairman, Vice-Chairman, Secretary, Treasurer and Member of Regional Councils and Branches will be 250 and 100 per year, respectively. The Council further decided not to permit any visiting cards to the office-bearers of study circle/chapters. For President and Vice-President, the number of cards to be printed will be left to be decided by them.
7. The visiting cards will be printed in the prescribed formats. The type of paper, printing, colour of ink of the visiting cards will be uniform and of the same type and manner.
8. In the visiting cards of Regional Councils and Branches, the name of the respective Regional Council and Branch will be printed in bold letters and the name of the Institute in normal letters.
9. In case, any further clarification/direction is required, the matter may be referred to the President.

IASB Exposure Drafts on:

- **Discontinued Operations: Proposed Amendments to IFRS 5**
- **Additional Exemptions for First-time Adopters: Proposed Amendments to IFRS 1**

The International Accounting Standards Board (IASB) has issued Exposure Draft on Discontinued Operations: Proposed Amendments to IFRS 5 with the objective "to revise the definition of discontinued operations and required additional disclosures related to components of an entity that have been (or will be) disposed of". The IASB proposes that a disposal activity should be presented as a discontinued operation only when an entity has made a strategic shift in its operations. Moreover, the IASB decided that a definition of discontinued operations based on operating segments, as defined in IFRS 8 *Operating Segments*, best captures a strategic shift in the entity's operations because the determination of operating segments is based on how the chief operating decision maker makes decisions about allocating resources and assessing performance. The proposals are the result of a joint project by the IASB and the US Financial Accounting Standards Board (FASB) to develop a common definition of discontinued operations and require common disclosures about them.

The Exposure Draft on Additional Exemptions for First-time Adopters: Proposed Amendments to IFRS 1, has been issued with the objective "to address potential challenges for jurisdictions adopting IFRSs in the near future".

As the Indian Accounting Standards are converging with the IFRSs, need has been felt to play an influential role in finalisation of IFRSs and other related pronouncements of the IASB. Hence, the Accounting Standards Board of the Institute of Chartered Accountants of India invites comments on any aspects of the Exposure Drafts. The downloadable version of the Exposure Draft on Discontinued Operations: Proposed Amendments to IFRS 5 is available at: http://www.iasb.org/NR/rdonlyres/B47D08C2-A78A-49E8-92A7-63A9DE737629/0/ED_Discontinued_Operations_IFRS_5.pdf.

Whereas, the downloadable version of the Exposure Draft on Additional Exemptions for First-time Adopters: Proposed Amendments to IFRS 1 is available at: http://www.iasb.org/NR/rdonlyres/2663F948-DBDE-453-F-8950-ABD3FCF9B76B/0/ED_IFRS_1_Additional_Exemptions.pdf.

Comments would be most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing to the Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi-110002, so as to be received not later than **December 05, 2008.** Comments can also be sent by e-mail at tdte@icai.org or edcommentsasb@icai.org.

"Success knocks on the doors of those who are brave"

Revised Resolution passed by the Council under Regulation 190A

(effective from 9th August, 2008)

AS A PART OF AND IN CONTINUATION OF THE EXISTING RESOLUTION [UNDER REGULATION 190A, WHICH APPEARS AS APPENDIX NO. (9) TO THE CHARTERED ACCOUNTANTS REGULATIONS 1988 (2002 EDITION)]

IT IS FURTHER RESOLVED that the following clause (14) is added in clause (A) of Appendix No. (9) to The Chartered Accountants Regulations, 1988 as under: -

Permission granted generally

(A) Members of the Institute in practice be generally permitted to engage in the following categories of occupations, for which no specific permission from the Council would be necessary in individual cases: -

14. Owning agricultural land and carrying out agricultural activity.

IT IS ALSO RESOLVED that the following clause (5) appearing under the heading *'Permission to be granted specifically'* in clause (B) of Appendix No. (9) to The Chartered Accountants Regulations, 1988 be deleted.

5. Interest in agricultural and allied activities carried on with the help, if required of hired labour.

Training the Trainers Programme on IFRS

We are pleased to inform that the Institute of Chartered Accountants of India is planning to develop a pool of trainers for training the members on International Financial Reporting Standards.

The Continuing Professional Education Committee of the Institute invites Chartered Accountants with skill sets in International Financial Reporting Standards (IFRS) for Training the Trainers Programme. These programmes would be held at New Delhi, Mumbai, Kolkata, Kanpur and Bangalore. Applicants with technical expertise in existing Accounting Standards would be given preference. Members selected for the training programme will be put on a training module to enable them to equip themselves in training other members on IFRS.

Members who are interested and who have an aptitude for training on IFRS need to apply to the Secretary, Continuing Professional Development Committee at the following address:

The Secretary, CPE Committee, The Institute of Chartered Accountants of India
ICAI Bhawan, Post Box Number 7100, Indraprastha Marg, New Delhi 110 002
E-mail id: seemag@icai.org, Fax - +91 11 3011 0583
Telephone: +91 11 3011 0451(D), 3989 3989 (EPABX) Ext. 451,

Members who have already applied earlier this year for the said programme, need not apply again.

Chairman
Continuing Professional Education Committee

FOR THE ATTTENTION OF ICAI MEMBERS ABROAD

The ICAI members residing abroad, who are being sent the Institute's *The Chartered Accountant* journal by Air Mail and Sea Mail of Indian Post, are hereby informed that Indian postal authorities have steeply increased the postal charges from Rs. 90 per copy to Rs. 175 for Air Mail and from Rs. 13 per copy to Rs. 90 for Sea Mail w.e.f 01.08.2008.

The Executive Committee of the Institute, taking note of the steep hike in foreign postal rates and the resultant expenses to be borne by the ICAI, has decided to charge the actual (revised) postal rates from **ALL** overseas members who desire to get the copy of their journal at their foreign addresses through Air Mail/Sea Mail facility as follows:

Air Mail – Rs. 2100 per annum

Sea Mail – Rs. 1100 per annum

In view of the above, the overseas members who wish to receive the journal (December 2008 onwards) at their foreign addresses, are requested to remit the sum equal to the actual revised air mail, sea mail charges payable, as the case may be, to their respective regional offices on an urgent basis. The overseas members who have already submitted airmail charges at the old rates of Rs. 900 per annum are requested to remit the balance amount as per the new postal rates (Rs.2100 per annum) for the remaining months (December 2008 onwards) of their respective existing air mail periods.

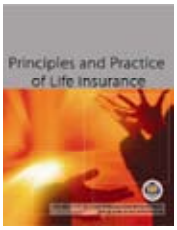
In case, the overseas members don't remit the required postal charges, the journal will be dispatched at their Indian addresses as per ICAI records free of cost.

"You see, in life, lots of people know what to do, but few people actually do what they know. Knowing is not enough! You must take action"

NEW PUBLICATIONS

From the Committee on Insurance & Pension

Principles and Practice of Life Insurance



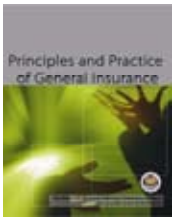
Pages: 244+8 (initial pages)
Price: Rs. 250/- (with CD)

Significant features of the book are as follows:

- Explain the basic concepts of Life Insurance Business, various types of insurance products available in the market.
- Process of Claim Settlement and lapsation and revival of life insurance policies
- Define the actuarial principles and techniques for ascertaining the liability of a life insurer.
- The book may also be referred as reference material to the Module-1 of the DIRM Course of ICAI.

Postal Charges :
Courier: NCR : *Rs. 7/-* and ***Other cities****: Rs. 23/-*
Registered Post : *Rs. 48/-;* ***Unregistered Parcel:*** *Rs. 31/-*

Principles and Practice of General Insurance



Pages: 325+8 (initial pages)
Price: Rs. 300/- (with CD)

Significant features of the book are as follows:

- Introduction to General Insurance Business, General Insurance Contract Design and various legislations which governs the general insurance business in India.
- Various types of general insurance business and introduction to general insurance products available in the market.
- Regulations and law governing the Accounting and Investment of insurance companies.
- The book may also be referred as reference material to the Module-2 of the DIRM Course of ICAI.

Postal Chargesm :
Courier: NCR : *Rs. 8/-****, Other cities:*** *Rs. 32/-*
Registered Post : *Rs. 57/****-; Unregistered Parcel:*** *Rs. 40/-*

Risk Management and Reinsurance

Pages: 250+8 (initial pages)
Price: Rs. 250/- (with CD)

Significant features of the book are as follows:

- Introduction to risk management, essential of risk management, measuring severity and frequency of risk and the process of risk management.
- Define the strategic risk management and corporate risk management with case studies.
- Introduction of reinsurance and reinsurance theory, regulations and law governing the reinsurance business
- Reinsurance administration, accounting, financials and reinsurance practice.
- The book may also be referred as reference material to the Module-3 of the DIRM Course of ICAI.

Postal Charges:
Courier: NCR: *Rs. 7/-,* and ***Other cities:*** *Rs. 23/-*
Registered Post: *Rs. 48/-,* ***Unregistered Parcel:*** *Rs. 31/-*

Business Strategic Planning and Information Technology for Insurance Sector

Pages: 411+8 (initial pages)
Price: Rs. 325/- (with CD)

Significant features of the book are as follows:

- Classify insurance business, functions and general introduction to various Law and Regulations applicable on insurance sector.
- Management of assets-liability of insurance companies
- BPO and insurance companies
- System development process including system analysis and design, implementation and operation.
- Various technique of data storage and processing methods and information system controls
- The book may also be referred as reference material to the Module-4 of the DIRM Course of ICAI.

Postal Charges:
Courier: NCR: *Rs. 9/-****, and Other cities:*** *Rs. 43/-*
Registered Post: *Rs. 66/-****, Unregistered Parcel:*** *Rs. 49/*

Ordering Information for all publications:

The publication(s) can be obtained from the sale counter at the Regional offices or at the Head Office of the Institute.

Copies can also be obtained by post. To order by post, send a demand draft for the amount of the price of the publication(s) (add the postal charges indicated for the desired mode of delivery) in favour of 'The Secretary, The Institute of Chartered Accountants of India' payable at New Delhi to the Postal Sales Department, The Institute of Chartered of India, ICAI Bhawan, A-94/4, Sector-58, Noida – 201 301 (U.P.)

"Be nice to people on your way up because you meet them on your way down"

ISA Assessment Test, December 2008

TO BE PUBLISHED IN PART III SECTION 4 OF THE GZETTE OF INDIA
NOTIFICATION

7th November, 2008

No.13-CA(EXAM)/ISA/D/2008: -In pursuance of Rule 7 of Schedule 'F' to Regulation 204 of the Chartered Accountants Regulations, 1988 (as amended vide Notification No. 1-CA(7)/59/2001 dated 28th September 2001), the Council of the Institute of Chartered Accountants of India is pleased to notify that the Information Systems Audit (ISA) Course Assessment Test will be held on **20th December, 2008 from 10.30 am to 2.30 pm** at the following centres provided that sufficient number of candidates offer themselves to appear from each centre as detailed below.

1	AHMEDABAD	16	KANPUR
2	BANGALORE	17	KOLKATA
3	BAREILLY	18	LUCKNOW
4	BHUBANESWAR	19	LUDHIANA
5	BIKANER	20	MUMBAI
6	CHANDIGARH	21	NAGPUR
7	CHENNAI	22	NASHIK
8	DELHI/ NEW DELHI	23	PUNE
9	ERNAKULAM	24	RAIPUR
10	GHAZIABAD	25	RAJKOT
11	HYDERABAD	26	RANCHI
12	INDORE	27	SURAT
13	JABALPUR	28	UDAIPUR
14	JAIPUR	29	VARANASI
15	JALGAON		

The Council reserves the right to withdraw any centre at any stage without assigning any reason. The above Test is open only to eligible Members of the Institute who are already registered with the Institute for the said course. The fees payable for the above Assessment Test is Rs. 1000/-.

Applications for admission to the Assessment Test is required to be made in the prescribed form which may be obtained from the Senior Joint Secretary (Exams), The Institute of Chartered Accountants of India, ICAI Bhawan, Indraprastha Marg, New Delhi – 110 002 on payment of Rs.25/- per application form. **The forms are also available in the Regional and Branch Offices of the Institute and can be obtained upon cash payment on or from 12th November, 2008. Alternatively, the format of application form can be downloaded from the website of the Institute viz. www.icai.org and the cost of the application form of Rs. 25/- can be added to the Assessment Test fee of Rs. 1000/- and the Demand Draft for Rs. 1025/- has to be sent. The last date for receipt of duly filled in application forms is 2nd December, 2008.**

The application together with the prescribed fee should be sent by Speed Post/Registered Post to the Senior Joint Secretary (Exams.), New Delhi. Payment of fees for the Assessment Test should be made only by Demand Draft. The Demand Draft may be of any Scheduled Bank and should be drawn in favour of " The Secretary, The Institute of Chartered Accountants of India, payable at New Delhi" only. Application together with the prescribed fee be sent so as to reach the Senior Joint Secretary (Exams) at New Delhi on or before **2nd December, 2008.** The applications received after **2nd December, 2008** will not be entertained under any circumstances.

(G. SOMASEKHAR)
SENIOR JOINT SECRETARY (EXAMS.)

Committee on Public Finance

The Committee on Public Finance constituted by The Institute of Chartered Accountants of India desires to have associates on full-time, part-time or honorary basis to work in the field of Public Finance, Tax Policy, Public Expenditure & Control, Public Debt Management, Inter-Governmental Fiscal Relations and Financial Planning etc. The Committee invites authors, researchers and faculty having interest to contribute articles in different areas of Public Finance. Published articles will be suitably rewarded.

Those desirous may please contact at the following address:

The Chairman
Committee on Public Finance
The Institute of Chartered Accountants of India
ICAI BHAWAN, Indraprastha Marg
New Delhi-110002
Mobile No. 09830022848, Email: subodhka@yahoo.com, pfc@icai.in

"The only way to get rid of a temptation is to yield to it"

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 from **1st January 2009 to 16th February 2009.**

The last date for the receipt of ***specified documents*** in this office is **27th 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)

Important Announcement for members of the Institute
CPE Credit Requirements for three-years rolling period 2008-2010

The first calendar year 2008 of the three years rolling period 2008-2010 is on the verge of its completion. Members may kindly ensure that they complete the minimum CPE Credit Requirements for the calendar year 2008. The CPE Credit Requirements for the three years' rolling period 2008-2010 are as given below:

- All the members who are holding Certificate of Practice (except those members who are residing abroad), unless exempted, are required to:
  - (a) Complete at least 90* CPE credit hours in each rolling three-year period of which 60 CPE credit hours should be of structured learning.
  - (b) **Complete minimum 20 CPE credit hours of structured learning in each year.**
- All the members who are not holding Certificate of Practice or are residing abroad (whether holding Certificate of Practice or not), unless exempted, are required to:
  - (a) Complete at least 45 CPE credit hours of structured/unstructured learning in each rolling three-year period.
  - **(b) Complete minimum 10 CPE credit hours of structured/unstructured learning in each year.**

*We may clarify that out of minimum 90 hours of CPE requirements, the members have to complete 60 CPE hours of Structured Learning **(20 CPE hours of structured learning per year of three years rolling period is mandatory).** The remaining 30 hours could be completed either through structured or unstructured CPE learning activities, any time during the three years period from 1st January, 2008 to 31st December, 2010.

Continuing Professional Education Committee

Committee on Information Technology, ICAI

Forthcoming Practical Workshops

City	Workshop Theme	Date
Ahmedabad	SOX	Dec 13
Chennai	ACL & IDEA	Dec 20
Chennai	Using MS-Excel as an Audit Tool	Dec 27
Mumbai	System Audit in CBS Environment	Dec 12-14
Mumbai	Advance Excel & Macro	Dec 20-21

Further details, workshop brochures & registration form are available at 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 for further details/assistance/registration.

"Nothing in the world is more dangerous than sincere ignorance and conscientious stupidity"

ANNOUNCEMENT
Permission for other engagements by students

Attention of Articled Assistants seeking permission for other engagement (i.e. for Teacher, Director and for Sleeping partner in a family business) is invited to the following provisions.

An articled/audit assistant cannot engage himself in any business or occupation without the previous approval of the Council. He/she is required to submit an application in Form 112, duly recommended by the Principal to obtain prior permission of the Council to be engaged in any business or occupation.

(a) For Teaching:

(i) The engagement should be either before or after normal office hours of the Principal.

(ii) The Institution wherein he is to be engaged should be in the same town/city wherein he undertakes training.

(iii) An application should be made mentioning the office hours and the timings of the lectures on each day of the week along with:

A certificate from the Principal to the effect that such engagement does not interfere his training as an articled/audit assistant under him.

A certificate regarding the time required to be spent/to be devoted per week by the articled/audit assistant from the concerned authorities for the engagement.

(iv) Permission is not granted where the number of hours prescribed is exceeded.

Requirements

(1) Apply in Form 112 duly recommended by the Principal.

(2) Attach certificate issued by the Princiapl of the College (where he intends to teach).

(3) The starting and ending timings of the classes taken by the articled/audit assistant.

The total hours to be devoted.

(i) daily basis

(ii) weekly basis

(4) Attach certificate from the Principal clearly stating that the engagement of the articled assistant in other occupation as "Teacher" does not interefere with his training as an articled/audit assistant.

(b) For Director:

(i) The Company in which the articled/audit assistant proposes to be appointed as a Director should be a Family Company i.e. a majority of the capital of the company is held by the members of the family of the articled/audit assistant.

(ii) The company should have been in existence before the assistant had entered into articled/audit service.

(iii) Neither the principal nor the firm in which he is engaged as an articled/audit assistant is a partner or an auditor of the company.

(iv) The assistant should not be entitled to receive any allowance apart from the sitting fee for attending the Director's meetings.

(v) The assistant should give an undertaking on a non-judicial stamp paper duly sworn in before a Magistrate that he would not take any active part in the business of the company apart from attending the Director's meeting.

(vi) The other Directors should confirm that such an undertaking would not interfere with the normal functioning of the company.

Requirements

(1) Apply in form 112 duly recommended by the Principal alongwith :

(a) Attested true copy of Memorandum and Articles of Association of the company.

(b) Undertaking by the articled/audit assistant duly sworn in before a Magistrate/Notary Public.

(c) Declaration by the Principal of the articled/audit assistant.

(c) For Sleeping Partners:

(i) An articled/audit assistant should not be deemed to be engaged in any business or occupation within the meaning of Regulation 65/78, if he is merely a sleeping partner in a family business concern. There should be no objection to an articled/ audit assistant being a sleeping partner in one or more business concerns, if there is a recital in the partnership deed that he is a sleeping partner which will constitute *prima-facie* evidence, unless there is evidence to the contrary.

(ii) Permission can be given, if (1) the partnership deed contains a recital that he is a sleeping partner; (2) all the partners including the articled/audit assistant furnish affidavits that the assistant is neither taking active part nor will be entitled to take active apart nor will be entitled to take active part in the management of the business and (3) a declaration is given by the employer of the articled/audit assistant that the latter is a sleeping partner and in case any change in his status in the partnership comes to his attention, he shall inform the Institute.

"Talent does what it can; genius does what it must"

Requirements

The student concerned is required to :

(1) apply in Form 112 duly recommended by the Principal.

(2) Attach true copy of Partnership Deed (attested).

(3) Submit affidavit by all the partners of the business firm duly sworn in before the Magistrate or Notary Public.

(4) Submit affidavit by the articled/audit assistant duly sworn in before the Magistrate.

A letter granting permission to engage in other occupation i.e. Teaching , as Sleeping Partner or Director in family business concern/ Limited company will be issued to the Principal/Articled/Audit assistant.

The student may inform regarding disassociation from other occupation so as to revoke permission.

In case Form 112 is not submitted within 30 days of joining the course, the procedure laid down for condonation of delay in submission of form will apply.

Provisions relating to grant of additional vacancies:

Additional Vacancies under Regulation 57

(a) The additional vacancies can be granted to a member in practice under the following circumstances :

(i) the Principal has ceased to practice

(ii) name of the Principal is removed from the Register of Members

(iii) the Principal has died

(iv) Under sub-Regulation (1) of Regulation 56 and sub-Regulation(2) of Regulation 57

In all the above cases request for grant of additional vacancy shall be made within 30 days to the Secretary. Within 30 days from the date of the letter of the Secretary granting permission, the statement in form approved by the Council shall be sent for registration. In the case of death of the principal the date of commencement of training under fresh articles shall be taken the date following the date of death of the principal.

(b) Additional Vacancy may also be granted for accommodating articled assistants serving period of excess leave. The benefit of additional vacancy in such cases is given only where it could not have been reasonably anticipated that the articled assistant would have to serve an extra period on account of excess leave taken.

For any clarification and query, please email to mss@icai.in Phone: – 011-30110426/30110553 Fax: 011-30110588

"When you do the common things in life in an uncommon way, you will command the attention of the world"

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.***

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.

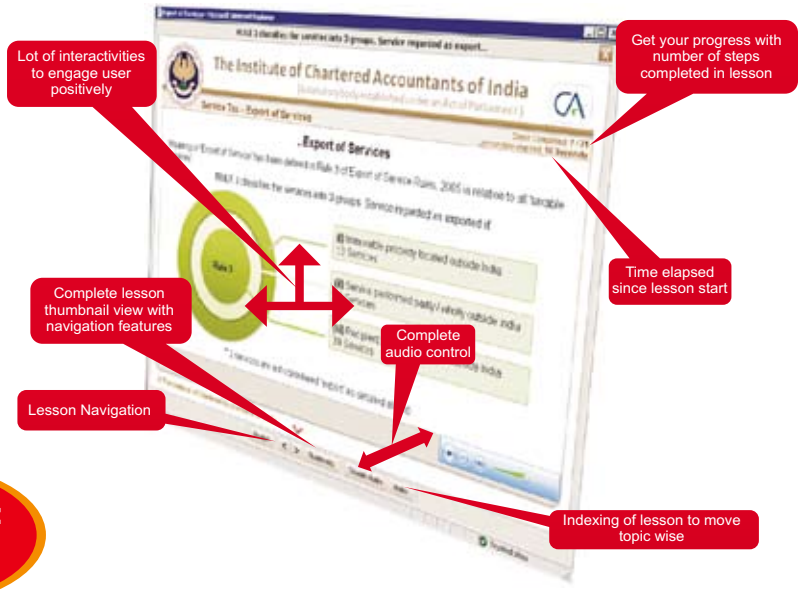
e-Learning Course on Service Tax

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 payble at New Delhi to the Secretary, CPE Committee, ICAI Bhawan, Post Box no. 7100, Indraprstha 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 E-mail: cpesec@icai.org Tel: +91 11 3011 0451

An initiative of The Continuing Professional Education Committee

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.in
Telephone: 011- 30110458

Museum of the Institute

Attention of members are invited that it has been decided to have an "Accountancy Museum" which can enable students and members to explore collections for inspiration, learning and enjoyment. You are therefore requested to provide any such item, viz., historic press clippings, mementoes, any document whose heritage needs to be shared with others, classic photographs and ancient paintings related to the Institute and the profession, handicrafts having any link with the culture heritage of our Institute, stamps, video shoots, posters etc, or an item which according to you may be preserved and displayed in the said museum for the inspiration of our coming generations

In case the material to be sent is delicate/bulky and, thus, needs extra care, you may inform us and the suitable arrangement for collecting the same shall be made.

- President

"A friendship founded on business is better than a business founded on friendship"

Invitation for Participation

ICAI's CORPORATE FORUM

Ascent to Pinnacle

CAreer Ascent

Mid Career Campus

23rd-24th-25th January 2009

JW Marriott, Juhu, Mumbai

OBJECTIVE : Career Ascent provides Chartered Accountants who have 1 year or more of industry experience and passed CA. final Examination on or before November 2007 with growth and career prospects, enabling them to realise their full potential and aspirations and widen their horizon. It also ensures that they are provided with careers that best suit their skill sets.

As a measure to develop employment opportunities for Chartered Accountants, the Committee for Members in Industry of ICAI has been successfully organising placement programmes twice a year for Newly Qualified Chartered Accountants, wherein prospective employers and new members interact and explore the possibility of taking up employment careers in various organisations.

Career Ascent is a step ahead as an extension to the same programme but with a different objective. It aims at providing the experienced Chartered Accountants with a platform to assess their potential and refinement in work, which they have acquired during their working tenure.

CHARTERED ACCOUNTANTS: MEET THE PROFESSIONALS Chartered Accountants are considered as complete business solution providers in this energetic business world. They are thoroughly trained practically in all avenues of accounting, auditing, finance and management and information technology. They can undertake responsibilities ranging from carrying out feasibility study, raising financial resources, compliance with regulatory framework, capital structure and planning, organisational development, installation of efficiency accounting, budgetary control, information system apart from giving advice on complex issues such as joint ventures, foreign collaborations, amalgamation, merger, diversification, modernisation, product pricing, BPO, KPO, restructuring, etc.

ADVANTAGE FOR CORPORATES : If you are looking for a complete business solution provider then end your search by participating in Career Ascent, wherein you would have access to a vast database of Chartered Accountants who have more than 1 year of industry experience. You can select your candidates from this pool of talent for a face-to-face interview.

The event would provide the companies to select Chartered Accountants as per their requirement criteria.

ADVANTAGE FOR CHARTERED ACCOUNTANTS IN INDUSTRY : The Chartered Accountants in industry with experience can gain a fair advantage by participating in Career Ascent. The event would provide them with the opportunity to meet many other companies and explore growth prospects. It would also enable them to realise their full potential in the new scenario of the corporate world.

Utmost care would be taken to ensure that the confidentiality of the candidates would be maintained during the entire process.

ELIGIBILITY OF CANDIDATES : Chartered Accountants who have more than 1 year of industry experience and passed CA final Examination on or before November 2007 are eligible to take part in Career Ascent.

PARTICIPATION FEES FOR CORPORATES

Day 1: Rs. 3,00,000/- + 12.36% Service Tax

Day 2: Rs. 2,50,000/- + 12.36% Service Tax

Day 3: Rs. 2,00,000/- + 12.36% Service Tax

Participation fee shall be payable by way of cheque/Demand Draft in favour of 'The Secretary, The Institute of Chartered Accountants of India' payable at New Delhi only.

At New Delhi Office: Dr. Sarbinder Pal, Secretary, CMII of ICAI

011-30110450 | spal@icai.in

At Mumbai Office: Ms. Sreberi Kapoor, Programme Co-ordinator,

022-2215 4536 | kapoor@icai.in

ICAI Awards 2008

Corporate CA Achievers' Acclaim

25th January 2009

Bangalore Sports Club, Mumbai

"The Highest Recognition for a man is to be honoured by his own mates"

The Chartered Accountants have performed exceedingly well in various fields and the Indian Industry has placed substantial faith on their ability to deliver. This has made the Indian Accountancy Professions as the Valued Trustee of World Class Financial Competencies, Good Governance and Competitiveness. To honour this exemplary work of Chartered Accountants in Industry the ICAI has instituted CA Awards which recognise the achievements of CAs in profession, personal life and in community service.

AWARD CATEGORIES		CA Business Achiever	CFO	CA Professional Achiever
	A.	Financial Services	Manufacturing	Manufacturing
	B.	Corporate	Financial Sector	Financial Sector
	C.	SME	Service Sector	Service Sector
	D.	Others	Information Technology, Media, Communication and Entertainment Enterprises	Information Technology, Media, Communication and Entertainment Enterprises
	E.		Infrastructure and Construction	Infrastructure and Construction
	F.		Public Sector	Public Sector
	G.		Others	Others
	H.		Women	Women

NOMINATION GUIDELINES

- Nominations shall be given only for members in industry.
- A member of Steering Committee, Nomination Committee, Process auditors and the Jury can neither be a nominee nor can he nominate any person.
- Minimum period of service in current employment should be 2 years.
- Multiple nominations will be ignored.
- Steering Committee reserves its rights to reject nomination without providing reasons thereof.

NOMINATION REQUIREMENTS

- A duly filled nomination form in duplicate.
- Two passport sized photographs.
- A brief description of the nominee's organisation, including description of products, services and overall strategic goals.
- Copies of the company's latest annual report and organisation chart.
- Information on the various evaluation parameters, as listed above.
- The financials of the company to be provided as of 31st March, 2008.
- The personal milestone(s) achieved up to 30th September, 2008.
- The last date for receipt of nominations by the Committee is 31st December, 2008.

23 24 25

January 2009

Organised by

COMMITTEE FOR MEMBERS IN INDUSTRY

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
[Set up by an Act of Parliament]
ICAI Bhawan, Indraprastha Marg, New Delhi 110 002

THE AWARDS PROCESS

A Steering Committee shall be formed to oversee the award process. It will ensure highest level of credibility and professionalism in the entire process of awards. Jury, consisting of eminent personalities, shall be formed for judging the awards. An experienced CA firm will be appointed to carry out the process audit. A Nomination Committee will be constituted to invite nominations directly through applications or through internal/independent Research. Applications can be made by -

01. Chartered Accountant himself

02. Employer

03. Any other member of ICAI

04. Others, which the Nomination Committee may deem fit.

The Nomination Committee will examine, review and evaluate the nominations. Short listing shall be based on the indicative evaluation parameters and the aggregate of scores thereon. Decision regarding shortlisting by the committee would be treated as final. List of top five nominations in each category selected by the Nomination Committee will be sent to the Jury for final selection. The Jury shall consist of eminent personalities who commands high respect and recognition in the Indian Industry. The Jury will include leading businessmen, representative of national trade bodies, regulators, academicians, heads of universities, past presidents of ICAI and such other eminent personalities. The Jury will consider the criteria used for shortlisting by the Nomination Committee along with other criteria as they deem fit. They may conduct personal interviews with the finalists, if required. The Jury will determine the winner of each category based on these results. The decision of the Jury will be final.

FOR NOMINATION FORM VISIT:

www.icai.org | www.cmii.icai.org

FOR FURTHER INFORMATION:

CA Sanjeev Maheshwari, *Chairman, CMII of ICAI*
098211 19043 | sanjeev.maheshwari@icai.in

CA Vijay Garg, *Vice-Chairman, CMII of ICAI*
094140 41872 | vijaymgarg@gmail.com

CA B. M. Agarwal, *Chairman, WIRC*
098201 38573 | bmj@bmmca.com

FOR REGISTRATION:

Dr. Surinder Pal, *Secretary, CMII of ICAI*
The Institute of Chartered Accountants of India
ICAI Bhawan, Indraprastha Marg, New Delhi 110 002
011-30110450 | cpsi@icai.in

CORPORATE Conclave

In Pursuit of Excellence

23rd-24th-25th January 2009

JW Marriott, Juhu, Mumbai

OBJECTIVE
Three full days National Conclave on Contemporary topics to enrich the knowledge and to enhance the skill set of members:

IFRS vs. INDIAN GAAPs — CPE 6 Hrs.

23rd January 2009

(Organised jointly with Continuing Professional Education Committee)

• Constitution of Board, Preface to IFRS • Business Combinations vs. Amalgamations • Property Plant and Equipment, Leasing, ARO • Presentation of Financial Statements • Revenue Recognition • Accounting Policies, Changes in Accounting Estimates, Errors, Events after Balance Sheet date • EPS • Income Taxes • Share Based Payments and Employee Benefits • Consolidation Segments • Operating Segments • Agriculture • Intangible assets • SME • Accounting of transactions in Foreign Currency • Investment Property • IFRIC 12 – Service concession arrangements

DIRECT TAXES — CPE 6 Hrs.

24th January 2009

(Organised jointly with Direct Taxes Committee)

- Witholding Tax on International Transactions – Sec:195
- Issues in Transfer Pricing Assessment
- Survey – Rights and Obligations
- Adjustments u/ss 14A, 40(a), 43B, 80 IE
- Capitalisation Principles – Capitalisation of Interest and Preoperative Expenses
- Issues in FBT and MAT

RAISING OF FINANCIAL RESOURCES — CPE 6 Hrs.

25th January 2009

(Organised jointly with Committee on Financial Markets and Investors' Protection)

• Venture and Angel Funding in the changed environment – Investors Perspective • Merger and Amalgamation – Mapping, Deal Making and Structuring • Listing Avenues for mid-cap companies in Indian and International market • Restructuring & reorganisation of Corporate Debt under CDR Mechanism • Operation of Securitisation Act, Role of Asset Reconstruction companies and Rebuilding of Assets • Rating requirement under BASEL II – Methodology and Credit Risk Assessment

Hosted by: WIRC of ICAI

PARTICIPATION FEES:	Members of ICAI	Non-Members
IFRS vs. Indian GAAPs	Rs. 2,500/-	Rs. 3,500/-
Direct Taxes	Rs. 2,500/-	Rs. 3,500/-
Raising of Financial Resources	Rs. 2,500/-	Rs. 3,500/-
Participation Fees for all three Conclaves	Rs. 7,000/-	Rs. 9,500/-

Payment: Cheque / DD in favour of **'The Secretary ICAI'** payable at Mumbai and should be sent to Mrs. S. Kapoor, *Programme Co-ordinator*, The Institute of Chartered Accountants of India, ICAI Bhawan, 27 Cuffe Parade, Mumbai- 5

At New Delhi Office: Dr. M. S. Turan, *Additional Director*
011-3011 0536 | ms.turan@icai.in
At Mumbai Office: Ms. Sraboni Kapoor, *Programme Co-ordinator*
022-2215 4936 | kapoor@icai.in

ICAI-NFCG (Half Day) Seminar on Corporate Governance

Organized by: Committee on Corporate Governance (CCG) of ICAI
Hosted by: Central India Regional Council (CIRC) of ICAI
Sponsored by: National Foundation for Corporate Governance (NFCG)

Date	Venue	CPE (Credit)	Fees
Wednesday, December 24, 2008, (11.00 a.m – 2.00 p.m.)	Hotel, Land Mark, Kanpur	3 Hours	Rs. 400 Per delegate

Sessions

Inaugural /Keynote Address Session	**2nd Technical Session:** Harmonizing the requirements of Clause 49 (Listing Agreement) with the provisions of the Companies Act, 1956.
1st Technical Session: Role of the Regulators and the Board towards further improvement in India's Corporate Governance Practices.	**3rd Technical Session:** Global Meltdown and financial turmoil- Role of Professionals to restore confidence and strengthen control mechanism.

Contact Persons and Contact Details

CA. S. Santhanakrishnan, Chairman, CCG, ICAI. **Programme Chairman** Mobile: 09841073008 Email id: skca@sandsca.com ssca@vsnl.com	**CA. Akshay Kumar Gupta,** Central Council Member, ICAI. **Programme Director** Mobile: 09839034107, Email id: mgco@mgcoca.com	**CA. D. C. Shukla,** Treasurer - CIRC of ICAI. **Programme Coordinator** Mobile: 09839032619 Email id: dcshukla@hotmail.com	**CA. H. Ghosh,** Sr. Deputy Director & Secretary, CCG, Mobile: 09350799928 Email id: corpgov@icai.org, ghosh@icai.org

Programme on Insurance and Pension Sector (Residential) Shri Mahavirji, Rajasthan

Organised by Committee on Insurance and Pension of ICAI

Date & Time	*Venue*	*CPE Hours*
03.01.2009 (2.00 pm) to 04.01.2009 (2.00 pm)	*Shri Mahavirji, Rajasthan*	*6 hours*

Discussion Sessions

Technical Session I
New Professional Opportunities for CAs in Insurance and Pension sectors covering Insurance survey and loss assessment

Technical Session II
AS-15 (revised) on Employee Benefits with inputs on Actuarial Sciences

(Nationally renowned experts are being invited to address the participants)

Technical Session III
Impressing the stakeholders – the Right Approach (Personality Development for Professionals)

Technical Session IV

- Recent Amendments in Income Tax :
  - Tax Implications of Real Estate Investment
  - TDS – Recent developments
- Tax Audit – Recent Amendments

Fee: Rs. 1,500/- for Associate members of ICAI; Rs. 2,100/- for Fellow members of ICAI; Rs. 2,500/- for others

Contact Persons with Contact Details

Programme Chairman	Programme Directors		Programme Coordinator
CA. Pankaj I. Jain, Chairman, Committee on Insurance and Pension of ICAI 022-56385000,22007373 9820087168; 9324185000 *pankaj@kjco.net*	**CA. Vijay Kumar Garg,** Member - Central Council of ICAI 0141- 2311 992, 2310 631 09414041872 *vijaymgarg@yahoo.com*	**CA. Pawan Kumar Kanungo,** Member, Committee on Insurance and Pension 0141-2605121,2574001 9414050311,9351160011 *pkanungoca@yahoo.co.in*	**CA. Pawan Parashar,** Chairman, Jaipur Branch of CIRC of ICAI, 0141 2201862, 98280-22660 *taxmanpawan@sify.com*

Website & URL of the detailed announcement: http://www.icai.org/resource_file/13859event_030109.pdf

All India Conference at Kolkata

Internal Audit Standards Board and Committee for Members in Industry

Theme	Winds of Change - Challenges to the Accountancy Profession
Date & Time	*Tuesday 16th and Wednesday 17th, December, 2008 at 11:00 AM to 6:00 PM and 10:00 AM to 5:00 PM respectively*
Venue	*Hotel Park, Kolkata*

Topics to be Discussed

(i) Global Crisis and its Impact on the Indian Economy

(ii) Role of CFOs in Enterprise Risk Management

(iii) Codifying the Best Practices in Internal Audit- the Way Forward

(iv) Private Equity and Other Forms of Raising Resources

(v) Overview of IFRS, Model IFRS Financial Statements and First Time Adoption of IFRS

(vi) IFRS – Managing Transition

(vii) Corporate Taxation Planning

(viii) GST- The Road Ahead

***(Speakers are being finalised and would be announced shortly.)**

CPE Hours	*12 hours*
Fees	• For Member: Rs. 1,600 • For Non-Members: Rs. 2,000 Cheque/Demand Draft should be drawn in favor of "The Institute of Chartered Accountants of India, EIRC"

PROGRAMME CHAIRMAN		PROGRAMME DIRECTOR
CA Abhijit Bandyopadhyay Chairman, Internal Audit Standards Board Mob. 91 98310 59999 Email: babhijit@deloitte.com	CA. Sanjeev Maheshwari Chairman, Committee for Members in Industry Mob. 91 98211 19043 Email: casanjeevmaheshwari@gmail.com	CA. Nirupam Halder Chairman, EIRC Mob: 919830110453 Email: haldarn@icai.org

FOR REGISTRATION AND ENQUIRY CONTACT

Mr. Abhijit Basu, Deputy Secretary, EIRC, ICAI, Phone: (033) 30211132, Email: eircchairman@icai.org

Non-Receipt of Journal

This is for the attention of Members/subscribers who fail to receive The Chartered Accountant journal despatched to them either due to unintimated change of address or postal problems. The membership/subscriber numbers of the members/subscribers whose journals have been returned undelivered are hosted on the website of the Institute at the link http://www.icai.org/resource_file/13832Sep08_undelivered.pdf for the information of members/subscribers.

Please inform the respective regions immediately after you change the address to ensure regular and timely delivery of journals to you. Other queries and complaints in this regard can also be sent to journal@icai.org or call at 0120-3054847.

Diamond Jubilee Residential Workshop on

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) and CODE OF ETHICS

Jointly Organised by Continuing Professional Education Committee & Committee on Ethical Standards & Hosted by Ernakulam Branch of SIRC of ICAI

Day & Date	*CPE Credit Hours*	*Venue*
Friday, Saturday & Sunday, 12th –14th December 2008	12 hours	The Siena Village, **Munnar**, Kerala

Topics	Faculty
Technical Session I Ethical Guidelines – Recent Developments / Notifications	**CA. Jaydeep N. Shah, Chairman, Committee on Ethical Standards, ICAI**
Technical Session II Overview of Peer Review	**CA. S.L.Daga, Chairman, Peer Review Board, ICAI**
Technical Session III New Disciplinary Mechanism / Procedures / Guidelines	**CA. V.C. James, Central Council Member, ICAI**
Technical Session IV IAS 1 - Presentation of Financial Statements IAS 8 - Accounting Policies , Accounting Estimates and Errors. IAS 12 – Income Taxes	**CA. K. Kanagaraj Antonysamy, Chennai**
Technical Session V IAS 10 - Events after the Balance Sheet Date IAS 19 - Employee Benefits	**CA. K. Kanagaraj Antonysamy, Chennai**
Technical Session VI Introduction to IFRS – Conceptual Framework Challenges in adoption of IFRS	**CA. C.Ganesan, Chennai**
Technical Session VII First Time Adoption of IFRS Issues in Change over to IFRS	**CA. C.Ganesan, Chennai**

Special Attractions	yoga/trekking in the morning, special classes for Ladies regarding cookery /arrangement of dining table, bedroom etc.

Fees

Members: Residential - Rs. 8000/- per head (Twin Sharing basis); Non-Residential - Rs. 5000 per head

Non-Members: Residential - Rs. 10,000/- per head (Twin Sharing basis); Non-Residential - Rs. 6000/- per head

Accompanying Spouse - Rs. 6000/-

Accompanying Children - Rs. 4500 for children below 15 years.

Cheque/DD to be drawn in favour of "Ernakulam Branch of SIRC of ICAI" payable at Ernakulam and should be sent to:

Ernakulam Branch of SIRC of the Institute of Chartered Accountants of India, "ICAI Bhawan", 57/3146, Dewan's Road, Ernakulam, KOCHI – 682 016

Logistics Arrangements	Arrangement of a special coach from Alwaye Muncipal Town Hall Area (Both Alwaye Railwaystation & Kochin Airport are near) to Munnar on 12th December which will start sharp at 9 A.M. Same way the coach will drop back the delegates at Alwaye on 14th December 2008.

Contact Persons & Contact Details			
CA. K. Raghu Chairman, Continuing Professional Education Committee Workshop Chairman E-Mail: Kraghu9999@gmail.om	CA. Jaydeep Narendra Shah Chairman, Committee on Ethical Standards Workshop Chairman E-Mail: shchco_ngp@sanchar-net.in, jnshah@icai.org	CA. V. C. James Central Council Member Workshop Director E-Mail: vcjames_2005@yahoo.com vcjames@icai.org	CA. S. L. Daga Chairman, Peer Review Board, ICAI Workshop Co-ordinator E-Mail: dagasl@rediffmail.com
For any further information, kindly contact, Committee on Ethical Standards on ph no. 011-30110422 and e-mail id ces@icai.in or Continuing Professional Education Committee on ph no. 011-30110451 and e-mail id cpesec@icai.org.			

ICAI-NFCG National Seminar on Corporate Governance

Theme- Corporate Governance - Myth to Reality- A Way Forward

Organized by: Committee on Corporate Governance (CCG) of ICAI
Hosted by: Southern India Regional Council (SIRC) of ICAI
Sponsored by: National Foundation for Corporate Governance (NFCG)

Date	Venue	CPE (Credit)
Friday, December 26, 2008	Hotel Savera, Dr. Radha Krishnan Salai, Chennai	6 Hours

Sessions

Inaugural/Keynote Address Session	**4th Technical Session:** Role of the Board and Audit Committee in ensuring good governance.
1st Technical Session: Corporate Governance Demystified.	**5th Technical Session:** Corporate Governance in family owned enterprises and SME Sector.
2nd Technical Session: Role of Regulators for effective compliance in ensuring best Corporate Governance Practices.	**6th Technical Session:** Independent Directorship- Enhanced role of Chartered Accountants.
3rd Technical Session: Harmonizing the requirements of Clause 49 (Listing Agreement) with the provisions of the Companies Act, 1956.	**7th Technical Session:** Global Melt down and financial turmoil- Implications on the current economic scenario.

Programme organizing/managing authority

CA. S. Santhanakrishnan, Chairman, CCG, ICAI. **Programme Chairman** Mobile: 09841073008 Email id: skca@sandsca.com ssca@vsnl.com	**CA. V. Murali,** Central Council Member, ICAI. **Programme Director** Mobile: 09841040010, 09381046952 Email id: victorgrace321@rediffmail.com victorgrace321@gmail.com	**CA. P. Rajendra Kumar,** Chairman, SIRC of ICAI. **Programme Coordinator** Mobile: 09444017087 Email id: council.rk@gmail.com rajendrakp@icai.org	**For Registration & further queries please contact-** **CA. V. Murali,** Central Council Member, ICAI. Mobile-09841040010, 09381046952 E Mail id: victorgrace321@rediffmail.com victorgrace321@gmail.com

Joint State Summit on issues concerning Public Finance

Organised by: **The Committee on Public Finance of The Institute of Chartered Accountants of India (ICAI) jointly with Centre for Taxation Studies, Kerala Government at Ernamkulam.**

Chief Guest: Hon'ble Finance Minister Dr. T.M. Thomas Isaac, Kerala
Venue: Mercy Tourist Home, M G Road, Ravipuram, Ernamkulam

Discussion Sessions
Date: 27th December 2008

Inaugural/ Keynote Sessions **1st Discussion Session** Public expenditure-Control Measures **2nd Discussion Session** Kerala's Fiscal Policy and Planning **3rd Discussion Session** Evaluation of State's Welfare Schemes	**4th Discussion Session** From VAT to GST: Issues and Remedies **5th Discussion Session** Fiscal Prudence & Government Accounting: From Cash to Accrual System **Concluding Session & Vote of thanks**

Please Contact:

CA. Subodh Kumar Agrawal, Chairman, Committee on Public Finance, ICAI.
Mobile: 09830022848, **Email id:** subodhka@yahoo.com, pfc@icai.in

CA. James V.C., Member, Committee on Public Finance, ICAI.
Mobile: 09847034528, **Email id:** vcjames@airtelmail.in, vcjames_2005@yahoo.com, vcjames@icai.in

CA. P G Sajeev, Chairman Ernakulam Branch of SIRC of ICAI
Mobile No. 9447025378 Email id : chairmanekm@gmail.com; sajeevpg@gmail.com

Secretary, Committee on Public Finance, ICAI.
Mobile: 09350799922, **Email id:** shivam@icai.in

INTERNATIONAL CONFERENCE ON GST ARCHITECTURE IN FEDERAL SYSTEM

(With special reference to proposed introduction of GST in India)
Organised by Indirect Taxes Committee & Hosted by NIRC of ICAI

Theme	*Government of India has announced intention to introduce GST from 2010. Designing model of GST is the first step in this direction. Various suggestions have been made in this regard considering the federal structure of governance in India. Group constituted by the Empowered Committee of State Finance Ministers to study this aspect and suggest a model for the country have submitted their report and also dealt with other issues that need to be addressed. ICAI too had issued concept paper on the subject This Conference aims to bring together experts from countries which have implemented GST in federal system to share their experiences and discuss related matters with eminent faculties in Indian context to generate thoughts and ideas for implementation of GST in India by 2010.*

Date, Day & Time	***Venue***	***CPE Hours***
16th January, 2008, Friday at 9:30AM to 05.30PM	*New Delhi*	*6 Hrs.*

Discussion Sessions

Inaugural Session	
First Technical Session **GST Models- Challenges and Responses** • Canadian Experience • Brazilian Experience • EU Experience of Intra-community trade	**Second Technical Session** **GST Model for India- Imperatives** • Selection of Model – feasibility perspective • Taxation of Services – Intra and Inter state trade • Concerns of trade and industry and responses • Concerns of administration and responses
	Panel Discussion

Fees	*Rs. 2,500/- (Rupees Two Thousand Five Hundred only. Registration form is available on www.icai.org.* DD/Pay order should be drawn in favour of NIRC of ICAI, Payable at New Delhi.

Contact Persons

Conference Chairperson	**Conference Director**	**Conference Convenor**	**Committee Secretary**
CA. Bhavna Doshi, Chaiperson, Indirect Tax Committee	CA. Amarjit Chopra, Central Council Member	CA Sudhir Kr. Aggarwal, Chairman, NIRC	CA Karuna Bhansali, Secretary, Indirect Taxes Committee, Mob. No. 9310 998451, E Mail ID : idtc@icai.org

Contact Details for Registration	NIRC Office, ICAI Bhawan, 5th Floor, Annexe Building, Indraprastha Marg, New Delhi – 110002, Mobile No. : 9871817394, E Mail ID : rpchopra@icai.in; nirc@icai.org

Diamond Jubilee All India Conference

Hosted by Guwahati Branch of EIRC of ICAI
Under the aegis of Perspective Planning Committee of the ICAI

Theme	ICAI@60 – Challenges and Opportunities	
Date & Time	***Venue***	***CPE Hours***
13th &14th December, 2008 (Saturday and Sunday)	Pragjyoti ITA Centre for performing Arts, Machkhowa , Guwahati	12 hours

Inaugural Session

Chief Guest	- **Governor of Assam his Excellency, Mr. Shiv Charan Mathur***
Other Dignatories	- **CA. Ved Jain**, President, ICAI*, **CA. Uttam Prakash Agarwal**, Vice President, ICAI

Technical session 1 - Corporate Laws	**Technical Session 3 – Direct Taxation**
Main Speakers – 1. CA. Nawshir Mirza, Mumbai 2. CA. Debasish Mitra, Guwahati	Main Speakers – 1. CA. R. Bupathy, Chennai 2. CA. Girish Ahuja, Delhi
Technical Session 2 – IFRS and AS and AAS	**Technical Session 4 – Indirect Taxes**
Main Speakers – 1. CA. Amarjit Chopra, Delhi 2. CA. S. C. Vasudeva, Delhi	Main Speakers – 1. Mr. V. Raghuraman, Bangalore 2. Mr. Ashok Saraf, Guwahati

Delegate Fees	Members – Rs. 1800; Students - Rs. 600; Others – Rs. 2000

Contact Persons and Contact Details

Conference Chairman	Conference Director	Conference Co-Ordinator	Conference Convenor
CA Shantilal Daga Chairman, PPC Email : dagasl@rediffmail.com Mob: 9849023555	CA Subodh Agarwal Central Council Member Email: subodhka@gmail.com Mob: 9830022848	CA. Nirupam Haldar Chairman, EIRC Email: nirupamhaldar@vsnl.net Mob: 09830110453	CA Ravi kumar Patwa Chairman, Guwahati Branch of EIRC Email: ravipatwa@hotmail.com Mob: 09435071192

Registration

Please send your Registration details to Guwahati Branch of EIRC of ICAI, Near AGP Office, Ambari, Guwahati – 788001, Ph. No. 0361 2513774, Email – icai.guwahati@gmail.com

Please Issue your Cheque/Draft in the name of "Guwahati Branch of EIRC of ICAI payable at Guwahati

Diamond Jubilee All India Conference

Hosted by Hyderabad Branch of SIRC of the ICAI
Under the aegis of Perspective Planning Committee and Peer Review Board of ICAI

Theme	Emerging Paradigm of Accountancy Profession	
Date	***Venue***	***CPE Hours***
24th & 25th December, 2008 (Wednesday and Thursday)	Shri Satya Sai Nigamagamam, Hyderabad	12 hrs

Discussion Sessions

Technical Session 1 - Beyond Governance
- Corporate Governance of non-listed Companies
- Transparency as a Regulatory Tool
- The Board and Audit Committee's Role in Risk Over sight - taking a strategic view of the enterprise

Technical Session 4 - World Economic Crisis - The Future of the Accounting Profession

Keynote Address - Regulatory Landscape: Principle vs Rule Based Context Approaches

Technical Session 2 - Sustaining Quality in the Audit Process
- Promoting Audit Quality
- Audit Monitoring
- Internal Auditing Priorities Today

Technical Session 3 - Financial Reporting
- Disclosure and Accounting Reforms
- Going Concern and Financial Reporting
- Fair Value and Valuation

Technical Session 5 - Capacity Building for Profession
- Practitioner's Perspective
- Industry Members Perspective
- Stake Holders Perspective

Technical Session 6 – Convergence the road ahead- IFRS; AS and AAS

Technical Session 7 – Challenges Ahead

Delegate Fees	Members : Rs. 1250; Non-members: Rs. 1500	
Contact Persons and Contact Details	**Conference Director** CA Shantilal Daga, Chairman, PPC Email : dagasl@rediffmail.com Mob: 9849023555	**Conference Convenor** Shri Chakrapani B, Chairman, Hyderabad Branch Email: bchakrapani@yahoo.com Mob: 9849025872

Registration: For registration and further inquiry please contact ppc@icai.in; hyderabad@icai.org

Accounting Standard for Local Bodies (ASLB) 3

Revenue from Exchange Transactions

(This Accounting Standard includes paragraphs set in ***bold italic*** *type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the Preface to the Accounting Standards for Local Bodies[1])*

The Accounting Standard for Local Bodies (ASLB) 3, 'Revenue from Exchange Transactions', issued by the Council of the Institute of Chartered Accountants of India, will be recommendatory in nature in the initial years for use by the local bodies. This Standard will be mandatory for Local Bodies in a State from the date specified in this regard by the State Government concerned[2].

The following is the text of the Accounting Standard for Local Bodies.

Objective

This Standard uses the term "revenue", which encompasses both revenues and gains, in place of the term "income". Certain specific items to be recognised as revenues are addressed in other Standards and are excluded from the scope of this Standard. For example, gains arising on the sale of property, plant and equipment will be specifically addressed in the Standard on property, plant and equipment[3] and are not covered in this Standard. Guidance on accounting for fixed assets can be found in Accounting Standard (AS) 10, Accounting for Fixed Assets, until the ASLB on this subject is formulated.

The objective of this Standard is to prescribe the accounting treatment of revenue arising from exchange transactions and events. The primary issue in accounting for revenue is determining when to recognise revenue. Revenue is recognised when it is probable that future economic benefits or service potential will flow to the entity and these benefits can be measured reliably. This Standard identifies the circumstances in which these criteria will be met and, therefore, revenue will be recognised. It also provides practical guidance on the application of these criteria.

Scope

1. This Standard applies to the entities described as Local Bodies in the Preface to the Accounting Standards for Local Bodies[4].

2. An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting for revenue arising from the following exchange transactions and events:

(a) The rendering of services yielding revenue;

(b) The sale of goods; and

(c) The use by others of entity assets yielding interest, royalties and dividends.

3. This Standard does not deal with revenue arising from non-exchange transactions. Revenue arising from non-exchange transactions will be dealt with in the proposed Standard on *'Revenue arising from Non-exchange Transactions'*[5]. Examples of non-exchange transactions include revenue from the use of statutory powers (for example, taxes, duties, and fines), grants and donations.

4. Local Bodies may derive revenues from exchange or non-exchange transactions. An exchange transaction is one in which the entity transfers goods or services, or use of assets, and receives some value (primarily in the form of cash, goods, services or has liabilities extinguished) from the other party in exchange. Examples of exchange transactions include:

(a) The purchase or sale of goods or services; or

(b) The lease of property, plant and equipment

5. The rendering of services typically involves the performance by the entity of an agreed task over an agreed period of time. The services may be rendered within a single period or over more than one period. Examples of services rendered by local bodies for which revenue is typically received in exchange may include the provision of housing and shopping complexes, management of water facilities, management of toll roads, and management of transfer payments. Some agreements for rendering of services are directly related to the construction contracts. Revenue arising from construction contracts will be dealt with in the proposed ASLB, *'Construction Contracts'*[6]. Guidance on accounting for revenue arising from construction contracts can be found in Accounting Standard (AS) 7, *'Construction Contracts'* until the ASLB on this subject is formulated.

6 Goods includes goods produced by the entity for the purpose of sale, such as publications, and goods purchased for resale, such as merchandise or building and other property held for resale.

7. The use by others of entity assets

[1]Attention is specifically drawn to paragraph 4.2 of the *'Preface to the Accounting Standards for Local Bodies'*, according to which Accounting Standards are intended to apply only to items which are material.

[2]Reference may be made to the paragraph 7.1 of the *'Preface to the Accounting Standards for Local Bodies'* providing the discussion on the compliance with the Account ing Standards for Local Bodies.

[3]The proposed ASLB on *'Property, Plant and Equipment'* is under preparation.

[4]Refer paragraph 1.3 of the 'Preface to the Accounting Standards for Local Bodies'.

[5]The proposed ASLB on 'Revenue from Non-exchange Transactions' is under preparation.

[6]The proposed ASLB on 'Construction Contracts' is under preparation.

gives rise to revenue in the form of:

(a) Interest — charges for the use of cash or cash equivalents or amounts due to the entity;

(b) Royalties — charges for the use of long-term assets of the entity, for example, patents, trademarks, copyrights and computer software; and

(c) Dividends or equivalents — distributions of surpluses to holders of equity investments in proportion to their holdings of a particular class of capital.

8. This Standard does not deal with revenues arising from:

(i) Lease agreements (Guidance on accounting for revenue arising from lease agreements can be found in Accounting Standard (AS) 19, *'Leases'*, until the ASLB on this subject is formulated);

(ii) Dividends from investments which are accounted for under the equity method in Consolidated Financial Statements (Guidance on accounting for associates can be found in Accounting Standard (AS) 23, *'Accounting for Investments in Associates in Consolidated Financial Statements'*, until the ASLB on this subject is formulated);

(iii) Gains from the sale of property, plant and equipment (which will be dealt with in proposed ASLB, *'Property, Plant and Equipment'*[7], guidance on accounting for fixed assets can be found in Accounting Standard (AS) 10, *'Accounting for Fixed Assets'*, until the ASLB on this subject is formulated);

(iv) Insurance contracts of insurance entities;

(v) Changes in the fair value of financial assets and financial liabilities or their disposal (Guidance on accounting for financial instruments can be found in Accounting Standard 30, *'Financial Instruments: Recognition and Measurement'* until the ASLB on this subject is formulated);

(v) Changes in the value of other current assets;

(vii) Natural increases in herds, and agricultural and forest products; and

(viii) Extraction of mineral ores.

Definitions

9. The following terms are used in this Standard with the meanings specified:

***Fair value* is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.**

***Revenue* is the gross inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners.**

Revenue

10. Revenue includes only the gross inflows of economic benefits or service potential received and receivable by the entity on its own account. Amounts collected as agent of the government or another government organisation or on behalf of other third parties are not economic benefits or service potential which flow to the entity and do not result in increases in assets or decreases in liabilities. Therefore, they are excluded from revenue. Similarly, in a custodial or agency relationship, the gross inflows of economic benefits or service potential include amounts collected on behalf of the principal and which do not result in increases in net assets/equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of any commission received or receivable for the collection or handling of the gross flows.

11. Financing inflows, notably borrowings, do not meet the definition of revenue because they result in an equal change in both assets and liabilities and have no impact upon net assets/equity. Financing inflows are taken directly to the statement of financial position and added to the balances of assets and liabilities.

Measurement of Revenue

12. Revenue should be measured at the fair value of the consideration received or receivable.

13. The amount of revenue arising on a transaction is usually determined by agreement between the entity and the purchaser or user of the asset or service. It is measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity.

14. In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest free credit to the purchaser or accept a note receivable bearing a below-market interest rate from the purchaser as consideration for the sale of goods. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest, where the effect of time value of money is material. Ordinarily, when the inflow of cash or cash equivalents is deferred beyond a period of twelve months, the effect of time value of money is likely to be material. The imputed rate of interest is the more clearly determinable of either:

(a) The prevailing rate for a similar instrument of an issuer with a similar credit rating; or

(b) A rate of interest that dis-

[7]The proposed ASLB, 'Property, Plant and Equipment' is under preparation.

counts the nominal amount of the instrument to the current cash sales price of the goods or services.

The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in accordance with paragraphs 31 and 32.

15. When goods or services are exchanged or swapped for goods or services which are of a similar nature and value, the exchange is not regarded as a transaction which generates revenue. This is often the case with commodities where suppliers exchange or swap inventories in various locations to fulfill demand on a timely basis in a particular location. When goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred.

Identification of the Transaction

16. The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the effect cannot be understood without reference to the series of transactions as a whole. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.

Rendering of Services

17. When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognised by reference to the stage of completion of the transaction at the reporting date. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

(a) The amount of revenue can be measured reliably;

(b) It is probable that the economic benefits or service potential associated with the transaction will flow to the entity;

(c) The stage of completion of the transaction at the reporting date can be measured reliably; and

(d) The costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

18. The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method. Under this method, revenue is recognised in the reporting periods in which the services are rendered. For example, an entity providing property valuation consultancy services would recognise revenue as the individual valuations are completed. The recognition of revenue on this basis provides useful information on the extent of service activity and performance during a period.

19. Revenue is recognised only when it is probable that the economic benefits or service potential associated with the transaction will flow to the entity. However, when an uncertainty arises about the collectability of an amount already included in revenue, the uncollectable amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

20. An entity is generally able to make reliable estimates after it has agreed to the following with the other parties to the transaction:

(a) Each party's enforceable rights regarding the service to be provided and received by the parties;

(b) The consideration to be exchanged; and

(c) The manner and terms of settlement.

It is also usually necessary for the entity to have an effective internal financial budgeting and reporting system. The entity reviews and, when necessary, revises the estimates of revenue as the service is performed. The need for such revisions does not necessarily indicate that the outcome of the transaction cannot be estimated reliably.

21. The stage of completion of a transaction may be determined by a variety of methods. An entity uses the method that measures reliably the services performed. Depending on the nature of the transaction, the methods may include:

(a) Surveys of work performed;

(b) Services performed to date as a percentage of total services to be performed; or

(c) The proportion that costs incurred to date bear to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in costs incurred to date. Only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction.

Progress payments and advances received from customers often do not reflect the services performed.

22. For practical purposes, when services are performed by an indeterminate number of acts over a specified time frame, revenue is recognised on a straight line basis over the specified time frame unless there is evidence that some other method better represents the stage of completion. When a specific act is much more significant than any other acts, the recognition of revenue is postponed until the significant act is executed.

23. When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue should be recognised only to the extent of the expenses recognised that are recoverable.

24. During the early stages of a transaction, it is often the case that the outcome of the transaction cannot be estimated reliably. Nevertheless, it may be probable that the entity will recover the transaction costs incurred. Therefore, revenue is recognised only to the extent of costs incurred that are expected to recoverable. As the outcome of the transaction cannot be estimated reliably, no surplus is recognised.

25. When the outcome of a transaction cannot be estimated reliably and it is not probable that the costs incurred will be recovered, revenue is not recognised and the costs incurred are recognised as an expense. When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue is recognised in accordance with paragraph 17 rather than in accordance with paragraph 23.

Sale of Goods

26. Revenue from the sale of goods should be recognised when all the following conditions have been satisfied:

(a) The entity has transferred to the purchaser the significant risks and rewards of ownership of the 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 the economic benefits or service potential associated with 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.

27. The assessment of when an entity has transferred the significant risks and rewards of ownership to the purchaser 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 purchaser. This is the case for most sales. However, in certain 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.

28. If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised. An entity may retain a significant risk of ownership in a number of ways. Examples of situations in which the entity may retain the significant risks and rewards of ownership are:

(a) When the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;

(b) When the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the purchaser from its sale of the goods (for example, where a local body distributes educational material to schools on a sale or return basis);

(c) When the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity; and

(d) When the purchaser 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.

29. If an entity retains only an insignificant risk of ownership, the transaction is a sale and revenue is recognised. For example, a seller may retain the legal title to the goods solely to protect the collectability 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 recognised. Another example of an entity retaining only an insignificant risk of ownership may be a sale when a refund is offered if the purchaser is not satisfied. Revenue in such cases is recognised at the time of sale provided the seller can reliably estimate future returns and recognises a liability for returns based on previous experience and other relevant factors.

30. Revenue is recognised only when it is probable that the economic benefits or service potential associated with the 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, the revenue may be dependent upon the ability of another entity to supply goods as part of the contract and if there is any doubt that this will occur, recognition may be delayed until it has occurred. When the goods are supplied, the uncertainty is removed and revenue is recognised. However, when an uncertainty arises about the collectability of an amount already included in revenue, the uncollectable amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

Interest, Royalties and Dividends

31. Revenue arising from the use by others of entity assets yielding interest, royalties and dividends should be recognised using the

accounting treatments set out in paragraph 32 when:

(a) It is probable that the economic benefits or service potential associated with the transaction will flow to the entity; and

(b) The amount of the revenue can be measured reliably.

32. Revenue should be recognised using the following accounting treatments:

(a) Interest should be recognised on a time proportion basis that takes into account the effective yield on the asset;

(b) Royalties should be recognised as they are earned in accordance with the substance of the relevant agreement; and

(c) Dividends or equivalents should be recognised when the shareholder's or the entity's right to receive payment is established.

33. The effective yield on an asset is the rate of interest required to discount the stream of future cash receipts expected over the life of the asset to equate to the initial carrying amount of the asset. Interest revenue includes the amount of amortisation of any discount, premium or other difference between the initial carrying amount of a debt security and its amount at maturity.

The calculation of effective yield rate and its application is illustrated in Appendix A.

34. When unpaid interest has accrued before the acquisition of an interest-bearing investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; only the post-acquisition portion is recognised as revenue. When dividends on equity securities are declared from pre-acquisition net surplus, those dividends are deducted from the cost of the securities. If it is difficult to make such an allocation except on an arbitrary basis, dividends are recognised as revenue unless they clearly represent a recovery of part of the cost of the equity securities.

35. Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the agreement, it is more appropriate to recognise revenue on some other systematic and rational basis.

36. Revenue is recognised only when it is probable that the economic benefits or service potential associated with the transaction will flow to the entity. However, when an uncertainty arises about the collectability of an amount already included in revenue, the uncollectable amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

Disclosure

37. An entity should disclose:

(a) The accounting policies adopted for the recognition of revenue including the methods adopted to determine the stage of completion of transactions involving the rendering of services;

(b) The amount of each significant category of revenue recognised during the period including revenue arising from:

(i) The rendering of services yielding revenue;

(ii) The sale of goods;

(iii) Interest;

(iv) Royalties; and

(v) Dividends or their equivalents; and

(c) The amount of revenue arising from exchange of goods or services included in each significant category of revenue.

38. Guidance on disclosure of any contingent assets and contingent liabilities can be found in (AS) 29, *'Provisions, Contingent Liabilities and Contingent Assets'*[8] until the ASLB on this subject is formulated. Contingent assets and contingent liabilities may arise from items such as warranty costs, claims, penalties or possible losses.

Appendix A

The appendix is illustrative only and does not form part of the Standard. The purpose of the appendix is to illustrate the application of the Standard to assist in clarifying its meaning in a number of situations. The examples focus on particular aspects of a transaction and are not a comprehensive discussion of all the relevant factors which might influence the recognition of revenue. The examples generally assume that the amount of revenue can be measured reliably, it is probable that the economic benefits or service potential will flow to the entity and the costs incurred or to be incurred can be measured reliably. The examples do not modify or override the Standard.

Local Bodies derive revenues from exchange or non-exchange transactions. This Standard deals only with revenue arising from exchange transactions. Revenue from exchange transactions is derived from:

(a) Sale of goods or provision of services to third parties;

(b) Sale of goods or provision of services to other government agencies; and

(c) The use by others of entity assets yielding interest, royalties and dividends.

Rendering of Services

1. *Rentals*

Rental income from the provision of municipal properties like shopping complexes is recognised as the income

[8]*The proposed ASLB on 'Provisions, Contingent liabilities and Contingent Assets' is under preparation.*

is earned in accordance with the terms of the tenancy agreement.

2. *Transport*

Revenue from fares charged to passengers for the provision of transport is recognised as the transport is provided.

3. *Management of toll roads*

Revenue from the management of toll roads is recognised as it is earned, based on the usage of the roads.

4. *Management of facilities, assets or services*

Revenue from the management of facilities, assets or services is recognised over the term of the contract as the management services are provided.

5. *Installation fees*

Installation fees are recognised as revenue by reference to the stage of completion of the installation, unless they are incidental to the sale of a product in which case they are recognised when the goods are sold.

6. *Servicing fees included in the price of the product*

When the selling price of a product includes an identifiable amount for subsequent servicing (for example, after sales support on the sale of certain goods), that amount is deferred and recognised as revenue over the period during which the service is performed. The amount deferred is that which will cover the expected costs of the services under the agreement, together with a reasonable return on those services.

7. *Admission fees*

Revenue from artistic performances, banquets and other special events is recognised when the event takes place. When a subscription to a number of events is sold, the fee is allocated to each event on a basis which reflects the extent to which services are performed at each event.

8. *Tuition fees*

Revenue is recognised over the period of instruction.

9. *Initiation, entrance and membership fees*

Revenue recognition depends on the nature of the services provided. If the fee permits only membership, and all other services or products are paid for separately e.g. library fees, or if there is a separate annual subscription, the fee is recognised as revenue when no significant uncertainty as to its collectability exists. If the fee entitles the member to services or publications to be provided during the membership period, or to purchase goods or services at prices lower than those charged to non-members, it is recognised on a basis that reflects the timing, nature and value of the benefits provided.

10. *Franchise or concession fees*

Franchise or concession fees may cover the supply of initial and subsequent services, equipment and other tangible assets, and know-how. Accordingly, franchise or concession fees are recognised as revenue on a basis that reflects the purpose for which the fees were charged. The following methods of franchise or concession fee recognition are appropriate:

(a) Supplies of equipment and other tangible assets

The amount, based on the fair value of the assets sold, is recognised as revenue when the items are delivered or title passes.

(b) Supplies of initial and subsequent services

Fees for the provision of continuing services, whether part of the initial fee or a separate fee, are recognised as revenue as the services are rendered. When the separate fee does not cover the cost of continuing services together with a reasonable return, part of the initial fee, sufficient to cover the costs of continuing services and to provide a reasonable return on those services, is deferred and recognised as revenue as the services are rendered.

(c) *Continuing franchise or concession fees*

Fees charged for the use of continuing rights granted by the agreement, or for other services provided during the period of the agreement, are recognised as revenue as the services are provided or the rights used.

(d) *Agency transactions*

Transactions may take place between the franchisor and the franchisee which, in substance, involve the franchisor acting as agent for the franchisee. For example, the franchisor may order supplies and arrange for their delivery to the franchisee at no return. Such transactions do not give rise to revenue.

Sale of Goods

11. "Bill and hold" sales, in which delivery is delayed at the purchaser's request but the purchaser takes title and accepts billing

Revenue is recognised when the purchaser takes title, provided:

(a) It is probable that delivery will be made;

(b) The item is on hand, identified and for delivery to the purchaser at the time the sale is recognised;

(c) The purchaser specifically acknowledges the deferred delivery instructions; and

(d) The usual payment terms apply.

Revenue is not recognised when there is simply an intention to acquire or manufacture the goods in time for delivery.

12. *Goods shipped subject to conditions*

(a) Installation and inspection

Revenue is normally recognised when the purchaser accepts delivery, and installation and

inspection are complete. However, revenue is recognised immediately upon the purchaser's acceptance of delivery when:

(i) The installation process is simple in nature; or

(ii) The inspection is performed only for purposes of final determination of contract prices.

(b) *On approval when the purchaser has negotiated a limited right of return*

If there is uncertainty about the possibility of return, revenue is recognised when the shipment has been formally accepted by the purchaser or the goods have been delivered and the time period for rejection has elapsed.

(c) *Consignment sales under which the recipient (purchaser) undertakes to sell the goods on behalf of the shipper (seller)*

Revenue is recognised by the shipper when the goods are sold by the recipient to a third party.

(d) *Cash on delivery sales*

Revenue is recognised when delivery is made and cash is received by the seller or its agent.

13. *Lay away sales under which the goods are delivered only when the purchaser makes the final payment in a series of installments*

Revenue from such sales is recognised when the goods are delivered. However, when experience indicates that most such sales are consummated, revenue may be recognised when a significant deposit is received provided the goods are on hand, identified and ready for delivery to the purchaser.

14. *Orders when payment (or partial payment) is received in advance of delivery for goods not presently held in inventory, for example, the goods are still to be manufactured or will be delivered directly to the customer from a third party*

Revenue is recognised when the goods are delivered to the purchaser.

15. Sale and repurchase agreements (other than swap transactions) under which the seller concurrently agrees to repurchase the same goods at a later date, or when the seller has a call option to repurchase, or the purchaser has a put option to require the repurchase, by the seller, of the goods

The terms of the agreement need to be analysed to ascertain whether, in substance, the seller has transferred the risks and rewards of ownership to the purchaser and hence revenue is recognised. When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to revenue.

16. Sales to intermediate parties, such as distributors, dealers or others for resale

Revenue from such sales is generally recognised when the risks and rewards of ownership have passed. However, when the purchaser is acting, in substance, as an agent, the sale is treated as a consignment sale.

17. Subscriptions to publications and similar items

When the items involved are of similar value in each time period, revenue is recognised on a straight line basis over the period in which the items are dispatched. When the items vary in value from period to period, revenue is recognised on the basis of the sales value of the item dispatched in relation to the total estimated sales value of all items covered by the subscription.

18. Installment sales, under which the consideration is receivable in installments

Revenue attributable to the sales price, exclusive of interest, is recognised at the date of sale. The sale price is value of the consideration, determined by discounting the installments receivable at the imputed rate of interest. The interest element is recognised as revenue as it is earned, on a time proportion basis that takes into account the imputed rate of interest.

19. Real estate sales

Revenue is normally recognised when legal title passes to the purchaser. However, where the equitable interest in a property may vest in the purchaser before legal title passes and therefore the risks and rewards of ownership have transferred at that stage. In such cases, provided that the seller has no further substantial acts to complete under the contract, it may be appropriate to recognise revenue. In either case, if the seller is obliged to perform any significant acts after the equitable and/or legal title, revenue is recognised as the acts are performed. An example is a building or other facility on which construction has not been completed.

In some cases, real estate may be sold a degree of continuing involvement by the seller such that the risks and rewards of ownership have not been transferred. Examples are sale and repurchase agreements which include put and call options, and agreements whereby the seller guarantees occupancy of the property for a specified period, or guarantees a return on the purchaser's investment for a specified period. In such cases, the nature and extent of the seller's continuing involvement determines how the transaction is accounted for. It may be accounted for as a sale, or as a financing, leasing or some other profit sharing arrangement. If it is accounted for as a sale, the continuing involvement of the seller may delay the recognition of revenue.

A seller must also consider the means of payment and evidence of the purchaser's to complete payment. For example, when the aggregate of the payments received, including the purchaser's initial down payment, or continuing payments by the purchaser, provide insufficient evidence of the purchaser's commitment to complete payment, revenue is recognised only to the extent cash is received.

Interest, Royalties and Dividends

20. License fees and royalties

Fees and royalties paid for the use of an entity's assets (such as trademarks, patents, software,) are normally recog-

nised in accordance with the substance of the agreement. As a practical matter, this may be on a straight line basis over the life of the agreement, for example, when a licensee has the right to use certain technology for a specified period of time.

An assignment of rights for a fixed fee or non refundable guarantee under a non cancelable contract which permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform is, in substance, a sale.

In some cases, whether or a license fee or royalty will be received is contingent on the occurrence of a future event. In such cases, revenue is recognised only when it is probable that the fee or royalty will be received, which is normally when the event has occurred.

21. Effective yield on an Asset

When calculating the effective interest/yield rate, an entity should estimate cash flows considering all contractual terms of the financial asset. The calculation includes all fees paid or received that are an integral part of the effective interest rate, directly attributable transaction cost and all other premiums or discounts.

For example, Local Body XYZ purchases a 5-year bond carrying 4.7% interest (paid annually) with a face value of Rs. 1,250, for Rs. 1,000 (including transaction costs).

The effective yield rate method is applied as follow:

Effective Yield Computation	
Years	**Cash inflows / (outflows)**
Year 0	(1,000)
Year 1	59
Year 2	59
Year 3	59
Year 4	59
Year 5	59+1250
Effective Yield Rate	**10%**

Year	(a) Amortised Cost at the beginning of the year	(b = a10%) Interest income	(c) Cash flows	(d = a + b – c) Amortised cost at the end of the year
Year 1	1,000	100	59	1,041
Year 2	1,041	104	59	1,086
Year 3	1,086	109	59	1,136
Year 4	1,136	113	59	1,190
Year 5	1,190	119	1,250 + 59	-

As per the effective yield method, the amount of interest to be recognised in Year 1 to Year 5 would be Rs. 100, Rs. 104, Rs. 109, Rs. 113 and Rs. 119 respectively.

Appendix B

Note: This Appendix is not a part of the Accounting Standard for Local bodies. The purpose of this appendix is only to bring out the major differences between this Accounting Standard for Local Bodies (ASLB) and the corresponding International Public Sector Accounting Standard (IPSAS) 9, Revenue from Exchange Transactions.

COMPARISON WITH IPSAS 9, REVENUE FROM EXCHANGE TRANSACTIONS

1. Definition of the term 'Exchange Transactions'

International Public Sector Accounting Standard (IPSAS) 9 *'Revenue from Exchange Transactions'* issued by International Public Sector Accounting Standards Board (IPSASB) defines a transaction as an exchange transaction, in which one entity receives assets or services, or has liabilities extinguished and directly gives approximately equal value to other party in exchange. For determining whether there is exchange of approximately equal value requires determining the fair value of the consideration given and received.

The ASLB 3 however describes an exchange transaction as one in which the entity transfers goods or services or use of assets and receives some value instead of equal value.

The ASLB 3 has changed the definition of 'Exchange Transaction' because in India most of the transactions undertaken by Local Bodies providing goods and services at subsidised prices does not involve the exchange of equal value and would not be covered under exchange transactions. Since the Local Bodies in India are at a very early stage of adoption of accrual basis of accounting, it would be difficult for the Local Bodies to determine the fair value for deciding whether there is exchange of approximately equal value for a transaction. Consequent to the above, other changes have also been incorporated in the proposed Standard.

2. Materiality of the effect of time value of money

The ASLB 3 'Revenue from Exchange Transactions' requires to measure revenue at fair value of the consideration received or receivable as provided in International Public Sector Accounting Standard (IPSAS) 9 *'Revenue from Exchange Transactions'* issued by the International Public Sector Accounting Standards Board (IPSASB). In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, in case of the financing transactions, where the inflow or outflow of cash or cash equivalents is deferred, IPSAS 9 requires to measure the fair value of the consideration by discounting all future receipts using an imputed rate of interest. However, ASLB 3 requires discounting of cash receipts only when the time value of money is material. It also provides that ordinarily, when the inflow of cash or cash equivalents is deferred beyond a period of twelve months, the effect of time value of money is material.❑

Accounting Standard for Local Bodies (ASLB) 4
Borrowing Costs

(This Accounting Standard includes paragraphs set in ***bold italic*** *type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the Preface to the Accounting Standards for Local Bodies[1])*

The Accounting Standard for Local Bodies (ASLB) 4, 'Borrowing Costs', issued by the Council of the Institute of Chartered Accountants of India, will be recommendatory in nature in the initial years for use by the local bodies. This Standard will be mandatory for local bodies in a State from the date specified in this regard by the State Government concerned[2].

The following is the text of the Accounting Standard for Local Bodies.

Objective

This Standard prescribes the accounting treatment for borrowing costs.

Scope

1. This Standard should be applied in accounting for borrowing costs.

2. This Standard applies to the entities described as Local Bodies in the Preface to the Accounting Standards for Local Bodies[3].

3. This Standard does not deal with the actual or imputed cost of net assets/equity. Where a capital charge is applied to individual entities, judgement will need to be exercised whether the charge meets the definition of borrowing costs or whether it should be treated as an actual or imputed cost of net assets/equity. Charges will be treated as borrowing costs only if it meets the definition of borrowing costs.

Definitions

4. The following terms are used in this Standard with the meanings specified:

Borrowing costs ***are interest and other costs incurred by an entity in connection with the borrowing of funds.***

Control ***is the power to govern the financial and operating policies of another entity so as to benefit from its activities.***

Controlled entity ***is an entity that is under the control of another entity (known as the controlling entity).***

Controlling entity ***is an entity that has one or more controlled entities.***

Economic entity ***means a group of entities comprising a controlling entity and one or more controlled entities.***

Net assets/equity ***is the residual interest in the assets of the entity after deducting all its liabilities.***

Qualifying asset ***is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.***

Borrowing Costs

5. Borrowing costs may include:

(a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings;

(b) amortisation of discounts or premiums relating to borrowings;

(c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings;

(d) finance charges in respect of assets acquired under finance leases or under similar arrangements; and

(e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. Exchange differences arising from foreign currency borrowings and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest

[1]Attention is specifically drawn to paragraph 4.2 of the 'Preface to the Accounting Standards for Local Bodies', according to which Accounting Standards are intended to apply only to items which are material.

[2]Reference may be made to the paragraph 7.1 of the 'Preface to the Accounting Standards for Local Bodies' providing the discussion on the compliance with the Accounting Standards for Local Bodies.

[3]Refer paragraph 1.3 of the 'Preface to the Accounting Standards for Local Bodies'.

on foreign currency borrowings is considered as borrowing costs to be accounted for under this Standard and the remaining exchange difference, if any, will be accounted for under Accounting Standard for Local Bodies (ASLB) on *'The Effects of Changes in Foreign Exchange Rates'*[4]. For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the entity would have raised the borrowings locally had the entity not decided to raise the foreign currency borrowings. Guidance on accounting for the effects of changes in foreign exchange rates can be found in Accounting Standard (AS) 11, *'The Effects of Changes in Foreign Exchange Rates'*, until the ASLB on this subject is formulated.

The application of this explanation is illustrated in the Appendix A.

Economic Entity

6. The term "economic entity" is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.

7. Other terms sometimes used to refer to an economic entity include "administrative entity", "financial entity", "consolidated entity" and "group".

8. An economic entity may include entities with both social policy and commercial objectives. For example, a local body XYZ (controlling entity) may control by way of majority voting power in an entity ABC (controlled entity) that provides services of health care for a nominal charge, as well as another entity PQR (controlled entity) that provides transport services on a commercial basis. The group of entities comprising local body XYZ and the controlled entities, viz., ABC and PQR, is the economic entity.

Net Assets/Equity

9. "Net assets/equity" is the term used in this Standard to refer to the residual measure in the balance sheet (assets less liabilities). Net assets/equity may be positive or negative. Other terms may be used in place of net assets/equity, provided that their meaning is clear.

Qualifying Assets

10. What constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get ready for its intended use or sale should be considered.

11. Examples of qualifying assets are office buildings, hospitals, infrastructure assets such as roads, bridges and power generation facilities, and inventories that require a substantial period of time to bring them to a condition ready for use or sale, and investment properties. Other investments and those inventories that are routinely produced over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Recognition

12. Borrowing costs should be recognised as an expense in the period in which they are incurred, except to the extent that they are capitalised in accordance with paragraph 13.

13. Borrowing costs that are specifically incurred for the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard.

14. Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits or service potential to the entity and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

15. When an entity borrows funds generally and uses them for the purposes of obtaining a qualifying asset, the entity recognises an expense for the borrowing costs in respect of such funds in the period in which they are incurred.

Borrowing Costs Eligible for Capitalisation

16. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified. Funds sourced from general borrowings of the entity are not specifically incurred and costs related to such borrowings are not eligible for capitalisation.

17. Funds that have been borrowed centrally may be transferred to other entities within the economic entity as a loan, a grant or a capital injection.

[4]The Accounting Standard for Local Bodies is under preparation.

Some loans may be interest-free or require that only a portion of the actual interest cost be recovered and grants or capital injections do not normally incur interest. Borrowing costs in respect of such borrowings do not qualify for capitalisation.

18. To the extent that an entity borrows funds specifically for the purpose of acquiring, constructing or producing a qualifying asset, the entity should determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

19. The financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditures on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on temporary investment of such funds is deducted from the borrowing costs incurred.

20. If a controlling entity borrows funds which are then loaned to a controlled entity, the controlled entity may captalise only those borrowing costs which it itself incurs specifically in relation to the acquisition, construction or production of a qualifying asset. Such costs will normally be documented in loan agreement with the controlling entity. Where a controlled entity receives an interest-free capital contribution or capital grant, it will not incur any borrowing costs and consequently will not capitalise any such costs.

21. When a controlling entity transfers funds at partial cost to a controlled entity, the controlled entity may capitalise that portion of borrowing costs which it itself has incurred specifically for the acquisition, construction or production of a qualifying asset. These borrowing costs are not necessarily identical to the borrowing costs incurred by the controlling entity. In the financial statements of the economic entity, the full amount of borrowing costs specifically incurred for the acquisition, construction or production of a qualifying asset can be capitalised as part of the cost of that qualifying asset, provided that appropriate consolidation adjustments have been made to eliminate those costs capitalised by the controlled entity.

22. When a controlling entity has transferred funds at no cost to a controlled entity, neither the controlling entity nor the controlled entity would meet the criteria for capitalisation of borrowing costs in their separate financial statements. However, if the economic entity met the criteria for capitalisation of borrowing costs, it would be able to capitalise the borrowing costs to the qualifying asset in its financial statements.

23. When a controlling entity borrows funds generally, and lends part of those funds to a controlled entity specifically for the acquisition, construction or production of a qualifying asset, the borrowing costs of the controlling entity are not eligible for capitalisation either by that controlling entity in its separate financial statements or by the economic entity in its consolidated financial statements. The borrowing costs of the controlled entity may, however, be eligible for capitalisation in the controlled entity's separate financial statements. If the controlling entity borrows funds specifically for the acquisition, construction or production of a qualifying asset by a controlled entity, those borrowing costs, if transferred to the controlled entity, are capitalised in the separate financial statements of the controlled entity and in the consolidated financial statements of the economic entity.

Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount

24. When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Accounting Standards for Local Bodies. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those Accounting Standards.

Commencement of Capitalisation

25. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

(a) expenditure for the acquisition, construction or production of qualifying asset is being incurred;

(b) borrowing costs are being incurred specifically for the acquisition, construction or production of a qualifying asset; and

(c) activities that are necessary to prepare the asset for its intended use or sale are in progress.

26. Expenditures on a qualifying asset include only such expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest bearing liabil-

ities. The expenditure is reduced by any progress payments received and grants received in connection with the asset.

27. The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

Suspension of Capitalisation

28. Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted. Such borrowing costs are expensed.

29. Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

Cessation of Capitalisation

30. Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

31. An asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that is outstanding, this indicates that substantially all the activities are complete.

32. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are completed.

33. Example of a qualifying asset for which each part is capable of being used while construction continues for the other parts is an office development comprising several buildings, each of which can be used individually.

34. Examples of qualifying assets that need to be completed before any part can be used include an operating room in a hospital when all construction must be complete before the room may be used; a sewage treatment plant where several processes are carried out in sequence at different parts of the plant; and a bridge forming part of a highway. In such cases, capitalisation of borrowing costs should be continued.

Disclosure

35. The financial statements should disclose:

(a) the accounting policy adopted for borrowing costs incurred specifically for the acquisition , construction or production of a qualifying asset; and

(b) the amount of borrowing costs capitalised during the period.

Appendix A

Illustration 1

Note: This appendix is illustrative only and does not form part of the Accounting Standard. Its purpose is to assist in clarifying the meaning of the paragraph 4 (e) of the standard.

Facts:

Local Body XYZ has taken a loan of USD 10,000 on April 1, 20X3, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 20X3, the exchange rate between the currencies was Rs. 45 per USD. The exchange rate, as at March 31, 20X4, is Rs. 48 per USD. The corresponding amount could have been borrowed by Local Body XYZ in local currency at an interest rate of 11 per cent per annum as on April 1, 20X3.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of this Accounting

Standard for Local Bodies:

(i) Interest for the period = USD 10,000 x 5%x Rs. 48/USD = Rs. 24,000/-

(ii) Increase in the liability towards the principal amount =USD10,000 x (48-45) = Rs. 30,000/-

(iii) Interest that would have resulted if the loan was taken in Indian currency = USD 10000 x 45 x 11% = Rs. 49,500

(iv) Difference between interest on local currency borrowing and foreign currency borrowing =Rs. 49,500 – Rs. 24,000 =Rs. 25,500

Therefore, out of Rs. 30,000 increase in the liability towards principal amount, only Rs. 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be Rs. 49,500 being the aggregate of interest of Rs. 24,000 on foreign currency borrowings (covered by paragraph 4(a) of this *Accounting Standard for Local Bodies*) plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of Rs. 25,500. Thus, Rs. 49,500 would be considered as the borrowing cost to be accounted for as per this *Accounting Standard for Local Bodies* and the remaining Rs. 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard for Local Bodies (ASLB) on *'The Effects of Changes in Foreign Exchange Rates'*[5]. Guidance on accounting for the effects of changes in foreign exchange rates can be found in Accounting Standard (AS) 11, *'The Effects of Changes in Foreign Exchange Rates'*, until the ASLB on this subject is formulated.

In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of Rs. 30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings (i.e., Rs. 34,500 (Rs. 58,500 – Rs. 24,000)) is more than the exchange difference of Rs. 30,000. Therefore, in such a case, the total borrowing cost would be Rs. 54,000 (Rs. 24,000 + Rs. 30,000) which would be accounted for under this Accounting Standard for Local Bodies and there would be no exchange difference to be accounted for under proposed ASLB on *'The Effects of Changes in Foreign Exchange Rates'*.

Appendix B

Note: This Appendix is not a part of the Accounting Standard for Local bodies. The purpose of this appendix is only to bring out the major differences between this Accounting Standard for Local Bodies (ASLB) and the corresponding International Public Sector Accounting Standard (IPSAS) 5, Borrowing Costs issued by International Public Sector Accounting Standards Board.

COMPARISON WITH IPSAS 5, *BORROWING COSTS*

1. Capitalisation of Borrowing Costs

IPSAS 5 prescribes the expensing of the borrowing costs as 'benchmark treatment'. However, in relation to the borrowing costs directly attributable, (both specifically and generally incurred), to the acquisition, construction or production of a qualifying asset, it provides an option of capitalising such borrowing costs in the cost of that asset. Recently, International Public Sector Accounting Standards Board (IPSASB) has issued ED 35 that proposes amendments to IPSAS 5 which inter alia include that the borrowing costs related to general borrowings are not eligible for capitalisation.

As compared to above, ASLB 4 does not prescribe expensing of borrowing costs as in IPSAS 5. It requires capitalisation of borrowing costs. However, keeping in view the initial stage of introduction of accrual accounting in Local Bodies, the ASLB 4, 'Borrowing Costs', incorporates the amendments proposed in the ED 35 requiring that only those borrowing costs that are specifically incurred for the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Thus, ASLB 4 does not require capitalisation of borrowing costs arising from general borrowings as presently required in IPSAS 5.

2. Substantial Period of Time

IPSAS 5 does not provide the meaning of the expression 'substantial period of time'. It provides only examples of the qualifying Asset requiring the substantial period of time. ASLB 4 provides the interpretation of the expression 'substantial period of time'. It provides that ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case.

3. Commitment Charges

ASLB 4 provides that the Borrowing Costs may include commitment charges on bank borrowings. However, IPSAS 5 does not provide for including the commitment charges on bank borrowings.❑

[5]*The Accounting Standard for Local Bodies is under preparation.*

Revised Standard on Auditing (SA) 250
Consideration of Laws and Regulations in an Audit of Financial Statements*

Standard on Auditing (SA) 250 (Revised), "Consideration of Laws and Regulations in an Audit of Financial Statements", should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services[1] ", which sets out the authority of SAs.

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to consider laws and regulations when performing an audit of financial statements. This SA does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

Effect of Laws and Regulations

2. The effect on the financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health). Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

Responsibility of Management for Compliance with Laws and Regulations

3. It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. *(Ref: Para. A1-A2)*

Responsibility of the Auditor (Ref: Para. A3-A6)

4. The requirements in this SA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

5. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.[2] In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.[3] In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- There are many laws and regulations, relating principally to the operating aspects of an entity, that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.
- Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

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

6. This SA distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows:

(a) The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws. (see paragraph 13); and

(b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of

*Hitherto known as AAS 21, "Consideration of Laws and Regulations in an Audit of Financial Statements".

[1]Published in the July, 2007 issue of the Journal.

[2]Attention is invited to SA 200, "Basic Principles Governing an Audit" and SA 200A, "Objective and Scope of the Audit of Financial Statements" . Both the SAs are being revised in the light of the Revised ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with International Standards on Auditing".

[3]See footnote 2.

the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements (see paragraph 14).

7. In this SA, differing requirements are specified for each of the above categories of laws and regulations. For the category referred to in paragraph 6(a), the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations. For the category referred to in paragraph 6(b), the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

8. The auditor is required by this SA to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected non-compliance to the auditor's attention. Maintaining an attitude of professional skepticism throughout the audit, as required by proposed SA 200 (Revised),[4] is important in this context, given the extent of laws and regulations that affect the entity.

Effective Date

9. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objectives

10. The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and

(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

Definition

11. For the purposes of this SA, the following term has the meaning attributed below:

Non-compliance – Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

Requirements

The Auditor's Consideration of Compliance with Laws and Regulations

12. As part of obtaining an understanding of the entity and its environment in accordance with SA 315,[5] the auditor shall obtain a general understanding of:

(a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and

(b) How the entity is complying with that framework. *(Ref: Para. A7)*

13. The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements. *(Ref: Para. A8)*

14. The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

(a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and

(b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities. *(Ref: Para. A9-A10)*

15. During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. *(Ref: Para. A11)*

16. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor. *(Ref: Para. A12)*

17. In the absence of identified or suspected non-compliance, the auditor is not required to perform audit procedures regarding the entity's compliance with laws and regulations, other than those set out in paragraphs 12-16.

Audit Procedures When Non-Compliance is Identified or Suspected

18. If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain: *(Ref: Para. A13)*

(a) An understanding of the nature of the act and the circumstances in which it has occurred; and

(b) Further information to evaluate the possible effect on the financial statements. *(Ref: Para. A14)*

19. If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with

[4]See footnote 2.

[5]SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 11.

governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice. *(Ref: Para. A15-A16)*

20. If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

21. The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action. *(Ref: Para. A17-A18)*

Reporting of Identified or Suspected Non-Compliance

Reporting Non-Compliance to Those Charged with Governance

22. Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor,[6] the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

23. If, in the auditor's judgment, the non-compliance referred to in paragraph 22 is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

24. If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

Reporting Non-Compliance in the Auditor's Report on the Financial Statements

25. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with Proposed SA 705[7], express a qualified or adverse opinion on the financial statements.

26. If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with Proposed SA 705.

27. If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion in accordance with Proposed SA 705.

Reporting Non-Compliance to Regulatory and Enforcement Authorities

28. If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity. *(Ref: Para. A19-A20)*

Documentation

29. The auditor shall document identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity. *(Ref: Para. A21)*

***

Application and Other Explanatory Material

Responsibility for Compliance with Laws and Regulations

Responsibility of Management for Compliance with Laws and Regulations (Ref: Para. 3)

A1. Management, with the oversight of those charged with governance, is responsible for ensuring that the entity's operations are conducted in accordance with laws and regulations. Laws and regulations may affect an entity's financial statements in different ways: for example, most directly, they may affect specific disclosures required of the entity in the financial statements or they may prescribe the applicable financial reporting framework[8]. They may also establish certain legal rights and obligations of the entity, some of which will be recognised in the entity's financial statements. In addition, laws and regulations may impose penalties in cases of non-compliance.

A2. The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate systems of internal control.
- Developing, publicising and following a code of conduct.

[6]Revised SA 260, "Communication with Those Charged with Governance", paragraph 9.

[7]Proposed SA 705, "Modifications to the Opinion in the Independent Auditor's Report". The Standard is being formulated in the light of the corresponding International Standard. Presently, the concept of modified opinion is dealt within SA 700, "The Auditor's Report on Financial Statements".

[8]Revised ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with International Standards on Auditing", paragraph 13 (a) defines the applicable financial reporting framework as "The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation. The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

(i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or

(ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

- Ensuring employees are properly trained and understand the code of conduct.
- Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
- Engaging legal advisors to assist in monitoring legal requirements.
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to the following:

- An internal audit function.
- An audit committee.
- A compliance function.

Responsibility of the Auditor (Ref: Para. 4-8)

A3. Non-compliance by the entity with laws and regulations may result in a material misstatement of the financial statements. Detection of non-compliance, regardless of materiality, may affect other aspects of the audit including, for example, the auditor's consideration of the integrity of management or employees.

A4. Whether an act constitutes non-compliance with laws and regulations is a matter for legal determination, which is ordinarily beyond the auditor's professional competence to determine. Nevertheless, the auditor's training, experience and understanding of the entity and its industry or sector may provide a basis to recognise that some acts, coming to the auditor's attention, may constitute non-compliance with laws and regulations.

A5. In accordance with specific statutory requirements, the auditor may be specifically required to report, as part of the audit of the financial statements, on whether the entity complies with certain provisions of laws or regulations. In these circumstances, proposed SA 700 (Revised)[9] or proposed SA 800[10] deal with how these audit responsibilities are addressed in the auditor's report. Furthermore, where there are specific statutory reporting requirements, it may be necessary for the audit plan to include appropriate tests for compliance with those provisions of the laws and regulations.

A6. In some audit engagements, specially those relating to audit of government ventures and undertakings, etc., there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity's operations.

The Auditor's Consideration of Compliance with Laws and Regulations

Obtaining an Understanding of the Legal and Regulatory Framework (Ref: Para. 12)

A7. To obtain a general understanding of the legal and regulatory framework, and how the entity complies with that framework, the auditor may, for example:

- Use the auditor's existing understanding of the entity's industry, regulatory and other external factors;
- Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;
- Inquire of management as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations; and
- Inquire of management regarding the policies or procedures adopted for identifying, evaluating and accounting for litigation claims.

Laws and Regulations Generally Recognised to have a Direct Effect on the Determination of Material Amounts and Disclosures in the Financial Statements (Ref: Para. 13)

A8. Certain laws and regulations are well-established, known to the entity and within the entity's industry or sector, and relevant to the entity's financial statements (as described in paragraph 6(a)). They could include those that relate to, for example:

- The form and content of financial statements;
- Industry-specific financial reporting issues;
- Accounting for transactions under government contracts; or
- The accrual or recognition of expenses for income tax or retirement benefits.

Some matters may be relevant to specific assertions (for example, the completeness of income tax provisions), while others may be relevant to the financial statements as a whole (for example, the required statements constituting a complete set of financial statements). Non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements as described in paragraph 6(a).

Procedures to Identify Instances of Non-Compliance – Other Laws and Regulations (Ref: Para. 14)

A9. Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity (as described in paragraph 6(b)). Non-compliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations, or call into question the entity's continuance as a going concern. For example, non-compliance with the requirements of the entity's license or other entitlement to perform its operations could have such an impact (for example, for a bank, non-compliance with capital

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above".

[9]Hitherto known as AAS 28. Proposed SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", is under revision.

[10]Proposed SA 800, "Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks".

or investment requirements). To illustrate further, a Non Banking Financial Company might have to cease to carry on the business of a non-banking financial institution if it fails to obtain a certificate of registration issued under Chapter III B of the Reserve Bank of India Act, 1934 and if its Net Owned Funds are less than the amount specified by the RBI in this regard. There are also many laws and regulations relating principally to the operating aspects of the entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.

A10. As the financial reporting consequences of other laws and regulations can vary depending on the entity's operations, the audit procedures required by paragraph 14 are directed to bringing to the auditor's attention instances of non-compliance with laws and regulations that may have a material effect on the financial statements.

Non-Compliance brought to the Auditor's Attention by Other Audit Procedures (Ref: Para. 15)

A11. Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. For example, such audit procedures may include:

- Reading minutes;
- Inquiring of the entity's management and in-house legal counsel or external legal counsel concerning litigation, claims and assessments; and
- Performing substantive tests of details of classes of transactions, account balances or disclosures.

Written Representations (Ref: Para. 16)

A12. Because the effect on financial statements of laws and regulations can vary considerably, written representations provide necessary audit evidence about management's knowledge of identified or suspected non-compliance with laws and regulations, whose effects may have a material effect on the financial statements. However, written representations do not provide sufficient appropriate audit evidence on their own and, accordingly, do not affect the nature and extent of other audit evidence that is to be obtained by the auditor.[11]

Audit Procedures When Non-Compliance is Identified or Suspected

Indications of Non-Compliance with Laws and Regulations (Ref: Para. 18)

A13. When the auditor becomes aware of the existence of, or information about, the following matters, it may be an indication of non-compliance with laws and regulations:

- Investigations by regulatory organisations and government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
- Unusual payments towards legal and retainership fees.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorised transactions or improperly recorded transactions.
- Adverse media comment.

Matters Relevant to the Auditor's Evaluation (Ref: Para. 18(b))

A14. Matters relevant to the auditor's evaluation of the possible effect on the financial statements include:

- The potential financial consequences of non-compliance with laws and regulations on the financial statements including, for example, the imposition of fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations, and litigation.
- Whether the potential financial consequences require disclosure.
- Whether the potential financial consequences are so serious as to call into question the fair presentation of the financial statements, or otherwise make the financial statements misleading.

Audit Procedures (Ref: Para. 19)

A15. The auditor may discuss the findings with those charged with governance where they may be able to provide additional audit evidence. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to transactions or events that have led to the possibility of non-compliance with laws and regulations.

A16. If management or, as appropriate, those charged with governance do not provide sufficient information to the auditor that the entity is in fact in compliance with laws and regulations, the auditor may consider it appropriate to consult with the entity's in-house legal counsel or external legal counsel about the application of the laws and regulations to the circumstances, including the possibility of fraud, and the possible effects on the financial statements. When it is not considered appropriate to consult with the entity's legal counsel or when the auditor is not satisfied with the legal counsel's opinion, the auditor may consider it appropriate to consult the auditor's

[11] SA 580 (Revised), "Written Representations", paragraph 3.

own legal counsel as to whether a contravention of a law or regulation is involved, the possible legal consequences, including the possibility of fraud, and what further action, if any, the auditor would take.

Evaluating the Implications of Non-Compliance (Ref: Para. 21)

A17. As required by paragraph 21, the auditor evaluates the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. The implications of particular instances of non-compliance identified by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or employees involved, especially implications arising from the involvement of the highest authority within the entity.

A18. In exceptional cases, the auditor may consider whether, unless prohibited by law or regulation, withdrawal from the engagement is necessary when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances, even when the non-compliance is not material to the financial statements. When deciding whether withdrawal from the engagement is necessary, the auditor may consider seeking legal advice. If withdrawal from the engagement is prohibited, the auditor may consider alternative actions, including describing the non-compliance in an Other Matter(s) paragraph in the auditor's report.[12]

Reporting of Identified or Suspected Non-Compliance

Reporting Non-Compliance to Regulatory and Enforcement Authorities (Ref: Para. 28)

A19. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting identified or suspected non-compliance with laws and regulations to a party outside the entity. However, the auditor's legal responsibilities vary under different laws and regulations and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. Under the present legal and regulatory framework for financial institutions in India, their auditor has a statutory duty to report the occurrence, or suspected occurrence, of non-compliance with laws and regulations to supervisory authorities. For example, the auditor is required to report certain matters of non-compliance to the Reserve Bank of India as per the requirements of Non Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1988, issued by the Reserve Bank of India. Also, some laws or regulations require the auditor to report misstatements to authorities in those cases where management and, where applicable, those charged with governance fail to take corrective action. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action.

A20. In case of certain entities, such as national governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises), the auditor may be obliged to report on instances of non-compliance to governing authorities or to report them in the auditor's report.

Documentation (Ref: Para. 29)

A21. The auditor's documentation of findings regarding identified or suspected non-compliance with laws and regulations may include, for example:

- Copies of records or documents.
- Minutes of discussions held with management, those charged with governance or parties outside the entity.

Material Modifications to ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements"

Deletions

1. Paragraph A6 of the Application Section of ISA 250 deals with the application of the requirements of ISA 250 to the audits of public sector entities regarding the additional audit responsibilities with respect to the consideration of laws and regulations. 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 in case of non public sector entities, there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity's operations. Accordingly, the spirit of erstwhile A6, highlighting the fact that in case of certain entities, there may be additional audit responsibilities with respect to the consideration of laws and regulations, has been retained.

2. Paragraph A20 of the Application Section of ISA 250 deals with the application of the requirements of ISA 250 to the audits of public sector entities regarding the obligation to report on instances of non-compliance to governing authorities or to report them in the auditor's report. 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 in case of non public sector entities, the auditor may be obliged to report on instances of non-compliance to governing authorities or to report them in the auditor's report. Accordingly, the spirit of erstwhile A20, highlighting the fact that in case of certain entities, there may be instances of reporting non-compliance to governing authorities or to report them in the auditor's report, has been retained.❑

[12]Proposed SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report". The Standard is being formulated in the light of the corresponding International Standard.

Revised Standard on Auditing (SA) 260 Communication with Those Charged with Governance[1]

Revised Standard on Auditing (SA) 260, "Communication with Those Charged with Governance", should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[2], which sets out the authority of SAs.

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate with those charged with governance in relation to an audit of financial statements. Although this SA applies irrespective of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity, and for listed entities. This SA does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.

2. This SA has been drafted in terms of an audit of financial statements, but may also be applicable, adapted as necessary in the circumstances, to audits of other historical financial information when those charged with governance have a responsibility to oversee the preparation and presentation of the other historical financial information.

3. Recognising the importance of effective two-way communication during an audit of financial statements, this SA provides an overarching framework for the auditor's communication with those charged with governance, and identifies some specific matters to be communicated with them. Additional matters to be communicated, which complement the requirements of this SA, are identified in other SAs. Further matters, not required by this or other SAs, may be required to be communicated by laws or regulations, by agreement with the entity, or by additional requirements applicable to the engagement. Nothing in this SA precludes the auditor from communicating any other matters to those charged with governance. *(Ref: Para. A28-A31)*

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objectives

5. The objectives of the auditor are to:

(a) Communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;

(b) Obtain from those charged with governance information relevant to the audit;

(c) Provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and

(d) Promote effective two-way communication between the auditor and those charged with governance. *(Ref: Para. A1-A4)*

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:

(a) ***Those charged with governance*** – The person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector undertakings or an owner-manager. In some cases, those charged with governance are responsible for approving[3] the entity's financial statements (in other cases management has this responsibility). For discussion of the diversity of governance structures, see paragraphs A5-A12.

(b) ***Management*** – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager. Management is responsible for the preparation of the financial statements, overseen by those charged with governance, and in some cases management is also responsible for approving[4] the entity's finan-

[1]Hitherto known as AAS 27, "Communications of Audit Matters with Those Charged with Governance".
[2]Published in the July, 2007 issue of the Journal.
[3]As described at paragraph [A43] of [proposed] SA 700, (hitherto known as AAS 28) "The Independent Auditor's Report on General Purpose Financial Statements". The Standard is being revised in the light of the corresponding International Standard.
[4]See footnote3.

cial statements (in other cases those charged with governance have this responsibility).

Requirements

Those Charged with Governance

7. The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate. *(Ref: Para. A5-A8)*

Communication with a Subgroup of Those Charged with Governance

8. When the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body. *(Ref: Para. A9-A11)*

When All of Those Charged with Governance are Involved in Managing the Entity

9. In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this SA are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role. These matters are noted in paragraph 12(c). The auditor shall nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. *(Ref: Para. A12)*

Matters to be Communicated

The Auditor's Responsibilities in Relation to the Financial Statement Audit

10. The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:

(a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and

(b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. *(Ref: Para. A13-A14)*

Planned Scope and Timing of the Audit

11. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit. *(Ref: Para. A15-A19)*

Significant Findings from the Audit

12. The auditor shall communicate with those charged with governance: *(Ref: Para. A20)*

(a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework[5], not to be most appropriate to the particular circumstances of the entity; *(Ref: Para. A21)*

(b) Significant difficulties, if any, encountered during the audit; *(Ref: Para. A22)*

(c) Unless all of those charged with governance are involved in managing the entity:

(i) Material weaknesses, if any, in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention and have been communicated to management as required by SA 315[6] or SA 330[7];

(ii) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and *(Ref: Para. A23)*

(iii) Written representations the auditor is requesting; and

(d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process. *(Ref: Para. A24)*

[5]Revised ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with International Standards on Auditing", Paragraph 13(a) defines the applicable financial reporting framework as "The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation. The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

(i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or

(ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above".

[6]SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 32. SA 315 is published in the February, 2008 issue of the Journal.

[7]SA 330, "The Auditor's Responses to Assessed Risks", paragraph 19. SA 330 is published in the February, 2008 issue of the Journal.

Auditor Independence

13. In the case of listed entities, the auditor shall communicate with those charged with governance: *(Ref: Para. A25-A27)*

(a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms[8] have complied with relevant ethical requirements regarding independence; and

(b) (i) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and

(ii) The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

The Communication Process

Establishing the Communication Process

14. The auditor shall communicate with those charged with governance the form, timing and expected general content of communications. *(Ref: Para. A32-A40)*

Forms of Communication

15. The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit when, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit. *(Ref: Para. A41-A43)*

16. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required by paragraph 13.

Timing of Communications

17. The auditor shall communicate with those charged with governance on a timely basis. *(Ref: Para. A44-A45)*

Adequacy of the Communication Process

18. The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action. *(Ref: Para. A46-A48)*

Documentation

19. Where matters required by this SA to be communicated are communicated orally, the auditor shall document them, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation. *(Ref: Para. A49)*

***

Application and Other Explanatory Material

The Role of Communication (Ref: Para. 5)

A1. This SA focuses primarily on communications from the auditor to those charged with governance. Nevertheless, effective two-way communication is important in assisting:

(a) The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity;

(b) The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and

(c) Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

A2. Although the auditor is responsible for communicating matters required by this SA, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility. Similarly, communication by management with those charged with governance of matters that the auditor is required to communicate does not relieve the auditor of the responsibility to also communicate them. Communication of these matters by management may, however, affect the form or timing of the auditor's communication with those charged with governance.

A3. Clear communication of specific matters required to be communicated by SAs is an integral part of every audit. SAs do not, however, require the auditor to perform procedures specifically to identify any other matters to communicate with those charged with governance.

[8]As defined in SQC 1, "Network firm is an entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally".

Legal or Regulatory Restrictions on Communicating with Those Charged with Governance

A4. Laws or regulations may restrict the auditor's communication of certain matters with those charged with governance. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.

Those Charged with Governance (Ref: Para. 7)

A5. Governance structures may vary reflecting different size and ownership characteristics. For example:

- In most of the entities, those charged with governance hold positions that are an integral part of the entity's legal structure, for example, company directors. In others, for example, some government undertakings a body that is not part of the entity is charged with governance.
- In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.

A6. In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, a council of governors, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities. Alternatively, a subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body.

A7. Such diversity means that it is not possible for this SA to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organisations, and some government entities. In such cases, the auditor may need to discuss and agree with the engaging party the relevant person(s) with whom to communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with SA 315 is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.

A8. Proposed Revised SA 600, "Special Considerations- Audits of Group Financial Statements (Including the Work of Component Auditors)[9]", includes specific matters to be communicated by group auditors with those charged with governance. When the entity is a component of a group, the appropriate person(s) with whom the component auditor communicates depends on the engagement circumstances and the matter to be communicated. In some cases, a number of components may be conducting the same businesses within the same system of internal control and using the same accounting practices. Where those charged with governance of those components are the same (e.g., common board of directors), duplication may be avoided by dealing with these components concurrently for the purpose of communication.

Communication with a Subgroup of Those Charged with Governance (Ref: Para. 8)

A9. When considering communicating with a subgroup of those charged with governance, the auditor may take into account such matters as:

- The respective responsibilities of the subgroup and the governing body.
- The nature of the matter to be communicated.
- Relevant legal or regulatory requirements.
- Whether the subgroup has the authority to take action in relation to the information communicated, and can provide further information and explanations the auditor may need.

A10. When deciding whether there is also a need to communicate information, in full or in summary form, with the governing body, the auditor may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor may make explicit in agreeing the terms of engagement that, unless prevented by laws or regulations, the auditor retains the right to communicate directly with the governing body.

A11. Audit committees (or similar subgroups with different names) exist in many jurisdictions. Although their specific authority and functions may differ, communication with the audit committee, where one exists, has become a key element in the auditor's communication with those charged with governance. Good governance principles suggest that:

- The auditor will be invited to regularly attend meetings of the audit committee.
- The chair of the audit com-

[9]The Exposure Draft of Revised SA 600, has been published in the June, 2008 issue of the Journal.

mittee and, when relevant, the other members of the audit committee, will liaise with the auditor periodically.

- The audit committee will meet the auditor without management present at least annually.

When All of Those Charged with Governance are Involved in Managing the Entity (Ref: Para. 9)

A12. In some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognise this position. In such cases, communication with person(s) with management responsibilities may not adequately inform all of those with whom the auditor would otherwise communicate in their governance capacity. For example, in a company where all directors are involved in managing the entity, some of those directors (e.g., one responsible for marketing) may be unaware of significant matters discussed with another director (e.g., one responsible for the preparation of the financial statements).

Matters to be Communicated

The Auditor's Responsibilities in Relation to the Financial Statement Audit (Ref: Para. 10)

A13. The auditor's responsibilities in relation to the financial statement audit are often included in the engagement letter or other suitable form of written agreement that records the agreed terms of the engagement. Providing those charged with governance with a copy of that engagement letter or other suitable form of written agreement may be an appropriate way to communicate with them regarding such matters as:

- The auditor's responsibility for performing the audit in accordance with SAs, which is directed towards the expression of an opinion on the financial statements. The matters that SAs require to be communicated, therefore, include significant matters arising from the audit of the financial statements that are relevant to those charged with governance in overseeing the financial reporting process.
- The fact that SAs do not require the auditor to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance.
- When applicable, the auditor's responsibility for communicating particular matters required by laws or regulations, by agreement with the entity or by additional requirements applicable to the engagement.

A14. Laws or regulations, an agreement with the entity or additional requirements applicable to the engagement may provide for broader communication with those charged with governance. For example, (a) an agreement with the entity may provide for particular matters to be communicated when they arise from services provided by a firm or network firm other than the financial statement audit; or (b) the mandate of a public sector auditor may provide for matters to be communicated that come to the auditor's attention as a result of other work, such as performance audits.

Planned Scope and Timing of the Audit (Ref: Para. 11)

A15. Communication regarding the planned scope and timing of the audit may:

(a) Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures; and

(b) Assist the auditor to understand better the entity and its environment.

A16. Care is required when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

A17. Matters communicated may include:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.
- The auditor's approach to internal control relevant to the audit.
- The application of materiality in the context of an audit.[10]

A18. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, the extent to which the auditor will use the work of internal audit, and how the external and internal auditors can best work together in a constructive and complementary manner.
- The views of those charged with governance of:
  - The appropriate person(s) in the entity's governance structure with whom to communicate.
  - The allocation of responsibilities between those charged with governance and management.
  - The entity's objectives and

[10]Proposed Revised SA 320, "Materiality in Planning and Performing an Audit". Hitherto known as AAS 13, "Audit Materiality". The Standard is being revised in the light of the corresponding Proposed International Standard, ISA 320.

strategies, and the related business risks that may result in material misstatements.

- Matters, which those charged with governance, consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
- Significant communications with regulators.
- Other matters, which, those charged with governance, consider may influence the audit of the financial statements.

- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.
- The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, exchange listing rules, and related matters.
- The responses of those charged with governance to previous communications with the auditor.

A19. While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Significant Findings from the Audit (Ref: Para. 12)

A20. The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

Significant Qualitative Aspects of Accounting Practices (Ref: Para. 12(a))

A21. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures. Open and constructive communication about significant qualitative aspects of the entity's accounting practices may include comment on the acceptability of significant accounting practices. Appendix 1 identifies matters that may be included in this communication.

Significant Difficulties Encountered During the Audit (Ref: Para. 12(b))

A22. Significant difficulties encountered during the audit may include such matters as:

- Significant delays in management providing required information.
- An unnecessarily brief time within which to complete the audit.
- Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- The unavailability of expected information.
- Restrictions imposed on the auditor by management.
- Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.[11]

Significant Matters Discussed, or Subject to Correspondence with Management (Ref: Para. 12(c)(ii))

A23. Significant matters discussed, or subject to correspondence with management may include such matters as:

- Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.
- Concerns about management's consultations with other accountants on accounting or auditing matters.
- Discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services.

Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 12(d))

A24. Other significant matters arising from the audit that are directly relevant to those charged with governance in overseeing the financial reporting process may include such matters as material misstatements of fact or material inconsistencies in information accompanying the audited financial statements that have been corrected.

Auditor Independence (Ref: Para. 13)

A25. The auditor is subject to independence and other ethical requirements as enunciated in the **Code of Ethics** issued by the ICAI[12]

A26. The relationships and other matters, and safeguards to be communicated, vary with the circumstances of the engagement, but generally address:

[11]The concept of modification of the auditor's opinion has been dealt in SA 700, "The Auditor's Report on Financial Statements" (hitherto known as AAS 28). The AASB is however also in the process of developing a Standard corresponding to ISA 705, "Modifications to the Opinion in the Independent Auditor's Report".

[12]Attention of the members is also invited, for instance, to the Guidance Note on Independence of Auditors, issued by the ICAI.

(a) Threats to independence, which may be categorised as: self-interest threats, self-review threats, advocacy threats, familiarity threats, and intimidation threats; and

(b) Safeguards created by the profession, legislation or regulation, safeguards within the entity, and safeguards within the firm's own systems and procedures.

The communication required by paragraph 13(a) may include an inadvertent violation of relevant ethical requirements as they relate to auditor independence, and any remedial action taken or proposed.

A27. The communication requirements relating to auditor independence that apply in the case of listed entities may also be relevant in the case of some other entities, particularly those that may be of significant public interest because, as a result of their business, their size or their corporate status, they have a wide range of stakeholders. Examples of entities that are not listed entities, but where communication of auditor independence may be appropriate, include public sector entities, credit institutions, insurance companies, and retirement benefit funds. On the other hand, there may be situations where communications regarding independence may not be relevant, for example, where all of those charged with governance have been informed of relevant facts through their management activities. This is particularly likely where the entity is owner-managed, and the auditor's firm and network firms have little involvement with the entity beyond a financial statement audit.

Supplementary Matters (Ref: Para. 3)

A28. Those charged with governance are responsible for ensuring, through oversight of management, that the entity establishes and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

A29. The auditor may become aware of supplementary matters that do not necessarily relate to the oversight of the financial reporting process but which are, nevertheless, likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity's obligations related to accountability. Such matters may include, for example, significant deficiencies in governance structures or processes, and significant decisions or actions by senior management that lack appropriate authorisation.

A30. In determining whether to communicate supplementary matters with those charged with governance, the auditor may discuss matters of this kind, of which the auditor has become aware, with the appropriate level of management, unless it is inappropriate to do so in the circumstances.

A31. If a supplementary matter is communicated, it may be appropriate for the auditor to make those charged with governance aware that:

(a) Identification and communication of such matters is incidental to the purpose of the audit, which is to form an opinion on the financial statements;

(b) No procedures were carried out with respect to the matter other than any that were necessary to form an opinion on the financial statements; and

(c) No procedures were carried out to determine whether other such matters exist.

The Communication Process

Establishing the Communication Process (Ref: Para. 14)

A32. Clear communication of the auditor's responsibilities, the planned scope and timing of the audit, and the expected general content of communications helps establish the basis for effective two-way communication.

A33. Matters that may also contribute to effective two-way communication include discussion of:

- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are better placed to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- The form in which communications will be made.
- The person(s) in the audit team and amongst those charged with governance who will communicate regarding particular matters.
- The auditor's expectation that communication will be two-way, and that those charged with governance will communicate with the auditor, matters they consider relevant to the audit, for example, strategic decisions that may significantly affect the nature, timing and extent of audit procedures, the suspicion or the detection of fraud, and concerns with the integrity or competence of senior management.
- The process for taking action and reporting back on matters communicated by the auditor.
- The process for taking action and reporting back on matters communicated by those charged with governance.

A34. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with governance is not adequate for the purpose of the audit (see paragraph A48).

Considerations Specific to Smaller

Entities

A35. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of listed or larger entities.

Communication with Management

A36. Many matters may be discussed with management in the ordinary course of an audit, including matters required by this SA to be communicated with those charged with governance. Such discussions recognise management's executive responsibility for the conduct of the entity's operations and, in particular, management's responsibility for the preparation of the financial statements.

A37. Before communicating matters with those charged with governance, the auditor may discuss them with management, unless that is inappropriate. For example, it may not be appropriate to discuss questions of management's competence or integrity with management. In addition to recognising management's executive responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance.

Communication with Third Parties

A38. Those charged with governance may wish to provide third parties, for example, bankers or certain regulatory authorities, with copies of a written communication from the auditor. In some cases, disclosure to third parties may be illegal or otherwise inappropriate. When a written communication prepared for those charged with governance is provided to third parties, it may be important in the circumstances that the third parties be informed that the communication was not prepared with them in mind, for example, by stating in written communications with those charged with governance:

a) That the communication has been prepared for the sole use of those charged with governance and, where applicable, the group management and the group auditor, should not be relied upon by third parties;

(b) That no responsibility is assumed by the auditor to third parties; and

(c) Any restrictions on disclosure or distribution to third parties.

A39. The auditor may be required by laws or regulations to, for example:

- Notify a regulatory or enforcement body of certain matters communicated with those charged with governance. The auditor has a duty to report misstatements to authorities where management and those charged with governance fail to take corrective action;
- Submit copies of certain reports prepared for those charged with governance to relevant regulatory or funding bodies, or other bodies such as Central Government in the case of some public sector undertakings; or
- Make reports prepared for those charged with governance publicly available.

A40. Unless required by laws or regulations to provide a third party with a copy of the auditor's written communications with those charged with governance, the auditor may need the prior consent of those charged with governance before doing so.

Forms of Communication (Ref: Para. 15-16)

A41. Effective communication may involve structured presentations and written reports as well as less structured communications, including discussions. The auditor may communicate matters other than those identified in paragraphs 15 and 16 either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.

A42. In addition to the significance of a particular matter, the form of communication (e.g., whether to communicate orally or in writing, the extent of detail or summarisation in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:

- Whether the matter has been satisfactorily resolved.
- Whether management has previously communicated the matter.
- The size, operating structure, control environment, and legal structure of the entity.
- In the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.
- Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The amount of ongoing contact and dialogue the auditor has with those charged with governance.
- Whether there have been significant changes in the membership of a governing body.

A43. When a significant matter is discussed with an individual member of those charged with governance, for example, the chair of an audit committee, it may be appropriate for the auditor to summarise the matter in later communications so that all of those charged with governance have full and balanced information.

Timing of Communications (Ref: Para. 17)

A44. The appropriate timing for

communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. For example:

- Communications regarding planning matters may often be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.
- It may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion.
- Similarly, it may be appropriate to communicate material weaknesses in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention as soon as practicable.
- Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards, for example, when accepting an engagement to provide non-audit services, and at a concluding discussion. A concluding discussion may also be an appropriate time to communicate findings from the audit, including the auditor's views about the qualitative aspects of the entity's accounting practices.
- When auditing both general purpose and special purpose financial statements, it may be appropriate to co-ordinate the timing of communications.

A45. Other factors that may be relevant to the timing of communications include:

- The size, operating structure, control environment, and legal structure of the entity being audited.
- Any legal obligation to communicate certain matters within a specified timeframe.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The time at which the auditor identifies certain matters, for example, the auditor may not identify a particular matter (e.g., non-compliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

Adequacy of the Communication Process (Ref: Para. 18)

A46. The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and those charged with governance; rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include:

- The appropriateness and timeliness of actions taken by those charged with governance in response to matters raised by the auditor. Where significant matters raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.
- The apparent openness of those charged with governance in their communications with the auditor.
- The willingness and capacity of those charged with governance to meet with the auditor without management present.
- The apparent ability of those charged with governance to fully comprehend matters raised by the auditor, for example, the extent to which those charged with governance probe issues, and question recommendations made to them.
- Difficulty in establishing with those charged with governance a mutual understanding of the form, timing and expected general content of communications.
- Where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.
- Whether the two-way communication between the auditor and those charged with governance meets applicable legal and regulatory requirements.

A47. As noted in paragraph A1, effective two-way communication assists both the auditor and those charged with governance. Further, SA 315 identifies participation by those charged with governance, including their interaction with internal audit, if any, and external auditors, as an element of the entity's control environment.[13] Inadequate two-way communication may indicate an unsatisfactory control environment and influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

A48. If the two-way communication between the auditor and those charged

[13]SA 315, " Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement", paragraph A66.

with governance is not adequate and the situation cannot be resolved, the auditor may take such actions as:

- Modifying the auditor's opinion on the basis of a scope limitation.
- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (e.g., a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (e.g., shareholders in a general meeting), or the responsible government minister or parliament in the public sector.
- Withdrawing from the engagement where permitted in the relevant jurisdiction.

Documentation (Ref: Para. 19)

A49. Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

Material Modifications to ISA 260, Communication with Those Charged with Governance

The SA 260, "Communication with Those Charged with Governance" does not contain any material modifications *vis-a-vis* ISA 260.

Appendix

(Ref: Para. 12(a), and A21)

Qualitative Aspects of Accounting Practices

The communication required by paragraph 12(a), and discussed in paragraph A21, may include such matters as:

Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, having regard to the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements. Where acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant accounting policies as well as information on accounting policies used by similar entities.
- The initial selection of, and changes in significant accounting policies, including the application of new accounting pronouncements. The communication may include: the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity; and the timing of a change in accounting policies in relation to expected new accounting pronouncements.
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).
- The effect of the timing of transactions in relation to the period in which they are recorded.

Accounting Estimates

- For items for which estimates are significant, issues discussed in Proposed Revised SA 540[14] including, for example:
  - Management's identification of accounting estimates.
  - Management's process for making accounting estimates.
  - Risks of material misstatement.
  - Indicators of possible management bias.
  - Disclosure of estimation uncertainty in the financial statements.

Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (e.g., disclosures related to revenue recognition, remuneration, going concern, subsequent events, and contingency issues).
- The overall neutrality, consistency, and clarity of the disclosures in the financial statements.

Related Matters

- The potential effect on the financial statements of significant risks, exposures and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- The extent to which the financial statements are affected by unusual transactions, including non-recurring amounts recognised during the period, and the extent to which such transactions are separately disclosed in the financial statements.
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets. The communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.
- The selective correction of misstatements, for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.❑

[14]The Exposure Draft of Revised SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", has been published in the September, 2008 issue of the Journal.

Revised Standard on Auditing (SA) 570 Going Concern[1]

Standard on Auditing (SA) 570 (Revised), "Going Concern" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[2], which sets out the authority of SAs.

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility in the audit of financial statements with respect to management's use of the going concern assumption in the preparation and presentation of the financial statements.

Going Concern Assumption

2. Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Special purpose financial statements[3] may or may not be prepared in accordance with a financial reporting framework[4] for which the going concern basis is relevant. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. (Ref: Para. A1)

Responsibilities of Management

3. Some financial reporting frameworks contain an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern, and standards regarding matters to be considered and disclosures to be made in connection with going concern. The financial reporting framework may require the management to make an assessment of the entity's ability to continue as a going concern and prepare the financial statements on a going concern basis unless the management intends to liquidate the entity or cease operations, or has no realistic alternative but to do so. In case the financial statements have not been prepared on a going concern basis, the fact would need to be appropriately disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern[5]. The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may also be set out in law or regulation.

4. In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Nevertheless, since the going concern assumption is a fundamental principle

[1] Hitherto known as SA 570 (AAS 16), "Going Concern".

[2] Published in the July, 2007 issue of the Journal.

[3] Financial Statements prepared and presented in accordance with a financial reporting framework designed to meet the financial information needs of specific users are referred to as special purpose financial statements. Examples of special purpose financial statements include:

(i) financial statements which are prepared in addition to general purpose financial statements;

(ii) financial statements prepared in compliance with requirements of any agreement or statute or regulation; or

(iii) financial information given in special purpose formats or schedules.

[4] ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing" defines the term, 'Applicable financial reporting framework' as follows:

"The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objectives of the financial statements, or that is required by law or regulation.

The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

(i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or

(ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain acknowledgements in (i) or (ii) above".

[5] In India, Section 217(2AA) of the Companies Act, 1956 *inter alia* requires the directors to make a specific assertion in their Directors' Responsibility Statement under this section that "the directors had prepared the annual accounts on a going concern basis". Further, paragraph 9 of the Accounting Standard (AS) 1, "Disclosure of Accounting Policies", states as follows:

"Fundamental Accounting Assumptions

9. Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed."

Further, paragraph 10 of AS 1 states as follows:

"The following have been generally accepted as fundamental accounting assumptions:-

a. *Going Concern*

The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations…."

in the preparation of financial statements as discussed in paragraph 2, management's responsibility for the preparation and presentation of the financial statements includes a responsibility to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so.

5. Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. The following factors are relevant to that judgment:

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, financial reporting frameworks normally require an explicit management assessment specify the period for which management is required to take into account all available information.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

Responsibilities of the Auditor

6. The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. This responsibility exists even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

7. However, as described in SA 200,[6] the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Effective Date

8. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objectives

9. The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements;

(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and

(c) To determine the implications for the auditor's report.

Requirements

Risk Assessment Procedures and Related Activities

10. When performing risk assessment procedures as required by SA 315,[7] the auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and: (Ref: Para. A2-A5)

(a) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or

(b) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern assumption, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

11. The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. (Ref: Para. A6)

Evaluating Management's Assessment

12. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. (Ref: Para. A7-A9; A11-A12)

13. In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of

[6]SA 200 (AAS 1), "Basic Principles Governing an Audit" and SA 200A (AAS 2), "Objective and Scope of the Audit of Financial Statements" correspond to International Standard on Auditing (ISA) 200 (Revised and Redrafted). Both the SAs are currently being revised in the light of the ISA 200 (Revised and Redrafted). Post this revision, the principles covered by SA 200 (AAS 1) and SA 200A (AAS 2) will be merged into one standard, i.e., SA 200.

[7]SA 315 , "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 5.

the financial statements as defined in SA 560,[8] the auditor shall request management to extend its assessment period to at least twelve months from that date. (Ref: Para. A10-A12)

14. In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

Period Beyond Management's Assessment

15. The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern. (Ref: Para. A13-A14)

Additional Audit Procedures When Events or Conditions Are Identified

16. When events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include: (Ref: Para. A15)

(a) When management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.

(b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances. (Ref: Para. A16)

(c) When the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future action: (Ref: Para. A17-A18)

(i) Evaluating the reliability of the underlying data generated to prepare the forecast; and

(ii) Determining whether there is adequate support for the assumptions underlying the forecast.

(d) Considering whether any additional facts or information have become available since the date on which management made its assessment.

(e) Requesting written representations from management or, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

Audit Conclusions and Reporting

17. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for:

(a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or

(b) In the case of a compliance framework, the financial statements not to be misleading. (Ref: Para. A19)

Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists

18. When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

(a) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business. (Ref: Para. A20)

19. If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report to:

(a) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to

(b) Draw attention to the note in the financial statements that discloses the matters set out in paragraph 18. (See SA 706[9]) (Ref: Para. A21-A22)

20. If adequate disclosure is not made in the financial statements, the auditor shall express a qualified or adverse opinion, as appropriate (See SA 705[10]). The auditor shall state in the auditor's report that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern. (Ref: Para. A23-A24)

Use of Going Concern Assumption Inappropriate

21. If the financial statements have been prepared on a going concern

[8]The Council at its 282nd meeting held in November, 2008, has approved Revised SA 560, "Subsequent Events", which is effective for audits of financial statements for periods beginning on or after April 1, 2009.

[9]Presently, SA 700 (AAS 28), "The Auditor's Report on Financial Statements" deals with this aspect. The AASB proposes to issue an Exposure Draft of the proposed new Standard SA 706, "Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report" based on the corresponding International Standard on Auditing in the near future.

[10]Presently, SA 700 (AAS 28), "The Auditor's Report on Financial Statements" deals with this aspect. The AASB proposes to issue an Exposure Draft of the proposed new Standard SA 705 , "Modifications to the Opinion in the Independent Auditor's Report" based on the corresponding International Standard on Auditing in the near future.

basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, the auditor shall express an adverse opinion. (Ref: Para. A25-A26)

Management Unwilling to Make or Extend Its Assessment

22. If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report. (Ref: Para. A27)

Communication with Those Charged with Governance

23. Unless all those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. Such communication with those charged with governance shall include the following:

(a) Whether the events or conditions constitute a material uncertainty;

(b) Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements; and

(c) The adequacy of related disclosures in the financial statements.

Significant Delay in the Approval of Financial Statements

24. When there is significant delay in the approval of the financial statements by management or those charged with governance after the date of the financial statements, the auditor shall inquire as to the reasons for the delay. When the auditor believes that the delay could be related to events or conditions relating to the going concern assessment, the auditor shall perform those additional audit procedures necessary, as described in paragraph 16, as well as consider the effect on the auditor's conclusion regarding the existence of a material uncertainty, as described in paragraph 17.

Application and Other Explanatory Material

Introduction

Going Concern Assumption (Ref: Para. 2)

A1. In some enterprises, for example, those where the funding arrangements are guaranteed by the Central Government, going concern risks may arise, but are not limited to, situations where such type of entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatisation. Events or conditions that may cast significant doubt on an entity's ability to continue as a going concern may include situations where such type of entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by such an entity.

Risk Assessment Procedures and Related Activities

Events or Conditions That May Cast Doubt about Going Concern Assumption (Ref: Para. 10)

A2. The following are examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labour difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

A3. The risk assessment procedures required by paragraph 10 help the auditor to determine whether management's use of the going concern assumption is likely to be an important issue and its impact on planning the audit. These procedures also allow for more timely discussions with manage-

ment, including a discussion of management's plans and resolution of any identified going concern issues.

Considerations Specific to Smaller Entities

A4. The size of an entity may affect its ability to withstand adverse conditions. Small entities may be able to respond quickly to exploit opportunities, but may lack reserves to sustain operations.

A5. Conditions of particular relevance to small entities include the risk that banks and other lenders may cease to support the entity, as well as the possible loss of a principal supplier, major customer, key employee, or the right to operate under a license, franchise or other legal agreement.

Remaining Alert throughout the Audit for Audit Evidence about Events or Conditions (Ref: Para. 11)

A6. SA 315 requires the auditor to revise the auditor's risk assessment and modify the further planned audit procedures accordingly when additional audit evidence is obtained during the course of the audit that affects the auditor's assessment of risk.[11] If events or conditions that may cast significant doubt on the entity's ability to continue as a going concern are identified after the auditor's risk assessments are made, in addition to performing the procedures in paragraph 16, the auditor's assessment of the risks of material misstatement may need to be revised. The existence of such events or conditions may also affect the nature, timing and extent of the auditor's further procedures in response to the assessed risks. SA 330[12] establishes requirements and provides guidance on this issue.

Evaluating Management's Assessment

Management's Assessment and Supporting Analysis and the Auditor's Evaluation (Ref: Para. 12)

A7. Management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of management's use of the going concern assumption.

A8. It is not the auditor's responsibility to rectify the lack of analysis by management. In some circumstances, however, the lack of detailed analysis by management to support its assessment may not prevent the auditor from concluding whether management's use of the going concern assumption is appropriate in the circumstances. For example, when there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis. In this case, the auditor's evaluation of the appropriateness of management's assessment may be made without performing detailed evaluation procedures if the auditor's other audit procedures are sufficient to enable the auditor to conclude whether management's use of the going concern assumption in the preparation of the financial statements is appropriate in the circumstances.

A9. In other circumstances, evaluating management's assessment of the entity's ability to continue as a going concern, as required by paragraph 12, may include an evaluation of the process management followed to make its assessment, the assumptions on which the assessment is based and management's plans for future action and whether management's plans are feasible in the circumstances.

The Period of Management's Assessment (Ref: Para. 13)

A10. Most financial reporting frameworks requiring an explicit management assessment specify the period for which management is required to take into account all available information.

Considerations Specific to Smaller Entities (Ref: Para. 12-13)

A11. In many cases, the management of smaller entities may not have prepared a detailed assessment of the entity's ability to continue as a going concern, but instead may rely on in-depth knowledge of the business and anticipated future prospects. Nevertheless, in accordance with the requirements of this SA, the auditor needs to evaluate management's assessment of the entity's ability to continue as a going concern. For smaller entities, it may be appropriate to discuss the medium and long-term financing of the entity with management, provided that management's contentions can be corroborated by sufficient documentary evidence and are not inconsistent with the auditor's understanding of the entity. Therefore, the requirement in paragraph 13 for the auditor to request management to extend its assessment may, for example, be satisfied by discussion, inquiry and inspection of supporting documentation, for example, orders received for future supply, evaluated as to their feasibility or otherwise substantiated.

A12. Continued support by owner-managers is often important to smaller entities' ability to continue as a going concern. Where a small entity is largely financed by a loan from the owner-manager, it may be important that these funds are not withdrawn. For example, the continuance of a small entity in financial difficulty may be dependent on the owner-manager subordinating a loan to the entity in favour of banks or other creditors, or the owner-manager supporting a loan for the entity by providing a guarantee with his or her personal assets as collateral. In such circumstances the auditor may obtain appropriate documentary evidence of the subordination of the owner-manager's loan or of the guarantee. Where an entity is dependent on additional support from the owner-manager, the auditor may evaluate the owner-manager's ability to meet the obligation under the support arrangement. In addition, the auditor may request written confirmation of the terms and conditions attaching to such support and the owner-manager's intention or understanding.

Period Beyond Management's Assessment (Ref: Para. 15)

A13. As required by paragraph 11, the auditor remains alert to the possibility that there may be known events, scheduled or otherwise, or conditions that will occur beyond the period of assessment used by management that may bring into question the appropriateness of management's use of the going concern assumption in preparing the financial statements. Since the degree of uncertainty associated with the outcome of an event or condition increases as the event or condition is

[11]SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 30.
[12]SA 330, "The Auditor's Responses to Assessed Risks".

further into the future, in considering events or conditions further in the future, the indications of going concern issues need to be significant before the auditor needs to consider taking further action. If such events or conditions are identified, the auditor may need to request management to evaluate the potential significance of the event or condition on its assessment of the entity's ability to continue as a going concern. In these circumstances the procedures in paragraph 16 apply.

A14. Other than inquiry of management, the auditor does not have a responsibility to perform any other audit procedures to identify events or conditions that may cast significant doubt on the entity's ability to continue as a going concern beyond the period assessed by management, which, as discussed in paragraph 13, would be at least twelve months from the date of the financial statements.

Additional Audit Procedures When Events or Conditions Are Identified (Ref: Para. 16)

A15. Audit procedures that are relevant to the requirement in paragraph 16 may include the following:

- Analysing and discussing cash flow, profit and other relevant forecasts with management.
- Analysing and discussing the entity's latest available interim financial statements.
- Reading the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Evaluating the entity's plans to deal with unfilled customer orders.
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherw ise affect the entity's ability to continue as a going concern.
- Confirming the existence, terms and adequacy of borrowing facilities.
- Obtaining and reviewing reports of regulatory actions.
- Determining the adequacy of support for any planned disposals of assets.

Evaluating Management's Plans for Future Actions (Ref: Para. 16(b))

A16. Evaluating management's plans for future actions may include inquiries of management as to its plans for future action, including, for example, its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital.

The Period of Management's Assessment (Ref: Para. 16(c))

A17. In addition to the procedures required in paragraph 16(c), the auditor may compare:

- The prospective financial information for recent prior periods with historical results; and
- The prospective financial information for the current period with results achieved to date.

A18. Where management's assumptions include continued support by third parties, whether through the subordination of loans, commitments to maintain or provide additional funding, or guarantees, and such support is important to an entity's ability to continue as a going concern, the auditor may need to consider requesting written confirmation (including of terms and conditions) from those third parties and to obtain evidence of their ability to provide such support.

Audit Conclusions and Reporting (Ref: Para. 17)

A19. The phrase "material uncertainty" means the uncertainties related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern that should be disclosed in the financial statements. In some other financial reporting frameworks the phrase "significant uncertainty" is used in similar circumstances.

Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists

Adequacy of Disclosure of Material Uncertainty (Ref: Para. 18)

A20. The determination of the adequacy of the financial statement disclosure may involve determining whether the information explicitly draws the reader's attention to the possibility that the entity may be unable to continue realising its assets and discharging its liabilities in the normal course of business.

Audit Reporting When Disclosure of Material Uncertainty Is Adequate (Ref: Para. 19)

A21. The following is an illustration of an Emphasis of Matter paragraph when the auditor is satisfied as to the adequacy of the note disclosure:

Emphasis of Matter

Without qualifying our opinion, we draw attention to Note X in the financial statements which indicates that the Company incurred a net loss of ZZZ during the year ended March 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

A22. In situations involving multiple material uncertainties that are significant to the financial statements as a whole, the auditor may consider it appropriate in extremely rare cases to express a disclaimer of opinion instead of adding an Emphasis of Matter paragraph. SA 705[13] provides guidance on this issue.

Audit Reporting When Disclosure of Material Uncertainty Is Inadequate (Ref: Para. 20)

A23. The following is an illustration

[13]See footnote 10

of the relevant paragraphs when a qualified opinion is to be expressed:

Basis for Qualified Opinion

The Company's financing arrangements expire and amounts outstanding are payable on May 19, 20X1. The Company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore the Company may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not fully disclose this fact.

Qualified Opinion

In our opinion, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion paragraph, the financial statements give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the company as at March 31, 20X1;

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date; and

(c) in the case of the cash flow statement, of the cash flows for the year ended on that date.

A24. The following is an illustration of the relevant paragraphs when an adverse opinion is to be expressed:

Basis for Adverse Opinion

The Company's financing arrangements expired and the amount outstanding was payable on March 31, 20X0. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore it may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not give the information required by the Companies Act, 1956, in the manner so required and also do not give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the company as at March 31, 20X0; and

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date; and

(c) in the case of the cash flow statement, of the cash flows for the year ended on that date.

Use of Going Concern Assumption Inappropriate (Ref: Para. 21)

A25. If the financial statements have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, the requirement of paragraph 21 for the auditor to express an adverse opinion applies regardless of whether or not the financial statements include disclosure of the inappropriateness of management's use of the going concern assumption.

A26. If the entity's management is required, or elects, to prepare financial statements when the use of the going concern assumption is not appropriate in the circumstances, the financial statements are prepared on an alternative basis (e.g., liquidation basis). The auditor may be able to perform an audit of those financial statements provided that the auditor determines that the alternative basis is an acceptable financial reporting framework in the circumstances. The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein but may consider it appropriate or necessary to include an Emphasis of Matter paragraph in the auditor's report to draw the user's attention to that alternative basis and the reasons for its use.

Management Unwilling to Make or Extend Its Assessment (Ref: Para. 22)

A27. In certain circumstances, the auditor may believe it necessary to request management to make or extend its assessment. If management is unwilling to do so, a qualified opinion or a disclaimer of opinion in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding the use of the going concern assumption in the preparation of the financial statements, such as audit evidence regarding the existence of plans management has put in place or the existence of other mitigating factors.

Material Modifications to ISA 570, "Going Concern"

Addition

1. In Paragraph 3, the responsibilities of management to make an assessment of the entity's ability to continue as a going concern have been made more country specific.

Deletion

1. Paragraph A1 of the Application Section of ISA 570 deals with the application of the requirements of ISA 570 to the audits of public sector entities in the context of going concern risks that may arise, but are not limited to, situations where public sector entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatisation. 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 such a situation may arise in the case of non-public sector enterprise. Accordingly, the spirit of erstwhile A1, highlighting the appropriateness of the going concern assumption in the preparation of the financial statements where the funding arrangements are guaranteed by the Central Government has been retained.❑

Standard on Internal Audit (SIA) 8
TERMS OF INTERNAL AUDIT ENGAGEMENT

The following is the text of the Standard on Internal Audit (SIA) 8, *Terms of Internal Audit Engagement*, 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 260th 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 in respect of terms of engagement of the internal audit activity whether carried out in house or by an external agency. A clarity on the terms of the internal audit engagement between the internal auditors and the users of their services (hitherto known as "*auditee*") is essential for inculcating professionalism and avoiding misunderstanding as to any aspect of the engagement.

2. **The internal auditor and the auditee should agree on the terms of the engagement before the its commencement.** The agreed terms would need to be recorded in an engagement letter. Normally, it is the responsibility of the internal auditor to prepare the engagement letter and it is to be signed both by the internal auditors as well as the auditee.

Terms of Engagement

3. The terms of engagement of the internal audit *inter alia* define the scope, authority, responsibilities, confidentiality, limitation and compensation of the internal auditors. **The terms of engagement should be approved by the Board of Directors[1] or a relevant Committee thereof such as the Audit Committee or such other person(s) as may be authorised by the Board in this regard. The terms should be reviewed by the internal auditor and the audit committee periodically and modified suitably, if required, to meet the changed circumstances.**

Elements of Terms of Engagement

4. The following are the key elements of the terms of the internal audit engagement:

i. Scope
ii. Responsibility
iii. Authority
iv. Confidentiality
v. Limitations
vi. Reporting
vii. Compensation
viii. Compliance with Standards

Each of these elements has been discussed in the following paragraphs.

Scope

5. Paragraph 3.1 of the Preface to the Standards on Internal Audit describes internal audit as *"an independent function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system."*

6. The terms of the engagement should contain a statement in respect of the scope of the internal audit engagement. It should clearly delineate the broad areas of function of internal audit like evaluating internal controls, review of business process cycle controls, risk management and governance.

7. It should indicate areas where internal auditors are expected to make their recommendations and value added comments.

8. The terms of engagement should clearly mention that the internal auditor would not, ordinarily, be involved in the preparation of the financial statements of the auditee. It should also be made clear that the internal audit would not result in the expression, by the internal auditor, of an opinion, or any other form of assurance on the financial statements or any part thereof of the auditee.

9. The scope of the terms of the engagement, after delineating the broad areas of function of internal audit, should clarify that any additional services that are not encom-

[1]Or an equivalent authority where the entity is not in a corporate form. For example, the Board of Trustees in a cooperative society.

passed by the engagement letter shall be performed only on mutual agreement and with separate engagement letter.

Responsibility

10. **The terms of the engagement should clearly mention the responsibility of the auditee *vis a vis* the internal auditor.** The auditee is responsible for establishing, maintaining and ensuring operating effectiveness of a system of internal control. The auditee would also be responsible for timely communication of material weaknesses or other significant issues relating to internal controls, misstatements in the financial information or similar matters to its external auditors, the Audit Committee, the Board of Directors, regulators and to those to whom the auditee is required to so communicate.

11. The management of the auditee is responsible for providing timely and accurate data, information, records, personnel etc., and for extending co-operation to the audit team.

12. Similarly, where the internal auditor has a specific responsibility, say that arising out of a law or a regulation or a professional standard applicable to the internal auditor, to communicate directly, the above mentioned issues to an appropriate authority or someone within the entity or a regulator, the terms of the engagement should contain a clear mention of such responsibility.

13. The internal auditor has the responsibility to inform the management before commencement of the assignment about the engagement team and the audit plan.

Authority

14. The terms of engagement should provide the internal auditor with requisite authority, including unrestricted access to all departments, records, property and personnel and authority to call for information from concerned personnel in the organisation.

15. The internal auditor should have full authority on his technologies and other properties like hardware and audit tools he may use in course of performing internal audit.

Confidentiality

Confidentiality of Working Papers

16. The terms of engagement should be clear that the ownership of the working papers rests with the internal auditor and not the auditee. It should also be made clear that the internal auditor may, upon a request received in this regard from the auditee, provide copies of non proprietary working papers to the auditee. The terms should lay down the policy and the procedures to be followed regarding requests received for internal auditor's working papers from third parties including external auditors.

17. The internal audit engagement may also be subject to a peer review by a regulator, requiring the internal auditor to disclose his working papers to the peer reviewer without the permission of the auditee. **The engagement letter should bring out this fact clearly.**

Confidentiality of the Report

18. The engagement letter should contain a condition that the report of the internal auditor should not be distributed or circulated by the auditee or the internal auditor to any party other than that mutually agreed between the internal auditor and the auditee unless there is a statutory or a regulatory requirement to do so.

Limitations

19. **The terms of engagement should specify clearly the limitations on scope, coverage and reporting requirement, if any.** It may also mention that the internal auditor or any of his employees shall not be liable to the auditee for any claims, damages, liabilities or expenses relating to the engagement exceeding the aggregate amount of compensation agreed upon by both the parties.

Reporting

20. The terms of the engagement should clearly lay down the requirements as to the manner, frequency of reporting and the list of intended recipients of the internal audit report.

Compensation

21. There should be a clear understanding among the internal auditor and the client as to the basis on which the internal auditor would be compensated, including any out of pocket expense, taxes etc., for the services performed by him.

Compliance with Standards

22. The terms of the internal audit engagement should contain a statement that the internal audit engagement would be carried out in accordance with the professional Standards applicable to such engagement as on the date of audit.

Withdrawal from the Engagement

23. In case the internal auditor is unable to agree to any change in the terms of the engagement and/or is not permitted to continue as per the original terms, he should withdraw from the engagement and should consider whether there is an obligation, contractual or otherwise, to report the circumstances necessitating the withdrawal to other parties.

Effective Date

24. This Standard on Internal Audit is effective for all internal audits beginning on or after..... Earlier application of the Standard is encouraged.❑

EXPOSURE DRAFT
Standard on Internal Audit (SIA)
ENTERPRISE RISK MANAGEMENT

The Internal Audit Standards Board (hitherto known as the Committee on Internal Audit), of the Institute of Chartered Accountants of India invites comments on the Exposure Draft of the Standard on Internal Audit (SIA), Enterprise Risk Management. Comments are most helpful if they indicate the specific paragraph(s) to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing to:
Secretary, Internal Audit Standards Board,
The Institute of Chartered Accountants of India,
ICAI Bhawan, C-1, Sector-1,
Noida – 201 301
The last date for receiving comments is **January 12, 2009.**
Comments can also be emailed at **cia@icai.in.**

Introduction

1. The purpose of this Standard on Internal Audit is to establish standards and provide guidance for review of an entity's risk management initiatives during an internal audit or such other review exercise with the objective of providing an assurance thereon.

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 damage, loss of value and /or loss of an opportunity to enhance the enterprise operations or activities. Risk is the product of probability of occurrence and the financial impact of such occurrence.

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. *Operations 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. Management is responsible for establishing and operating the risk management framework on behalf of the board.

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 taken 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 extent of internal audit'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 audit'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 audit has a role only in commenting and advising on risk management and assisting in the effective mitigation of risk.

9. The Internal Auditor has to review the structure, effectiveness

and maturity of an enterprise risk management system and in doing so, 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;

e) Creates a system to proactively manage risks.

10. The internal auditor would be responsible for the following activities:

a) Review of compliance to the enterprise risk management process with regard to the existing internal control systems and procedures followed.

b) Defining risk tolerances where none have been identified, based on internal auditor's experience, judgment, and consultation with management.

c) Developing a detailed assurance calendar as a part of their annual audit plan and submit the review report to the Committee of the Board.

d) Reviewing key risk evaluation, assessment of exposure, recording and reporting.

e) Expanding assurance activities to cover overlooked risk areas.

f) Strengthen risk coverage of technology, fraud and strategic areas of significant importance and priority.

g) Coordinate with other risk and control functions to ensure that risks are efficiently managed and controlled.

h) Leveraging and identifying Key Risk Indicators (KRI) to effectively monitor risk conditions.

i) Reviewing whether Enterprise Risk Management structure is designed to identify opportunities to improve performance by taking maximum advantage of risk opportunities, focus on risk control/ risk transfer/ risk finance and exploit technological advantages.

j) Providing advice on the design, implementation and operation of control systems, identify opportunities to make control cost savings.

k) Reviewing and commenting on the extent of residual risk.

l) Promoting a risk and control culture within the enterprise.

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, not to identify, prioritize, and manage 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 enterprise and concentrate on those issues where assurance is sought by those charged with governance.**

13. The risk review and assurance 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 and assurance process conducted by internal auditors will help to determine, *inter alia*

a) The adopted measures results in what was intended;

b) The procedures adopted and information gathered for undertaking the assessment were appropriate;

c) Improved knowledge would help in reaching better decisions and identify what lessons should be learnt to improve future assessment and management of risks.

15. The internal auditor should submit his report to the Committee of the Board delineating the following information:

- **Assurance rating;**
- **Test conducted;**
- **Sample covered; and**
- **Detailed assurance comments.**

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.❑

EXPOSURE DRAFT
Standard on Internal Audit (SIA)
INTERNAL CONTROL EVALUATION

The Internal Audit Standards Board (hitherto known as the Committee on Internal Audit), of the Institute of Chartered Accountants of India invites comments on the Exposure Draft of the Standard on Internal Audit (SIA), Internal control Evaluation. *Comments are most helpful if they indicate the specific paragraph(s) to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.*

Comments should be submitted in writing to:

Secretary, Internal Audit Standards Board,

The Institute of Chartered Accountants of India,

ICAI Bhawan,

C-1, Sector-1, Noida – 201 301

The last date for receiving comments is ***January 12, 2009.***

Comments can also be emailed at ***cia@icai.in.***

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 continuing supervision by management to determine that it is functioning as prescribed and is modified, as appropriate, for changes in conditions. 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 thical values
- Commitment to competence
- Board of Directors or Audit Committee
- Organizational Structure
- 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 some 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 the misunderstanding of instructions.
- The possibility of circumvention of internal controls through the 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 and contribute to the ongoing effectiveness of the internal control system through evaluation and recommendations. However, the internal auditor is not vested with management's primary responsibility for designing, implementing, maintaining and documenting internal control. Internal audit functions add 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;
- Developing Control self-assessment.

9. The internal auditor's evaluation of internal control implies:

- 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;
- 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.
- 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 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 auditors 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 document and understand 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 are:

- 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.** Segregation of duties is a deterrent to fraud because it requires collusion with another person to perpetrate a fraudulent act.

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 control - general control and application control. General control applies to all information systems-mainframe, minicomputer, network, and end-user environments. Application control is 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 software applications that protect confidential or sensitive information from unauthorized individuals;**
- **back-up and restore features of software applications that reduce the risk of lost data;**
- **virus protection software;**
- **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:

- The size and complexity of the entity and of its information system.
- Materiality considerations.
- The type of internal controls involved.
- The nature of the entity's documentation of specific internal controls.
- The 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;

c. observation of the entity's activities 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;

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 comput-

erised applications or over 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 follow up with management to document either that audit recommendations have been effectively implemented, or that senior management 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, open to misinterpretation;
- Roles and responsibilities are not explicit throughout the entity;
- Lack of performance appetite and understanding of the entity's appetite for risk taking;
- Management or boards 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 to management of material weaknesses 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.❑

Smile Please

The classified advertisement said, "CEO needs a one armed consultant, with a social sciences degree and five years of experience."

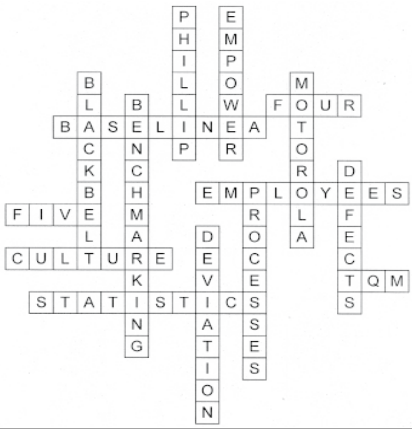
The man who won the job asked, "I understand most of the qualifications you required, but why `one armed`?"

The CEO answered, "I have had many consultants, and I am tired of hearing with each advice the phrase `on the other hand`."

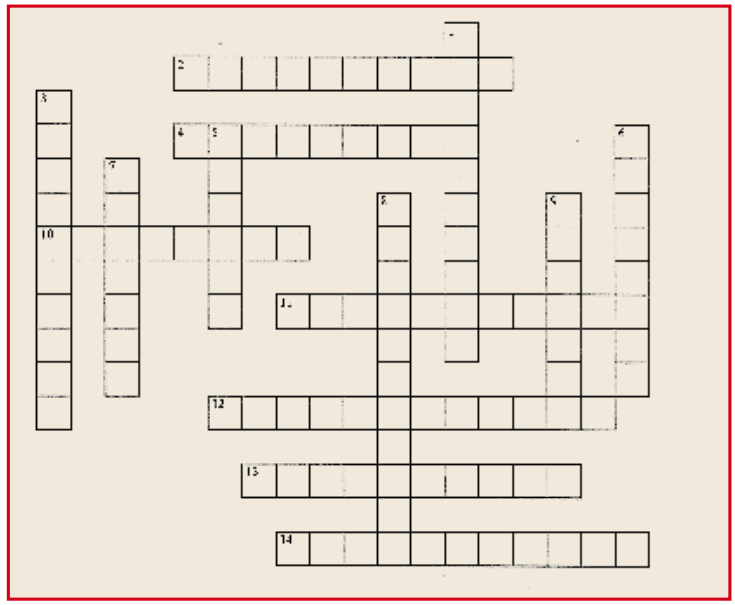
OUT OF THE BOX

This is our new corporate offer, everytime you replace an executive, we give you a free laptop replacement!

Crossword 029 - Solution



CROSSWORD 030



ACROSS

2. A process of Risk Management. (10)
4. Name of ship breaking company whose claim of deduction under section 80HH and 80L was allowed on ship breaking activities by the Supreme Court. (5,4)
10. Name of the street named after the ICAI at the Salem Branch is _____ Street. (8)
11. One of the components to bring Financial Sustainability in Urban Local Bodies is Revenue _____. (11)
12. The auditor shall communicate with those charged with the governance about significant _____ encountered during the audit. (12)
13. As per SA 250 Non-compliance does not include personal _____ by those charged with governance, management or employees of the entity. (10)
14. One of the Certificate Courses recently started by the ICAI. (11)

DOWN

1. To ensure that the banks comply not only with the banking laws but with all the laws to which a banking company is exposed there is need to have a _____ Committee. (10)
3. The ICAI had a tie-up with this university to allow CA students/members to pursue the BBA and MBA courses. (10)
5. ASLB 3 uses the term 'revenue', which encompasses both revenues and gains, in place of the term '_____'. (6)
6. One of the methods to identifying the risk is to create a Risk _____. (8)
7. Name of housewife against whom penalty imposed under section 273A of the Income-tax Act, 1961 was waived by the Supreme Court. (7)
8. Regarded as 'Father of Accounting'. (4,7)
9. _____ key financial ratios is one of the conditions that may cast doubt about Going Concern assumption. (7)

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.*