



# THE CHARTERED ACCOUNTANT

JOURNAL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA



ICAI has served India  
with great distinction:  
Dr. Manmohan Singh

Our Chartered  
Accountants are second  
to none anywhere in the  
globe: P.C. Gupta

ICAI has played significant  
role in providing policy  
inputs to Government:  
P.Chidambaram

## INDIAN ECONOMY SLOWING DOWN?

In May 2008, industrial growth came down to 3.8 per cent as against 10.6 per cent in the same month last year, and 6.22 per cent in April 2008. This is the slowest pace of industrial growth in last more than six years, which has triggered speculations on whether Indian economy is slowing down and facing the risk of an economic downturn.

What makes the scenario a little more worrisome is that Standard & Poor's has said it may lower the nation's credit rating in a big way if the economy deteriorates further. A rating downgrade would indeed be a blow to India. Even heading in that direction is not good as investors seem to be already panicking about inflation, growth and fiscal prospects. Foreign investors, who bought a record \$17.2 billion of Indian stocks last year, seem to be fleeing Asia's third largest economy amid the fastest inflation in 13 years and weakest economic growth since 2004. Further, the global ratings agency Fitch has already lowered its outlook on India's local currency debt to "Negative" from "Stable" citing fears that fiscal deficit could rise to 6.5 per cent of GDP as against the targeted 2.8 per cent. The negative outlook suggests a likely increase in sovereign default rate, which may affect the fund flow in the country leading to rise in the interest rates. Fitch also projected Indian economy to grow at the rate of only 7.7 per cent and not at a little less than 9 per cent predicted earlier.

The sharp fall in industrial growth has come mainly in the wake of high interest rate. As the inflation continues to be in two digits, there is a need to continue tighter money policy, and therefore, industry is expected to show low growth figure for some more time. This double trouble of slow industrial growth along and rising inflation will indeed make monetary policy maneuvers of Reserve Bank of India all the more difficult in near future. But, the policy dilemma facing the RBI as to how much it should worry about the slowdown in industrial growth

and how much the strength of inflation needs to be resolved sooner than later for the benefit of the national economy.

However, the world at large should not be worried about India's medium to long-term prospects as the nation's economic credentials and fundamentals are sound and robust. The 'stagflation' (stagnation and inflation), as so referred by RBI, is indeed worrying, but this scenario is likely to prevail only for a very short period. Despite the recent fall in industrial growth, it may not be right to think the economy as a whole is slowing down. As per Confederation of Indian Industry, corporates have an investment of \$700 billion in various infrastructure projects and the order books of companies now are also much higher than the last year. Corporate profitability too has not dropped despite high interest rates. The corporate sector registered a robust top line growth at 18 per cent and bottom line growth at 26 per cent in 2007-08, creating much room for capex in 2008. Further, the service sector is set to register a growth rate of 10 per cent.

India is not a large borrower— \$15 billion borrowing for a country with a \$1 trillion GDP is not much. The country has a strong savings rate of 34.8 per cent, investment rate of 35.9 per cent and incremental capital-output ratio of 4 per cent, better than China (4.3 per cent). The country also had a strong domestic consumption of 6.7 per cent of GDP in 2007-08 and strong 20 per cent growth in export and foreign exchange reserves at over \$308 billion. Moreover, as per the projections, by 2022, India could be the world's largest pool of trained manpower and leaders in industry and commerce, accounting for 10 per cent of the world trade. These data are enough to silence any economic doomsayer.

— **Editorial Board**

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Cover: Launch of ICAI Diamond Jubilee Celebrations

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*CA. Ved Jain presents a memento to Deputy Chairman of Planning Commission Mr. Montek Singh Ahluwalia*

**D**ear Esteemed Colleagues,  
Our Institute entered the 60<sup>th</sup> year of its glorious existence on July 1, 2008 in style. The entire nation took note of our milestone when the Hon'ble President of India Mrs. Pratibha Devisingh Patil and the Hon'ble Vice-President of India Mr. Hamid Ansari personally wrote laudatory messages for us; and the Hon'ble Prime Minister Dr. Manmohan Singh himself formally launched our Diamond Jubilee celebrations in the day-long function at the Vigyan Bhawan, New Delhi. The Hon'ble Finance Minister Mr. P. Chidambaram, the Hon'ble Union Minister for Corporate Affairs Mr. P.C. Gupta, the Hon'ble Deputy Chairman, Rajya Sabha, CA. K. Rahman Khan and a host of other dignitaries also graced the occasion. Mr. Chidambaram released a Special Cover of the Department of Post to mark our Diamond Jubilee.

In his thought-provoking and inspiring speech on this occasion, the Hon'ble Prime Minister wholeheartedly acknowledged our services to the nation when he said: "Your Institute has served our country with great distinction. I sincerely believe

that we cannot be satisfied with the status quo and I sincerely hope that the best is yet to come and that the next 60 years will be still more productive, innovative in the service of the people of our great country." He added: "On this happy occasion...it would be most appropriate for Indian Chartered Accountants to reaffirm their commitment to the cause of excellence, independence, ethical conduct and the highest standards of professional integrity."

The Hon'ble Corporate Affairs Minister was no less complimentary when he said: "the Institute has been playing a very important role in the healthy development and regulation of the profession. I have no hesitation in asserting that our Chartered Accountants are second to none anywhere in the globe." This is high praise indeed. The Hon'ble Finance Minister too acknowledged that "the Institute has played a significant role in providing policy inputs to the Government in the areas of fiscal reforms, financial sector reforms and public finance. I thank you for the cooperation and support that you have extended to the Government."

The Hon'ble Deputy Chairman of the Rajya Sabha even went so far as to attribute all his success to his being a Chartered Accountant. The full texts of the speeches delivered at the function have been published in this issue of the Journal for your perusal.

The other important event to mark the occasion was a special two-day conference on 'Chartered Accountancy Profession in Retrospect & Prospect', inaugurated on July 2, 2008, which was addressed by Deputy Chairman, Planning Commission, Mr. Montek Singh Ahluwalia, Comptroller & Auditor General of India Mr. Vinod Rai, Member of Parliament CA. C. Ramachandraiah, Acting Chairman Competition Commission of India, Mr. V.K. Dhall, Secretary, Ministry of Corporate Affairs Mr. Anurag Goel, eminent journalist Dileep Padgaonkar and a number of other eminent personalities. A comprehensive report on this conference is being published elsewhere in this Issue.

Many similar conferences and programmes were organised in other parts of the country as well, which were attended by a host of eminent leaders including Karnataka Governor CA. Rameshwar Thakur, Haryana Governor Dr. A.R. Kidwai, Union Minister for Urban Development Mr. S. Jaipal Reddy, Gujarat Chief Minister Mr. Narendra Modi and Union Minister of State for Home Mr. Shriprakash Jaiswal.

Besides, a number of social and cultural programmes were organised across the length and breadth of the country to mark the occasion. These included tree plantations, health check-ups, blood donation camps, a marathon run to support the cause of environment and a discourse on 'Lifestyle Management using Yoga & Meditation' by Swami Ramdev. We plan to plant more than 60,000 saplings over the year in and around Delhi itself as part of the Diamond Jubilee celebrations. A brief report on some of these programmes has been published elsewhere in the journal.

I am simply overwhelmed by the sentiments expressed by our national leaders with regard to our profession and, on behalf of the entire CA fraternity, I thank them all and assure them that the nation will never find us wanting in any area of economic or social concern. We have been and

will continue to be proactive partners in nation building.

I also appreciate the great enthusiasm with which the members participated in all these programmes.

### **Institute's Museum**

I have envisaged a museum of the Institute comprising a rare collection of objects of historic and heritage value from the point of view of the chartered accountancy profession in India. Such a museum could serve as a great source of learning, inspiration and professional pride for all of us. I request you to help us bring such a museum in existence by donating to us anything worth showcasing in it. These could be in the form of historic press clippings, mementos, photographs, paintings, handicrafts, etc. linked with the profession or the Institute.

### **Value Added Consultancy Services by Small and Medium Practitioners**

You will perhaps recall that in my Action Plan I had talked about empowering Small and Medium Practitioners. I am happy to inform you that the first such programme of business assurance and consultancy service by Small and Medium Practitioners to Small and Medium Enterprises was launched on 12<sup>th</sup> July 2008. On the face of it this might look to be a small IT initiative but I can assure you that this will go a long way in empowering SMPs in providing value added services to SMEs and could in fact be a big professional opportunity. I request you to utilise this facility to the maximum to expand your professional horizon, capabilities and practice. Many similar programmes are in the pipeline and will be launched soon.

### **MoU with ISACA**

In yet another major capacity and credibility enhancing initiative for members associated with Information Systems Audit, we have finalised an agreement with Information Systems Audit and Control Association (ISACA), which, as you know, is the world's leading association serving IS Audit Professionals. Under this agreement, our members will be able to freely access and make use of internationally accepted standards, guidelines and procedures of ISACA. It will not only bring

increased global acceptability of our DISA qualification in carrying out IS Audits but also facilitate active participation of our members in further research being conducted by ISACA for development of IS Audit standards. The Indian Corporate Sector will also benefit by having a framework within which IS Audits will be carried out by the professionals. I have no doubt that this initiative will further boost our brand image and value.

### Examination Results — Women Students Forging Ahead

It should be highly satisfying for all of us that the results of the latest CA Final Examination (May 2008) and Common Proficiency Test (June, 2008) have not only been encouraging but have also set some welcome trends. I heartily congratulate all those who have passed the examinations. My special compliments to the rank holders. As many as 2,645 (25%) students out of a total of 10,580 students, who appeared for both the Groups of the Final Examination, passed while 6,444 (36.71%) of 17,552 students cleared Group I and 5,290 (28.81%) of 18,685 candidates passed Group II.

The percentage of women students over the period is also increasing. As against the present strength of 21,038 (14.47%) women members out of a total of 1,45,378 members, women students comprised 2,767 (26%) of 10,580 students who appeared for both Groups. The pass percentage of women students has also been better – 27.57% as against 24.09% of their male counterparts. Out of the first five positions, three (2<sup>nd</sup>, 3<sup>rd</sup> and 4<sup>th</sup>) have been bagged by women students. My heartiest congratulations to them again.

In the CPT, 28,751 (37.81%) students of a total 76,026 students have passed the examination. Here again, not only has there been an increase in the number of girls opting for CA course – 25,807 (34%) of total 76,026, but they have also outperformed boys with a pass percentage of 41.37% compared to 36% of the boys. On a broader scale, you will find it heartening to note that within a period of about 22 months since 14<sup>th</sup> September 2006 when the CPT was introduced, more than 3 lakh students have opted for CA Course, out of which more than 1.2 lakh have passed the CPT examination. Thus, there has been more than a three-fold increase in the number of students

enrolling for articleship as compared to the average during the year 2001-2005.

### Steps for Welfare of Members and Students

In another major development coinciding with our Diamond Jubilee celebrations, we have decided to extend further benefits to the beneficiaries of the Chartered Accountants Benevolent Fund (CABF). An ex gratia payment of Rs. 1 lakh shall be given to the legal heir of a member in case of unnatural/premature death below the age of 45 years. It has also been decided to provide financial assistance to the tune of Rs. 1 lakh towards medical treatment of specified ailments. Further, the rate of monthly assistance which is at present Rs.3000-Rs.4,500 per month has been increased to Rs.4000-Rs.5,500 per month. A similar benevolent fund is being set up for CA students and I hope that we shall be able to raise a substantial corpus in the CA Students Benevolent Fund to provide benefits to CA students on the above lines.

As I conclude, I am reminded of an inspirational anecdote involving the great Italian Renaissance painter Michelangelo. Once, while painting frescos in the Sistine Chapel, he was lying on his back in a posture that caused pain on a high scaffold, carefully outlining a figure in an obscure corner of a ceiling. A friend asked him why he was taking such pains with a figure, which could hardly be seen by anyone. "After all", said the friend, "who will know whether it is perfect or not?" The artist replied, "I will". This illustrates the attitude of a dedicated perfectionist, which is worth taking note of, particularly when we are celebrating the 60<sup>th</sup> year of our professional excellence and service to the nation. In this landmark year, let's resolve to proactively pursue perfection with dedication and to be satisfied with nothing less. We cannot expect the world to be perfect, but we need to look inwards and exact the best from ourselves. Only thus can we justify the many bouquets and compliments that our leaders have given us.



**CA. Ved Jain**  
New Delhi, July 22, 2008

### A Commemorative Issue

The July 2008 issue of the Journal was extremely informative. It presented many lesser known facts about our profession and the Institute too. The messages from the great leaders were really thought provoking. I wish this Journal continues to share more of such information in future also.

- CA. Arvind Varaganti

The July 2008 issue was all about the past and present of the Institute, and about the CA profession. All the features, particularly

'Glorious History of ICAI – The Timeline', 'What the Leaders Said' and 'Window to the Past' that carried rare photographs, were significant and very interesting. The ICAI-President's message effectively presented the vision of ICAI and the CA profession. I congratulate the Institute for bringing out this issue that is worth preserving.

- CA. Ravi Shanker, Allahabad

### Enterprising ICAI Needs to be Congratulated

ICAI is doing a great job. I appreciate its efforts for starting lectures on Gyandarshan channel for CPT students. I also thank ICAI for taking such great initiatives and offer my best wishes. Since many students are still unaware of this noble and enterprising step of ICAI, I feel the lectures for CPT and other such programmes should be more popularised through advertisements etc.

- CA. Lokesh Khadaria, Surat

I congratulate the Institute for celebrating its Diamond Jubilee year and for other initiatives including arranging International Residential Refresher Course at Bangkok, launching ITT computer course, CPT certification course, PCO crash courses, inauguration of WICASA of VASA branch and conducting PCC classes.

- Ajay Dogra, CA student, Ambala Cantt.

### Praiseworthy Contents

The June 2008 issue of the Journal was quite informative as usual. The article, 'Japanese SOX – An Emerging Opportunity for CAs', was worth reading. However, I would request you to address and include more such contemporary issues. A separate article on

'Taming the Inflation' could have been more satisfying.

- CA. Ashish Gogia

I have always found the Journal informative and helpful. The June 2008 issue of the Journal was praiseworthy. As student, I have been benefited by the information quotient of its legal updates and articles. I recently appreciated the article 'Determination of Arm's Length Price' in the May 2008 issue. I am happy to see the continuous improvement in the contents and style of the Journal.

- Ravi Mansaka, CA Student

The article on 'Corporate Environment Management' in the June 2008 issue emphasised the need of the hour. It brings to light the need to ensure a clean and green environment. It is gratifying to know that Chartered Accountants can play a vital role in advising their clients on environmental issues. Solving the Crossword at the end of the Journal always becomes a challenge and Smile Please does regale us with its selection! Kudos to the Institute for organising intensive training programmes!

- CA. Arijit Chakraborty, Kolkata

### E-learning Portal is Helpful

I am extremely excited to know that our Institute has taken an initiative to launch an e-learning portal 'ICAI-Online' to satisfy the needs of our e-generation. It is heartening to note that ICAI is proactively working as a veritable partner in nation building.

- CA. Sahil P Shah, Ahmedabad

### Revive the DjVu format

Earlier the Journal was available in DjVu format, which was very user-friendly. Now this format has been discontinued. Can the ICAI continue with the previous format?

- Riten Gosar

### Write to the Editor

'Information is Power' and our ever-evolving profession needs more and more of that today than ever before. Do you have any relevant points to make, experiences to share, and views to spread among the CA fraternity? If yes, e-mail us at [eboard@icai.org/nadeem@icai.org](mailto: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



### Members

- Diamond Jubilee celebrations of the ICAI have started from July 1, 2008 across India and world through its network of branches and chapters.
- Guidelines for training of Articled Assistants outside India have been issued.
- Campus Placement Programme for the newly qualified CAs will be held in August-September 2008.

### Students

- All students who have passed PE-II are permitted to appear in the final examination, irrespective of whether they have been registered under Final (Old) syllabus or (New) syllabus, provided they have completed the practical training as is required for admission as member

or are serving the last twelve months of articulated training on the first day of the month in which the final examination is scheduled to be held and complied with other eligibility conditions(s).

- Council of the Institute has decided to hold two more Professional Education (Examination-II) in November 2008 and May 2009 as well, in order to mitigate the hardship being faced by the students.
- 6<sup>th</sup> National Convention for CA Students to be held on 23<sup>rd</sup>-24<sup>th</sup> August 2008 at Kolkata.
- Verification fee of answer books of the CA Examinations has been revised. The revised verification fee will be Rs. 100/- per paper, subject to a maximum of Rs. 400/- effective from May 2008 Examinations.

## Special Cover of Department of Post Released to Commemorate Diamond Jubilee of ICAI



The Special Cover of Department of Post released by Finance Minister Mr. P. Chidambaram on July 1, 2008 in New Delhi to commemorate Diamond Jubilee of Institute of Chartered Accountants of India

## ICAI NEWS

### 3 Months Residential Programme on Professional Skills Development

*(General Management, Personality Development and Communication Skills)*

After the successful completion of first three months' residential programme on Professional Skills Development for CA students, the ICAI has decided to conduct second programme. The course duration to be considered as part of Articled Training. Special Campus interview for participants of the programme will be held. The programme is scheduled to start from August 11, 2008. The programme would be completely residential in the campus of the National Institute of Financial Management, Faridabad. The Course Fee will be Rs. 48,000 per participant after subsidy from ICAI. For more details visit ICAI website [www.icai.org](http://www.icai.org) or contact Mr. S. Suneja at 9810938177 or email at [ssuneja@icai.org](mailto:ssuneja@icai.org).

## A Report on the Function to Launch Diamond Jubilee Celebrations of ICAI



(From L to R) ICAI President CA. Ved Jain, Union Minister of Corporate Affairs Mr. Prem Chand Gupta, Prime Minister of India Dr. Manmohan Singh, Deputy Chairman of Rajya Sabha CA. K. Rahman Khan and ICAI Vice President CA. Uttam Prakash Agarwal at the launch of ICAI's Diamond Jubilee celebrations at Vigyan Bhawan, New Delhi on July 1, 2008.



ICAI President CA. Ved Jain addresses the gathering

*The Diamond Jubilee celebrations of ICAI were formally inaugurated by Prime Minister of India Dr. Manmohan Singh on CA Day on 1<sup>st</sup> July 2008 at Vigyan Bhawan, New Delhi in the presence of Union Minister of Corporate Affairs Mr. Prem Chand Gupta, Deputy Chairman of Rajya Sabha CA. K. Rahman Khan and a large number of members and students of ICAI. Following is the text of address by ICAI President CA. Ved Jain given on this occasion.*

"We are extremely honoured that on the occasion of the Diamond Jubilee celebrations of the Institute of Chartered Accountants of India, we are blessed with the august presence of the Hon'ble

Prime Minister. Friends, we all know Hon'ble Prime Minister as a well renowned economist, a man of few words, a man who has with his unique zeal and meticulous planning, catapulted

*"Hon'ble Prime Minister Sir, today on our Diamond Jubilee day, we commit ourselves to provide the best of accounting education and rededicate ourselves to give transparent and truthful accounting, audit and governance service to the industry and the Nation. On this historic and momentous day, each one of our 500,000 fraternity, commit to uphold the best of our declared norms as listed in our charter."*

India into one of the fastest growing economies of the world; A man who is selfless, is a thinker, is a doer, is a leader and a man who inspires one and all. A man who has only one mission; to take India forward; to make every Indian - a proud Indian. Hon'ble Prime Minister, you are an ideal for many many of us and we are overwhelmed with your presence and we heartily welcome you.

We are also delighted to have the august presence of Hon'ble Minister of Corporate Affairs, Shri P.C. Gupta ji. A dynamic minister, the one who has been able to bridge the gap between the corporate sector and the Government by making and implementing a revolutionary programme MCA-21, the biggest e-Governance programme in the country. We heartily welcome you, Sir.

We are especially delighted to have with us Hon'ble Deputy Chairman of the Rajya Sabha Shri Rahman Khan ji. We are proud to have you with us – a distinguished humble man, holding such a high office – a qualified Chartered Accountant – a member of our Institute. This goes on to prove that today Chartered Accountants are and can be, in any important position, be it in private sector or Government.

Hon'ble Prime Minister, our Institute is the single largest educational institute in the country. We have, during the last 60 years, produced 1,45,000 brilliant Chartered Accountants and today, we have more than 3,50,000 young men & women registered with us as students, who are aspiring to be Chartered Accountants of tomorrow. We are, therefore, a family of 5,00,000 members.

Sir, our educational curriculum is one of the best in the world, the most cost effective and available to all strata of society across India. Our accounting and professional norms are well integrated with the global norms of accounting, auditing and governance.

Sir, the spectacular growth of Indian economy has led to enormous increase in the demand of qualified chartered accountants and accounting professionals, and the Institute of Chartered Accountants of India, with the support and under the guidance of Ministry of Corporate Affairs is doing its best to meet this requirement. Today, Indian Chartered accountants are much in demand in India and globally, and more than 10,000 chartered accountants are working in different parts of the world.

Sir, apart from accounting and auditing, we at the Institute of Chartered Accountants of India, understanding our social responsibility, are fully committed to take up the social aspects as well.

We have a Committee on Government Accounting and on Public Finance to study and make policy suggestions for improvement in public finances at Central and State Governments. Our Institute is working with different Ministries of the Central and State Governments, sector specific regulators and we are providing policy inputs and assistance in resource mobilisation, management of public expenditure, implementation of economic reforms, e-governance, simplification and rationalisation of taxes.

Hon'ble Prime Minister Sir, today on our Diamond Jubilee day, we commit ourselves to provide the best of accounting education and re-dedicate ourselves to give transparent and truthful accounting, audit and governance service to the industry and the Nation. On this historic and momentous day, each one of our 500,000 fraternity, commit to uphold the best of our declared norms as listed in our charter and we shall continue to support the Government and be a helping hand in your dream and vision to make India an economically and socially strong and proud Nation.

Hon'ble Prime Minister Sir, we are blessed with your presence and we whole-heartedly welcome you. I request you all to please join me in welcoming the Hon'ble Prime Minister.

Jai Hind!"

## ICAI Has Served Our Country With Great Distinction: Prime Minister Dr. Manmohan Singh



Prime Minister of India Dr. Manmohan Singh  
speaks on the occasion of launch of ICAI  
Diamond Jubilee celebrations

*The Diamond Jubilee celebrations of ICAI were formally inaugurated by Prime Minister of India Dr. Manmohan Singh on CA Day on 1<sup>st</sup> July 2008 at a function at Vigyan Bhawan, New Delhi. Following is the text of speech delivered by him on the occasion.*

"I am truly delighted to be here at this inaugural function of the Diamond Jubilee Celebrations of the Institute of Chartered Accountants of India. I wish all the members, past and present, and students of the ICAI every success on this very auspicious and happy occasion. I compliment you for the high standards of professionalism that you have come to be known for. An Indian chartered accountant is recognised worldwide as being among the best and the brightest in the profession.

Your Institute has served our country with great distinction. But I sincerely believe that we cannot be satisfied with the status quo and I sincerely hope that the best is yet to come. Another 60 years will be still more productive, innovative in the service of the people of our great country.

The Institute of Chartered Accountants of India has been at the forefront in the development of our accounting profession. The impressive growth in your membership, from 1700 members in 1949 to over 1.5 lacs today, bears testimony to the growing demand for your services, both at home and abroad. Yours is one of the premier accounting bodies in the world today and this is a matter of great pride for all of us.

Indian Chartered Accountants have truly earned a name and fame for themselves like so many of our professional workers. Indeed, long before Indian business was ready to face the challenge of globalisation and benchmark our businesses against global best standards, our professionals were excelling themselves.

Like our engineers, doctors, scientists, technologists and other professionals, our chartered accountants too faced global competition and to their credit they stood their ground. It is for this reason that today they are able to face the heat of that competition at home

as well as abroad. Indian Chartered Accountant firms, I believe, should expand their operations outside India and seek global opportunities and challenges that I believe is the destiny of our great country.

The role of the accounting profession is critical in lending credibility to the financial market transactions. Market participants, investors and shareholders look up to you for high quality information, which ensures market discipline and fosters confidence of various stakeholders. It is your responsibility to ensure that our corporate entities do indeed conform to high governance standards.

In the public discourse on governance, I do not find adequate attention being given to corporate governance. Unless Indian firms come to be recognised world wide for good corporate governance, they will not be able to compete globally in an increasingly interdependent integrated world. In the era of protectionism, few bothered about corporate governance and transparency in accounting and in management. Such laxity, however, is no longer possible. Shareholder democracy has come to stay and you are the watchdogs of this new corporate world of immense challenges but also of immense opportunities.

The dynamism of a globalised capital market and the emergence of a knowledge based economy and society have posed major challenges for accurate and speedy financial reporting. I am, therefore, happy to learn that your Institute has faced these challenges by creating a large base of high class Chartered Accountants, and developing high quality financial reporting standards.

Ladies and gentlemen, I commend the Institute's commitment to the convergence of accounting, auditing and ethical standards with international best practices and improving corporate governance. I urge

*“Your institute has served our country with great distinction. I sincerely believe that we cannot be satisfied with the status quo and I sincerely hope that the best is yet to come. Another 60 years will be still more productive, innovative in the service of the people of our great country.”*

you to continue to benchmark yourselves against the best available global practices. We cannot be satisfied with the chalta-hai attitude if we have to satisfy the ambitions of our growing work force for a fast expanding economy and a polity with tremendous opportunities on the horizon.

India has made a mark in the services sector and must, therefore, acquire the very top slot and top spot in terms of excellence, professionalism, speed, quality and predictability of service and, above all, reliability and integrity of service providers. I would like to see the day when the world looks up to Indian professionals in every field of modern professional work. I would believe that is the destiny of our great nation.

Ladies and gentlemen; I am happy to note that the Ministry of Corporate Affairs has taken the initiative to amend the Chartered Accountants Act, 1949 to enable your Institute to strengthen its professional standing. A law on limited liability partnership is on the anvil. This would help in the consolidation and growth of small firms and promote multi-disciplinary practices in line with evolving global trends. The e-governance initiative of MCA-21, for user-friendly regulation and compliance management is a revolutionary step for effective administration of the Companies Act and I congratulate my esteemed colleague Shri Prem Chand Gupta for having presided over the Ministry at this very innovative phase of its function.

Our government would greatly welcome your suggestions and suggestions from the Institute membership on ways and means to introduce greater transparency and accountability in financial accounting and reporting systems of the government at all levels.

We have placed great emphasis on the devolution of financial and administrative powers to the Panchayat Raj Institutions. This will impart local ownership to development schemes and encourage transparency and accountability. A proper accounting system for funds received and spent by Panchayat Raj Institutions will be critical to making this innovative experiment in decentralisation a success. With the presence of Chartered Accountants even in the remotest parts of

our country, you can also facilitate financial inclusion and access to finance for the rural poor through micro finance and other innovative measures.

I believe the Institute should also focus its attention on creating a second tier of accounting qualification which could meet the emerging demand for skilled accounting personnel in the growing rural economy and in small and medium sectors. I congratulate the Ministry of Corporate Affairs for having taken lead in making this happen.

I am happy to note that your Institute has taken a number of steps to develop the profession of accountability in other countries where the profession is in its infancy. These initiatives should be further intensified so that the benefit of expertise of the accounting profession in India is available to other developing countries across the world.

Technical excellence and adherence to high ethical standards are essential conditions for growth and development of any profession. Your Institute has been pro-active in aligning its educational curriculum with a changing business environment. I am glad that you have made continuous professional education mandatory for your members that is, as it should be in this fast changing world. Ethical standards for the profession in India should be no less stringent than existing international standards found elsewhere. There should not be any laxity in enforcing these rigorous standards.

Ladies and gentlemen, on this happy occasion of the inauguration of the Diamond Jubilee celebrations of the ICAI, it would be most appropriate for Indian Chartered Accountants to reaffirm their commitment to the cause of excellence, independence, ethical conduct and highest standards of professional integrity. I once again congratulate the Institute of Chartered Accountants of India and all of you on this occasion. The Institute, as I said, has served our country with great distinction in the last 60 years and I sincerely hope and pray that the best is yet to come. I wish the Institute and all those connected with it all success in your endeavour to scale greater heights of excellence and commitment to our national goals and ideals. I thank you”.

*“I urge you to continue to benchmark yourselves against the best available global practices. We cannot be satisfied with the chalta hai attitude if we have to satisfy the ambitions of our glowing workforce for a fast expanding economy and a polity with tremendous opportunities on the horizon.”*

## Our Chartered Accountants are Second to None Anywhere in the Globe: P.C Gupta



Union Minister for Corporate Affairs Mr. Prem Chand Gupta addresses the gathering.

*Following is the full text of the speech of Hon'ble Union Minister for Corporate Affairs Mr. Prem Chand Gupta delivered on the occasion of the launch of Diamond Jubilee celebrations of ICAI at Vigyan Bhawan, New Delhi on 1<sup>st</sup> July 2008.*

“At the outset, I wish you all a very happy Chartered Accountants Day. I also happily join you in Diamond Jubilee celebrations. Ladies and gentlemen, during the last four years, it has been my privilege, as the Minister for Corporate Affairs, to be part of various initiatives and achievements of ICAI. The Institute has been playing a very important role in the healthy development and regulation of the profession of chartered accountancy in the country. I have no hesitation in asserting that our Chartered Accountants are second to none anywhere in the globe.

Friends, thanks to the visionary leadership of our Prime Minister Dr. Manmohan Singh that we are today one of the fastest growing economies in the world. It is he, who as Finance Minister in early nineties, chartered an entirely new path for country's economic development. He did this with rare foresight and finesse, at a time when the country seemed to be on the brink of economic disaster.

His stewardship as Prime Minister has given to India a status and standing in the international community, it never enjoyed before. The world has acclaimed the country's transformation into a rapidly growing modern economy, at the same time managing the complex problems of poverty and social inequality, meaningfully. His commitment to inclusive growth has led to a large number of new initiatives, focusing on the needs and aspirations of the common man as also on bridging regional disparities. His vision on the new global order has inspired respect and support for him and for the country.

Creation of an independent Ministry of Company



ICAI President CA. Ved Jain presents a memento to Union Minister for Corporate Affairs Mr. Prem Chand Gupta on the occasion of the launch of ICAI Diamond Jubilee celebrations at Vigyan Bhawan, New Delhi on July 1, 2008.

Affairs was one of the early steps taken by the Hon'ble Prime Minister. I count myself as fortunate that he reposed his confidence in me to lead this Ministry. Sir, it gives me immense happiness today to report that the Ministry, renamed as the Ministry of Corporate Affairs, has been able to deliver in line with your vision. A silent revolution, at times unnoticed, is sweeping the corporate landscape of the country. The amendments to the Chartered Accountants Act

*"I would like to call upon the accounting professionals to seize the opportunities unleashed by the economic liberalisation, globalisation and information technology while preserving and promoting the integrity and trustworthiness of their profession"*

1949 has enabled ICAI, whose Diamond Jubilee we celebrate today, to function far more effectively. Similar amendments to Cost & Works Accountants Act, 1959 and Company Secretaries Act, 1980 have led to palpable improvements in the functioning of these institutes. The Limited Liability Partnership Bill is ready for consideration in the Monsoon session of Parliament. You have been waiting for this for last three decades, sir. We sincerely hope that the long wait shall now be over and the power of this new corporate structure would soon be available to the business, entrepreneurs and professionals alike. On the other hand, it has taken little too long to complete the process of drafting and legal vetting of the new Companies Bill. We are completing the process very soon.

The Accounting Standards have been notified, and we are now moving towards convergence with the International Financial Reporting Standards by the year 2011.

The Ministry of Corporate Affairs has also been at the forefront of the e-Governance initiatives of the Government. The MCA-21 pilot project for Delhi was launched by the Hon'ble Prime Minister from this very place on 18<sup>th</sup> of March, 2006. As this august gathering is aware, MCA-21 has been the most successful initiative so far under the National e-Governance initiative of the Government. We are already planning for the next-generation MCA-21 programme.

We have also drawn great inspiration from the emphasis laid by you sir on institutional reforms and knowledge infrastructure. A unique institution, named the Indian Institute of Corporate Affairs is being established to strengthen the knowledge infrastructure in the field of corporate affairs. At present there is a no institutional mechanism for holistic treatment of all issues, laws and disciplines, which impact effective functioning of corporates. IICA would meet this felt need, synergising the disciplines involved presently in courses for MBA, Chartered Accountancy,

Company Secretariship etc. The institute would work autonomously in close partnership with the corporates, professional and national/international institutes of eminence, with minimal involvement of Government in governance and management. It would focus on supporting entrepreneurs and small/medium enterprises, thereby assisting in employment generation besides economic growth. IICA would act as a think tank, capacity building and service delivery institution for the ministry.

Our trade and industry is very positive about this initiative of the Ministry and domestic as well as international institutions of repute such as IIT Kharagpur, CII, Evian Group, Carnegie Mellon University and George Washington University Law School USA have shown keen interest in working together with the IICA.

Friends, we strongly believe that for the progress and development of any profession, freedom and autonomy coupled with accountability is essential. It is in this direction that we undertook amendments in the Chartered Accountants Act, 1949, and completed the process in the year 2006. I believe that the amendments so made will enable the ICAI to restructure the profession of chartered accountancy in the desired manner and in the best interest of the nation. Among other things, these amendments would enable the Chartered Accountants to form multidisciplinary firms, which will help them face global competition more effectively. The Limited Liability Partnership form will be better suited for such multidisciplinary practices.

Today, trade and industry, particularly in small and medium sector, is facing acute shortage of qualified accountants. In order to address this problem we have been working for introduction of a second tier qualification enabling certification of a sizeable number of professionals as Accounting Technicians. This will serve twin purposes of providing new opportunities of gainful employment to lakhs of our young boys and girls while fulfilling the need of businesses. I would compliment the Institute, and its President in particular, for immediately responding to the call of the Government of this important issue. The course is likely to be available within couple of months.

While concluding my address, I would like to call upon the accounting professionals to seize the opportunities unleashed by the economic liberalisation, globalisation and information technology while preserving and promoting the integrity and trustworthiness of their profession. With these words, I once again wish you the very best on this memorable occasion.

Thank You and Jai Hind."

## Whatever I am Today It is Because I am a Chartered Accountant: K. Rahman Khan



Deputy Chairman of Rajya Sabha  
CA. K. Rahman Khan addresses  
the gathering

*Following is the Speech for Hon'ble Deputy Chairman, Rajya Sabha CA. K. Rahman Khan delivered on the occasion of CA Day and inauguration of Diamond Jubilee celebrations of ICAI at Vigyan Bhawan, New Delhi on 1<sup>st</sup> July, 2008.*

"I am extremely happy and privileged to be here as a Chartered Accountant who has been a humble member of this illustrious profession for last 44 years. The values and virtues of a professional and of a citizen that I have learnt while being a student and later on as a member of the Institute have always guided me in my public and professional life. Whatever I am today it is because I am a Chartered Accountant. I salute my profession.

Looking back, the profession of Chartered Accountants has grown in India to become one of the most prominent worldwide. It is a profession in public interest - an integral part of the Indian economy, and indeed indispensable. The Chartered Accountants guide the policies, strategies and growth of the corporate sector and help the regulators in discharge of their functions in public interest. It is one of the most sought after profession, and a qualification, which is within the reach of the students in the remotest part of the country and those in the economically weaker sections of the society.

Hon'ble Prime Minister Sir, after having been in public life for years, I envision a much larger role for the profession of Chartered Accountants in development of Indian economy in the times to come. As an architect of modern Indian economy, you have always been concerned in taking the benefits of economic reforms to the poorest of the poor. Proper accounting and accountability of the public finances is a major issue. Need for greater financial discipline, and focus on outputs and outcomes in programme implementation and in the public service delivery mechanism has been long felt. The profession of Chartered Accountancy can play an important role in supporting Government of India's initiatives in this direction.

I congratulate the Institute of Chartered Accountants of India for attaining this milestone with excellence and wish the Institute, fellow members and students every success in their future endeavors for scaling new heights and many more years of valuable service to the nation. Thank You."



The inaugural session of the function to launch Diamond Jubilee celebrations ended with the Vote of Thanks by **ICAI Vice President CA. Utam Prakash Agarwal** who thanked the Hon'ble Prime minister for inaugurating the Diamond Jubilee Celebrations. Thanking the Hon'ble Prime Minister, he stated that he is truly regarded as "Architect of Modern India" for

spurring economic growth, and pledged to strive for the cause of the society. He stated that the vision given by Dr. Manmohan Singh would be the guiding principle for the profession and assured that the Institute would follow the same. He gave assurance that the fraternity of chartered accountants will take steps and initiatives to further enhance the level and quality of service to the various segments of the Society. Thanking the Hon'ble Ministry of Corporate Affairs, he termed it as 'friend, philosopher and guide to profession'. He also requested indulgence by the Hon'ble Deputy Chairman, Rajya Sabha, CA. K. Rahman Khan with the CA fraternity for all times to come. □

## A Report on Second Session of the Function to Launch Diamond Jubilee Celebrations of ICAI

*Union Finance Minister Mr. P Chidambaram was the Chief Guest at the second session of the function held at Vigyan Bhawan, New Delhi on July 1, 2008 to launch the Diamond Jubilee celebrations of the ICAI. He released a Special Cover of Department of Post to commemorate the occasion. Following is a brief report on the proceedings of this session.*



Welcoming the Hon'ble Finance Minister Mr. P. Chidambaram, the ICAI Secretary Dr. Ashok Haldia recalled that we have just been through a historic moment

when Dr. Manmohan Singh, Hon'ble Prime Minister of India, inaugurated the Diamond Jubilee celebrations. While describing linkage between the growth of Profession to be coterminous with the growth of Indian economy and applauding the Hon'ble Finance Minister for his thrust on Financial Inclusion and percolation of economic reforms to all, he credited the Finance Minister for breaking the vicious circle of economic stagnation and leading the Indian economy to modern era of rapid growth and innovation.



The ICAI President CA. Ved Jain, in his address, stated that Hon'ble Finance Minister is a person who in matters of style swim with the current but in matters

of principle stands like a rock and is an ardent advocate of value system, ethical corporate practices, fiscal discipline and transparency. Tracing the evolution of Indian Accountancy Profession, Mr. Jain stated that ICAI has made available a large number of world class accountants and has been developing high quality financial reporting standards. While highlighting the contributions by ICAI in Taxation regime, he also added that ICAI has been providing inputs to Ministry of Affairs for widening the tax base, increasing tax collections and rationalisation of tax law.



*Union Finance Minister Mr. P Chidambaram releases a Special Cover of Department of Post to commemorate Diamond Jubilee of ICAI at Vigyan Bhawan, New Delhi on July 1, 2008.*



*Union Finance Minister Mr. P Chidambaram with ICAI President CA. Ved Jain, ICAI Vice President CA. Uttam Prakash Agarwal, ICAI Secretary Dr. Ashok Haldia, Secretary, Ministry of Corporate Affairs Mr. Anurag Goel, ICAI Central Council members and other dignitaries on the occasion of the release of Special Cover of Department of Post to mark the ICAI Diamond Jubilee celebrations at Vigyan Bhawan, New Delhi on July 1, 2008.*

He also highlighted the ICAI's initiative of constituting a group to study GST, innovative step of setting up a committee on Public Finance at ICAI to study issues related to resource mobilisation and public expenditure, initiatives relating to Outcome Budget and Sustainability Reporting and Accounting in the Government, Urban and local bodies.

## ICAI has Played a Significant Role in Providing Policy Inputs to Government: P. Chidambaram



Union Finance Minister  
Mr. P Chidambaram addresses the  
gathering.

*Following is the full text of the speech of Hon'ble Finance Minister Mr. P. Chidambaram delivered in the second session of the function organised to launch Diamond Jubilee celebrations of ICAI on 1<sup>st</sup> July 2008 at Vigyan Bhawan, New Delhi.*

"I am very happy to join you in the Diamond Jubilee celebrations of the Institute of Chartered Accountants of India. I extend my best wishes on this occasion to the Institute, its members and students.

The ICAI is a statutory body responsible for regulation and development of profession of Chartered Accountancy. In this process, the Institute not only produces world class Chartered Accountants but also sets the benchmark for high quality of financial reporting for commercial entities. The Institute has also played a significant role in providing policy inputs to the Government in the areas of fiscal reforms, financial sector reforms and public finance. I thank you for the cooperation and support that you have extended to government, especially during my current tenure as Finance Minister, and I look forward to your continued support and advice.

Diamond Jubilee is a solemn yet proud occasion. While the profession at large celebrates its glorious existence over the last 60 years, it is an opportune time to reflect on the past and also plan for the future. I learn that the Institute is organising a conference tomorrow on the theme of "Chartered Accountancy Profession in Retrospect and Prospect". I would urge you to explore the role of the profession in national economic development, particularly on how the accounting profession can support the Central Government in ensuring that outlays are translated into outcomes and the benefits of various programmes actually reach the intended beneficiaries.

The Indian economy has recorded splendid growth in recent years. Simultaneously we have taken measures to reform the tax laws and their administration. This has resulted in substantial increase in resource mobilisation from direct as well as indirect taxes. The tax to GDP ratio had increased from 9.2 per cent in 2003-04, to 12.8 per cent in 2007-08 and is projected to rise to 13 per cent in 2008-09 according to the Budget estimates. However, there is scope for better tax compliance and larger tax revenues. I would, therefore welcome suggestions from the Institute for widening the tax base, increasing voluntary compliance, simplification and rationalisation of tax laws, and enhancing efficiency of tax administration.

Our endeavour is to provide a tax regime that is moder-



ICAI President CA. Ved Jain presents a memento and shield to Union Finance Minister Mr. P. Chidambaram during the function at Vigyan Bhawan, New Delhi on July 1, 2008.

ate, efficient and friendly to the tax payer. As you are aware, we have taken a number of initiatives for streamlining tax administration. The message from our side is simple and clear: those who comply with the tax laws will be treated with courtesy and respect and will be facilitated to pay their taxes; those who evade or violate the tax laws will be tracked down and asked to face the consequences under the law. As Chartered Accountants, you should convey the same message to your clients and advise them that it is in their interest as well as in the interest of the nation that they comply with tax laws.

Government has already announced its decision to introduce Goods and Service Tax by the year 2010. There is considerable progress in preparing a roadmap for introducing the GST. We will value the suggestions that the Institute is able to provide on the approach to introducing the Goods and Service Tax.

Financial inclusion of those who still do not have access to formal sources of finance is a major challenge before us. Chartered Accountants are spread throughout the length and breadth of the country. They can play a vital role in promoting financial inclusion by creating

*“There is scope for better tax compliance and larger tax revenues. I would, therefore welcome suggestions from the Institute for widening the tax base, increasing voluntary compliance, simplification and rationalisation of tax laws, and enhancing efficiency of tax administration.”*

awareness among the people about financial literacy and encouraging them to join the formal financial system. They can educate the masses about micro finance and other innovative initiatives being taken by the Government, NABARD and other institutions.

High quality financial reporting lends credibility to the financial markets. The institute has done commendable work in prescribing Accounting Standards. Ensuring compliance with the Accounting Standards while preparing the financial statements is the responsibility of the management of the enterprise. It is the duty of the members of the Institute to examine whether the Accounting Standards are complied with in the presentation of financial statements covered by their audit. I urge members of the Institute to be diligent in the exercise of their duty because a true and fair presentation of accounts is the basis of good corporate governance and a sound financial information system.

The International Financial Reporting Standards issued by the International Accounting Standards Board are increasingly being recognised as Global Reporting Standards. More than hundred countries, including the countries of the European Union, Australia and Russia, currently require the use of IFRSs in their countries. Countries such as China, Canada and the United States of America have also taken up convergence projects. I compliment the Institute for the efforts made in benchmarking accounting, auditing and ethical standards in India with the International standards and pursuing the programme for full convergence by the year 2011. I request the Institute to also focus on enhancing the capacity of preparers, users and auditors of the financial statements for ensuring effective compliance with the new requirements.

Emergence of a knowledge economy and developments in information technology have redefined world trade and



The session ended with the Vote of Thanks by the **ICAI Vice President CA. Utam Prakash Agarwal** who thanked Union Finance Minister Mr. P. Chidambaram for taking part in the Diamond Jubilee celebrations. He added that the words of wisdom by the Hon'ble Finance Minister has encouraged professional fraternity

commerce. The forces of globalisation are not only breaking down borders but also opening numerous opportunities for Indian Accountants. The profession of Chartered Accountancy should develop the ability to cope with the changing economic and business environment. The domestic accounting firms in India should take up effective capacity building measures in order to equip themselves to face competition from international accounting firms. I commend the Institute for its initiative in taking up Continuing Professional Education (CPE) projects.

Indian Chartered Accountants are considered among the best in the world and are in demand. The Institute should promote movement of accountants and accounting services from India to various parts of the world. The non-tariff and other barriers coming in the way of such cross-border movement should be taken up with countries that impose such barriers. In the ultimate analysis, services such as accounting will – and should – become truly global so that excellence is recognised and rewarded anywhere in the world.

Apart from excellence in the profession, adherence to high ethical standards is also an essential condition for growth and development of any profession. I have been told that ethical standards of the chartered accountancy profession are as stringent in India as in any other country. The true test, however, lies in the application and enforcement of these standards. We cannot have rigorous standards and soft enforcement. There should be a speedy, transparent and participatory method of redressing grievances of clients and customers against the members of the profession. In these matters, perception is as important, if not more important, than the reality. You must do everything to retain the faith and confidence of the people in your profession.

I once again compliment the Institute of Chartered Accountants of India and wish you success in your endeavours.

Thank you.”

*“Financial inclusion of those who still do not have access to formal sources of finance is a major challenge before us. Chartered Accountants are spread throughout the length and breadth of the country.”*

to achieve newer heights. He assured that the Institute will continue to strive for rendering quality services reflecting “Services with Excellence, Independence and Integrity” in every sphere of life in the years to come. He also thanked Mr. P. K. Gopinath, Chief Post Master General, and the Ministry of Communications and Information Technology for having agreed, at a short notice, for the release of a Special Cover on this unforgettable occasion. He assured that the fraternity of Chartered Accountants will take steps and initiatives to further enhance the level and quality of service to the various segments of the society. □

## A REPORT ON DIAMOND JUBILEE CONFERENCE ON

“Chartered Accountancy Profession in Retrospect & Prospect”

*As a part of the overall Diamond Jubilee celebrations of the ICAI, a conference on “Chartered Accountancy Profession in Retrospect & Prospect” was also organised by the ICAI on 2<sup>nd</sup>-3<sup>rd</sup> July 2008 at New Delhi. Given below a brief report on the proceedings of the conference:*

### DAY 1

#### Special Address by CA. K.Rahman Khan, Deputy Chairman, Rajya Sabha



CA. K. Rahman Khan

CA. K. Rahman Khan observed that initially, ICAI had started with 1700 members but now the strength has increased to 1,50,000. There is a need for the profession to be more vibrant and dynamic so that Chartered Accountants can play their role in both traditional as well as new areas.

- Transparency and efficiency in dealings
- Good governance and accountability
- Participation of civil bodies in growth
- Commercialisation of agricultural sector
- Use of Information technology in financial system
- Purchasing power parity-for social sector development
- Reforms in Government accounts especially Public Expenditure

He pointed out some issues, which constantly need to be considered, like,

- Credibility
- Contribution in economic development especially in rural areas

He also noticed that the average rate of growth in developing countries is more than twice the average rate of growth in developed countries. He concluded by stating that proliferation of MNCs requires changes in our approach.

#### Government Accounting Reforms: Approach and Way Forward Key Note Address by Mr. Vinod Rai, CAG of India



Mr. Vinod Rai

Delivering keynote address on “Government Accounting Reforms: Approach and Way Forward”, Mr. Vinod Rai, Comptroller and Auditor General of India dwelt at length on the Government Accounting Reforms Framework. He noted that at present, the Government Accounting is cash based and follows bookkeeping

rules rather than accounting principles. The cash system of accounting is not depicting the full cost of services being provided by the government as well as not capturing the distinction between the capital and revenue expenditure.

He noted the following:

1. The role of the CA profession is commendable in the ongoing process of accounting reforms in urban local bodies. The members of the CA profession would continue to play an important role in the reforming of the accounts of Central Govern-

ment, State Governments and Local Bodies.

2. The Government accounting is lacking in accountability and transparency. Consequently, it is deprived of the benefits of Accrual system of Accounting such as full cost service recovery, strong stewardship, capturing capital and revenue expenditure, accrual based outcome budgeting etc.
3. The complexities in valuation of heritage and defence assets are the concerns for developing standard practices.
4. The practice of signing the internal control statements in U.K. to control risks in internal control environment is to be considered for adoption in India in order to align with the best global practices and thereby ensure public accountability of the government.
5. The government accounting reforms involve a lot of changes in the present accounting and budgeting system of the government. The vision of ICAI would be useful to the government in the government accounting reforms process.

**Key Note Address: Changing Profile of Company Law  
Mr. Anurag Goel, Secretary, Ministry of Corporate Affairs**



Mr. Anurag Goel

The Ministry of Corporate Affairs is responsible for taking into account various day-to-day affairs in Company Law and to bring the legal framework in sync with the environment of today. The vision of Ministry of Corporate Affairs (MCA) is to start a system, which can see the future scenario. As a first step in this direction, it changed its name from "Ministry of Company Affairs" to "Ministry of Corporate Affairs". He said that MCA is to be the leader in corporate reforms with a view to promote and facilitate corporate functioning, investor protection and good governance.

He further explained various initiatives taken by MCA like proper regulation of services, amendment in the respective acts, introduction of vari-

ous bills and notifications, creating disciplinary structure of three professional Institutes i.e., ICAI, ICSI and ICWAI to bring more transparency and establishing Quality Review Board for reviewing of quality, multiple services by professionals, limited liability partnerships, modifying Accounting Standards for true and fair financial reporting to shareholders, enacting Competition Act, making Companies Act, 1956 a compact law for enabling globally competency of the corporates.

He stated that the ICAI and its members are the natural partners of MCA. Chartered accountants would ensure compliance with the law through the procedure of audit. They can bring out the lacunas in the law, which would help the MCA in plugging loopholes. In fact, both share the same vision of ensuring investors' rights and reporting of correct and true picture by the companies.

**Key Note Address: Emerging Competition Regime  
Mr. V. K. Dhall, Acting Chairman, Competition Commission of India**



Mr. V. K. Dhall

The Competition Act actually came into light in 2003 and has been amended in September last year. As per WTO, the Competition Act is the modern economic law. The regulations which the Competition Commission of India (CCI) has posted on its website have been recognised globally.

The Competition Act has been enacted to promote competition, for higher level of efficiency and for greater interest of consumer. There are some kinds of market failures such as Cartels in the form of abuse of dominance, Merger etc in which the

competition does not reach the consumers and main motive is own profit maximisation.

There are broadly four areas on which CCI would work i.e., to prevent and prohibit Anti-Competitive Agreement, to prevent abuse of dominant position, to control merger and to advocate and create public awareness about this Act through Self Compliance Program, Compliance Booklet etc.

CCI needs some prerequisites such as more staff and establishment of Appellate Tribunal. Unfortunately, India is the only large economy in the world, which is without CCI. Chartered Accountants have huge opportunity under the Act because they would find it easier to understand terms prevailing in Competition Act like Predatory Pricing, Cartel etc.

**Theme: Achieving Convergence with IFRSs in Emerging Economies**



CA. Kamlesh Vikamsey

This session was chaired by CA. Kamlesh Vikamsey, President, CAPA. The theme of the session was "Achieving

Convergence with IFRSs in Emerging Economies", an issue whose current relevance cannot be overemphasised. Emerging economies of the world including India are in the process of conver-

gence with IFRSs. CA. Kamlesh Vikamsey's concerns were that these emerging economies should work hard to achieve convergence. The challenges highlighted were: capacity building, preparation and implementation of road map, fair value measurement, taxation issues, regulatory and legisla-

tive changes, and changes required in insurance and banking financial statement formats and, complexity of implementation of Standard on Financial Instruments. He also mentioned that India is the 3<sup>rd</sup> largest economy of the World and thus it should have a representation in IASB.

**“Updating IASB-FASB, Memorandum of Understanding”.**  
**Mr. Wayne Upton, IASB Director (International Activities)**



Mr. Wayne Upton

Mr. Wayne Upton gave a short introduction of the progress and plans of IASB on converging with International Financial Reporting Standards (IFRSs) with special reference to U.S.A. on “Updating IASB-FASB, Memorandum of Understanding”. He also briefly explained his views on International Financial

Reporting Standards for Small and Medium Enterprises (IFRSs for SMEs).

He mentioned about the composition and working of ‘IASB’, ‘FASB’ and detailed the modalities of IASB-FASB Convergence Program which inter alia includes Norwalk Agreement for eliminating differences in existing Standards, SEC 2005 road map for eliminating reconciliations requirements and 2006 MOU regarding replacing weaker Stan-

dards with stronger Standards. He informed that 11 major projects have been identified under the said MOU and the target date of completion of these major projects is stated to be June 2011.

He further stated that top priorities have been assigned to the: Revenue Recognition, Fair Value Measurement Guidance, Consolidation policy, De-recognition, Financial Statement Presentation, Post Retirement Benefits, Lease Accounting and Financial Instruments.

He also informed about the present status of the project on “IFRS for SMEs”. He inter alia told that the title of the proposed Standard will be “IFRS for Private Entities” and this will be fully stand-alone i.e. no cross reference to full IFRS. He also highlighted the benefits of having IFRS for SMEs such as, access to capital, improved quality, comparability, users’ trust building, and ease of burden on SMEs of full IFRS. The case study regarding adoption by South Africa was also presented.

**“Preparing Industry for Compliance”.**  
**Mr. Suresh C. Senapaty, CFO, Wipro Ltd**



Mr. Suresh Senapaty

Mr. Suresh Senapaty reflected the need for convergence in India by identifying the rationale for the same such as confidence in home-market, growing share of global market, ECB, rising corporate profitability.

He explained the reasons for convergence with IFRSs such as need for high quality financial information in a common accounting language, better allocation of risk capital, investors seeking information on financial performance comparable across jurisdictions, lower compliance costs, need for one GAAP for multi-country operations. He said that this will also avoid

costs on converting /reporting under multiple GAAPs and will provide opportunity for qualified professionals to expand into global markets and thus address customers across globe. There will be greater scope of achieving system and process excellence, acceptance by international credit rating agencies & global analysts.

Shri Senapaty also mentioned the current status of convergence in India and also India’s approach to convergence. The differences and issues in Indian GAAP vs. IFRSs were also highlighted.

He also suggested the way forward strategy such as implementing IFRS across organisation vs conversion to IFRS at group level, understanding business impacts, diagnostic review of key differences vis a vis IFRS.

**Role of Accountancy Profession in Anchoring Economic Order.  
Mr. C. Ramachandraiah, Member of Parliament**



CA. C. Ramachandraiah

Member of Parliament and a Chartered Accountant, Mr. C. Ramachandraiah introduced the subject. Delivering his keynote address Mr. Ramachandraiah said a public auditing and accounting system should be there in place on all the governmental expenditure on welfare programmes. He was very critical about the drawbacks in

the implementation of welfare programmes like National Rural Employment Guarantee Programme. He emphasised that the targeted groups are not being benefited from such programmes and public money

is being siphoned. The huge amounts sanctioned for the implementation of these programmes are not being properly utilised. He also welcomed good suggestions from ICAI on this issue. He also criticises the ways in which government accounts are being made. He also sought suggestions for improving accounting practices in the government bodies. He remarked that even in budget presentations there is a lot of window dressing. National accounts also do not give a fair picture of the state of country's affairs. Many items are not shown while calculating fiscal deficit and as a result it is under reported. He requested CAs to come forward and help in improving the government accounting system and cater to the needs of the country.

**India Inc.: Integrating to Global Economy  
CA. Gautam Doshi, Group Managing Director, Reliance ADAG**



CA. Gautam Doshi

Mr Doshi began his presentation with the remark that India is the fastest growing free market democracy. In 1990, we had less than 4.9 per cent growth rate, less than 1 billion dollars of foreign exchange, about 97 million dollars of FDI, per capita income of US \$390 and inflation as high as 9 per cent. In 2008, we have a totally different scenario. The

GDP growth rate has jumped to over 8.7 per cent, foreign exchange reserves have crossed US dollars 300 billion, FDIs stand at more than US \$12.7 billion, per capita income has nearly doubled and inflation rate is more than 11 per cent. India's share in the world exports has improved from 0.7 per cent in 2001 to 1 per cent in 2007. He noticed that with the pace with which Indian economy is growing, it is expected that 2015 onwards, it will outperform the other BRIC economies.

Over a period of time, India's integration with the world economy has strengthened as is evidenced by Tata Steel buying Corus, Hindalco acquiring Novelis, Tata acquiring Land Rover and Jaguar, Essar Steel taking over Algoma Steel. India's remarkable performance has been made possible by economic reforms undertaken by the Indian government since 1991. These reforms embrace almost all the sectors namely industries, taxation, finance and banking, international trade, and power sector. However growth demands more reforms especially in the fields of financial services and FDI. According to Mr. Doshi, insufficient and incomplete reforms are leading to uncertainty and insecurity in the corporate sector. Second generation reforms are needed in Direct Taxes (namely foreign tax credits and underlying tax credits, CFC rules, DTAA interpretation), Indirect Taxes (namely Central VAT and Local and Municipal Octroi), Company Law reforms (bankruptcy, decisions needing government approvals), Labour laws and Accounting reforms (E-governance, IFRS and valuation) etc.

**DAY 2**

**Theme: Diverse Demand, Disciplined Approach  
Special Address: Issues in International Taxation by Dr. R.C. Vaish**



Dr. R. C. Vaish

Dr. R.C. Vaish commenced his speech on international taxation by explaining the concept of quantum physics, which triggered electronic revolution leading to internet and e-commerce. It was thereafter that transactions started taking place

in cyber space and the existing concepts of permanent establishment and business connection became non-workable.

As a consequence of the disparity between the economic order and the tax system, tax havens emerged and business and industry were attracted to these tax havens. He pointed out that shifting of income from a

high tax country to a low tax country is inevitable and in this context, transfer pricing becomes very important.

He also explained that the present trend of cross border merger involves the transfer of ownership itself and not the transfer of wealth. He pointed out that there is an on going tussle between the developing countries and developed countries. Developing countries use tax incentives as an instrument for promoting economic growth. He explained that the tax forgone by the developing

countries is collected by the developed countries. The solution to this problem lies in the harmonisation of tax laws. However, business and industry cannot wait till then. This results in a gap and it is the responsibility of the Chartered Accountants to bridge this gap between "what is" and "what is to be".

He concluded his brilliant speech aptly with a few words of advice to the emerging Chartered Accountants "Young men – Go Global"

### Special Address: Issues in transition to Accrual Accounting in Government Mr. V.N.Kaila, CGA, Government of India



Mr. V. N. Kaila

Mr. V.N. Kaila narrated the accomplishments of his department which included, prompt payment and settlement of claims, timely rendering of accounting information, e-receipts, e-payments and e-Lekha and greater transparency. He discussed that accrual accounting is required in Government bodies due to various reasons like, changing information needs of decision makers, changing concept of accountability, implication of the FRBM Act, and outcome oriented budget, and greater disclosure and transparency requirements. Further, he elaborated the benefits of Accrual Accounting, which include better allocation of resources, better management of assets and liabilities etc.

He also discussed how Government accounting differs from private sector accounting. There are many points of distinction, for example, absence of profit motive in the case of government, Government's

social and national commitments etc. Any new service proposed by the Government requires parliament approval.

There are many issues in transition to accrual accounting in Government, like, how this task can be completed with available resources, what would be the benefits and costs consideration in accrual accounting, whether we should go for accrual budgeting, how soon should the various departments be covered by accrual accounting etc. Referring to the implications of Accrual Accounting, he said that the distinction between Revenue and Capital would have to be revisited with a view to differentiating between revenue expenses and capital items.

There are many other issues also like, who would be the reporting entity (Central Government, State Government), which standards and policies (international standards, standards of other nations, Indian public standards, private sector standards etc.) would have to be followed etc. Keeping accrual accounting simple is another issue involved.

### Accountancy Profession in 2021

In this technical session CA. Ved Jain, President, the Institute of Chartered Accountants of India, welcomed Shri Syed Mohammad Shabbar Zaidi, President, SAFA; Shri Imran Afzal, President, Institute of Chartered Accountants of Pakistan; Shri Mohd. Humayun Kabir, President, Institute of Chartered Accountants of Bangladesh; Mr.S.Rajapakse, Institute of Chartered Accountants of Sri Lanka and Shri Ratnaraj Bajracharya, President, Institute of Chartered Accountants of Nepal.

CA. Ved Jain, President, ICAI discussed the issues regarding the role of small and medium enterprises. He observed that a chunk of the chartered accountants in practice belong to the small and medium category. He also explained as to how services of



Mr. Shabbar Zaidi

the chartered accountants can be networked.

Shri Shabbar Zaidi, President SAFA opined that there would be only one accounting and reporting standard regulating framework by the year 2021. He added that the proportion of women chartered accountants would have gone up considerably by the year 2021. The chartered accountants would be sought after not merely for complying with law but also for strategic planning and planning of financial affairs. Their role would be more focused on tax planning and not merely tax compliance.



Mr. Humayun Kabir

Shri Mohd. Humayun Kabir, President, Institute of Chartered Accountants of Bangladesh opined that by the year 2021, the number of BPOs/ KPOs would significantly increase. Also, networking of the CA profession will increase and affiliation of membership will be spread across many countries.

New challenges will emerge in our profession. Further, forensic accounting will get its due recognition.



Mr. Ratnaraj Bajracharya

Shri Ratnaraj Bajracharya, President, Institute of Chartered Accountants of Nepal congratulated ICAI on celebrating its diamond jubilee year. He said that Institute of Chartered Accountants of Nepal was established in 1977. Presently, there are 7000 registered auditors in Nepal. He explained that the biggest challenge for Institute of Chartered Accountants

of Nepal is to continue to educate those registered auditors.

Mr.S.Rajapakse, from the Sri Lankan Institute strongly suggested that the accounting professionals should be there in the Board of Directors of every company. Defending the profession, he said, the accounting professionals should not remain as mere back room operators. He also called for more reliability in the Financial Statements.



Mr. S. Rajapakse

Responding to the question rose regarding the capturing of businesses by the big 4 firms, CA. Ved Jain answered that the way forward in this regard lies in networking.

Shri Shabbir Zaidi, President SAFA responded to the question on the position of CAs vis-a-vis MBAs in 2021 by answering that the trust reposed on the auditors is unparalleled. CA Ved Jain supplemented the answer by adding that, by the year 2021, CAs will play a predominant role in the economy.

### Changing Profile of CFO

The post lunch session witnessed exciting presentations of three successful Chief Financial Officers respectively from Bharti Airtel Ltd, Jubilant Organosys Ltd. and the software major, Satyam Computer Systems Ltd.

Making a presentation on the Changing Profile of CFOs, Airtel Group Managing Director, CA. Akhil Gupta said, the role of CFOs has undergone significant changes in the recent past. He said that earlier, CFOs were only accountable for results i.e., loss or profit. But, now they have become the most important spokesman of the company to the outside world. Praising the role being played by the ICAI



CA. Akhil Gupta

in imparting training, Mr.Gupta said such high professionalism couldn't be gained from any other stream. Now a days, CFOs are a part and parcel of the business and actively participate in the entire sphere of planning and administration. The quality of professional training provided by ICAI is quite good as it trains people to get fitted easily in the top slot. But we still find people from marketing and other streams being at the top of the helm. He called upon the Chartered Accountants to find reasons for this. Mr.Gupta said perhaps "We are too finance oriented. We are unable to come out of that aspect. This is a serious drawback. If we want to reach the top order, we need have to come

out of the finance structure". The CAs should also change their mindset of remaining only as facilitators. Mr.Gupta also urged ICAI to include more HR and other Management subjects in the CA curriculum.

In his presentation, the CFO of Jubilant Organosys Ltd. Mr. Sankariah described in detail, the role and functions of CFOs. He called upon the CFOs to work in tandem with the CEOs. Calling for a change of strategy of CFOs, Mr. Sankariah put forward a three-way shift in their functioning. They are: -



Mr. R. Sankariah

- (a) Transformation
- (b) Cost and Profit Centre focus
- (c) Decision making system

Mr. Sankariah said that apart from insisting on good corporate governance and practices in the company, the CFO should establish excellent relationship with the investors. He should also play a major role in acquisitions.

Making a power point presentation on the subject, CA. V Srinivas of the Satyam Computer Systems strongly suggested that there should be collabora-



CA. V. Srinivas

tion between ICAI and the Industry. He said that as a CFO, CAs need to take care of entity, propriety and society. He has also suggested the following for the consideration of ICAI: -

- (a) CFO survey
- (b) Online forum for up gradation of skills
- (c) New benchmarks

**Key Note Address: Professionalism as a tool to Economic Growth by Shri Montek S. Ahluwalia, Deputy Chairman, Planning Commission**



Mr. Montek Singh Ahluwalia

Shri Montek S. Ahluwalia congratulated the Institute on its diamond jubilee year. He highlighted the three relevant factors, which are responsible for the growth of the Indian Economy, namely, shift from public to private sector, growth of financial intermediation and growth of capital markets and globalisation.

He opined the chartered accountancy profession has to bring out simplified guides in accounting. He pointed out that the public sector is also gearing up to switch over to commercial accounting. He also highlighted that the role of accounting and standards have become very important in identifying and eliminating risks. He congratulated the Institute for its role in ensuring transparency and aligning its standards with the

global standards. He said that to do well in a global world, we have to follow global standards. In this regard, he explained that globalisation could be interpreted as to how the rest of the world views our financial system.

He emphasised that the ICAI has to chart out a credible approach for globalisation of the profession. Presently, the world economy is passing through an exceptional phase of high prices. He concluded that hopefully, sooner rather than later, the world economy would get back to its normal form.

On this occasion, he also released the book titled "The Accountancy Profession and Economic Development in India", which is an attempt to construct an integrated picture of the monumental work being performed by the Institute as a partner in nation building.



**Accounting Profession-New Challenges, New Opportunities**



Mr. Pramod Bhasin

Two noted journalists and a most successful CEO participated in the last session. Three subjects were presented in the session. The President and CEO, Genpact, Mr. Pramod Bhasin spoke on the subject "Leveraging Knowledge Economy for CA Profession".

He made a power point presentation on the aspects that led to the growth of his company. He explained in detail the strategy of his company for scaling new heights. Winding up the presentation, Mr. Bhasin called upon the urgent need of molding talents for the present day need.



Mr. Dilip Padgaonkar

Introducing the subject, "Imperatives of New Economic Order", eminent Journalist Dileep Padgaonkar stated that India couldn't sustain the high GDP without maintaining a minimum standard in the goods and services. La-

menting on the present day politics, Mr. Padgaonkar said that a sound economy depends upon sound governance. India had survived all the setbacks in the past. The generation change from old to young is remarkable in India. This is our strength. India also outnumbered the rest of the world in the number of youth with professional and other skills, he said.

Speaking on the subject "Perspective on Role of Accounting Profession in National Economic Development", Mr. T.K. Arun, Resident Editor, Economic Times urged the professional Chartered Accountants to go for introspection about their role. He urged the CAs to think about what they can contribute further rather than what they are contributing now. Mr. Arun also called for a mechanism to compensate the farmers who lost their land in the name of industrialisation. The CAs have a major role in making a fair evaluation of the price. He also asked ICAI to understand the gravity of the problem.



Mr. T. K. Arun

## A Panorama of the Institute's Diamond Jubilee Celebrations

The ICAI Diamond Jubilee Celebrations in the national capital had some lighter moments as well. As a prelude to the Diamond Jubilee Celebrations (which were formally launched on 1<sup>st</sup> July, 2008), a marathon was organised from Vijay Chowk, Rajpath to India Gate to promote the cause of environment on June 29, 2008. Thousands of members and students turned out for the event. **Chief Minister of Delhi Mrs. Sheila Dikshit** was the Chief Guest on the occasion.



ICAI President CA. Ved Jain presents a memento to Delhi Chief Minister Mrs. Sheila Dikshit, the Chief Guest at marathon event on June 29, 2008.



A view of marathon organised on June 29, 2008 from Vijay Chowk, Rajpath to India Gate to promote the cause of environment.



Swami Ramdev with ICAI President CA. Ved Jain, ICAI Vice President CA. Uttam Prakash Agarwal and ICAI Secretary Dr. Ashok Haldia at a discourse on 'Lifestyle Management using Yoga & Meditation' on June 29, 2008.

The same afternoon **Swami Ramdevji Maharaj** addressed the Chartered Accountants and their families on 'Lifestyle Management using Yoga & Meditation'. In his discourse, which was coupled with selective bouts of simple rhythmic exercises, Ramdev stressed that in today's world, to live life to the fullest, one needs to eat properly, exercise and have a positive outlook towards life. In a lighter vein, he stated that "health is also like balance sheet ... *thoda mismatch hua to .....health loss*". The health tips given by him on the occasion were very well received by gathering of more than 1000 people on the occasion. He particularly focused on daily dose of small exercises to keep professional stress at bay. An enlightening panel discussion

saw a team of elite doctors having one-to-one exchange of views with Swami Ramdev on medicine and yoga and how the two can supplement each other.

## DIAMOND JUBILEE CELEBRATIONS

The famous **Sharma sisters** performed at a 'Bhajan Sandhya' on 29<sup>th</sup> June 2008. Through their mesmerising rendition of bhajans, they added a spiritual flavour to the celebrations.

On June 30, 2008, a free health check-up camp was organised for the benefit of members and students wherein a team of doctors from Escort Hospital and Mahavir Netra Chikitsalya provided their services to all. Further the Rotary club, Delhi organised a Blood Donation Camp, which received good response from members and students.

The same day, renowned management and motivation guru **Mr. Shiv Khera** addressed a workshop on 'Motivation: Key to Success' for the benefit of Chartered Accountant students. Mr. Khera emphasised on the importance of first setting up clear goals and then directing one's resources to achieve the goals. He stressed that 'winners and achievers always walk the extra mile', and exhorted youths to be actively involved in the world around them and act responsively. The workshop was attended by more than 1000 students.

**Flag Hoisting:** On the 60<sup>th</sup> foundation day of the Institute on July 1, 2008, on which day the ICAI also entered the 60<sup>th</sup> year of its existence, the ICAI President CA. Ved Jain hoisted the flag at the ICAI Headquarters in the presence of Vice President CA. Uttam Prakash Agarwal, Council Members, Northern India Regional Council Members and employees of the Institute. Tributes were also paid to the first president of ICAI Mr. G.P Kapadia.



Management and motivation guru Mr. Shiv Khera at a workshop on 'Motivation: Key to Success' on June 30, 2008.



Mayor of Municipal Corporation of Delhi Ms. Aarti Mehra plants sapling in the Institute headquarters premises on July 1, 2008.

The Diamond Jubilee Celebrations in the national capital had entertainment dimension as well. The delegates and invitees to the Diamond Jubilee Celebrations were enthralled to see live performance by Padmashri **Hema Malini** and her troupe on 1<sup>st</sup> July 2008. The dance performance, which was oriented to Lord Shiva and Maa Durga (Shakti), kept the audience spellbound. A musical night was organised on 2<sup>nd</sup> July 2008 during which noted singers **Ms. Shreya Ghoshal, Mr. Toshi Sabri** and other members of their troupe performed live and rendered latest chart blockbusters to the joy of the audience.

Padmashri Hema Malini performs at Siri Fort Auditorium in New Delhi on July 1, 2008.



## Glimpses of Nation-wide Celebrations

The Institute of Chartered Accountants of India's entry into Diamond Jubilee year was celebrated in various other cities and regions across the country as well. A series of programmes were organised to mark the occasion, which were attended by a host of dignitaries. Following is a brief report on some of such programmes:



**Haryana Governor Dr. A.R. Kidwai** was the Chief Guest at a programme organised by Faridabad branch of NIRC of ICAI on July 5, 2008. Dr. Kidwai said that the future of the Indian Chartered Accountants was very bright as they are one of the best human resources that the country has. He urged the Chartered Accountants to increasingly equip themselves with the global knowledge and required skills in tune with the transition in Indian and world economy, and help national as well as world economy to grow further. He also urged them to continue to stick to high ethical and professional standards for the larger benefit of the society and country.

*ICAI President CA. Ved Jain presents a memento to Haryana Governor Dr. A.R. Kidwai at a programme in Faridabad on July 5, 2008.*

**Tamil Nadu Governor Mr. Surjit Singh Barnala** was the Chief Guest at a programme organised in Chennai by SIRC of ICAI on July 17, 2008, which was attended by more than 850 delegates. Mr. Barnala said the accountants should continuously strive to add value to government initiatives for ensuring good governance and better quality of life for citizens. Eminent columnist CA. S. Gurumoorthy also spoke on the occasion. Some founding members of ICAI from Chennai were also felicitated. Other programmes in Chennai included a 'walkathon' at Marina Beach which was flagged off by Past President of ICAI CA. T.N. Manoharan, a mass 'diabetes prevention & awareness camp' and a meeting on the topic 'Know Your Kidneys'.



*Tamil Nadu Governor Mr. Surjit Singh Barnala with other dignitaries at a programme organised in Chennai by SIRC of ICAI on July 17, 2008.*

**Union Minister for Urban Development Mr. S. Jaipal Reddy** was the Chief Guest at the Diamond Jubilee conference organised at Hyderabad on July 18-19, 2008. In his address, Mr. Reddy appreciated the contributions made by the ICAI in the last 59 years towards the growth of Indian business and economy and in promoting the profession at international level. He welcomed the ICAI's decision to adopt the IFRS with effect from 2011. He also acknowledged that over the years, the Government had been constantly giving recognition to the accountancy profession, and made it a partner in growth of economy. He said that the Institute of Chartered Accountants of India's



*ICAI President CA. Ved Jain with Union Minister for Urban Development Mr. S. Jaipal Reddy at the Diamond Jubilee conference organised at Hyderabad on July 18-19, 2008.*

## DIAMOND JUBILEE CELEBRATIONS

are taken and given due importance in framing various economic and commercial laws in the country. Members of the profession are nominated on the Boards of Public Sector Undertakings Banks, Insurance companies etc. He hailed the ICAI for "restructuring the CA course to make it a world class professional course". He said that without the active involvement and guidance of Chartered Accountants, the growth in Indian business and economy can neither be achieved nor sustain. ICAI President CA. Ved Jain was also present at the conference, which was attended by 2100 delegates from Andhra Pradesh, Maharashtra, Tamil Nadu and Orissa.



Union Minister of State for Home Mr. Sriprakash Jaiswal speaks at a conference on the theme "Blooming Corporates - Blossoming Opportunities" organised by CIRC of ICAI in Kanpur on July 5-6, 2008.

**Union Minister of State for Home Mr. Sriprakash Jaiswal** was the Chief Guest at a conference on the theme "Blooming Corporates- Blossoming Opportunities" organised by Central India Regional Council in Kanpur on July 5-6, 2008. ICAI President CA. Ved Jain, Vice President CA. Uttam Prakash Agarwal and Rajya Sabha member Vinay Katiyar were also present on the occasion. Addressing the gathering, Mr. Jaiswal commended the contribution of Chartered Accountants in the economic development of the Nation and sought their increased involvement in formulation and administration of state economic policies.



Gujarat Chief Minister Mr. Narendra Modi was the Chief Guest at a programme organised as part of the ICAI Diamond Jubilee celebrations at Ahmedabad on July 1, 2008.

**Gujarat Chief Minister Mr. Narendra Modi** was the Chief Guest at a programme organised as part of the ICAI Diamond Jubilee celebrations at Ahmedabad on July 1, 2008. Mr. Modi spoke at length on his vision of Gujarat, the immense present and future opportunities available for CAs in the state, and the role Chartered Accountants could play in the state's development.

He said that the state would be in need of more Chartered Accountants once the Gujarat International Finance Tech (GIFT) city comes up in more than 27,000 hectares of land near Ahmedabad. This project is likely to put Gujarat on the global finance sector map. He added that the state's booming agriculture would also be a new avenue for CAs as their services would be required by farmers who had crossed national boundaries to reach global markets.

## COMPLIANCE WITH ACCOUNTING STANDARD 15 (REVISED) 2005 – AN ACTION PLAN

Considering the quantum and percentage of adjustments made by the companies who have implemented Accounting Standard 15: *Employee Benefits (Revised) 2005* from 1-4-2006, the implementation of this revised standard is a team effort and an elaborate exercise to be understood by everybody concerned. It is also worth referring to the published Financial Statements of the companies who have implemented the AS 15 (Revised). This article attempts to provide an action plan with regard to compliance with Accounting Standard 15 (Revised) 2005.



**N**ational Advisory Committee on Accounting Standards (NACAS) had notified all Accounting Standards issued by Institute of Chartered Accountant of India (ICAI) AS 1 to AS 29 (except AS 8) on 7-12-2006. The rules say that all these Standards would come into effect for accounting year commencing on or after 7-12-2006. As per the provisions of Companies Act, till NACAS notifies, all Standards prescribed by ICAI will be the mandatory Standards. Hence, for the year 2006-07 the Standards issued by ICAI were the mandatory Standards. NACAS has not made any changes in the Standards. But, in the applicability, it has combined level II and level III enterprises as single group. This means all Standards applicable to level II enterprises are also applicable to level III enterprises.

ICAI has originally made AS-15 (Revised) as mandatory for all accounting years com-

mencing on or after 1-4-2006. Considering the notification issued by NACAS, ICAI has also postponed the applicability of AS 15 (Revised) to accounting years commencing on or after 7-12-2006. This means for the Accounting year 2006-07 old AS-15 is applicable.

The notification from ICAI came very late and in the meanwhile many companies for interim financial reporting purpose based on AS-25 have started implementing provisions of AS 15 (Revised) from 1-4-2006. The ICAI encourages early application of a new Accounting Standard. Hence, some companies implemented AS 15 (Revised) with effect from 1-4-2006.

### Formation of a Committee

Considering the quantum of adjustment, it looks as though AS 15 (Revised) has increased scope of coverage, accounting treatment, presentation and disclosures, compared to old AS 15. Therefore, it is more important to have



– CA. L. Venkatesan  
(The author is a member of ICAI. He can be reached at l.venkatesan@hotmail.com)

ICAI has originally made AS-15 (Revised) as mandatory for all accounting years commencing on or after 1-4-2006. Considering the notification issued by NACAS, ICAI has also postponed the applicability of AS 15 (Revised) to accounting years commencing on or after 7-12-2006. This means for the Accounting year 2006-07 old AS-15 is applicable.

an in-depth understanding of various provisions of AS 15 (Revised). The first step is to form a committee, being the first year of implementation, consisting of representatives from Human Resources, Finance, Internal Audit, External Auditors and Actuaries. This will enable smooth implementation of AS 15 (Revised). The Finance people should have two or three meetings with the committee members explaining the provisions of AS 15 (Revised). Similarly the Actuaries should explain the critical factors involved in actuarial valuation so that everybody will understand and participate as a team at the first time implementation.

### Coverage of Employees

The standard does not define the term "Employee". Paragraph 6 of the Standard states that 'an employee may provide services to an enterprise on a full-time, part-time, permanent, casual or temporary basis and the term would also include the whole-time directors and other management personnel. The standard is applicable to all forms of employer-employee relationships. There is no requirement for a formal employer-employee relationship. All relevant factors need to be considered to determine the nature of relationship.

Generally, 'outsourcing contracts' may not meet the definition of employer-employee relationship. However, such contracts need to be carefully examined to distinguish between a "contract of service" and a "contract for services". A 'contract for services' implies a contract for rendering services, e.g., professional or technical services which is subject to limited directions and

control whereas a 'contract of service' implies a relationship of an employer and employee wherein the person is obliged to obey orders in the work to be performed and as to its mode and manner of performance.

Since the coverage is wide particularly one should ensure that state contributions like Provident Fund and ESI are regularly remitted both for temporary and contract workers. The contract in respect of such workers should be studied in detail and clauses relating to Post Employee benefits such as Gratuity etc. have to be properly defined in the contract.

The contracts should specifically make the contractors responsible for all employee benefits. Human Resources Department should assist them in making the contractors to fund the post employee benefits of contract workers as per the practice of the company. Suitable representation should be obtained by the Auditors from the management after duly verifying the records that all the employees liability are taken into account for the purpose of implementation of AS 15 (Revised), including contract workers.

Some of the employees who have left the organisation would not have been paid separation benefits like gratuity, leave encashment etc. While reconciling the number of eligible employees, in the case of left employees suitable inclusion should be made for employees whose settlement is not yet complete and the provisions should cover such employees also. Since obligation in the form liability, fund-

ing etc. is on the employer as per the provisions in AS-29 and AS-15, the termination letter issued to employee should set a time limit making the employee and the employer to settle such benefits in a time bound manner. Human Resource Department should include necessary clauses in the termination letter.

### Identification of Benefits

The Standard covers all the employee benefits:

- Short Term Employee Benefits – payable within 12 months from the end of the financial period.
- Post Employment Benefits such as gratuity, pension, other retirement benefits and post-employment medical care.
- Other long-term employee benefits including long-service award, leave availment and encashment, other long service benefits, long-term disability benefits and deferred compensation – Payable after 12 months.
- Termination Benefits.

All the companies are generally familiar with short term employee benefits, termination benefits such as gratuity, super annuation, provident fund, pension etc. The standard requires identification of other long-term employee benefits including long-term service award, leave-availment and encashment on separation and other long service benefits, long-term disability benefits and deferred compensation. Here, the representative from the Human Resource department should

The Standard does not define the term “Employee”. Paragraph 6 of the Standard states that ‘an employee may provide services to an enterprise on a full-time, part-time, permanent, casual or temporary basis and the term would also include the whole-time directors and other management personnel. The Standard is applicable to all forms of employer–employee relationships.

help in identifying all such benefits, which requires measurement and valuation. Considering the enormous responsibility on the management and taking account the current trends, the employee benefits may be re-defined. The committee should also take into account the major changes during the current year in respect of the following:

- Wage Settlements.
- Introducing Voluntary Retirement Schemes.
- Introduction of any new Employee Benefit plan or any amendment to an existing plan.
- Retrenchments.
- Closure of a section of the enterprise.
- Settlements where an existing obligation has been extinguished by payment of a lump sum, etc.

An example of long-term employee benefits is the grant of relocation expenses from the place of employment to the native place of the employee. Considering the present attrition rate, a number of companies are paying substantial long-term award, incentive and retention bonus. All the benefits should be properly identified by the committee and placed before the audit committee giving the suitable description of the benefits covered. The team should specifically look into informal practices which will result in formal obligation later.

#### Leave Special Considerations

There are generally three types of leave:

- i. Casual leave which cannot be carried forward beyond one year.

- ii. Earned (or Privilege) leave, which can be encashed/ carried forward till separation with certain limits.
- iii. Sick leave that can be carried forward with certain limits but cannot be encashed.

Bifurcation of the above said leaves into Short Term and Long Term Benefit is one of the important elements, while complying with AS 15 (Revised). When leave is expected to be taken within 12 months from the end of the financial period, based on past experience it will fall under short-term benefits and the balance will fall under long-term benefits. Short-term benefits have to be provided at full cost to the company and long-term benefits need to be provided at the encashable value subject to actuarial valuation.

A reading of paragraph 8(b) together with paragraph 7.2 would imply that the classification of short-term compensated, absence should be only when absences have “**fallen due**” and are also “**expected to occur**”. In other words, where employees are entitled to earned leave which can be carried forward to future periods the benefit would be a short term benefit provided the employee is entitled and also encashes/utilises the benefit during the twelve months after the end of the period when he became entitled to the leave and is also expected to do so. Whilst it is necessary to consider the earned leave which “**falls due**”, the pattern of actual utilisation/ encashment by employees, although reflective of the behavioral pattern of employees, does determine the status of the ben-

efit, i.e., whether ‘short term’ or ‘long term’. The value of short-term benefits should be determined without discounting and if the benefit were determined as long term, it would be recognised and measured as “other long term benefits” in accordance with paragraph 129 of the Standard. The categorisation in short-term or long-term employee benefits should be done on the basis of the overall behavioral pattern of all the employees of the enterprise as a group and not on individual basis.

Obligation in respect of unutilised casual leave (CL), as on valuation date has to be valued without discounting again based on behavioral pattern. Using the Last in First Out (LIFO) approach and taking into account the past experience one needs to estimate the provision for CL, which will lapse without giving rise to any liability. The remaining unutilised CL should be valued in full on CTC (cost to company) basis. As far as PL/EL is concerned, only a portion is likely to be encashed/availed within twelve month of the date of valuation. In such cases the whole of such leave may be treated as long term compensated absence in terms of provisions for encashment and dealt with as per the requirement stated in paras 127 – 132 and 49 – 91 (Excluding paras 55 and 61) of AS 15 (Revised).

Enterprises, which offer “sick leave” benefits to their employees, do not usually permit encashment of unavailed sick leave. In other words, sick leave, which has not been availed, usually lapses after the ceiling is reached or on separation.

Therefore, this benefit has to be valued taking into account the probability that a portion of this leave will lapse without giving rise to any liability. Such leave may be valued using actuarial assumptions.

All forms of leave will involve the best estimation of consumption of leave at credit expressed as a percentage-

- a. Availment during service – within 12 months and after 12 months.
- b. Encashment during service – within 12 months and after 12 months.
- c. Encashment on retirement.

The best estimate as to be based on past experience is preferably a three-year moving average. In this respect both Human Resources Department and Finance Department should work closely to arrive at the best estimate.

### Actuarial Valuation

Most part of the Standard discusses the actuarial valuation and its impact in Profit and Loss Account and Balance Sheet. A detailed discussion with Actuaries should help in understanding the actuarial valuation.

Actuarial valuation involves estimating present value obligations payable on exit. This is arrived at by taking into account service up to valuation date multiplied by the projected salary on the date of retirement. This value is discounted using the discount rate – Government Bonds rates of the term, which is equal to estimated balance term at employee service.

The debit to Profit and Loss Account is bifurcated into current service cost, interest cost, past service cost and actuarial losses and gains. In order to arrive at the current service cost, the salary as to be projected up to the date of retirement/exit taking into account promotion and future

salary increases. Here again it should be a joint exercise of both Human Resource Department and Finance Department based on past trend and expected future increases. The interest cost is a new concept and is determined by multiplying the Discount rate by 'Present Value of Obligations (PVO)' at the beginning of the year after adjusting the same for any material changes in the obligation. Past service cost arises only if there is a change in terms of benefit. Actuarial gain and losses represent expected changes in fair value of obligation and asset due to changes in actuarial assumptions and also includes difference between actual interests earned minus the expected return on investment.

One of the important assumptions in actuarial valuation is arriving at the "Attrition rate" of employees. The term attrition rate refers to exit other than death but includes resignation/ill-health retirements/voluntary retirement and any other form of separation coming under this category. A multiple decrement table is constructed taking into account all forms of exit. This table gives probability of exit at each age and at the normal retirement age. This will vary from industry to industry and within industry from company to company. Generally, software companies experience a very high attrition rate. Attrition rate is decided by the enterprise based on past experience and future trends. This should be arrived at after taking into account the past experience, expected future trend and companies policies on Human Resources. Human Resources Department should play a key role in arriving at this rate.

Actuarial valuation involves estimating present value obligations payable on exit. This is arrived at by taking into account service up to valuation date multiplied by the projected salary on the date of retirement.

The Balance Sheet contains the Present Value of Obligations (PVO) of a defined benefit plan. Actuarially determined PVO is the present value of the benefits payable on exit viz, normal retirement or death or resignation or earlier retirement duly using discounted cash flow method using a Discounting Rate. While computing this, one takes into account future projected salary, but service up to valuation date only. This is known as Projected Unit Credit Method. It considers each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up final obligation. The Finance Department plays a major role in arriving at the discount rate which is determined by reference to market yield [as on the relevant balance sheet date] of Government Bonds of term which is equivalent to estimated term of the benefit obligations. This is arrived at by applying a single weighted average discount rate that reflects the estimated timing and amount of benefit payment. This is one of the new requirements and for the first time the discount rate has been de-linked from the yield on invested assets.

The next important figure to be arrived at is the Fair value of the planned asset on the Balance Sheet date. The fair value of plan assets can be defined as the amount at which an asset could be exchanged or a liability settled between knowledgeable willing parties in an arm's length transaction. Where no market price is available, fair value is estimated by discounting expected future cash flows. All Plan Assets are to be valued at its 'Fair value'. This is at variance with the current practice of valuing Plan Assets at cost. The finance people will play a major role in estimating the fair

value of the Plan Assets. Here, one needs to also calculate the expected rate of return at Plan Assets, which refers to average rate of earning expected on the funds invested or to be invested during the year. Since, a lot of estimations are involved, these should be approved by Audit Committee.

### Data Collection

In addition to the above financial data, actuarial valuation requires employee-wise details of Name, Date of Birth, Date of joining, Salary ranking for retirement benefits, Date of retirement, details of leave at credit. In addition to valuation of leave, the salary requires employee-wise availment of leave and encashment for arriving at average as explained above. With the help of actuaries, a proper format should be developed employee-wise for giving necessary particulars to arrive at the valuation. Here, the actuaries play an important role in designing a proper format for giving necessary particulars. Both the Human Resources Department and Finance Department should get involved in completing the format and reconciling the employee numbers at the beginning of the year to the end of the year. One should not forget to give the details of the employees who have left the organisation but whose accounts are not yet settled.

### Transitional Provisions

The enterprises, to which the pre-revised AS 15 was applicable, were required to comply with the provisions of that Standard in the preparation and presentation of the financial statements. In case an enterprise had not created a provision for retirement benefits as per the earlier Standard, the amount of benefit as at the commencement of the financial year when the revised Standard is first

applied would be a prior period item as it represents an omission in the preparation of the financial statements of earlier periods. The amount of such benefits should be charged to the profit and loss account in the period when it is first accounted for and should be dealt with in accordance with AS 15. The enterprise would not be entitled to use the transitional provisions of the revised AS 15 to account for such under-provisioning. The transitional provisions of revised AS 15 can be applied only to those items where the revised Standard requires recognition and measurement for the first time and to changes in the principles of recognition and measurement in the revised Standard as compared to the pre-revised Standard. Errors or changes in actuarial assumption will become current year cost representing actuarial gain or losses for the current year. The transitional provision cannot be utilised to recognise or provide for errors in measurement based on the pre-revised Standard for the periods in which that Standard was applicable.

### Limited Revision To AS – 15 (Transitional Provision)

The ICAI has announced the limited revision to Accounting Standards (AS) 15, *Employee Benefits (Revised 2005)*, with a view to provide the following:

- i. Under the Transitional Provisions, an option has been given to charge additional liability arising upon the first application of the Standard as an expense over a period up to 5 years. On the lines of IAS 19, the Transitional Provisions of revised AS 15 require disclosure of un-recognised amount. If this option is chosen then it cannot be

The enterprises, which offer “sick leave” benefits to their employees, do not usually permit encashment of unavailed sick leave. In other words, sick leave, which has not been availed, usually lapses after the ceiling is reached or on separation. Therefore, this benefit has to be valued taking into account the probability that a portion of this leave will lapse without giving rise to any liability. Such leave may be valued using actuarial assumptions.

reversed during the period of 5 years.

- ii. An entity may disclose the amounts required by Paragraph 120(n) i.e., giving comparative figures for the past four years—as the amount determined for each accounting period prospectively from the transitional date.

This limited revision is published in The Chartered Accountant Journal in December 2007 issue. As per the provisions of Sections 210(A) and 211(3C) of the Companies Act, 1956, this amendment requires the approval of the NACAS and hence may not be applicable to companies to whom Companies Act, 1956 is applicable unless NACAS notifies before the accounts are signed. However, certain Corporations or Banks, to whom the standards issued by ICAI applies, but not the Companies (Accounting Standards) Rules, 2006 and other entities to whom the Standards issued by ICAI apply could take benefit of the above revision. The ICAI may approach NACAS for early notification of this limited revision.

### Provident Fund Trust

Notes to the half yearly accounts of *Infosys Technologies Ltd.* state that: “Accounting Standard Board guidance on implementing AS 15, *Employee Benefits (Revised 2005)* states that the benefits involving employer established provident funds, which require interest shortfall to be compensated, are to be considered as Defined Benefit Plans. Pending the issuance of the Guidance Note from the

Actuarial Society of India, the Company’s actuary has expressed an inability to reliably measure provident fund liabilities. Accordingly, the company is unable to exhibit the related information”.

However, some of the actuaries maintain that the obligation of the enterprise to make good the differential interest is similar to the obligation of the seller of a floor who has to compensate the buyer when the actual rate of interest [on an interest reset date] turns out to be less than the guaranteed rate. The Black’s Model [which is an extension of the Black-Scholes Model for valuing options] is a valuation model that is widely used for valuing the potential obligations associated with an interest rate floor. The Black’s Model provides for the stochastic behavior of future interest rates by assuming that the future interest rates follow a log-normal probability distribution.

*Larsen & Tubro Ltd.* for the year ended 31-3-2007 has valued the provident fund based on actual valuation. However, the surplus value of the present value of the planned assets over the present value obligation has not been recognised in the companies account for the reason that provident fund trust is an irrecoverable trust and surplus cannot be recognised in the books of the accounts as per the provisions of the Provident Fund Act.

*Coromendal Fertilizers Ltd.* on the other hand has given a general note stating the liability has been actually valued and there

has been no deficit. A greater clarity is expected to emerge on this point shortly.

### Role of Audit Committee

The Finance Department should submit a detailed plan of action for implementation of AS 15 (Revised) based on the above discussion. The Audit Committee should particularly approve estimations in the areas of:

- Valuation of liability as at the beginning of the year bifurcating into liability arising out of mistakes in estimation under the old AS 15 and additional liability towards the application of AS 15 (Revised).
- Determination of attrition rate, expected return on planned asset, discounting rate, interest rate.
- Determination of expected increase in salary levels.
- Major changes during inter-valuation period like wage settlement, introduction of voluntary retirement scheme, introduction of any new Employee Benefit Plan or any amendment to an existing plan, retrenchments, closure of a section of the enterprise, settlements where an existing obligation has been extinguished by payment of a lump sum, etc.

Being the first year of introduction, the Actuaries should give a presentation to the Audit Committee explaining the salient points. □

## ACTIVITY BASED COSTING IN SERVICE SECTOR

For service companies, customer profitability is far more important than product profitability because the costs of providing a service product are usually determined by customer behaviour. Activity Based Costing (ABC) helps to find out customer profitability as well as product profitability. ABC is a technique for calculating the expenditure associated with the performance of group of tasks within an organisation. However, one must know when to go in for ABC as it is slightly costly affair as compared to other traditional costing methods. This article delves into the concept.

Service

For service companies, customer profitability is far more important than product profitability because the costs of providing a service product are usually determined by customer behaviour. Take the example of a standard product like a savings/current account. One customer may make very few deposits, withdrawals or balanced and service requests, and use only electronic channels - ATM and Internet. Such a customer imposes low demands on the bank's resources. A second customer, however, may manage her Savings/current account balance very closely, keeping only the minimum amount on hand, and make many in-person branch withdrawals and deposits. This

customer's account may be highly unprofitable under current pricing arrangements. Service companies need to identify the differential profitability of individual customers, even those using standard products. The customer almost completely determines the quantity of demands for the organisation's operating activities, so, unlike manufacturing companies, the variation in demand for organisational resources is much more customer-driven than product-driven. Customer balances or sales volume are poor proxies for profitability. Small-balance customers can be quite profitable and large-balance customers can be highly unprofitable. And to complete the picture, financial service companies need to integrate information about the transfer price of fund



— CA. Venkata Ramani

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When Activity Based Costing is implemented, then every department head will be required to oversee activity costs and he will be on tenterhooks to reduce the costs. He will voluntarily surrender idle assets to improve his bottom-line. He will say: "I have space which I do not need and use, please use it for some other activity."

s and the cost of risk (e.g., loan loss provisions and reserves, and risk-adjusted cost of equity) when calculating individual customer profitability.

Activity based costing (ABC) helps to find out customer profitability as well as product profitability. Before going deep into it, we must know when to go in for ABC as it is slightly costly affair as compared to other traditional costing methods.

The use of volume-based allocations which is traditional one will provide fairly accurate calculated costs when the following conditions exist.

- Few and very similar products and service lines.
- Low overhead expenses.
- Homogeneous processes, channels, customer demands and customers.
- Very very high margins.

How many banks possess those characteristics today? Hardly any.

Five people go to a restaurant. One of them does not want to eat, he orders one cold drink. The others order cocktail drinks, a full meal and a desert. The total bill comes to Rs.5000. Whether this amount will be shared by all? If it is to be shared, then this is the surest way of losing friends. In a sense, ABC is like this. You have to put the resources in the right activity, right pocket. Otherwise, you lose customers.

In Traditional accounting, number of transactions or volume

forms the base for apportioning the total expenses among products. Transaction for a particular activity may be sizeable and for another, it may not be so, for e.g., for opening a cash credit account process, activities are more but for opening one simple savings account, it is simpler on KYC basis. One activity takes much more time and effort as compared to another. So there is differential cost impact.

In another example, a machine manufactures two products. Assuming that the production volume of the two products is the same, using traditional costing methods, the cost of using the costly machine will be factored by two and assigned to the two products. However, this might not be correct as one product might require more processing time in the machine than the other. Traditional costing methods always assume a relation between overhead and the production volume. It always fails to take into account the size or complexity of the product. In reality, it is not safe to assume that the manufactured volume of the final product is directly proportionate to the product cost as not all overheads vary with the number of units produced. With traditional costing methods, there is always a danger of one product subsidising another.

In one more case, a company was having ten products and the advertisement and selling costs are apportioned based on volume of sales. When concerned Sales Manager was interviewed, he was of the view

that he did not labour much for nearly seven products and the orders were automatically coming. Out of the advertisement and selling costs budget, hardly 20% is spent on seven fast moving products. He was compelled to do lot of canvassing only for three products by way of advertisements, personal persuasions, and visuals etc. by spending 80% of budget for pushing up sales. In fact, seven products cross-subsidised the three products.

We can have another good example. We all know that most customers have a better payment history than others. Let's say ABC assessed cost to chase customer payments is Rs.10,00,000 a year and concerned bank have 10000 customers. On traditional cost basis, the cost per customer will be Rs.100. ABC dictates that only customers who pay late cause the costs of "chasing customers for late payment". If 90% of bank customers pay on time, then the remaining 10% alone should receive this cost, i.e., Rs.1000 per customer. Further when we go deep into the details, some customers had to be reminded many times about late payments and hence their share should have been more than Rs.1000 as compared to others. So application of traditional method, which is based on total number of customers and total cost of chasing the customers for payment, affects customer relationship i.e., 9000 customers who do not want to

pay for this activity for which they are not responsible. They will be dissatisfied with this levy though they are right in time for payment. This type of view could not be obtained through traditional costing methods.

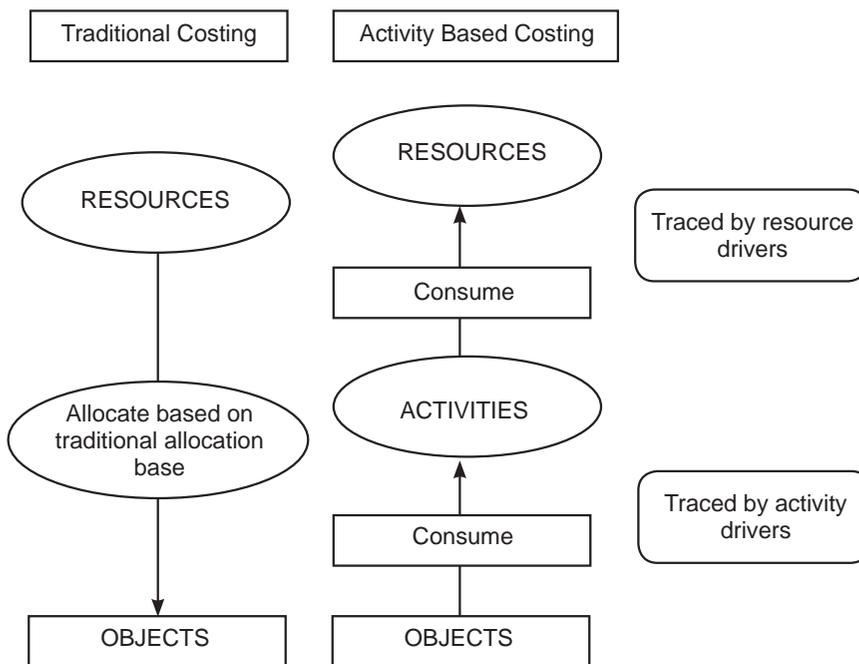
Any sensible marketing man will not sell his product unless he recovers men, material and overhead costs along with some profit. Only in exceptional cases and market catching activities, compromise may be made temporarily on pricing. In the same way, each activity enjoyed by the customer of any firm or bank should pay for the services. Otherwise, in the long run, the firm/bank may incur losses. At least a total income from bundle of complex activities should exceed the cost of the activities though some plus and minuses are there among the activities. Hence ABC is the remedy for this complex business where overhead plays major part and, customers in service sectors are demanding only complex or bundle of products nowadays.

ABC stands out from traditional costing methods especially when:

- Overhead is high,
- Products are complex, and
- Competition is stiff.

Activity Based Costing (ABC) is a technique for calculating the expenditure associated with the performance of group of tasks within an organisation.

- Cost objects consume activities.
- Activities consume resources.
- This consumption of resources is what drives costs.



Activities know no boundaries of department or division as some activities like loans depending on values go to higher levels for sanction. Costs increase or decrease as there are changes in the work load that affect the activity costs via their cost drivers. Work activities are triggered by events and the costs react as the effect.

### Some Definitions

**An Activity** is defined as "a value adding process which consumes resources".

**Cost driver** is "an activity or factor which generates cost", for example, a cost driver could be number of material receipts in the stores department which is measurable or it can be a natural disaster like earthquake or electrical short-circuit fire which cannot be expected or measurable in advance. We are concerned with measurable drivers.

**Resource drivers:** Trace expenditures to work activities.

**Activity drivers:** Trace work activity to cost objects.

An activity driver may be the number of times an activity is performed—transaction driver—or the length of time an activity is performed—duration driver or deep intensive operation-intensity driver.

The traditional report and activity based report are shown in Table A & B. The General Ledger uses a chart of account whereas ABC uses a chart of activities as its language. When you translate those "chart of accounts" expenses into the "chart of activities" that consume the financial general ledger's expenses, a manager's insights from viewing the activity costs begin to increase. His responsibility is defined and he will take interest in showing performance.

ABC is very work-centric whereas the General Ledger is transaction-centric. The General ledger view on the traditional view describes "what was spent" whereas the activity-based view describes "what for it was spent?"

**Traditional Presentation of Costs (Table A)**

Dept: X

Expense Head	Amt in Rs.
Direct Labour cost	2600
Direct material	100
Direct expenses	100
Indirect expenses	500
<b>Total costs:</b>	<b>3300</b>

**ABC Method of Presentation of Costs (Table –B)**

Dept: X

Departmental activities	cost	No. of transactions	Cost/trans (actual Rs)
Sanctioning and opening loan a/cs - term loans	1000	10	100
Sanctioning and opening loan a/cs - project loans	1500	10	150
Follow up of term loans	50	10	5
Follow up of project loans	50	10	5
Transactions in term loans	300	15	20
Transactions in project loans	400	20	20
<b>Total activity costs:</b>	<b>3300</b>		

**Six General Steps to Activity-Based Costing Implementation:**

**1. Identify Cost Centres or Strategic Business Units:** First identify the cost centres or SBU of the banks or service units.

**2. Identify Activities:** First we should conduct an in-depth analysis of the operating processes. Each process may consist of one or more activities required by outputs. Activities may be subdivided into tasks if need be.

Some of the activities in a savings section of a bank which is a service sector are:

- Opening savings account

- Cash collection
- Cheque collection
- Cheque payment
- Electronic payment
- Setting up internet account access
- Cheque issue
- Customer complaint/enquiry processing
- Pass book updating

**Activity Dictionary** is to be made department wise or cost centre wise which will help mapping up all activities and to avoid any overlapping of activities. If this is supported by codes it will help to prepare a software

wherein all costs/revenues can be captured as a routine and for identification activity wise.

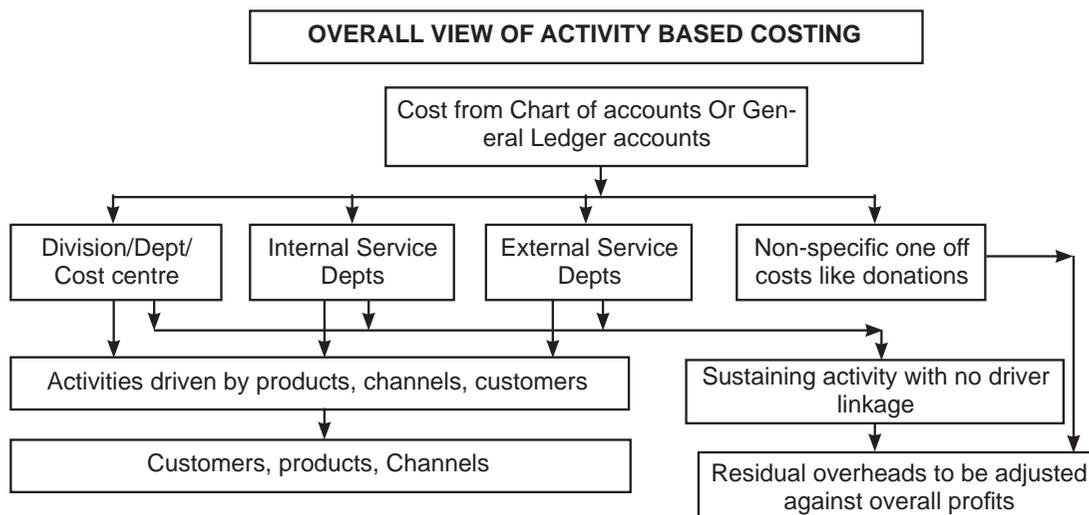
**3. Assign Resource Costs to Activities:** This is also referred to as "tracing," assigning costs to cost objects determines why costs were incurred.

**4. Identify Outputs:** Then we have to identify all of the outputs for which activities are performed and resources are consumed. Outputs can be products, services, or customers-persons or entities to which a bank is required to provide goods or services.

**5. Assign Activity Costs to Outputs:** We can use activity drivers to assign activity costs to outputs based on individual outputs' consumption of or demand for activities. For example, a driver may be the number of times an activity is performed—transaction driver—or the length of time an activity is performed—duration driver or intensity driver, which emphasise about intensity or quality of the product.

**6. Note and Report Unnecessary Activities and Unused Capacity:** We can note down and report unnecessary activities which consume resources but not benefit to customers and growth of bank and also report any underutilised capacity. These can be identified when we look into facets of activities and its importance in value chain of the bank.

For activities, there is one unwritten rule i.e., "It is wise to pay heed to the "5% rule" which states that if any activity which does not account for 5% or more of the department's time, then it should probably be aggregated with another activity". So in a department, there can be maximum of 20 activities.



The mapping is self-explanatory. Using this method of ABC, we can identify costs per activity whether it is inside branch of a bank or in virtual bank like internet banking or in insurance company etc. When customer using these activities can be analysed for costs and these costs can be compared with the revenues they give to the service sector thus profitability per consumer can be worked out. Product profitability is also easy to calculate. The only major problem is to identify the activities properly using cost and activity drivers and assign to products/customers/channel etc. Direct costs can be assigned directly. Only indirect costs can be identified with activities using resource drivers and cost objects like customers, products, channel etc. can be identified with activity drivers.

### What Happens When ABC is Done in Service Sector

When Activity Based Costing is implemented, then every department head will be required to oversee activity costs and he will be on tenterhooks to reduce the costs. He will voluntarily surrender idle assets to improve his bottom-line. He will say: "I

have space which I do not need and use, please use it for some other activity."

Someone will say "I have surplus people, so take them away. I am having machines, I am not using it most of the time, it is inherited, take them away or allow it to be shared with others."

If we see the substitute in banking, it is electronic payments which cost very meagre amount per transaction. It is swift and smart. It is extremely customer centric without seeing the customer in the bank. Customer stay at home and we will look after his interests. At a negligible cost, great personal relationship gained. But of course, chances of cross selling the products are lost. This can be only managed with frequent visits by officers to the residences of good customers because at branch, if valued customer comes, tea or coke offered, bank time is spent for transactions and it also costs the bank. Activity base has converted a deliverable to the bottom-line. If deliverables go to bottom-line which is the least incidence of costs, bank can maximise those transactions with least incidence of cost.

If the electronic data processing mechanism is cheaper for most

of the activities with less manpower, it is better to go for the software. The banks can seek system administrator rather than clerks as customers have to pay high for clerks for improving their competitiveness and cost reduction. ABC helps to identify the areas. Live contacts with customers are also a must as cross selling is catching up to prop up the revenues of the service sectors. So marketing department of service sector should be geared to analyse the customer trends based on ABC and identify the existing good customers where there is chance to cross sell more products. It'll cost you five times more to attract a new customer than it is to bring one of your past customers back to you. It is still cheaper to cross sell to your existing customers. If you're a smart business owner, you'll understand that every cent you invest in advertising is going towards acquiring new customers. You'll also realise that once you've acquired the customers, you just can't afford to let them go.

More banks are now opting for ABC due to its utility in complex product mixing as in banks products are sold as bundles from different segments. □

## ACCOUNTING TREATMENT FOR WIND MILL PROJECT SET UP TO PRODUCE POWER FOR CAPTIVE CONSUMPTION

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

### A. Facts of the Case

1. A public sector undertaking is engaged primarily in the extraction and sale of manganese ore from its mines in two States. It also produces and sells ferro manganese, a value added product at one of its mines in one of the States by using a small quantity of its manganese ore production as principal raw material.

2. The company has recently ventured into generation of electricity by installation of wind turbine generators in one of the States. The company has entered into an agreement with another company (which installed and commissioned the generators) for operating the wind turbine generators by paying operations and maintenance charges.

3. The existing regulations framed by the State Government permitted the company to opt for any one of the following:

- (a) Direct sale of electricity to X State (Western Region) Electricity Distribution Company Ltd., at the rates decided by the regulatory authority.
- (b) Use of the power units generated at the Wind

Mills Project (WMP) for the company's own activities at any other location in State X by transmitting the power generated to grid through the X State (Western Region) Electricity Distribution Company Ltd., and drawing 98% of the units generated from the X State (Eastern Region) Electricity Distribution Company Ltd., for its specified consuming units. In this case, the company enters into an agreement with various arms of the X State Government, viz., (i) X-State (Western Region) Electricity Distribution Company Ltd. (where power is generated), (ii) X State Power Transmission Company Ltd. (through which power is transmitted) and (iii) X State (Eastern Region) Electricity Distribution Company Ltd., (where actual consumption is made).

4. As the company is in a position to get more benefit by way of reduction in electricity bills of consuming units as compared

with direct sale of electricity, the company has opted for (b) above. The company has identified one of its manganese mines and ferro manganese plant as its specified consuming unit. By virtue of the agreement with the above distribution/transmission arms of the electricity companies (hereafter referred to as 'XEDCL'), gross consumption by manganese mine and ferro manganese plant is reduced by actual power generated at the WMP less 2% towards wheeling charges/transmission and distribution losses. Thus, the company gets electricity bills of specified consuming units for net amount payable to XEDCL.

5. Further, if the actual consumption at the consuming units is less than the units generated at the WMP, the reduction in power units is restricted to actual consumption at the consuming units. The additional units generated, termed as "inadvertent flow", are compensated at a specified fixed rate per unit by the distribution company.

6. The querist has stated that although the revenue generated from the project is not substantial in relation to the total turnover of the company, the investment in the project is more than 10% of its gross block of

assets. In view of this and the fact that the risks and rewards of the new venture are different from that of the existing business, the company considers the WMP as a separate reportable segment.

7. The querist has stated that the company considers the following accounting treatment and presentation to be appropriate and in line with the accounting standards:

- (i) Since the ultimate consumers are units of the company itself, the transaction shall not be termed as 'sale of electricity'.

Consumption of products of one of the units by other units, commonly referred to as 'captive consumption', is generally charged to other units as the cost of production of the producing unit. However, in this case, the revenue generated from the project shall be disclosed separately under the heading 'other income' in the profit and loss account for the following reasons—

- (a) The reduction allowed in electricity bills by XEDCL towards units generated at WMP, which otherwise would have been charged to consuming units at normal power tariff rates, represents gain realised

'in cash' as distinguished from a mere book adjustment.

- (b) Power generated by the company goes into the grid and loses its identity there itself (as distinguished from a case where the same commodity is transported to another location).
- (c) Power generating/consuming company, power receiving company and power distributing company are three different legal entities involved in the transaction and a third party (XEDCL) is quantifying the value of electricity generation.

In view of the above, the net reduction in electricity charges of the two divisions, i.e., ferro manganese plant and manganese mine, equal to the value of credit given by XEDCL in its monthly bills, shall be treated as revenue generated from the project. Further, in the event of generation at WMP exceeding the consumption at consuming units, amount credited by XEDCL in electricity bills shall also be treated as revenue generated from the project and shall also be treated as 'other income'.

The querist has furnished a statement containing extracts from the electricity bill for November 2006 for the perusal of

the Committee to explain the methodology. As against the gross bill of Rs. 39,14,579, the company is required to pay only Rs. 26,85,455 thus resulting in reduction of Rs. 12,29,124 towards power generation at WMP. This sum of Rs. 12,29,124 shall be treated as revenue generated from the project.

Separate accounting of 2% wheeling charges on expenditure side, by grossing up revenue, is not considered necessary because the reduction is made by XEDCL at generation point and accounting on expenditure side will pose difficulty in allocation of the charges to consuming units.

- (ii) Operations and maintenance charges are payable after a specified period at agreed rate per machine on annual basis. Besides this, administrative expenses like rates and taxes, inspection fees, etc., are to be borne by the company right from the first year of operation. All the above expenses shall be disclosed separately in the profit and loss account as expenditure of wind mills division.
- (iii) Depreciation on WMP assets shall be indicated separately below the fixed assets schedule in line with the practice followed by the company in respect of manufacturing units.
- (iv) Ferro manganese plant and mine will not

be charged with actual cost of generation of electricity at WMP because (a) these units continue to consume the same quantity of power (b) the credit given by the XEDCL in electricity bills of these units towards electricity generation at WMP represents gain realised in cash, (c) power generating/consuming company, power receiving company and power distributing company are three different legal entities involved in the transaction and a third legal entity (XEDCL) is quantifying the value of electricity generated and (d) profit centre concept does not permit such an adjustment.

In view of the above, the company shall also value stock of manganese ore and ferro manganese by considering gross cost of power at these power consuming units without deduction of credit given by XEDCL in electricity bills.

- (v) Net profit from operating wind mills, after deducting operational/administrative expenses and depreciation, shall be disclosed in segment reporting and memorandum profit and loss account separately.

### B. Query

8. In view of the above, the querist has sought the opinion of the Expert Advisory Committee specifically on the issue of the treatment of reduction in electricity bills on account of credit given by XEDCL in electricity bills towards generation of electricity at wind mills division.

### C. Points considered by the Committee

9. The Committee notes from paragraph 8 above that the querist has raised the issue only with respect to the treatment of reduction in electricity bills on account of credit given by XEDCL in the electricity bill towards generation and supply of electricity by the company through its wind mill division. The Committee has, therefore, considered only this issue and has not considered or touched upon any other issue arising from the Facts of the Case, such as, segment reporting for wind mill division, treatment of various expenses of the wind mill division, disclosure of depreciation on the assets of the wind mill division, etc.

10. The Committee notes from the Facts of the Case that the company is not selling the power generated at its wind mill division. Rather, the company is using the power generated at the wind mill division for the company's own activities at another location. For this purpose, the company is transmitting the power generated through a distribution company. The extracts from the agreement with the distribution company furnished

by the querist also indicate that the power is being transmitted by the company to the distribution company for its self-use only. For this purpose, wheeling charges in the form of 2% of the energy fed into the system by the company, are paid to the distribution company. Thus, the company is drawing only 98% of the energy fed into the system for its self-use at a different location. The energy drawn above this limit is charged to the company separately. In case, a lesser quantity of energy is drawn by the company, the company is compensated for the excess units generated at specified rates. The Committee notes that the distribution company in the electricity bill sent to the company shows charges for the full energy drawn by the company and then gives a credit for 98% of the energy that was actually fed into the system by the company itself. The Committee is of the view that this is only a manner of disclosure in the electricity bill. It does not amount to sale and purchase of energy to and from the distribution company. Thus, the Committee is of the view that the energy drawn by the company for its self-use is only an inter-divisional transfer from the wind mill division to its consuming divisions, though at a different location.

11. The Committee notes that the querist has argued in paragraph 7 above that the net reduction in electricity charges of the consuming divisions equivalent to the 98% of the energy fed into the system by the company by its wind mill division, should be treated as revenue

generated by the wind mill division. In this context, the Committee notes the definition of the term 'revenue' as per Accounting Standard (AS) 9, 'Revenue Recognition', which is reproduced below:

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

The Committee is of the view that as per the definition of the term 'revenue' as reproduced

above, inter-division transfers do not constitute revenue. The Committee further notes that as per an Announcement issued by the Institute of Chartered Accountants of India in the year 2005, titled 'Treatment of Inter-divisional Transfers', transfers within an enterprise cannot be considered as fulfilling the definition of the term 'revenue'.

12. The Committee also notes that the reduction in the electricity bills of the consuming units does not constitute 'income' for the company. In this context, the Committee notes that the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, defines the term 'income' as "increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants". The Committee is of the view that selling to itself does not result in enhancement of assets and, therefore, the reduced electricity bills do not fit into the definition of the term 'income' as above. Accordingly, it is not appropriate to present the same as 'other income'.

13. The Committee is of the view that the expenditure incurred by the wind mill division together with the electricity charges paid by the consuming divisions to the distribution company for excess electricity drawn, would represent the cost on account of electricity charges of the consuming divisions. Thus, no separate accounting entries need be passed for the saving in cost towards electricity charges. However, it may be noted that to the extent of the 'inadvertent flow' of electricity to the XEDCL (referred in paragraph 5 above), the compensation received towards the same would be treated as sale of electricity and appropriately disclosed in the profit and loss account.

#### D. Opinion

14. On the basis of the above, the Committee is of the opinion that the accounting treatment suggested by the querist for the reduction in the electricity bills on account of credit given by the distribution company in electricity bills towards generation and supply of electricity by the wind mill division, is incorrect. The correct treatment would be as given in paragraph 13 above. □

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

## NOTIFICATIONS AND CIRCULARS

### Significant Notifications/Circulars Issued during the Month of May-June, 2008

#### A. DIRECT TAXES INCOME-TAX ACT

##### I. Notifications

##### 1. Notification No. 70/2008-FTD, dated 18-06-2008

The Central Board of Direct Taxes has through this Notification clarified that agreement between the Government of the Republic of India and the Government of the Republic of Botswana for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income shall be given effect to in the Union of India with effect from 01-04-2009.

For Details visit:

[http://law.incometaxindia.gov.in/DitTaxmann/Notifications/IncomeTaxAct/2008/notf70\\_2008.htm](http://law.incometaxindia.gov.in/DitTaxmann/Notifications/IncomeTaxAct/2008/notf70_2008.htm)

#### B. INDIRECT TAXES EXCISE

##### I. Notifications:

**1. Notification No. 23/2008 CE (NT) dated 23.05.2008** has amended rule 17 of the Central Excise Rules, 2002 to provide that in case of removal of excisable goods from 100% export oriented undertaking to domestic tariff area, the duty leviable on such goods shall be paid by utilising the CENVAT credit or by crediting the duty payable to the account of the Central Government in the manner specified in rule 8. Thus, duty can be paid monthly in case of removals from 100% EOUs also.

Further, sub-rule (4) has been inserted in rule 17 to provide that the proper officer may on the basis of information contained in the return filed by the unit under sub-rule (3), and after such further enquiry as he may consider necessary, scrutinise

the correctness of the duty assessed by the assessee on the goods removed, in the manner to be prescribed by the Board.

Sub-rule (5) has also been inserted to provide that every assessee shall make available to the proper officer all the documents and records for verification as and when required by such officer.

The above amendments shall be effective from 01.06.2008.

For Details visit:

<http://www.cbec.gov.in/excise/cx-act/notfns-2k8/cent23-2k8.htm>

**2. Notification No. 24/2008 CE(NT) dated 23.05.2008** has prescribed a new monthly return [Form ER-2] for hundred percent export-oriented undertakings in respect of goods manufactured, goods cleared and receipt of inputs and capital goods.

For Details visit:

<http://www.cbec.gov.in/excise/cx-act/notfns-2k8/cent24-2k8.htm>

##### II. Circulars:

**1. Circular No. 868/6/2008-CX dated 09.05.2008** has clarified certain issues in respect of amendments made in rule 6 of CENVAT Credit Rules, 2004.

For Details visit:

<http://www.cbec.gov.in/excise/cx-circulars/cx-circulars-08/868-2008-cx.htm>

**2. Circular No. 869/07/2008 CX dated 16.05.2008** has been issued to prescribe a procedure relating to sanction and post-audit of refund/rebate claims.

For Details visit:

<http://www.cbec.gov.in/excise/cx-circulars/cx-circulars-08/869-2008-cx.htm>

**3. Circular No. 870/08/2008-CX**

**dated 16.05.2008** has withdrawn Circular No. 599/36/2001-CX dated November, 2001 wherein the issue of the applicability of the provision of section 11D of the Central Excise Act, 1944 in cases of payments made under erstwhile rule 57CC (1) of the Central Excise Rules, 1944 was examined. The said circular has been withdrawn in view of some decisions of the Tribunal contrary to the said circular and amendments made in rule 6 of the CENVAT Credit Rules, 2004.

For Details visit:

<http://www.cbec.gov.in/excise/cx-circulars/cx-circulars-08/870-2008-cx.htm>

#### CUSTOMS

##### I. Notification:

**1. Notification No. 64/2008 Cus. (NT) dated 29.05.2008** has amended rule 3 of the Customs, Central Excise Duties and Service Tax Drawback Rules, 2008 to provide that no drawback shall be allowed on any of the goods falling within Chapter 72 or heading 1006 or 2523 of the First Schedule to the Customs Tariff Act, 1975. Rule 6 and rule 7 have also been amended to provide that no amount or rate of drawback shall be determined in respect of any of the goods falling within Chapter 72 or heading 1006 or 2523 of the First Schedule to the Customs Tariff Act, 1975.

For Details visit:

<http://www.cbec.gov.in/customs/cs-act/notifications/notfns-2k8/csnt64-2k8.htm>

##### II. Circular:

**1. Circular No.7/2008-Cus dated 28.05.2008** has been issued in respect of sanction of customs duty refunds. It has been clarified that in terms of sub-section (2) of section 27,

the concerned Assistant/Deputy Commissioner of Customs has to go through the facts of the case and the material placed before him in order to determine whether the amount claimed by an applicant is refundable to him or not. Further, the Assistant/Deputy Commissioner of Customs should go through the details of audited balance sheet and other related financial records, certificate of the Chartered Accountant etc., submitted by the applicant in order to decide whether the applicant had not passed on the incidence of the duty and interest thereon, if any, to any other person. The Order-in-Original passed by the Assistant/Deputy Commissioner of Customs in the adjudication process should be a speaking order providing specific details including the relevant financial records that are relied upon to arrive at a conclusion whether the burden of duty or interest, as the case may be, has been passed on or not.

Refund orders issued in a routine and casual manner thereby sanctioning the amount but crediting the same to the Consumer Welfare Fund without going through the factual details of the case and the due process as provided in the first proviso cannot be considered as a complete and speaking order.

For Details visit:

<http://www.cbec.gov.in/customs/cs-circulars/cs-circulars08/circ07-2k8-cus.htm>

## SERVICE TAX

### I. Notifications:

**1. Notification No. 18/2008 ST dated 10.05.2008** has notified 16.05.2008 as the date on which the services introduced by the Finance Act, 2008 would become effective. Further, the amendments made in the existing service vide the Finance Act, 2008 would also become effective from 16.05.2008.

For Details visit:

<http://www.servicetax.gov.in/notifications/notfns-2k8/st18-2k8.htm>

**2. Notification No. 19/2008 ST dated 10.05.2008** has made the following amendments in Service Tax Rules, 1994:

(i) in rule 4A, for the words "to a customer" wherever they occur, the words "to any person" have been substituted with effect from 16.05.2008;

(ii) in rule 4B, for the words "to the customer", the words "to the recipient of service" have been substituted with effect from 16.05.2008;

(iii) in rule 6, -

(a) in sub-rule (1), after the third proviso, the following Explanation has been inserted, namely:

*"Explanation.* - For the removal of doubts, it is hereby declared that where the transaction of taxable service is with any associated enterprise, any payment received towards the value of taxable service, in such case shall include any amount credited or debited, as the case may be, to any account, whether called 'Suspense account' or by any other name, in the books of account of a person liable to pay service tax."

(b) after sub-rule (7A), sub-rule (7B) has been inserted with effect from 16.05.2008. Sub-rule (7B) provides that the person liable to pay service tax in relation to purchase or sale of foreign currency, including money changing, provided by a foreign exchange broker, including an authorised dealer in foreign exchange or an authorised money changer, referred to in sub-clauses (zm) and (zzk) of clause (105) of section 65 of the Act, shall have the option to pay an amount calculated at the rate of 0.25% of the gross amount of currency exchanged towards discharge of his service tax liability instead of paying service

tax at the rate specified in section 66 of Chapter V of the Act.

However, such option shall not be available in cases where the consideration for the service provided or to be provided is shown separately in the invoice, bill or, as the case may be, challan issued by the service provider.

#### *Illustration*

Buying rate \$US 1 = Rs.38, selling rate \$US 1 = Rs.40

(i) Person exchanged \$100 for equivalent rupees

Transaction value = Rs.3800  
(Rs.38 x 100)

Service tax payable = Rs. 9.5  
(0.25% x 3800)

(ii) Person exchanged equivalent rupees for \$100

Transaction value = Rs.4000  
(40 x 100)

Service tax payable = Rs. 10  
(0.25% x 4000).

For Details visit:

<http://www.servicetax.gov.in/notifications/notfns-2k8/st19-2k8.htm>

**3. With effect from 16.05.2008, Notification No. 20/2008 ST dated 10.05.2008** has made the following amendments in sub-rule (1) of rule 3 of the Export of Services Rules, 2005:

(a) in clause (ii), for the brackets, letters and word "(zzzf) and (zzzp)", the brackets, letters and word "(zzzf), (zzzp), (zzzzg), (zzzzh) and (zzzzi)" have been substituted;

(b) in clause (iii), after the proviso, the following proviso has been inserted, namely:-

"Provided further that where the taxable service referred to in sub-clause (zzzzj) of clause (105) of section 65 of the Act is provided to a recipient located outside India, then such taxable service shall be treated as export of taxable service subject to the condition that the tangible goods supplied for use are located outside India during the period of use of such tangible

goods by such recipient.”

For Details visit:

<http://www.servicetax.gov.in/notifications/notfns-2k8/st20-2k8.htm>

4. With effect from 16.05.2008, **Notification No. 21/2008 ST dated 10.05.2008** has made the following amendments in rule 3 of the Taxation of Services (Provided from Outside India and Received in India) Rules, 2006:

(a) in clause (ii), for the brackets, letters and word “(zzzf) and (zzzp)”, the brackets, letters and word “(zzzf), (zzzp), (zzzzg), (zzzzh) and (zzzzi)” have been substituted;

(b) in clause (iii), the following proviso has been inserted at the end, namely: -

“Provided that where the taxable service referred to in sub-clause (zzzzj) of clause (105) of

section 65 of the Act is received by a recipient located in India, then such taxable service shall be treated as taxable service provided from outside India and received in India subject to the condition that the tangible goods supplied for use are located in India during the period of use of such tangible goods by such recipient.”

For Details visit:

<http://www.servicetax.gov.in/notifications/notfns-2k8/st21-2k8.htm>

5. With effect from 16.05.2008, **Notification No. 22/2008 ST dated 10.05.2008** has made the following amendments in *Notification No.1/2006 ST dated 01.03.2006*, which prescribes various abatements in respect of certain taxable services specified therein:

In the said notification, Table, -

(i) in case of mandap keeper services, for the words “to the client”, the words “to any person” have been substituted;

(ii) in case of convention services, where service provided includes catering service, for the words “client”, the words “recipient of service” have been substituted;

(iii) in case of erection, commissioning or installation service, for the words “customer”, the words “recipient of service” have been substituted.

For Details visit:

<http://www.servicetax.gov.in/notifications/notfns-2k8/st22-2k8.htm>

6. With effect from 16.05.2008, **Notification No. 23/2008 ST dated 10.05.2008** has amended the following notifications in the manner given below:

S. No.	Notification No. and date	Amendments
1.	18/2002 ST dated 16.12.2002: It exempts the taxable services provided by a consulting engineer to a client on transfer of technology from so much of the service tax leviable thereon as is equivalent to the amount of cess paid on the said transfer of technology under the provisions of Section 3 of the Research and Development Cess Act, 1986.	In the said notification, for the words “to a client”, the words “to any person” shall be substituted.
2.	33/2004 ST dated 03.12.2004: It exempts the taxable service provided by a goods transport agency to a customer, in relation to transport of fruits, vegetables, eggs or milk by road in a goods carriage, from the whole of service tax leviable thereon.	In the said notification, for the words “to a customer”, the words “to any person” shall be substituted.
3.	34/2004 ST dated 03.12.2004: It exempts the taxable service provided by a goods transport agency to a customer, in relation to transport of goods by road in a goods carriage, from the whole of service tax where-xxxx	In the said notification, for the words “to a customer”, the words “to any person” shall be substituted.

For Details visit: <http://www.servicetax.gov.in/notifications/notfns-2k8/st23-2k8.htm>

7. With effect from 16.05.2008, **Notification No. 24/2008 ST dated 10.05.2008** has amended *Notification No.41/2007 ST dated 06.10.2007*, which exempts certain specified taxable services received by an exporter and used for export of goods. The following services received by an exporter and used for export of goods have also been exempted vide this notification subject to fulfillment of conditions specified therein: -

(1) Services of purchase or sale of foreign currency, including money changing provided to an exporter in relation to export goods [Section 65(105)(zm)].

(2) Services of purchase or sale of foreign currency, including money changing provided to an exporter in relation to export goods [Section 65(105)(zzk)].

(3) Services of supply of tangible goods for use, without transferring right of possession and effective control of tangible

goods, provided to an exporter in relation to goods exported by the exporter [Section 65(105)(zzzzj)].

For Details visit:

<http://www.servicetax.gov.in/notifications/notfns-2k8/st24-2k8.htm>

8. **Notification No. 27/2008 ST dated 27.05.2008** has amended *Notification No. 1/2006 ST dated 01.03.2006* so as to provide an abatement of 30% in case of services provided in relation

to chit from the gross amount charged for such service. Chit has been defined to mean a transaction whether called chit, chit fund, chitty, kuri, or by any other name by or under which a person enters into an agreement with a specified number of persons that every one of them shall subscribe a certain sum of money (or a certain quantity of grain instead) by way of periodical installments over a definite period and that each subscriber shall, in his turn, as determined by lot or by auction or by tender or in such other manner as may be specified in the chit agreement, be entitled to the prize amount.

For Details visit:

<http://www.servicetax.gov.in/notifications/notfns-2k8/st27-2k8.htm>

**9.** With effect from 01-07-2008 **Notification No. 28/2008 ST dated 04.06.2008** have introduced the Dispute Resolution Scheme Rules, 2008. As per this Rules the declaration, under section 94, in respect of tax arrears and the amount payable under the Scheme shall be made in Form 1 and the certificate under sub-section (2) of section 96, stating full and final settlement of tax arrears, shall be issued in Form 2.

For Details visit:

<http://www.servicetax.gov.in/notifications/notfns-2k8/st28-2k8.htm>

**10. Notification No. 29/2008 ST dated 26.06.2008** has exempts the taxable service of supply of a goods carriage, without transferring right of possession and effective control of such goods carriage, referred to in sub-clause (zzzzj) of clause (105) of section 65 of the Finance Act.

For Details visit:

<http://www.servicetax.gov.in/notifications/notfns-2k8/st29-2k8.htm>

## II. Circulars:

### 1. **Circular No. 101/4/2008-ST dated 12-05-2008**

The notification No. 41/2007-ST, dated 6/10/2007 allows refund of service tax paid on specified services used for export of goods. This notification stipulates that a merchant exporter shall file the claim of refund to the Assistant Commissioner/Deputy Commissioner of Central Excise having jurisdiction over the registered office or the head office. *Vide* Circular No. 101/4/2008-ST dated 12-05-2008 the Central Board of Excise & Customs clarified that refund claims can be filed from any premises/office of a merchant exporter provided the same is registered for service tax purposes under the Finance Act, 1994 or rules made thereunder. However, even in such cases, if the merchant exporter so desires, he may file refund claim at the location where his head office/registered office is located.

For Details visit:

<http://www.servicetax.gov.in/circulars08/st-circ-101-2k8.htm>

### 2. **Circular No. 102/5/2008-ST dated 04-06-2008**

The Central Board of Excise & Customs *Vide* Circular No. 101/4/2008-ST dated 12-05-2008 issued Guidelines in respect of the Dispute Resolution Scheme, 2008. The Dispute Resolution Scheme Rules, 2008 have been issued vide notification No. 28/2008-ST, dated 4.6.2008. This compounding scheme has been notified as a one-time measure for quick resolution of disputes (a) involving small service tax amounts upto Rs 25000; and (b) involving non-recovery of penalty or interest. However, cases involving non-payment of service tax after having collected the same from client/customer are not included in the Scheme.

The salient features of this Scheme are as follows:

(i) The Scheme covers all such cases where tax arrears, including interest and penalty, were payable or leviable under the Finance Act, 1994, but not paid prior to 1.3.2008 and where a Show Cause Notice/order has been issued on or before 1.3.2008.

(ii) This Scheme would be in operation from 1.7.2008 to 30.9.2008. The benefit, concession or immunity under the Scheme would only be available in respect of the case in respect of which declaration is made under the Scheme within this period;

(iii) The Scheme shall not apply to (a) any show cause notice or order issued under section 73A of the Finance Act, 1994, i.e., cases involving non-payment of service tax after having collected the same from client/customer; and (b) any case where tax arrears includes service tax amount of more than Rs 25,000;

(iv) The order passed under the Scheme would be conclusive and would not be subjected to any appeal. Any pending appeal in the matter shall stand withdrawn. In such cases where the declarant has pursued a petition in a court of law, he shall withdraw such petition for availing benefit of this Scheme in respect of such matter;

(v) The amount paid under the Scheme would not be refundable under any circumstances;

(vi) The Central Government shall have power to make rules to implement this Scheme as well as for removal of difficulties for implementation of this Scheme.

For Details visit:

<http://www.servicetax.gov.in/circulars08/st-circ-102-2k8.htm>

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

### A. DIRECT TAXES

#### Recovery of Debts

***1. Agricultural lands owned by partners of appellant firm had been attached and sold in public auction following entire procedure for recovery of debts. Whether revenue was justified?***

**Janatha Textiles and Others vs Tax Recovery Officer and Another (SC) 16 May 2008**

The appellant is a registered firm with four partners. The firm and its partners were in arrears of tax. The agricultural lands owned by the partners of the appellant firm had been attached and sold in public auction after following the entire procedure laid down under second schedule to the Income Tax Act, 1961. No procedural irregularity or illegality in public auction process was even alleged by the appellants. The appellants never complained about fixing of the reserve price before holding of auction, though they were intimidated of the same through sale proclamation. Later, the appellants contended that the land was of higher value than the price at which it was auctioned.

It is established principle of law that third party auction purchaser's interest in the auctioned property continues to be protected notwithstanding that the underlying decree is subsequently set aside or otherwise.

After going through the facts of the case the Supreme Court observed that law makes a clear

distinction between a stranger who is a bona fide purchaser of the property at an auction sale and a decree holder purchaser at a court auction. The strangers to the decree are afforded protection by the court because they are not connected with the decree. Unless the protection is extended to them, court sales would not fetch market value or fair price of the property.

Upholding the order of the High Court, the Supreme Court dismissed the appeal.

#### Agricultural Income

***2. Income from 'tea grown and manufactured' business, the income shall be computed in accordance with provisions of the Income-tax Act, 1961 by the Assessing Officer under the 1961 Act and 40% of the income is taxable under the 1961 Act and 60% income is taxable under the Bengal Agricultural Income Tax Act, 1944 by the State treating it as income from agriculture***

**UOI and Another vs Belgachi Tea Company Limited and Others (SC) 9 May 2008**

The assessee is a public limited company carrying on the composite business of growing and manufacturing tea in the district of Darjeeling. The assessee company has tea gardens, which consists of the gardens and a factory for manufacture of tea. The assessee company sells the tea grown and manufactured in the tea gardens. The

income from such business has been assessed all along under the provisions of Income Tax Act, 1961 (1961 Act). The claim of the assessee company is that the entire income should be assessed under the provisions of the 1961 Act and after the income is assessed, the tax should be charged on 40% of such income under the 1961 Act and on the balance 60%, the State can tax under the Bengal Agricultural Income Tax Act, 1944 (1944 Act).

The Supreme Court observed that a combined reading of Rule 8, Income Tax Rules, 1962 and Section 8 of the 1944 Act and its amendment by insertion of sub-Section (1A) in Section 8 of the 1944 Act left no doubt that the income from 'tea grown and manufactured' business, the income shall be computed in accordance with provisions of the 1961 Act by the Assessing Officer under the 1961 Act and 40% of the income is taxable under the 1961 Act and 60% income is taxable under the 1944 Act by the State treating it as income from agriculture.

The Court observed that for the purpose of computation of income under the 1961 Act, it should be the mixed income from 'tea grown and manufactured' by the assessee. As the income from sale of green tea leaves is purely income from the agricultural product, there is no question of taxing it as incidental income of the assessee when there is a specific provi-

<sup>1</sup>These cases have been compiled and contributed by [www.Indlaw.com](http://www.Indlaw.com). Readers are invited to send their comments on the selection of cases and their utility at [eboard@icai.org](mailto: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/icairoot/departments/editorial\\_board/dept\\_editorial\\_board\\_index.jsp?icaideptid=20](http://www.icai.org/icairoot/departments/editorial_board/dept_editorial_board_index.jsp?icaideptid=20)

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sion and authority to tax that income under the 1944 Act. The agricultural income cannot be taxed under 1961 Act.

The Court held that in case the assessee directly sells the green tea leaves resulting into an income from agricultural products, it cannot be taken as incidental income to the business and whatever the income is derived from the sale of the green tea leaves can be assessed by the Agricultural Income Tax Officer under the 1944 Act.

The Court upheld the view taken by the Division Bench of the High Court.

### Method of accounting

#### **3. Whether income accrued to assessee on registration of sale deed in favour of third party (plot purchaser) or whether it accrued at time of execution of tripartite agreement?**

#### **CIT, New Delhi vs Realest Builders and Services Limited (SC) 7 May 2008**

The Supreme Court held that in cases where the Department wants to tax an assessee on the ground of the liability arising in a particular year, it should always ascertain the method of accounting followed by the assessee in the past and whether change in method of accounting was warranted on the ground that profit is being under estimated under the impugned method of accounting. If the Assessing Officer comes to the conclusion that there is under estimation of profits, he must give facts and figures in that regard and demonstrate to the Court that the impugned method of accounting adopted by the assessee results in under estimation of profits and is therefore rejected. Otherwise, the pre-

sumption would be that the entire exercise is Revenue neutral. In the instant case, that exercise has never been undertaken. The AO was required to demonstrate both the methods, one adopted by the assessee and the other by the Department.

The Court dismissed the appeal.

### Film Producer

#### **4. Whether the amortisation loss computed under Rule 9A of Income-tax Rules is subject to or not subject to the provisions of Section 80 and Section 139, Income-tax Act, 1961?**

#### **CIT, Thiruvananthapuram vs Joseph Valakuzhy (SC) 6 May 2008**

The assessee is a film producer. In his income tax return, the assessee claimed the benefit of carry forward of Rs. X as amortisation expenses.

The Supreme Court noted that the deduction for expenditure incurred on production of feature films is appropriately governed by Rule 9A of the Rules.

The Court held that that if a film is not released for exhibition on a commercial basis at least 180 days before the end of such previous year, the cost of production of the film insofar as it does not exceed the amount realised by the film producer by exhibiting the film on a commercial basis, is to be allowed as a deduction in computing the profits and gains of such previous year and the balance, if any, is to be carried forward to the next following previous year and allowed as a deduction in that year.

The appeal was dismissed.

### Fringe Benefit Tax

#### **5. Whether expenditure in-**

**curred by appellant, in providing transportation facility by bringing employees to Rig from their own country (outside India) and back is not liable to fringe benefit tax and the words 'in India' cannot be read after the word 'residence' in sub-section (3) of section 115 WB of Income-tax Act, 1961?**

**R and B Falcon (A) Private Limited vs CIT (SC) 6 May 2008** The appellant is incorporated under the laws of the Commonwealth of Australia and has a permanent establishment in India. It is engaged in the business of providing Mobile Offshore Drilling Rig (MODR) along with crew on a day rate charter hire basis to drill offshore wells. The employees from different countries come to India, stay in the Rig for 28 days and go back to their own country being their place of residence for a further period of 28 days.

Authority for Advance Ruling held that the company is liable to pay fringe benefit tax for providing transportation and movement of offshore employees for their residence and home countries outside India to the place of rig and back, opined that (1) The exemption provision contained in sub-section (3) of Section 115WB is restricted to sub-section (1) whereas the exemption falls under the deeming provision contained in sub-section (2); (2) Residence within the meaning of the said provision would mean residence in India and as the employees concerned are residents of the countries outside India, sub-section (3) of Section 115WB is not applicable.

The interpretation and/or application of the provisions of s. 115WB, Income Tax Act, 1961 providing for imposition of tax on 'fringe benefits' is in ques-

tion in the appeal.

The Supreme Court held that the employer incurs the expenditure, of bringing the employee to the Rig by providing air tickets for their coming from their place of residence to the Rig, as of necessity. It, therefore, clearly falls within the purview of the words 'consideration for employment'. If fringe benefits are provided for consideration for employment, which is given or provided to the employee by way of an amenity, reimbursement or otherwise, sub-section (1)(a) shall be attracted.

The Court held that when the expenditure incurred by the employer so as to enable the employee to undertake a journey from his place of residence to the place of work or either reimbursement of the amount of journey or free tickets therefore are provided by him, the same, would come within the purview of the term 'by way of reimbursement or otherwise'. Hence, matters enumerated in section 115WB(2) are not covered by sub-section (3), and the amenity in the nature of free or subsidised transport is covered by sub-section (1).

As regards to the question that whether the employee concerned should be a resident of India the Supreme Court observed that the appellant has a permanent establishment in India. It pays income-tax in India. It carries on business in India. It has for the purpose of carrying out its business activities engaged persons from within India or outside India. If it makes any expenditure for bringing any employee from abroad, the same would also liable to

be taken into consideration for the purpose of sub-section (1) of Section 115WB. Thus, AAR with respect was not correct in its view in reading the words 'in India' after the word residence in sub-section (3) of Section 115WB.

The appeal was allowed.

### **Additional tax**

#### ***6. Whether appellant-assessee was liable to pay additional tax on account of adjustment on its return under Section 143(1)(a) read with Section 143(1A), Income tax Act, 1961?***

#### **Kvaverner John Brown Engineering (India) Private Limited vs Assistant CIT, Bangalore (SC) 29 Apr 2008**

The Appellant claimed deduction under section 80-O, Income tax Act, 1961 in respect of qualifying income brought into India in convertible foreign exchange. Assessee claimed gross income, earned in foreign exchange, as qualifying income whereas the ITO granted deduction by restricting the claim of the assessee to the net income.

The Supreme Court held that when there were conflicting judgments on interpretation of section 80-O, prima facie adjustments contemplated under section 143(1)(a) was not applicable and, consequently appellant was not liable to pay additional tax under s. 143(1A).

The appeals were allowed.

### **Transfer of cases**

#### ***7. Interpretation/application of Section 127 of Income-tax Act, 1961 vis-à-vis Provision of Block Assessment.***

#### **K.P. Mohammed Salim vs CIT,**

#### **Cochin (SC) 24 Apr 2008**

A search was conducted by the Officers of the Income Tax Department in the residence as also in the business premises of the assessee. Consequent whereupon, it was proposed to transfer the cases pertaining to the assessee to facilitate effective and coordinate investigation.

The Supreme Court observed that a block period not only would include ten years of assessment but also that portion of the assessment year in which assessment was to take place as on the date of the search.

The Court further observed that only because in Section 127 of the Income-tax Act, 1961 the words "any case" has been mentioned, the same, would not mean that an order of transfer cannot be passed in respect of cases involving more than one assessment year. It would not be correct to contend that only because explanation appended to Section 127 refers to the word 'case' for the purpose of the said Section as also Section 120, the source of power for transfer of the case involving block assessment is relating only to Section 120 of the Act.

The power of transfer is in effect provides for a machinery provision. It must be given its full effect. It must be construed in a manner so as to make it workable. Even Section 127 of the Act is a machinery provision. It should be construed to effectuate a charging Section so as to allow the authorities concerned to do so in a manner wherefore the statute was enacted.

The word 'any' must be read in the context of the statute and for

the said purpose, it may in a situation of this nature, means all. The word 'any' may be read as all in the context of the Income Tax Act for which the power of transfer has been conferred upon the authorities specified under Section 127. Therefore, the power under Section 127 can also be exercised in respect of a block assessment.

The appeals were dismissed with costs.

### **Special audit under section 142(2A) of Income-tax Act**

**8. Whether a pre-decisional hearing is required to be given to the assessee before an order under section 142(2A) is passed by the Assessing Officer?**

**Sahara India (Firm), Lucknow vs CIT, Central-I and Another (SC) 11 Apr 2008**

In the present case, before passing the orders, no show cause notice was given to the appellants. Further, when the impugned orders were made, the Assessing Officer had no occasion to have even a glimpse of the accounts maintained by the appellants.

The issue under consideration is whether in every case where the Assessing Officer issues a direction under Section 142(2A), Income-tax Act, 1961, the assessee has to be heard before such an order is passed.

The Supreme Court observed that an order under section 142 (2A) does entail civil consequences. The exercise of power under section 142(2A) leads to serious civil consequences and, therefore, even in the absence of express provision for affording an opportunity

of pre-decisional hearing to an assessee and in the absence of any express provision in section 142 (2A) barring the giving of reasonable opportunity to an assessee, the requirement of observance of principles of natural justice is to be read into the said provision.

The appeals were allowed.

## **II. INDIRECT TAXES**

### **EXCISE & CUSTOMS**

#### **Territorial jurisdiction and preventive detention**

**1. Territorial jurisdiction of High Court and parameters within which the Writ Court can provide its protection to the Petitioners at the pre-execution stage of preventive detention were the issues before Court.**

**Maqsood Yusuf Merchant and Another vs UOI thru The Secretary and Others (DEL) 19 May 2008**

On information received by the Respondents, a consignment consisting of four hundred bags was examined and it was found to have been misdeclared. The Directorate of Revenue Intelligence (DRI) issued sundry summons to several persons including the petitioner who was eventually arrested and was produced in the Court of Additional Chief Metropolitan Magistrate, Mumbai. The High Court of Bombay granted Bail.

The High Court observed that even if a small part of cause of action arises within the territorial jurisdiction of the High Court, the same by itself might not be considered to be a determinative factor compelling the High Court to decide the matter on

merit. In appropriate cases, the Court may refuse to exercise its discretionary jurisdiction by invoking the doctrine of forum conveniens. Any High Court is justified in exercising powers under Article 226 either if the person, Authority or Government is located within its territories or if the significant part of the cause of action has arisen within its territories. The Bombay High Court would indubitably be the forum conveniens.

It was further held once it is found that the offence has been committed, or a violation of the Customs Act has been perpetrated in India, persons who have abetted in the perpetration of this violation would justifiably be charged as abettors. A distinction has to be drawn between the commission of an offence, or the perpetration of a violation of the Customs Act beyond the territory of India, and the abetment of this species of offences committed outside India. Once abetment is proved, the law would take its course even with respect to persons who were at the material time outside Indian boundaries.

It is important to draw a distinction between an inquiry and trial under the Cr.P.C, 1973 and preventive detention under the COFEPOSA or any other law. However, since Detention Orders have been passed by the Central Government, the proviso to s. 188 would stand impliedly complied with, assuming its applies. There can be no gainsaying that criminal prosecution and preventive detention have different fields of operation and do not require to co-exist or to be prosecuted contemporaneously. Every prosecution does not result in

preventive detention. Preventive detention may, in certain circumstances, become imminently necessary, whereas prosecution may be initiated later on, especially since no prescriptive period is prescribed in respect of such offences.

The petition was dismissed.

## **Demand of Duty**

**2. Whether the amount received by the respondent towards charges for designs, drawings, tooling, jigs and fixtures etc. as per the agreement could have been loaded on the value of the machine made and delivered subsequently as per the separate written orders?**

**C.C.Ex., Belgaum vs Mysore Kirloskar Limited, Karnataka (SC) 9 May 2008**

The respondent-company was manufacturing machine tools, their accessories, high-grade castings, pollution control equipments and other incidental and ancillary equipments. It used to accept orders to manufacture engineering machines as per the drawings, patterns, jigs, fixtures and tools etc. developed by it.

The Supreme Court held that it is true that the charges for drawings, designs etc. have to be added to the assessable value of the machines manufactured, based on use of such drawings, designs, jigs, fixtures, tooling etc. However, before adding the value of the drawings etc, it has to be established that the consideration had a nexus with the negotiated price of the assessable goods under clearance. Without establishing any such nexus, the Commissioner could not have demanded the duty on

the additional amount of consideration. On the basis of vague allegations made in the show cause notice neither the proviso to section 11A(1) could have been invoked nor penalty could have been imposed upon the respondent under rule 173Q, Central Excise Rules.

The appeal was dismissed.

## **Porcelain glazed tiles**

**3. Whether unglazed porcelain tiles imported by appellants were goods fell under restricted list or free list of import?**

**Orient Ceramics and Industries Limited vs CC, New Delhi (SC) 29 Apr 2008**

The appellants imported two consignments of unglazed porcelain tiles and claimed classification of the tiles under sub-heading 6907.90 of the Customs Tariff Schedule. Since goods falling under sub-heading 6907.90 were freely importable without any license, appellants sought clearance of the same on payment of appropriate customs duty. On examination, it was found that the goods were glazed tiles. Such tiles were classifiable under heading 6908.90 of the Customs Tariff Schedule and being restricted for importation as per classification, could not be imported without proper license. Also, test report revealed that the goods had characteristics of glazed tiles.

The point involved relates to the classification of goods in question under Indian Trade Classification (Harmonised System) [ITC (HS)] Policy.

The Supreme Court observed that from the reading of the report of Central Revenue Control

Laboratory (CRCL) and the distinction between the unglazed and glazed tiles pointed out by the appellants in their correspondence with the Department, it is evident that the imported goods were not unglazed but glazed which was classifiable under tariff heading 6908.90. License of import for such goods was required, as per policy, before importing. In view of the report submitted by the CRCL, which is an expert body, the tiles imported by the appellants were glazed tiles and were liable to be classified under tariff heading 6908.90.

The Court further held that in the absence of any material to show that the tiles manufactured by the appellants were porcelain tiles made out of kaolin and petuntse, it couldn't be held that the tiles imported by the appellants were other ceramic articles falling under tariff entry 6914.10.

The appeal was dismissed.

## **SERVICE TAX**

### **Consulting Engineer Service**

**4. Whether technical know-how fee and royalty paid to foreign collaborator fell under the category of Consulting engineer service?**

**Commissioner of Sales Tax, Ahmedabad vs Trumac Engineering Comoany Private Limited (CESTAT) 10 Jan 2008**

The respondents are engaged in the manufacture of textile machinery and parts. They entered into a technology transfer agreement with a German company and paid technical know how fee and royalty to their foreign collaborator. The Revenue

was of the view that the same fell under the category of consulting engineer.

The Tribunal held that the technical know-how provided by the foreign company as per the licensed agreements was transfer of intellectual property rights and no consultancy or advice was involved. Hence, the same was not liable to service tax under consulting engineer service.

The appeal was rejected.

### **Rent-a-cab Service**

**5. Vehicles not provided on rental basis for any continuous period of time, whether come under the 'rent-a-cab' scheme and therefore, recovery of demand to be stayed?**

**P. Sugumar vs C.C.Ex., Pondicherry (CESTAT) 09 Jan 2008**

The appellant had entered into an agreement with BSNL to provide vehicles with drivers for transport of officials employed with BSNL for their tours. The appellant provided his vehicle and vehicles hired by him from other parties. He received hire charges as per the agreed rates depending on the time of deployment of the vehicles and the distance run. The original authority demanded service tax.

The Tribunal observed that when the vehicles are not provided to a person on rental basis for any continuous period of time and are only made available for making journeys as and when required, will not come under the 'rent a cab' scheme.

The Tribunal therefore, directed waiver of pre-deposit of the tax demanded and stay of recovery of the same till the final disposal of the appeal.

### **Advertising agency**

**5. Whether charges collected towards services for evolution of prototype conceptual design (i.e. creation of concept), on which service tax had been paid under the Finance Act, 1994 as amended from time to time is liable to tax under the Karnataka Value Added Tax Act, 2003 (the Act)?**

**Imagic Creative Private Limited vs Commissioner of Commercial Taxes (SC) 9 Jan 2008**

The appellant is an advertising agency and provides for advertisement services. It creates original concept and design advertising material for their clients and design brochures, annual reports etc.

In the case of Tata Consultancy Services v. State of A.P. 2005 (1) SCC 451 the Supreme Court held that the copyright in a programme may remain with the originator of the programme, but the moment copies are made and marketed, it becomes goods, which are susceptible to sales tax.

The Supreme Court observed that the Court, while interpreting a statute, must bear in mind that the legislature was supposed to know law and the legislation enacted is a reasonable one. The Court must also bear in mind that where the application of a Parliamentary and a Legislative Act comes up for consideration; endeavours shall be made to see that provisions of both the acts are made applicable.

The Court further held that payments of service tax as also the VAT are mutually exclusive. Therefore, they should be held

to be applicable having regard to the respective parameters of service tax and the sales tax as envisaged in a composite contract as contradistinguished from an indivisible contract. It may consist of different elements providing for attracting different nature of levy. Hence, it is difficult to hold that in a case of this nature, sales tax would be payable on the value of the entire contract; irrespective of the element of service provided.

The appeal was allowed.

### **Commercial and Industrial construction service**

**6. Whether construction of a warehouse for Central Warehousing Corporation on the land owned by Railway comes under purview of Commercial and Industrial construction service?**

**Gangaadhar and Sharma and Sons vs C.C.Ex., Bhopal (CESTAT) 3 Jan 2008**

The applicant constructed warehouse on the land owned by railways. The railway land was leased out to Central Warehousing Corporation and Central Warehousing Corporation is paying rent as per the terms and conditions of the agreement.

The Tribunal observed that service provided in respect of roads, airports, and railways is not covered under the commercial or industrial construction service. On facts, it cannot be said that the applicant constructed a warehouse on behalf of the railway.

Hence, it is not a fit case for waiver of amount of service-tax.

### **SALES TAX / VAT**

#### **Rate of tax on Bubble-gum**

**7. Whether Bubble-gum is**

***taxable as an unclassified good and would attract duty at rate of 10% inclusive of surcharge?***

**Commissioner of Trade Tax, UP vs Associated Distributors Limited (SC) 5 May 2008**

The Tax Assessing Officer for the assessment year 1994 - 95 has levied the tax with additional tax at the rate of 10% treating Bubble-gum as unclassified and non-scheduled item.

The Supreme Court held that when common parlance test is applied and in fact ask someone to bring the sweets from the market, he will never bring Bubble-gum. In common parlance, even items of confectionery will not be construed as sweetmeat (mithai). Chewing gum and Bubble-gum do not fall in the category of Sweetmeat (mithai).

The Supreme Court further held that the High Court came to the specific finding that the Bubble-gum cannot be treated as a sweetmeat but it is certainly an item of confectionery. In the impugned judgment, the High Court gave no reasons for its finding. The respondent did not give any break up of the ingredients of Bubble-gum. It was never the case of the respondent that Bubble-gum is a sugar product. Confectionery is not even mentioned in the no-

tification. The High Court ought to have properly comprehended the object of the notification.

Hence, the tax is liable to be paid on Bubble-gum as an unclassified item.

The appeals were allowed.

### **III. OTHERS**

#### **FEMA / FERA**

#### **Constitutional validity**

***1. Constitutionality of section 18(2) and (3) of Foreign Exchange Regulation Act, 1973 on the ground of infringement of art. 14, Constitution of India, 1950***

**Seema Silk and Sarees and Another vs Directorate of Enforcement and Others (SC) 12 May 2008**

The appellant No. 1, a partnership firm, used to export garments and textiles to various countries. Appellants' business came to a standstill because of its inability to repatriate export proceeds from a few overseas buyers. A notice was issued by the Enforcement Directorate under sections 18(2) and 18(3) alleging that in view of their failure to repatriate the entire sale proceeds of the exports, the provision is attracted.

The Supreme Court held that the Act was protected under art. 31B of the Constitution of

India, 1950 having been placed in the Ninth Schedule. Discrimination on the ground of valid classification, which answers the test of intelligible differentia, does not attract the wrath of art. 14 of the Constitution of India, 1950. Hardship, by itself, may not be a ground for holding the said provision to be unconstitutional. Commercial expediency or auditing of books of accounts cannot be a ground for questioning the constitutional validity of a Parliamentary Act. If the Parliamentary Act is valid and constitutional, the same cannot be declared ultra vires only because the appellant faces some difficulty in writing off the bad debts in his books of accounts. He may do so. But that does not mean the statute is unconstitutional or the criminal prosecution becomes vitiated in law.

Further, the appellants did not obtain any general or special permission from the Reserve Bank of India for non-realisation of export proceeds beyond six months, which is the period specified under section 18(1).

The Court further observed that in absence of factual foundation having been pleaded, no case has been made out for declaring the said provision ultra vires the Constitution of India, 1950.

The appeal was dismissed.

### **RECOGNITION OF CA STATUS**

Mr. Nand Lal Kedia, Chartered Accountant, in his Criminal Revision Case before the Addl. Sessions Judge, Delhi pleaded that if the police intends to proceed against him on any ground whatsoever, his professional qualification or status should be given due recognition, and his status i.e., Chartered Accountant may be suffixed with his name.

The Court held that the status of a person cannot be divorced from him. If the revisionist is a Chartered Accountant, he is bound to be given due recognition as per law.

## DISCIPLINARY CASE

**Summary of a disciplinary case - The Council of the Institute of Chartered Accountants of India Vs. Shri Ramesh R Kapadia (Chartered Accountant Reference No. 1 of 2000) decided on 12.08.2004 by the Bombay High Court under Section 21(6) of the Chartered Accountants Act, 1949.**

### Facts of the case:

The Joint Director of Industries (hereinafter referred to as 'Complainant') filed a complaint against Shri Ramesh R Kapadia, Chartered Accountant, (hereinafter referred to as 'Respondent') under Section 21 of the Chartered Accountants Act, 1949 (hereinafter referred to as the 'Act') to the Institute of Chartered Accountants of India (hereinafter referred to as the 'Institute') alleging, *inter alia*, that the respondent had issued the certificates for consumption of raw material and production for the year AM-86/AM-87 in respect of four units at Latur and there was no co-relation between the cost of raw material and value of finished products. It was also alleged that in the certificates, value of raw material was shown as CIF value whereas this value should be a landed cost of the raw material including customs duty paid by the units. This was not taken into consideration by the Respondent while reporting figures of production. It was further alleged that the certificates were issued without any records.

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 the evidence and hearing the submission made on behalf of the parties came to the conclusion that the Respondent was guilty of professional misconduct under clauses (7) and [8] of Part I of Second Schedule of the Chartered Accountants Act, 1949 read with Section 21 and 22 of the said Act.

The Council on consideration of the report of the Disciplinary Committee along with the letters of the Complainant, written representations of the respondent and oral submission made by him accepted the Report of the Disciplinary Committee that the Respondent was guilty of professional misconduct within the meaning of Section 21 read with Section 22 of the Chartered Accountants Act, 1949 and clauses (7) & [8] of Part I of the Second Schedule to the said Act. The Council recommended to the High Court that the Respondent be reprimanded. As required under Section 21(5) of the Act, the matter was referred to the Bombay High Court with the recommendations of the Council.

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

### Decision of the Hon'ble Court:

The Hon'ble Court observed that there appears to be no dispute that the respondent issued the certificates for consumption of raw material and production for the year 1986-87 in respect of four units of Latur district. The Court further observed that it also appears from the available

material that there was some discrepancy in the cost of raw material and the value of the finished products in the certificates issued by the respondent. Shri Kapadia did not bring the working papers to satisfy the Disciplinary Committee that he had examined the relevant record before the issuance of the said certificates. In a way he admitted before the Disciplinary Committee that he did not verify the record, but the documents were verified by his office people. The fact that all the certificates were issued on one day was not in dispute. He failed to satisfy that reasonable care and caution was taken by him in verifying and checking the relevant record before the issuance of the said certificates. He admitted before the Disciplinary Committee that there was mistake, but his explanation was that the mistake was genuine.

On overall consideration of the entire material, the Hon'ble Court found that the certificates, four in number for consumption of raw material and production for the years 1986-87 in respect of the four units of Latur Region were issued by the respondent without proper care and caution and, thus, there was some professional negligence on the part of the respondent. Accordingly, the Court upheld the finding of the Disciplinary Committee as accepted by the Council that the respondent was guilty of professional misconduct within the meaning of Clauses (7) and (8) of Part I of Second Schedule read with Sections 21 and 22 of the Chartered Accountants Act, 1949 and ordered that the respondent be reprimanded particularly in view of the fact that the respondent had been candid in admitting the mistake.

# TDS FROM RENT UNDER SECTION 194-I – SOME CONTRADICTIONS

In businesses of warehousing, cold storage, clearing and forwarding agents, selling agents, hotel etc, the property is used by owner or operator and not by the customers who just enjoy facilities and services. These are not simply letting out of house property or plant and machinery to which section 194-I, relating to TDS on rent can be applied. The CBDT has recently issued circular that in case of cold storage section 194-I is not applicable as there is no case of letting out of cold storage. The same principal is applicable in case of warehouse and hotel. However, old circulars prescribing TDS under section 194-I has not been modified though it is contrary to provisions of section 194-I. A corrective circular is desirable to avoid disputes.

## Rent

Generally speaking, 'rent' is reward or consideration paid by one person (tenant) to other person (owner) when the tenant is granted rights to hold, possess and use the property by himself. In absence of such rights, when owner holds, possesses and uses the property and provides services or facilities to any other person then there is no tenancy and consideration for facilities and services is not in the nature of rent.

## Owner and Tenant

A guest of hotel can-

not be regarded as a tenant of hotel. A farmer or trader who keeps potatoes in cold storage cannot be called a tenant of cold storage. A farmer or trader who keeps grains in a warehouse cannot be called a tenant of warehouse.

## Composite Activities

In businesses of warehousing, cold storage, clearing and forwarding agents, selling agents, hotel etc. systematic, organised and composite activities are carried out on regular basis to provide relevant facilities and rendering necessary services to customers, clients or principals as



— CA. Dev Kumar Kothari  
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From the circulars relating to hotels it appears that the letting out of property is recognised as an essence under section 194-I. However, the concept of letting out of property is misunderstood and misapplied by taking into an extraneous consideration - regularity. As discussed earlier in case of rooms taken in a hotel there is no letting out of property in its common sense.

the case may be. The property is used by owner/operator and not the customers. These are not simply letting out of house property or plant and machinery. The letting out of property is incidental to business activities.

### “Rent” For the Purpose of Section 194-I

Provisions relating to TDS on ‘rent’ are subject matter of section 194-I of the Income-tax Act, 1961. In the said section meaning of ‘rent’ is provided by way of an explanation, which is reproduced below with highlights:

*“Explanation:* For the purposes of this section, -

- (i) “rent” means any payment, by whatever name called, under any lease, sub-lease, tenancy or any other agreement or arrangement for the use of (either separately or together) any, -
  - (a) land; or
  - (b) building (including factory building); or
  - (c) land appurtenant to a building (including factory building): or
  - (d) machinery; or
  - (e) plant; or
  - (f) equipment; or
  - (g) furniture; or
  - (h) fittings,

whether or not any or all of the above are owned by the payee”.

On analysis, we find that:

1. Meaning of rent is exhaustive

and is not subject to context. Therefore, the meaning is to be strictly interpreted.

2. Lease, sub-lease, tenancy or any other arrangement is necessary. The expression ‘any other arrangement’ would take its colour from other words used that is lease, sub-lease, or tenancy. That means there should be letting out of property in some or other manner. Without letting out of property, the tenant cannot have possession and cannot use the property. Therefore, an arrangement in which property is handed over to the tenant is a precondition.
3. The ownership is not necessary. This is because some times, sub-lease or sub-tenancy may exist. In such cases also, the provision of TDS on rent may be applied.
4. ‘Rent’ will be received when any land, building, plant or machinery, furniture... etc is given to any other person for use and not when the owner or operator keeps it with himself and uses it to provide some facilities or services to other person for some consideration or charges.

Therefore, it appears that when possession of any such property is not given to the tenant and possession remains with the owner or operator and he uses it in business of providing

facilities, then the consideration received is not rent.

### Rent Presupposes A Case Of Bailment Of Property

In case where rent is received, the position will be as follows:

The property is handed over to the tenant and he holds, possesses and uses it – he has some rights and obligations, which are governed by agreement, understanding, customs and trade practices. The tenant holds property as a bailee.

The owner cannot use the property as it is with tenant. The tenant has control and interest in property as per agreement during continuation of tenancy.

The consideration is payable by the tenant, whether he uses or does not use the property. The consideration is for holding property for use. Actual use by tenant is not necessary. Though, in some situations, slab of rent may depend on extent of use. For example, agreement may provide varying rate of rent if the property is used in different manner or for varying hours (say working on single shift or multiple shift basis). However, there is a minimum element of rent, which is simply for right to hold and possess the property with a right to use.

Simple examples:

The cases with or without letting out of property are illustrated in the following table.

Case of letting out of property	Case not involving letting out of property
<p><b>Cold Storage:</b> A cold storage building with plant and machinery is let out under lease, sub-lease or tenancy and possession is handed over to tenant. The tenant has control and uses the cold storage. The consideration for letting out of cold storage will be 'rent'.</p>	<p>Cold storage is operated by owner/ operator. Customers who are owners of goods keep goods in cold storage. They have no control over cold storage and they do not use the cold storage. Cold storage is used by the owner/operator in providing cold storage facilities and services. Therefore, the consideration paid is not in nature of 'rent'.</p>
<p><b>Car:</b> When a car owner or taxi operator or cab operator hands over car, taxi or cab to the customer who uses it and pays charges, the customer uses the car, taxi or cab and pays rent.</p>	<p>A taxi owner/operator uses car, taxi in his business of plying taxis for hire or reward popularly known as fare. He does not give possession of car, taxi or cab to the passenger. The fare received by him is not 'rent' within the above meaning.</p>
<p><b>Factory:</b> A factory owner lets out factory to tenant and hands over possession to tenant who uses factory for processing his goods. The factory does not remain in control of factory owner; the customer has its control and possession. Consideration payable is rent.</p>	<p>A factory owner provides facility to others on time-sharing basis or on piece rate basis for processing of goods of customers. The factory remains in control of factory owner; the customer is not a tenant in any manner. Consideration payable is not rent.</p>
<p><b>Warehouse:</b> An owner of warehouses lets out one of his buildings to tenant and hands over possession to him. Tenant uses the building as a tenant and pays rent. The consideration is 'rent'.</p>	<p>A warehouse owner/operator keeps goods of other persons in his warehouse without letting out any room or space. The owner has control over premises and the customer is not having possession or control. The consideration for warehousing of goods is not 'rent'.</p>
<p><b>Sewing Machine:</b> Sewing machine is hired out by owner to tailor, who takes it to his shop or home and uses it for his business of tailoring. It is a case of letting out of sewing machine. The consideration is 'rent'.</p>	<p>Tailor uses machine for sewing dress of his clients. Machine is in his possession. Charges received – per hours or per dress, for stitching dresses in not 'rent' of machine. Tailor allows Tailor Jr. to use his machine (taken on rent from owner- see column 1)) for three hours a day at premises of Tailor. Tailor Jr. is not in control and possession of machine though he can use the machine on time-sharing basis. Consideration payable is not 'rent'.</p>
<p><b>Library:</b> Library lends/provides books with a right to take them to home or office of customers. The customer reads and uses books. The consideration will be rent.</p>	<p>Customers or members are allowed to sit in library and read books. Charges payable for sitting and reading facility are not in nature of rent.</p>
<p><b>Furniture:</b> Owner allows customer to take furniture to his place for few days and use them. The consideration is rent.</p> <p><b>Hotel:</b> In a hotel, certain areas are provided to banks, travel agents, and boutiques to open their offices or shops. The bank, travel agent or shopkeepers have possession and control over designated area on a continuous basis. The consideration will be rent.</p>	<p>Owner as a caterer, decorator or event organiser takes furniture to place of customer for furnishing and decoration. The charges are not rent. Hotel provides banquet hall to bank or boutique for holding exhibition. The consideration is not in nature of rent.</p>

In case of warehousing charges without examining the concept of letting out of property and use of property by tenant, it has been provided that section 194-I will apply. Thus the circulars directing TDS from warehousing charges and hotel charges are contrary not only to the provisions of section 194-I but are also contrary to the essence of letting out of property and use of property by payer of charges, which is recognised in circulars relating to cinema halls and cold storage. The same needs to be rectified by another clarificatory circular.

### Cold Storage Facilities Not a Case of Simple Letting Out of Property

In cold storage the owner and/or operator of cold storage provides facilities to other parties to keep their goods in the cold storage for certain period of time. He/she asks for cold storage charges and the agreement is governed by understanding between parties and some trade customs and practices. The salient features of the arrangement are as follows:-

- (i) The owner or operator of the cold storage holds goods on behalf of others in the cold storage and, therefore, he/she is in capacity of bailee of goods stored in his/her cold storage by others who are owners of such goods who are bailor of such goods. Thus the contract is a commercial contract involving bailment of goods, to be kept in controlled atmosphere for certain period.
- (ii) The owner of goods is a bailor of goods.
- (iii) For storage, certain charges are to be paid by bailor of goods to the bailee (cold storage).
- (iv) Charges are paid as agreed. The charges are fixed based on requirement of space

and duration of holding goods in cold storage. The agreement may provide for certain minimum charges and minimum/maximum duration.

- (v) As per agreement and trade practice, the cold storage has to maintain proper environment at prescribed level of temperature and humidity, and properly maintain the space in proper condition of repair and cleanliness, safe, secure, insured etc.
- (vi) No letting out – In course of arrangement for cold storage, the owners of cold storage do not let out any premises to the owners of goods. The owners of goods do not have any control over the premises. There may be provision for some locks on certain areas for which the keys may be held by the owner of goods and cold storage owner jointly/severally. However, ultimate control over the premises remains with the cold storage owner. Therefore, the charges payable for cold-storage are not in nature of rent for letting out of any property.
- (vii) The charges are for providing the space, maintaining

controlled atmosphere as per specifications in the cold storage, safekeeping, security and handling charges etc. In the course of this activity, the cold storage deploys labour, buildings, plant and machinery, provides electricity to run and maintain the cold storage plant. Therefore, the activity of cold storage is a business activity and it is not a simple letting out of properties.

### Storage Facilities

In warehousing business the owner and/or operator of warehouse provides facilities to other parties to keep their goods in the warehouse for certain period of time, charge warehousing charges or storage charges and the agreement is governed by understanding between parties and some trade customs and practices. The salient features of the arrangement are as follows: -

- (i) The owner or operator of the warehouse holds goods on behalf of others in the warehouse/storage space and, therefore, he is in capacity of bailee of goods stored in his warehouse. Owners of such goods are bailor of such goods. Thus the contract is a commercial contract involving bail-

In cases where a commercial property like factory building, warehouse building, cold storage, hotel, hospital etc are used in the business, application of provision of TDS under section 194-I is not justified. The provision of TDS is to collect tax at source in an estimated manner. Therefore, in such cases instead of TDS, reliance should be placed more on provisions of advance tax and self-assessment tax.

- ment of goods, to be kept in warehouse for certain period.
- (ii) The owner of goods is a bailor of goods.
  - (iii) For storage certain charges are to be paid by bailor of goods to the bailee (warehouse/storage).
  - (iv) Charges are paid as agreed. The charges are fixed based on requirement of space and duration of holding goods in warehouse. The agreement may provide for certain minimum charges and minimum/maximum duration.
  - (v) As per agreement and trade practice, the warehouse has to maintain proper environment at prescribed level of temperature and humidity and properly maintain the space in proper condition of repair and cleanliness, safe, secure, insured etc.
  - (vi) No letting out – In course of arrangement for warehousing, the owners of warehouse/storage do not let out any premises to the owners of goods. The owners of goods do not have any control over the premises. Control over the premises remains with the warehouse/storage owner. Therefore, the charges payable

for warehousing are not in nature of rent for letting out of any property— building or land.

- (vii) The charges are for providing the space, maintaining suitable atmosphere as per specifications and necessity for goods kept, safekeeping, security and handling charges etc. In the course of this activity, the warehouse may deploy labour, buildings, plant and machinery; provide electricity for lighting, material handling etc. Therefore, the activity of warehousing/storage is a business activity and it is not a simple letting out of properties.

Thus, we find that as in case of cold storage or warehouse the customer brings its goods/packages for storage for a required period and takes away its goods/packages after paying warehousing charges. The customer does not hire the building, plant/machinery etc. in any manner and does not become a tenant of any kind.

### Case of Hotel

In case of hotel rooms, conference halls, pandals etc. space is provided to customers (guests) with common facilities and amenities. The owner/operator of hotel has control over the property. Even for the room provided

to the guests, the guest is supposed to keep key of the room with staff concerned of hotel (at reception/booking section) and functions of cleaning, maintaining etc. are carried out by hotel. Tariff charges received is not rent because control including ultimate control and possession remain with the hotel. Even in case of regular visitors/guests of hotel there is no letting out of property. Thus, consideration payable to hotel is not in nature of rent.

### Nature of Income

It is well settled that the income derived by cold storage, warehousing, hotels, lending libraries etc. is income from business and not income from house property. This is so because of the market difference in the activities carried out in such businesses and simple letting out of a property. In case of simple letting out of property, statutory deductions are allowed on notional basis against the income. However, in case of business activities all business related expenses are allowed. Under head income from house property, depreciation is not allowed on property. In case of business, depreciation on building, furniture, plant and machinery etc. is also allowed – in fact we find separate rate of depreciation for buildings used as hotel building, boarding house and cold storage etc. The pure rent

is considered as an unearned income whereas incomes from such business activities are considered as earned income. These factors are also relevant in the context of determining the nature of receipt even in context of provisions of TDS.

### Letting Out of Buildings

I. Mr. O, the owner of a building let out the same to M/s. B, a businessman to use the building as a hotel. Mr. O hands over possession and control of building to B who uses the building for running as a hotel with facilities of rooms, restaurant, conference halls, exhibition halls etc. The consideration payable by B to O will be rent within the meaning of section 194-I. However, consideration collected by B from visitors and guests in the hotel will not be in the nature of rent.

II. (a) The owner is operating cold storage and providing facilities to the others to store goods in cold storage. This will, as discussed above be a business activity and not mere letting out of property. Cold storage charges received from customers is not rent because any property is not let out and allowed to be used by customers.

(b) The owner lets out a part of the cold storage building and facilities to one of the owner of goods for certain charges as rent for the property for six months. The owner of goods is put into possession and control of the portion let out to him and he has right to use the same. The consideration will be rent.

### Recent CBDT Circular

In the latest Circular no.1 of

10.01.2008, F.No.275/59/2007-IT (B), the Board has clarified that the cold storage charges are not in nature of rent and provisions of 194-I would not be applicable for cold storage charges. The circular is reproduced below with highlights of context necessary for this write-up:

“1. Representations have been received from various quarters regarding applicability of the provisions of section 194-I to cooling charges paid by the various customers to the owners of cold storages. It has been represented that the cold storage owners provide a composite service, which involves preservation of essential food items including perishable goods at various temperatures suitable for specific food items for required periods and storage of goods being incidental to the activity of preservation. The cooling of goods is controlled through mechanical process. The customer brings its packages for preservation for a required period and takes away its packages after paying cooling charges. The customer does not hire the building, plant/machinery etc. in any manner and does not become a tenant of any kind.

2. The matter has been examined. The main function of the cold storage is to preserve perishable goods by means of a mechanical process, and storage of such goods is only incidental in nature. The customer is also not given any right to use any demarcated space/place or the machinery of the cold store and thus does not become a tenant. Therefore, the provision of 194-I is not applicable to

the cooling charges paid by the customers of the cold storage.”

### Old Circular About Cinema Halls

In Circular no. 736 of 13.02.1996 also letting out of property is considered as an essential ingredient for applicability of section 194-I. The relevant part of circular is reproduced below:

“Representations have been received from the various quarters regarding applicability of the provisions of section 194-I of the Income-tax Act to the sharing of the proceeds of film exhibition between film distributors to a film exhibitor owning a cinema theatre. The matter has been examined by the Board and the Board is the view that the provisions of section 194-I are not attracted to such payment because:

- (i) The exhibitor does not let out the cinema hall to the distributor;
- (ii) Generally, the share of the exhibitor is on account of composite services; and
- (iii) The distributor does not take cinema building on lease or sub-lease or tenancy or under any agreement of similar nature.”

### Comments

As discussed in this article the recent circular and the circular about Cinema halls fully recognises that letting out of property is a must and Section 194-I can apply only to simple cases of letting out of building (or other property) and not in nature of business activities of composite nature.

### Circular About Warehousing Charges

In Circular no. 715 dated 22.08.1995 provisions of section 194-I were explained. The text of the circular to the extent necessary for this article is reproduced below:

“Query No.3: Whether, the tax is to be deducted at source from warehousing charges?

Answer: The term "rent" as defined in Explanation (i) below section 194-I means any payment by whatever name called, under any lease, sub-lease, tenancy or any other agreement or arrangement for the use of any building or land. Therefore, warehousing charges will be subject to deduction of tax under section 194-I.

Query No. 5: Whether section 194-I is applicable to rent paid for the use of only a part or a portion of any land or building?

Answer: Yes, the definition of the term "any land" or "any building" would include a part or a portion of such land or building.”

### Circulars About Hotel

In Circular no. 715 dated 08.08.1995 *vide* Question no. 20 matter of payment to hotel was clarified as follows:

“Question 20: Whether payments made to a hotel for rooms hired during the year would be of the nature of rent?

Answer: Payments made by persons other than in-

dividuals and HUFs for hotel accommodation taken on regular basis will be in the nature of rent subject to TDS under section 194-I”.

Later on, the matter has been clarified by Circular no. 5 of 30.07.2002 in relation to hotel with reference to the above Q. no. 20 as follows:

“In this context, doubts have been raised as to what constitutes 'hotel accommodation taken on regular basis' for the purpose.

xxxxx

(2) The Board has considered the matter.

xxxxx

Where an employee or an indi-

vidual representing a company (like a consultant, auditor, etc.) makes a payment for hotel accommodation directly to the hotel as and when he stays there, the question of tax deduction at source would not normally arise (except where he is covered under section 44AB as mentioned above) since it is the employee or such individual who makes the payment and the company merely reimburses the expenditure.

Furthermore, for purposes of section 194-I, the meaning of "rent" has also been considered. "Rent" means any payment, by whatever name called, under any lease ... or any other agreement or arrangement for the use of any land.... The meaning of "rent" in section 194-I is



wide in its ambit and scope. For this reason, payment made to hotels for hotel accommodation, whether in the nature of lease or license agreements are covered, so long as such accommodation has been taken on "regular basis". Where earmarked rooms are let out for a specified rate and specified period, they would be construed to be accommodation made available on "regular basis". Similar would be the case, where a room or set of rooms are not earmarked, but the hotel has a legal obligation to provide such types of rooms during the currency of the agreement.

However, often, there are instances where corporate employers, tour operators and travel agents enter into agreements with hotels with a view to merely fix the room tariffs of hotel rooms for their executives/guests/customers. Such agreements, usually entered into for lower tariff rates, are in the nature of rate contract agreements. A rate contract, therefore, may be said to be a contract for providing specified types of hotel rooms at pre-determined rates during an agreed period. Where an agreement is merely in the nature of a rate contract, it cannot be said to be accommodation "taken on regular basis", as there is no obligation on the part of the hotel to provide a room or specified set of rooms. The occupancy in such cases would be occasional or casual. In other words, a rate contract is different for this reason from other agreements, where rooms are taken on regular basis. Consequently, the provisions of section 194-I while applying to hotel accommodation taken on

regular basis would not apply to rate contract agreements."

### Comments

From the circulars relating to hotels it appears that the letting out of property is recognised as an essence under Section 194-I. However, the concept of letting out of property is misunderstood and misapplied by taking into an extraneous consideration - regularity. As discussed earlier in case of rooms taken in a hotel there is no letting out of property in its common sense. Rooms are taken as a part of composite service agreement and not simply on basis of landlord and tenant relationship. Even in case of regularly occupying rooms there is no case of letting out of property. Therefore, in view of author the provisions of section 194-I are not at all applicable in case of payment to hotels for rooms as generally provided by hotels. In case of letting out of property only Section. 194-I will apply.

Similarly, in case of warehousing charges without examining the concept of letting out of property and use of property by tenant, it has been provided that section 194 I will apply. Thus the circulars directing TDS from warehousing charges and hotel charges are contrary not only to the provisions of section 194-I but are also contrary to the essence of letting out of property and use of property by payer of charges, which is recognised in circulars relating to cinema halls and cold storage. The same needs to

be rectified by another clarificatory circular.

Thus, in view of author, TDS is not applicable in case of payment to warehouse for storage of goods and to hotels for occupying rooms as a customer or guest of hotel in ordinary course of hotel business.

### TDS u/s 194C or 194 I is Not Justified, Advance Tax Should be Preferred

In a case where a commercial property like factory building, warehouse building, cold storage, hotel, hospital etc are used in the business of providing processing, warehousing or cold storage facilities or accommodation in a hotel to others there is not a simple case of letting out of property. In such cases systematic and organised commercial activity is involved. It is not a simple case of letting out of property. Therefore, provisions relating to computation of business income apply, including depreciation allowance.

All these businesses are highly capital and labour intensive and require high fixed costs. Therefore, break-even level is high and profitability depends on extent and regularity of occupancy and use for customers. These businesses are also cyclical and seasonal.

Therefore, in such cases application of provision of TDS under section 194-I is not justified. The provision of TDS is to collect tax at source in an estimated manner. Therefore, in such cases instead of TDS, reliance should be placed more on provisions of advance tax and self-assessment tax. □

# DOES BETTER CORPORATE GOVERNANCE PAY?

Corporate Governance is often looked as a matter of regulatory compliance and not as a practice that could result in superior market valuations. Consequently, considerable research has been done globally on whether there exists a correlation between market valuations and the level of governance practised by companies. While many of these studies have established that market valuations certainly depend on the level of governance, the conclusiveness of studies varies. This article deals with the analysis of relationship between corporate governance level and market valuation.

Good corporate governance is now widely recognised as very essential for establishing an attractive investment climate characterised by competitive companies and efficient financial markets. The discussion on 'governance' has absorbed most of the economies for more than a decade. Corporate Governance has not yet settled on any universally acceptable definition. In fact, the very definition of corporate governance stems from its organic link with the entire gamut of activities having a direct or indirect influence on the financial health of corporate entities (Kamesam 1992). In its broadest sense, governance refers to the range of institutions and practices by

which authority is exercised to satisfy the interest of all stakeholders including society, and its meaning is shaped by the specific value system prevalent in the country.

Good corporate governance should provide proper incentives for the Board and Management to pursue objectives that are in the interest of the company and shareholders. It should facilitate effective monitoring, thereby encouraging firms to use the resources more effectively (OECD 1999).

In general, good corporate governance practices ensure that:

- 1) Board members act in the best interest of shareholders;



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Good governance requires a mindset within the corporation, which integrates the corporate code of ethics into the day-to-day activities of its managers and workers. As the sociologists Rossouw and Van Vuuren note, companies must move from the “reactive and compliance mode” of corporate ethics, to the “integrity mode”, where the functions of the entire organisation are completely aligned with its value system.

- 2) The company acts in a lawful and ethical manner in their dealings with all stakeholders and their representatives;
- 3) All shareholders have the same right to participate in the governance of the company and receive fair treatment from the board and management, and all rights of shareholders and other stakeholders are clearly delineated and communicated;
- 4) The board and its committees are structured to act independently from management, individuals or entities that have control over management, and other non-shareholder groups;
- 5) Appropriate controls and procedures are in place covering management’s activities in running the day-to-day operations of the company; and
- 6) The company’s operational and financial activities as well as its governance activities are consistently reported to shareholders in a fair, accurate, timely, reliable, relevant, complete and verifiable manner.

To improve corporate governance, the government of the respective country and legal systems concerned obviously have very important role to play. The government should strengthen laws that protect shareholder interests and should ensure enforcement of such laws and regulations. It is also important for the firms to take action on voluntary basis. But do the firms

have incentives to do so? This depends on whether a firm’s corporate governance practices have a positive effect on its market value? If the answer is yes, then firms will have incentives to improve their governance, because by doing so, they increase their market value and reduce their future cost of investment.

### Review of Literature

Institutional investors in companies based in emerging markets claim to be willing to pay as much as 30 per cent more for shares in companies that are well-governed. Do these investors mean what they say? The authors examined 188 companies from India, Korea, Malaysia, Mexico, Taiwan, and Turkey to test the link between market valuation and corporate-governance practices. They found that companies with better corporate governance had higher price-to-book ratios, indicating that investors do indeed reward good governance, and with quite a large premium: companies can expect a 10 to 12 per cent boost to their market valuation by going from worst to best on any single element of governance (Mc Kinsey survey). One can relatively easily develop financial market, through a determined effort to improve corporate governance practices.

A number of studies published in recent years have shown a strong link between good corporate governance and strong profitability and investment performance measures. For example, a joint study of Institutional Shareholder Services (ISS) and Georgia State University

found that the best-governed companies — as measured by ISS’s Corporate Governance Quotient — had mean returns on investment and equity that were 18.7 % and 23.8% better, respectively, than those of poorly governed companies during the year reviewed. Against this background, the present study in this article attempts to examine the impact of corporate governance practices on operating performance and market valuation of Infosys Technologies. Section I discusses the methodology. Section II deals with Corporate Governance variables. Section III deals with Corporate Governance practices at Infosys. Section IV examines the relationship between CG score and Company Valuation. Finally the paper submits conclusions and suggestions in Section V.

### Section I: Methodology

**Scope:** The study in this article has been conducted in the Indian context on the effect of governance levels on firm financial and operating performance and market valuations based on data available over a period of five years from the period FY 2002-2007.

**Objective of the study:** The objective of the study is to develop a measure of Corporate Governance; to determine the corporate governance score of the company and its comprehensive financial performance; and, to examine the relationship between financial performance and market valuation with Corporate Governance Score of the companies.

Investors should determine whether the board has established a committee of independent board members, including those with recent and relevant experience of finance and accounting, to oversee the audit of the company's financial reports. The audit committee should be responsible for hiring and supervising the independent external auditors, ensuring that the external auditors' priorities are aligned with the best interests of shareholders.

**Data Collection:** Following resources have been explored to collect the data required for the present study:

- Prowess database: The CMIE: (Center for Monitoring Indian Economy) database contains detailed information on the financial performance of Companies in India. The information has been compiled from the Profit and Loss Accounts and the Balance Sheet of companies. In addition to the financial information, the database also contains background information such as ownership pattern, product profile, etc.
- Bulletins from Asian Corporate Governance Association, Confederation of Indian Industry (CII), National Institute of Corporate Governance.
- Published Annual reports and corporate governance reports, websites of the companies chosen.
- Company's articles of organisation or by-laws; or
- National corporate governance codes or stock exchange-mandated corporate governance requirements.

**Technique Used for the Study:** In this study, the corporate governance score of the company is correlated with its market valuations, profitability, and dividends. For calculation of corporate governance score we have used the six major variables, which are then divided into sub components. Weights are assigned to each of

these components. (As shown in Table 1). The variables and weights have been taken after careful study of existing litera-

ture. The CG score has been calculated by assigning to each variable component points on a 5 to 1 Linker's Point scale.

**Table 1**

Following Variables are assessed:	Weights
<b>(1) Structure, Composition and Management of Board: (20%)</b>	
(a) Independence of the Board	6%
(b) Qualifications of the Board	5%
(c) Authority to hire External Consultants	2%
(d) Board Member Terms and Meetings of the Board	4%
(e) Presence and Implementation of Code of Ethics	3%
<b>(2) Board Committees: (20%)</b>	
(a) Audit Committee	6%
(b) Remuneration Committee	6%
(c) Nominations Committee	5%
(d) Other Board Committees	3%
<b>(3) Transparency (20%)</b>	
(a) Related Party Transactions	10%
(b) Executive Compensation	10%
<b>(4) Shareholder Rights: (15%)</b>	
(a) Confidential Voting and Proxy Voting	7%
(b) Voting for Corporate Changes	8%
<b>(5) Other Shareholder Rights Issues: (15%)</b>	
(a) Ownership Structure	9%
(b) Takeover Defences	6%

<b>(6) Value Creation and Social Awareness: (10%)</b>	
(a) Credit Rating	4%
(b) Growth in Number of Employees	3%
(c) Social Responsibility	3%
<b>Total Score</b>	<b>100%</b>

## Section II: Analysis of Variables Used

### (1) Structure and Composition of Board:

Board members owe a duty to make decisions based on what ultimately is best for the long-term interests of shareholders. In order to do this effectively, the board members need a combination of three things:

- **Independence:** A board should be composed of at least a majority of 'Independent Board Members' with the autonomy to act independently from management.
- **Experience:** Board members who have appropriate experience and expertise relevant to the company's business are capable to evaluate what is in the best interest of shareholders. Depending on the nature of the business, this may require specialised expertise by at least some board members.
- **Resources:** There needs to be internal mechanisms to support the independent work of the board, including the authority to hire outside consultants without management's intervention or approval. This mechanism alone preserves the integrity of the board's independent oversight function.

**(a) Independence:** Independence, as it relates to board members, refers to the degree

to which they are not biased or otherwise controlled by company management or other groups who exert control over management. Whether the board is independent can be judged on whether following conditions are fulfilled:

- **Majority:** Independent board members constitute, at a minimum, a majority of the Board.
- **Meetings of independent directors:** Independent board members regularly meet without the presence of management and report on their activities at least annually to shareholders. Such meetings permit these board Members to discuss issues facing the company without influence from Executive Board members.
- **Separation of Chairman/CEO:** The board chairman who also holds the title of chief executive, combining the two positions may give too much influence to Executive Board members and impair the ability and willingness of independent board members to exercise their independent judgment.

**(b) Experience and Qualifications:** Investors should assess whether individual board members have the knowledge and experience that is required for management of that Company, its businesses, and the competitive environment. Board members who lack the skills, knowledge and expertise to conduct a

meaningful review of the company's activities are more likely to defer decisions to management.

**(c) Authority to Hire Outside Consultants:** Investors should determine whether the board and its committees have authority to hire independent third-party consultants without having to take approval from management. It is important to recognise that independent board members typically have limited time to devote to their board duties. Consequently board members need support in gathering and analysing a large amount of information relevant to management and overseeing of the company.

### (d) Board Member Terms and Board Meetings:

- Shareholders should determine whether board members are elected annually and understand the mechanisms that provide, limit, or eliminate altogether their ability to exercise their rights to vote on individual board members. Shareholders elect board members every year, or for staggered multiple-year terms. An annually elected board may provide more flexibility to nominate new board members to meet changes and challenges in the marketplace. Staggered boards also may on one hand serve as an anti-takeover device while on the other hand, a staggered board may provide better continuity of board expertise.
- **Board Size:** A large board may have difficulty coordinating its members' views, be slow to act, and defer decisions more frequently to the chief executive. A small board may lack depth of experience and

counsel, and may not be able to adequately spread the workload among its members to operate effectively.

- **Board Meetings:** The board shall meet at least four times a year, with a maximum time gap of three months between any two meetings.

**(e) Presence and Implementation of Code of Ethics:** A company's code of ethics sets standards for ethical conduct based on basic principles of integrity, trust, and honesty. It provides personnel with a framework for behavior while conducting the company's business, as well as guidance for addressing conflicts of interest. Reported breaches of ethics in a company often result in regulatory sanctions, fines, management turnover, and unwanted negative media coverage, all of which can adversely affect the company's performance.

## (2) Board Committees

**(a) Audit Committee:** Investors should determine whether the board has established a committee of independent board members, including those with recent and relevant experience of finance and accounting, to oversee the audit of the company's financial reports. The audit committee should be responsible for hiring and supervising the independent external auditors, ensuring that the external auditors' priorities are aligned with the best interests of shareholders. Misrepresentations of the Company's performance and financial condition ultimately could have a detrimental affect on the Company's share valuation.

**(b) Remuneration / Compensation Committee:** Investors should determine whether the company has a committee of

independent board members charged with setting executive remuneration/compensation. Committees that lack independence could be overly pressured by management to award compensation that is excessive when compared with other comparably situated companies, or to provide incentives for actions that boost short-term share prices at the expense of long-term profitability and value. It is also responsible for ensuring that the remuneration packages offered to management are commensurate with the level of responsibilities of the executive, and appropriate in light of the company's performance.

**(c) Nominations Committee:** Investors should determine if the company has a nominations committee of independent board members that is respon-



sible for recruiting board members. The nominations committee is responsible for:

- Recruiting new board members with appropriate qualities and experience in light of the company's business needs;
- Regularly examining the performance, independence, skills and expertise of existing board members to determine whether they meet the current and future needs of the company and the board;
- Creating nominations policies and procedures; and
- Preparing for the succession of executive management and the Board.

**(d) Other Board Committees:** Investors should determine whether the board has other committees that are responsible for overseeing management's activities in certain areas, such as risk management, corporate governance, mergers and acquisitions, or legal matters. Whether these committees consist of only independent members is an important factor to weigh in evaluating the degree to which the committee is dedicated to achieving what is best for the company and shareholders.

## (3) Transparency

**(a) Related Party Transactions:** Investors should investigate whether the company engages in outside business relationships for goods and services on behalf of the company with management or board members, or individuals associated with them. To ensure the independence of board members, the company should discourage them from engaging in such related party transactions.

**(b) Executive Compensation:** Investors should analyse both the amounts paid to

key executives for managing the company's affairs, and the manner in which compensation is provided to determine whether compensation paid to its executives is commensurate with the executives' level of responsibilities and performance, and provides appropriate incentives. Disclosures of how much, in what manner, and on what basis executive management are paid shed light on how the board guards interests of shareholder. A biased compensation programme may encourage executives to make decisions that generate additional compensation to them through short-term gains, rather than implement an appropriate strategy that focuses on long-term growth. On the other hand, an appropriately designed programme can create incentives for company executives to generate positive results for shareholders.

#### **(4) Shareholder Rights**

Among the rights associated with shares of common stock is the right to elect board members and to vote on matters that may affect the value of their holdings, such as mergers or acquisitions. Other rights may include the right to apply the cumulative votes of one's shares to one or a limited number of Board nominees, the ability to nominate persons to the Board, or to propose changes to company operations. Shareholders may not have all these rights in all cases, and even when they do, they may have difficulty exercising them.

**(a) Proxy Voting:** Investors should determine whether the company permits shareholders to vote their shares by proxy regardless of whether they are able to attend the meetings in person. The ability to vote one's shares is a fundamental right of share ownership. In some jurisdictions, shareholders may find

it difficult to vote their shares because the company accepts only those votes cast at its annual general meeting, and does not allow them the right to vote by proxy or imposes other constraints. By making it difficult for Shareholders to vote their common shares, the company limits a shareholder's ability to choose board members or otherwise to express their views on other initiatives that could alter the company's course.

**(b) Convey Transfer of Shares:** Shares traded through stock exchanges are transferred through book entry at the depositories. Cash settlement occurs at the designated clearing banks of the stock exchanges' clearinghouses.

**(c) Obtain relevant information on corporation on a timely and regular basis.** Annual and half yearly statements are mailed to shareholders; quarterly accounts are published in newspapers and posted on the websites of issuers and stock exchanges. Companies must file their memorandum, articles of association and financial information with a Registrar of Companies.

**(d) Voting for Other Corporate Changes:** Changes to certain corporate structures have the ability to affect the value, ownership percentage, and rights associated with the company's securities. Among the issues shareholders should review is the ability of shareholders to effect changes to the Company's Articles of organisation, by-laws, governance structures, voting rights and mechanisms, poison pills, and change-in-control provisions.

#### **(5) Other Shareholder Rights Issues**

**(a) Ownership Structure:** A Company that assigns one vote to each share is more likely to

have a board that considers and acts in the best interest of all shareholders. Conversely, a company with different classes of common shares in which the majority, or all, of the voting rights are given to one class of shareholders is more likely to have a management team and board that are focused on the interests of only those shareholders. The rights of other shareholders may suffer as a consequence. Companies with dual classes of common equity could encourage potential acquirers to deal directly with those shareholders who own the shares with super-voting rights.

**(b) Takeover Defences:** Shareholders should carefully evaluate the structure of existing or proposed takeover defences and analyse how they could affect the value of shares in a normal market environment and in the event of a takeover bid. Such disclosures should provide shareholders with information about the situations in which takeover defences — such as so-called golden parachutes, poison pills and greenmail — could be used to counter a hostile bid.

#### **(6) Value Creation and Social Awareness**

Until recently value creation was primarily associated with satisfying the equity shareholders, given shareholder's voting rights and power to influence the board constitution. The concept of equitable value creation for all stakeholders including debt-holders, employees, customers, suppliers and society is now gaining momentum. Strong and equitable value creation for each of the stakeholders has undoubtedly been a contributing factor in this company's continued success. Thus, unless companies create value for stakeholders, shareholder wealth creation will not be sustained in the long run.

The shareholders should determine whether:

- The company has been given high ratings by any approved credit rating agency like CRISIL and ICRA.
- There is growth in the number of employees and the job opportunities created by the company.
- The company has contributed to social projects and whether company has taken any steps towards its environmental and social responsibility.

### Section III: CG Practices of Infosys

Infosys was incorporated in 1981 with the vision of building a globally respected corporation – a vision that has translated into a strong organisational commitment towards discipline, fair play, and good corporate governance. Infosys was the first Indian company to emphasise on strong corporate governance practices in India. The company expanded its corporate governance practices significantly beyond what was required by the letter of the law. It voluntarily complied with the US GAAP accounting requirements, and was the first company to prepare financial statements in compliance with the GAAP requirements of eight countries. The company was also among the first in the country to incorporate a number of innovative disclosures in its financial reporting, including human resources valuation, brand valuation, value-added statement and EVAR report. ‘Integrity, fairness and transparency across its operations’ has been the main mantra for Infosys.

Infosys emphasises its commitment to a strong value system and corporate governance practices, by making this an integral

part of the training of every employee. Infosys was a pioneer in inducting independent directors to its Board, thus greatly strengthening Board oversight of senior management in the company. Over the years, the management emphasised continuous dialogue with its investors and placed a high priority on investor relations and feedback. For example, Infosys’ early investments in stock markets ended as soon as it was apparent that investors felt that these added no value. Infosys’ focus on corporate governance not only brought global visibility to the company but also created pressure on other Indian firms to raise their governance standards. This led to an encouraging trend of companies across industries scaling up their corporate governance standards and going beyond mandatory requirements.

Infosys believes that good corporate governance must also translate into being a responsible corporate citizen. The senior executives of Infosys have also served on various task forces set up by the Indian government to develop meaningful corporate governance codes and ethical industry practices. Over the last 25 years, Infosys has remained committed to being ethical, sincere and open in its dealings with all its stakeholders. It has enabled the company to build an organisation that is trusted and admired not just in India but also by companies across the world. Its disclosure standards, detailed segmental data, presentation of accounts as per GAAP of eight countries, detailed cost break-ups - are among the best in the industry. Infosys also provides the most detailed manpower data - very important in its space. Age profiles, experience, education levels and gender mix are all elaborated in detail. Infosys is one of

the very few companies in India to have a nomination committee, which provides training to its non-executive directors and appraises their performance. Where Infosys loses out is on the issue of stock options, high cash levels impacting return ratios and a relatively large board with about 15 board members. Corporate governance has emerged as the foundation of successful companies both in India and globally. Today shareholders, institutional investors, lenders and other stakeholders demand more information on the capability and integrity of boards and management of companies they deal with and the processes these companies follow.

### Corporate Governance Ratings

**CRISIL:** CRISIL assigned “CRISIL GVC Level 1” rating to Infosys. This Governance and Value Creation (GVC) rating indicates capability to create wealth for all our stakeholders while adopting sound corporate governance practices.

**ICRA:** ICRA assigned CGR 1 rating to corporate governance practices of Infosys. The rating of CGR 1 is the highest on ICRA’s Corporate Governance Rating (CGR) scale of CGR1 to CGR 6. Infosys is the first company to be assigned the highest CGR by ICRA.

**TNS Survey:** “Ranked 1” in the category of “Good reputation Index”.

### The financial transparency and disclosure standards of Infosys are the world’s best.

- It is awarded First position in SAFA (South Asian Federation of Accountants)
- Best Presented Accounts Award 2004 in the Communication and Information technology Sector based on the evaluation of the Annual Report of the company.

- “Best Annual report” award from the Institute of Chartered Accountants of India for the 10<sup>th</sup> successive year.
- Infosys topped the regional rankings for best Corporate Governance in Asia Money’s Corporate Governance Poll.
- It has also received National award for Excellence

in Corporate Governance from the Institute of Companies Secretaries of India.

### Section IV: CG Score & Company Valuation

Taking into account the above variables and studying the corporate governance of the company in detail we got the following scores for Infosys Technologies Ltd. (The details of the scores are given in the table below)

#### Corporate Governance Score of Infosys Technologies (2002-2007)

	2007	2006	2005	2004	2003	2002
Corporate governance score	85%	85%	83%	81%	79%	75%

**Corporate Governance and Company Valuation:** To determine the relationship between Corporate Governance and Market Valuation following three indicators have been considered.

1. Company Valuation.
2. Dividend Payout Ratio.
3. Operating Performance. (Turnover and Profit after Tax)

Market capitalisation (the current stock price multiplied by the number of shares outstanding) also serves as a company's price tag. But market capitalisation ignores debt, and with some companies, debt is substantial enough to change the picture significantly. To overcome this shortcoming the latest concept is Enterprise Value, which is a modification of market capitalisation that incorporates debt.

It represents a company's economic value -- the minimum amount someone would have to pay to buy it outright. It's an important number to consider when market value of a company is calculated.

To calculate enterprise value, company's market capitalisation value is taken, total debt added (found on a company's balance sheet, to get total debt, add together long and short term debt), and cash and investments subtracted (also on the balance sheet).

Market capitalisation = current share price times total shares outstanding

Debt = long-term debt + short-term debt

Enterprise value = Market capitalisation - Cash and Equivalents + Debt

Following table shows the CG score, market Capitalisation and Enterprise Value of Infosys Technologies Limited.

Period	2007	2006	2005	2004	2003	2002
Market Capitalisation (in Rs. Cr)	115307	82154	61073	32909	26847	24654
Enterprise Value (in Rs. Cr)	109657	78375	59390	31070	25208	23627
Corporate governance score	85%	85%	83%	81%	79%	75%

**Result of correlation:** Between Market Capitalisation and CG Score is + 0.83 and between Enterprise value and CG Score is + 0.82

It is very interesting to note from the above table that with the rise in CG score the Market Capitalisation and Enterprise Value is also on the rise. Both of these clearly suggest a very high positive correlation between the variables.

**Coefficient of determination:** Coefficient of determination; indicates how much variation in the response is explained by the model. The higher the R<sup>2</sup>, the better the model fits the data.

Here, the coefficient of determination between the CG score and market capitalisation is:

$$R = 0.90 \quad R \text{ Square} = 0.81$$

And, the coefficient of determination between the CG score and Enterprise valuation is:

$$R = 0.85 \quad R \text{ Square} = 0.72$$

Regression coefficients above suggest that 81% variation in Market Capitalisation and 71% Enterprise value is explained by corporate governance.

#### t-Test: Two-Sample Assuming Equal Variances

	Market Capitalisation	CG Score
Mean	4.68	0.81
Variance	0.07	0.001
Observations	6	6
Pooled Variance	0.039	
Hypothesised Mean Difference	0	

Df	10	
P(T<=t) one-tail	5.98	
t Critical one-tail	1.81	
P(T<=t) two-tail	1.19	
t Critical two-tail	2.23	

	<i>Enterprise Value</i>	<i>CG Score</i>
Mean	4.66	0.81
Variance	0.07	0.01
Observations	6	6
Pooled Variance	0.039	
Hypothesised Mean Difference	0	
df	10	
P(T<=t) one-tail	6.69	
t Critical one-tail	1.81	
P(T<=t) two-tail	1.33	
t Critical two-tail	2.22	

### Corporate Governance and Payout Policy

The major objective of adequate corporate governance practices is the satisfactory payback to company shareholders. Under the assumptions of the original Modigliani Miller irrelevant theorems, dividend policies are irrelevant for company value and shareholders wealth.

Among the various theories, the

rent seeking theory of the effect of agency problems on payout policies seems to be especially relevant in India. Large and controlling shareholders have the incentives and the power to extract private benefits of control at the expense of the minority shareholders, because they receive the full benefits

but only bear a fraction of the cost. In that context, a dividend payment guarantees equal treatment to all shareholders.

In this section, we correlate the dividend per share and corporate governance score of the company for the period FY 2002-2007.

### CG Score and Dividend Payout Ratio of Infosys Technologies (2002-2007)

	2007	2006	2005	2004	2003	2002
<b>Dividend Payout Ratio</b>	11.5	15	11.5	29.5	27	20
<b>Corporate governance score</b>	85%	85%	83%	81%	79%	75%

Result of Correlation: + 0.62

Regression Statistics:

R = 0.62      R Square = 0.39

### t-Test: Two-Sample Assuming Equal Variances

	<i>Dividend Payout</i>	<i>CG Score</i>
Mean	19.08	0.81
Variance	60.74	0.00
Observations	6	6
Pooled Variance	30.37	
Hypothesised Mean Difference	0	
df	10	
t Stat	5.74	
P(T<=t) one-tail	9.36	
t Critical one-tail	1.81	
P(T<=t) two-tail	0.00	
t Critical two-tail	2.22	

A moderate positive correlation has been established between CG and dividend payout. It signifies that better CG though leads to better operating performance but does not necessarily mean high payout to shareholders.

### Corporate Governance and Operating Performance

“Indeed reputation harm and financial damage that can be caused by conflicts of interest and poor oversight are undeniable”- Bob Stein

Improving the performance is related with profitability, which in turn is return of brand image. Therefore, the brand is the practical reason for improving the governance. Improved governance also protects the viability of business by regaining the customer confidence and market trust.

In this section, we correlate the profit after tax and turnover with corporate governance score of the company for the period FY 2002-2006.

**CG Score, Turnover and PAT of Infosys Technologies Limited (2002-2007)**

Period	2007	2006	2005	2004	2003	2002
Profit after tax in Rs. (Cr)	3777	2421	1859	1243	958	808
Income (Turnover in Rs. Cr)	13149	9028	6860	4761	3623	2654
Corporate governance score	85%	85%	83%	81%	79%	75%

**Results of Correlation:** Correlation with profit after tax is +0.83 and with turnover is +0.86

Regression Statistics: with profit after tax is:

R = 0.95      R Square = 0.90

With Turnover is:

R = 0.92      R Square = 0.84

Turnover proxy of Firm size is positively correlated with good corporate governance practices. High positive correlation between PAT also suggests that better corporate governance practices result in better operating performance. Coefficient of determination confirms the inferences drawn from the coefficient of correlation. One can argue that even with the highest estimates of financial fundamentals one can achieve the same growth in value by more than twice sales growth or 35% increase in profitability. Therefore, increase in financial results demands more efforts compared to corporate governance practices improvement leading to the same value growth. But again improving the performance is related with profitability, which in turn is the

return of brand image. Therefore, the brand is the practical reason for improving the governance.

**Section V: Summary and Conclusions**

The relation between corporate governance and organisational performance is of fundamental importance to practitioners, academics and policy makers. Assumptions and strongly held beliefs about the importance of governance are shaping the current regulatory climate for the design of governance structures. In this study, we have developed through a comprehensive analysis a very high positive relationship between level of Corporate Governance and market valuations of the company which indicates that superior governance results in better valuations. Companies with high governance rankings enjoy superior market premiums.

To sum up:

1. We find that better corporate governance is associated with higher operating per-

formance and higher valuations.

2. Firms could improve investors' wealth and protection rights by increasing disclosure, selecting well-functioning and independent boards, imposing disciplinary mechanisms.
3. These results are consistent with results found in Gompers et al. (2001), which find that firms with stronger corporate governance have relatively higher wealth creation in the US.
4. Better Corporate Governance leads to value creation for all the stakeholders.

Good governance requires a mindset within the corporation, which integrates the corporate code of ethics into the day-to-day activities of its managers and workers. As the sociologists Rossouw and van Vuuren note, companies must move from the "reactive and compliance mode" of corporate ethics, to the "integrity mode", where the functions of the entire organisation are completely aligned with its value system. □

## GLOBAL BEST PRACTICES IN INDIAN BANKING



With greatly improved strength and financials, Indian banks are now well placed to capitalise on increasing global opportunities for further growth through diversification. Healthier balance sheets, consequent to the financial sector reforms, have created the enabling environment for Indian banks to progress towards achieving global benchmarks in terms of prudential norms and best practices.

**T**he Indian banking landscape has witnessed unprecedented transformation in the past decade. At one point of time Indian banking operated in a very tightly regulated environment but today it operates in an increasingly deregulated and market driven, competitive environment. Alongside introduction of new players and instruments, there has been strengthening of prudential regulation and supervision. With greatly improved strength and financials, Indian banks are now well placed to capitalise on increasing global opportunities for further growth through diversification. In the words of RBI Governor, Dr. Y.V. Reddy, “our banking cannot afford to lag behind international standards nor remain unaffected by global developments in banking”. Healthier bal-

ance sheets, consequent to the financial sector reforms, have created the enabling environment for banks to progress towards achieving global benchmarks in terms of prudential norms and best practices.

### Why Best Practices

Following international best practices and observing universally acceptable standards and codes is necessary for strengthening the domestic financial architecture as also ensuring smooth integration with world financial markets, tapping new markets and expanding business. This includes best practices in areas such as risk management, corporate governance, transparency and disclosures in financial statements, business management, and customer access. Moreover, operating in a liberalised system,

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Best practices in risk management suggest that the performance of commercial entities such as banks be measured not in accounting terms alone such as return on assets or return on equity, but by measuring the contribution to shareholder wealth maximisation, taking into account the actual risk taken to earn the expected return.

driven by market forces, almost by definition, exposes financial intermediaries to greater risk and to the disequilibrium tendencies inherent in financial markets. In order to reap the benefits of liberalisation, it is, therefore, desirable for financial institutions to work within a defined framework in terms of certain minimum standards and to benchmark their performance and progress in terms of widely accepted best practices. For a bank, best practices provide a benchmark to assess performance vis-à-vis peers and industry leaders, with the objective of enhancing value for all stakeholders.

### Global Best Practices

The reference to 'best practices' is usually a reference to 'international standards' set by international financial institutions and other standard setting bodies, notably the BCBS. These standards, or best practices, which have evolved mostly as a result of the recognition and understanding of the weaknesses that precipitated financial crises, are generally accepted as good principles, practices and guidelines for relevant areas in the financial system. They are accorded importance because of their contribution to sound financial fundamentals, their role in strengthening financial regulation, enhancing transparency, facilitating institutions development and reducing vulnerabilities. By facilitating informed decision-making in lending and investment, they help

minimise the risks of financial distress and contagion. By promoting convergence of practices among countries, they allow clear assessment methodologies for comparability across jurisdictions.

### Risk Management

In today's competitive and complex financial environment, the success of a bank depends critically on how well it assesses, prices and manages risks; on its ability to limit losses from particular transactions; and to keep its overall exposure controlled. Proactive management of risk ensures that risks are consciously taken with full knowledge, clear purpose and understanding so that it can be measured and mitigated wherever it is felt necessary. In the era of Basel II, the art of effectively managing risk has become even more challenging and require that the nature of risks inherent in banking business be properly understood.

Best practices in risk management suggest that the performance of commercial entities such as banks be measured not in accounting terms alone such as return on assets (ROA) or return on equity (ROE), but by measuring the contribution to shareholder wealth maximisation, taking into account the actual risk taken to earn the expected return. To arrive at such a measure, viz the Risk Adjusted Return on Capital (RAROC), it is necessary to regard each business segment such as co-

porate, retail, trading, etc as a specialised business unit (SBU) with an expected target of return. If the SBU is able to earn a return higher than the target, it is adding value to the bank. Allocation of capital based on the contribution of each SBU to the overall risk of the bank, and risk-adjusted performance measurement facilitates alignment of objectives at SBU and bank level as similar measures of performance are used throughout the bank. Establishment of an enterprise-wide risk management system will enable capital allocation to businesses within the bank based on risk-adjusted performance measurement. As Indian banks move towards international best practices, integrating risk management into the business process, use of RAROC will help banks determine pricing, measure performance, and manage capital effectively. Transiting from capital adequacy to capital efficiency, banks may increasingly focus on "just-in-time balance sheet" management to ensure efficient use of capital.

Since advances in technology, telecommunications, and markets have changed the way that banks assess, measure and manage their risks, the Basel Committee has drawn up the New Capital Adequacy framework, with a view to providing incentives "to advance the state of the art in risk management across the industry". The Basel II framework envisages a three-pillar approach.

In order to pursue the global best practices, Dr A.S Ganguly, Chairman of the Consultative Group on Corporate Governance recommended and stressed, *inter alia*, the need for making the boards of banks more contemporarily professional by the observance of “fit and proper norms” in nomination of Directors. The whole-time directors should have sufficiently long tenure to enable them to leave a mark of their leadership and business acumen on the bank’s performance.

The first pillar aligns minimum capital requirements more closely to banks’ actual underlying risks. Qualifying banks will rely partly on their own measures of those risks, a rule that is designed to create incentives for banks to improve those measures. The second pillar – supervisory review, allows supervisors to evaluate each bank’s assessment of its own risks and to determine whether those assessments seem reasonable. The third pillar - market discipline, provides external incentives for prudent management. Disclosures allow market participants to assess key information on the scope of application, capital, risk exposures, risk assessment process and hence the capital adequacy of a bank. It strengthens the ability of market participants to reward well-managed banks and to penalise poorly managed ones by enhancing transparency in bank’s financial reporting.

It is widely acknowledged that implementing Basel II is a complex task, given the magnitude of data required, the need for technical skills, technology implications, cost of compliance and capacity building. The task is particularly daunting in the Indian context given the diversity of banks and divergence in structure. The implementation issues have to be, therefore, viewed in a country context. For example, the extent of

disclosures to be made would need to keep in view the level of maturity of the financial sector and the levels of assimilation of information by the stakeholders and the public.

Keeping in view the Reserve Bank’s goal to have consistency and harmony with international standards and to adopt the pace as appropriate in the context of country-specific needs, the Reserve Bank had in April 2003 accepted in principle to adopt the New Accord and taken several initiatives to sensitise banks to the opportunities and challenges emerging from Basel II norms. Accordingly, at a minimum, all banks in India, to begin with, will adopt Standardised Approach for credit risk and Basic Indicator Approach for operational risk. The importance of capacity-building for successful implementation of the Accord has been recognised and appropriate action initiated by banks and RBI. After adequate skills are developed, both in banks and at supervisory levels, some banks may be allowed to migrate to Internal Rating Based (IRB) Approach.

### **Anti-Money Laundering and Know Your Customer Norms**

The globalisation of financial markets, dismantling of controls, capital mobility, and technological advancement has exposed banks to the risk of criminal misuse for laundering of illegal

proceeds. (Money Laundering refers to the process by which criminals attempt to conceal the true origin and ownership of the proceeds of their criminal activities. It encompasses involvement in a transaction or series of transactions that seek to disguise the nature or source of proceeds derived from illegal activities). In a deregulated environment, with more operational freedom devolving on banks, the risk of being unwittingly used as intermediaries for transfer or deposit of funds derived from criminal activity is accentuated. Sound ‘Know Your Customer’ (KYC) policies and procedures are, therefore, critical for protecting the safety and soundness of banks. The inadequacy of KYC standards can subject banks to serious customer and counterparty risk, resulting in substantial financial cost to banks.

Considerable work has been done by international standard-setters such as Basel Committee and the Financial Action Task Force (FATF) to lay down detailed Guidelines on Account Opening and Customer Identification and Consolidated KYC Risk Management apart from the Customer Due Diligence process for financial institutions. The Financial Action Task Force has formulated Forty Recommendations which provide a comprehensive blueprint of the action required to prevent the use of the financial system

In Indian context, it is emphasised that the customer acceptance policy should not be so restrictive that it results in a denial or access by the general public to banking services, especially for people who are financially or socially disadvantaged. On the other hand, quite extensive due diligence would be essential for an individual with a high net worth whose source of funds is unclear.

for money laundering. International best practices for combating money laundering require banks to develop clear customer acceptance policies and procedures, including a description of the types of the customers that are likely to pose a higher than average risk to a bank. By developing graduated customer acceptance policies and procedures, banks can conduct more extensive due diligence for higher risk customers.

In Indian context, it is emphasised that the customer acceptance policy should not be so restrictive that it results in a denial or access by the general public to banking services, especially for people who are financially or socially disadvantaged. On the other hand, quite extensive due diligence would be essential for an individual with a high net worth whose source of funds is unclear.

Developing appropriate methods of monitoring is critical for identification of 'suspicious activity' throughout the customer relationship, and reports are required to be made to the competent authorities. The Prevention of Money Laundering Rules, notified in July 2005, have provided a definition of what constitutes 'suspicious activity' and the procedure for reporting by banks to the newly constituted Financial Intelligence Unit (FIU) is being finalised by the Government in consultation with RBI. The same has already been communicated to banks.

The extant KYC guidelines issued by RBI incorporates best practices in this regard and provides guidance to banks regarding account opening, risk management, reporting of transactions, record maintenance and training of staff. Recognising that there are certain issues in implementing KYC norms in the Indian context such as difficulty in obtaining suitable documentation especially for customers in rural/semi-urban areas, suitable relaxations have been made. Notwithstanding initial difficulties such as in determining appropriate parameters for risk profiling and migration depending on account/transaction behaviour, need for customer education, etc. the issue is to put in place the requisite systems and procedures for preventing criminal misuse of the banking system.

### Corporate Governance

Corporate governance deals with "the ways that suppliers of finance to corporations assure themselves of getting a return on their investments". In banks, depositors are the main suppliers of finance and, therefore, their interest is paramount. Strong banking system pre-supposes good leaders who would ensure that highest ethical standards are maintained while carrying on business operations with due diligence. The Basel Committee proposed the following seven principles, viz establishing strategic objectives, setting and enforcing clear lines of re-

sponsibility and accountability, ensuring that board members are qualified for their position and not subject to undue influence from the management or outside powers, ensuring proper oversight by senior management, effectively utilising the work conducted by internal and external auditors, ensuring that compensation policies are consistent with the banks' ethical values, and conducting operations in a transparent manner.

In order to pursue the global best practices, Dr A.S Ganguly, Chairman of the Consultative Group on Corporate Governance recommended and stressed, *inter alia*, the need for making the boards of banks more contemporarily professional by the observance of "fit and proper norms" in nomination of Directors. The whole-time directors should have sufficiently long tenure to enable them to leave a mark of their leadership and business acumen on the bank's performance. The Board's focus should be on strategic issues, risk management systems, internal control processes and overall governance standards.

Sound corporate governance is premised on two pillars, viz the mechanism by which corporations are directed and controlled and the mechanism by which those controllers of the corporations are supervised. The best corporate governance practices are essential to avoid risks of systemic crisis and to enhance value of all stakeholders. Em-

A bank can choose to follow a passive approach or a proactive approach in regard to adoption of best practices. What is important is to understand the logic underlying the evolution of the best practice and to use it as a benchmark to strive towards value enhancement for all stakeholders.

Empirical evidence has clearly proved that the effect of bad governance could lead to serious systemic crisis.

There is an increasing body of public opinion that deems a business enterprise not merely as an economic unit but also as a good corporate citizen. For this, corporate governance in business organisations must be based on a genuine respect for business ethics and values. Organisations that do not follow good governance practices will not be able to create "value". Value creation will be measured by the quality of business strategy to achieve adequate balance between growth and profitability.

The key to good governance goes beyond regulation and includes commitment to core values, ethics and culture but these are country-specific, and driven more by climate of acceptable behaviour than by board structure. The evolution of a culture of social conscience is difficult to capture and enshrine as best practices for all time and, therefore, would necessarily have to be constantly reviewed in a dynamic environment.

### Transparency and Disclosures in Financial Statements

The users of the financial statements of a bank need relevant and reliable information which assists them in evaluating the financial position and performance of the bank and which

is useful to them in making economic decisions. The users of the financial statements of a bank are interested in the liquidity and solvency and the risks related to the assets and liabilities recognised on its balance sheet and also its off balance sheet items. The risks that a bank is exposed to such as risk arising from interest rate movements may be reflected in the financial statements, but users obtain better understanding if the management provides a commentary on the financial statements which describes the way it manages and controls the risks associated with the operations of this bank. Banks use different methods for the recognition and measurement of items in their financial statements.

The Generally Accepted Accounting Principles (GAAP), encompass conventions, rules and procedures necessary to define accepted accounting practices

at a particular point in time. The discussion of standards refers to the work by standard setting entities, i.e., International Accounting Standards Committees (IASC), International Auditing Practices Committee (IAPC), United States Generally Accepted Accounting Principles (US GAAP) and Accounting Standards Board (ASB). The adherence to US GAAP has become necessary in view of the growing interest in raising resources through ADRs and listing in US exchanges. In India, the Accounting Standards Board of the Institute of Chartered Accountants of India is responsible for setting accounting standards. ASB of ICAI has so far issued 32 standards, which are at par with those of international standards subject of course to differences arising from country specific characteristics.

The Auditing and Assurance Standards Board (AASB) of the Institute of Chartered Accountants



tants of India has issued 35 standards.

### Assessment of Position *vis-à-vis* Industry Best Practices

Assessment of bank's position *vis-à-vis* industry best practices, using key benchmarking financial metrics and processes, provides senior management with an external 'snapshot' of where the organisation ranks vs. peers and industry leaders. Assessment of best practices analyses the organisation's processes, workflow, and staffing major areas such as retail delivery, sales and customer relationship management (CRM), human resources, finance and

accounting. The objective of such an assessment is to reduce current operating expenses, improve productivity to avoid future cost increases, increase revenue, improve the quality of consistency of service delivery and position the organisation for continued growth and expansion.

In the growing trend towards consolidation, transitioning to the right market position, based on core competencies and capitalising on synergies, is a significant strategic decision for a bank, with the challenge of achieving successful integration of manpower and culture in the merged entity. Since it is the

bank's human resources, which is the driver of change, a critical issue is development of this human capital and leveraging of existing capacities/capabilities to achieve organisational goals in a dynamic environment. Absorption of appropriate technology and better knowledge management will be key enablers for strategic business positioning to meet future challenges.

According to solution providers like SAP, many banks are moving away from traditional practices and adopting forward thinking "best practices" to support profitable growth in key areas (Strategies for Profitable Growth in Banking Industry).

<b>Business Issue</b>	<b>Traditional Practice</b>	<b>Best Practice</b>
Customer and market access	Multiple channels for customer access and service	Integrated multi-channel access linked to CRM tools for cross-setting, back office systems, and a single, risk related view of the customer
Product delivery	Mass-market targeting for all products	Efficiently targeted market segments with an appropriate mix of fast time to time market and flexible product development capabilities – or focus on high volume sales combined with low-cost production and economies of scale
Business management	Improved cost/income ratio through cost cuts incremental process enhancement within siloed, legacy systems and processes	Improved return on equity (ROE) and year over year revenue growth through increased business agility via. a step change in operational efficiency gained by streamlining business processes and making them more effective
Risk management and regulatory compliance	Viewed as cost of doing business and invested with the minimum effort and resources required	Leveraged risk management and regulatory compliance efforts for a better understanding of customers, markets, demands and processes while improving business efficiency and year over year revenue growth

### Indian Approach

India has been playing an increasingly active role in international fora, contributing to the formulation of best practices by providing the developing country perspective on relevant is-

sues. It was one of the first countries which subjected itself voluntarily to the Financial Sector Assessment Programme (FSAP) of the IMF and assessed to be in high compliance with the relevant principles. The

RBI's association with the Basel Committee on Banking Supervision dates back to 1997 with India being among the 16 non-member countries, which were consulted in the drafting of the Basel Core Principles. The Re-

serve Bank of India became a member of the Core Principles Liaison Group in 1998 and subsequently became a member of the Core Principles Working Group (CPWG) on Capital. Within the CPWG, the Reserve Bank has been actively participating in the deliberations on the Accord and led a group of 6 major non G-10 supervisors which presented a proposal on a simplified approach for Basel II to the Committee.

Although best practices provide a benchmark for market participants to operate efficiently, their implementation will necessarily have to be suitable to country-specific priorities and circumstances, varying under different economic circumstances. To quote Dr. Y.V. Reddy, "The Im-

plementation of standards must fit into a country's overall strategy for economic and financial sector development taking into account the stage of development, level of institutional capacity and other domestic factors". (Market Integrity, *ibid*). The Standing Committee on International Financial Standards and Codes, monitors developments in global standards and codes, and looks into applicability of these standards to the Indian financial system. The Reserve Bank's approach to the Institution of prudential norms is one of gradual convergence with International standards and best practices with suitable country specific adaptations. The objective is to reach global best standards in a deliberately

phased manner through consultative process evolved within the country.

## Conclusion

There is need to understand clearly the controllable and uncontrollable variables in the dynamic environment in which banks operate and to acknowledge that 'best' practices are themselves evolving in the light of experience and in time with changing circumstances. A bank can choose to follow a passive approach or a proactive approach in regard to adoption of best practices. What is important is to understand the logic underlying the evolution of the best practice and to use it as a benchmark to strive towards value enhancement for all stakeholders. □

# SOCIAL SECURITY IN INDIA AND REVERSE MORTGAGE LOAN — RATIONALE, CONCEPT AND APPLICATION

Shift from joint families to nuclear families, particularly in urban areas, and increasing lifespan over the years have given rise to old age social security concerns in India on a vast scale. Most of senior citizens in urban India today depend either on 'retirement benefits' or on their children for their financial needs, which increase with age, particularly in view of increase in medical expenses. While returns on investments in traditional saving instruments are increasingly proving inadequate for them, an investment in riskier high return instruments is not advisable for them. In this backdrop, the Reverse Mortgage Loan (RML), which has been recently introduced to Indian financial market, offers a viable option to the senior citizens to earn a steady income by pledging their homes for a comfortable living. This article provides an overview of this new concept in Indian context.

World wide, the percentage of people over 60 years of age is expected to rise from 9% to 16% in the next 35 years whereas in India, the number is estimated to double between 1991 and 2016. Old age comes with its own share of problems. As a person grows older and his regular source of income dries up, his dependence on others increases significantly. With health care expenses on the rise and little social security available, living the golden years respectfully can be quite a challenge for senior citizens in India. In such a scenario, a regular income flow that can help them meet their financial needs and maintain their current living standards becomes important. One

typical feature of most senior citizens is that their residential property accounts for a significant portion of their total asset composition. And, given its illiquid nature, property fails to aid senior citizens on the liquidity front.

## The Genesis

With unstable interest rate movement, it becomes very difficult to earn these days by investing in traditional instruments on a regular basis. Alternatively, investing in riskier instruments, which offer higher returns than traditional instruments, is not advisable for the elderly at this stage of their life. They simply cannot afford to gamble with their hard-earned money. Moreover, not all of them are fortunate enough to have sufficient deployable



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fund for investment and majority of them do not receive any pension. At present, there are only two main ways of getting cash for one's house, either by selling it or borrowing against the house. In the former, when the house is sold, one has to move out, while in the latter case, the person would have to make monthly loan repayments, both of which might not be feasible in old age.

With the fall in returns on savings due to the soft interest rate regime and increased longevity, "reverse mortgage loan", enabling senior citizens to earn a steady income by pledging their homes for a comfortable living, has recently been introduced to the Indian financial market. Unlike life insurance, where a person pays throughout life to get a lump sum amount at the end, reverse mortgage, a loan against home, enables a person get payment either in lump sum or on monthly basis or as customised by borrower, even as his or her income might be nil and need no repayment till death. A recent World Bank study found that only about 10 per cent of the population had some of other sort of social coverage in India. As such, nearly 90% of the population has no formal social security. National Housing Bank had commissioned a research, which found that there were 3.87 million house-owning individuals above 65 years in India in March 2006.

Most of the reverse mortgage loans require no repayment for as long as the 'principal resident' lives in the house, but must be repaid in full, including all interest and other charges, when the last living borrower dies, sells the house, or permanently

moves away. Reverse mortgage loan would be better suited for the issueless senior citizens so that after their death, the lender could dispose it in the market. Unlike the situation in India where people need money for maintaining a comfortable living due to the reduced employment prospects after retirement, in the US, these types of mortgages typically go to the oldest borrowers living in the most expensive homes. According to industry experts, it is right time that the concept is brought into India, especially when the real estate sector is resurgent.

### International Scenario

Reverse Mortgage (known as lifetime mortgage in the United Kingdom) is now a well-exposed financial product in countries like USA, UK, Canada, France, Japan, Australia, and Singapore and in various other countries. A banker named Nelson Haynes of Deering Savings & Loan (Portland, ME); Maine issued the first known reverse mortgage in 1961 in USA. He delivered this product to Nellie Young, the widow of his high school football coach. In the US, the government launched the first RM product in 1991 through a government undertaking to build confidence in the product. Reverse mortgages were later used in other areas of US as well. But it was in eighties that their existence gained widespread popularity and got government endorsement. Today, there are a host of both state insured reverse mortgages as well as privately funded products.

### The Concept

Finance Minister of India introduced the idea of reverse

mortgage in 2007 Budget. To understand the concept of reverse mortgage, first let us understand what a regular mortgage is? In a regular mortgage, a borrower mortgages his new/existing house with the lender (Banks/PLI) in return for the loan amount (which in turn he uses to finance the property); the same is charged at a particular interest rate and runs over a predetermined tenure. The borrower then has to repay the loan amount in the form of EMIs (equated monthly installments), which comprise both principal and interest amounts. The property is utilised as a security to cover the risk of default on the borrower's part. Under RML, citizens aged 60 year and above will be able to pledge their house and derive a monthly income or a lump sum for 15 years while living in it. If you go for the lump sum amount, you can deposit it in a bank, withdraw from your account according to your requirements and keep earning interest on the balance. It is mainly meant for home rich senior citizens who are otherwise cash-poor. Reverse Mortgage works like a traditional mortgage loan, only in reverse direction. A borrower does not make regular payments to a lender; instead he receives payments from the lender. The National Housing Bank (NHB), a subsidiary of the Reserve Bank of India (RBI), has prepared the operational guidelines on reverse mortgage loan. In Budget speech 2008-09, the Finance Minister clarified the doubts related to Income-tax, saying that incomes receivable by the home owners are only a part of loan not an income therefore there arises no liability of income tax under

Income-tax Act, 1961.

### The Scheme

The National Housing Bank (NHB) recently introduced a novel product for senior citizens: a RML under which a senior citizen who is the owner of a house can avail of a monthly flow of income against the mortgage of his/her house, while remaining the owner and occupying the house throughout his/her lifetime, without repayment or servicing of the loan. Under this new scheme, a senior citizen, who owns a house, can be given a loan up to 40% of the market value of his house, if he is in the age group of 60-65 years. If the borrower's age is between 66-70, he can avail loan up to 50% of the market value. Similarly, people belonging to the age group of 71-75 can avail loans up to 55% of the market value of their houses. For the age group of above 75 years, loans up to 60% of houses will be offered. Borrowers can opt for receiving the money as fixed monthly payment also. In this case, the entire amount will be paid in the form of annuity (a sort of monthly income) for 15 years, which will be fixed, irrespective of the age at which borrowers take the loan.

In terms of receiving the loan amount, the borrower can opt for monthly, quarterly, annual or lump sum payments or payments at any other point in time as per his requirement. Also, a revaluation of the property has to be undertaken by the bank/HFC once every five years. However, before resorting to sale of the house, preference will be given to the owner or his heirs to repay or prepay the loan amount, along with the interest, and to get the mort-

gaged property released. Lenders are entitled to retain only the amount lent by them and any surplus over and above the original loan amount belongs to the borrower's children or legal heirs since the amount owed on a reverse mortgage can never exceed the value of the home at the time the loan is extinguished. The amount received through reverse mortgage is considered as loan and not income; hence it will not attract any tax liability.

This kind of mortgage helps a senior citizen avoid selling his property and thereby losing possession of the house during his lifetime, which he constructed as a shelter for his old age from savings of his lifetime. It is quite likely that whatever income he is having by way of pension or interest would be losing in value due to inflation, making it inadequate for his living. So the reverse mortgage offers a solution for the aged citizens who own a house. He can continue to live in the house till his demise and if the agreement is so worded, till the demise of himself or his spouse, whichever is later.

In India, PNB is one of the first state-run banks to launch the product. Corporation Bank has signed up with the country's largest insurer, Life Insurance Corporation of India to jointly launch a reverse mortgage product soon. Dewan Housing Finance Company Ltd. introduced the first Reverse Mortgage product named "Sakh-sam", in 2006. Of late, ICICI has launched a new product in this segment. Recently, NHB has developed a scheme of Reverse Mortgage Loan for elderly in India.

### Main Features of RML Scheme

1. When applying for a reverse mortgage, all owners must apply and sign the papers. The applicants must be at least 60 years old and own a home in India. Residual life of the home is more than 20 years, and must generally live in the home. Mobile homes are usually not eligible for reverse mortgages.
2. A borrower can request regular monthly payments, a credit line, or a lump sum distribution of cash. A combination of these payment plans can also be requested.
3. Loan amount is based on the age of the borrowers and co-borrowers, current and future value of the property, current interest rate and interest rate fluctuations.
4. Revaluation of the property is done ones in every five years and amount of loan may be revised on the basis of valuation of the property.
5. RML will be secured by way of mortgage of residential property; commercial property will not be eligible for RML.
6. In Reverse mortgage there is no formal restriction for the use of money. It can be used for any purpose e.g. domestic expenses, medical expenses, life style expenses, traveling expenses, and home repair expenses. etc.
7. Typically, a reverse mortgage loan requires no repayment for as long as

you live in your home. If the home is sold, the borrower moves, or the last living borrower dies, the loan must be repaid. Usually the home is sold to repay the mortgage.

8. Maximum duration of the RML product is 15 years.
9. House owners are responsible for repairs, local taxes, and insurance of the house. A default on any of these could cause your loan to become payable in full.
10. Reverse mortgage loan is not free of cost. Other than interest, some costs include application fees, closing costs, insurance, appraisal fees, credit report fees, legal fee, stamp duty and registration fee and possibly a monthly service fee.
11. The home is usually sold to repay the loan or the heirs can choose to repay. If the home is sold and the selling price exceeds the amount of the balance owed, the excess goes to the heirs.
12. Money received from a reverse mortgage is tax-free and does not affect social security or medicare benefits.
13. All reverse mortgages have a "non-recourse" feature, which means that the total amount owed can never exceed the appraised value of the home. If the amount owed exceeds the home's appraised value, then the lender or the NHB will absorb that loss.

Other than Reverse Mortgage products, there are a good number of similar **Home Equity Conversion**-based Products available in various countries.

These include:

**Mortgage Loan & Sharing Appreciation:**

In this scheme lender gets a pre-agreed share in any appreciation that may take place in the property value beyond the accumulated value of the loan. Here, the lender charges lower-than-market interest rate. Loan is fully repaid on death/sale/movement.

**Mortgage Loan with interest-only Payment:**

People having limited loan repayment capacity, but in urgent need of lump sum amount can take advantage of this product. During the tenure of the loan, the borrower is not required to make any payment of principal amount. He/She is to make only interest payments. The principal is due only on maturity/death/permanent move/sale.

**Mortgage Loan for Annuity Income:**

Here the loan amount is used to buy a life annuity. The interest on mortgage based loan is deducted from the annuity and the balance is paid as income periodically. The principal is repaid on death. The special feature of the product is that the annuity continues even if the borrower sells the house or moves out permanently.

**Risk Associated With Reverse Mortgage**

Reverse mortgage loan is not free from risk. Many direct or indirect risks are involved in Reverse Mortgage. The major risk here centers on mortality factor, interest rate factor and house property price factor. *Mortality Risk* surfaces if the borrower's life gets extended. Consequently, the loan repayment is also delayed and the loan outstanding goes on increasing with in-

terest application. *Interest Rate Risk* arises due to rate volatility which may disturb anticipated future rate structure altogether. Rise in interest rate increases loan outstanding. *Real Estate Market Risk* arises with fall and rise of property prices. A decline in home price always creates a risky proposition for the lender. All or any one or combination of these risks may create a situation of under securitisation for the lender.

**Reverse Mortgage Cost / Fees**

Reverse Mortgage loans are not free of cost. Other than interest cost, some other costs are also involved in the form of various fees, which are charged by the banks/financial institutions at the time of reverse mortgage agreement, which includes:

**1. Origination Fee:** The Origination Fee is the upfront fee charged by the Reverse Mortgage lender to initiate the loan.

**2. Mortgage Insurance Cost:** This is the cost of Reverse Mortgage insurance, which guarantees that reverse mortgage borrowers will continue to receive benefits under any circumstances and ensures that they will never owe more than the value of the home.

**3. Appraisal Fee:** An appraiser is responsible for assigning a current market value to your home. In addition to placing a value on the home, an appraiser must also make sure that there are no major structural defects, such as a bad foundation, leaky roof or termite damage. It is mandatory that your home be structurally sound, and complies with all home safety codes, in

order for the reverse mortgage to be made.

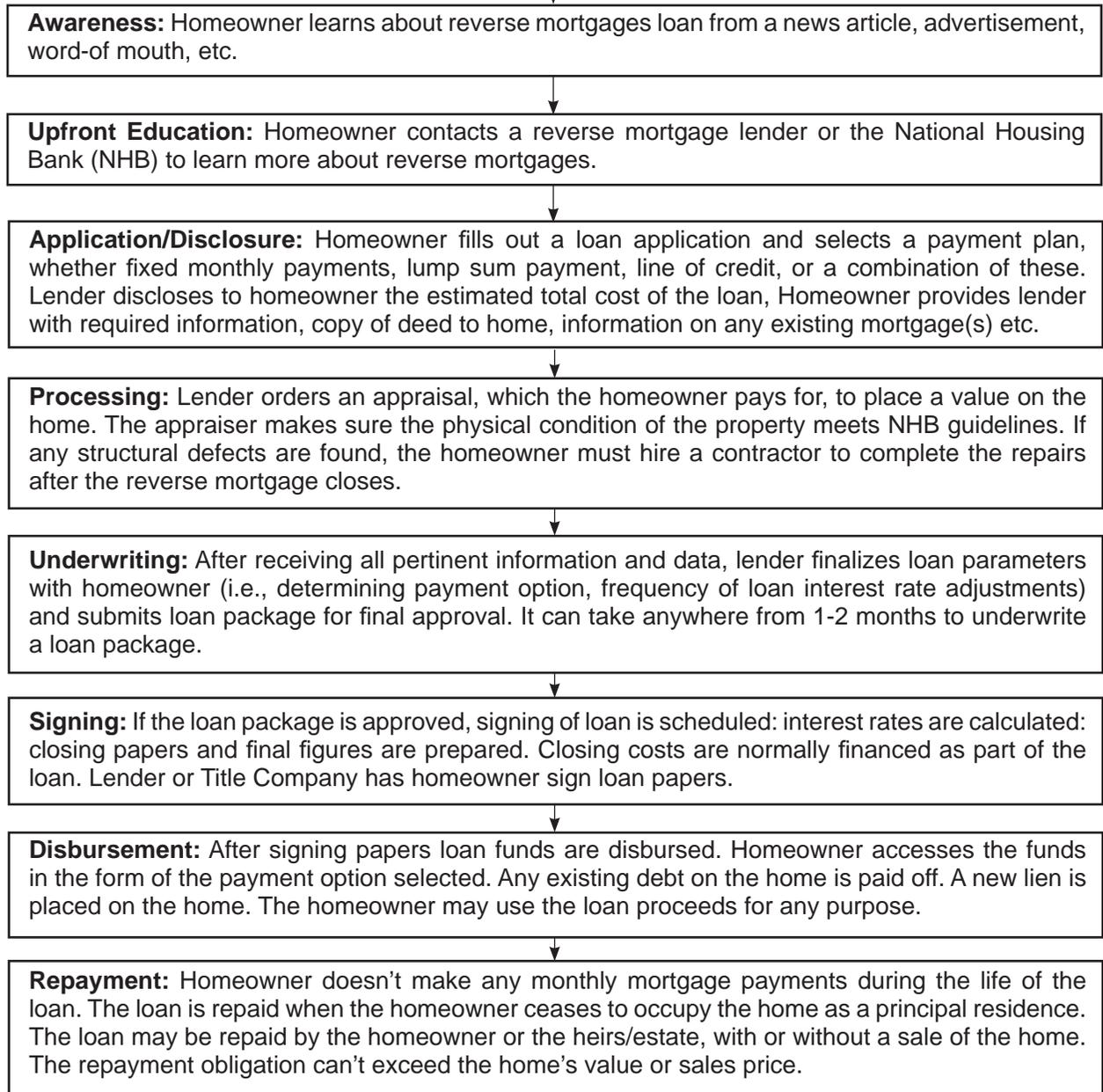
**4. Third Party Closing Costs:** Third Party Closing Costs represent a number of services such as, title searches, surveys, inspections, recording fees, credit report fee, document preparation fee, title insurance etc. that may need to be undertaken

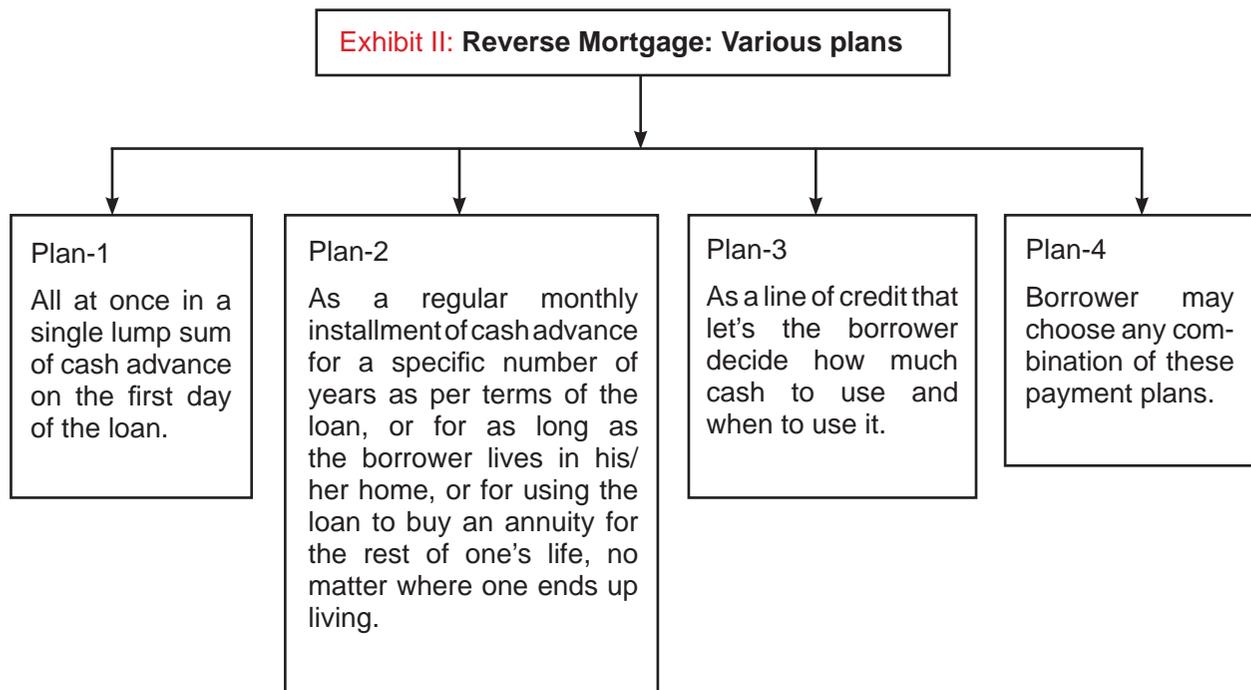
before the Reverse Mortgage is sanctioned.

**5. Service Fee Set Aside:** The Servicing Fee Set Aside is an amount of money taken out of the loan funds on a month-by-month basis to cover the future costs of monthly service fees charged to the loan.

**6. Termination Fee:** Some lenders may charge a termination or maturity fee. This fee is the actual cost of arranging for the sale or foreclosure of the house property securing the Reverse Mortgage loan. This could include broker's fees, advertising costs, legal and other fees that the lender incurs.

**Exhibit I: Steps to Getting a Reverse Mortgage Loan**





### Benefits

The following are the benefits of the RMLs:

1. In this scheme the house owner retains its ownership and is entitled to live in the same throughout his lifetime along with regular income, which can help meet his day-to-day needs.
2. Payment received under RML will be treated as loan, not as income and no liability of income tax.
3. Home owners can pull needed cash from the equity of the home, without incurring monthly expenses.
4. Lenders cannot force home owners to sell the property to pay back the loan.
5. Reverse mortgages provide guarantee that the home owner can stay on

the property for as long as he or she lives, even if the outstanding loan and interest grow to exceed the valued property's value.

6. From the banks/HFC's point of view mortgage on the property in its favour ensures that there is no scope for default.

### Disadvantages

1. Reverse mortgage fees can be high, although the fees are often rolled into the loan and not paid upfront. A reverse mortgage can cost thousands more than a conventional mortgage.
2. It's important to calculate the cost of a reverse mortgage against what you would gain, because once you enter a reverse mortgage agreement, the mortgage company essentially owns your home.

3. In reverse mortgage plans it is better to discuss with your legal and financial advisors and family members, before making a decision. Because home ownership is often a person's most valuable asset and getting a reverse mortgage is essentially the same as spending the money you'd expect to leave to your heirs.

4. Be sure that the older homeowner is thinking clearly when making this decision because having a sudden arrival of cash can be a heady experience and it would be a shame to waste it or become the victim of a scam.

5. Reverse mortgages are often seen as a last resort if the homeowner needs cash and there are no other options.

### Comparison of Traditional Mortgage and Reverse Mortgage

Items	Reverse Mortgage Loan (RML)	Conventional Mortgage Loan (CML)
Purpose of loan	To release the equity in the home and use the proceeds to live a more comfortable, stress-free, retirement.	To purchase a home for residential purpose.
Before loan closing	You have substantial equity in the home.	No or little equity in the home.
Regular income	For RML no regular income is required.	For CML regular income is required.
At loan closing	You owe very little and have substantial equity.	Owe a lot, and have little equity.
Credit capacity	For RML credit capacity is not required, at the time of agreement residual life of the house is important factor.	For CML credit capacity is must along with regular income. Cost of the residential house and security is also a matter of judgment.
Monthly installments	There are no monthly installments or the repayment of loan. Entire loan is payable after the death of borrower or co-borrowers.	Here monthly installments are regular you have to pay each and every installment till the loan is over.
Duration of the loan	Duration of the loan is 15 years or the death of the borrowers and co-borrowers, thereafter loan is payable.	Maximum duration of the loan is 20 years. You have to pay the loan within that period of time.
Age limitation	In case of RML, age limit in India is 60 or more years.	In case of CML you cannot take a loan after the age of 70 years.
While the loan is outstanding	You receive payments from the lender, Loan balance rises, Equity declines.	You make payments to the lender, Loan balance goes down, Equity grows.
At the end	You owe whatever amount was borrowed, plus accrued interest; Have much less, little, or no equity.	Owe nothing, Have Substantial Equity.
Final analysis	Rising Debt-Falling Equity Loan Program.	Falling Debt-Rising Equity Loan Product.

#### Taxation Issues

Following are the main taxation issues involved in RMLs:

- From the tax-planning angle, a person who has to mortgage the property for his living expenses is not likely to have any tax liability, especially in the light of exemption up to Rs.1,95,000 for the senior citizens aged above 65 years (form the A.Y. 2008-09 on words). Since what he receives is a mere loan, even if he receives it in instalments, it should not be taxable.
- There would be liability only if the property is surrendered for an annuity, which is always taxable.
- For the lender (banks/FIs), there is no saving in tax, as tax would have to be paid on interest on accrual or cash basis.
- Major issue is related to capital gains. No liability for capital gains would arise when the property is mortgaged because a mortgage is not considered as 'transfer' within the meaning of this term as given in section 2(47) of the Income Tax Act, 1961 (Act). This question would arise when the property is finally sold. At that time, the amount of capital gain or loss can be computed in accordance with the provisions of section 48 of the Act after taking into account the cost

inflation index for consideration in the hands of the borrower or his heirs, as the case may be.

### Reverse Mortgage Insurance Scheme

The National Housing Bank (NHB) has proposed a mortgage assurance scheme in line with the bancassurance scheme that is operated by banks. According to NHB, the housing finance regulator is negotiating with insurance regulator IRDA to develop reverse mortgage insurance. NHB is also in talks with several insurance companies to build on the mortgage assurance concept further. Recently, NHB disclosed norms for reverse mortgages, following the announcement in this year's budget. The housing and refinancing agency is also planning to develop a slide of financial products for the poor, which could be offered to them through microfinance. From experience, it has been noticed that there is a latent desire among them to own a house after their income stabilises a bit. The poor also have displayed a high degree of willingness to repay. The NHB plans to provide guarantee to borrowers against default by lenders by starting a loan mortgage company. The company would also safeguard the interest of lenders in case borrowers bungle on the terms of the agreement.

### Issues and Challenges

**Legal issues:** Various legal issues arise in case of RMLs. In case of a simple housing loan product now we have the Securitisation Act to take care of defaults. In case of reverse mortgage, the legal heirs may not agree to dispose off the property though they may be reluctant to settle the debt with lenders or may not have the funds to do so. In that situation a separate

law is required to protect the RML lenders.

**Social issues:** It is one of the common phenomenons, that joint families are still widespread in many parts of India, although their number has significantly reduced in size. In many cases, the culture of joint families continues even after nuclearisation. In this scenario, many parents would still prefer to leave their house to their children rather than live off it. Social status and emotional attachment are among the key challenges for RMLs.

**Regulation and transparency issue:** In RML products, a solid regulation and transparency is required. In India, it is better to permit for RML products those banks and PLIs who have good track record of the financial dealing and transparency in their transactions. At least they should disclose their entire scheme to the borrowers before the RML agreement, particularly with respect to exact loan amount, any interest rate variation in future etc.

**Financial issues:** For banks and HFCs, it is a big challenge to maintain level of capital as per their requirement, because while in traditional mortgage they monthly get some amount as instalment of loan, which facilitates liquidity to the banks, in case of RML they have to pay monthly instalment of loan to the borrowers. It is only after a long period of time (after 15 years or more) that they will get entire amount back. During this period management of capital as per the requirement is a major challenge for the Banks/HFCs.

**Accounting issues:** For the banks/HFCs, accounting of RML product is also a major issue. There are two methods for accounting of RML— ac-

crual method and cash method. In case of RML, banks and financial institutions earn interest every year but they will get entire amount (principal and interest) only after 15 years or more. Now the question is interest income of banks will be taxable on accrual basis or cash basis. If it is taxable on accrual basis, in that condition interest earned by the banks every year will be treated, as income and it will be taxable. At the time of final disposal of agreement, entire amount, which are paid by the borrowers, are exempted for tax. But another issue is that what will be the accounting adjustment for the loss if at final disposal the receivable amount is less than the total due (principal and interest). Because in accrual method interest is already treated as income in the previous years. Under cash method entire interest will be treated as income at the time of final disposal and during the RML tenure interest will not be treated as income. In that situation at the time of final disposal of loan total interest earned will be treated as income and it will be a huge burden of tax for the banks and HFCs.

**Interest rate regulations and fluctuations:** Now-a-days interest rate regulation is one of the major issues for all the banks. In the last two years, interest rate on conventional mortgage loan has gone up from 7.5% to 11% which is very crucial for borrowers because it adversely affects their EMIs (equated monthly instalments)/duration of the loan. A variation of interest rate is a big challenge in case of RML products too. How PLIs (Primarily lending institutions) manage their interest rate fluctuations, is equally important for the senior citizens too because after entering into RML agreement they generally will not be in position

to cancel their RML and pay entire principal and interest.

**Supervisory issues:** In case of RML, supervisory work is very important. Once agreement is over and loan disbursed to borrowers it is important to supervise it. The aspects like regular monthly instalments, market value of the property, working conditions of the property, payment of local taxes, insurance of the property etc. are all very important. Similarly, to keep track of the main beneficiary of RML and how they are utilising his money is also an important supervisory issues related with RML.

### Indian Scenario

In India, reverse mortgage loan is a new financial product for the senior citizens recently lunched by the NHB. Saksham is a major reverse mortgage product launched by Mumbai-based Dewan Housing and Finance Corporation Ltd (DHFCL) in September 2006. The company has received close to 200 enquiries from major cities in India about Saksham, which shows that senior citizens are waiting for such type of new financial products to meet their financial needs. Meanwhile, in anticipation of reverse mortgage gaining popularity in India, HDFC proposes to enter the market with a customised mortgage product for the elderly. The process of identifying potential customers has already been initiated in Athashri in Pune, a housing society exclusively for senior citizens. HDFC Realty Fund has made a major investment of almost Rs.75 crore in Pune's senior citizens project under the Paranjape Schemes banner. With its interests in the project, HDFC would extend a moderate mortgage policy to the residents of Athashri. Paranjape plans to go national with its senior citizens projects in the next

2-3 years, and HDFC has expressed its willingness to partner them all the way.

PNB is the first Public Sector Bank to come out with a Reverse Mortgage concept based product for senior citizen titled "PNB Baghban". The product addresses one of the very important requirements of the society in the fast changing culture of Indian society. Their rate of interest is 10%.

According to demographic projections, reverse mortgage loan products could be a hit among the metros and also in areas like Kerala, Tamil Nadu, Goa and Chandigarh in India where most the old age families are residing in India.

In India, RML's success will depend on its structure and confidence-building ability. As per NHB estimation, in our country a big market of Rs 5,000 crore is available with the plan of 15-year period. There are many private, public sector banks and HFC, which are waiting for operational guidelines of this product. Now with NHB having already prepared all the operational guidelines related with RML, it is great opportunity for the banks as well as borrowers in current competitive environment. At the same time, mandatory reinsurance (as proposed by the NHB) to protect lenders and borrowers from undue risks, and the non-recourse nature of RMs, are attractive features. However, success will depend on the government recognising RMs as part of its own welfare obligation and ensuring they are not taxed as income in the hands of individuals. In India, initial seekers of RM are likely to be individuals who have no family support or prefer to live independently rather than worry about inheritance laws or leaving assets for their heirs. It is advisable to ensure that regulations

are structured to prevent any harassment of senior citizens through unreasonable property maintenance conditions, stoppage of monthly payments or the threat of eviction from their homes. The products must be developed with due sympathy and a realisation that the very ages of these borrowers prevent them from fighting long battles in consumer courts. In India Union bank of India, State Bank of India, Central Bank of India, Punjab National Bank, Indian Bank, LIC Housing Finance, State Bank of Mysore, Union Bank, Oriental Bank of Commerce, Allahabad Bank, National Housing Bank, DHFL are the main banks/HFCs who have launched different RML products with different names according to the guidelines with the NHB.

### Conclusion

No doubt reverse mortgage loan is a noble product for the senior citizens, which caters to their financial needs in their second inning. RML is a nice product for elderly couples that do not have any child or those who don't want to depend upon others for their old age financial needs. But regularisation and transparency is very important for the better execution of this product, especially in country like India where most of the people are emotionally attached with their residential property and want to preserve such properties for the next generation. The extent to which the potential of reverse mortgage gets realised in India will depend a lot on the guidelines that will govern it. More or less, it will also depend on how Indian society takes it. The government must ensure that only the most credible institutions are allowed to offer RM products and that they keep interest rates and service charges reasonable, with no hidden increase of rates. □

## RISK IN REAL ESTATE FINANCING AND FOCUS OF BASEL II ACCORD

The regulatory authorities have from time to time encouraged banks/financial institutions to deal with credit applications for real estate on priority. However, the fixation of higher risk weights as advised by RBI needs review for smooth growth of this sector. Certain lend-

ing safeguards such as creation of a system of Property Insurance and Credit Guarantee cover may require consideration by Government of India/RBI. This will certainly pave way for a balanced and healthy real estate portfolio by banks/financial institutions in India.

One of the most important comforts of a lender (banks/financial institutions) lies in tangible and marketable assets as a security cover for any loan/advance. Real estate comprising open land or land with structures thereon has almost all the attributes of an ideal security except that its 'conversion time' into hard cash involves larger time span unlike any non-fixed asset.

A properly structured real estate loan / advances are advantageous and remunerative for the lender in many respects. Not only that real estate value appreciates generally over time, the servicing of loan/advance in terms of repayment of Principal and Interest often be-

comes spontaneous at times. This is especially when mortgaged premises are let out and rentals are directly deposited in the account maintained with financing bank/financial institution.

From socio-economic angle in developing / underdeveloped countries, in particular, real estate financing while taking shape by way of financing small dwelling houses for poor people, has high value implications aimed at the well being of the masses.

### What is the Exact Coverage of Real Estate Financing?

As per dictionary, the word 'Estate' implies 'landed property' i.e., simply land or land with structure thereon. In that sense the word 'Real' does



— Prof. S. K. Bagchi

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The Basel Accord II is primarily concerned with the capital adequacy aspect of banks with respect to their risk-weighted assets. In this respect the Accord does not seem to consider real estate financing on a different risk constituting item. In fact, the Accord provides incentive of lower risk weights for real estate exposures having probably taken a world-view of lower risk elements in real estate financing.

not have any additional connotation from the viewpoint of lending.

Real Estate may have three classifications:

- 1) Owner occupied residential real estate.
- 2) Income-producing Real Estate.
- 3) Developing Real Estate i.e., creating structure / building for eventual sale.

It would appear that the classification need not always be entirely compartmentalised. It may so happen that a portion of land and building is occupied by the owner and remaining portion let out. Also developing a real estate may be for residential purpose or for multiple purposes.

The financing requirements for real estate may cover any of the above purposes. However, at present public sector financial institutions/banks treat financing residential premises for occupation by the borrowers with greater priority, especially low-cost dwelling houses for people with relatively low income.

### Situation Prevailing before 90's and After

Indian commercial banks were not at all involved in real estate financing till 90's except, however, in cases of construction of factory building and/or factory workers, residential premises that were of course treated under the package of industrial finance. The main reason was

certainly the long-term nature of such finance. With the commencement of implementation of financial sector reforms in India from 1990's the regulatory authorities directed that commercial banks – particularly Public Sector Banks should increasingly take part in real estate financing in the form of financing residential houses. This was treated as a national priority in view of the need of providing 'Own Shelter' of the masses and thereby to do away with the shackles of landlords with their restrictive covenants for letting out of their properties.

It was also concurrently felt that for a rapid progress of the economy, finance for constructing of properties for the purpose of 'renting out' should also be liberalised so that a larger supply of rental properties for residential as also commercial purposes were available.

Therefore, it would appear that there was a clear policy shift, which meant that providing finance for real estate was a bankable proposition unlike before 90's. In a sense, it was an 'opening out' of financial/banking system to a new area of financing.

### What are Special Risks in Financing Real Estate?

In any financing proposition a lender is predominantly concerned with 'default' risk, which has the effect of total/partial erosion of funds lent. That way, financing of real estate is no better or no worse either. But

banking/financial system is confronted with following 'special' risks in real estate lending:

- Funds are lent generally for a larger period say over 10 years. The capacity and/or willingness of the borrower to service the debt for such a long period is more uncertain.
- The value of property to remain under security for the loan may go down over a period of time for various macro-economic and/or societal reasons. It had so happened substantially in 1980's in USA and in Japan in particular.

Currently as per progress reports in metropolis like Mumbai & Kolkata property prices are reportedly moving southwards. Thus, the safety of loan with respect to market value remains always suspect as such loans remain in the books of the lender for a fairly long period.

- While lawyer's scrutiny reports and search reports are always taken before financing against property, the same do not always come to the rescue of the lenders if eventually some defects in land records and/or scrutiny of the property come to light. The lender loses the security and the loan turns out irrecoverable.
- Generally, mortgage by deposit of title deeds (known popularly as eq-

Real Estate financing will be the order of the day in new-age bank/ institutional lending in the interest of the development of the country. Real Estate financing is no longer 'untouchable' as it used to be before 1990's. However, it is also a fact that this sector contains a higher order risk 'default' and lower order scope of eventual 'recovery' since the fate of real estate is inter-woven with macro-economic fundamentals and volatility of asset prices.

uitable mortgage) under section 58(f) of Transfer of Property Act is preferred in financing real estate for reasons of convenience as well as cost. A number of reports have come to light recently that due to fraudulent act of the borrower (and sometimes may be in association with lending officers) the forged/duplicate Title Deeds were offered as security. In practice it is difficult for any lender to insulate itself from such risks.

- Another aspect, which may not strictly be treated as a risk but certainly is a major hurdle in bank finance in real estate is with respect to 'maturity mismatch' from Asset-Liability Management angle. Commercial banks are permitted to hold deposit for maximum of 10 year – duration, while most of the real estate loans are for a period longer than 10 years. This mismatch creates a negative effect in bank lending for real estate. 'Banks' owned fund (share capital + Reserves) are thus required to be utilised in accounting sense to finance real estate.
- Viewed in the above mentioned context, there

is currently some noise about the larger intensity of risk in real estate financing.

### Basel Accord II Risk Management

The Basel Accord II is primarily concerned with the Capital Adequacy aspect of banks with respect to their risk-weighted assets. In this respect, the Accord does not seem to consider real estate financing on a different risk constituting item. In fact, the accord provides incentive of lower risk weights for real estate exposures having probably taken a world-view of lower risk elements in real estate financing.

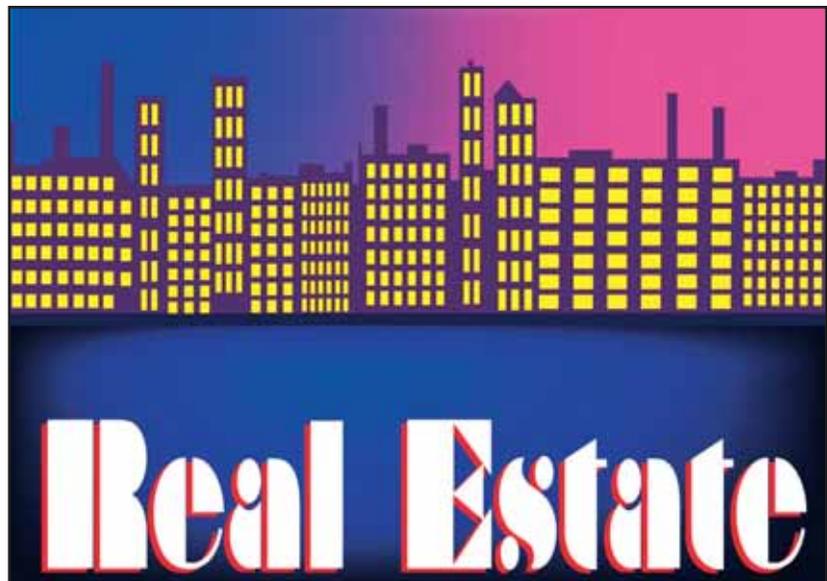
Reserve Bank of India, however, has a different view. It seems to consider real estate

financing a larger risk segment going by the overall macro-economic parameters and existing legal system in obtaining real estate as security cover by the lenders as also default experience over last couple of years.

Quoted below is RBI's guideline on residential property and commercial real estate (income – producing) for a fair assessment of the position:

#### **"5.10. Claims secured by residential property**

*5.10.1 Lending to individuals meant for acquiring residential property which are fully secured by mortgages on the residential property that is or will be occupied by the borrower, or that is rented, shall be risk weighted at 75%, provided*



The banks/financial institutions in India have by now acquired a decade's experience in financing this sector. While, in general, the experience is fairly in line with other forms of lending, instances of fraudulent play by some unscrupulous persons in offering forged title deeds/duplicate deeds have often dampened the spirit and enthusiasm of the lenders.

*there is a margin of at least 25 per cent over the amount of the loan, based on Board approved valuation policy.*

5.10.2 *Lending for acquiring residential property, which meets the above criteria but have a margin lesser than 25%, will attract a risk weight of 100%.*

5.10.3 *All other claims secured by residential property would attract the higher of the risk weight applicable to the counterparty or to the purpose for which the bank has extended finance.*

5.10.4 *Loan/exposures to intermediaries for on lending will not be eligible for inclusion under claims secured by residential property but will be treated as claims on corporates or claims included in the regulatory retail portfolio as the case may be.*

**5.11 Claims secured by commercial real estate**

5.11.1 *Commercial real estate exposure is defined as "fund based and non-fund based exposures secured by mortgages on commercial real estates (office buildings, retail space, multi-purpose commercial premises, multi-family residential buildings, multi-tenanted commercial premises, industrial or warehouse space, hotels, land acquisition, development and construction, setting up Special Economic Zones (SEZs) or for*

*acquiring units in SEZs etc.).*

5.11.2 *Commercial real estate exposures as defined above will attract a risk weight of 150 per cent."*

It is clear that real estate financing by banks in India has to be more risk – focused and with higher provision of capital charge.

It is likely that RBI is guided past unsatisfactory experience of banks/financial institutions in lending against real estate. However, the situation seems to be changing for the better and it is expected that RBI also may fine-tune its directives over a period of time. In this context one may appreciate the comments of Mr. Deepak Parikh – Chairman of HDFC: -

*"Over the years, we have seen the Indian housing sector evolve and take different and sometimes unexpected turns along the way. Today, we find ourselves in a vastly distinct environment from the one we faced just a few years back".*

**A New Dimension**

The regulatory authorities have now approved of a new vehicle of real estate financing in the form of Reverse Mortgage. The senior citizens (over 60 years of age) would now be allowed loan for 15 years without the requirement of servicing installment and/or interest against the landed property occupied by them. The question of repayment would come up only after

the death of the borrower when out of sale proceeds the loan will be repaid/reduced without any financial obligation on the legal heirs of the deceased. Although this type of loan is more risky – but it has a very valid social cause and hence needs full support from institutional financial system. Though, theoretically speaking, such loan may require higher risk weight say 200% or so, it is felt that the risk weight may be limited to 100% only as otherwise it may create a clear disincentive for a lending bank.

**Suggestions**

Real Estate financing will be the order of the day in new-age bank/institutional lending in the interest of the development of the country. Real estate financing is no longer 'untouchable' as it used to be before 1990's. However, it is also a fact that this sector contains a higher order risk 'default' and lower order scope of eventual 'recovery' since the fate of real estate is inter-woven with macro-economic fundamentals and volatility of asset prices.

In order to contain risk factor in real estate financing, following suggestions are offered:

1. Land records at land registration offices in the entire country be streamlined and be brought under contemporary technology support system.
2. Banks / Financial Institutions should create a special cadre of credit

investigation offices who have to perform like private detectives to ascertain track record of would – be borrowers/generators. Incidentally, it may be stated that in 1970's/80's many large banks used to have their own credit investigators. Based on their feedback various lending decisions used to be taken.

3. No loan / advance should be granted merely against deposit of title deed by way of Equitable Mortgage as is permissible presently. Instead simplified Registered mortgage system (as is prevalent in many advanced countries) is devised with provision for low registration fee for loans against any real estate. This will remove the 'fraud' aspect in depositing forged /duplicate title deeds.
4. 'Title Insurance' system be devised in terms of which lenders may obtain insurance cover against any defective title of documents or any infirmities in the property from any approved insurance company.
5. At corporate headquarters of each bank/financial institutions there should be a cell as "Real Estate Financing Cell" who would be involved in the entire cycle starting with sanction, disbursement of such loan to periodical monitoring and recovery thereof.
6. Risk weight for any real estate finance may be fixed at maximum of

75% for banks financing against real estate.

7. An institutional credit guarantee system (in line with guarantee cover for SSI Units / Small Borrowers) should be devised to provide credit guarantee cover against default risks in financing against real estate.

### Conclusion

No business is 'risk-free' – more so, in the case of business of lending. It is, of course, true that there is always a degree of difference of risk in relation to purpose, security and above all capacity/willingness of borrower/guarantor in meeting financial commitments.

Real Estate financing in India by banks/financial institutions made its real public appearance upon the implementation of financial sector reforms from 1990's. The banks / financial Institutions have by now acquired a decade's experience in financing this sector. While, in general, the experience is fairly in line with other forms of lending, instances of fraudulent play by some unscrupulous persons in offering forged title deeds/duplicate deeds have often dampened the spirit and enthusiasm of the lenders.

Real Estate financing, particularly financing acquisition of residential properties, serves a very important social purpose – provision of 'shelter'. Mr. Deepak Parikh has rightly observed:

"Across cities, across income levels and across age-groups, owning one's home is realising one of life's primary quests". □

## REVERSE OUTSOURCING — CONTEMPLATING BEYOND OUTSOURCING HORIZON

Outsourcing has undoubtedly its own advantages and is an effective strategy for five to ten years down the line. But if we take a vision of more than a decade or even two decades, which is how sustainability is colloquially quantified, the outsourcing business does not seem to remain equally lucrative and would result into diminishing returns, particularly with growth in economy and resultant rise in per capita income and labour costs. As such, India Inc has to look beyond outsourcing and get prepared for the challenges and opportunities lying ahead. One of the strategies, which India Inc can adopt, is that of Reverse Outsourcing, i.e., outsourcing its non-core processes and activities to other countries

*Take hold of the future or future will take hold of you*  
-- Dr. Patrick Dixon (Business Thinker and Futurist)

One of the strategies adopted by India Inc, which has placed India on the Global Map and made it a focus of other economies, is that of 'Outsourcing & Off-shoring'. Outsourcing in its simplest form is contracting with an external supplier to provide part or all of a business process or function. Outsourcing has a specific niche market for India Inc due to the Labour Arbitrage that India enjoys with around 16% of world's population concentrated in India. China is the immediate rival to India in this bat-

tle of outsourcing followed by Brazil and Russia. Albeit less populated than China, India enjoys competitive advantage in outsourcing business due to wide range of knowledgeable population particularly in young age groups.

The factors that drive outsourcing and have proved as a competitive advantage for India Inc are: –

- Competitive and budgetary pressures – focus on cost reduction.
- Advances in technology and communications.



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- The need for improved performance. India has so far led the global market for outsourcing services with its relatively cheap workforce and abundant supply of skilled labour. This trend is likely to continue as the demand for knowledge workers in developed economies outstrips supply. Companies are forced to look beyond the geographical boundaries of the countries they are located in for the skills they need.

Outsourcing has evolved over a period of time in different forms from Business Process Outsourcing, Knowledge Process Outsourcing, Legal Process Outsourcing and most recent – People Process Outsourcing.

The advantages of outsourcing for external supplier are obvious ranging from cost reduction, radical transformation, growth through business partnering and increased innovation. However, it also entails certain drawbacks. To name a few are – loss of control, risk to proprietary data, risk to innovation etc.

Outsourcing for India has mainly opportunities in terms of –

1. Greater Business Opportunities.
2. Greater Employment.
3. Business Partnership.
4. Sharing of Information, Knowledge-base & Technology Infrastructure.
5. Exploiting the disparity existing between two economies particularly in terms of timing and currency rates.

### Towards Beginning of the End

Outsourcing has undoubtedly its own advantages and is an effective strategy for five to ten years down the line. But, if we take a vision of more than a decade or even two decades, which is how sustainability is colloquially quantified, the outsourcing business does not seem to remain equally lucrative and would result into diminishing returns. This is because the basic rationale of outsourcing is based on labour arbitrage, which exists between two economies. Once this arbitrage opportunity is eliminat-

ed or reduced, which is most likely to happen with growth in economy and increase in its per capita GDP, the returns which outsourcing bestow currently shall also be eliminated or reduced. This can be more clamoring particularly when another economy akin to India and China emerges which can provide similar talent & labour at a cost lower than India. In other words, the sustainability of outsourcing is questionable, given the fact of rising economy of India.

If we were to perform a scenario analysis for the situation existing two decades from now, the most evident scenario, which emerges, would be something as evinced under –

Outsourcing business today fuels India's growth; this growth would result into increase in per capita GDP, as a corollary of which the *Indian Majdoor* would become costlier; costly majdoor would eventually reduce the labour disparity between two economies; this in turn can dilute the existing niche outsourcing business; developed countries may then siphon their business process to other economies where the labour cost is lower than ours – What After That? How will India Inc sustain after this opportunity is eliminated?

On the other hand, Indian Inc would be developing vertically in Business Value Chain; as Indian Inc moves up the value chain, they would now focus on their core business while outsourcing their non-core processes. As a corollary, a reverse trend would be manifested, which can be termed as '*Reverse Outsourcing*'.

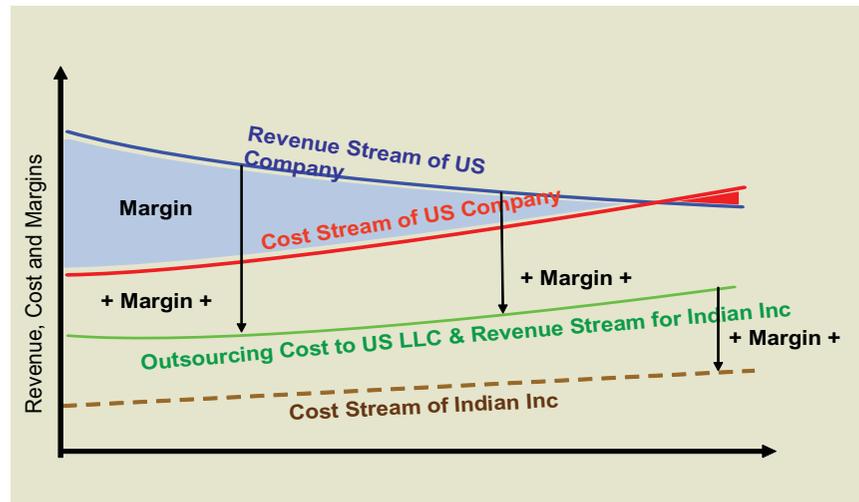
The strategy suggested here to attain sustainable growth of

India Inc is to look beyond outsourcing and getting prepared for the challenges & opportunities lying ahead on the road. One of the strategies, which Indian Inc can adopt, is that of Reverse Outsourcing, hues of which has already started shading in industries like design, aircraft pilots, film-making technology, architecture, civil consulting etc.

Without referring to academic definitions & jargons, Reverse Outsourcing, in its simplest form means India Inc outsourcing its non-core process & non-essential activities, to other countries. The countries to which outsourcing is done may be developed, developing or under-developed.

### Rationale of Reverse Outsourcing

At the epicenter of Offshoring/ Outsourcing is the cost advantage which the outsourcers achieve by delegating work and processes beyond its own the enterprise & across the national boundaries. This is driven through developments in technology, evolution of internet and other telecommunication facilities, which have led to seamless integration of national economies. Technology has brought about metamorphosis in concept of Globalisation. It can be said that value creation in outsourcing is the function of Technological Innovation and Labour Arbitrage.



Thus, as evinced from the above, outsourcing plays a salutary role in creating a win-win situation for both the parties to the outsourcing.

There are various possible reasons for labour disparity existing between the two economies. However, one of the most significant and direct factors contributing to such a disparity is the stage of economic devel-

opment of the two economies. Labour Arbitrage can exist only between a developed & developing economy or developing and under-developed economy. However, the skill set and quality of labour available in under-developed economies is not competitive enough to meet the needs of companies based in developed economies.

Due to this reason, countries

that are in the developing phase, like Brazil, Russia, India and China (*alias* BRIC), are preferred destinations of outsourcing and off-shoring for developed economies like US, UK, Canada, Australia and others.

Labour cost has direct positive correlation to cost of living and inflation of a particular economy. Going by Fischer's Theorem supported with Purchasing Power Parity Relationships, *ceteris paribus*, the labour disparity between two economies (assuming the availability of required skill set) will be equal to the differentiation existing between the currencies to the said economies, which will then be offset with inflation existing between the two economies. Thus, at the bottom of outsourcing pyramid lays economic factors, which determine the stages of development. If we take the instance of US and India, the labour arbitrage exists between the two economies mainly due to the different stages of development of two economies.

As mentioned earlier, outsourcing helps in the economic development of both the economies; more so for the developing economies like India. It makes the slope of escalating economic graph even steeper.

If we apply the S-Curve phenomenon, every thing – wheth-



er it is an economy, industry, company or a product – passes from four different development phases – which are colloquially referred to as initiation phase, growth phase, maturity phase and decline phase. While US is on growth-maturity phase of its growth cycle, India is still in the growth phase, with its growth being registered as high as 8-9% per annum (in terms of GDP). With the rising pace of economic growth, the economic gap between the two economies is and will be reducing and so will be labour disparity, which is a direct function of economic development.

It would be highly speculative to say anything about when India Inc will be at par with that of US in terms of economic growth. To some economists, the landmark is not far beyond 2050 and to some optimists it is likely to happen much before it. However, one

of the most certain conjectures by the economists' world over is that by 2025 India will emerge as one of the leading economic powers, ranking among the zenith of developing economies and may also be on the trajectory of developed economies.

As the economic growth and labour disparity are inversely related, the rising economy of India will reduce the labour disparity, thereby diluting the existing niche market of outsourcing.

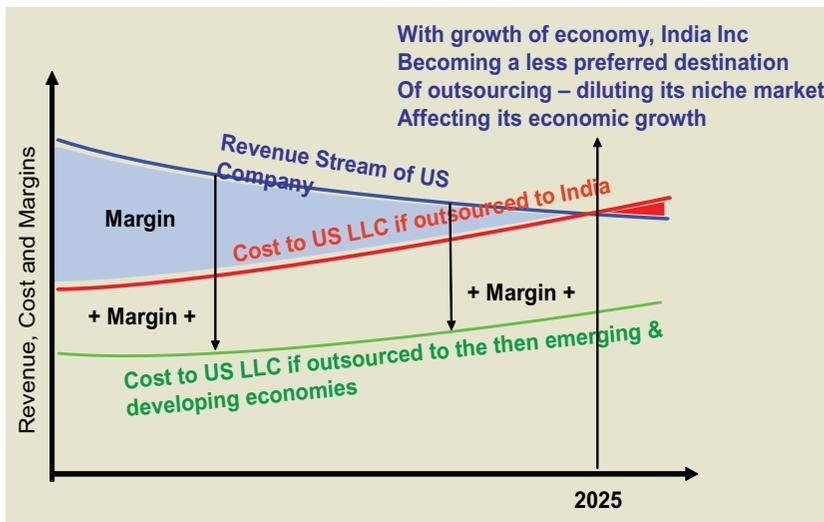
Albeit, India may not be at par with US, there is all the eventuality of other economies evolving which can render greater and better labour arbitrage as India does at present. In other words, labour cost of India Inc would increase with economic growth making it less competitive with labour cost of other economies that would be rela-

tively at lower stage of economic development. With these low cost economies coming into play, the competitive positioning of India Inc is most likely to dilute. In other words, as Indian economy grows and labour disparity reduces, India may no longer remain the preferred destination of outsourcing for developed countries like US. At this point, economies like US would be looking for other emerging economies, which can provide outsourcing service at competitive cost than India Inc.

Thus there will be siphoning of outsourcing business from India Inc to other economies.

*Thus there lies a threat & risk in future, which mainly augments from natural process of growth of economies. Although the threat lies ahead in decade after 2020, opposite sustainability strategies need to be adopted now if India Inc is to combat potential threat effectively.*

Extending the above graph further till the period of 2025, following scenario emerges.



**Utopia News:** To some, the trend of Reverse Outsourcing has already started. Following statements hitting the headlines in recent times, manifests the glimpses of Reverse Outsourcing utopia.

**Dr. Gupta, CEO, Inkoru** (excerpts of speech)

*“Today I would like to post on a trend called by some as reverse outsourcing. Here India or other countries outsource jobs to US companies or individuals. Of course, this is not as strong a trend as offshore outsourcing but the fact is that it is there and*

*has been for a very long time. In fact, if you go back about 10 years or so then from countries like India it was mostly reverse outsourcing and very little offshore outsourcing from US to India.*

*Even today areas like Management Consulting, Marketing and Management Guru (Tom Peters, Philip Kotler, Michael Porter, Stephen Covey etc.) trainings and seminars see a lot of reverse outsourcing. Similar in creative areas like design, architecture, very large scale project contracts or project management the projects typically*

*go to US firms or in some cases European firms. Take areas like Filmmaking technology etc. and again you will see reverse outsourcing.*

*The tide keeps turning and it could happen more and more again.*

**Excerpt of Article in Financial Magazine**

*The outsourcing story so far has been one way --- of Indians and Indian firms eating into jobs in the US and UK (often referred to as “Being Banglored”). As Indian Information Technology firms reach global scales, a reverse trend is evolving --- Americans and others from the west are finding employment in overseas operations of Indian firms. This is to add to the many out-of-work executives from US who have shifted base to India in search of better opportunities. It is being termed as reverse outsourcing.*

*In the past, Indian outsourcing companies have set up offices in the United States, but they have been largely restricted to marketing, generating new clients as well as establishing a countrywide network that have created very few jobs and that too mostly for Indians. Several reports now indicate that Indian IT giants such as Infosys, Wipro, Tata Consultancy Service have resorted to hiring western employees to deal with local populations abroad riding profits generated on huge international business deals as well as the need to penetrate markets further.*

**‘We No Longer Discuss the Future of India; We Say The Future Is India’**

– Mr. Kamal Nath, Union Minister of Commerce & Industry

## ISLAMIC FINANCE: AN OVERVIEW

Financial dealings and investment of a follower of Islam have to be in accordance with the laws of *shariat*, which contain tenets and code of conduct on these topics. These tenets not only prohibit the concept of interest in any financial dealing, they also specify the type of contracts and nature of contracts, which are permissible. This led to the growth of a branch of finance, which could be as per the *shariat* laws, and it has come to be popularly known as Islamic finance. India has a negligible presence of Islamic finance despite a vast population of followers of Islam and, as such, it opens up an array of opportunities to both the investors and the financial service providers.

Islam as a religion has several commandments for its followers regarding their financial dealings. No other religion in the world has such specific directives to its followers regarding their financial and business dealings. The followers of Islam are required to invest their savings in only those avenues and instruments, which adhere to the Islamic law called *shariat*. While a variety of financial products suiting the requirements of different investors have emerged over time, the followers of Islam could not avail of these investments. The concept of banking which evolved

and became popular across the globe was contrary to the basic tenet of Islam, which prohibited charging interest on loans. Such income was not approved by the Islamic law. *Riba* prohibits charging interest on loans either as a borrower or a lender. Due to this limitation, certain investment avenues were developed in the Arab world, which complied with the *shariat* laws. However, as the oil rich Arab world began to have more wealth, the need for appropriate investment products, which were as per the Islamic codes, was felt more acutely. Thus, the Islamic finance, which was purely



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While prohibition of interest is the key feature of Islamic finance, it is not the only thing in this system. The *shariat* also codifies the concept of risk sharing, nature of contracts, compliance of contract and the penalty in case of non-compliance with the contracts. Islam treats business as an integral part of the overall religious life of its followers.

within the domain of interpretation of Islamic clergy, started getting the necessary support from finance professionals and the Islamic finance, as a branch of finance began to grow. Today some of the world's largest banks like HSBC and Citi Bank offer financial products, which are *shariat* compliant.

### Tenets of Islamic Finance

The *shariat* laws contain certain directives to the followers of Islam, which they are required to practise in their financial dealings. The two most important tenets of Islamic finance are:

**1. Interest is Prohibited:** The concept of *riba*, which is akin to 'interest', as interpreted by the religious scholars of Islam is prohibited. According to *shariat* laws, whether it is a sale or a loan, if there is a clause, which directly or indirectly specifies any pre-determined accretion to the loan amount at maturity is *riba* and is prohibited (*haram*) for a follower of Islam. This concept is based on equity and creation of a better social order. It requires that the profit as well as the losses have to be shared between the one who is carrying on the business and the one who has lent money to carry on that business. The *shariat* laws do not forbid the sharing of profits but precludes the payment of a pre-determined amount as a reward to the supplier of capital. In the traditional financial sys-

tem, the concept is based on proportionate risk reward system whereas in Islam the emphasis is on all dimensions like religious, spiritual and social, ultimately hoping to have a better and equitable society. Due to this prohibition, all are investors in the business including the lender and the risk has to be shared by everyone. According to Islamic clergy, this promotes entrepreneurial activities in the society, as there is risk sharing in this system and there are no creditors who can demand a return even in an adverse situation, but Islam does recognise the time value of money.

**2. Nature of Contracts:** While prohibition of interest is the key feature of Islamic finance, it is not the only thing in this system. The *shariat* also codifies the concept of risk sharing, nature of contracts, compliance of contract and the penalty in case of non-compliance with the contracts. Islam treats business as an integral part of the overall religious life of its followers. A follower will be in breach of *shariat* if he is following the religious tenets in other walks of life but is not complying with the directives in his business activities. Therefore, the *shariat* also indicates the kind of activities into which a Muslim is not supposed to make investments, which include liquor, gambling etc. A person is also prohibited from entering into activities

where the outcomes are highly uncertain and the risks are very high. Islam stresses on absolute full disclosure at the time of entering into a contract. It is the sacred duty of every Muslim to uphold and honour the contractual obligations.

### Types of Financial Contracts

Islamic financial system is very broad even though the growth in the Islamic banking has been most significant. This covers capital formation, insurance and capital markets. Some of the popular contracts, which are *shariat* compliant and generally adopted in Islamic financial markets are: -

- i. **Buy-Sell Back:** This is called *murabaha* wherein there is trade with a mark-up or a cost plus sale. The investor or the banker (lender) enters into a contract with the customer that he/she will purchase the particular asset on credit at cost plus a margin. Once this agreement has been reached the investor buys the asset and sells it off to the customer. The mark-up is determined in such a contract on the basis of the traditional financial markets' prevailing interest rates.
- ii. **Leasing:** The Arabic name for this is *Jiara* or *Musharaka Mutaragisa* wherein the lender buys the property

The *shariat* also indicates the kind of activities into which a Muslim is not supposed to make investments, which include liquor, gambling etc. A person is also prohibited from entering into activities where the outcomes are highly uncertain and the risks are very high. Islam stresses on absolute full disclosure at the time of entering into a contract. It is the sacred duty of every Muslim to uphold and honour the contractual obligations.

and either on its own or through a special purpose vehicle leases it out to the borrower or the customer who is required to make a consolidated monthly payment, which consists of two components. The first part is the monthly rent, which is calculated, based on the prevailing interest rates. The second part is towards the principal amount. One such variation is like hire purchase called as *Ijarah*, which enables the lessee, the same advantages which are curable in a conventional leasing arrangement. The terms and conditions provide for the flexibility enabling the lessee to have better planning and budgeting. This arrangement facilitates off-balances financing and the payments made by lessee are fully tax-deductible. In an *Ijarah-wd-Iqtina* the bank or the client gives a unilateral undertaking to take the asset at the end of the lease but this condi-

tion does not form part of the subject matter of the contract. Another variation is *Musauramah*, which is a normal sale transaction wherein the price is determined without taking into consideration the cost incurred by the seller. In this contract, the seller is not under an obligation to disclose the cost.

**iii. Profit Sharing:** This is termed as *Mudaraba* and involves the concept of profit sharing and is similar to investment fund in which managers handle a pool of funds. In this case there are two parties, the fund provider and the fund manager and the banker or the fund

manager is called *Mudarib*. The provider either does not have the expertise or capability or is otherwise constrained by other factors to carry on a business on his own by investing the funds. The fund manager has ideas or business, which can reap huge, profits but lacks the capital or funds to start the business. In such a situation the fund provider hands over the funds to the fund manager. This may be equated with venture capital but with one very distinct feature, i.e., the contract entered into clearly specifies the risk sharing arrangement and is just and equitable to both the parties ensuring a re-



The Islamic financial market, as it evolved had one problem that is the absence of a unified acceptable framework and guidelines and standardised products. To overcome these barriers, the International Islamic Financial Market was founded with an objective to provide a common platform to the participants and the regulatory bodies, which are involved in Islamic capital and money markets.

turn, which is *halal* (permissible) as per the directives of *shariat*. In profit-sharing arrangements, the terms of the contract have to be strictly in accordance with the dictates of *shariat* and have to necessarily imbibe the spirit of risk sharing. Islamic banks have popularised this concept by pooling in the deposits from various fund providers and then deploying them profitably by identifying various investment opportunities. While in case of profits, the bank will charge the fees for the time and efforts, but in case there is a loss the bank will not charge any fee for the services.

- iv. **Joint Venture:** This is termed as *Musharakah* wherein the parties come together to jointly contribute to capital and manage the operations of the business. This is like a joint venture where both or all the parties contribute in terms of capital, assets, managerial and technical know-how in either equal or different proportions and agree in advance about the ratios in which the profits will be shared. However, the losses will have to be shared in proportion to the capital contributed into the business.

### Islamic Financial Institutions

It was in the late 1960s and 70s that Islamic Financial institutions emerged on the global financial system. While the Islamic financial institutions started almost fifty years back, the growth was slow in the early stages and it is a system which is still young, evolving and expanding in terms of innovation and geographical location. It is estimated that as of now there are more than three hundred Islamic financial institutions spread across both the Islamic and non-Islamic countries. Some of the major forms of Islamic financial institutions are:

#### Islamic Banking

Islamic banking is the most popular form of financial institution and it is estimated to be into several hundred billion dollars. There are different models of Islamic banking, one wherein the Islamic banking is a private institution with a traditional conventional economy, second is a nationalised Islamic banking and third is the existence of both the Islamic and conventional banking system running parallel. Many commercial banks have innovated and engineered new products, which have led to their impressive growth. While countries like Iran and Pakistan follow the second model, Egypt, Sudan, Malaysia follow the first model whereas Arab countries have both the first and the third model. In a traditional system the stress is on efficiency and

productivity, the basic thrust of an Islamic financial system is ethical code of conduct with an underlying idea of equitable and just distribution of resources to achieve an equitable society. The concept of efficiency and productivity of resources comes later in this system. The Islamic banking is currently undertaken through two channels, the Islamic banks and Islamic windows. Islamic banks are purely based on Islamic principles and all their operations are in conformity with *shariat*. Islamic windows are services provided by the traditional commercial banks to Muslim customers who engage in Islamic banking through an exclusive window.

#### Islamic Insurance (Takaful) Institutions

Risk sharing and management is an important constituent of any financial system. There are scholars who believe that insurance can never find place in an Islamic financial system as a Muslim should be dependent upon Allah (*tawakkul*) and getting insured amounts to challenging the will of Allah. But there is another school of thought, which believes that a Muslim should take all precautions to mitigate the risk and then not worry about the outcome and leave it to the will of Allah. The traditional concept of insurance is considered to be *Maisir* (*gambling*) and a contract, which has lot of *gharar*

The Islamic investment requires that the investors can pool in their money and invest it to earn *halal* (*shariat* compliant) profits but in India, there are no well known established banks, which are engaged in Islamic banking. In India wherever it is prevalent, it is done at a very small scale at local levels. Therefore, there is an urgent need to develop and promote the growth of Islamic financial system in India.

(uncertainty). Islamic insurance is based on *takaful* wherein every person participating gives a donation or *tabarru*, all these donations together constitute the fund from which any participant that suffers a loss or damage gets reimbursement. The balance amount, if any, left in the fund is returned back to the participants.

#### **Investment Banking and Mutual Funds**

The conventional investment banking deals with raising capital for a business either through sale of shares to the public or allotting the shares to certain Qualified Institutional Buyers (QIB). Investment banks also create venture capital funds wherein they provide seed capital for the start-up business and capital for subsequent growth stages of the business. The Financial Services Authority in U.K. has authorised European Islamic Investment Bank to undertake investment-banking activities, which are in compliance with *shariat* laws. An investment banker raises money through equity, debt and other investments like derivatives. An Islamic investment banker cannot deal in debt instruments and derivatives. In case of equity and preference shares, the majority of Islamic scholars permit it on the ground that it involves pro-rata ownership of assets of the

company. But the investment bankers must deal with only those companies, which are engaged in *shariat* compliant business. Venture capital financing by investment bankers should be after fully appraising and evaluating the venture, which will eliminate uncertainty (*gharar*) and, therefore, permissible. Investment in the form of venture capital without analysing the business proposition is outside the preview of an Islamic investment banker as it has lot of uncertainty involved in it. Dealings in the secondary market by fund managers, which are purely speculative in nature, are un-Islamic. The pre-condition for Islamic mutual funds is that there can be no assured profits and the profits and losses from the investment of the pooled funds will have to be shared on a pro-rata basis. Though this type of fund resembles a traditional mutual fund, but the funds have to be invested in a company only if it fulfills certain conditions prescribed in the *shariat* laws. One of these conditions for the company is that its principal business must be *halal*, that is, it should not be dealing in business like pork selling, liquor, gambling. Secondly, the company should not be using debt, in other words having no borrowed money on which it is paying interest and it should not be keeping its money in a

bank, which pays interest on these deposits. These two conditions, especially the second one about interest on deposits and borrowings make it almost impossible for the followers of Islam to invest their money in stock markets through pooled funds. However, certain scholars have advocated that if the business of the company is *halal* and it is a zero debt company and it receives a small amount from its deposits with banks, then if an investor who receives dividends, gives away that part of the dividend which is attributable to the interest on deposits, then such income will be considered *halal*. Thirdly, the shares of company can be purchased only if the company holds a combination of liquid and illiquid assets. If all the assets are in money then the shares will have to be purchased at par. There has been a huge growth in Islamic equity funds and there are Islamic indexes, one of the popular ones is the Dow Jones Islamic index. Even though a fund may be tracking an Islamic index, this by itself does not make the profits fully *shariat* compliant. There are two conditions, which must be satisfied before the returns from a fund become *halal* for a follower of Islam. These two conditions are:

- i. The fund must be supervised by a board consisting

of scholars who are well versed with the interpretation of *shariat* laws relating to finance.

- ii. Since a component of returns from the funds will automatically consist of interest, it is necessary to have the purification process wherein the appropriate interest portion must be given away as charity (*sadaqah*).

### Islamic Mortgage Companies

The traditional concept of mortgage and house loans is not in accordance with Islamic faith as it involves interest. Therefore, a number of Islamic mortgage companies have come into existence even in the western world to provide home acquisition financing to faithful Muslims. The usual procedure followed by Islamic mortgage companies is to first raise the amount or obtain the funds in accordance with *shariat* laws. The funds are then used to buy the property jointly in the name of the company and the customer, but the title deeds are in the name of the company. The customer occupies the property and for this he/she is charged a rent, which is calculated with reference to some benchmark, says London-Interbank-Offered Rate (LIBOR). The customer also pays a certain amount towards the cost of the house and buys the share of the company gradually over a number of years. The agreement entered into at the beginning requires the customer to promise to buy the share of the company over a number of years. There is a school of thought, which objects to the rent being calculated with reference to the benchmark as it

brings uncertainty into the contract.

### Mudaraba Companies

These companies adopt the transaction discussed in *mudaraba* or profit sharing contracts. The *Mudareb*, who has the skills and ability, manages the funds provided by the other person. This is akin to a partnership where the fund provider is a dormant partner and the profit and losses may be agreed upon well in advance. *Mudaraba* may be of two types, in a single-tier, the fund providers directly provide the resources to the fund-managers in a two-tier structure; the investors pool the funds and provide it to an intermediary who then identifies the business partners for the investors.

### International Islamic Financial Market (IIFM)

The Islamic financial market, as it evolved had one problem that is the absence of a unified acceptable framework and guidelines and standardised products. To overcome these barriers, the International Islamic Financial Market was founded with an objective to provide a common platform to the participants and the regulatory bodies, which are involved in Islamic capital and money markets. The central banks of Bahrain, Sudan, Malaysia, Indonesia were the main promoters of IIFM. The main activities of IIFM involve bringing in uniformity and standardisation of products, contracts and financial instruments across the Islamic financial world. It also aims at integrating the Islamic financial market with the mainstream financial markets while trying to maintain the basic tenets of Islam.

### Conclusion

While Islamic finance has been growing and evolving, there have been efforts from certain quarters of diluting the basic characteristics of Islamic finance to make it suitable to the current scenario and make it more productive and profitable. Though, efficiency is the most important characteristic of any financial system, what is to be appreciated is that in an effort to increase allocational efficiency, the basic tenets of *shariat* cannot be diluted and there should be no efforts to have distorted interpretation. Therefore, the big challenge for Islamic financial system is to strike a balance between its Islamic jurisprudence and an efficient financial system thereby providing the real Islamic financial investment avenues to the followers of Islam. In a country like India, which has a huge population of followers of Islam, there is almost a negligible presence of Islamic banking and finance in India. In many other parts of the world, Islamic finance has enabled the participation of those people who refrained from dealing with the traditional financial system. Even the huge growth and returns in the Indian capital markets have not been able to benefit the followers of Islamic *shariat* law. The Islamic investment requires that the investors can pool in their money and invest it to earn halal (*shariat* compliant) profits but in India, there are no well known established banks, which are engaged in Islamic banking. In India wherever it is prevalent, it is done at a very small scale at local levels. Therefore, there is an urgent need to develop and promote the growth of Islamic financial system in India. □

## ENHANCING AUDIT QUALITY

*As you are aware, in the June 2008 issue we had published certain observations of the Reviewers noticed during the conduct of Peer Review exercise, for the information of the members and to empower them in their day-to-day work and thus finally enhance the overall image of the profession. Continuing with the observations earlier published, given below are some more observations relating to Technical Standards.*

### AAS 15 (Audit Sampling)

- While determining the sample size, the practicing units (PUs) does not consider the sampling risk, the tolerable error, and the expected error.
- No use of either statistical or non-statistical sampling methods to design and select an audit sample.
- Audit objectives have not been specified while selecting the sample and its size. It has not been indicated whether sampling risk has been minimised or not.

### AAS 17 (Quality Control of Audit Work)

- System for scheduling and staffing for carrying out the audit engagement needs to be established.
- No system to lay down qualifications deemed necessary for various levels of responsibility to ensure the technical standards and professional competence required to enable them to fulfill their responsibility with due care.
- The units does not have a written manual for policy of review of audit work.
- Review of work done by assistants and supervisions, directions given or any observation are not found in few files particularly in large audit.
- Proper system of control not in existence.

- Work assigned to staff is regardless of the qualification required.
- Monitoring of progress of engagements has not documented.
- Review of audit work performed by each assistant not done by the personnel of at least equal competence.
- Complete record of work assignment and instructions to Audit Assistants found lacking.
- A system of second partner review is not prevalent in some firms.
- The practice units has not established system for second person review.
- There was no checklist or standardised format or questionnaire on record to show the review of work by senior partner for compliance with technical standards.
- No proper policies & procedures for quality control of the attestation services.
- No panel for outside consultation and the record of such consultation is maintained.

### AAS 23 (Related Parties)

- Sufficient audit evidence was not received regarding the identification and disclosure of related parties and related parties' transactions that are material to financial information.
- In few cases, related parties

list and organisational structure are not available.

### AAS 26 (Terms of Audit Engagement)

- Acceptance letters are not sent to clients.
- PUs does not have any practice of issuing engagement letter.
- Engagement letters of Tax audits not obtained.

### AAS 28 (The Auditor's Report on Financial Statement)

- It was noticed that the qualifications in the Auditors reports to the members of the company were not in accordance with the requirements of this AAS.
- The basis of confirmation from outside parties viz., Debtors, Creditors, etc. not on record.
- Audit reports are invariably in report formats as prescribed under relevant statute & without incorporating reporting standard as prescribed (AAS 28).

### AAS 29 (Auditing in a Computer Information System Environment)

- In case of auditing in computerised environment, scope and nature of the terms of assignment and extent of responsibility not specified.

***(To be continued in the next issue...)***

### **IT Investment Regions not Eligible for New Tax Benefits**

The Information Technology Investment Regions (ITIRs) planned across the country will lay stress only on creating infrastructure and 'investor-friendly' policy environment for the information technology (IT) sector. The ITIRs will not be eligible for new tax benefits, according to Mr Jainder Singh, Union IT Secretary. If there are any special economic zones in the ITIR area, those will get existing tax benefits eligible for them.

### **Global Broadcasters of Cricket to be Taxed in India**

Global broadcasters making big money from live telecast of cricket matches in India will have to pay taxes in India, ruled the Commissioner of Income Tax (CIT) while dismissing the plea of sports channel Nimbus, which said that it was not liable to be taxed. Although the Singapore-based World Sports Nimbus (WSN) has decided to file an appeal against the CIT (Appeals) order with the Income Tax Appellate Tribunal (ITAT), the tax case will have wide implications for foreign companies telecasting live cricket matches. The decision of the Income tax Appellate tribunal in this case will have a bearing on the broadcasters of the high profile Indian Premier League (IPL), Sony-WSG combine.

### **Make Compliance Audit Mandatory**

The Competition Commission of India (CCI) said it had asked market regulator Securities and Exchange Board of India to amend regulations relating to corporate governance to make compliance auditing mandatory for listed companies. The CCI had written to SEBI in this regard. The ambit of Clause 49 of the listing agreement, which deals with corporate governance and disclosure norms, could be expanded to include an audit report on the status of compliance with the Competition Act. Inclusion of compliance audit would help ensure safety of shareholders' wealth, he added.

### **BCCI - Whether Qualify as a Charitable Organisation**

The Central Board of Direct Taxes (CBDT) is examining whether the Board of Control for Cricket in India (BCCI), the organisers of the money-minting Indian Premier League, can qualify as a charitable organisation, which entitles it to a tax holiday on all its earnings. CBDT, which had, through a circular in 1984, classified promotion of sports or games as a charitable purpose, is now examining the circular's validity in the backdrop of IPL and the changes made in the definition of charitable purpose in the Finance Act this year.

### **Law Commission Moots Duty of Care on Taxman**

The Law Commission is considering duty of care provisions to protect taxpayers from taxman who acts wrongfully. The Law Commission is considering the need for more redress against public sector bodies such as HM Revenue & Customs (HMRC) when they act wrongfully, making compensation more available under judicial review and reforming the tort of negligence – the area of the law which governs duty of care.

### **Agriculture a New Avenue for CAs**

"As one of the fastest growing states, Gujarat offers immense opportunity to professionals such as chartered accountants (CAs), who will be in short supply once the Gujarat International Finance Tech (GIFT) city shapes up," said Gujarat Chief Minister Narendra Modi. He added that apart from GIFT, the state's booming agriculture would also be a new avenue for CAs, as their services would be required by farmers who have crossed national boundaries to reached global markets. Modi was addressing an event organised by the Ahmedabad branch of Western Indian Regional Council, a part of the Institute of Chartered Accountants of India on Tuesday. The event was part of the ICAI's Diamond Jubilee Year celebrations.

### Income Tax Day on July 24<sup>th</sup>

In the recent conference of Chief Commissioners of Income Tax held in June 2008, a decision was taken to celebrate the Income Tax Day on 24<sup>th</sup> July. To mark this occasion, it was also decided to bring out a compilation of best orders and practices in the form of a booklet.

### CBDT Relaxes Scrutiny Norms in a Few Cases

The Central Board of Direct Taxes has decided to relax norms on scrutiny of taxpayers, whose premises have been surveyed by the officials, a step aimed at encouraging evaders to pay up. "The decision is likely to provide relief to thousands of taxpayers and it would save them from harassment at the hands of taxmen apart from litigation costs," said a senior Finance Ministry official. The decision has been taken following Finance Minister P. Chidambaram's assertion that government wanted to send a message that those who comply with the tax laws would not be harassed by the tax officials.

### Rs 9,000-cr Tax Evasion in Import of 270 Aircraft

The Customs department has unearthed tax evasion of more than Rs 9,000 crore in the import of aircraft and the list of wrongdoers reads like a who's who of Indian business. Sources say that as many as 270 aircraft imported under the non-scheduled operator (NSO) category in the past 30 months and as many as 68 operators (business concerns), have been diverted for private use rather than to run passenger services. "The duty liability arising out of alleged violation of post-importation conditions of the aircraft might be well over the conservative estimate of Rs 9,000 crore at 28% duty," said a source familiar with the investigations. However another source in the customs department said the aircraft operators might go scot-free by paying much less duty as the current DGCA rules are ridden with loopholes.

CRISIL Executive Training



## Training Calendar: August 2008

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	Title	Dates	Location
1	Understanding Customer Financials	August 08, 2008	Mumbai
2	Options Pricing and Trading Workshop	August 11-12, 2008	Mumbai
3	Operational Risk Measurement and Management under Basel II (In association with Global Association of Risk Professionals GARP)	August 20-22, 2008	Mumbai
4	Finance Fundamentals for Managers	August 21-22, 2008	Bangalore
5	Advanced Corporate Credit Risk Analysis	August 22-23, 2008	Delhi
6	Gas Contracts, Regulation and Pricing	August 28-29, 2008	Delhi

Contact CRISIL Executive Training Desk on 022 6691 3236/ 3041 or email at [executivetraining@crisil.com](mailto:executivetraining@crisil.com)

### **Business Continuity Management Systems Auditor Certification Programme**

The International Register of Certificated Auditors (IRCA) has announced the launch of its new Business Continuity Management Systems Auditor Certification Programme. Developed in partnership with the Business Continuity Institute (BCI), the programme responds to the international demand for competent auditors of business continuity management systems. Under the new scheme, IRCA offers certification across six auditor grades for business continuity management systems auditors, consultants and practitioners.

### **Young Accountant Becomes Olympic Hopeful**

Haley Chura, an associate at CPA firm Bennett Thrasher, is trying out for a spot on the U.S. Olympic swimming team on July 4. She will be competing in trials for the 200-meter backstroke event in Omaha, hoping to earn a place at the Summer Olympics in Beijing. Chura, 22, is currently seeded 21<sup>st</sup> out of approximately 90 swimmers on the strength of her college swimming experience. ([www.webcpa.com](http://www.webcpa.com))

### **IFAC's International Ethics Standards Board Issues Proposals to Clarify Code of Ethics for Accountants**

To further promote and facilitate accountants' adherence to high ethical and independence standards, the International Ethics Standards Board for Accountants (IESBA), an independent standard-setting board within the International Federation of Accountants (IFAC), has proposed changes to the IFAC Code of Ethics for Professional Accountants. The changes, outlined in an exposure draft with the same title, focus on enhancing the clarity of the Code. The proposed changes make clear the specific requirements that are contained in the Code and refine the application of the Code's conceptual framework. Comments on the exposure draft are requested by October 15, 2008. The exposure draft may be viewed by going to <http://www.ifac.org/eds>. Comments may be submitted by email to [edcomments@ifac.org](mailto:edcomments@ifac.org).

([www.ifac.org](http://www.ifac.org))

### **IFAC's International Auditing and Assurance Standards Board Issues Strategy and Work Program for 2009-2011**

The International Auditing and Assurance Standards Board (IAASB) released its Strategy and Work Program, 2009-2011. The three-year strategy includes an emphasis on the development of standards that contribute to the effective operation of the world's capital markets and that address the needs of small- and medium-sized entities and small and medium practices. The Strategy and Work Program 2009-2011 can be downloaded free-of-charge from the IFAC online bookstore <http://www.ifac.org/store>.

([www.ifac.org](http://www.ifac.org))

### **Risk Management Concerns Audit Committees**

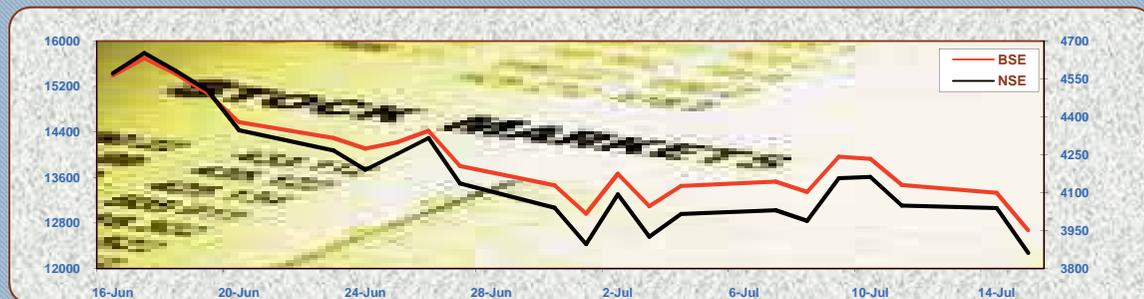
Risk management has become a top concern of audit committee members, according to a new report. A survey of 300 audit committee members found that only 28 percent consider themselves "very satisfied" that they understand the process used by management to identify and assess significant business risks. Only 21 percent are very satisfied with the risk reports they receive from management. ([www.webcpa.com](http://www.webcpa.com))

### **IAASB Issues Auditing Standard on Related Parties; Makes Further Progress on Clarity Standards**

Following the consideration and approval of due process by the Public Interest Oversight Board (PIOB), the International Auditing and Assurance Standards Board (IAASB) released International Standard on Auditing (ISAs) 550 (Revised and Redrafted), Related Parties and three clarity redrafted ISAs. The complete set of clarified ISAs, including newly revised standards such as ISA 550 (Revised and Redrafted), will be effective for audits of financial statements for periods beginning on or after December 15, 2009. The ISAs can be downloaded free-of-charge from the IFAC online bookstore at <http://www.ifac.org/store>.

([www.ifac.org](http://www.ifac.org))

## Economic Indicators



## Selected Indicators

Item	Unit/Base	2004-05	2005-06	2007						
				05-May	28-Mar	04-Apr	11-Apr	18-Apr	25-Apr	02-May
Cash Reserve Ratio	per cent	5.00	5.00	6.50	7.50	7.50	7.50	7.50	7.50	7.75
Bank Rate	Per cent per annum	6.00	42.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Prime Lending Rate	Per cent per annum	10.25-10.75	10.25-10.75	12.75-13.25	12.25-12.75	12.25-12.75	12.25-12.75	12.25-12.75	12.25-12.75	12.25-12.75
Deposit Rate	Per cent per annum	5.25 - 6.25	6.00 - 7.00	7.50-9.00	8.25-9.00	8.25-9.00	8.25-9.00	8.25-9.00	8.25-9.00	8.25-9.00
Call Money Rate (Low/High)	Per cent per annum	2.60/6.25	3.00/8.25	5.25/14.00	4.00/9.00	3.50/10.30	1.00/6.50	4.00/7.60	2.00/7.50	4.75/7.50

Readers are Invited to contribute write-ups or any relevant and interesting piece of information for this feature at [ebboard@icai.org](mailto:ebboard@icai.org).

## ACCOUNTANT'S BROWSER

**"PROFESSIONAL NEWS & VIEWS PUBLISHED ELSEWHERE"**

Index of some useful articles taken from Periodicals/Newspapers received during June – July 2008 for the reference of Faculty/Students & Members of the Institute.

### 1. ACCOUNTING

A Gag for sale: A glimmer of reform eases the tight grip on professions in India by Pragya Singh. *Outlook*, 9<sup>th</sup> June 2008, pp.32-33.

IAS 1: Presentation of financial Statements – A closer look by K.S. Muthupandian. *The Management Accountant*, June 2008, pp.420-425.

IFRS – One Accounting language for the entire World by A.L. Saini. *CAPJ*, June (1<sup>st</sup>) 2008, pp.20-26.

Lean Accounting by Ross Maynard. *Accountants Today*, June 2008, pp.14-16.

Major departures in Indian Accounting Standards from the Corresponding IFRSs. *CAPJ*, June (1<sup>st</sup>) 2008, pp. 611-633.

### 2. AUDITING

The Impact of Non-mandatory Corporate Governance on Auditors' Client Acceptance Risk & Planning Judgments by D.S. Sharma etc. *Accounting & Business Research*, vol.38/2, 2008, pp. 105-120.

Public Oversight on Auditing Profession in the South Asian

Region- Sri Lankan Experience by Ajith S. Ratnayake. *The Management Accountant*, June 2008, pp. 416-417.

### 3. ECONOMICS

Evolution of Rural Banking in India & its Future by Ravi N. Kadam. *Banking Finance*, May 2008, pp.9-11.

How to survive a Disaster by Amanda Ripley. *Time*, June 23, 2008, pp.30-35.

Indian Economy: Prospects for Growth with Stability by Dr. Y.V. Reddy. *RBI Bulletin*, June 2008, pp.973-978.

Insider Trading: An Economic Justification by Shlok Chandra & Kaushalya Venkataraman. *Company Law Journal*, Vol.2, 2008, pp.145-159.

Ten Fundamental Issues in Reforming Financial Regulation & Supervision in a World of Financial Innovation & Globalisation by Nouriel Roubini. *Corporate Governance*, Vol.8/2, 2008, pp.6-10.

Power Sector Reforms in India: A Case Study from Delhi by Shahid Hasan & Vikas Gaba. *International Journal of Regulation & Governance*, Vol.8/1, pp.31-67.

### 4. INVESTMENT

Company Limited by Guarantee: Introduction of Share Capital Clause in Memorandum of Association by Dibyojyoti Sarkar. *Company Law Journal*, Vol.2, 2008, pp.160-165.

### 5. LAW

Board of Director Performance Reporting by Michael L. McIntyre & Steven A. Murphy. *Corporate Governance*, Vol.8/2, 2008, pp.165-178.

Open File: RTI to Complete Three Years in October, Review Underway by Ravleen Kaur. *Down to Earth*, June 1-15, 2008, pp.22-24.

Social & Environmental Reporting in UK Company Law & the Issue of Legitimacy by David Williamson & Gary Lynch-Wood. *Corporate Governance*, Vol.8/2, 2008, pp.128-140.

### 6. MANAGEMENT

Building Power Brands by Amitava Chattopadhyay. *B Sensex*, June-July, 2008, pp.31-33.

A Case Study on the Influence of Corporate Governance Beyond the Boardroom: Perceptions from Business Unit Managers by Teerooven Soobaroyen &

## FINANCIAL INSTRUMENTS STANDARDS\*

The decision of the Council of the Institute of Chartered Accountants of India (ICAI) to have convergence with the International Financial Reporting Standards (IFRS), effective from April 1, 2011, is in consonance with the worldwide trends. Within the entire set of IFRSs, the standards related to financial instruments, i.e., IAS 32, IAS 39 and IFRS 7, require more interpretational and application inputs, and hence always carry resultant complexities. Recent announcement by Ministry of Corporate Affairs to move towards convergence in India is an important policy decision and shall accelerate the process of observance of IFRSs in the corporate world.

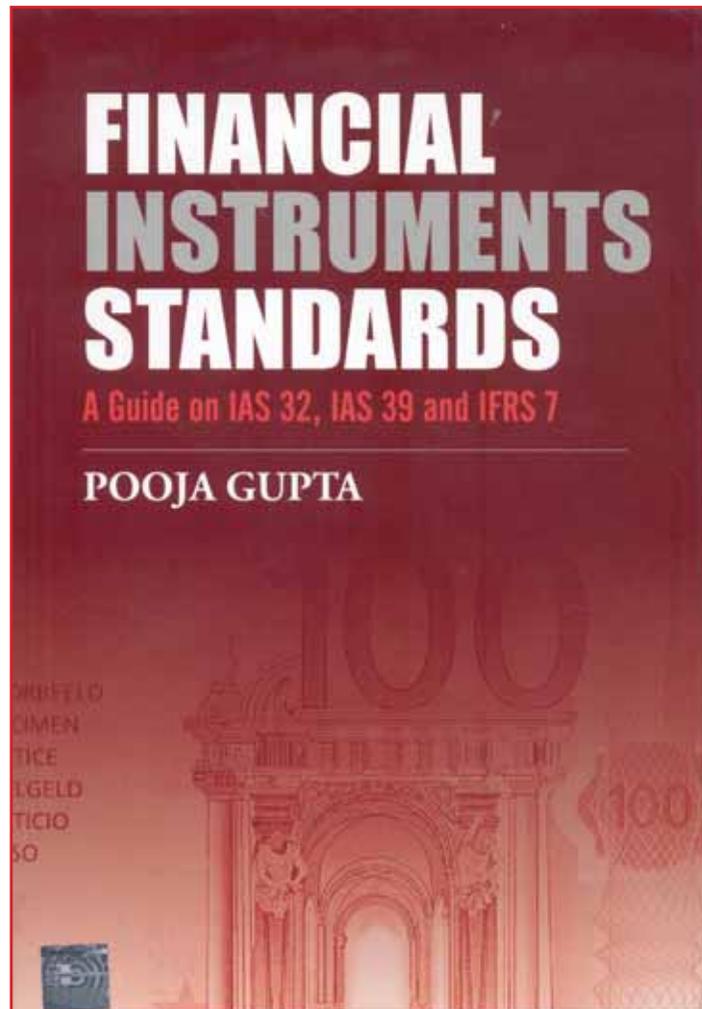
In such a scenario, there is a need for a guide, which can provide application guidance with the research-based interpretation and analysis. This gap seems to have been filled by Pooja Gupta through her work, *Financial Instruments Standards: A Guide on IAS32, IAS 39 and IFRS 7*.

Divided into eleven chapters containing about 200 pages, the Guide deals with the entire gamut of issues related to financial instruments including embedded derivatives, de-recognition of financial instruments and hedge accounting. Written in a very lucid and simple language, it provides prelude and scope to the financial instruments standards and moves on to explain their presentation, classification, recognition and measurement. It further delves on de-recognition of the financial instruments and hedge accounting including its models, and concludes with the explana-

tion of their disclosure requirements. The worked-out example to illustrate the explanations and to practically explain complex calculations and disclosures is another feature of the Guide. A comparison of IFRS, US GAAP

and Indian GAAP given in the appendix will surely be handy in understanding nitty-gritty of the financial instruments standards.

Overall, it will prove be a value-addition to the shelf of a professional's library. □



**Title** : Financial Instruments Standards: A Guide on IAS 32, IAS 39 and IFRS 7

**Author** : Pooja Gupta

**Publisher** : Tata McGraw-Hill

\*Reviewed by CA. Amarjit Chopra, Central Council Member and Chairman, Accounting Standards Board of the ICAI.

## EXPOSURE DRAFT OF AN IMPROVED CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING AND DISCUSSION PAPER ON PRELIMINARY VIEWS ON AN IMPROVED CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING ISSUED BY IASB AND FASB

### **(Comments invited by August 30, 2008)**

In May 2008, the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) published for public comment: (i) Exposure Draft of An improved Conceptual Framework for Financial Reporting: Chapter 1: The Objective of Financial Reporting and Chapter 2: Qualitative Characteristics and Constraints of Decision - useful Financial Reporting Information (ii) Discussion Paper on Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity.

The IASB and FASB seek public comment on two of the eight phases of their joint project to develop an improved conceptual framework. IASB and FASB invite comments to be received by September 29, 2008. The objective of the project is to develop an improved conceptual framework that provides a sound foundation for developing future accounting standards.

### ***Exposure draft of Chapters 1 and 2 of the framework***

The exposure draft of chapters 1 and 2 of the framework seeks views on an improved objective of financial reporting, the qualitative characteristics of information provided by financial reporting and constraints on the provision of that information. The draft reflects the boards' updated proposals in the light of comments received on an initial consultation document published in July 2006. The exposure draft now proposes that the objective of financial reporting is to provide financial information that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers. It also presents an improved description of 'faithful representation', one of the qualitative characteristics that financial information should possess if it is to provide a useful basis for economic decisions.

### ***Preliminary views on the reporting entity concept***

The discussion paper on Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity sets out the boards' preliminary

views on the reporting entity concept and related issues. Although the reporting entity concept determines some important aspects of financial reporting, the boards' existing frameworks do not address it specifically. The boards' preliminary views are:

- a reporting entity is a circumscribed area of business activity of interest to present and potential equity investors, lenders and other capital providers.
- control is the basis for determining the composition of a group reporting entity.
- consolidated financial statements should be prepared from the perspective of the group reporting entity.

With the Indian Accounting Standards 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 (i) Exposure Draft of An improved Conceptual Framework for Financial Reporting: Chapter 1: The Objective of Financial Reporting and Chapter 2: Qualitative Characteristics and Constraints of Decision - useful Financial Reporting Information (ii) Discussion Paper on Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity, issued by the IASB and FASB.

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 – 110 002, so as to be received not later than **August 30, 2008**. Comments can also be sent by e-mail at [tdte@icai.org](mailto:tdte@icai.org) or at [edcommentsasb@icai.org](mailto:edcommentsasb@icai.org).

Downloadable version of documents is available on IASB's website [www.iasb.org](http://www.iasb.org)

## Important Announcement for Members attaining the age of 60 years or are at present at the age of 60 years and above

Members may kindly refer to the announcement published in the July, 2008 issue of the Journal whereby members were apprised of the Council's decision with regard to making the CPE hours requirements mandatory, w.e.f. 15<sup>th</sup> May 2008, also for the members of the Institute, who are attaining the age of 60 years during a particular calendar year within 2008-2010 or are at present of the age of 60 years and above. Such members could earn the CPE hours either by **structured or unstructured CPE learning activities**.

We understand that the members are not clear on the issue of unstructured CPE learning activities. It is therefore, reiterated that unstructured CPE learning activities are equally applicable to Members attaining the age of 60 years during a particular calendar year within 2008-2010 or are at present at the age of 60 years and above. The unstructured learning activities includes the following:

- Web-based learning modules (e-learning)
  - *e-learning is "instructional content or learning experiences delivered or enabled by electronic technology". Electronic technology encompasses everything from Computer-Based Training (CBT), to compact disks (CDs), to Web-based applications."*
- Self-learning modules and courses (use of audiotapes, videotapes, correspondence courses, computer based learning programmes).
- Reading and individual home study
  - *Reading and Individual Home Study may constitute reading articles in the*

*Journal, 'The Chartered Accountant' of the Institute, reading technical, professional, financial or business literature.*

- Group or bilateral discussion on technical issues
- Acting as visiting faculty or guest faculty at the various Universities/Management Institutions/Institutions of National Importance
- Participation in CPE Teleconferencing Programmes without the supervision of the POU
- Providing solutions to questionnaires/puzzles available on Web/Professional Journals
- Internal Training Programmes being organised by firms of Chartered Accountants having seven or more partners

We would also like to inform the members that an Advisory on Unstructured CPE Learning Activities has also been issued which was published in the June, 2008 issue of the Institute's Journal. According to this advisory, the members would be required to submit a self-declaration form **once in a year**, before 31<sup>st</sup> May, to avail the CPE Hours Credit for the entire Unstructured Learning Activities undergone by them in the previous year. These forms would have to be submitted to the concerned Decentralised Offices. The members could also submit the same to the Sub-Decentralised Offices for onward submission to the concerned Decentralised Offices.

The format of the said self-declaration form is published elsewhere in this issue of the Journal.

**Continuing Professional Education Committee**

## FOR YOUR INFORMATION

### 59<sup>th</sup> Annual Report and Audited Annual Accounts of the Institute for the year 2007 – 2008.

Members of the Institute are hereby informed that full text of the 59<sup>th</sup> Annual Report and Audited Annual Accounts for the year 2007 - 2008 together with 'Activities in Detail' will be hosted on the Institute's Website (<http://www.icai.org>) for general information of the Members in the month of September/October, 2008. With a view to making available, free of cost, the hard copy and/or soft copy of the Annual Report and Accounts to interested members, it has been decided to seek their consent/willingness. Accordingly, you are requested to kindly indicate your willingness for the same to Shri T. Karthikeyan, Director [email: [councilaffairs@icai.org](mailto:councilaffairs@icai.org)]. It may please be noted that a copy of the Abridged version of said Annual Report and Accounts would in any case be sent to all members, after its publication in the Gazette of India, as required.

## ICAI Encourages Members abroad to form Chapters abroad and Liaison Point

Formation of a Chapter of member abroad in the city/country reside would not only add to the knowledge and skill up-gradation but they will also bring the Indian accountancy profession visible to the outside World and creating a bonhomie. The Institute is taking initiatives in promoting the Indian Chartered Accountants as a "brand" to promote various range of value added services, which can be provided by members abroad and for addressing the issues and concerns/interest of them. The Chapter aboard and member abroad as integral part of the Chapter would play a vital role in promoting the Indian chartered accountancy as preferred brand worldwide.

The opening of Chapter inter alia requires 20 members in a city, if Chapter is to be formed in a city of foreign country and 100 members, if Chapter is to be formed at country level. Your active participation and role would go in the larger

interest of making further forays in furthering the interest of the profession worldwide. Given the globalisation of business and opportunities coming in way of services trade; the Institute would request its members to form Chapters in the area/country they reside; the Guidelines of which are available at <http://www.icai.org/icairoot/overview/network/guidelines.jsp>.

Another organ which has been contemplated for promoting the activities of the Institute in foreign territories is the liaison point wherein any member of the Institute can forward the proposal for carrying forward the work programme of the Institute in the respective country/city in a foreign territory as per the structured format available at [http://www.icai.org/icairoot/departments/international\\_affairs/icai\\_liaison\\_info.pdf](http://www.icai.org/icairoot/departments/international_affairs/icai_liaison_info.pdf)

For further details, please write to [ia@icai.org](mailto:ia@icai.org).

## AN APPEAL The S.Vaidyanath Aiyar Memorial Fund

### 1. ESTABLISHMENT

The S.Vaidyanath Aiyer Memorial Fund was established in the year 1963 to commemorate the name of the late S.Vaidyanath Aiyer, a former President of the Institute by raising contributions on voluntary basis from the members of the Institute.

### 2. BENEFITS TO THE MEMBERS

- Providing an annual award to one or more members of the Institute who have made outstanding contribution in the field of Accountancy or in any allied field.
- Payment of honoraria for delivering Research Memorial Lectures or for contributing a series of articles in the Journal of the Institute.
- Financing a research in project by payment of expenses of a research in advanced aspects of accounting or auditing either independently or in collaboration with a University Research Foundation or Chambers of Commerce.

### 3. BENEFITS TO THE STUDENTS

- Providing financial assistance to poor and

deserving articled and/or audit assistants for payment of coaching board and examination fees.

### 4. MEMBERSHIP

Life Members	: One time nominal payment of Rs.500/-
Ordinary Member	: Annual Subscription of Rs. 50/-
Voluntary Contribution	: Any amount

### 5. EXEMPTION

Contribution to SVAMF is exempted from Income Tax under Section 80G of the Income Tax act.

### APPEAL

I therefore urge the members to attain the membership of the said fund and also motivate the members to carry out research Activities & at the same time help the needy & deserving candidates pursuing the Chartered Accountancy Course. The prescribed Form for the life membership is available at [www.icai.org](http://www.icai.org)

**Vice President**

**BECOME MEMBER OF SVAMF AND HELP OUR STUDENTS' FRATERNITY**



**INDIRA GANDHI NATIONAL OPEN UNIVERSITY**  
Maidan Garhi, New Delhi-110 068

**Invites Application for Admission to the  
B.COM WITH MAJOR IN ACCOUNTANCY AND FINANCE (B.COM A&F)  
M.COM IN FINANCE AND TAXATION (M.COM F&T)**

For July 2007 session

Exclusively for Chartered Accountancy students

Designed and Developed in collaboration with

The Board of Studies, The Institute of Chartered Accountants of India

**BACHELOR OF COMMERCE WITH MAJOR IN ACCOUNTANCY AND FINANCE (B.COM A&F)**

**Eligibility for Admission:** (i) 10+2 or its equivalence; (ii) Passed Common Proficiency Test/PE-1/ Foundation From ICAI; and (iii) Registration in Professional Competency Course/PE-II/Intermediate of ICAI **(OR)** Already passed Professional Competency Course/PE-II/Intermediate of ICAI

**Duration:** 3 Years (1 year for those who have already passed CA First Stage)

**Medium of Instruction:** English and Hindi

**Fee:** Rs.4,000/- consolidated

**MASTER OF COMMERCE IN FINANCE AND TAXATION (M.COM F&T)**

**Eligibility for Admission:** (i) Graduate in any discipline or equivalence from a recognised University/ Institute; and (ii) Admitted in Chartered Accountancy Final Course **(OR)** *Already passed Chartered Accountancy*

**Duration:** 2 Years (1 year for those who have already passed CA)

**Medium of Instruction:** English

**Fee:** Rs.5,000/- consolidated

The Student Handbook and Prospectus can also be obtained from **15<sup>th</sup> July 2008** from all the Regional Centres of IGNOU, or from the Registrar, SR&E Division, IGNOU, Maidan Garhi, New Delhi-110068, in person on payment of **Rs.400/-** in cash or through post by sending an IPO or Demand Draft of **Rs.450/-** drawn in favour of IGNOU

**Last Dates**

Requisition for supply of Prospectus by post:

**10<sup>th</sup> August 2008**

Submission of forms at the Regional Centres:

**31<sup>st</sup> August 2008**

Late and complete application forms shall be summarily rejected. No correspondence in this regard will be entertained.

Please see the website of ICAI "www.icai.org ----students---bos announcement

**EXAMINATION DEPARTMENT IMPORTANT ANNOUNCEMENT**

**Sub: UPWARD REVISION OF VERIFICATION FEE OF THE CHARTERED ACCOUNTANTS  
EXAMINATIONS**

The Council of the Institute has decided to increase the verification fee of answer books of the Chartered Accountants Examinations and accordingly, the revised verification fee will be Rs. 100/- per paper, subject to a maximum of Rs. 400/- effective from May 2008 Chartered Accountants Examinations.

Candidates intending to apply for verification of answer books after the declaration of results of May 2008 CA Examinations may kindly note the above change in verification fee and pay the revised fee as indicated above alongwith the application for verification of answer books.

**(G. Somasekhar)**  
**Sr. Joint Secretary (Exams)**

## CAMPUS PLACEMENT PROGRAMME AUGUST-SEPTEMBER 2008 FOR NEWLY QUALIFIED CHARTERED ACCOUNTANTS

The Committee for Members in Industry of the Institute organises Campus Placement Programme for newly qualified Chartered Accountants at various centres all over India. The scheme has been evolved to provide an opportunity both to employing organisations as well as the young professional aspirants to meet and explore the possibility of taking up positions in Industry. In the last such Interviews conducted in February-March-April, 2008 at various centres, about 250 recruiting teams of leading organisations of the country reviewed the bio-data of around 3800 newly qualified Chartered Accountants.

### INVITATION TO CANDIDATES QUALIFIED IN CA FINAL MAY 2008 EXAMINATION

It has been decided to organise Campus Placement Programme at 18 centres, viz., Ahmedabad, Bangalore, Baroda, Chandigarh, Chennai, Coimbatore, Ernakulam, Hyderabad, Indore, Jaipur, Kanpur, Kolkata, Mumbai, Nagpur, Nashik, New Delhi, Pune & Surat in August-September 2008. As earlier, a large number of leading organisations are expected to participate.

The **revised** schedule of the Campus Placement Programme is as below:

Centre	Dates*
Pune	26 <sup>th</sup> August 2008 to 29 <sup>th</sup> August 2008
Ahmedabad, Baroda, Chandigarh, Coimbatore, Ernakulam, Hyderabad, Indore, Jaipur, Kanpur, Nagpur, Nashik and Surat	2 <sup>nd</sup> September 2008 to 5 <sup>th</sup> September 2008
Bangalore, Chennai, Kolkata, Mumbai and New Delhi	17 <sup>th</sup> September 2008 to 25 <sup>th</sup> September 2008

\* Excluding Sunday

### INVITATION TO EMPLOYERS

The Committee for Members in Industry of the Institute provides opportunity to the employers to interact with newly qualified Chartered Accountants and makes all arrangements at its centres, thereby providing a cost effective mode of recruiting newly qualified Chartered Accountants.

Organisations intending to recruit newly qualified Chartered Accountants through the above said scheme of Campus Placement Programme are requested to get in touch with Dr. Surinder Pal, Secretary, Committee for Members in Industry, Indraprastha Marg, New Delhi - 110002, Tel. No. (011) 30110450/442 E-mail: [placements@icai.org](mailto:placements@icai.org), [spal@icai.org](mailto:spal@icai.org); Fax- +91(11) 30110583 (or) Mr. Ajeet Nath Tiwari, Placement Coordinator, at Tel +91(11) 30110450..

An organisation can also participate in one or more centres, as per its requirements. Firms of Chartered Accountants are also welcome to join. For further details please log on to [www.cmii.icai.org](http://www.cmii.icai.org) or <http://www.icai.org>.

Chairman  
Committee for Members in Industry

### Museum of the Institute

Attention of members are invited that it has been decided to have a museum of the Institute 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

## Auditing and Assurance Standards Board Outstanding Exposure Drafts (Issued by AASB)

<b>AUDITING AND ASSURANCE STANDARDS BOARD (AASB)</b>	
<b>Exposure Drafts</b>	<b>Comments Due by</b>
Revised Standard on Auditing (SA) 600, <i>Special Considerations – Audits of Group Financial Statements (Including The Work of Component Auditors)</i> (Published in June, 2008 issue of the Journal.) <a href="http://www.icai.org/icairoot/announcements/announ1453.pdf">http://www.icai.org/icairoot/announcements/announ1453.pdf</a>	July 31, 2008
Revised Standard on Auditing (SA) 260 “ <i>Communication with Those Charged with Governance</i> ” (Published in May, 2008 issue of the Journal.) <a href="http://www.icai.org/icairoot/announcements/announ1379.pdf">http://www.icai.org/icairoot/announcements/announ1379.pdf</a>	June 15, 2008
Revised Standard on Auditing (SA) 530, <i>Audit Sampling</i> (Published in March, 2008 issue of the Journal.) <a href="http://www.icai.org/icairoot/announcements/announ1321.pdf">http://www.icai.org/icairoot/announcements/announ1321.pdf</a>	April 30, 2008
Revised Standard on Auditing (SA) 250, <i>The Auditor’s Responsibilities Relating to Laws and Regulations in an Audit of Financial Statements</i> (Published in February, 2008 issue of the Journal.) <a href="http://www.icai.org/icairoot/announcements/announ1296.pdf">http://www.icai.org/icairoot/announcements/announ1296.pdf</a>	April 30, 2008
Revised Standard on Auditing (SA) 580, <i>Written Representations</i> (Published in November, 2007 issue of the Journal.) <a href="http://www.icai.org/icairoot/resources/revise_sa580.pdf">http://www.icai.org/icairoot/resources/revise_sa580.pdf</a>	December 15, 2007
Revised Standard on Auditing (SA) 570, <i>Going Concern</i> (Published in October, 2007 issue of the Journal.) <a href="http://www.icai.org/icairoot/resources/expd_sa_570.pdf">http://www.icai.org/icairoot/resources/expd_sa_570.pdf</a>	December 15, 2007

**Note:** Though, for the benefit and information of the interested readers, an exposure draft shall continue to be hosted on the website of the AASB even after its last date for comments has expired, no comments thereon, after the expiry of the said date, would be considered by AASB, as the case may be.

An exposure draft would be removed from the AASB’s website when the final standard is issued or if the project is dropped.

### ANNOUNCEMENT REGARDING ELECTRONIC NEWSLETTER ON INSURANCE AND PENSION

#### COMMITTEE ON INSURANCE AND PENSION

As an endeavour to achieve its objectives, the Committee on Insurance & Pension has started compiling an electronic newsletter containing the daily news updates in the area of Insurance & Pension, which is uploaded on its portal [www.insuranceicai.org] on daily basis, except for Saturdays, Sundays and other Gazetted holidays. The newsletter focuses on topics related to:

- Life Insurance: covering news from various life insurance companies.
- Non life Insurance: covering news from various general insurance companies.
- Developments relating to health Insurance
- Developments relating to Reinsurance
- Developments relating to Pension/PFS
- Developments relating to The Insurance Regulatory Development Authority (IRDA)
- Excerpts from interviews with CEO’s, CFO’s and CMD’s of Insurance companies.
- News involving global players such as Lloyd’s, Swiss Re and Munich Re (related to India)

The Newsletter is available at hyperlink:

<http://www.insuranceicai.org/pressclippings.aspx>

Members and others concerned to keep abreast of the developments in Insurance & Pension sectors may make use of this facility.

## Announcement for Senior Members regarding Computer Awareness Programmes (CAPs)

It has always been the focus of the Institute to provide learning opportunities to all the members and also to introduce new courses and IT based programmes for our members and students to acquire proficiency in the sphere of Information Technology and attain the required level of competency in the professional world.

We would like to draw your attention towards the President's message page of the April, 2008 issue of the Journal, 'The Chartered Accountant'. In his address to the professional colleagues, the President has emphasised on the need to ensure that all members of the Chartered Accountant fraternity of 1,45,000 plus members, especially senior members, become computer savvy and hence, be able to use the latest technology to synchronise with the dynamic working methodology. The President has expressed his desire that all members should become proficient in the use of computers by the end of this year, without dependency of any kind.

Keeping the above in view, the Continuing Professional Education Committee and the Committee on Information Technology, in this Diamond Jubilee Year of the Institute, are together organising Computer Awareness Programmes (CAPs) at Regional and Branch levels, especially for senior members, to ensure their compatibility with the latest technologies and to make them self-dependent in using computers. These programmes intend to make the members conversant with the usage of computers for their day-to-day working. To enable the participants to have a future reference material, a brief background material along with a set of Computer Based Training CDs is also being provided to the POUs without any cost to them.

We therefore suggest all the senior members of the Institute, who find it difficult to work on computers, to approach the concerned Regional Councils and Branches to coordinate and participate in these programmes and also encourage other professional colleagues to join the same, if felt necessary by them also.

**Chairman,  
Continuing Professional Education Committee**

**Chairman,  
Committee on Information Technology**

### Committee on Information Technology, ICAI

#### A. Practical Workshop Scheduled for July-August, 2008

Chennai		Delhi		Mumbai	
MS-Excel as an Audit tool	Aug-09	CAAT's/GAS Tools	Aug-24	Tally for Auditors	Aug 9-10
Demo Of Penetration Tool	Aug-23	MS-Excel as an Audit tool	Aug-31	CAAT Tools	Aug 30-31

Further details about these workshops are available on the ISA Portal at [www.isaicai.org](http://www.isaicai.org). Workshop registration is on first-come-first-served-basis on receipt of duly filled-in form with workshop fee. Please book seats well in time. Walk-in registrations are generally not available.

#### B. ICAI ERP Courses - SAP FICO, Oracle 11i Financials & Microsoft NAV Dynamics

The Committee has identified ERP as the next focus area for the development of members, after Information Systems Audit (ISA), which has been very popular amongst the members. As a part of this initiative, special training programme on (a) **SAP ERP FICO** module training, (b) **Oracle 11i Financials** (c) **Microsoft NAV Dynamics (Delhi Aug 22-24, Mumbai Aug 28-30)** (d) IT conference at Kolkatta (Aug 29-30). Further details are available on the official website of the Institute at [www.icai.org](http://www.icai.org) (Exact URL is <http://www.icai.org/icairoot/announcements/announ1056/TechnologyInitiativeERP.html>).

#### C. Information Systems Audit Course (ISA)

Members interested in qualifying the Information Systems Audit (ISA) Post Qualification Course (PQC) AT in December 2008 attempt may join now and complete their ISA Professional Training by, October 2008. For further details about the ISA PQC, please refer to ISA Prospectus available at sale counters of the Institute and the ISA Portal at [www.isaicai.org](http://www.isaicai.org).

## ICAI AWARDS FOR EXCELLENCE IN FINANCIAL REPORTING

Invitation to Participate in the Competition for the year 2007-08

Last date for receipt of entries: 30<sup>th</sup> September, 2008

### Objective

To recognise and encourage excellence in the preparation and presentation of financial information with the mission of greater accountability and well-informed decision making.

### Categories of the Awards

**Category I Manufacturing and Trading enterprises** (including Processing, Mining, Plantations, Oil and Gas enterprises)

**Category II Banking and Financial Institutions** (including NBFCs, Mutual Funds, Unit Trust of India, Investment Bankers, HFCs etc.)

**Category III Service sector** (including Hotels, Consultancy, Transport, Stock Exchanges, R&D, Private Hospitals)

**Category IV Insurance Sector**

**Category V Information Technology, Communication and Entertainment enterprises**

**Category VI Infrastructure & Construction sector** (including Power Generation and Supply, Port Trusts, Metro, Roads)

**Category VII Others** (Section 25 companies, Educational Institutions, NGOs, Charitable hospitals and other organisations)

In a case, where an organisation is engaged in more than one business, the dominant source of revenue will determine the category to which the organisation belongs.

### Awards to be distributed

One Gold Shield and one Silver Shield will be awarded in each category for the best entry and the next best entry, respectively.

### Conditions for Entry

- I The Annual Report for entry to the 2007-08 Competition should relate to the financial year ending on any day between 1<sup>st</sup> April, 2007 and 31<sup>st</sup> March, 2008 (both days inclusive).
- II Ten copies of the following documents should be sent:
  - (a) Annual Report
  - (b) Quarterly/Half-yearly Financial Results published during the year (specifically mentioning their date of publication) alongwith the Limited Review/Audit Report, where applicable.
- III The following documents (or such other similar documents as are prepared by the organisation concerned) should form part of the Annual Report:
  - (a) Balance Sheet
  - (b) Profit and Loss Account
  - (c) Directors' Report
  - (d) Chairman's statement or speech at the Annual General Meeting. If a copy of the statement or speech of the Chairman was circulated to the shareholders alongwith the Annual Accounts, specific mention of this fact may be made.
- IV The entry to the Competition should be accompanied by a declaration that the Annual Reports submitted are the same that have been circulated to the common shareholders.
- V No fee is payable.
- VI Cyclostyled copies of the Annual Report and Accounts will not be accepted. This condition, however, does not apply to entities covered by Category VII.
- VII In all matters concerning the Competition, the decision of the panel of judges appointed by the Institute will be final.

Entries to the Competition for the year 2007-2008 should be submitted in the duly filled entry form (available on the Institute's Website [www.icai.org](http://www.icai.org) under the link <http://www.icai.org/icairoot/announcements/announ1487.pdf> or can be obtained from the Institute's Office at New Delhi) with relevant enclosures and sent to:

Secretary, Research Committee, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002; E-mail: [research@icai.org](mailto:research@icai.org), [tdte@icai.org](mailto:tdte@icai.org).

## Announcement for all Members regarding Self Declaration Form for availing CPE Hours Credits through Unstructured Learning Activities

The CPE Committee has been issuing various pronouncements for guidance and reference of the members to enable them to comply with the CPE requirements easily.

Since, the Unstructured CPE learning activities have been made applicable w.e.f. 1<sup>st</sup> January 2008, the Council has issued a new CPE Advisory on Unstructured CPE Learning Activities, which was published in the June, 2008 issue of the Institute's Journal. This Advisory serves as a guidance and direction to the members who desire to avail CPE Hours Credits through Unstructured CPE Learning Activities.

According to this Advisory, the members would be required to submit a self-declaration form **once in a year only** before 31<sup>st</sup> May, to avail the CPE Hours Credit for the entire Unstructured Learning Activities undergone by them in the previous year. **The last date of submission of the Self Declaration Form for the current calendar year is 31<sup>st</sup> May 2009.** The format of the said self-declaration form is given below for reference of the members. This format has been included as **Annexure I** in the CPE Advisory on Unstructured Learning Activities. This form would have to be submitted to the concerned Decentralised Offices. The members could also submit the same to the Sub-Decentralised Offices for onward submission to the concerned Decentralised Offices.

### Self-Declaration Form to avail CPE Hours Credit for Unstructured Learning Activities For the Calendar Year \_\_\_\_\_

**Name:**  
**Membership No.:**  
**Address:**  
**Contact No.:**  
**E-mail id:**

#### Details of Unstructured Learning Activities Undergone

Type of ULAs	Particulars	Details		
		Topic	Date	Requested CPE hours
Web-based	Web-based Learning modules			
Self-learning	Self-learning Modules and Courses (1) Audio-tapes/video-tapes. (2) Correspondence courses. (3) Computer based learning programmes			
Home study	Reading and Individual Home Study			
Discussion on Technical Issues	Group or Bilateral Discussion on Technical Issues			
Acting as Faculty	Acting as visiting faculty or guest faculty at various Universities/Management Institutions/Institutions of National Importance			
Teleconferencing Programmes	Participation in CPE Teleconferencing Programmes without supervision of the POU			
Questionnaires/Journals	Providing solutions to questionnaires/puzzles available on Web/Professional Journals			
Internal Training Programmes	Internal Training Programmes being organised by firms of Chartered Accountants with seven or more partners			
Total CPE Hours requested				

#### Undertaking

I, \_\_\_\_\_, (name of the Member) hereby declare that I have undergone the unstructured learning activities as indicated by me in this form above.

I also confirm that the information given by me for claiming CPE credit hours for each unstructured activity is correct.

Place:

Date:

**Signature of the Member**

**Note: Members may annex a separate sheet if the given format is not sufficient for filling in complete details.**

Continuing Professional Education Committee



**Two Days Workshop on IFRS**  
**Organised by Committee for Members in Industry of ICAI**

<b>Objective</b>	The Program is intended to give an overview of Application of IFRS in Indian Scenario. The program focuses more on concepts that are relatively new under Indian GAAP and on topics which by and large potentially impact the net worth and profit or loss under more common situations. Additionally it is intended to give overview on select other topics across the spectrum. Considering the fact that a lot of challenges are faced during the first time implementation, a session is dedicated on sharing implementation experience by various consultants and users both large and SME.
<b>Date &amp; Time</b>	August 29 – 30, 2008 (0830 hours to 1730 hours daily)
<b>Venue</b>	Welcom hotel, Baroda
<b>CPE Credit</b>	12 hrs
<b>Resource Persons</b>	Nationally renowned experts having in-depth knowledge, experience and expertise about the IFRS will be addressing the program.
<b>Topics to be discussed</b>	<ul style="list-style-type: none"> <li>● Overview of IFRS – Model IFRS Financial Statements First Time Adoption of IFRS</li> <li>● Consolidation/Joint Venture and Equity Affiliates, Business Combinations</li> <li>● Revenue Recognition, Financial Instruments, Foreign Currency Transactions and Translation</li> <li>● Employee Benefits including ESOPs</li> <li>● Fixed Assets/Asset Retirement Obligation/Embedded Leases/Borrowing Costs/Impairment/Deferred Tax Provisions, EPS, Segmental Information, Related Parties</li> <li>● Changes in Accounting Policies and estimates</li> <li>● Events after Balance Sheet Date, Intangible Assets, Discontinued Operations, Interim Financial Statements, Service Concession Agreements</li> </ul>
<b>Fees</b>	Rs. 3,000/- for members Rs. 4,000/- for non-members Cheque (local)/draft in favour of “Workshop on IFRS” payable at Baroda.
<b>Contact Details</b>	
<b>Programme Chairman</b>	CA. Sanjeev Maheshwari, Chairman CMII +9198211 19043 Email: <a href="mailto:casanjeevmaheshwari@gmail.com">casanjeevmaheshwari@gmail.com</a>
<b>Programme Director</b>	CA. Ashok Rameshchandra Thakkar Chairman, Baroda Branch of WIRC +91 9327243479\9825048551, Email: <a href="mailto:artvca@gmail.com">artvca@gmail.com</a>
<b>Programme Coordinator</b>	CA. Atul Parikh 093762 17261
<b>For Registration and Enquiry Contact</b>	Dr. Surinder Pal Secretary, Committee for Members in Industry The Institute of Chartered Accountants of India ICAI Bhawan, Indraprastha Marg New Delhi – 110 002 Ph. 011-30110442; Fax No. 011-30110583 Email: <a href="mailto:spal@icai.org">spal@icai.org</a> ; <a href="mailto:cmii@icai.org">cmii@icai.org</a>
<b>Hosted By</b>	<b>Baroda Branch of WIRC of ICAI</b>

<b>THREE DAYS RESIDENTIAL REFRESHER WORKSHOP</b>	
<b>Date &amp; Time</b>	22 <sup>nd</sup> to 24 <sup>th</sup> August (Friday - Sunday) (Reporting time 2 .00PM on 22 <sup>nd</sup> August and Check out at 1.00 PM on 24 <sup>th</sup> August, 2008)
<b>Venue</b>	Lake Palace, Thirumala Ward, Chungam, Alleppey, Kerala Website address: <a href="http://www.lakepalaceresort.com">www.lakepalaceresort.com</a>
<b>CPE Credit</b>	12 hours
<b>Discussion Sessions</b>	<ul style="list-style-type: none"> <li>● International Taxation</li> <li>● Inbound &amp; Outbound Foreign Investments</li> <li>● Raising of Financial Resources – through Private Equity</li> <li>● Issues &amp; Implementation of Important Accounting Standards</li> <li>● Compliance issues in Taxation - e-filing, TDS, etc.</li> </ul>
<b>Resource Persons</b>	Eminent Speakers will address the Residential Refresher Course
<b>Fees</b>	<p><b>Residential (including accommodation, breakfast, lunch, dinner and course material):</b></p> <p>For Members: ● Per Participant (on twin sharing basis): Rs. 8000/- ; ● Per Participant – Individual: Rs.15,000/- ; ● Accompanying person: - For Spouse: Rs. 6000/-, - For Children: Rs.4,500/- (Age below 15 years)</p> <p>For Non-Members: Rs.10,000/-</p> <p><b>Non- Residential :</b> ICAI Members - Rs.4,000/- ; Non-Members - Rs.5,000/-</p> <p>Fees payable by DD/Cheque in favor of `Chairman, Alleppey Branch of SIRC of ICAI' payable at Alleppey and send it to Chairman, Alleppey Branch of SIRC of ICAI, "ICAI Bhawan", Behind District Co-operative Bank Building Lane, Municipal Office Ward, Opp. Town Hall, Palace Road, ALAPPUZHA-688 001.</p> <ul style="list-style-type: none"> <li>● Restricted to 50 participants on FIRST COME FIRST SERVED BASIS</li> </ul> <p>For further information logon to <a href="http://www.icaai.org">www.icaai.org</a>; <a href="http://www.placements-icaai.org">www.placements-icaai.org</a></p>
<b>Contact Details</b>	
<b>Programme Chairman</b>	CA. Sanjeev Maheshwari, Chairman, Committee for Members in Industry Mob. 098211 19043, Email: <a href="mailto:casanjeevmaheshwari@gmail.com">casanjeevmaheshwari@gmail.com</a>
<b>Programme Director</b>	CA. V.C. James, Member, Committee for Members in Industry Mob. 098470 34528, Email: <a href="mailto:vcjames_2005@yahoo.com">vcjames_2005@yahoo.com</a> ; <a href="mailto:vcjames@airtelmail.in">vcjames@airtelmail.in</a>
<b>Programme Chief - Coordinator</b>	CA. Antony Mathew.M. Chairman, Alleppey Branch of SIRC of ICAI Mob. 98470 85332; 0477 - 226 1458, Email: <a href="mailto:amalayil@vsnl.com">amalayil@vsnl.com</a>
<b>Programme Coordinator</b>	Dr. Surinder Pal Secretary, Committee for Members in Industry The Institute of Chartered Accountants of India ICAI Bhawan, Indraprastha Marg New Delhi – 110 002 Ph. 011-30110442; Fax N. 011-30110583, Email: <a href="mailto:spal@icaai.org">spal@icaai.org</a> ; <a href="mailto:cmii@icaai.org">cmii@icaai.org</a>

**NATIONAL MEGA CONFERENCE – ‘GOA 2008’**  
Organised by Continuing Professional Education Committee  
& Hosted by Goa Branch of WIRC of ICAI

<b>TITLE</b>	<b>“INVIGORATING INTELLIGENCE”</b>	
<b>Date &amp; Time</b>	Friday, Saturday & Sunday, 22 <sup>nd</sup> - 24 <sup>th</sup> August 2008	
<b>Venue</b>	Holiday Inn Resorts & Spa, Varca – Salcete - Goa.	
<b>Discussion Sessions</b>	<b>Topics</b>	<b>Speakers</b>
	<b>Technical Session I</b> Direct Tax issues in Real Estate Transactions/ Immovable Properties & Construction Contracts <b>Technical Session II</b> Service Tax – Union Budget '08 Changes & Recent Developments <b>Technical Session III</b> Indian Capital Markets – 10K or 24K? Portfolio Management/Consulting for HNI's <b>Technical Session IV</b> Accounting Standards Insights/Auditing standards insights- Perspective for SME's and Getting Ready for the Future <b>Technical Session V</b> Direct Tax Issues – International Taxation & Tax Planning (FBT/TDS etc) – SME Perspective <b>Technical Session VI</b> Direct Tax Issues in Tax Audit (Including Reference to Accounting Standards Applicable) <b>Technical Session VII</b> Brief Insights into Accounting & Taxation aspects of Carbon Credits	CA. Tarun Ghia  CA. A. R Krishnan  CA. C. S Nanda, Chairman CFM & IP  CA. Rakesh Agarwal  CA. Sunil Kothare  CA. Jayant Gokhale, Central Council Member, ICAI  CA. Rajkumar S. Adukia, Central Council Member, ICAI
<b>CPE Credit Hours</b>	12 hours	
<b>Fees</b>	<b>Registration –</b> <b>Residential:</b> Rs. 7,950/- per Member Accompanying Spouse Rs. 6,950/- Accompanying Children: Below 12 years Rs. 3875/- Above 12 years Rs. 6,950/- (Includes Course Material / 2 nights Stay / 2 lunches / 2 Dinners / 2 Breakfast / Entertainment & Conference) <b>Non Residential:</b> Rs. 2,750/- (Includes Course Material / 2 lunches / Conference 2 Days) Cheque/DD to be drawn in favour of “Goa Branch of WIRC of ICAI” payable at Goa and should be sent to: Goa Branch of WIRC of ICAI, Kamat Towers, 201/202, Second Floor, Patto Plaza, Panaji Goa.	
<b>Contact Persons &amp; Contact Details</b>	CA. K. Raghu Chairman, CPE Committee Conference Chairman	E-Mail: <a href="mailto:Kraghu9999@gmail.com">Kraghu9999@gmail.com</a>
	CA. Preeti P. Mahatme Vice-Chairperson, CPE Committee Conference Director	E-Mail: <a href="mailto:preeti@mahatmeindia.com">preeti@mahatmeindia.com</a>
	CA. Gautam R. Verlekar Chairman, Goa Branch Joint Co-ordinator	E-Mail: <a href="mailto:gautamscorpio@rediffmail.com">gautamscorpio@rediffmail.com</a> Mobile No. 09326102192
	CA. Shreepati G. Hegde Vice-Chairman, Goa Branch Joint Co-ordinator	E-Mail: <a href="mailto:sghegde_goa@sancharnet.in">sghegde_goa@sancharnet.in</a> Mobile No. 09422063632

**Two days programme on Professional opportunities in Drafting, conveyancing, registration and stamping of commercial and other documents**

**Organised by Committee on Economic and Commercial laws  
of the Institute of Chartered Accountants of India  
Hosted by Western India Regional Council of ICAI**

**At J.S. Lodha Auditorium, ICAI Bhawan, Mumbai**

**On 1<sup>st</sup> and 2<sup>nd</sup> August 2008**

**CPE Hours – 12 Hours**

<b>Topics</b>	<b>Speakers</b>
Principles of good drafting and conveyancing	Shri Jairam Chandnani, Advocate
Provisions of Indian Stamps Act -- States Acts —Planning --- Stamp duty amnesty scheme	Shri Vinod Sampat, Advocate*
Mandatory registration of documents --- advantages of registration of non-mandatory documents	Shri Praveen N Veera, Advocate *
Drafting of sole selling agency agreements, merger schemes, scheme of rehabilitation	CA Rajkumar S. Adukia, Chairman, CECL, ICAI
Drafting trust deed (Private/public), Partnership deeds, Memorandum of Association	Shri Ankoosh Mehta*
Drafting of foreign collaboration agreements and joint venture agreements	Shri Vishal Gandhi, Advocate
Drafting of LLP agreements and anti competitive agreements	Shri Ramnarayan, Advocate *
Drafting of wills-Provisions of Indian Succession Act 1925, Hindu Succession Act, 1956	Shri Jairam Chandnani, Advocate
Other laws relating to intestate and testate succession Agreements	Dr. A.L. Saini
<b>Contact Persons</b>	<ul style="list-style-type: none"> <li>• CA. Rajkumar S. Adukia, Chairman, Committee on Economic and Commercial laws</li> <li>• CA Pankaj I. Jain, Central Council Member, ICAI, Programme Director Mob: 9820087168, E-mail: - <a href="mailto:pankaj@icai.org">pankaj@icai.org</a></li> <li>• CA Brijmohan Agarwal, Chairman, WIRC, Programme Co-ordinator Office: - 022-26691254, Mob: 09820188573 Email- <a href="mailto:brijmohan@icai.org">brijmohan@icai.org</a></li> <li>• CA Dhiraj Kumar Khandelwal, Secretary, WIRC, Programme Co-ordinator Phone: - 022-22073080, Mob: 09322516004 Email: - <a href="mailto:kdhiraj123@hotmail.com">kdhiraj123@hotmail.com</a></li> </ul>
<b>Fees</b>	Rs. 2,200/- per participant, Rs. 2,500/- for non-members. The cheque should be drawn in favour of Western India Regional Council of the Institute of Chartered Accountants of India payable at Mumbai and should be sent to Western India Regional Council of the Institute of Chartered Accountants of India, ICAI Bhawan, 27, Cuffe Parade, Colaba, Mumbai 400 005.

\* Subject to confirmation

## Diamond Jubilee ALL INDIA CA CONFERENCE – 2008

**Organised by Continuing Professional Education Committee  
& Jointly Hosted by Bhubaneswar & Cuttack Branches of EIRC of ICAI**

<b>TITLE</b>	“TODAY’S CHALLENGES - TOMORROW’S OPPORTUNITIES”	
<b>Date &amp; Time</b>	Saturday & Sunday, 23 <sup>rd</sup> - 24 <sup>th</sup> August 2008	
<b>Venue</b>	HOTEL SWOSTI PLAZA, BHUBANESWAR	
<b>Discussion Sessions</b>	<b>Topics</b>	<b>Speakers</b>
	<b>Technical Session I</b> Moving towards complete convergence to IFRS.	CA. Dolphy D'Souza
	<b>Technical Session II</b> Issues in Corporate Taxation	CA. Suresh Senapati
	<b>Technical Session III</b> Motivation & Communication Skills Restructuring Professional Practice	Dr. S.K. Mishra CA. Rajkumar S. Adukia, Chairman Professional Development Committee
	<b>Technical Session IV</b> Technology shaping the audit Practice  Effectiveness of Audit Committee – myth or reality	CA. S. Gopalakrishnan, Central Council Member ICAI Prof. Mubeen
	<b>Technical Session V</b> Taxation of Charitable Institutions  <b>Technical Session VI</b> Current issues in Service Tax	Dr. Girish Ahuja  CA. Raghuraman Shri. Goutam Bhattacharya
<b>CPE Credit Hours</b>	12 hours	
<b>Fees</b>	Members Rs. 1700/- Non-Members Rs. 2000/- Corporate Members - Rs. 2500/- Cheque/DD to be drawn in favour of “Diamond Jubilee ALL INDIA CA CONFERENCE” payable at Bhubaneswar and should be sent to: Bhubaneswar Branch of the EIRC of ICAI, “ICAI Bhawan”, A-122/1, Neelkant Nagar, Nayapalli, Bhubaneswar - 751 012 <b>OR</b> Cuttack Branch of EIRC of ICAI, “ICAI Bhawan”, Room No. 210 & 211, Gallery No. 4, Barabati Stadium Complex, Cuttack - 753 005	
<b>Contact Persons &amp; Contact Details</b>	CA. K. Raghu Chairman, CPE Committee Conference Chairman	E-Mail: <a href="mailto:kraghu9999@gmail.com">kraghu9999@gmail.com</a>
	CA. Subodh Kumar Agarwal Central Council Member, ICAI Conference Director	E-Mail: <a href="mailto:subodhka@yahoo.com">subodhka@yahoo.com</a> <a href="mailto:subodhka@gmail.com">subodhka@gmail.com</a>
	CA. Sanjit Patra Chairman, Bhubaneswar Branch, Joint Co-ordinator	E-Mail: <a href="mailto:patrasanjit@yahoo.com">patrasanjit@yahoo.com</a> Mobile No. 09861166226
	CA. Shiba Narayan Sahu Chairman, Cuttack Branch, Joint Co-ordinator	E-Mail: <a href="mailto:shiba_narayan@rediffmail.com">shiba_narayan@rediffmail.com</a> Mobile No. 09437269919

**National Seminar on Corporate Governance**  
**Organised by: Committee on Corporate Governance (CCG) of ICAI jointly**  
**with WIRC of ICAI.**

**Sponsored by: National Foundation for Corporate Governance (NFCG)**

Date	Venue	CPE (Credit)	Fees
Saturday, August 23, 2008	Raghuleela Mega Mall, Kandivali West, Mumbai	6 Hours	For ICAI Members -Rs.1000/- and for Non-Members Rs. 1200/-

**Discussion Sessions**

<b>1<sup>st</sup> Technical Session:</b> Proactive Role of Board to improve Corporate Governance effectiveness.	<b>3<sup>rd</sup> Technical Session:</b> Corporate Governance in Family Owned Business & SME Sector.
<b>2<sup>nd</sup> Technical Session:</b> Corporate Governance practices in Public Sector Enterprises	<b>4<sup>th</sup> Technical Session:</b> Impact of IT in facilitating Corporate Governance & Risk Management.

**Contact Persons and Contact Details**

CA. S. Santhanakrishnan, Chairman, CCG, ICAI. Programme Chairman Mobile: 09841073308 Email id: <a href="mailto:skca@sandsca.com">skca@sandsca.com</a> <a href="mailto:ssca@vsnl.com">ssca@vsnl.com</a>	CA. Atul Bheda, Chairman, Committee on Information Technology, ICAI. Programme Director Mobile: 09323323667 Email id: <a href="mailto:bhedaac@mtnl.net.in">bhedaac@mtnl.net.in</a>	CA. Brijmohan Agarwal, Chairman, WIRC of ICAI. Programme Co-ordinator Mobile: 09820188573, 09322867449 Email id: <a href="mailto:brij@bnmca.com">brij@bnmca.com</a> , <a href="mailto:brijmohan@icai.org">brijmohan@icai.org</a>	CA. Dhiraj Khandelwal, Secretary, WIRC of ICAI. Programme Coordinator Mobile: 09322516004, 09867642684 Email id: <a href="mailto:dkkhandelwal@icai.org">dkkhandelwal@icai.org</a> , <a href="mailto:kdhiraj123@hotmail.com">kdhiraj123@hotmail.com</a>
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**Kolkata Diamond Jubilee IT Conference on**  
**IT - An Enabler in the Success of CA's**  
**On August 29-30, 2008 from 9.30 am to 5.30 pm**

Organised by Committee on Information Technology, ICAI Hosted by Eastern India Regional Council, ICAI

**At: Royal Bengal City Centre, Salt Lake, Kolkata**

Session	Theme	
1 <sup>st</sup>	ERP implementation & Audit	Off Shoring and Outsourcing – Max. Benefits & Man. Risks.
2 <sup>nd</sup>	IS Audit	Forensic Audit
3 <sup>rd</sup>	Taxation and IT	Information Security & Management Standards including COBIT
4 <sup>th</sup>	Data Warehousing	Valuation of Software Companies
5 <sup>th</sup>	IT Risk Management	e-Filing
6 <sup>th</sup>	Panel Discussion	

**12  
CPE  
Hours**

Conference Registration is on *First-Come-First-Served* basis on receipt of application with Conference Fee of Rs.1,600/- per delegate by DD/Pay-Order/Cheque drawn in the favour of "The Institute of Chartered Accountants of India, EIRC" payable at Kolkata at "The Eastern India Regional Council of ICAI, The Institute of Chartered Accountants of India, ICAI Bhawan, 7 Russell Street, Kolkata – 700 071". *Please register early to reserve seat, as seats are limited.* For further/updated details see [www.icai.org](http://www.icai.org) or Ph.033 30211132/33/34.

Conference Chairman	Conference Director	Conference Convener
<b>CA. Atul Bheda, FCA</b> Chairman, Committee on IT, ICAI. E-Mail: <a href="mailto:bhedaac@mtnl.net.in">bhedaac@mtnl.net.in</a> Mobile: 09323323667	<b>CA. Subodh Kr. Agrawal</b> Member, Committee on IT, ICAI E-Mail: <a href="mailto:subodhka@yahoo.com">subodhka@yahoo.com</a> Mobile: 9830022848	<b>CA. Nirupam Haldar</b> Chairman, EIRC, ICAI E-Mail: <a href="mailto:eircchairman@icai.org">eircchairman@icai.org</a> ; <a href="mailto:nirupamhaldar@vsnl.net">nirupamhaldar@vsnl.net</a> Mobile: 09830110453

**Programme for Independent Directors of Mutual Funds & Asset Management Committees  
Organised by Professional Development Committee  
Hosted by Western India Regional Council  
at Hotel Taj Lands End, Mumbai on 29<sup>th</sup> - 30<sup>th</sup> August, 2008**

**Topics to be Discussed at the programme**

- (i) Overview of mutual funds-in the world and in India
- (ii) Various types of MFs
- (iii) Structure of MF funds-sponsor, AMC-including drafting of MF deed/Trustee Company concept-Provisions of Indian Trust Act 1882
- (iv) Overview of MF regulations-SEBI regulations 1996
- (v) Ideal Corporate governance in MF - Role of audit committee, internal control, risk management
- (vi) Business of MF, various schemes, NAV, maximising returns etc
- (vii) Investor relation committee
- (viii) Accounting and taxation aspects of MF investments-Is the present accounting appropriate
- (ix) Inspection of MF by SEBI
- (x) Role of independent directors/independent trustee

<b>CPE Hours</b>	12 Hours
<b>Fees</b>	Rs. 4000/- for members and Rs. 4500/- for non-members. The cheque should be drawn in favour of "Western India Regional Council of the Institute of Chartered accountants of India" payable at Mumbai and should be sent to The Western India Regional Council of the Institute of Chartered Accountants of India, 'ICAI Bhawan', 27, Cuffe Parade Colaba Mumbai 400 005.
<b>Contact Persons and Contact Details</b>	<ul style="list-style-type: none"> <li>• CA. Rajkumar S. Adukia, Chairman, PDC</li> <li>• CA. Jayant Gokhale, Programme Director E-Mail: jayant@icai.org</li> <li>• CA. N. K. Munjal, Secretary, PDC, Programme Co-ordinator Ph. 011-30110411; Fax: 011-30110583 Mob. : 9350799907; E-mail: nkmunjal@icai.org</li> <li>• CA. B. M. Agarwal, Chairman, WIRC, Programme Co-ordinator Ph. 022-26691254/55/56/57; Fax: 022-26691233 Mobile:9820188573/9322867449;E-Mail:brij@bnmca.com</li> </ul>

**National Seminar on Corporate Governance  
Organised by: Committee on Corporate Governance (CCG) of ICAI jointly with EIRC of ICAI.  
Sponsored by: National Foundation for Corporate Governance (NFCG)**

Date	Venue	CPE (Credit)	Fees
13 <sup>th</sup> September, 2008	Park Hotel, Kolkata	6 Hours	Rs 1000/-

**Discussion Sessions**

<b>1<sup>st</sup> Technical Session:</b> CAs - An indispensable entity for ensuring better Governance leading to Corporations' continual success.	<b>3<sup>rd</sup> Technical Session:</b> Code of Governance for Public Sector Enterprises & NGOs.
<b>2<sup>nd</sup> Technical Session:</b> Corporate Governance practices in the Banking and Insurance Sectors.	<b>4<sup>th</sup> Technical Session:</b> Corporate Social Responsibility & Sustainability Reporting.

**Contact Persons and Contact Details**

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# THE ULTIMATE ACT OF LEADERSHIP

For leaders, the significance and consequences of judgment calls are magnified exponentially because they influence the lives and livelihood of others. It is a leader's judgment that determines an organisation's success or failure. Healthy organisations have good leaders who nurture the development of other leaders at all levels of the organisation. This article explores the concept of leadership from professional point of view.

Each one of us makes thousands of judgment calls over the course of our lives. Some are trivial, such as what kind of cereal to buy; some are monumental, such as whom to marry. Our ability to make the right calls has an obvious impact on the quality of our own lives. An organisation's success or failure depends on leader's judgment. On a more personal level, it is the sum of a leader's judgment calls that will deliver the verdict on his or her career and life. Good leaders make a habit of sensing, framing, and

aligning so that they are prepared for the call, which can arise at any moment, frequently without warning. This is particularly important in crisis situations; the likelihood of making a good call is vastly increased if the call is made in the context of a story line.

## Decision Making

The ultimate test of a leader is not whether he makes smart decisions and takes effective action in the short term, but whether he teaches others to be leaders and builds an organisation that can continue to be healthy and to thrive when he is not



— Jagendra Kumar  
(The author is Corporate Head, Shriram Group of Companies. He can be reached at [kumar\\_jagendra@rediffmail.com](mailto:kumar_jagendra@rediffmail.com))

Leader's most important role in any organisation is making good judgments—well informed, wise decisions that produce the desired outcomes. When a leader shows consistently good judgment, little else matters. When he or she shows poor judgment, nothing else matters.

around. The first phase of judgment, preparation, incorporates three steps. First is to sense and identify the issue, which entails reading early signals; second is to frame and name it, setting clear parameters and providing a context; and third is to mobilise and align key stakeholders, inviting their input and harnessing their energy. Leader's most important role in any organisation is making good judgments—well informed, wise decisions that produce the desired outcomes. When a leader shows consistently good judgment, little else matters. When he or she shows poor judgment, nothing else matters. Of course, it is not humanly possible to make the right call every single time. But the most effective leaders make a high percentage of successful judgment calls at the time when it counts the most.

### The Story Line

Most leadership judgment calls arise in calmer circumstances. Business decisions may in fact be more complex than official ones because the defining values are so diverse. But normally, business leaders enjoy the luxury of more time, so they arguably have no excuse for inadequate preparation, especially for having no story line. For example, look at a strategic judgment call by Dhirubhai Ambani.

Ms Piramal's book chronicles how brokers loyal to Dhirubhai created, virtually overnight, the "Friends of

Reliance Association" to pick up the large chunk of shares, which the Marwari cartel was dumping in the market. They reportedly bought up 8.57 lakh shares out of the 11 lakh shares which the cartel had short-sold, thereby saving the stock from certain collapse. To break the cartel's back, they even insisted on delivery and charged an unprecedented backwardation, or *undha badla*, of Rs 50 per share. And thus was born the legend of Dhirubhai. A man who, it is now said, not only created India's largest corporate house, but shared his wealth with shareholders creating unparalleled loyalty among investors. His basic principle: if his shareholders and suppliers and everyone connected to Reliance earned money, Reliance would also generate wealth that way.

As Dhirubhai Ambani battled for his life at the Intensive Care Unit of Mumbai's upmarket Breach Candy Hospital, the markets, which had so often chanted his name in awe, were waiting for every bit of information, every statement emanating from the Ambani family. In Mumbai's streets, trains and the crowded lanes surrounding Dalal Street, the predominant topic of discussion on a monsoon-washed day was Dhirubhai's health condition. So what is it that keeps the Dhirubhai mystique alive at the markets? The legend of Dhirubhai was an enduring one in the markets. There have been many stories of his successes, which

the market has heard over the years. The signs of Dhirubhai's vision were clear when, after his first stroke 16 years ago, he clearly groomed his two sons Mukesh and Anil to take over the reins of his empire. Thereafter, he became a kind of philosopher and guide for his sons, while the two of them grew in stature.

### Creating the Culture

Leaders create the culture, the place, and the conditions for employees and their work. This includes the physical conditions and the management process. The most effective leaders first look at those elements before looking to individuals or groups of employees for assigning blame or attempting a fix. Most failures of organisations are failure to the management process, not employees' behavior. Although most organisations have some form of process management, few can specify their behavior management process. Indeed, supervisors and managers are often advised to find a management style that fits their personality and the situation. Because there are so many different personality types and possible situations in an organisation, there will be many different solutions to the same problem. No effective, stable leadership process is possible with this number of uncontrolled management variables. Conflict is inevitable, but broken relationships are optional. Learn the skills necessary to make conflict an opportunity

Leaders create the culture, the place, and the conditions for employees and their work. This includes the physical conditions and the management process. The most effective leaders first look at those elements before looking to individuals or groups of employees for assigning blame or attempting a fix. Most failures of organisations are failure to the management process, not employees' behavior.

for growth. Effective leaders do not shy from confrontation, but those leaders also have the necessary skills to handle conflict successfully. Give the leaders on your team the skills and the vision they need to make confrontation work to everyone's advantage.

### The 'Follower' Syndrome

An effective management process causes employees to do the right things at the right time in the right way. To have an effective management process, it is critical that you have an understanding of the variables that affect performance. Getting and keeping followers occupied in meaningful activity is essential to a leader. Is it possible to train people to do the safe thing or the quality thing and have them doing what you trained them to do every time? Can you communicate priorities and have employees make decisions about their time accordingly? Can you delegate to others and know that you will not have to worry about the cost, quality, timeliness, or appropriateness of their actions? Of course you can. Thus, the key issue of healthy organisations is leadership development. The effective leader is not only a continuous learner himself; he must also be a continuous teacher and builder of others. He must pass along what he has learned to others who will then pass their learning along to others.

### Making Permutation & Combinations

Despite the common belief that the bigger the reward, the more it impacts behavior, science tells us that the most effective consequences are those that are immediate and certain. The least effective are those that are delayed and uncertain. While important, removing an obstacle to performance does not guarantee that the desired performance will take place. A bank discovered this truism after they spent millions of dollars removing certain types of paperwork from their branches. Their consultants had convinced them that the administrative burden was suppressing sales. To increase sales, paperwork was reduced by 90 per cent, yet sales didn't increase. They failed by not building in PICs for the new behaviours, a very common mistake. They built in bonuses, thinking that doing so would drive the correct behavior. Bonuses are positive, future, and uncertain consequences from the performers' perspective and are weak performance drivers. Guess which category is the most common in the modern organisation? Bonuses, profit sharing, promotions, and raises in pay are all positive, but they are future and uncertain consequences to the performers and as such they have little impact on behavior on a day-to-day basis. The size of the payoff only increases the pool of people who want to par-

ticipate in the activity and has little to say about how well they will work once selected. Unfortunately, not all consequences are created equal. Some are more effective than others. Most of the consequences that organisations use, such as compensation, performance appraisal, and reward and recognition practices are weak when it comes to getting behavior to occur every day.

### Transparent Character in Leadership

Leader is a mirror that shows the true picture. A leader reflects the total transparent image to his team. Leaders need to know how to build healthy boundaries with the people they lead and within their organisation. Discover how to resist outside forces and set limits. Leaders know that they are serving and building something bigger than themselves. Learn the freedom of developing transcendent character as a leader. Much of what is common knowledge about leadership is, in fact, fallacious. Ideas extracted from our experience or that of others may not actually identify the critical variables that made that approach work in that specific situation. We are all taught, for instance, to lead by example and to communicate, communicate, communicate! This kind of advice peddles the banal as wisdom and ignores the essentials. While the leader's actions and the visual images he or she

An effective management process causes employees to do the right things at the right time in the right way. To have an effective management process, it is critical that you have an understanding of the variables that affect performance. Getting and keeping followers occupied in meaningful activity is essential to a leader.

paints with words are important, these are not the most powerful influences on behaviour. Much more has been modeled and communicated than has been done. Simply put, the impact of your example and of your communications is to get followers do something once, perhaps twice. After that, they must see some personal benefit from their actions or the response to your example and your communications will diminish.

### Extracting Optimal Responses

Leaders who think that people will do their best because that's what is expected of them are prone to make errors by relying primarily on antecedents. This is especially pernicious because it leads to leadership beliefs and practices that produce suboptimal responses from the followers. You can best understand this when you consider the most important aspect of human behavior. The telephone may ring, but because we are in a hurry, we ignore it; we may know a company policy and not follow it; we may know a safety rule but violate it every way; we may know the speed limit and the consequences for speeding but exceed it every day. All of these things point to the fact that most problems that organisations face daily are not the result of not knowing what to do but are often treated by the organisation as though they are. Most attempts to resolve

performance issues involve emphasising the importance of the actions, stressing the cost of failure, making our expectations clear, re-telling them, creating new policies and procedures, re-training employees and simply nagging them to do the right things.

### Setting the Example

Things that save your followers time and effort are almost always positive, immediate, and certain. Problem solving requires a disciplined approach, for instance, because the reinforcers for most people come from solving the problem, not from analysing the causes of the problem. Bypassing the analysis phase allows them to get into action sooner so that they experience immediate, positive consequences sooner and more often. This law means that every change must start with an analysis of what will happen to the performers if they do what we need and what will happen to them if they don't. While most leaders feel that consequences in an organisation are in place for those who do or don't do what is required, the consequences that are typically used are often ineffective in either maintaining desirable action or in stopping undesirable action. The closest thing we have to a behavioral law, as gravity is a physical law, is that the behavior is a function of its consequences. Antecedents get their power from the consequences that are associated

with them. The bottom line is that the effectiveness of most of what leaders do is determined by how they use behavioural consequences. If this simple statement was fully understood and put into practice then not a major organisation exists that could not improve by 20-30 per cent per year (the government by more than 50 per cent). This model shows that there are only two ways to change behavior: by what happens before a behavior and what happens after it. An antecedent is simply anything that tells you what to do. It could be a memo, a meeting, company policy or a thousand things that we see, hear, touch, smell, or taste in a day. In most cases, the antecedent contains enough information to know exactly what to do. However, knowing what to do and doing it are two different things. This relationship is clear in the most basic expression of the causes of behavior.

### Developing Down the Line Leaders

This is the desire of the truly great leader: to build other leaders who will entirely outdo him. His goal is to raise leaders who will stand on his shoulders and then raise more leaders who will stand on their shoulders and so forth. Leadership building is the central activity of the effective organisation. It is hard-wired into everything everyone does. It is everyone's responsibility to nurture and expect leadership

Leader is a mirror that shows the true picture. A leader reflects the total transparent image to his team. Leaders need to know how to build healthy boundaries with the people they lead and within their organisation. Discover how to resist outside forces and set limits.

everywhere. This creates leadership multiplication. A common leadership issue is the execution of strategy. Every day, opportunities for positive, immediate, and certain consequences arise for less consequential behaviors which compete with the leader's strategy. If the leader's process for implementing his strategy doesn't have built-in positive, immediate, and certain consequences, then such consequences must be created to keep the implementation plan on schedule. The leader must ensure that the followers are receiving PICs on a daily basis. If they are not built into the business processes, the leader must find a way to overlay them onto the process. One of the ways leaders do this is by taking work out of the process. This is a common task where the leader removes obstacles wherever possible rather than requiring the follower to surmount each obstacle unaided. In this way the leader reduces the number of negative, immediate, and certain consequences experienced by the followers. However, the determinant of whether these things will be done is not the clarity of communication and effectiveness of training, but what happens to employees when they do what has been communicated.

Building leaders is, however, easier said than done. It is not sufficient merely to send some-

one to a seminar or to give them a book on leadership to read. Leadership development is highly complex and very little understood. Consequently, in most organisations it is essentially left up to chance. The small efforts at leadership development that are made are usually haphazard and not part of any overall cohesive strategy. Usually we simply hope – and pray – that the leaders will somehow raise themselves up! When asked what his leadership development strategy was, one leader said, “You just have to let the cream rise to the top.” In other words, “We have no intentional strategy for leadership development, we’re just hoping for the best!” If a person was trained to do something one way and when he applied it found that it didn't work, would he continue? If a person is given a priority assignment and then someone comes in with an emergency request, will the priority likely be put aside? If a person is delegated responsibility for a project and the boss second-guesses every action that the person takes, will the person soon defer all decisions to the boss? You know the answer to these types of questions.

Leaders have the responsibility for creating a work environment that causes people to do their best every day. In theory this should be simple, since the overwhelming majority of employees are willing workers.

Only an extremely small number of people take a job expecting to get paid for minimal effort. Most people, by the act of taking a job, demonstrate that they want to do it well. We find that many companies squander this goodwill through their leadership practices. Apparently, it is easier to lose discretionary effort than it is to build it. If people are willing to perform at their best and they don't, where does the problem lie? Dr Edwards Deming, the noted quality guru, attributed well over 90 per cent of the problems of quality not to front-line employees, but to management. I certainly agree and I extend this to most other performance deficiencies as well. The same leadership practices that throw away the employee's goodwill also create the climate that sub-optimises organisational effectiveness. Effective leaders personally invest time and emotional energy in building others. Moreover, they expect all other leaders to do the same. The effective organisation is learning and teaching organisation. Its way of life is continuous learning and teaching – at all levels. What scares more people than cancer, flying, an unfriendly takeover, being fired or mugged, losing one's hair or sex appeal? The world's most corrosive, but curable, social disease is the fear of public speaking. The second greatest fear is doing something effective to deal with the first. □

## Guidance Note on Applicability of Accounting Standard (AS) 20, Earnings Per Share<sup>1</sup>

*(The following is the text of the 'Guidance Note on the Applicability of Accounting Standard (AS) 20, Earnings Per Share', issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance Note, Accounting Standards Interpretation (ASI) 12 – 'Applicability of AS 20 (Re. AS 20)', stands withdrawn.)*

### Introduction

1. This Guidance Note deals with the issue whether companies which are required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings

per share in accordance with Accounting Standard (AS) 20, *Earnings Per Share*.

2. AS 20 came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with

the requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20.

### Recommendation

3. Since Part IV of Schedule VI to the Companies Act, 1956, requires, among other things, disclosure of earnings per share, every company which provides information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

<sup>1</sup> This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 12, 'Applicability of AS 20 (Re. AS 20)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by the ICAI, ASI 12 has not been so incorporated as it was felt that it is primarily clarificatory in nature. The Council of the ICAI, has accordingly, decided to withdraw ASI 12, and issue the same as a Guidance Note as it provides appropriate guidance on the subject.

## Guidance Note on Remuneration paid to key management personnel - whether a related party transaction<sup>1</sup>

*(The following is the text of the 'Guidance Note on Remuneration paid to key management personnel – whether a related party transaction' issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance Note, Accounting Standards Interpretation (ASI) 23, 'Remuneration paid to key management personnel – whether a related party transaction (Re. AS 18)', stands withdrawn.)*

### Introduction

1. This Guidance Note deals with the issue whether remuneration paid to key management personnel is a related par-

ty transaction. Another related issue dealt by this Guidance Note is whether remuneration paid to non-executive directors on the Board of Directors is a related party transaction.

2. Accounting Standard (AS) 18, *Related Party Disclosures*, defines "related party transaction" as "**a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.**" Further, paragraph 24 of AS 18 provides as under:

"The following are examples of the related party transactions in respect of which disclosures may be made by a reporting enterprise:

- purchases or sales of goods (finished or unfinished);
- purchases or sales of fixed assets;
- rendering or receiving of services;
- agency arrangements;
- leasing or hire purchase arrangements;
- transfer of research and development;
- licence agreements;
- finance (including loans and equity contributions in cash or in kind);
- guarantees and collaterals; and
- management contracts including for deputation of employees."

3. As per the definition of the expression 'related party transaction', the transaction should be between related parties to qualify as a related party transaction. Since key management personnel are related parties under AS 18, remuneration paid to key management personnel is a related party transaction

requiring disclosures under AS 18. Further, in case non-executive directors on the Board of Directors are not related parties, remuneration paid to them is not considered a related party transaction.

#### Recommendation

4. Remuneration paid to

key management personnel should be considered as a related party transaction requiring disclosures under AS 18. In case non-executive directors on the Board of Directors are not related parties, remuneration paid to them should not be considered a related party transaction.

<sup>1</sup> This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 23, 'Remuneration paid to key management personnel - whether a related party transaction (Re. AS 18)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by the ICAI, ASI 23 has not been so incorporated as it was felt that it is primarily clarificatory in nature. The Council of the ICAI, has accordingly, decided to withdraw ASI 23, and issue the same as a Guidance Note as it provides appropriate guidance on the subject.

## Guidance Note on Applicability of AS 25 to Interim Financial Results<sup>1</sup>

*(The following is the text of the 'Guidance Note on Applicability of AS 25 to Interim Financial Results', issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance Note, Accounting Standards Interpretation (ASI) 27 - 'Applicability of AS 25 to Interim Financial Results (Re. AS 25)', stands withdrawn.)*

### Introduction

1. This Guidance Note deals with the issue whether Accounting Standard (AS) 25, *Interim Financial Reporting*, is applicable to interim financial results presented by an enterprise pursuant to the requirements of a statute/regulator, for example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises.

2. Accounting Standard (AS) 25, *Interim Financial Reporting*, issued by the Council of the Institute of Chartered Accountants of India, came into effect in respect of accounting periods commencing on or after 1-4-2002. If any enterprise is required or elects to prepare

and present an interim financial report, it should comply with this Standard (applicability paragraph).

3. AS 25 further provides as follows:

**"1. This Statement does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Statement.**

2. A statute governing an enterprise or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Statement. In such a case, the recognition and measurement principles as laid down in this Statement are applied in respect of such information, unless otherwise specified in the statute or by the regulator."

**"4. The following terms are**

**used in this Statement with the meanings specified:**

.....

***Interim financial report means a financial report containing either a complete set of financial statements or a set of condensed financial statements (as described in this Statement) for an interim period.***"

### Recommendation

4. The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as per AS 25) presented by an enterprise. For example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises do not meet the definition of 'interim financial report' as per AS 25. However, the recogni-

tion and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

<sup>1</sup>This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results (Re. AS 25)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by ICAI, ASI 27 has not been so incorporated as it was felt that it was not relevant to the requirements of the Companies Act, 1956. The Council of the ICAI, accordingly, has decided to withdraw ASI 27 and issue the same as a Guidance Note as it provides appropriate guidance on the subject.

## Guidance Note on Turnover in case of Contractors<sup>1</sup>

*(The following is the text of the 'Guidance Note on Turnover in case of Contractors', issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance Note, Accounting Standards Interpretation (ASI) 29 – 'Turnover in case of Contractors (Re. AS 7)', stands withdrawn.)*

### Introduction

1. This Guidance Note deals with the issue whether the revenue recognised in the financial statements of contractors as per the requirements of Accounting Standard (AS) 7, *Construction Contracts* (revised 2002), can be considered as 'turnover'.

2. AS 7 (revised 2002) deals, *inter alia*, with revenue recognition in respect of construction contracts in the financial statements of contractors. It requires recognition of revenue by reference to the stage of completion of a contract (referred to as 'percentage of completion method'). This method results in reporting of revenue which can be attributed to the proportion of work completed. Under this method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting period in which the work is performed.

3. The paragraph dealing with the 'Objective' of AS 7 (revised 2002) provides as follows:

#### **“Objective**

The objective of this Statement is to prescribe the ac-

counting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Statement uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognised as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria.”

From the above, it may be noted that AS 7 (revised 2002) deals, *inter alia*, with the allocation of contract revenue to the accounting periods in which construction work is performed.

4. Further, paragraphs 21 and 31 of AS 7 (revised 2002) provide as follows:

**“21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract**

***should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.”***

**“31. When the outcome of a construction contract cannot be estimated reliably:**

- (a) revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and**
- (b) contract costs should be recognised as an expense in the period in which they are incurred.**

***An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.”***

From the above, it may be noted that the recognition of revenue as per AS 7 (revised 2002) may be inclusive of profit (as per paragraph 21 reproduced above) or exclusive of profit (as per paragraph 31 reproduced above) depending on whether the outcome of the construction contract can be estimated reliably or not. When the outcome of the construction contract can be estimated reliably, the revenue is recognised inclusive of profit and when the same can-

not be estimated reliably, it is recognised exclusive of profit. However, in either case it is considered as revenue as per AS 7 (revised 2002).

5. 'Revenue' is a wider term. For example, within the meaning of Accounting Standard (AS) 9, *Revenue Recognition*, the term 'revenue' includes revenue from sales transactions, rendering of services and from the use by

others of enterprise resources yielding interest, royalties and dividends. The term 'turnover' is used in relation to the source of revenue that arises from the principal revenue generating activity of an enterprise. In case of a contractor, the construction activity is its principal revenue generating activity. Hence, the revenue recognised in the statement of profit and loss of a contractor in accordance with

the principles laid down in AS 7 (revised 2002), by whatever nomenclature described in the financial statements, is considered as 'turnover'.

### Recommendation

6. The amount of contract revenue recognised as revenue in the statement of profit and loss as per the requirements of AS 7 (revised 2002), should be considered as 'turnover'.

<sup>1</sup>This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 29, 'Turnover in case of Contractors (Re. AS 7)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by the ICAI, ASI 29 has not been so incorporated as it was felt that it is primarily clarificatory in nature. The Council of the ICAI, has accordingly, decided to withdraw ASI 29, and issue the same as a Guidance Note as it provides appropriate guidance on the subject.



## National Seminar on "Emerging Professional Opportunities" at Ahmedabad Organised by the Professional Development Committee and Hosted by Western India Regional Council

<b>Date &amp; Time</b>	On Friday, 22 <sup>nd</sup> August 2008 (09:30 p.m. to 06:15 p.m.)	
<b>Venue</b>	Hotel Grand Bhagvati, Sarkhej-Gandhinagar Highway, Ahmedabad	
<b>Discussion Sessions</b>	Restructuring of Professional Practice and Capacity Building of Members	CA. Sunil H. Talati, Immediate Past President of ICAI (Session Chairman) CA. Gopalakrishnan, Chairman of Capacity Building Committee of ICAI (Speaker)
	Professional Opportunities in new Economic and Commercial Laws	CA. Rajkumar S. Adukia, Chairman, Professional Development Committee, ICAI (Session Chairman) CA. Ramaswamy G., CCM, Coimbatore (Speaker)
	Issues in Takeover Code, Insider Trading, ESOPs, etc.	Ms. D. N. Raval (Session Chairman) Shri R. S. Loona, Advocate, Mumbai (Speaker)
	Impact of Allied Laws on Business Restructuring – Stamp Duty, Rent Act, FEMA, Takeover Regulations, DIP Guidelines, etc.	CA. Mahesh P. Sarda, Central Council Member, ICAI (Session Chairman) CA. Anup Shah, Advocate, Mumbai (Speaker)
<b>CPE Hours</b>	6 hours	
<b>Fees</b>	Rs. 750/- for Members, Rs. 400/- for CA Students (limited to 75 Students only), and Rs. 1,000/- for non-members. Cheque should be drawn in favour of "Ahmedabad Branch of WIRC of ICAI", payable at Ahmedabad and sent to Ahmedabad Branch of WIRC of ICAI, 'ICAI Bhawan', 123, Sardar Patel Colony, Nr. Usmanpura Underbridge, Naranpura, Ahmedabad – 380 014.	
<b>Contact Persons &amp; details thereof</b>	<ul style="list-style-type: none"> <li>• CA. Rajkumar S. Adukia, Chairman, PDC</li> <li>• CA. Parag R. Raval (M) 098243 39200, email - <a href="mailto:parag@gkcco.com">parag@gkcco.com</a></li> <li>• CA. Purshottam H. Khandelwal (M) 098250 20844, email - <a href="mailto:phkhandelwal@rediffmail.com">phkhandelwal@rediffmail.com</a></li> </ul>	

## Explanatory Memorandum to the Exposure Draft Standard on Auditing (SA) 265 Communicating Deficiencies in Internal Control

### Background

The Institute is a member of the International Federation of Accountants (IFAC). Therefore, as a part of its membership obligations, while formulating any Auditing and Assurance Standard it is required to harmonise with the corresponding International Standards on Auditing (ISAs), if any, issued by the International Auditing and Assurance Standards Board (IAASB) of the IFAC. The IAASB felt that the definition of Material Weaknesses is too general, which needs to be improved upon so as to enhance the consistency with which auditor treat identified weaknesses in internal control as material and how it should be communicated and/or reported to the management and Those Charged with Governance. Considering this fact, the IAASB decided to develop the proposed International Standard on Auditing (ISA) 265, "Communicating Deficiencies in Internal Control" so as to provide the clear guidance on the relevant internal control-related matters to be communicated in an audit of financial statements, and above all, to ensure that the auditor communicates identified non-trivial deficiencies in internal control to those parties within the entity who can competently deal with them on a timely basis. **In the light of the above decision, the IAASB had, in December 2007, issued the Exposure Draft of ISA 265 for public comments that also contains the appropriate conforming amendments to be made to the relevant ISA so as not to use the term "Material Weaknesses" in the ISAs.**

### IAASB's Clarity Project

The IAASB, in December 2007, issued the exposure draft of the ISA 265 written pursuant to the style adopted

under the Clarity Project. As a part of its Clarity Project, an International Standard on Auditing is divided into two sections, one, the Requirements part containing the fundamental principles of the Standard and second, the Application and Other Explanatory Materials section and Appendices, detailing the implementation aspects of the principles. Attention of the readers is also drawn to, "A Guide for National Standard Setters that Adopt IAASB's International Standards but Find it Necessary to Make Limited Modifications", issued by the IAASB in July, 2006.

### ICAI's Response

The Council of the Institute, at its 267<sup>th</sup> meeting held in April, 2007, has also decided to adopt this approach for writing Standards. The Council, at the said meeting, also decided to rename, re-categorise and re-number the existing Auditing and Assurance Standards on the lines followed by the IAASB. The readers are also requested to refer to the **Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services** published in the July, 2007 issue of the Journal. This revised Preface is effective from April 1, 2008.

### Highlights of the New Preface

#### I. Engagement Standards

The new Preface introduces the concept of Engagement Standards. The term "Engagement Standards" comprises the following Standards:

(a) **Standards on Auditing (SAs)**, to be applied in the audit of historical financial information.

(b) **Standards on Review Engagements (SREs)**, to be applied in the review of historical financial informa-

tion.

(c) **Standards on Assurance Engagements (SAEs)**, to be applied in assurance engagements, dealing with subject matters other than historical financial information.

(d) **Standards on Related Services (SRSs)**, to be applied to engagements involving application of agreed upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI .

The new Preface therefore, does away with the terminology "**Auditing and Assurance Standards**" in use till date.

The **Standards on Quality Control (SQC)**s are to be applied to all services covered by the Engagement Standards.

#### II. Standards on Auditing

The Standards on Auditing (SAs) referred to in I. above are formulated in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

#### III. New Format of Presenting the Standards on Auditing

In line with the format adopted by the IAASB under its Clarity Project, the Standards on Auditing would now contain two distinct sections, one, the Requirements section and, two, the Application Guidance section.

#### Requirements Section

The fundamental principles of the Standard are contained in the Requirements section and represented by use of "shall". Hitherto, the word, "should" was used in the Standards, for this purpose. Further, this format

<sup>1</sup> The full text of the Policy Position can be downloaded free of charge at [http://www.ifac.org/IAASB/downloads/Modification\\_Policy\\_Position.pdf](http://www.ifac.org/IAASB/downloads/Modification_Policy_Position.pdf).

also does away with the need to present the principles laid down by the Standard in bold text.

### Application and Other Explanatory Material

The application and other explanatory material contained in an SA is an integral part of the SA as it provides further explanation of, and guidance for carrying out, the requirements of an SA, along with the background information on the matters addressed in the SA. It may include examples of procedures, some of which the auditor may judge to be appropriate in the circumstances. Such guidance is, however, not intended to impose a requirement.

In view of this format of writing, the standard portion or principles enunciated in a Standard are no longer given in **bold face**.

*There is no change in the authority attached to the Standards, i.e., they are mandatory in nature, notwithstanding the new format of writing the Standards.*

### This Exposure Draft

This Exposure Draft of the Standard on Auditing (SA) 265, “Communicating Deficiencies in Internal Control”, is based on the corresponding Exposure Draft of ISA 265 issued by the IAASB in December, 2007 and follows the same writing style. The first, i.e., the Introduction and Requirements section contains the principles. The second, i.e., the Application and Explanatory Material section contains implementation guidance on the topics discussed in the Requirements section. Cross reference to the relevant paragraphs of the Application Material is built within the Requirements section. The para-

graphs in the Requirements section have been numbered as 1 to 11 and the paragraphs in the Application and Other Explanatory Material are numbered as A1 to A22.

### Topics Covered by Standard on Auditing (SA) 265

The Standard contains the following main aspects:

- (i) Scope
- (ii) Effective date
- (iii) Objectives
- (iv) Definitions
- (v) Requirements
  - (a) Identification of Deficiencies in Internal Control
  - (b) Communication of Deficiencies in Internal Control
- (vi) Application guidance on the above aspects.

### Highlights of Standard on Auditing (SA) 265

1. The Exposure Draft of this Standard on Auditing (SA) deals with the auditor’s responsibility to **communicate the non-trivial (including significant deficiencies) in internal control** appropriately to management and Those Charged with Governance that the auditor has identified in an audit of the financial statements, and also the control matters that the auditor considers important.
2. The Exposure Draft requires the auditor to **assess the risk of material misstatement** through understanding of the entity and the internal control, and accordingly to design his risk audit procedures. In addition to this, it also establishes the communication responsibilities for the auditor regarding identified deficiencies in in-

ternal control to the management and Those Charged with Governance so that they can fulfill their respective responsibility in relation to the financial statements.

3. The **definition of significant deficiencies** has been introduced to define those deficiencies meriting the attention of those overseeing the financial reporting process.

4. The Exposure Draft further requires the auditor to communicate all non-trivial deficiencies (including significant deficiencies) identified during the audit **in writing** to management at an appropriate level of responsibility **on a timely basis**.

5. **The following Standards on Auditing (SAs) have undergone a limited revision pursuant to the issuance of proposed SA 265:**

- (a) SA 240 (Revised), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”
- (b) SA 260 (Revised), “Communicating with Those Charged with Governance”
- (c) SA 300 (Revised), “Planning the Audit of Financial Statements”
- (d) SA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”
- (e) SA 330, “The Auditor’s Responses to Assessed Risks”
- (f) SA 600 (Revised), “Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)”.

*Your comments on the Exposure Draft should reach us by **September 30, 2008**. 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. The comments should be sent to:*

**Secretary, Auditing and Assurance Standards Board**  
**The Institute of Chartered Accountants of India**  
 ICAI Bhawan, C-1, Sector-1,  
 NOIDA,  
 Uttar Pradesh – 201 301.

*Comments can also be emailed at: [aasb@icai.org](mailto:aasb@icai.org)*

## Proposed Exposure Draft (ED) of Standard on Auditing (SA) 265 Communicating Deficiencies in Internal Control

*Proposed Standard on Auditing (SA) 265, "Communicating Deficiencies in Internal Control" should be read in conjunction with [proposed] SA 200 (Revised), "Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with Standards on Auditing".*

### Introduction

#### Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate appropriately to management and those charged with governance deficiencies in internal control<sup>2</sup> that the auditor has identified in an audit of the financial statements. This SA does not address deficiencies in internal control the potential financial effects of which are clearly trivial.<sup>3</sup>

2. The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement.<sup>4</sup> In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. Knowledge of deficiencies in internal control is relevant to management and those charged with governance in fulfilling their respective responsibilities in relation to the financial reporting process. This SA therefore establishes communication responsibilities for the auditor regarding identified deficiencies in internal control.

3. Nothing in this SA precludes the auditor from communicating control matters that the auditor has identi-

fied during the audit that are not relevant to the audit but that the auditor considers important.

#### Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after .....

#### Objective

5. The objective of the auditor is to communicate appropriately to management or those charged with governance deficiencies in internal control relevant to the audit that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

#### Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:

- (a) Deficiency in internal control – A control that is either missing or is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis.
- (b) Significant deficiency – A deficiency or combination of deficiencies in internal control relevant to the audit that, in the auditor's professional judgment, is of sufficient importance

to merit the attention of those charged with governance.

### Requirements

#### Identification of Deficiencies in Internal Control

7. The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. (Ref: Para. A1-A3)

8. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A4-A8)

#### Communication of Deficiencies in Internal Control

9. The auditor shall communicate all deficiencies in internal control (other than those that are clearly trivial) identified during the audit to management at an appropriate level of responsibility on a timely basis, unless: (Ref: Para. A9-A11, A22)

- (a) The auditor has obtained sufficient appropriate audit evidence about the operating effectiveness of other controls that would prevent, or detect and correct, misstatements arising from the identified deficiencies; or (Ref: Para. A3, A12)

<sup>1</sup>Presently, SA 200 (AAS 1), "Basic Principles Governing an Audit" and SA 200A (AAS 2), "Objective and Scope of an Audit of Financial Statements" correspond to Proposed International Standard on Auditing (ISA) 200 (Revised and Redrafted). Both the SAs are currently being revised in the light of the Proposed ISA 200 (Revised and Redrafted). Post this revision, the principles covered by SA 200 and SA 200A will be merged into one Standard, i.e., SA 200

<sup>2</sup>SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," paragraph 4(c), defines the terms "internal control" and "controls."

<sup>3</sup>[Proposed] SA 450 (Revised), "Evaluation of Misstatements Identified during the Audit," paragraph [A1], explains "clearly trivial" as "matters that will be of a wholly different (smaller) order of magnitude than materiality used in planning and performing the audit, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are "clearly trivial," the matter is considered not "clearly trivial.""

<sup>4</sup>SA 315, paragraph 12. Paragraphs A56-A61 provide guidance on controls relevant to the audit.

(b) It would be inappropriate to communicate directly to management in the circumstances. (Ref: Para. A13)

10. The auditor shall communicate significant deficiencies identified during the audit to those charged with governance in writing and on a timely basis. (Ref: Para. A14-A18, A22)

11. The auditor shall include in the written communication of significant deficiencies:

- (a) A description of the deficiencies and an explanation of their potential effects; and (Ref: Para. A19)
- (b) Sufficient information to enable those charged with governance to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A20-A21)
  - (i) The auditor did not plan and perform the audit with a view to identifying all deficiencies in internal control that might exist;
  - (ii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded should be reported to those charged with governance; and
  - (iii) The purpose of the audit was for the auditor to express an audit opinion on the financial statements, and the auditor has not performed audit procedures to obtain reasonable assurance, and is not providing any assurance, on the effectiveness of internal control.

## Application and Other Explanatory Material

### Identification of Deficiencies in Internal Control (Ref: Para. 7)

A1. Deficiencies in internal control may be identified at any stage of the

audit. In determining whether the auditor has identified one or more deficiencies, the auditor may seek to agree the relevant facts and circumstances of the auditor's findings with management. Doing so also provides an opportunity for the auditor to alert management on a timely basis to the existence of deficiencies of which management may not have been previously aware.

A2. In agreeing the facts and circumstances of the auditor's findings with management, the auditor may obtain other relevant information for further consideration, such as:

- Management's understanding of the actual or suspected causes of the deficiencies.
- Exceptions arising from the deficiencies that management may have noted, for example, misstatements that were not prevented by the relevant IT controls.
- A preliminary indication from management of its response to the findings.

A3. Management may also inform the auditor of controls not previously known to the auditor that it believes would prevent, or detect and correct, potential misstatements that would not be caught by the control(s) giving rise to the deficiencies. The existence of these other controls does not change the fact that the auditor has identified deficiencies in internal control. This SA does not require the auditor to obtain audit evidence regarding the design and operating effectiveness of these other controls. In concluding whether deficiencies in internal control exist, the auditor is, however, not precluded from obtaining and evaluating additional audit evidence regarding such other controls.

### Determination of Whether Identified Deficiencies Constitute Significant Deficiencies (Ref: Para. 8)

A4. Controls may be designed to

operate individually or in combination to effectively prevent, or detect and correct, misstatements.<sup>5</sup> For example, controls in an IT subsystem may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the relevant account balances. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency. However, a combination of deficiencies affecting the same account or disclosure, relevant assertion, or component of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.

A5. Significant deficiencies may exist even though the auditor has not identified misstatements during the audit. The significance of a deficiency or combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the risk that a misstatement could occur and the potential magnitude of the misstatement.

A6. Indicators of significant deficiencies include, for example:

- Deficiencies in the control environment<sup>6</sup>, such as:
  - Ineffective oversight of the financial reporting process by those charged with governance, especially in an environment with limited segregation of duties.
  - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
- A deficiency in a control over a significant risk.
- Material misstatements detected by the auditor's procedures that were not identified by the entity's internal control.
- Re-statement of previously issued financial statements to

<sup>5</sup> SA 315, paragraph A62 provides guidance on evaluation of design of Controls.

<sup>6</sup> The control environment means "the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity".

reflect the correction of a material misstatement due to error or fraud.

A7. Examples of other matters that the auditor may consider in determining whether a deficiency or combination of deficiencies constitutes a significant deficiency include:

- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as those involving fair values.<sup>7</sup>
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process; for example:
  - General monitoring controls (such as oversight of management).
  - Controls over the prevention and detection of fraud.
  - Controls over the selection and application of significant accounting policies.
  - Controls over significant transactions outside the entity's normal course of business.
  - Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency in internal control with other

deficiencies in internal control.

A8. Law or regulation in some jurisdictions may establish requirements for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) details of specific types of deficiencies in internal control that the auditor has identified during the audit, and may define terms such as "material weakness"<sup>8</sup> for this purpose.

### **Communication of Deficiencies in Internal Control**

#### **Communication of Identified Deficiencies to Management** (Ref: Para. 9)

A9. The auditor may identify deficiencies in certain controls that do not relate directly to the financial reporting objective of internal control. These controls may, nevertheless, be relevant to the audit if they address in particular the completeness and accuracy of information produced by the entity that the auditor intends to use in designing and performing audit procedures. For example, it is appropriate to communicate to management, in accordance with paragraph 9, a deficiency in a control that did not detect the use of a superseded price list by the entity's computerized sales system, resulting in lower margins than would be expected.

A10. How the auditor communicates a deficiency may be influenced by whether the auditor has communicated it in a previous audit, or whether management already has knowledge of it. If the auditor has previously communicated the matter to management, the current year's communication may include the same description of the deficiency as previously communicated. Alternatively, it may be summarized, specifically referring to the previous communication. However, the fact that the auditor communicated a deficiency to management in a previous audit, or that management

already had knowledge of the deficiency through other means (such as from relevant work done by internal auditors), does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. The auditor may ask management why the deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

A11. Management may already be aware of deficiencies that the auditor has identified during the audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management. Accordingly, the requirement for the auditor to communicate deficiencies to management applies regardless of cost or other considerations that management may consider relevant in determining whether to remedy such deficiencies.

A12. Unless the auditor has obtained sufficient appropriate audit evidence about the operating effectiveness of other controls that would prevent, or detect and correct, misstatements arising from the identified deficiencies, the auditor does not have sufficient audit evidence to conclude that a deficiency in internal control does not exist. Audit evidence regarding the effective design and implementation of such other controls is not in itself sufficient to support such a conclusion.

A13. It may be inappropriate to communicate identified deficiencies directly to management in situations that call into question the integrity or competence of management. For example, there may be evidence of actual or suspected fraud on management's part, or management may exhibit an inability to prepare adequate financial statements that may raise doubt about management's competence.

<sup>7</sup> SA 540 (AAS 18), "Audit of Accounting Estimates" establishes standards on the audit of accounting estimates contained in financial statements.

<sup>8</sup> SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," paragraph 4(f), defines the term, "Material Weakness".

**Communication of Significant Deficiencies to Those Charged with Governance** (Ref: Para. 10)

A14. Communicating significant deficiencies to those charged with governance in writing reflects the importance of these matters, and assists those charged with governance in fulfilling their responsibility relating to overseeing the financial reporting process. The communication may include details of any proposed remedial action from management, together with a statement as to whether the auditor has undertaken any steps to verify that such action has been implemented.

A15. In determining when to issue the written communication to those charged with governance, the auditor may consider that receipt of such communication would be an important factor in enabling those charged with governance to discharge their oversight responsibilities. Further, for listed entities in certain jurisdictions, those charged with governance may need to receive the auditor's written communication before the date of approval of the financial statements in order to discharge specific responsibilities in relation to internal control for regulatory or other purposes. For other entities, the auditor may issue the written communication at a later date. Nevertheless, in the latter case, as the auditor's written communication of significant deficiencies forms part of the final audit file, the written communication is subject to the overriding requirement<sup>9</sup> for the auditor to complete the assembly of the final audit file on a timely basis.<sup>10</sup>

A16. Regardless of the timing of the written communication of significant deficiencies to those charged with governance, the auditor may communicate these orally in the first instance to management and, when the auditor considers it appropriate to do so, to those charged with governance. This may assist them in taking timely remedial ac-

tion to minimize the risks of material misstatement. Doing so, however, does not relieve the auditor of the responsibility to communicate the significant deficiencies in writing to those charged with governance, as paragraph 10 requires.

A17. The level of detail at which to communicate significant deficiencies to those charged with governance is a matter of the auditor's professional judgment in the circumstances. Factors that the auditor may consider in determining an appropriate level of detail for the communication include, for example:

- The nature and size of the entity.
- The nature and volume of significant deficiencies that the auditor has identified.
- The entity's governance structure.
- The nature of the oversight responsibilities of those charged with governance.
- The preferences of those charged with governance.
- Legal or regulatory requirements regarding the communication of specific types of deficiencies in internal control.
- Whether the significant deficiencies were communicated to those charged with governance in previous audits.
- Whether those charged with governance already had knowledge of the significant deficiencies through other means, such as from relevant internal audit reports.

A18. The auditor may also communicate other control deficiencies to those charged with governance, whether in summarized form or as otherwise agreed. For example, in some circumstances those charged with governance may prefer to know of all deficiencies communicated to management. In other circumstances, those charged with governance

may prefer only brief descriptions or summaries of the nature of the other deficiencies.

**Content of Written Communication of Significant Deficiencies** (Ref: Para. 11)

A19. In explaining the potential effects of significant deficiencies, the auditor need not quantify those effects.

A20. The auditor may consider it appropriate to include the following information as additional context for the communication:

- An indication that if the auditor had performed more extensive audit procedures on internal control, the auditor might have identified more deficiencies to be reported, or concluded that some of the reported deficiencies need not, in fact, have been reported.
- An indication that such communication has been provided for the purposes of management and those charged with governance, and that it may not be suitable for other purposes.

A21. Laws or regulations may require the auditor or management to furnish a copy of the auditor's written communication on significant deficiencies to appropriate regulatory authorities. Where this is the case, the auditor's written communication may identify such regulatory authorities.

A22. In case of certain entities, the auditor may have additional responsibilities to communicate deficiencies in internal control that the auditor has identified during the audit, in ways, at a level of detail and to parties not envisaged in this SA. For example, significant deficiencies may have to be communicated to the legislature or other governing body. Legislation may also mandate the auditor to report deficiencies in internal control, irrespective of the significance of the potential effects of those deficiencies. Further, legislation may require the

<sup>9</sup>SA 230 (Revised), "Audit Documentation," paragraph 14.

<sup>10</sup>SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", Paragraph 75 prescribes that the firm should fix an appropriate time limit for the completion of the assembly of the final audit file, which is ordinarily not more than 60 days after the date of the auditor's report.

auditor to report on broader internal control-related matters than the deficiencies in internal control required to be communicated by this SA.

### Material Modifications to ISA 265, “Communicating Deficiencies in Internal Control”

#### Deletion

1. Paragraph A22 of the Application Section of ISA 265 dealt with the application of the communication and/or reporting requirements of ISA 265 to the audits of public sector entities. 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 specific communication and/or reporting requirement may also exist in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A22, highlighting the fact that in some cases, the auditor may be required by the legislature or the regulator to specifically communicate and/or report deficiencies in internal control that the auditor has identified during the audit.

### Limited Revision Consequential to issuance of Exposure Draft of the Standard on Auditing (SA) 265, “Communicating Deficiencies in Internal Control”

*The proposed amendments to the following Standards on Auditing (SAs) have been shown in track change mode.*

#### SA 240 (Revised), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”

A1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived

opportunity to do so and some rationalization of the act. For example:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.
- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific weaknesses deficiencies in internal control.
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

#### Appendix 1 – Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective.
- Accounting and information systems that are not effective,

including situations involving significant deficiencies material weaknesses in internal control.

#### Attitudes/Rationalizations

- Management failing to correct remedy known significant deficiencies material weaknesses in internal control on a timely basis.

#### Risk Factors Arising from Misstatements Arising from Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weaknesses other deficiencies in internal control that is not effective may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

#### Appendix 3 – Examples of Circumstances that Indicate the Possibility of Fraud

- An unwillingness to address identified significant deficiencies weaknesses in internal control on a timely basis.

#### SA 260 (Revised), “Communicating with Those Charged with Governance”

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, 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 or SA 330;~~
  - (ii). Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and (Ref: Para. A23)
  - (iii). ~~(i).~~ 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)

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, ~~the auditor~~ it may be appropriate to communicate ~~significant deficiencies material weaknesses in the design, implementation or operating effectiveness of~~ internal control that ~~the auditor has identified orally in the first instance to those charged with governance practicable, prior to communicating these in writing on a timely basis as required by [proposed] SA 265.~~<sup>11</sup> 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.

### **SA 300 (Revised), "Planning the Audit of Financial Statements"**

#### **Appendix – Considerations in Establishing the Overall Audit Strategy**

- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified ~~weaknesses~~ deficiencies and action taken to address them.

### **SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"**

4. For purposes of the SAs, the following terms have the meaning attributed below:

~~(f) Material Weakness—A weakness in internal control that could have a material effect on the financial statements.~~

14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

- (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
- (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment weaknesses. (Ref: Para. A65-A74)

16. If the entity has established such a process (referred to hereafter as the 'entity's risk assessment process'), the auditor shall obtain an understanding of it, and the results thereof. Where the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or if there is a material weakness significant deficiencies in the entity's risk assessment process.

17. If the entity has not established such a process or has an ad hoc

<sup>11</sup>[Proposed] SA 265, "Communicating Deficiencies in Internal Control," paragraphs [8 and A16].

process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or represents a significant deficiency material weakness in the entity's internal control. (Ref: Para. A76)

### **~~Material Weakness in Internal Control~~**

~~31. The auditor shall evaluate whether, on the basis of the audit work performed, the auditor has identified a material weakness in the design, implementation or maintenance of internal control. (Ref: Para. A124-A125)~~

~~32. The auditor shall communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility, and, as required by SA 260 (Revised), "Communication with Those Charged with Governance", with those charged with governance (unless all of those charged with governance are involved in managing the entity). (Ref: Para. A126)~~

A62. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a material weakness significant deficiency in the entity's internal control.

A70. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an abso-

lute deterrent to fraud. Conversely, deficiencies weaknesses in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures.

A99. Risks at the financial statement level may derive in particular from a weak control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies weaknesses such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

A119. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. This may indicate a significant deficiency material weakness in the entity's internal control.

### **~~Material Weakness in Internal Control~~** (Ref: Para. 31)

~~A124. The types of material weaknesses in internal control that the auditor may identify when obtaining an understanding of the entity and its internal controls may include:~~

- ~~• Risks of material misstatement that the auditor identifies and which the entity has not controlled, or for which the relevant control is inadequate.~~
- ~~• A weakness in the entity's risk assessment process that the auditor identifies as material, or the absence of a risk assessment process in those cases where it would be appropriate for one to have been established.~~

~~A125. Material weaknesses may also~~

~~be identified in controls that prevent, or detect and correct, error, or those to prevent and detect fraud.~~

~~A126. In case of certain audit engagements, there may be additional communication or reporting requirements. For example, internal control weaknesses may have to be reported to the regulator.~~

### **Appendix 2 – Conditions and Events that may Indicate Risks of Material Misstatement**

- Weaknesses Significant deficiencies in internal control, especially those not addressed by management.

### **SA 330, "The Auditor's Responses to Assessed Risks"**

~~18. The auditor shall evaluate whether, on the basis of the audit work performed, the auditor has identified a material weakness in the operating effectiveness of controls.~~

~~19. The auditor shall communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility and, as required by SA 260, "Communication with Those Charged with Governance", with those charged with governance (unless all of those charged with governance are involved in managing the entity).~~

A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. Deficiencies Weaknesses in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:

- Conducting more audit procedures as of the period end rather than at an interim date.

- Obtaining more extensive audit evidence from substantive procedures.
- Increasing the number of locations to be included in the audit scope.

~~A40. A material misstatement detected by the auditor's procedures may indicate the existence of a material weakness in internal control.~~

A56. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example,

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a ~~material weakness~~ significant deficiency in internal control.
- The auditor may become aware of discrepancies in accounting records, or conflicting or missing evidence.
- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognised risk of material misstatement.

In such circumstances, the auditor may need to re-evaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. SA 315 contains further guidance on revising the auditor's risk assessment.

### SA 600 (Revised), "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)"

41. The group engagement team

shall request the component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit. Such communication shall include: (Ref: Para. A60)

- (g) Description of any identified ~~significant deficiencies—material weaknesses~~ in internal control ~~over financial reporting relevant to the audit~~ at the component level;

46. The group engagement team shall make group management aware, on a timely basis and at an appropriate level of responsibility, of:

- (a) ~~Material weaknesses in the design or operating effectiveness of All deficiencies in group-wide controls (other than those that are clearly trivial) that the group engagement team has identified, unless: ;~~

(i) ~~The group engagement team has obtained sufficient appropriate audit evidence about the operating effectiveness of other group-wide controls that would prevent, or detect and correct, misstatements arising from the identified deficiencies; or (Ref: Para. A64)~~

(ii) ~~It would be inappropriate to communicate directly to group management in the circumstances. (Ref: Para. A65)~~

- (b) ~~Significant deficiencies Material weaknesses~~ that the group engagement team has identified in internal controls at components and judges are of significance to the group; and

- (c) ~~Significant deficiencies Material weaknesses~~ that component auditors have identified in internal controls at components and brought to the attention of the group engagement team judges are of significance to the group.

A20. The terms of engagement ~~identifies identify~~ the applicable financial reporting framework. Additional matters may be included in the terms of

a group audit engagement, such as the fact that:

- Important communications between the component auditors, those charged with governance of the component, and component management, including communications on significant deficiencies material weaknesses in internal control, should be communicated as well to the group engagement team.

A64. Unless the group engagement team has obtained sufficient appropriate audit evidence about the operating effectiveness of other group-wide controls that would prevent, or detect and correct, misstatements arising from the identified deficiencies, the group engagement team does not have sufficient audit evidence to conclude that a deficiency in internal control does not exist. Audit evidence regarding the effective design and implementation of such other group-wide controls is not in itself sufficient to support such a conclusion.

A65. It may be inappropriate to communicate identified deficiencies directly to group management in situations that call into question the integrity or competence of group management. For example, there may be evidence of actual or suspected fraud on group management's part, or group management may exhibit an inability to prepare adequate group financial statements that may raise doubt about group management's competence.

### Appendix 5-Required and Additional Matters Included in the Group Engagement Team's Letter of Instruction

Other information

- Significant deficiencies Material weaknesses in controls that ~~have come to the attention of the~~ component auditor has identified during the performance of the work on the financial information of the component, and information that indicates the existence of fraud.□

## Explanatory Memorandum to the Exposure Draft Revised Standard on Auditing (SA) 500 Considering the Relevance and Reliability of Audit Evidence

### Background

The Institute of Chartered Accountants of India had in May, 1988 issued the Standard on Auditing (SA) 500<sup>1</sup>, "Audit Evidence", effective for all audits relating to accounting periods beginning on or after January 1, 1989. The Institute is a member of the International Federation of Accountants (IFAC). Therefore, as a part of its membership obligations, while formulating any Auditing and Assurance Standard it is required to harmonise with the corresponding International Standards on Auditing (ISAs), if any, issued by the International Auditing and Assurance Standards Board (IAASB) of the IFAC.

### IAASB's Clarity Project

The IAASB, in April 2007, issued the exposure draft of the redrafted ISA 500 meaning thereby that the IAASB proposed a **redrafted** version of ISA 500, written pursuant to the style adopted under the Clarity Project. As a part of its Clarity Project, an International Standard on Auditing is divided into two sections, one the Requirements part containing the fundamental principles of the Standard and second, the Application and Other Explanatory Materials section and appendices, detailing the implementation aspects of the principles. Attention of the readers is also drawn to, "A Guide for National Standard Setters that Adopt IAASB's International Standards but Find it Necessary to Make Limited Modifications"<sup>2</sup>, issued by the IAASB in July, 2006.

### ICAI's Response

The Council of the Institute, at its

267<sup>th</sup> meeting held in April, 2007 has also decided to adopt this approach for writing Standards. The Council, at the said meeting, also decided to re-name, re-categorise and re-number the existing Auditing and Assurance Standards on the lines followed by the IAASB. The readers are also requested to refer to the **Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services** published in the July, 2007 issue of the Journal. This revised Preface is effective from April 1, 2008.

### Highlights of the New Preface

#### I. Engagement Standards

The new Preface introduces the concept of Engagement Standards. The term "Engagement Standards" comprises the following Standards:

- (a) **Standards on Auditing (SAs)**, to be applied in the audit of historical financial information.
- (b) **Standards on Review Engagements (SREs)**, to be applied in the review of historical financial information.
- (c) **Standards on Assurance Engagements (SAEs)**, to be applied in assurance engagements, dealing with subject matters other than historical financial information.
- (d) **Standards on Related Services (SRSs)**, to be applied to engagements involving application of agreed upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

The new Preface therefore, does away with the terminology "**Auditing and Assurance Standards**" in use till date.

The **Standards on Quality Control (SQC)s** are to be applied to all services covered by the Engagement Standards.

#### II. Standards on Auditing

The Standards on Auditing (SAs) referred to in I. above are formulated in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

#### III. New Format of Presenting the Standards on Auditing

In line with the format adopted by the IAASB under its Clarity Project, the Standards on Auditing would now contain two distinct sections, one, the Requirements section and, two, the Application Guidance section.

#### Requirements Section

The fundamental principles of the Standard are contained in the Requirements section and represented by use of "shall". Hitherto, the word, "should" was used in the Standards, for this purpose. Further, this format also does away with the need to present the principles laid down by the Standard in bold text.

#### Application and Other Explanatory Material

The application and other explanatory material contained in an SA is an integral part of the SA as it provides

<sup>1</sup> Hitherto known as Auditing and Assurance Standard (AAS) 5.

<sup>2</sup> The full text of the Policy Position can be downloaded free of charge at [http://www.ifac.org/IAASB/downloads/Modification\\_Policy\\_Position.pdf](http://www.ifac.org/IAASB/downloads/Modification_Policy_Position.pdf).

further explanation of, and guidance for carrying out, the requirements of an SA, along with the background information on the matters addressed in the SA. It may include examples of procedures, some of which the auditor may judge to be appropriate in the circumstances. Such guidance is, however, not intended to impose a requirement.

In view of this format of writing, the standard portion or principles enunciated in a Standard are no longer given in **bold face**.

***There is no change in the authority attached to the Standards, i.e., they are mandatory in nature, notwithstanding the new format of writing the Standards.***

#### **This Exposure Draft**

This Exposure Draft of the Revised Standard on Auditing (SA) 500<sup>3</sup>, "Considering the Relevance and Reliability of Audit Evidence", is based on the corresponding Exposure Draft of Redrafted ISA 500 issued by the IAASB in April, 2007 and follows the same writing style. The first, i.e., the Introduction and Requirements section contains the principles. The second, i.e., the Application and Explanatory Material section contains implementation guidance on the topics discussed in the Requirements section. Cross-reference to the relevant paragraphs of the Application

Material is built within the Requirements section. The paragraphs in the Requirements section have been numbered as 1 to 14 and the paragraphs in the Application and Other Explanatory Material are numbered as A1 to A35.

#### **Topics Covered by Revised SA 500**

The Standard contains the following main aspects:

- (i) Scope
- (ii) Audit Evidence
- (iii) Effective date
- (iv) Objectives
- (v) Definitions
- (vi) Requirements
  - (a) Information to be Used as Audit Evidence
  - (b) Selecting Items for Testing to Obtain Audit Evidence
  - (c) Inconsistency in, or Doubts Over Reliability of, Audit Evidence
- (vii) Application guidance on the above aspects

#### **Highlights of Revised SA 500**

1. This SA is applicable to all the audit evidence obtained by the auditor during the course of the audit, i.e., all the information used by the auditor in arriving at the conclusion on which the audit opinion is based.

It also deals with the auditor's responsibility to design and perform the audit procedure to obtain relevant and reliable audit evidence.

2. There is more emphasis on considering the **relevance and reliability of the audit evidence** obtained by an auditor during the course of an audit, and accordingly to focus on designing and performing the audit procedures by an auditor to obtain relevant and reliable audit evidence.

3. The concept of **risk assessment procedures**, as defined in SA 315 and SA 330, has been built in the Standard so that the auditor could draw reasonable conclusions to form his audit opinion.

4. Procedures for generating evidence have been changed significantly by introduction of the **new technologies** in the field of IT or in general. The Exposure Draft of SA 500 contains guidance in respect of relevance and reliability of such audit evidence.

5. The Exposure Draft of Revised SA 500 also contains guidance on the factors to be considered by the auditor in deciding about the methods for selecting the items for testing to obtain audit evidence (as per SA 530 (Revised), "Audit Sampling") that are effective in meeting the purpose of the audit procedure.

*Your comments on the Exposure Draft should reach us by **September 30, 2008**. 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. The comments should be sent to:*

**Secretary, Auditing and Assurance Standards Board  
The Institute of Chartered Accountants of India  
ICAI Bhawan, C-1, Sector-1,  
NOIDA,  
Uttar Pradesh – 201 301.**

*Comments can also be emailed at: [aasb@icai.org](mailto:aasb@icai.org)*

<sup>3</sup>Revises the existing Standard on Auditing (SA) 500 (AAS 5), "Audit Evidence", issued in May 1988.

## Proposed Exposure Draft (ED) of Standard on Auditing (SA) 500 (Revised) Considering the Relevance and Reliability of Audit Evidence

*Standard on Auditing (SA) 500 (Revised), "Considering the Relevance and Reliability of Audit Evidence" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"<sup>4</sup>, which sets out the authority of SAs.*

### Introduction

#### Scope of this SA

1. This Standard on Auditing (SA) explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain relevant and reliable audit evidence.

2. This SA is applicable to all the audit evidence obtained during the course of the audit. Other SAs deal with specific aspects of the audit, the audit evidence to be obtained, the procedures to be performed in obtaining audit evidence, and the evaluation of whether sufficient appropriate evidence has been obtained.

#### Audit Evidence

3. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence is necessary to support that opinion and the auditor's report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from, e.g., previous audits and a firm's quality control procedures for client acceptance

and continuance. The entity's accounting records are an important source of audit evidence along with other sources inside and outside the entity. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. (Ref: Para. A1-A3)

4. Most of the auditor's work in forming the audit opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, re-calculation, re-performance and analytical procedures and inquiry, often in some combination. Although inquiry may provide important audit evidence, inquiry alone ordinarily does not provide sufficient audit evidence to detect a material misstatement at the assertion level, nor of the operating effectiveness of controls. (Ref: Para. A4-A19)

5. As explained in [proposed] SA 200<sup>5</sup> (Revised), "Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level by obtaining sufficient appropriate audit evidence.

Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the risks of misstatement (the higher the risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

6. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for, or detecting misstatements in, the financial statements. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

7. The sufficiency and appropriateness of audit evidence are interrelated. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the audit opinion, is a matter for the auditor to determine using professional judgment.

<sup>4</sup> Published in the July, 2007 issue of the Journal.

<sup>5</sup> Presently, SA 200 (AAS 1), "Basic Principles Governing an Audit" and SA 200A (AAS 2), "Objective and Scope of an Audit of Financial Statements" correspond to Proposed International Standard on Auditing (ISA) 200 (Revised and Redrafted). Both the SAs are currently being revised in the light of the Proposed ISA 200 (Revised and Redrafted). Post this revision, the principles covered by SA 200 and SA 200A will be merged into one Standard, i.e., SA 200.

### **Effective Date**

8. This SA is effective for audits of financial statements for periods beginning on or after \_\_\_\_\_.

### **Objective**

9. The objective of the auditor is to design and perform audit procedures so as to be able to obtain relevant and reliable audit evidence.

### **Definitions**

10. For purposes of the SAs, the following terms have the meanings attributed below:

- (a) Accounting records – The records of initial accounting entries and supporting records, such as cheques and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in formal journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
- (b) Audit evidence – All the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.
- (c) Sufficiency – The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the risks of material misstatement and also by the quality of such audit evidence.
- (d) Appropriateness – The measure of the quality of audit evidence; that is, its

relevance and its reliability in providing support for, or detecting misstatements in, the financial statements.

### **Requirements**

#### **Information to be Used as Audit Evidence**

11. When designing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence. (Ref: Para. A20-A27)

12. When information used by the auditor for purposes of the audit was produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances:

- (a) Obtaining audit evidence about the accuracy and completeness of the information;
- (b) Evaluating whether the information is sufficiently precise or detailed for the auditor's purposes. (Ref: Para. A28-A30)

#### **Selecting Items for Testing to Obtain Audit Evidence**

13. When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. The means available to the auditor are:

- (a) Selecting all items (100% examination);
- (b) Selecting specific items; and
- (c) Audit sampling. (Ref: Para. A31-A34)

#### **Inconsistency in, or Doubts Over Reliability of, Audit Evidence**

14. When audit evidence obtained from one source is inconsistent

with that obtained from another, or the auditor has doubts over the reliability of information to be used as audit evidence, the auditor shall determine what modifications to or additional audit procedures are necessary to resolve the matter. (Ref: Para. A35)

### **Application and Other Explanatory Material**

#### **Sources of Audit Evidence** (Ref: Para. 3)

A1. Management is responsible for the preparation of the financial statements based upon the accounting records of the entity. Some audit evidence is obtained by performing audit procedures to test the accounting records, e.g., through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

A2. More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from evidence existing within the accounting records or from representations made by management.

A3. Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors (benchmarking data).

#### **Audit Procedures for Obtaining Audit Evidence** (Ref: Para. 4)

A4. As required by, and explained further in SA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment” and SA 330, “The Auditor’s Responses to Assessed Risks” audit evidence to draw reasonable conclusions on which to base the audit opinion is obtained by performing:

- (a) Risk assessment procedures; and
- (b) Further audit procedures, which comprise:
  - (i) Test of controls; and
  - (ii) Substantive procedures, including tests of details and substantive analytical procedures.

A5. The audit procedures described in paragraphs A8-A19 below may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor. As explained in SA 330, audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance.

A6. The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image-processing systems to facilitate storage and reference.

A7. Certain electronic information may not be retrievable after a specified period of time, e.g., if files are changed and if backup files do not exist. Accordingly, an entity’s data retention policies may require the auditor to request retention of some information for the auditor’s review or to perform audit procedures at a time when the information is available.

#### **Inspection**

A8. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

A9. Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity’s application of accounting policies, such as revenue recognition.

A10. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity’s rights and obligations or the valuation of the assets. Inspection of individual inventory items ordinarily accompanies the observation of inventory counting.

#### **Observation**

A11. Observation consists of looking at a process or procedure being performed by others, e.g., the auditor’s observation of inventory counting by the entity’s personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed. See SA 501 (Revised)<sup>6</sup>, “Audit Evidence—Additional Considerations for Specific Items” for further guidance on observation of the counting of inventory.

#### **Inquiry**

A12. Inquiry consists of seeking information from knowledgeable persons, both financial and non-financial, throughout the entity or outside the entity. Inquiry is used extensively throughout the audit as a complement to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

A13. Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, e.g., information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

A14. Although corroboration of evidence obtained through inquiry is often of particular impor-

<sup>6</sup>Currently, SA 501 (AAS 34), “Audit Evidence – Additional Considerations for Specific Items” is in force. The Standard is being revised in the light of the corresponding International Standard.

tance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions with respect to assets or liabilities, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information about management's intent.

A15. In respect of some matters, the auditor is required to obtain written representations from management to confirm responses to oral inquiries. See [proposed] SA 580<sup>7</sup> (Revised), "Written Representations" for further guidance.

#### **Confirmation**

A16. Confirmation is a specific type of inquiry that is the process of obtaining a representation of information or of an existing condition directly from a third party. Confirmations are frequently used in relation to account balances and their components. For example, the auditor may seek direct confirmation of receivables by communication with debtors. However, confirmations need not be restricted to these items. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request is designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. Confirmations also are used to obtain audit evidence about the absence of certain conditions, e.g., the absence of a "side agreement" that may influence revenue recognition. See SA 505(Revised)<sup>8</sup>, "External Confirmations" for further

guidance.

#### **Recalculation**

A17. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation can be performed manually or electronically.

#### **Re-performance**

A18. Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

#### **Analytical Procedures**

A19. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. See SA 520(Revised)<sup>9</sup>, "Analytical Procedures" for further guidance.

#### **Information to be Used as Audit Evidence**

##### **Relevance and Reliability** (Ref: Para. 11)

A20. As noted in paragraph 3, while audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources such as, e.g., previous audits, and a firm's quality control procedures for client acceptance and continuance. The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

##### **Relevance**

A21. Relevance deals with the

logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. Considering the relevance of information to be used as audit evidence includes considering the direction of testing. For example, if the purpose of an audit procedure is to test for overstatement of accounts payable, testing the recorded accounts payable may be appropriate. On the other hand, when testing for understatement of accounts payable, testing the recorded accounts payable is not appropriate but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be appropriate.

A22. A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off. On the other hand, the auditor often obtains audit evidence from different sources or of a different nature that is relevant to the same assertion.

##### **Reliability**

A23. Due to the fact that the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used

<sup>7</sup>The Auditing and Assurance Standards Board has issued the Exposure Draft of the proposed Standard on Auditing (SA) 580 (Revised), which was published in the November, 2007 issue of the Journal and was also hosted on the website. The last date for sending comments on the same was December 15, 2007.

<sup>8</sup>Currently, SA 505 (AAS 30), "External Confirmations" is in force. The Standard is being revised in the light of the corresponding International Standard.

<sup>9</sup>Currently, SA 520 (AAS 14), "Analytical Procedures" is in force. The Standard is being revised in the light of the corresponding International Standard.

as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over their preparation and maintenance, imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (e.g., observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (e.g., inquiry about the application of a control).
- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (e.g., a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over

their preparation and maintenance.

A24. The auditor's consideration of the reliability of audit evidence rarely involves the authentication of documentation. SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"<sup>10</sup>, deals with circumstances where the auditor has reason to believe that a document may not be authentic, or may have been modified without that modification having been disclosed to the auditor.

A25. Test of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation conditions, which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

A26. Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

A27. When designing tests of controls and tests of details, the auditor may need to make an assessment of the expected rate of deviation or expected misstatement in the population to be tested.

**Information Produced by the Entity and Used for Audit Purposes** (Ref: Para. 12)

A28. In order for the auditor to ob-

tain reliable audit evidence, information produced by the entity that is used for performing audit procedures needs to be sufficiently complete and accurate. For example, the effectiveness of auditing revenue by applying standard prices to records of sales volume is affected by the accuracy of the price information and the completeness and accuracy of the sales volume data. Similarly, if the auditor intends to test a population (e.g., payments) for a certain characteristic (e.g., authorisation), the results of the test will be less reliable if the population from which items are selected for testing is not complete.

A29. Obtaining audit evidence about the accuracy and completeness of such information may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.

A30. In some cases, the auditor may intend to use information produced by the entity for other audit purposes. For example, the auditor may intend to make use of the entity's performance measures for the purpose of analytical procedures, or to make use of the entity's information produced for monitoring activities, such as internal auditor's reports. In such cases, the appropriateness of the audit evidence obtained is affected by whether the information is sufficiently precise or detailed for the auditor's purposes. For

<sup>10</sup> Published in December, 2007 issue of the journal.

example performance measures used by management may not be precise enough to detect material misstatements.

**Selecting Items for Testing to Obtain Audit Evidence** (Ref: Para. 13)

A31. An effective test provides appropriate audit evidence to an extent that, taken with other audit evidence obtained or to be obtained, will be sufficient for the auditor's purpose. In selecting items for testing, the auditor is required by paragraph 11 to determine the relevance and reliability of information to be used as audit evidence; the other aspect of effectiveness (sufficiency) is an important consideration in selecting items to test. The application of any one or combination of the means of selecting items for testing identified in paragraph 13 may be appropriate depending on the particular circumstances, e.g., the risks of material misstatement related to the assertion being tested, and the practicality and efficiency of the different means.

**Selecting All Items**

A32. The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). 100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details. 100% examination may be appropriate when, e.g.:

- The population constitutes a small number of large value items;
- There is a significant risk and other means do not provide sufficient appropri-

ate audit evidence; or

- The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

**Selecting Specific Items**

A33. The auditor may decide to select specific items from a population. In making this decision, factors that may be relevant include the auditor's understanding of the entity, the assessed risks of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

- *High value or key items.* The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, e.g., items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- *All items over a certain amount.* The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- *Items to obtain information.* The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

A34. While selective examination of specific items from a class of transactions or account balance

will often be an efficient means of obtaining audit evidence, it does not constitute audit sampling. The results of audit procedures applied to items selected in this way cannot be projected to the entire population; accordingly, selective examination of specific items does not provide audit evidence concerning the remainder of the population. Audit sampling, on the other hand, is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it. Audit sampling is discussed in SA 530 (Revised)<sup>11</sup>, "Audit Sampling".

**Inconsistency in, or Doubts Over Reliability of, Audit Evidence** (Ref: Para. 14)

A35. Obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable, such as when audit evidence obtained from one source is inconsistent with that obtained from another. This may be the case when, for example, responses to inquires of management, internal audit, and others are inconsistent, or when responses to inquiries of those charged with governance made to corroborate the responses to inquiries of management are inconsistent with the response by management.

**Material Modifications to Proposed Redrafted ISA 500, "Considering the Relevance and Reliability of Audit Evidence"**

The Standard on Auditing (SA) 500 (Revised), "Considering the Relevance and Reliability of Audit Evidence" does not contain any material modifications vis-a-vis proposed Redrafted ISA 500. □

<sup>11</sup>The Auditing and Assurance Standards Board has issued the Exposure Draft of the proposed Standard on Auditing (SA) 530 (Revised), which was published in the March, 2008 issue of the journal and was also hosted on the website for public comments. The last date for sending comments on the same was April 30, 2008.

**Smile Please**

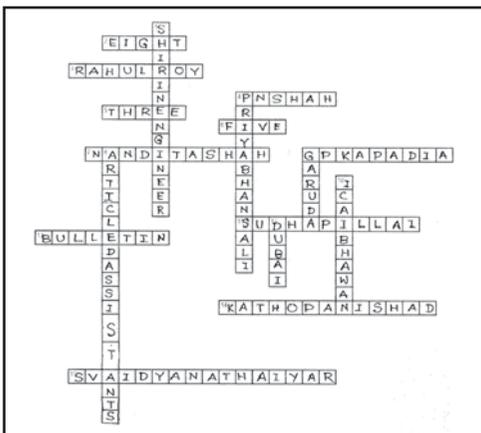
A little boy asked his father, "Daddy, how much does it cost to get married?" And the father replied, "I don't know son, I'm still paying."

**OUT OF THE BOX**

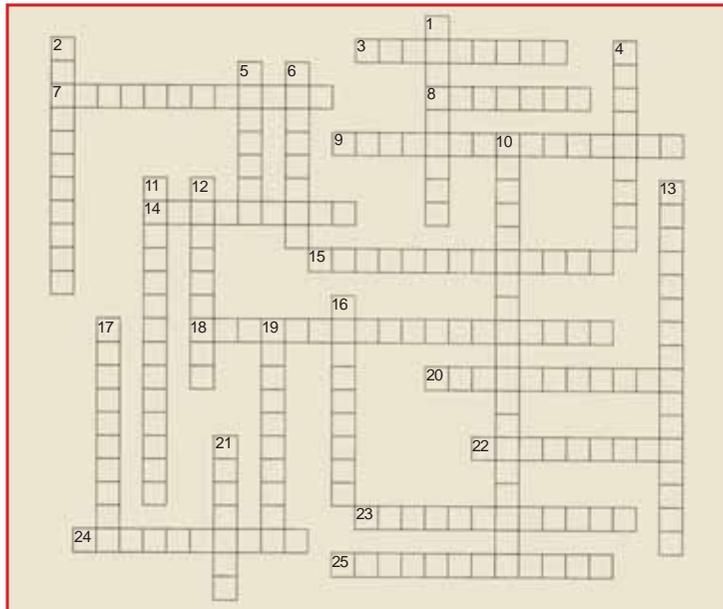


*Make a fresh list of your priority jobs... and all the jobs that I have given to you should be listed as your priority number one!*

**Crossword 025 - Solution**



**CROSSWORD 026**



Note: The above crossword is related to charitable trusts. It has been contributed by CA. T. Muralidhara Kalkura from Chennai.

**ACROSS**

- 3. An allied law to charitable trust
- 7. Form 10A to be made to it
- 8. One of the type of trust
- 9. Needed for Correct Interpretation of the Trust Deed
- 14. Other Name for Voluntary Contribution
- 15. Exemptions from Capital Gain Tax is not available to this Income for
- 18. Not for Charitable Cause
- 20. Trustee can seek this delayed Registration Application
- 22. One of the Charitable Purpose under IT Act
- 23. One of the Law applicable to Charitable Trust
- 24. Always Advisable to have the Deed
- 25. Element not essential to give relief to the poor

**DOWN**

- 1. One common cause for forming trusts
- 2. One of the three certainties of a valid Trust
- 4. Other name for the Instrument of Trust
- 5. One form of Charitable Trust
- 6. Propagation of this also is considered Charity
- 10. All Chambers of this kind is for general Public Utility
- 11. Also considered as an object for General Public Utility
- 12. Charitable Purpose must be directed towards this
- 13. Eligible Project under 35AC
- 16. Only this is required to be registered under Indian Registration Act
- 17. Required No of Form10G copies
- 19. Percentage of Income to be applied for Charitable Purpose under IT Act
- 21. Time Limit for Registration under IT Act

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.