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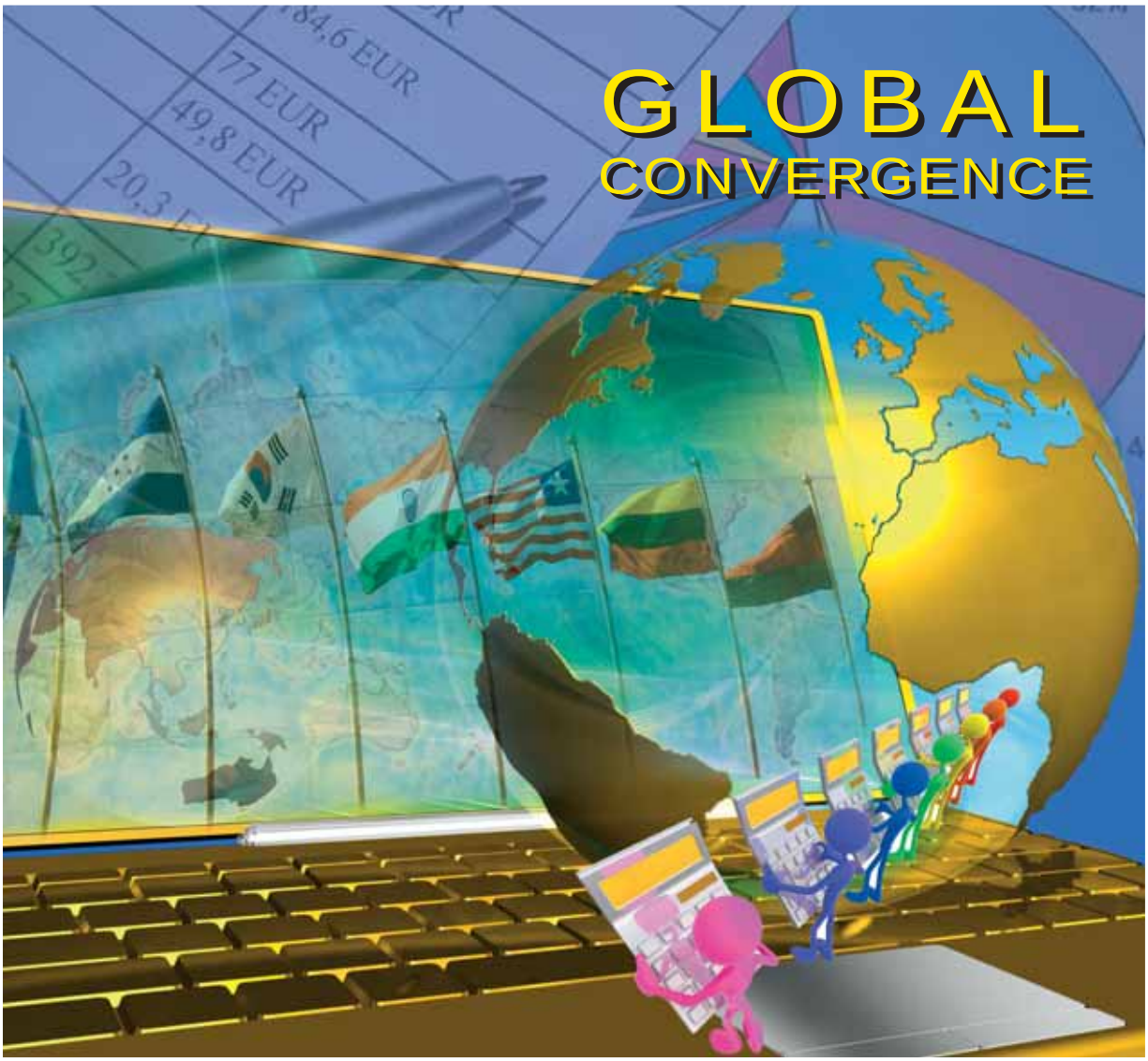
THE CHARTERED ACCOUNTANT

JOURNAL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA



Disclosure Requirements Introduced by 'IFRS 7, *Financial Instruments: Disclosures'*

Contemporary Accounting Concepts for Inorganic Growth: Acquisitions and Mergers under IFRS 3 - *Business Combinations*

Exchange Traded Funds - A Financial Innovation

Determination of Arm's Length Price

ICAI – Partner in Nation Building

Volume 56 No.11 May 2008
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CHALLENGE OF SUSTAINING GROWTH

Notwithstanding the global uncertainties, cut in global forecast to 3.7% growth and some negative number for the country's Index of Industrial Production, the India story still continues to be strong with a healthy about 8 per cent plus growth estimated in 2008. This positive projection, although lower than the near 9 per cent growth in the last few years, is indeed in itself a big success, but the bigger and real success lies in sustaining the growth. However, it is easier said than done, particularly in the backdrop of a host of external and internal factors posing a formidable challenge to the country's growth prospects. These factors include US recession, global slowdown, financial market turmoil, lack of required infrastructure in the country, shortage of skilled manpower compared to the growing demand, dismal growth of the agriculture sector and rising inflation which recently touched a 40 month high of 7.41 per cent.

The foremost challenge is the combination of increasing recessionary pressures in US and consequent global slowdown. It would hit capital inflows and exports, particularly of services. The prevalent pessimism in the environment is already affecting decisions of global investors who are in a wait-and-watch mode. The Indian economy is likely to lose between 1 to 2 percentage points in GDP growth in the next fiscal because of US recessionary trend. This challenge can be met in two ways– by tapping the new markets outside the US, particularly in Africa, and by exploring the still vast potential of rural Bharat as an emerging market. It is reassuring that our economic credentials remain sound while our domestic economy remains buoyant irrespective of the global slowdown.

Financial market turbulence is yet another hurdle to sustainability of our growth. Although only one Indian bank had exposure to US sub-prime mortgages, the problems stemming from the credit markets would indeed affect India. As the crisis has moved from the sub-prime mortgage market to the housing market and now to credit market, there is an impact upon India in terms of credit flows and financial flows. Further, the turmoil in financial currency markets has started affecting Indian companies and the stock market. Analysts note that the total mark-to-market losses of corporate India's exposure in the foreign exchange derivatives market could be in the region of $5 billion.

The solution lies in stimulating the demand in the Indian economy. Here, the measures announced in the recent budget, including a significant reduction in the personal income tax, expanding and deepening the corporate debt market and large outlays of public expenditure on education, health, roads, irrigation etc, should encourage both domestic and foreign investors to have faith in the India growth story.

Lack of adequate infrastructure remains a major internal challenge that has to be met head on if India is to sustain its growth in the long run. The adequate and constant supply of skilled manpower is another requirement for sustaining the growth. The shortfall on this front has to be dealt with in the right earnest by investing more in higher education, research and training. It is encouraging that the 11th Plan envisages setting up of 370 new colleges in educationally backward districts and 30 new Central Universities besides several new Indian Institutes of Science Education and Research, IITs, and IIMs etc.

The dismal show on the agricultural front continues to cast doubts on a long-term India story. This sector, which grew by only 2.7 per cent last year, has to grow by at least 4-5 per cent to help the country maintain its growth trajectory in future. The farm loan waiver to the tune of Rs. 60,000 crore is just a temporary relief and not a permanent solution to the ills afflicting this sector. Serious long-term initiatives need to be launched to strengthen the fundamentals of this sector.

And last but not the least, the rising inflation is another major internal challenge to growth, particularly when the Government is inclined more towards inflation control rather than growth. The possible inflation control measures like putting curbs on exports may affect the overall growth of the economy. Such a sharp rise in inflation has already dashed all hopes of a soft interest rate regime which is required to arrest the slowdown in the economy.

The combination of a global slowdown, rising inflation and subdued interest in investment can have only negative consequences for developing countries. As such, sustaining India's growth is indeed difficult but not at all impossible— particularly in view of its strong overall economic credentials and buoyant domestic economy. It is to be noted that easing concerns about a slowdown in economy, industrial production in February 2008 grew the fastest in four months at 8.6 per cent.

--Editorial Board

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THE CHARTERED ACCOUNTANT
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Cover: Global Convergence
TOTAL CIRCULATION: 1,86,000

CONTENTS

While convergence can have a wide variety of different meanings, it is generally assumed that, ultimately, all standard setters should agree on a single, high-quality answer. The accounting standards setters throughout the globe are working together & collaborating on projects & are moving towards convergence as they address urgent issues & improve accounting procedures.

The retrospective amendment for the year 2006-07 would result in excess payment to some people and short payment to some others where ever the allocable surplus after the amendment is less than 20% of salary eligible for bonus.

FROM THE PRESIDENT

Dear Esteemed Colleagues,

You will recall that in my earlier communication I had spoken of Action Plan 2008 and talked about several initiatives proposed for this year. I am happy to inform you that some of those initiatives are beginning to take a concrete shape.

Accounting Technicians Course

The multi-faceted growth of Indian economy has resulted in huge demand for second tier accounting personnel for large as well as small and medium enterprises. For long, a need was being felt for persons with accounting and related skills commensurate with the requirements at the operational level. Responding to this ever-increasing demand in industry as well as in the services sector, the Council has decided to launch 'Accounting Technicians Course'. These accounting technicians will not only fill gaps at the operational level as accountants but will also ensure that the value chain in the accounting process does not suffer. With closer integration of agriculture and informal sectors with the mainstream economy, the demand for such professionals is expected to go up every year. I believe that this step will provide a much needed service and further boost our image as a premier accounting Institute in the country. As per the proposal, a step up approach is being adopted whereby a student having qualified the Accounting Technicians Course will be eligible to enroll for the CA Course. At the same time, a student who has enrolled for the CA Course but who for one reason or the other is not able to complete the CA Course will have the option to become an accounting technician. Further, all those students who have passed Intermediate or PE-II Examination of the Institute at any time in the past and have completed articled training shall also be eligible for Accounting Technician Certificate.

Residential Programme for CA Students

As I had said in my first communication, we are working to set up Centres of Excellence to turn out first rate accounting professionals. However, till such time as that happens, we are continuing with our proactive initiatives to align our profession with the emerging global economic order and complex business environment. As such, I am pleased to inform you that from 28th April 2008, we are starting a 3 months residential programme for those who have recently passed the final examination or are nearing completion of their final course. The programme focuses exclusively on development of their personality, professional skills, communication skills, inter-personal and teamwork skills, problem solving skills and leadership skills, etc. A special campus recruitment has also been planned for the students joining the programme. The programme, which is highly subsidised by the Institute, is being administered by the National Institute of Financial Management (NIFM), Faridabad. The programme has been designed on the lines of the orientation that IAS probationers undergo, to equip potential Chartered Accountants to face the intricacies of the corporate world. The participation in the programme will be treated as equivalent to undergoing articled training.

Group on XBRL

As you may be aware, eXtensible Business Reporting Language (XBRL) is a novel way of the communication of business and financial data that is of immense utility to the government, regulators, stakeholders, etc.. Taking into account the importance and usefulness of this technology, a group has been constituted on XBRL for development of this technology in India and its promotion. The Institute has taken up the development of the taxonomy of XBRL-based reporting bearing in mind the peculiarities of the Indian legal and regulatory framework. The general purpose commercial and industrial taxonomy is expected to be ready by the end of May, 2008. Thereafter, sector-specific taxonomy for banking and insurance would be taken up. Besides developing the taxonomy, the Institute is also in the process of establishing the Institute as Indian jurisdiction of XBRL International, which is a non-profit consortium of a large number of organisations and government agencies worldwide. The Ministry of Corporate Affairs and various regulators namely SEBI, RBI and IRDA are supporting the Institute in establishing ICAI as the Indian jurisdiction of XBRL.

Articled Training

You will appreciate that articled training is an important part of the CA curriculum. To ensure that

this training is carried out in accordance with the schemes framed by the Institute and to clarify doubts being raised about the working hours of the articled assistants, the Council has recently issued directions in this regard. These directions aim to ensure compliance including the requirement on part of articled assistants to seek requisite permission in Form 112 to ensure that the working hours do not clash with the graduation or any other course. In this context, we must appreciate that a distinct characteristic of a Chartered Accountant is his proven ability to apply his or her theoretical knowledge to practical situations. The practical training, which he/she gets as an articled assistant, plays a paramount role here. This training not only helps build the core strength of the CA but is also crucial to maintaining high standards of the profession. The fast changing business environment and ever-increasing exposure of professionals to newer and newer areas and sectors have made such training more crucial than ever before. As such, the practical training must be taken very seriously not only by the articled assistants but also by the principals who impart the training. There is a need on part of the principals also to enhance the quality, range and depth of practical training and make it more systematic and comprehensive to help articled assistants develop into highly skilled multi-purpose professionals. To those students who wish to pursue graduation or post-graduation course, I wish to say that the Institute has signed a memorandum of understanding with Indira Gandhi National Open University (IGNOU) under which CA students will get exemption from papers in certain common subjects and can pursue the B.Com as well as M.Com course in accelerated mode.

French Delegation

A delegation led by Mr. Hubert Reynier, Managing Director of the Regulatory Policy and International Affairs Division, AMF along with Mr. Patrice Aguesse, Head of Regulation of Financial Disclosures and Corporate Financing, AMF and Mr. Patrick Parent, Deputy Head of Corporate Accounting and Auditing Division, AMF visited the Institute at SEBI's initiative recently. We interacted with the delegation on the enforcement of accounting standards and auditors' oversight in India. Both the Institutes, together with SEBI and the Ministry of Corporate Affairs, also discussed the challenges being faced by India and France in the convergence programme. I am sure that working together for the convergence with International standards will help both the countries.

Delivery of Journal at Residential Address on Request

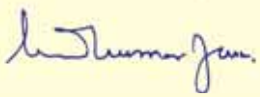
Presently the monthly journal of the Institute is delivered only at the professional address registered with the Institute. However, with a view to ensuring timely delivery of the journal to members and to enable them to read it at their convenience, it has been decided to give an option to the members to get their copy of journal at the residential address, if they so desire. All those members who are desirous of getting the journal at the residential address may send a request in writing. I may further inform members that the Institute's journal, including those of earlier months, are also available at the Institute's website – www.icai.org in an easy to read format.

Diamond Jubilee Suggestions

As I had said in my earlier communication, we will be celebrating the Institute's Diamond Jubilee from 1st July, 2008. We intend to come out with the compilation of important events and the experiences through which the Institute and its members have passed since its inception. I request all of you, particularly my senior members, to share their experiences, memorable moments and other important events, etc. about the Institute to make the publication truly reflect the Institute's journey during the last 59 years. The Diamond Jubilee is, I need hardly say, an occasion, which calls for participation of each and every one of us. Please send your suggestions as to how best we could celebrate the event in a befitting manner and make it truly memorable.

Before I conclude, let me remind you that as facilitators of credibility to the country's financial structure and system, we have to have the best of skills, the most up-to-date knowledge, a clear mission and the highest integrity to bind it all together in alignment with the changing facets of Indian economy. The country expects us to epitomise excellence and ethics today as well as tomorrow.

Sincerely Yours,



CA. Ved Jain

New Delhi, April 25, 2008

WRITE READERS

Journal Informative, Up-to-Date

I regularly receive issues of your remarkable magazine, thanks to the attentiveness of the Embassy of India, in Zimbabwe. As a past-President of the Institute of Chartered Accountants of Zimbabwe, I am privileged to receive diverse professional magazines from many parts of the world. Consistently your magazine is one of the most outstanding of all those publications I receive, being exceptionally informative, up-to-date, exceptionally well-presented, highly educational, and consistent with the principles that are the foundation of the profession. I sincerely congratulate you on your exemplary journal.

--Eric Bloch, Past President ICA of Zimbabwe

'Information is Power'

We are in the realm of globalization, deregulation, convergence and inclusiveness. Among the key challenges are - Managing information and devising ways of ongoing sustainability. Information management implies - transmitting the right information to the right person in the right channel at the right time. In today's knowledge- based economy an important role of the CA fraternity is to set up knowledge centers within the organization which will hand-hold the entity in global best practices and benchmark the same as standards to be emulated by others. CAs are expected to contribute significantly to various aspects of governance, strategy, compliance and risk management. The world-wide quest for superior information systems, knowledge portals, data warehouses and the continuous thrust on R&D underlines the tremendous power of information. As we step into the era of nano-technology, we need to further develop and update our knowledge hubs, sharpen our information management skills, be critical of the value we bring to the table in terms of our service quality and be ever-vigilant of the extent to which we meet and exceed stakeholder expectations. Information harnessing, assimilation and dissemination is a continuous process which requires dedicated, focused and conscious efforts. We need to address this with due sincerity and steadfastness.

-CA. Arijit Chakraborty, Kolkata

Forward March of Profession

There are only few types of professions in the world which are held in high esteem in public eye and the accountancy profession is one of them. The profession plays a pro-active role in promoting economic development by lending credibility to the financial structure and systems at a macro as well as micro level. Accounting and accountability are core to the accounting profession. The challenge lies in using the core competence of the profession not only to act as an accountant and auditor but also as an analyst, consultant, manager and reformist. There is an urgent need for paradigm shift in the thinking and vision of the accountancy profession from a post-mortem approach to a position of leadership, guiding decision making process at every stage of development, i.e planning, policy making, investment, implementation and evaluation. The profession has to gear up for this formidable challenge to better play its vital role in national and global development.

--Mrityunjay Kumar Jha, Director Mithila School of Commerce, Darbhanga

Residential Programme(s)

The new pattern of organising residential programme(s) by ICAI in general management, personality development & communication skills is highly commendable. It would certainly enhance the confidence of the students and create the right attitude of professionalism in them. I congratulate ICAI for taking such initiatives in the larger interest of the profession.

--Arti Kalra, CA Final Student, Jalandhar

Inspiring Chartered Accountants

I am highly inspired by the stories of the honest, daring and unbeatable CAs highlighted in the journal. These include CAs like Anita Jauhari who fulfilled her dream to become a Chartered Accountant even after having mountains of difficulties in her life, C.A Neha Bansal who never lost hope despite having paralysis attack, and C.A Paras Duggar and C.A Rajesh Rattan who have lost their life on the line of professional duties. More such cases need to be highlighted in the journal.

--Ajay Dogra, PCC Student, Ambala Cantt

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 or write to: The Editor, The Journal Section, ICAI Bhawan, C-1, Sector 1, Noida (U.P.) 201 301.

- Editor

A goal without a plan is just a wish.

Latest - At a Glance

Members

- The Council has issued a clarificatory announcement regarding Accounting for Derivatives which applies to financial statements for the period ending March 31, 2008 or thereafter.
- Announcements on 'Accounting for exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction' withdrawn.
- Fee for repeating the Information System Audit Professional Training classes has been revised from Rs.1000/- to Rs.2500/-.
- Exposure draft of Revised Standard on Auditing (SA) 260 '*Communication with Those Charged with Governance*' has been issued.
- Post Budget Memorandum – 2008 of ICAI has been submitted to the Ministry of Finance.

Students

- In view of the Election to the Karnataka Legislative Assembly scheduled to be held on 10th May, 2008, Paper 8- Indirect Taxes of the Final Examination of May 08 at **Bangalore and Mysore centres** scheduled to be held on 10th May, 2008 has been postponed and the same will now be held on 12th May, 2008 from 8.00 A.M. to 11.00 A.M.
- Important announcement regarding working hours of the Articled Assistant(s) has been issued by the ICAI and published elsewhere in the journal.

Suggestions Invited for ICAI Diamond Jubilee

As you may be aware, our Institute is entering into the Diamond Jubilee year on 1st July, 2008. For the purpose of commemorating the occasion in a befitting manner, a Diamond Jubilee Committee has been constituted at the Central Council level. This Committee is currently in the process of finalising various activities to be carried out during the year. In the process of formulating its action plan, the Committee has decided to seek the suggestions of the membership at large as well.

Accordingly, you are requested to kindly send your suggestions on the activities that may be undertaken by the Institute and its organs, as a part of the Diamond Jubilee celebrations, in a manner that befits the profession and further enhances the image of the Institute in the eyes of the public at large.

Your suggestions may be emailed to: djc@icai.org

Announcement
For Members in Industry

In order to ensure better delivery of journal to members in the industry, who generally change their jobs more frequently, the Editorial Board has decided to give them an option to get their copy of the journal *The Chartered Accountant* at his/her residential address in case they so desire. In view of the above, those members who are working in the industry and desire to receive their journal at their residential address may send a duly signed request for the same at their respective regional offices. Members in the industry may note that they may exercise this option for the purpose of the journal only and they will continue to receive all other communications from the Institute at their professional address only.

Convergence of Accounting Standards World Over With IFRS

While convergence can have a wide variety of different meanings, it is generally assumed that, ultimately, all standard setters should agree on a single, high-quality answer. The accounting standards setters throughout the globe are working together & collaborating on projects & are moving towards convergence as they address urgent issues & improve accounting procedures.

During the past few years, the accountancy profession has been significantly challenged and changed. Far-reaching measures have been undertaken in this regard by professional institutions as well as regulators. One of the most important of such measures has been an attempt to create a global financial reporting infrastructure. The most significant resultant development is the adoption of International Accounting Standards by a large number of countries. This article delves into the concept of convergence of accounting standards with IFRS.

— CA. Rajkumar S. Adukia

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

The process of adoption of International Accounting standards gained momentum after the decision taken by the EU to make IFRS mandatory for all its listed companies starting 2005. Consequently, more than 8,000 EU listed companies adopted IFRS in one go. Today, more than 100 countries require or permit the use of the IFRSs by various entities like listed entities, banks etc.

Why this fascination with adoption or convergence, one might ask. The answer is—sound business sense. Increasing cross border investing and proliferation of financial products has posed a challenge to accountants as they faced multiple standards. Harmonisation and convergence of standards can greatly contribute to the efforts to build global financial reporting infrastructure. While convergence can have a wide variety of different meanings, it is generally assumed that, ultimately, all standard setters should agree on a single, high-quality answer. The accounting standards setters throughout the globe are working together and collaborating on projects and are moving towards convergence as they address urgent issues and improve accounting procedures.

A single set of accounting standards would enable international auditing firms to standardise training and better assure the quality of their work on a global scale. It would also permit international capital to flow more freely, enabling auditing firms and their clients to develop consistent global practice on accounting problems. It would be beneficial to regulators too, as the complexity associated with needing to understand various reporting regimes would be reduced.

Apart from this, experience has shown that rule-based accounting leads companies to work around the rule. For example, in US, many airlines arrange most of their long-term leases as operating leases when, in fact, it can be argued that in substance they are capital leases. To stop such transaction structuring, the need is to move away from ' rules and closer to standards based on principles (like the IFRS).

IFRS in European Union

In June 2002, the European Commission (EC) published its communication entitled 'European Union (EU) Financial Reporting Strategy: The Way Forward' which proposed that all listed companies prepare their consolidated accounts in accordance with one single set of accounting

A single set of accounting standards would enable international auditing firms to standardise training and assure better quality of their work on a global scale. It would also permit international capital to flow more freely, enabling auditing firms and their clients to develop consistent global practice on accounting problems. It would be beneficial to regulators too, as the complexity associated with needing to understand various reporting regimes would be reduced.

standards, namely International Accounting Standards (IAS), latest by 2005. The EU decision to require IFRS for listed companies' consolidated accounts was a significant event in the drive towards convergence.

A major assumption of the proponents of convergence is that countries will adopt IFRS "as issued by the IASB" (i.e., with no modifications) for all companies. However, the EU has limited convergence in two important ways, thereby introducing "speed bumps" along the road to convergence.

EU convergence with IFRS beyond listed companies' consolidated financial statements: The EC has not mandated complete convergence within EU member countries. Regulation 1606/2002 allows each of the 25 member countries to determine whether "EU-endorsed IFRS" is required or allowed in preparation of listed companies' individual financial statements and non-listed companies' consolidated or individual financial statements. Thus, the position in relation to non-listed companies varies at the discretion of individual member states of the EU. The majority position on this is that IFRSs are not mandatory but permitted for non-listed companies in most EU countries. Clearly, a "two-standard" system is emerging in much of the EU, whereby IFRSs are used for listed companies' consolidated accounts

while national standards are required for individual accounts. This likely stem from a desire to maintain the tax orientation (i.e., the alignment between financial reporting standards and tax rules) in several continental European countries.

European Economic Area (EEA) members have responded more positively to convergence. The EEA agreement of 1994 allows Iceland, Liechtenstein and Norway to participate in the EU single market without full EU membership but they have to comply with EU accounting regulations and directives. All three EEA members require listed companies to prepare consolidated statements using IFRS. Also, they allow IFRS to be used for the consolidated and individual accounts of non-listed companies, except in the case of small companies in Iceland.

However, companies will find themselves implementing IFRS through the back door, as local GAAP (Generally Accepted Accounting Principles) increasingly converges with IFRS.

EU-Endorsed IFRS: The EU requires companies to use only those IFRSs, which the EU has specifically determined to be suitable for use in the EU (i.e., endorsed). Indeed, the EU has established an endorsement process to determine whether each IASB standard and interpretation will be approved for use in the EU, thereby introducing another speed bump to convergence.

First, the European Financial Reporting Advisory Group (EFRAG) technically assesses each new standard and interpretation approved by the IASB and submits the assessment to the EC. Then, the Standards Advice Review Group (SARG) reviews EFRAG's opinions to ensure their objectivity and proper balance. The EC then submits the proposed standard to the European Parliament and the Accounting Regulatory Committee (ARC). After approval by the ARC and the European Parliament, the EC formally decides on the use of new IASB standards and interpretations within the EU. The final part of the process requires the EC to adopt new IFRSs and publish them in the *Official Journal of the EU*. This step requires that standards be published in all 20 official EU languages.

"EU-endorsed IFRS" has enormous implications. On a positive note, the time-consuming process notwithstanding, the EU has eventually endorsed almost all IFRSs put before it. It, however, carved out some paragraphs of IAS 39 (paragraphs 9b, 35, and 81a) to yield a EU-endorsed IAS 39, which generated considerable controversy. After much discussion, in 2005 the IASB approved an amendment to eliminate some of the controversial provisions in IAS 39. It also did not endorse IFRIC 3 Emission Rights. The EU requirement to examine every IASB rule before endorsing it, even though the standards were previously approved through the IASB's own elaborate process, raises concern for the goal of convergence between the EU and United States.

China and IFRS

Chinese government in 2006 decided that companies would adopt International Financial Reporting Standards (IFRS). Lou Jiwei, Beijing's vice finance minister, said China would adopt "one basic accounting standard." This move would boost the credibility in China-based companies and attract more foreign investors. The new rules will apply to listed companies beginning January 1, 2007.

Chinese plan was to adopt a principles-based approach to the new accounting rules and then translate them into its own code, the Chinese Accounting Standards System. The system would embrace "fair-value" accounting principles, which is in sync with international practice. However, some exceptions would be made. For example, state enterprises would be exempt from the "related-party" disclosure provisions because of the dominance of government enterprises, as otherwise 95 per cent of the economy would be a related party. Some changes are expected to the "impairment of assets" provisions, which allow companies to write down the val-

ue of businesses, physical assets, and goodwill, as well as revalue assets upward if conditions change.

Convergence with US GAAP

Perhaps the biggest barrier to a truly global set of international accounting standards is the need to converge US GAAP with IFRS and already many steps are being taken in this regard. At their joint meeting in Norwalk, Connecticut, USA on September 18, 2002, both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting.

To achieve compatibility, the FASB and IASB agreed to give high priority to:

a. undertake a short-term project aimed at removing a variety of individual differences between US GAAP and International Financial Reporting Standards;

b. remove other differences between IFRS and US GAAP that will remain at January 1, 2005 through coordination of their future work programs, that is; through the mutual undertaking of discrete, substantial projects which both Boards would address concurrently;

c. continue progress on the joint projects that they are currently undertaking; and,

d. encourage their respective interpretative bodies to coordinate their activities.

Significant progress has been made since the Norwalk Agreement. FASB and the IASB have been meeting on a regular basis, and FASB has issued several standards that eliminate differences with IFRS (i.e., SFASs 151, 153, and 154) and amended one (SFAS 123) to be more in line with IFRS. FASB and the IASB are also working jointly to develop common standards in several key areas, including business combinations (applying the acquisition method), revenue recognition, liability extinguishment, leasing, and financial performance reporting by business entities. Additionally, a long-term project is underway to develop a common conceptual framework that will incorporate significant improvements. Short-term convergence projects are examining earnings per share, income taxes, and research and development.

There is immense opportunity in the realm of financial accounting as well. Foreign investors are more likely to invest in firms whose accounting is similar to accounting of the country of the investors. This will benefit not only Indian businesses and capital markets but also increase professional opportunities for Indian accountants once accounting in India is identical to that in Western Europe, which adopted IFRS in 2005.

The IASB, on its part, has modified several of its standards in line with US GAAP, a recent example being IFRS 8 Operating Segments issued in November 2006 that aligns IASB segment reporting requirements with SFAS 131 by requiring adoption of the management approach. Given the many changes associated with US GAAP convergence, and in order to allow companies time to translate and implement new IFRS, the IASB decided in July 2006 that no new major IFRS will be effective until January 1, 2009. However, the IASB will continue to work jointly with FASB during this time on the development of new standards.

The Roadmap in United States

In April 2005, the top EU and Securities and Exchange Commission (SEC) officials agreed on a roadmap toward "equivalence" between

IFRS and US GAAP. The roadmap is essentially an iterative set of reviews on the convergence process until the SEC staff decides whether and when it can recommend to the SEC that the IFRS–to–US GAAP–reconciliation requirement be eliminated. The target date is officially 2009, or possibly sooner. The roadmap itself is a 25-page document setting forth a series of steps and standards to be met before IFRS will be accepted by the SEC as equivalent to US GAAP for non-US private issuers.

Perhaps the biggest barrier to a truly global set of international accounting standards is the need to converge US GAAP with IFRS and already many steps are being taken in this regard. At their joint meeting in Norwalk, Connecticut, USA on September 18, 2002, both the FASB & the IASB acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic & cross-border financial reporting.

The key points of the roadmap are that FASB and the IASB must continue their convergence efforts and that high-quality standards must remain a cornerstone. The SEC has also stressed that the two boards should not focus on converging standards that need significant improvement. Rather, they should work jointly to develop new reporting requirements in areas where both US GAAP and IFRS require improvement. SEC Deputy Chief Accountant Julie Erhardt recommended that FASB and the IASB "tackle the toughest, most intractable and problematic standard setting issues." She specifically highlighted the need for the boards to prioritise financial instruments, performance reporting, revenue recognition, pensions, leases, and consolidation policy.

As part of the roadmap, the SEC will review the faithfulness and consistency of foreign private-issuer IFRS financial statements and their reconciliation to US GAAP from 2005 onwards. In August 2006, the SEC developed a work plan with the EU's Committee of European Securities Regulators (CESR) to promote "the high quality and consistent application of IFRS around the world."

In a press statement on 24th April 2007, the SEC said its plans to issue a proposal to allow the use of IFRS in financial reports filed by foreign private issuers that are registered with the Commission. It also indicated the possibility that the SEC could give US based companies the option of using IFRS for their financial statements instead of US GAAP. Finally on 20th June 2007 SEC announced its proposal to allow IFRS based financial statements of foreign issuers to be filed without any reconciliation requirement. The comment period was set at 75 days from date of publication in the Federal Register. The proposed amendments would:

- apply to foreign private issuers that file financial statements which comply with

the English language version of IFRS as published by the IASB, and

- allow those issuers to file those financial statements in their annual filings and registration statements without reconciliation to US GAAP.

IFRS in India

It is anticipated that number of countries adopting IFRS will be 150 in next five years, which means adoption by most countries. Within India, the issue of convergence with IFRSs has been raised time and again at various forums. If we adopt IFRS now, we will have an opportunity to influence and shape how international accounting standards are set. Since this window of opportunity will pass fairly soon, the Indian industry, government, and the accounting profession need to move quickly towards adopting IFRS.

There is immense opportunity in the realm of financial accounting as well. Foreign investors are more likely to invest in firms whose accounting is similar to accounting of the country of the investors. This will benefit not only Indian businesses and capital markets but also increase professional opportunities for Indian accountants once accounting in India is identical to that in Western Europe, which adopted IFRS in 2005.

The Council of the Institute of Chartered Accountants of India (ICAI), at its meeting in May 2006, expressed the view that the IFRSs may be adopted in totality at least for listed and large entities, also keeping in view the expected advantages such as saving in cost of capital, saving in cost for preparation of separate set of financial statements, and increasing opportunities for Indian professionals abroad. Indian accounting standards are fairly closely aligned with IFRS. In respect of the recently issued Accounting Standards, there are hardly any divergences from the corresponding IFRSs. So the switch to IFRS will be fairly easy.

To consider the issues involved in detail, the Council referred the matter to the Accounting Standards Board. The Accounting Standards Board (ASB) was, however, of the view that there were various implications of converging with IFRSs and that certain issues were required to be addressed such as the conflicting legal and regulatory requirements related to financial statements, the technical preparedness of industry and accounting professionals, economic environment prevailing in the country, etc. The Board also felt that convergence would significantly affect not only the status of accounting discipline in the country but would also affect its economy and therefore a concept paper should be developed to discuss the issues involving various interest-groups like the government, the National Advisory Committee on Accounting Standards, regulators, and industry associations.

The Concept Paper thus released provides an introduction discussing needs, objectives and effectiveness of convergence with IFRSs. It then evaluates the present status of Indian Accounting Standards, vis-à-vis, the International Financial Reporting Standards. It also proposes the strategy for convergence with IFRSs including the approach to be followed in this regard and the road map for convergence.

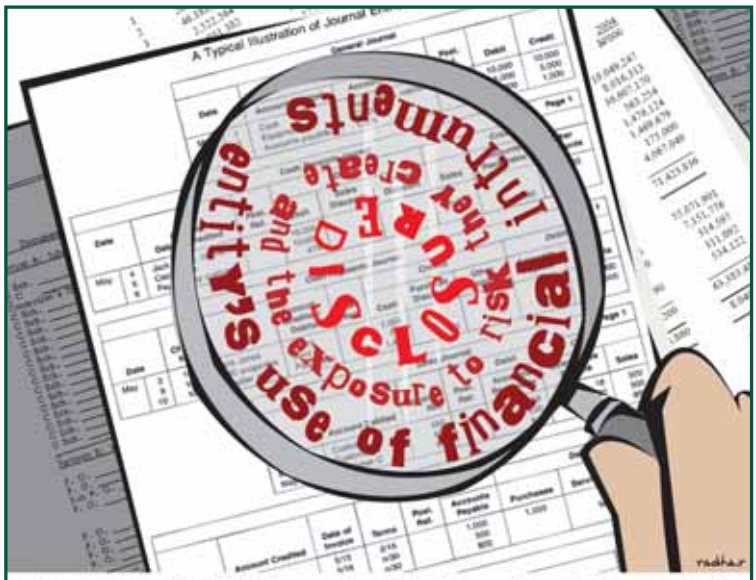
List of International Financial Reporting Standards

1	IFRS 1	First-time Adoption of International Financial Reporting Standards
2	IFRS 2	Share-based Payment
3	IFRS 3	Business Combinations
4	IFRS 4	Insurance Contracts
5	IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
6	IFRS 6	Exploration for and Evaluation of Mineral Assets

7	IFRS 7	Financial Instruments: Disclosures
8	IFRS 8	Operating Segments
9	IAS 1	Presentation of Financial Statements
10	IAS 2	Inventories
	IAS 5	Information to Be Disclosed in Financial Statement Superseded by IAS 1 in 1997
	IAS 6	Accounting Responses to Changing Prices Superseded by IAS 15
11	IAS 7	Cash Flow Statements
12	IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
	IAS 9	Accounting for Research and Development Activities Superseded by IAS 38
13	IAS 10	Events After the Balance Sheet Date
14	IAS 11	Construction Contracts
15	IAS 12	Income Taxes
	IAS 13	Presentation of Current Assets and Current Liabilities Superseded by IAS 1
16	IAS 14	Segment Reporting
	IAS 15	Information Reflecting the Effects of Changing Prices Withdrawn December 2003
17	IAS 16	Property, Plant and Equipment
18	IAS 17	Leases
19	IAS 18	Revenue
20	IAS 19	Employee Benefits
21	IAS 20	Accounting for Government Grants and Disclosure of Government Assistance

22	IAS 21	The Effects of Changes in Foreign Exchange Rates
	IAS 22	Business Combinations Superseded by IFRS 3
23	IAS 23	Borrowing Costs
24	IAS 24	Related Party Disclosures
	IAS 25	Accounting for Investments Superseded by IAS 39 and IAS 40
25	IAS 26	Accounting and Reporting by Retirement Benefit Plans
26	IAS 27	Consolidated and Separate Financial Statements
27	IAS 28	Investments in Associates
28	IAS 29	Financial Reporting in Hyperinflationary Economies
	IAS 30	Disclosures in the Financial Statements of Banks and Similar Financial Institutions Superseded by IFRS 7
29	IAS 31	Interests In Joint Ventures
	IAS 32	Financial Instruments: Presentation Disclosure provisions superseded by IFRS 7
30	IAS 33	Earnings Per Share
31	IAS 34	Interim Financial Reporting
	IAS 35	Discontinuing Operations Superseded by IFRS 5 effective 2005
32	IAS 36	Impairment of Assets
33	IAS 37	Provisions, Contingent Liabilities and Contingent Assets
34	IAS 38	Intangible Assets
35	IAS 39	Financial Instruments: Recognition and Measurement
36	IAS 40	Investment Property
37	IAS 41	Agriculture

Disclosure Requirements Introduced by 'IFRS 7, *Financial Instruments: Disclosures*'



The objective of IFRS 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate the significance of financial instruments for the entity's financial position & performance & the nature & extent of risks arising from financial instruments to which the entity is exposed during the period & at the reporting date & how the entity manages those risks.

The International Financial Reporting Standard (IFRS) 7, *Financial Instruments: Disclosures*, which replaces International Accounting Standard (IAS) 30 and IAS 32, introduces new disclosure requirements that companies need to take into account to improve the information on financial instruments that is given in entities' financial statements. The principles in IFRS 7 complement the principles for recognising, measuring and presenting financial assets and financial liabilities in IAS 32 and IAS 39.

— K.S. Muthupandian

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The International Accounting Standards Board's (IASB) predecessor body, the International Accounting Standards Committee issued IAS 32, *Financial Instruments: Disclosure and Presentation* in 1995 and IAS 39, *Financial Instruments: Recognition and Measurement* in 1999. Since then, several amendments have been made to these standards and on 18th August 2005 the IASB issued IFRS 7, *Financial Instruments: Disclosures.* All the previous disclosure requirements in IAS 32 are superseded by IFRS 7, which deals only with disclosure. The remaining parts of IAS 32 (whose title has been shortened to reflect the change) are still effective

and renamed as *Financial Instruments: Presentation*, deal only with presentation matters, including classifying instruments as debt or equity, compound financial instruments, offsetting, and treasury shares. The IFRS 7 combines the disclosure requirements arising from IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* and IAS 32 in a new standard. As a result, IAS 30 and the disclosure requirements (paragraphs 51 to 95) of IAS 32 have been withdrawn. The IFRS 7 disclosure requirements are less prescriptive than those of IAS 30 for banks and there are no longer any bank-specific disclosure requirements.

The IFRS 7 adds new disclosures about financial instruments to those currently required by IAS 32 (including amendments issued in 2005 for *The Fair Value Option* and *Financial Guarantee Contracts*). It replaces the disclosure requirements imposed on financial institutions by IAS 30 so that all financial instruments disclosure requirements are placed in a single standard for all types of companies. The IFRS 7 also puts all of those financial instruments disclosures together in a new combined Standard.

Scope

The IFRS 7 applies to financial and non-financial institutions. The extent of disclosure required depends on the extent of the entity's use of financial instruments and its exposure to risk. It applies to both recognised and unrecognised financial instruments. IFRS 7 does not apply solely to financial institutions and companies with large portfolios of financial instruments. The Standard applies to all entities irrespective of the size of financial instruments held as it focuses on the risks inherent in financial instruments. It is only the extent of disclosure that changes. Hence, companies which previously remained unaffected to a large extent may now find themselves falling under IFRS 7 and will need to prepare additional disclosures in the financial statements.

IFRS 7 does not apply solely to financial institutions and companies with large portfolios of financial instruments. The Standard applies to all entities irrespective of the size of financial instruments held as it focuses on the risks inherent in financial instruments. It is only the extent of disclosure that changes.

The following are excluded from the scope of IFRS 7:

- Interests in subsidiaries, associates, and joint ventures.
- Employee benefit plan obligations.
- Contingent consideration in a business combination.
- Insurance contracts.
- Share-based payment transactions.

Consistent with IAS 30 and IAS 32, there is no scope of exemption for the financial statements of subsidiaries or, as yet, for Small and Medium-sized Entities (SMEs). The IASB has issued an Exposure Draft (ED) of a proposed IFRS for SMEs that proposes to provide such entities with the option of applying either: (1) the special rules for financial instruments contained in the ED and no requirement to apply IFRS 7, or (2) the recognition and measurement rules in IAS 39 and disclosure requirements in IFRS 7.

Background

The primary objective of IFRS 7 is to provide risk and financial instrument disclosures that enable users to evaluate the significance of financial instruments to an entity's financial position and performance. Furthermore, IFRS 7 requires disclosure of the nature and extent of risks arising from financial instruments to which an entity is exposed and how those risks have been managed. Importantly, the level of disclosure required will depend on the extent of the entity's use of financial instruments and its exposure to financial risk.

Effective Date

IFRS 7 is effective for annual periods beginning on or after 1st January 2007, with earlier application encouraged, but not required. If an entity

applies IFRS 7 for a period beginning before 1st January 2007, that fact should be disclosed. Early adopters are given some relief with respect to comparative prior period disclosures. For many IFRS preparers, the new standard will result in more onerous disclosure requirements.

Objective

The objective of IFRS 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) The significance of financial instruments for the entity's financial position and performance; and

(b) The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

The overriding objective of IFRS 7 is that preparers should provide disclosures that enhance a user's understanding of the entity's exposures to financial risks and how the entity manages those risks.

Overview

IFRS 7 deals with the disclosure requirements in relation to all risks arising from financial instruments (with limited exemptions), and applies to any entity that holds financial instruments. The level of disclosure required depends on the extent of the entity's use of financial instruments and its exposure to financial risk.

The IFRS 7 retains many of the disclosure requirements currently within IAS 32 and IAS 30. IAS 32 disclosures retained in IFRS 7 include:

- Total interest income and total interest expense (calculated using the effective interest method) for financial assets and financial liabilities that are not measured at fair value through profit or loss.
- Gains or losses on available-for-sale financial assets recognised in equity and the amounts reclassified from equity to profit or loss for the period.

IFRS 7 makes a number of important improvements to disclosures in financial statements. IFRS 7 necessitates disclosure of information not previously required. Unfortunately, some companies may find that their existing financial reporting systems do not capture all the information they now need to disclose.

- Interest accrued on impaired financial assets.

However, there have been some editorial changes to the existing requirements as well as some additional disclosure requirements added. To this end, the IFRS 7 requires an entity to disclose:

- Information on the significance of financial instruments to the entity's financial position and performance;
- The nature and extent of risk exposures arising from financial instruments (quantitative disclosures); and
- The approach taken in managing those risks (qualitative disclosures).

Qualitative narrative and quantitative specific information about exposure to risks arise from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk. The qualitative disclosures describe management's objectives, policies and processes for managing those risks. The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. Together, these disclosures provide an overview of the entity's use of financial instruments and the exposures to risks they create.

Principal Changes From IAS 30 and IAS 32

The more significant changes from the disclosure requirements of IAS 30 and IAS 32 include:

- A new requirement to disclose the carrying amounts of financial assets and financial liabilities by category, either on the face of the balance sheet or in the notes. (The word 'category' refers to the categories of financial instruments defined in IAS 39, i.e., financial assets or liabilities designated as at fair value through profit or loss (FVTPL), held-to-maturity investments, loans and receivables, available-for-sale financial assets, and financial liabilities measured at amortised cost);
- New disclosure requirements regarding loans and receivables designated as at FVTPL;
- The requirement to disclose the fair value movement on financial liabilities designated as at FVTPL due to changes in credit risk has also been extended to include loans and receivables designated as at FVTPL. In addition, entities are required to disclose the method used to determine the amount of the change;
- New disclosure requirements where there is a difference between the fair value of a financial instrument at initial recognition and the amount that would be determined at that date using a valuation technique (known as "day one profit or loss"). IFRS 7 requires disclosure of the entity's accounting policy for recognising that difference in profit or loss, and the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference;
- New disclosure requirements for financial assets that are either past due or impaired. IFRS 7 requires an analysis of the age of financial assets that are past due and, unless impracticable, an estimate of the fair value of collaterals held by the entity;
- Where an entity records an impairment on a financial asset or a group of financial assets through an allowance account (e.g., for bad debts), as opposed to recording a direct reduction to the carrying amount of the financial asset, it shall disclose, for each class of financial asset, a reconciliation of changes in carrying amounts in that account during the period;
- Separate disclosure of the amount of ineffectiveness recognised in profit or loss on cash flow hedges and hedges of net investments in foreign operations;
- Separate disclosure of the gains or losses in fair value hedges arising from remeasuring the hedging instrument and on the hedged item attributable to the hedged risk;
- Disclosure of the net gain or loss for the following categories of financial assets and liabilities: held-to-maturity investments, loans and receivables, and financial liabilities measured at amortised cost; and
- Additional requirements on providing sensitivity analysis of market risks and how changes in these risks would have impacted profit or loss and equity in the period.

Some of the mandatory disclosures previously required by IAS 32 have been eliminated. At the same time, IFRS 7 introduces a number additional and far reaching disclosure requirements.

The most significant additions include the:

- Requirement to provide quantitative data of exposures to the relevant financial risk at the reporting date based on information reported internally to key management personnel of the entity;
- Preparation of a market risk sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date showing how profit or loss

and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date (alternatively, a sensitivity analysis, such as value at risk (VaR), that is used to manage financial risks may be used);

- Disclosure of the credit quality of financial assets that are neither past due nor impaired;
- Presentation of various disclosures for financial assets that are either past due or impaired;
- Preparation of a reconciliation of the amount yet to be recognised at the beginning and end of the period with respect to profit or loss to be recorded when a financial instrument is initially recognised (day one profit or loss) together with an accounting policy for the recognition of those amounts in profit or loss;
- Disclosure of the carrying amounts of financial assets and financial liabilities under each of the classifications of IAS 39, together with net gains and losses for each of those categories; and
- Disclosure of the hedge ineffectiveness.

Disclosure Requirements

IFRS 7 is divided into two distinct sections. The first covers disclosures about the numbers in the balance sheet and the income statement. The second deals with risk disclosures. IFRS 7 introduces new and amended disclosure requirements for entities preparing IFRS financial statements. The instruments covered by IFRS 7 are extensive, ranging from straightforward instruments such as bank accounts, trade receivables and trade payables to more complex financial instruments such as derivatives. Accordingly, IFRS 7 is likely to be relevant for all entities applying IFRS financial statements, including non-financial services entities.

The IFRS 7 also requires information about the extent to which the entity is exposed to risks arising from financial instruments, and a description of management's objectives, policies and processes for managing those risks. Together, these disclosures provide an overview of the entity's use of financial instruments and the exposures to risks they create. The extent of disclosure required depends on the extent of the entity's use of financial instruments and of its exposure to risk.

IFRS 7 retains the qualitative disclosures required by IAS 32 relating to risks (i.e., credit risk, liquidity risk, and market risk) arising from financial instruments to which a company is exposed, including a discussion of management's objectives and policies for managing such risks.

When IFRS 7 requires disclosures by class of financial instrument, an entity shall group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. An entity shall provide sufficient information to permit reconciliation to the line items presented in the balance sheet.

The financial instrument disclosures are intended: (1) to provide information that will enhance the understanding of the significance of financial instruments to a company's financial position, performance, and cash flows; and (2) to assist in evaluating the risks associated with these instruments, including how the company manages those risks.

The disclosure checklist that may be used to assist in checking of completeness of an entity's disclosures in a re-formatted extract from IFRS 7 is given in Table A.

Other Disclosures

Many of IFRS 7's other disclosure requirements may necessitate an update of an entity's internal financial reporting processes to obtain the

underlying data. IFRS 7 does not specify how an entity should present its financial instruments on the face of the balance sheet. Paragraph 8 of IFRS 7 does, however, require entities to disclose the carrying amount of its financial instruments by each of the IAS 39 categories. This may be done either:

- By presenting balance sheet line items that specifically refer to the category that a financial asset or financial liability has been classified into;
- By disclosure of the amounts in the notes; or
- By a combination of these approaches.

Hedge Accounting

IFRS 7 expands on the requirements of IAS 32 in that the gain or loss on a hedging instrument in a cash flow hedge that is transferred from equity to profit or loss must be analysed by income statement caption. Additionally, IFRS introduces the requirement to disclose the amount of ineffectiveness recognised in profit or loss for cash flow hedges and hedges of net investments in foreign operations, and the gain or loss during the period on the hedging instrument and hedged item attributable to the hedged risk for fair value hedges.

Fair Value

IFRS 7 retains the IAS 32 disclosures relating to the methods and significant assumptions used to determine fair value for the different classes of financial assets and financial liabilities.

IFRS 7 deals with the disclosure requirements in relation to all risks arising from financial instruments (with limited exemptions), and applies to any entity that holds financial instruments. The level of disclosure required depends on the extent of the entity's use of financial instruments and its exposure to financial risk.

Qualitative Risk Disclosures

IFRS 7 identifies the following main types of risk:

- Credit risk, i.e., the risk that the entity will experience a financial loss due to a counterparty failing to discharge an obligation;
- Liquidity risk, i.e., the risk that the entity will encounter difficulty in meeting its obligations arising from financial liabilities; and
- Market risk, i.e., the risk that the fair value or cash flows of a financial instrument will change because of changes in market conditions.

Market risk can be further subdivided into three main types:

- Currency exchange risk, i.e., the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in exchange rates;
- Interest rate risk, i.e., the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates; and
- Other price risk, i.e., the risk that the fair value or future cash flow of a financial instrument will fluctuate because of changes in market conditions not related to interest rate risk or currency exchange risk.

IFRS 7 retains the qualitative disclosures required by IAS 32 relating to risks (i.e., credit risk, liquidity risk, and market risk) arising from financial instruments to which a company is exposed, including a discussion of management's objectives and policies for managing such risks. The qualitative disclosures are intended to complement the required quantitative disclosures and assist readers of the financial statements to understand the company's risk management activities. IFRS 7 expands the qualitative risk disclosure requirements to include information on the processes

that a company uses to manage and measure its risks.

Quantitative Risk Disclosures

The risk disclosures arising from financial instruments are given 'through the eyes of management'. The information that is provided to key management personnel is the basis for the information that is disclosed. IFRS 7 expands on the quantitative disclosures contained in IAS 32, which are intended to provide information about the extent to which a company is exposed to risks based on the information provided internally to key management personnel. IAS 24, *Related Party Disclosures* defines key management personnel as "those persons having authority and responsibility for planning, directing and controlling the activities of the company, directly or indirectly, including any director (whether executive or otherwise) of that company." Disclosing information on this basis should save companies time and money, provided that the information they supply internally surpasses the minimum required by IFRS 7.

Credit Risk Disclosures Beefed Up

Credit risk disclosures have also been beefed up, with more detailed disclosure required now about the credit quality of financial assets that are not impaired as at the balance sheet date, and the carrying value of renegotiated assets that would have been past due or impaired as at the balance sheet date. In addition, entities are required to disclose the nature and carrying values of assets obtained as collateral or through calling in guarantees, and its policies for disposing of such assets or for using them in its operations.

Credit Risk: Credit risk is defined as "the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation." For each class of financial instrument, IFRS 7 requires disclosure of the maximum credit exposure before consideration of collateral or other credit enhancements received (for example master netting agreements), plus a description of collateral and other credit enhancements

IFRS 7 retains the qualitative disclosures required by IAS 32 relating to risks (i.e. credit risk, liquidity risk, & market risk) arising from financial instruments to which a company is exposed, including a discussion of management's objectives & policies for managing such risks. The qualitative disclosures are intended to complement the required quantitative disclosures & assist readers of the financial statements to understand the company's risk management activities.

available. A significant development in IFRS 7 is the extensive disclosure requirements regarding the credit quality of all financial assets.

Liquidity Risk: IFRS 7 requires a maturity analysis for financial liabilities to be presented showing their remaining *contractual* maturities, and a description of how the company manages those liquidity risks. In practice, most companies manage liquidity risk based not on contractual cash flows but on expected maturities.

Maturity Analysis: Companies are required to show maturity analysis based on future undiscounted gross contractual cash flows arising from financial liabilities, i.e., what will actually be paid in the future, and not the amounts at which the liabilities are stated in the financial statements.

Market Risk

IFRS 7 does not prescribe a format for financial risk disclosures. However, to meet the requirements of this Standard and organise the necessary disclosures, it may be useful to note that each type of risk needs to be discussed differently. Credit risk needs to be discussed by class of financial instruments, whereas the maturity analysis required explaining liquidity risk exposures

focuses on individual financial liabilities. Market risk exposures are usually explained by the type of risk and illustrated using a sensitivity analysis. Alternatively (or additionally) an integrated sensitivity analysis may be presented to explain market risk exposures, if such an approach is used internally to manage financial risks. Market risk is defined as "the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices" and includes interest rate risk, foreign currency risk and "other price risks", such as equity and commodity risk. All financial instruments are subject to market risk; however, the required market risk quantitative disclosures are restricted to the sensitivity of profit or loss and equity to changes in market risks. The disclosures, therefore, focus on accounting (as opposed to economic) sensitivity and exclude, for example, interest rate risk arising on fixed rate financial assets held to maturity or loans and receivables. Companies may also provide disclosures about such items but, arguably, they would need to be shown separately.

There are two ways in which market risk sensitivity may be disclosed:

- A separate sensitivity analysis for each type of market risk to which the company is exposed at the reporting date, based on changes in the risk variable that are considered "reasonably possible" at that date; or
- An analysis such as VaR that takes into account the inter-dependence between market risk variables, if this method is used by the company to manage its financial risks.

All sensitivity analyses should take into account the effects of hedges but, as the amounts to be disclosed are expected to have effect on profit or loss or equity, the Standard implies that the accounting treatment of the hedges needs to be taken into account in the analysis.

Implementing Sensitivity Analysis / VaR Model

Entities need to produce a quantitative analysis of how profit or loss and equity would have been affected by 'reasonably possible' changes in market movements. Sensitivity analysis is one of the crucial additions under IFRS 7 to disclosure requirements and is mandatory. Sensitivity analysis includes an analysis of the financial risks inherent in financial instruments by disclosing (for each type of market risk) the effect on profit or loss and equity in view of a change in the relevant risk variable (e.g., an increase/decrease in interest rates by certain basis points, or a change in foreign exchange rates by a certain percentage).

The instruments covered by IFRS 7 are extensive, ranging from straightforward instruments such as bank accounts, trade receivables and trade payables to more complex financial instruments such as derivatives. Accordingly, IFRS 7 is likely to be relevant for all entities applying IFRS financial statements, including non-financial services entities.

Position in India

Recently, the Council of the Institute of Chartered Accountants of India has approved the Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and Accounting Standard (AS) 31, *Financial Instruments: Presentation.* These two standards are based on IAS 39 and IAS 32 respectively as part of the convergence of IFRS to India. Accounting Standard corresponding to IFRS 7 is under preparation.

Conclusion

IFRS 7 makes a number of important improvements to disclosures in financial statements. IFRS 7 necessitates disclosure of information not previously required. Unfortunately, some companies may find that their existing financial reporting systems do not capture all the information they now need to disclose.

Table A

IFRS 7 Disclosure Checklist

Para of IFRS 7	Disclosure Requirement
Classes of financial instruments and level of disclosure	
6. When this IFRS requires disclosures by class of financial instrument, an entity shall group financial instruments into classes that are appropriate to the nature of the information disclosed and take into account the characteristics of those financial instruments. An entity shall provide sufficient information to permit reconciliation to the line items presented in the balance sheet.	
Significance of financial instruments for financial position and performance	
7. An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.	
Balance sheet **Categories of financial assets and financial liabilities** 8. The carrying amounts of each of the following categories, as defined in IAS 39, shall be disclosed either on the face of the balance sheet or in the notes: (a) financial assets at fair value through profit or loss, showing separately: (i) those designated as such upon initial recognition; and (ii) those classified as held for trading in accordance with IAS 39; (b) held-to-maturity investments; (c) loans and receivables; (d) available-for-sale financial assets; (e) financial liabilities at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition; and (ii) those classified as held for trading in accordance with IAS 39; and (f) financial liabilities measured at amortised cost.	
Financial assets or financial liabilities at fair value through profit or loss	
9. If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it shall disclose: (a) the maximum exposure to credit risk (paragraph 36(a)) of the loan or receivable (or group of loans or receivables) at the reporting date; (b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk; (c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either: (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or (ii) using an alternative method, which the entity believes more faithfully, represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.	

(d) the amount of the change in the fair value of any related credit derivatives or similar instrument that has occurred during the period and cumulatively since the loan or receivable was designated.

10. If the entity has designated a financial liability as at fair value through profit or loss in accordance with paragraph 9 of IAS 39, it shall disclose:

(a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability determined either:

(i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or

(ii) using an alternative method, which the entity believes more faithfully, represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.

(b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

11. The entity shall disclose:

(a) the methods used to comply with the requirements in paragraphs 9(c) and 10(a).

(b) if the entity believes that the disclosure it has given to comply with the requirements in paragraph 9(c) or 10(a) does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.

Reclassification

12. If the entity has reclassified a financial asset as one measured:

(a) at cost or amortised cost, rather than at fair value; or

(b) at fair value, rather than at cost or amortised cost,

it shall disclose the amount reclassified into and out of each category and the reason for that reclassification (paragraphs 51–54 of IAS 39).

Derecognition

13. An entity may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition (paragraphs 15–37 of IAS 39). The entity shall disclose for each class of such financial assets:

(a) the nature of the assets;

(b) the nature of the risks and rewards of ownership to which the entity remains exposed;

(c) when the entity continues to recognise all of the assets, the carrying amounts of the assets and of the associated liabilities; and

(d) when the entity continues to recognise the assets to the extent of its continuing involvement, the total carrying amount of the original assets, the amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.

Collateral 14. An entity shall disclose: (a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with paragraph 37(a) of IAS 39; and (b) the terms and conditions relating to its pledge.
15. When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it shall disclose: (a) the fair value of the collateral held; (b) the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and (c) the terms and conditions associated with its use of the collateral.
Allowance account for credit losses 16. When financial assets are impaired by credit losses and the entity records the impairment in a separate account (e.g., an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it shall disclose a reconciliation of changes in that account during the period for each class of financial assets.
Compound financial instruments with multiple embedded derivatives 17. If an entity has issued an instrument that contains both a liability and an equity component (paragraph 28 of IAS 32) and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it shall disclose the existence of those features.
Defaults and breaches 18. For loans payable recognised at the reporting date, an entity shall disclose: (a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable; (b) the carrying amount of the loans payable in default at the reporting date; and (c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.
19. If, during the period, there were breaches of loan agreement terms other than those described in paragraph 18, an entity shall disclose the same information as required by paragraph 18 if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the reporting date).
Income statement and equity
Items of income, expense, gains or losses

20. An entity shall disclose the following items of income, expense, gains or losses either on the face of the financial statements or in the notes:

(a) net gains or net losses on:

(i) financial assets or financial liabilities at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are classified as held for trading in accordance with IAS 39;

(ii) available-for-sale financial assets, showing separately the amount of gain or loss recognised directly in equity during the period and the amount removed from equity and recognised in profit or loss for the period;

(iii) held-to-maturity investments;

(iv) loans and receivables; and

(v) financial liabilities measured at amortised cost;

(b) total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss;

(c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:

(i) financial assets or financial liabilities that are not at fair value through profit or loss; and

(ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions;

(d) interest income on impaired financial assets accrued in accordance with paragraph AG93 of IAS 39; and

(e) the amount of any impairment loss for each class of financial asset.

Other disclosures

Accounting policies

21. In accordance with paragraph 108 of IAS 1 *Presentation of Financial Statements,* an entity discloses, in the summary of significant accounting policies, the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

Hedge accounting

22. An entity shall disclose the following separately for each type of hedge described in IAS 39 (i.e., fair value hedges, cash flow hedges, and hedges of net investments in foreign operations):

(a) a description of each type of hedge;

(b) a description of the financial instruments designated as hedging instruments and their fair values at the reporting date; and

(c) the nature of the risks being hedged.

23. For cash flow hedges, an entity shall disclose:

(a) the periods when the cash flows are expected to occur and when they are expected to affect profit or loss;

(b) a description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur;

(c) the amount that was recognised in equity during the period;

(d) the amount that was removed from equity and included in profit or loss for the period, showing the amount included in each line item in the income statement; and

(e) the amount that was removed from equity during the period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction.

24. An entity shall disclose separately:

(a) in fair value hedges, gains or losses:

(i) on the hedging instrument; and

(ii) on the hedged item attributable to the hedged risk;

(b) the ineffectiveness recognised in profit or loss that arises from cash flow hedges; and

(c) the ineffectiveness recognised in profit or loss that arises from hedges of net investments in foreign operations.

Fair value

25. Except as set out in paragraph 29, for each class of financial assets and financial liabilities (paragraph 6), an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

26. In disclosing fair values, an entity shall group financial assets and financial liabilities into classes, but shall offset them only to the extent that their carrying amounts are offset in the balance sheet.

27. An entity shall disclose:

(a) the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities. For example, if applicable, an entity discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates;

(b) whether fair values are determined, in whole or in part, directly by reference to published price quotations in an active market or are estimated using a valuation technique (paragraphs AG71–AG79 of IAS 39);

(c) whether the fair values recognised or disclosed in the financial statements are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable market transactions in the same instrument (i.e., without modification or repackaging) and not based on available observable market data. For fair values that are recognised in the financial statements, if changing one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly, the entity shall state this fact and disclose the effect of those changes. For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in equity, total equity;

(d) if (c) applies, the total amount of the change in fair value estimated using such a valuation technique that was recognised in profit or loss during the period.

28. If the market for a financial instrument is not active, an entity establishes its fair value using a valuation technique (paragraphs AG74–AG79 of IAS 39). Nevertheless, the best evidence of fair value at initial recognition is the transaction price (i.e., the fair value of the consideration given or received), unless conditions described in paragraph AG76 of IAS 39 are met. It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique. If such a difference exists, an entity shall disclose, by class of financial instrument:

(a) its accounting policy for recognising that difference in profit or loss to reflect a change in factors (including time) that market participants would consider in setting a price (paragraph AG76A of IAS 39); and

(b) the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

29. Disclosures of fair value are not required:

(a) when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;

(b) for an investment in equity instruments that do not have a quoted market price in an active market, or derivatives linked to such equity instruments, that is measured at cost in accordance with IAS 39 because its fair value cannot be measured reliably; or

(c) for a contract containing a discretionary participation feature (as described in IFRS 4 *Insurance Contracts*) if the fair value of that feature cannot be measured reliably.

30. In the cases described in paragraph 29(b) and (c), an entity shall disclose information to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those financial assets or financial liabilities and their fair value, including:

(a) the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;

(b) a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;

(c) information about the market for the instruments;

(d) information about whether and how the entity intends to dispose of the financial instruments; and

(e) if financial instruments whose fair value previously could not reliably be measured are derecognised, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognised.

Nature and extent of risks arising from financial instruments

31. An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date.

32. The disclosures required by paragraphs 33–42 focus on the risks that arise from financial instruments and how they have been managed. These risks typically include, but are not limited to, credit risk, liquidity risk and market risk.

Qualitative disclosures

33. For each type of risk arising from financial instruments, an entity shall disclose:

(a) the exposures to risk and how they arise;

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

(c) any changes in (a) or (b) from the previous period.

Quantitative disclosures

34. For each type of risk arising from financial instruments, an entity shall disclose:

(a) summary quantitative data about its exposure to that risk at the reporting date. This disclosure shall be based on the information provided internally to key management personnel of the entity (as defined in IAS 24), for example the entity's board of directors or chief executive officer;

(b) the disclosures required by paragraphs 36–42, to the extent not provided in (a), unless the risk is not material (materiality as discussed in paragraphs 29–31 of IAS 1); and

(c) concentrations of risk if not apparent from (a) and (b).

35. If the quantitative data disclosed as at the reporting date are unrepresentative of an entity's exposure to risk during the period, an entity shall provide further information that is representative.

Credit risk

36. An entity shall disclose by class of financial instrument:

(a) the amount that best represents its maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements (e.g., netting agreements that do not qualify for offset in accordance with IAS 32);

(b) in respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancements;

(c) information about the credit quality of financial assets that are neither past due nor impaired; and

(d) the carrying amounts of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

Financial assets that are either past due or impaired

37. An entity shall disclose by class of financial asset:

(a) an analysis of the age of financial assets that are past due as at the reporting date but not impaired;

(b) an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired; and

(c) for the amounts disclosed in (a) and (b), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value.

Collateral and other credit enhancements obtained

38. When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (e.g., guarantees), and such assets meet the recognition criteria in other Standards, an entity shall disclose:

(a) the nature and carrying amount of the assets obtained; and

(b) when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

Liquidity risk

39. An entity shall disclose:

(a) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and

(b) a description of how it manages the liquidity risk inherent in (a).

Market risk

Sensitivity analysis

40. Unless an entity complies with paragraph 41, it shall disclose:

(a) a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;

(b) the methods and assumptions used in preparing the sensitivity analysis; and

(c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.

41. If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects inter-dependence between risk variables (e.g., interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in paragraph 40. The entity shall also disclose:

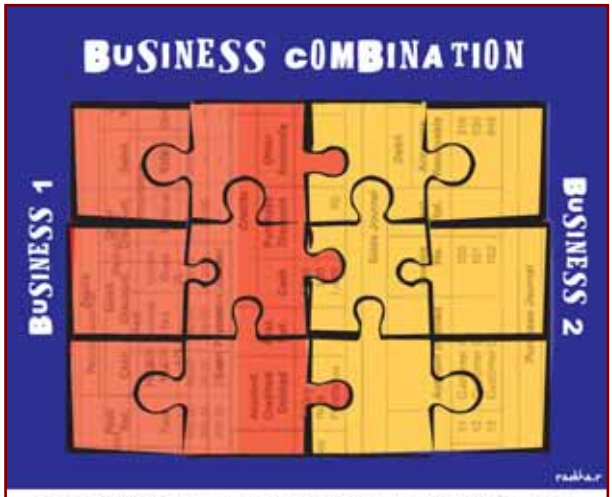
(a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and

(b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

Other market risk disclosures

42. When the sensitivity analyses disclosed in accordance with paragraph 40 or 41 are unrepresentative of a risk inherent in a financial instrument (for example because the year-end exposure does not reflect the exposure during the year), the entity shall disclose that fact and the reason why it believes the sensitivity analyses are unrepresentative.

Contemporary Accounting Concepts for Inorganic Growth: Acquisitions and Mergers under IFRS 3 - Business Combinations



IFRS 3 defines business combination as bringing together of separate entities or businesses into one 'reporting entity'. Simply bringing together of separate entities which are not 'businesses' is not considered as business combination. The main ingredient is the existence of business or businesses.

An increasing number of Indian companies are opting for 'inorganic' growth i.e., growth by acquisitions/mergers, to fulfill their global growth ambitions. The accounting concepts/methods applied for reflecting business transactions at the time of acquisition/merger significantly impacts the measurement of subsequent financial performance of the merged business entity. This article deals primarily with key accounting concepts prescribed by IFRS 3 in this regard and attempts to draw attention to some of the main differences vis-à-vis other accounting standards like Indian GAAP (AS 14 Accounting for Amalgamations) and US GAAP (SFAS 141 Business Combinations). It is important to note that differences with Indian GAAP will be fully eliminated by 2011.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Multinational companies (MNCs) have always considered 'inorganic' growth i.e., growth by acquisitions/mergers, as an important tool to fulfill their global growth ambitions. In recent years, many Indian corporates too followed the suit in quest of building global business powerhouses. The accounting concepts/methods applied for reflecting such business transactions at the time of acquisition/merger significantly impact the measurement of subsequent financial performance of the merged business entity. With this significance in mind and in the pursuit of convergence of IFRS with other global standards such as US GAAP, the International Accounting Standards Board (IASB)

had embarked on a path to revise the prevailing standard viz. IAS 22 Business Combinations. In view of the significance of issues and the huge efforts involved, the IASB had decided to undertake this task in a phased manner. Current, IFRS 3, which is applicable for transactions after 31 March 2004, is the result of improvements of Phase 1 of the larger project. Also, it should be noted that IASB, jointly with US FASB, has revisited few more areas and finalised the changes but not yet implemented. These changes will affect areas such as scope of type of transactions covered in the standard, goodwill/minority interest measurement, and accounting for costs directly attributable to acquisition.

Summary of the Main Accounting Prescriptions of IFRS 3

- The accounting standard applies to accounting for bringing together of two or more business entities i.e., acquisitions, mergers and amalgamations of business entities and continue progress on the joint projects that they are currently undertaking; and,
- There is only one approach mandated for accounting of all types of business combinations viz. Purchase (or Acquisition) Method of accounting; Pooling of interests method is no more recognised.
- The assets and liabilities of the 'acquiree' (not that of acquirer) entity have to be accounted at their fair values and as also the Purchase consideration. Acquiree entity's retained earnings and other reserves lose their identity upon business combination.
- Goodwill arising from business acquisition is 'not amortised' but subject to periodic impairment test. Negative goodwill (referred as capital reserve in Indian GAAP) will have to be released to income statement immediately.

For the purpose of this article, the IFRS 3 requirements are broadly segregated into two parts: (A) Scope of IFRS 3, and (B) Method of accounting for business combinations.

Scope of IFRS 3

Meaning of business and business combination:

In layman terms, the standard applies to accounting aspects relating to acquisitions, mergers and amalgamations of businesses. IFRS 3 uses the term 'business combination' and in this article, for convenience, we use the terms acquisitions, mergers, amalgamations or business combinations interchangeably. IFRS 3 applies to all business combinations except certain transactions/situations specifically excluded by the standard. As the standard applies to business combinations, it is relevant to understand the meaning of the terms 'business combination' and 'business', and when a transaction requires the application of this standard. The standard defines business combination as bringing together of separate entities or businesses into one 'reporting entity'. Further, it is stated that simply bringing together of separate entities which are not 'businesses' is not considered as business combination. Therefore, main ingredient is the existence of business or businesses. The standard defines this term as an integrated set of activities and assets conducted and managed for the purpose of providing:

(a) A return to investors

(b) Lower costs or other economic benefits directly and proportionately to policyholders or participants.

The standard goes on to explain that a business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be used to generate revenues. It is important to note that it is not necessary that a set of activities or assets must be self-sustaining or independent profit centre to qualify as business. Because such kind of pre-requisite would have narrowed down the scope of transactions covered under this standard; transactions where the existing systems, people etc. are not taken over by the new entity or situations where the activities or assets have not yet commenced planned operations would not have qualified for accounting as business combinations as in US GAAP. In many cases of acquisitions, the acquiring party discards the systems/processes of the acquired unit or do

not necessarily continue with the management team of the acquired entity etc. If one simply purchases a few assets like Plant & Machineries, Loans & Advances, it is unlikely to be termed as 'business', however, if an acquisition relates to division or unit comprising such assets which is capable of being converted into activities that will be used to generate revenues then it is a business acquisition falling under the ambit of this IFRS. As business segmentation becomes sharper and more sophisticated as services industry grows, 'business' will extend to a wider range of activity streams, beyond current limitations of understanding. Further, there is a presumption in the standard that transferred set of activities/ assets is a 'business' if *'goodwill'* is present in that set. Accordingly, if the purchase consideration explicitly includes value for 'goodwill' then by default the acquired set of activities is a business and requires accounting in terms of this IFRS. Therefore, the facts/information relating to valuation and determination of purchase consideration would play an important role in concluding whether a transferred set of activities/assets is a business or not.

Having elaborated on the term 'business', now let us understand the meaning of the term *'business combination'*. Under the standard, a transaction can be called as *'business combination'* when one entity obtains the *control* of one or more other businesses. The term 'control' is explained later in this article. The control can be achieved in various forms i.e., acquiring controlling stake in another entity, creation of new entity to control the acquirer/ acquiree entities, simple purchase of net assets of another entity etc. In some cases it may result into creation of parent-subsidiary relationship and in some cases merger/integration of an acquired entity's business into acquirer entity by dissolving the former entity. Interestingly, the former category of transactions are excluded from the scope of the Indian standard, probably because the standard was developed in an era where requirement/practice of consolidated financial statements didn't exist. In such type of situations, this IFRS requirement will have relevance in the consolidated financial statements of the parent and the 'old basis' of accounting remains relevant for stand-alone financials of the acquired entity. This would involve maintaining two sets of books of accounts for the acquired entity i.e., one set for the separate financials of the acquired entity on 'as-is-where-is' basis and the other one for inclusion in the consolidated financial statements based on the norms stated in the subsequent paragraphs.

IFRS 3 has brought in a very important change regarding treatment of restructuring provisions as compared to previous standard. Recognition criteria of Restructuring provisions i.e., costs for terminating or reducing the activities of the acquiree has been made stringent and such provisions can be recognised as a liability of the acquiree at the acquisition date only if they meet the recognition criteria of IAS 37 Provisions.

Exclusions from the scope of standard:

In view of the complexities and larger issues requiring detailed/separate consideration, the IFRS 3 currently excludes business combinations involving entities under common control, combinations involving mutual entities or bringing together separate entities to form a reporting entity by contract alone without obtaining ownership interest and initial accounting when joint ventures are formed. These aspects are proposed to be addressed in the future phases of project.

Method of Accounting for Business Combinations

The revised standard recognises and mandates only one accounting approach viz. the Purchase Method, for all types of business combinations. The previous international standard had two broad approaches as the business combinations were required to be viewed from two types – 'Uniting of interests' and 'Acquisitions' requiring application of 'Pooling of interest method' and the 'Purchase method', respectively. Under the former method, the assets/liabilities of the merged entities were simply recorded at the pre-merger carrying values in the books of the combined entity and no goodwill or negative

goodwill arose upon initial accounting for the merger. Although the use of the pooling of interests method was restricted to limited circumstances, it was decided to do away with this option primarily due to IASBs urge to achieve convergence with other GAAPs (US, Australia) and also on account of the considered view that the application of purchase method results into provision of superior financial information than pooling of interests method even if it is applied to situations which would have been eligible for application of pooling of interests method. However, the IASB is cognizant of the fact that there would be situations where none of the entities obtain control i.e., true mergers, though very rare, and would like to evaluate in future the *'fresh start'* method which seems to be the only more appropriate method other than purchase method for such situations. Fresh start method refers to recognition of assets/liabilities of each of the combining entities at their fair values. The Indian standard still requires classification of the mergers/acquisitions into two categories and thereby application of one of the two accounting approaches as in the old IAS.

The next important aspect is about the appropriate basis of accounting for initially reflecting the assets/liabilities acquired or assumed and purchase consideration given. Considering the fact that business combinations falling under this standard are viewed from an acquirer's perspective or 'acquisition' view, it is logical and ideal that the transaction is accounted with two objectives in mind i.e., recorded at values so as to truly reflect the underlying rationale for the purchase consideration and to facilitate the proper future performance evaluation of the investment made by that acquiring entity's management. With this objective in mind, the 'Purchase method', which involves extensive use of 'fair value' measurement concepts, has been mandated by the standard. Let us analyse its requirements in greater detail.

Application of Purchase Method of Accounting

The purchase method of accounting primarily involves the following:

- In the combined entity's books, accounting for the cost of the business combination and assets acquired, liabilities/contingent liabilities assumed of the acquired entity at fair values on the acquisition date.
- Measuring the initial result of the business combination- 'Goodwill (or Negative Goodwill) being difference between the fair values of the two components stated above.

In view of the complexities and larger issues requiring detailed/separate consideration, the IFRS 3 currently excludes business combinations involving entities under common control, combinations involving mutual entities or bringing together separate entities to form a reporting entity by contract alone without obtaining ownership interest and initial accounting when joint ventures are formed.

The above aspects can be broadly divided under three heads (a) identifying the acquirer, (b) computing the cost of acquisition, and (c) allocation of cost of acquisition to the assets/liabilities based on their fair values and arriving at the goodwill or negative goodwill. While the latter two have a significant influence on the initial result of the acquisition itself and in combination with the former assume high significance, as the results of this exercise would have far reaching consequences on the subsequent measurement of the performance indicators of the combined entity

Who is the Acquirer & Why it is Important to Identify the Acquirer?

As noted in earlier paragraphs, the IFRS 3 views the business combination as an acquisition. The standard requires that the assets/liabilities of the acquired entity or entities will be incorporated in the combined entity's financials at fair values and accordingly, it becomes necessary to identify which entity is the acquired or acquiree entity

and which one is the acquiring or acquirer entity. The standard clearly states that in cases where a new entity is formed to give the consideration by issuing the equity instruments, the acquirer entity has to identify as one of the entities that existed before combination and the newly formed entity cannot be an acquirer. Otherwise, it will result into fair valuation of assets/liabilities of all the existing entities acquired by the new entity and effectively, the application of 'fresh start' method, which is not in accordance with the conceptual framework of the standard. Interestingly, the standard does not put a similar restriction in cases where the newly formed entity gives consideration in the form of cash or other assets.

The cardinal principle for identifying the acquirer is the *'control concept'* i.e., the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities. It has same connotation as the one used in defining the Parent-Subsidiary relationship in IAS 27 Consolidated and Separate Financial Statements. The acquirer entity is the one that obtains control of the other combining entities or businesses. Commonly, the acquirer entity is the entity that gives cash or other assets in exchange for controlling interest i.e., equity instruments or the entity that issues the equity instruments or the larger entity. However, it is very important to examine in detail all the facts/circumstances from the angle of which party has gained control over the financial/operating policies of the other entity based on *'substance over form'*. Because, in some rare situations known as *'Reverse Acquisitions'* the smaller entity issues equity shares to a larger entity in proportion to the respective fair values of the two firms and the smaller entity formally appears as the acquirer, but in substance the larger entity is the acquirer as it has obtained control over the financial/operating policies of smaller entity that is issuing equity instruments. Also, it is not always necessary that smaller entity is the acquired entity and larger entity is the acquirer entity and vice versa.

Cost of Business Combination

The cost of business combination (we can call it 'cost of acquisition') plays an important role in the quantification of the amount of initial amount of *'goodwill (or negative goodwill)'* that will be recognised initially. We can segregate the cost of acquisition into two elements viz. the value of purchase consideration given and the costs directly attributable to the acquisition. The value of the purchase consideration given is the fair value of the assets given, liabilities assumed/incurred plus the equity instruments issued by the acquirer.

There are few important aspects to bear in mind when computing the value of the purchase consideration. To begin with, it is of foremost importance that the value of purchase consideration given should be for acquiring *control of the acquiree* and not for any other purposes or services rendered. The fair value is the one that is prevailing on the exchange date of the consideration and not the acquisition date (i.e., date of acquiring control). Under US GAAP, in case of consideration in the form of equity shares with quoted prices, the fair value is based on average prices prevailing during reasonable period before or after the acquisition date. The difference in acquisition date and exchange date can have impact on cost of business combination in cases of share purchases in phases as the computation of cost of business combination, determination of fair values of assets/liabilities and the measurement of goodwill has to be performed at each stage of acquisition and would require relevant data. Determining the fair value of cash consideration is simple and straight-forward. But, the same is not true for other modes of consideration especially when equity instruments are issued as consideration for acquiring control. In case of consideration in the form of equity instruments, well accepted norm of accepting the published price of the quoted equity instruments, as unquestionable fair value remains valid barring the exceptional situation of 'thinness' of the stock market. In the absence of quoted market price or non-suitability of market quotes, surrogates such as alternative cash offers made can be used. In case of reverse acquisitions, one has to note that cost of acquisition has to be based on fair value of equity instruments of the de facto acquirer and not the de jure acquirer. For this purpose, one needs to work out the number of equity shares that would

Assets/liabilities, including contingent liabilities of the acquired entity, have to be initially recognised at fair values in the financial statements of the merged entity as of acquisition date. The difference between the cost of acquisition and the acquirer's share in the net fair values of assets/liabilities acquired will have to be accounted.

have been issued by the de facto acquirer to the de jure acquirer to provide the same percentage of ownership in the combined entity. Another aspect to note is that if the actual payment of consideration is deferred, the standard requires the discounting of consideration payable to its present value. The discount rate to be used, and circumstances when discounting is considered necessary etc. will be based on management judgment and decision.

As noted above, the cost of acquisition includes the fair value of liabilities assumed or incurred. The standard specifically states that future losses or other costs expected to be incurred as a result of combination are not liabilities incurred or assumed by the acquirer in exchange for control of the acquiree, and therefore should not be included as part of cost of acquisition. This restriction, in our view, is justified, because, otherwise there will be very high subjectivity and uncertainty as to the scope of the items of cost of business combination. Further, care should be taken that the amount of liabilities assumed or incurred included, as part of cost of acquisition should not be counted again while allocating the cost of the business combination to the assets/liabilities of the acquiree. Otherwise it will lead to double counting of the liabilities and impact the resulting goodwill or negative goodwill.

Next component of the cost of acquisition is the costs directly attributable to the business combination. The type of costs allowed for inclusion here generally pertain to professional and consultancy services obtained such as due diligence, legal matters, etc and that too external in nature. Acquirer's internal general administrative costs such as payroll costs of acquisition department and costs incurred for issuing equity shares or debt instruments as a purchase consideration are specifically barred from inclusion as part of this component. The rationale for this approach is to exclude normal and business as usual costs of the acquirer being included here so as to maintain consistency with other IFRSs on similar items. Therefore, the scope of costs to be included here is quite limited though the wording of the standard appears otherwise. In practice, one could additionally apply another test i.e., whether the costs are incremental costs which would not have been incurred but for the occurrence of business combination.

At times, the agreement between parties requires adjustment to the purchase consideration depending upon the results of one or more future events called contingent events. According to the standard such adjustment can be factored in at the time of initial accounting for the business combination if the adjustment is *'Probable'* and it can be *'Quantified Reliably'*. Otherwise, the cost of business combination should be adjusted later as/when the probability and reliable measurement tests are fulfilled. However, there is one exception to this rule i.e., no adjustment is required to cost of acquisition when additional payment is made or additional equity or debt instruments are issued due to guaranteeing of the market price of such instruments and to restore the originally agreed cost of acquisition. In our view this exception appears to have some inconsistency with the main requirement of adjustment of cost acquisition, which include changes in the market price of the instruments issued as one of the contingent events. There is no outer timeline set for recognition of this adjustment. If the contingent consideration needs to be recognised after a significant time gap then it may have impact on the amount of goodwill (or negative goodwill) carried in the books of the combined entity.

In many business combinations, warranties and indemnities by the sellers (acquired entities) are quite common in respect of legal cases, bad and doubtful debts, title to properties, trade marks, patents etc. A question arises as to how to reflect

the effect/outcome of these indemnities in the initial accounting of acquisitions. These can be either treated similar to adjustment of cost of acquisition on account of contingent events or like arrangements independent of the business combination. The choice should be based on practicalities and appropriateness of the circumstances keeping in mind the reliability and faithfulness of the financial information.

Allocation of Cost of Acquisition to Acquiree's Assets and Liabilities – Principles and its Mechanics

As mentioned earlier, assets/liabilities including contingent liabilities of the acquired entity have to be initially recognised at fair values in the financial statements of the merged entity as of acquisition date. The difference between the cost of acquisition and the acquirer's share in the net fair values of assets/liabilities acquired will have to be accounted. The standard uses the terminology *'allocation of cost of business combination'* implying simple allocation or apportionment of the total cost across various assets/liabilities in proportion to their fair values. If that were the case then no goodwill or negative goodwill would arise upon business combination. Actually, what this step involves is that the various items of assets acquired, liabilities or contingent liabilities assumed should be initially recognised ***at their fair values***. The key aspects of this step can be sub divided as:

(a) Criteria for recognition of assets/liabilities.

(b) Basis of allocation of cost of business combination – fair value concept.

(c) Recognition of goodwill or negative goodwill.

Due diligence exercise, business valuation reports and other internal material information/ report will be of significant help and guidance in this process. However, it should be ensured that fair value measurement concepts in a business valuation could be different from those prescribed under the accounting standards, hence may not always be suitable for accounting purposes.

Criteria for Recognition of Assets, Liabilities and Contingent Liabilities

The main pre-requisites for separate recognition of assets and liabilities are as follows:

(a) Assets/liabilities should be capable of being separately identifiable.

(b) Fundamental principles of IFRS framework for asset/liabilities recognition are met i.e., it is probable that future economic benefits will flow to or resources embodying economic benefits will flow from and the values can be measured reliably.

In case of intangible assets the only criteria mandated is in respect of reliable measurement of air values because such assets have to be recognised separately only if they meet the definition of Intangible assets in IAS 38. That standard presumes that in case of intangible assets acquired in a business combination the probability criterion of future benefits is always met if the reliable measurement criteria are satisfied.

It is critical to note that only those assets, liabilities and contingent liabilities that exist at the acquisition date have to be recognised. Therefore, those likely to arise in future cannot be recognised as of acquisition date. However, it does not mean items that can be recognised should be only those already recognised in the acquired entity's financials. There could be some assets which become eligible for recognition as an asset because of the business combination, notable one being deferred tax benefit of the acquired entity, some assets of the acquiree may have to be written off (like redundant soft wares, unusable raw materials/work-in-progress) or valuation reports/due diligence exercise may identify some unrecognised liabilities of the acquired entity arising from past events which need to be considered for recognition.

IFRS 3 has brought in a very important change regarding treatment of *restructuring provisions* as compared to previous standard. Recognition criteria of Restructuring provisions i.e., costs for terminating or reducing the activities of the acquiree has been made stringent and such provisions can be recognised as a liability of the acquiree at the acquisition date only if they meet the recognition criteria of IAS 37 Provisions, Contingent Liabilities and Contingent Assets i.e., detailed formal plan of restructuring exists and a valid expectation of restructuring has been

created among those affected as of acquisition date. The latter condition is comparatively easier to satisfy while the former is relatively difficult. The previous standard (IAS 22), in view of this practical difficulty, had given a concession regarding the first criteria whereby additional time was allowed for development of detailed formal plan. Further, to avoid possibility of working around the standard by suitably structuring transactions, it is clearly stated that liabilities on account of the restructuring plans becoming effective or operational only upon occurrence of business combination are neither considered as present obligations nor contingent liabilities of the acquiree as of the acquisition date. As of now, US GAAP & Indian GAAP does not have such stringent norms. The main rationale behind this stringent norm appears to avoid inconsistent accounting of the same liability fewer than two different situations i.e., when it is incurred as part of business combination and when it is incurred as part of normal business conditions. Therefore, restructuring costs, no matter how directly attributable to the business combination, would have to be charged off to the income statement of the merged entity.

At the same time, contractual liabilities of the acquirer crystallising because of the occurrence of the business combination need to be recognised as liabilities as of acquisition date. These could be payments or compensations to contractors, employees etc. However, litigation liabilities arising because of occurrence of business combination do not fall under this category, as they are not of obligations arising from past events. The standard also requires recognition of contingent liabilities provided the fair value can be reliably measured. This recognition requirement is inconsistent with the other specific accounting standard viz. IAS 37 and IASB is expected to revisit this during future improvements of the IFRS.

Basis of Allocation of Cost of Business Combination – Fair Value Concept

After having identified the assets or liabilities that need to be recognised, the next step is to arrive at the value that can be assigned to those individual assets or liabilities. As said earlier, what this step involves is that the various items of assets acquired, liabilities or contingent liabilities assumed should be initially recognised *at their fair values*. Indian standard allows an option to retain the assets/liabilities at their pre-acquisition carrying values even when purchase method is applied. Under IFRS 3, in case of acquisitions involving minority interests, full fair values will be assigned to the assets and liabilities acquired and not just to the extent of majority interest acquired. However, under US GAAP & Indian GAAP fair values will not be assigned to the extent of minority interest and accordingly this will have impact on the amount of minority interest.

The term *fair value* continues to carry the oft-repeated definition i.e., 'the amount for which as asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'. However, determining fair values for many items in a business combination is not a simple task as this definition works perfectly well in an organised market with existence of a readily available quoted market price. Further, complexities around fair value determination can vary based on the nature of the industry. It can be comparatively easier in a financial services industry, which has many assets/liabilities traded in active market or where key ingredients of valuation models are readily/publicly available. At the same time it can be a very subjective exercise in a manufacturing industry. Therefore, determination of fair value for items involved in business combination requires considerable judgement, maturity and experience among the accountants and the auditors. At times, this debate among the parties involved can be as intense as Spanish bull fight. In view of this, IFRS 3 as well as US GAAP provide supplementary guidance on measurement basis of fair value for certain category of assets/liabilities. The guidance given prescribes certain specific adjustments to fair values like deduction for loan loss allowances/collection costs/cost of disposal, use of professional valuation concepts like depreciated replacement cost or income approach for specialised assets normally sold as part of a business, use of cash flow discounting technique and states fee/commission likely to be charged by a third party as basis for measurement of contingent liabilities. It should be noted that

IASB is in the process of issuing a comprehensive and separate standard on 'Fair Values' similar to a recently announced US standard 'SFAS 157 Fair Value Measurement'. This is going to bring in benefit of better application of the fair value concept under different and complex scenarios and would change some of the current fair value measurement practices.

Fair and proper determination of fair value for identified assets or liabilities or contingent liabilities is of high significance as any error, knowingly or unknowingly, will have an impact on the income/expense recognised in the subsequent income statements as well as the carrying value of the goodwill.

For example, Company A acquires Company B for a purchase consideration of Rs.400,000 and details of Company B's assets/liabilities are as under:

Liabilities	Carrying values	Fair values	Assets	Carrying values	Fair values
Capital & Reserves	300,000	-	Cash & Bank	50,000	50,000
Debentures	100,000	100,000	Fixed assets	300,000	400,000
Current Liab	300,000	350,000	Inventories	150,000	125,000
Contg Liab		50,000	Receivables	200,000	175,000
Total	700,000	500,000		700,000	750,000

In the above situation, the assets and liabilities of the acquired entity are initially recognised at their fair values. Accordingly, if the fair values are correctly determined and recorded initially, then goodwill of Rs.150,000 being excess of cost of acquisition (Rs.400,000) over fair value of net assets (Rs.750,000 less Rs.500,000 = Rs.250,000) will be recorded. However, if fixed assets are not assigned proper fair values and carried at their book values, then depreciation in subsequent period income statement will be lower leading to incorrect reflection of net income and also inaccurate recognition of goodwill at a higher amount by Rs.100,000. Similarly, if the current liabilities or receivables are not correctly recognised at fair values but only at book values, it will impact amount of goodwill recognised and also affect the income statement of the subsequent period when these receivables are written off or liabilities recognised.

Recognition of Goodwill and Negative Goodwill

Goodwill acquired in a business combination is measured as excess of the cost of acquisition over the acquirer's interest in the net fair value of assets acquired and liabilities assumed. This approach is in view of the fact that payments made in anticipation of future profits of the acquired entity but which cannot be specifically attributable to individual items represent goodwill. However, this residual method of goodwill measurement may have some flaws like overpaid consideration or less discernible errors in computation of fair values and therefore, resultant goodwill may not represent the *'real or core'* goodwill. But, it may not be practicable to separate all these elements of goodwill with fine perfection. Unlike the previous IAS and the current Indian standard, the Goodwill acquired in a business combination is no longer amortised over certain arbitrary period, but requires periodic impairment tests and write downs of goodwill, if necessary.

There might be circumstances where the cost of acquisition is lower than fair values of the net assets, resulting into a negative goodwill. This could be a genuine situation like bargain purchase or accounting fair values being different from those considered in computing purchase price or errors in computation of fair values of purchase consideration and assets/liabilities acquired. In order to safeguard against the latter situation, the standard requires the *'double check'* of the initial computations of these numbers by a process called *'re-assessment'*. Thereafter, negative goodwill still remaining after this re-assessment, is required to be recognised, as

income immediately i.e., gets included as income in the first income statement of the combined entity subsequent to business combination. Under US GAAP, the excess is first apportioned against certain specified category of assets and the excess, if any, is recognised in the income statement. Under Indian standard, such amount is called *'capital reserve'* and carried forward as shareholders funds in perpetuity and is also not eligible for dividend declaration.

Provisional Accounting and Subsequent Adjustment of Fair Values

It is quite common that determination of fair value and its allocation against individual items is not always practical before finalisation/issuance of the financial statements. This is especially true in cases of acquisitions materialising closer to the financial reporting date. Therefore, the standard provides a flexibility of reflecting the results of the acquisition on a *'provisional basis initially'* and subsequently adjusting the fair values within the allowed time window of twelve months from the acquisition date. Such adjustments would result into restatement of the comparative financials and adjustment of the carrying amounts of assets/liabilities and the goodwill. However, it is not mandatory that one should always review/adjust the carrying values during twelve months post acquisition date. If the fair value determination/allocation is final at the time of financial reporting and this fact is recognised as such, then there is no room for restatement of initially recognised numbers except for correction of errors or deferred tax adjustments. Accordingly, changes in carrying values of assets and liabilities subsequent to initial accounting date will have to be reflected as changes in accounting estimates in the period of change. Material movements in loan loss provisions or significant recoveries of previously provided receivables are all possible especially due to efforts of the new management and changes in business/economic environment, and do not necessarily require restatement of initial accounting of a business combination. They can be trigger points for reviewing errors but caution needs to be exercised to avoid invariably concluding that fair values initially determined were incorrect and require restatement.❑

OPINION

Amortisation of value of publishing title.

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

A. Facts of the Case

1. A listed company is in the publication business since its inception and publishes a daily newspaper. It commenced its business after taking over the running business of a partnership firm, acquiring all assets and liabilities, except the 'publishing title', which continued to be owned by the partnership firm which, at the time of transfer of business to the company, granted the rights to use the publishing title for a consideration which was payable annually on recurring basis.

2. The querist has stated that in 1996-97, the firm also sold the publishing title to the company for a lump sum consideration of Rs.17 crore. The said publishing title is about 65 years old. The company accounted for the consideration paid as a fixed asset upto its financial year ended on 31st March, 2002.

3. The querist has further stated that during the period from financial year 1996-97 to 2001-02, the company did not amortise the value of this asset at all. However, under section 35A of the Income-tax Act, 1961, the company has been allowed, since beginning, deduction from income @ 1/14, in view of the deemed life of the asset as 14 years, as per the provisions of the said section. According to the querist, this life is only for the purposes of tax allowance and in no way, can be assumed to be the actual useful life for accounting purposes because it is a well-settled principle that tax and accounting treatments are quite independent and one does not affect the other.

4. In the financial year ended on 31st March, 2003, the company wrote-off the entire amount of Rs.17 crore by debit to the profit and loss account to comply, as per the querist, with the practice and guidelines of the Institute of Chartered Accountants of India, then prevalent in respect of intangible assets and suggesting write-off of intangible assets in 3-5 years, although in the opinion of the company's Board of Directors, the value of this asset had considerably appreciated since acquisition of the title. Appropriate disclosure of such write-off and the opinion of the Board of Directors was made by way of note to the accounts.

5. The querist has stated that in the financial year ended on 31st March, 05, in the light of Accounting Standard (AS) 26, 'Intangible Assets', issued by the Institute of Chartered Accountants of India, becoming applicable to the company w.e.f. 1st April, 2003, the company reviewed the accounting treatment given in the financial year 2002-03 and came to the conclusion that the write-off needed reversal in terms of paragraphs 20 and 99 of AS 26 and reinstatement of this asset is required in the books since economic benefits from this asset were expected to flow in future. Accordingly, the value of the publishing title was reinstated in the books partly by credit to general reserve and partly by credit to deferred tax asset, making appropriate disclosure regarding reinstatement, reasons for such reinstatement and also accounting treatment given in the books of account by way of notes to the accounts. The amount credited to defer tax asset represented the write-off of deferred tax asset created at the time of complete write-off of publishing title in March 2003, which was remaining unadjusted till 31st March, 2005.

6. According to the querist, while the company has been continuing to claim the deduction under section 35A of the Income-tax Act, 1961, the company has not been amortising the value of publishing title after its reinstatement in the books in the financial year 2004-05 on the following grounds:

(i) The asset, for which consideration was paid, is appreciating in value year after year, which is evident from the following:

(a) Valuation of the publishing title was done by the experts in 2000, i.e., after 4 years from the date of purchase and the value was assessed at Rs.288 crore as against Rs.17 crore paid in the financial year 1996-97.

(b) The company had made an Initial Public Offer (IPO) in February, 2006 and its current enterprise value is Rs.2000 crore approximately, out of which the value of tangible assets was Rs.650 crore approximately, implying thereby that the value of publishing title, being intangible asset was over Rs.1300 crore.

(ii) AS 26 requires determination of following in order to be in a position to amortise the value of intangible assets, such as a publishing title:

(a) The useful life of an intangible asset on best estimate basis,

(b) Residual value,

(c) Depreciable amount which is the difference between the cost of an asset and its residual value, and

(d) Systematic amortisation which means that the amortisation cannot be *ad hoc*/arbitrary.

In the view of the company, if either (a) or (b) is not determinable, or any of these two can not be scientifically/ properly determined, or in other words, formulae prescribed for amortisation can not be applied, there can not be a "systematic" amortisation and, therefore, amortisation is neither possible nor desirable in terms of AS 26, because if it is done, it will be a "forced" amortisation as against "systematic" amortisation and will vitiate true and fair view of the accounts, which can not be the intention of any Accounting Standard.

(iii) Useful life as defined in AS 26 is not determinable as "the period of time over which an asset is expected to be used by the enterprise" can not be quantified even on prudent basis as required by paragraph 68 of AS 26, even after taking into consideration, the factors, such as those listed in paragraph 64 of AS 26. There is no way to limit the life of publishing title and particularly because the value of title, as detailed above, has been appreciating considerably and with the growing literacy, prosperity and economy of the country, expectations are that in foreseeable future the useful life of a publishing title in the country will not be over and the value thereof will significantly appreciate with every passing year. The querist has drawn the attention of the Committee to the illustrative list of factors, particularly clause (b) of paragraph 64 of AS 26, to be considered for determining the useful life. As per the querist, none of the factors can help in estimating useful life, except "public information on estimates of useful lives of similar types of assets that are used in a similar way". In this connection, it may be noted that there are publishing titles, which are nearly 200 years old and enjoy much higher value than the value of publishing title of the company and are still going very strong with no signs or indications available of their useful lives lasting in foreseeable future. In fact, it is typical of newspaper industry that the older is the title, the higher is the value.

(iv) Residual value as defined under AS 26 is ***"the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal".*** As stated above, the publishing title purchased at Rs.17 crore nearly 10 years ago has current value of over Rs.1300 crore and this value is expected to increase further with every passing year in foreseeable future. Even if the company attempts to arbitrarily attach a useful life to the publishing title, the expected

value at the end of such useful life will be several times higher than its present book value and thus, the company will have a negative depreciable amount. It may be noted that there is an active market for the asset, it is probable that such a market will exist at the end of useful life so determined and it is determined with reference to that market. Therefore, in the view of the company, its value can never be assumed to be zero at any point of time.

7. In view of the above facts and circumstances, the querist has stated that the company does not find itself competent to estimate useful life and residual value. Also, the company has not been able to identify anyone who can advise or assist it in estimating the useful life of the publishing title and to the best of its knowledge, there is no scientific method/ expert available to estimate the useful life of a publishing title even on prudent basis.

8. As per the querist, the auditors of the company are of the view that:

(i) each intangible asset has its useful life and, accordingly, useful life of the title must be determined,

(ii) useful life is always finite and can never be infinite in view of paragraph 68 of AS 26, and

(iii) value of publishing title should be amortised over its useful life and non-amortisation amounts to non-compliance of AS 26.

B. Query

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

(i) Whether it is mandatory to ascertain finite life for an intangible asset.

(ii) Whether the company is justified in not amortising the value of publishing title.

(iii) If not, how can the useful life as well as residual value as defined by AS 26 be determined?

(iv) Whether the life of 14 years, deemed for allowing deduction of amount paid for title under section 35A of the Income-tax Act, 1961 can be construed as useful life.

(v) Whether the residual value can ever be assumed to be zero.

(vi) If useful life and residual value, both are determined under the constraints explained above, whether it will be fair and whether the amortisation based on such determination will not be arbitrary as against "systematic", and not vitiate the true and fair view of the accounts.

(vii) Under the given circumstances, whether it will be proper and in accordance with AS 26, not to amortise the value and disclose it alongwith the reasons for non-amortisation. The querist has drawn the attention of the Committee to paragraph 67 of AS 26, which states that if the presumption that the useful life of an intangible asset generally does not exceed 10 years is rebutted, disclosure to that effect should be made.

C. Points considered by the Committee

10. The Committee notes from the definition of the term 'fixed asset' as given in paragraph 6.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India, and the Facts of the Case as stated in paragraph 2 above that the publishing title when it was acquired and at present, is of the nature of fixed asset. Accordingly, in the view of the Committee, even before AS 26 came into effect, the accounting treatment in respect of publishing title would have been governed by AS 10. The Committee further notes that since AS 10 does not require any specific accounting treatment in respect of 'publishing titles', the general provisions applicable in respect of fixed assets would have been applicable to it. Further, in the view of the Committee, the allocation of the cost thereof less residual value, i.e., amortisation of depreciable amount thereof would have been governed by Accounting Standard (AS) 6, 'Depreciation Accounting', issued by the Institute of Chartered

Accountants of India. The Committee further notes that AS 6 requires that the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset. In this regard, the Committee notes the definition of the terms 'useful life' and 'depreciable amount', as provided under paragraphs 3.3 and 3.4 of AS 6, which state as follows:

AS 6

"3.3 *Useful life* is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

3.4 *Depreciable amount* of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value."

11. The Committee also notes from the above that AS 6 excludes only 'goodwill' from the application of the Standard and that the term 'depreciation' includes 'amortisation'. Accordingly, the Committee is of the view that even before AS 26 came into force, AS 6 required determination of useful life and residual value of the title, and the allocation of the depreciable amount over its useful life. Thus, in the view of the Committee, the company should have amortised the depreciable amount of publishing title over its useful life keeping in view the provisions of the then prevailing AS 6. Thus, it is not correct to state, as stated by the querist in paragraph 4 above, that the guidelines issued by the Institute of Chartered Accountants of India, suggested write-off of intangible assets within 3-5 years.

12. The Committee further notes from the Facts of the Case that the company has reinstated the value of publishing title relying upon the provisions of paragraphs 20 and 99 of AS 26. The Committee notes that paragraph 20 deals with 'initial' recognition and, therefore, does not apply in case of reinstatement. The Committee further notes paragraph 99 of AS 26, containing the transitional provisions required to be made on the date of AS 26 coming into effect, which, states as follows:

"99. Where, on the date of this Statement coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than the period determined under paragraph 63 of this Statement and the period determined under paragraph 63 has expired on the date of this Statement coming into effect, the carrying amount appearing in the balance sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserves.

In the event the period determined under paragraph 63 has not expired on the date of this Statement coming into effect and:

(a) if the enterprise is following an accounting policy of not amortising an intangible item, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63.

(b) if the remaining period as per the accounting policy followed by the enterprise:

(i) is shorter as compared to the balance of the period determined under paragraph 63, the carrying amount of the intangible item should be amortised over the remaining period as per the accounting policy followed by the enterprise,

(ii) is longer as compared to the balance of the period determined under para-

graph 63, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63."

13. The Committee notes from the above, that the Standard requires restatement of the carrying amount of an intangible item on the Standard coming into effect only when the enterprise is following an accounting policy of not amortising an intangible item or the remaining period of amortisation as per the accounting policy followed by the company is higher than the useful life determined under paragraph 63 of AS 26. The Committee notes from the Facts of the Case that on the date of Standard coming into effect, there is no carrying amount of the publishing title existing in the books of account. Accordingly, paragraph 99 of AS 26 also does not apply for reinstatement of publishing title.

14. The Committee is, however, of the view that the reinstatement is permissible as a prior period item as per the provisions of AS 5 since to write it off was an error as stated in paragraph 11 above. However, the reinstatement would have to be made at the value at which the asset would have appeared in the books of account, if the correct accounting treatment had been followed from the beginning as per the requirements of AS 6 and AS 10.

15. As far as determination of useful life is concerned, the Committee notes the definition of the term 'useful life' as given in paragraph 6 of AS 26 and paragraphs 63, 64, 66, 67 and 68 of AS 26, which state as follows:

" Useful life is either:

(a) the period of time over which an asset is expected to be used by the enterprise; or

(b) the number of production or similar units expected to be obtained from the asset by the enterprise."

"63. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

64. As the future economic benefits embodied in an intangible asset are consumed over time, the carrying amount of the asset is reduced to reflect that consumption. This is achieved by systematic allocation of the cost of the asset, less any residual value, as an expense over the asset's useful life. Amortisation is recognised whether or not there has been an increase in, for example, the asset's fair value or recoverable amount. Many factors need to be considered in determining the useful life of an intangible asset including:

(a) the expected usage of the asset by the enterprise and whether the asset could be efficiently managed by another management team;

(b) typical product life cycles for the asset and public information on estimates of useful lives of similar types of assets that are used in a similar way;

(c) technical, technological or other types of obsolescence;

(d) the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;

(e) expected actions by competitors or potential competitors;

(f) the level of maintenance expenditure required obtaining the expected future economic benefits from the asset and the company's ability and intent to reach such a level;

(g) the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases; and

(h) whether the useful life of the asset is dependent on the useful life of other assets of the enterprise."

"66. Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. This Statement adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

67. In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:

(a) amortises the intangible asset over the best estimate of its useful life;

(b) estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss (see paragraph 83); and

(c) discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset (see paragraph 94(a)).

68. The useful life of an intangible asset may be very long but it is always finite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short."

16. On the basis of the above, the Committee is of the view that AS 26 envisages that the useful life of an intangible asset has to be finite, howsoever long it may be. It stipulates that the life has to be determined on a prudent and rational basis. The Committee also does not agree with the view of the querist that the useful life of a publishing title in the country will not be over. In the view of the Committee, the useful life of a publishing title depends upon many factors, apart from the growing literacy, prosperity and economy of the country, as stipulated by the querist, such as, the competition in the print media industry, demand for the product, expectations of the consumers, etc. Thus, not only the factor listed in clause (b) of paragraph 64 of AS 26 is relevant, but also the other factors listed in that paragraph need to be considered while determining the useful life of the publishing title.

17. The Committee is of the view that paragraph 67 does not remedy non-amortisation; it only requires disclosures where the useful life is considered more than ten years. Such a disclosure is required, if, for instance, the company considers the life of the title is, say 30 years, then disclosures are warranted under paragraph 67.

18. As regards the determination of residual value is concerned, the Committee notes paragraphs 75 to 77 of AS 26 which state as follows:

"75. The residual value of an intangible asset should be assumed to be zero unless:

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) there is an active market for the asset and:

(i) residual value can be determined by reference to that market; and

(ii) it is probable that such a market will exist at the end of the asset's useful life.

76. A residual value other than zero implies that an enterprise expects to dispose of the intangible asset before the end of its economic life.

77. The residual value is estimated using prices prevailing at the date of acquisition of the asset, for the sale of a similar asset that has reached the end of its estimated useful life and that has operated under conditions similar to those in which the asset will be used. The residual value is not

subsequently increased for changes in prices or value."

The Committee notes that the querist has not informed about whether there is any commitment by a third party to purchase the asset at the end of its useful life. From the Facts of the Case, it appears that there is no such commitment. The Committee notes that although the querist has mentioned that active market exists for the title and is expected to exist at the end of its life, the Committee does not agree with the querist in view of the fact that the characteristics of an 'active market' as commonly understood in the commercial and accounting parlance, do not exist. The Committee notes that as per AS 26, an active market is a ***"market where all the following conditions exist:***

(a) the items traded within the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public."

Further, the fact that the title has been valued does not indicate that 'active' market exists. Also, the fact of the value of the title being much in excess of the original cost and its likely increase in future has no relevance in the case of historical cost accounting on which AS 26 is based. The purpose of historical cost accounting is to allocate the original cost of the asset over its useful life irrespective of its fair value. Accordingly, the residual value of the asset should be taken at zero.

D. Opinion

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

(i) Yes, as per the requirements of AS 26, the life of an intangible asset has to be ascertained.

(ii) No, the company is not justified in not amortising the value of publishing title.

(iii) The useful life and residual value should be determined keeping in view the principles of AS 26, as discussed in paragraphs 15 to 18 above.

(iv) The life deemed for allowing deduction under the Income-tax Act is not necessarily the useful life for the purposes of AS 26. The useful life should be determined keeping in view the requirements of AS 26 as discussed in paragraphs 15 and 16 above.

(v) As per the requirements of AS 26, the residual value is assumed to be zero as discussed in paragraph 18 above.

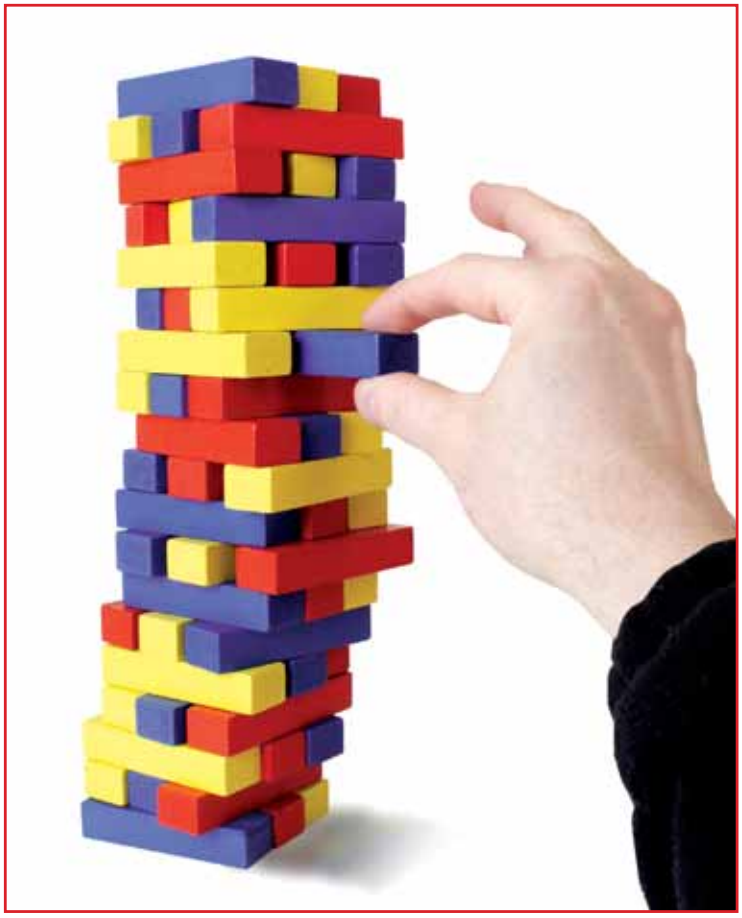
(vi) The useful life and residual value determined as per the requirements of AS 26 would be fair and the amortisation based on such determination would be systematic and would portray the true and fair view of accounts within the purview of the extant generally accepted accounting principles (GAAPs).

(vii) No, as per the requirements of AS 26, it would not be proper, not to amortise the value of publishing title and disclosing it along with the reasons, taking the plea of paragraph 67 of AS 26.

Notes:

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

Improving the Risk-Management and Compliance at Banks



Emergence of national and international legal and regulatory framework, particularly Basel-II, has necessitated higher priority for risk- management and compliance at banks. Growing use of IT in operations has indeed brought operational efficiencies and service effectiveness but at the same time it has also given rise to complexities and newer types of risks. In this backdrop, internal auditing plays an important role in the governance process by providing key strategic input to help manage risks, including those related to operational and compliance aspects. This article attempts to delve into some critical controls/areas at branches to be evaluated by internal auditors considering the probability of occurrence of significant errors, irregularities or non-compliances.

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In the wake of recent emergence of national and international legal/regulatory framework in general and with the evolvement of Basel-II framework in particular, risk- management and compliance at Banks have become heightened priority for those charged with Governance as well as for those charged with Management. Growing use of IT in operations, hav-

ing brought operational efficiencies and service effectiveness, has also given rise to complexities and newer types of risk. Sometimes, traditional controls e.g., principle of independent - check/segregation of duties/clarity of authority & responsibility relationship etc. are missing and non-compatible functions are clubbed. Besides, among other attributable causes, increasing appetite to meet budgeted growth-targets, coupled with non-increase in proportional infrastructure at branches, has also led into instances of errors, irregularities and non-compliances. Internal auditing plays an important role in the governance process by providing key input to strategic as well as to operational management in managing their risks in general and operational risk in particular including the compliance risk.

As per BCBS (Basel Committee on Banking Supervision) paper on Compliance and the Compliance Function in Banks (April 2005) Compliance risk is *"the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, codes of conduct applicable to its banking activities. (together, compliance laws, rules and standards)"*

Definition implies that apart from the risk of legal/regulatory non-compliances, it includes the risk of non-compliance of codes of conduct e.g., code prescribed by BCSBI (Banking Codes and Standards Board of India), internal codes of bank such as best practices code, employees code etc.

Realising the role of audit function in compliance evaluation, banking regulator, vide Para 6.2 of its circular No. DBS.CO.PP.BC 6/11.01.005/2006-07 dated April 20, 2007 narrates:

"Inspection/audit findings should serve as a feedback mechanism for the compliance department for assessing the areas of compliances breaches/failures. The chief Compliance Officer should be an invitee to the meetings of the ACB. A checklist on the compliance aspect may be made part of the inspection report for the inspectors/concurrent auditors to verify the level of compliance. The audit function should keep Head of Compliance informed of audit findings related to compliance." Further as per para 7.5 of the said circular:

"The activities of compliance function should be subject to annual review by the internal audit. Compliance risk shall be included in the risk assessment methodology of the internal audit function and the audit programme shall cover the adequacy and effectiveness of the bank's compliance function including the testing of controls commensurate with the perceived level of risk."

Instances on errors/irregularities/non-compliances/perpetrated frauds reveal that in many cases laid down systems & procedures have not been followed and vulnerabilities associated with weak internal control systems have been exploited resulting in material losses/misstatements. It is the management to ensure existence of adequate and effective internal control system addressing these risks appropriately. Yet, it becomes equally essential for audit function to consider the probability for significant errors, irregularities or non-compliances.

According to Para 11 Standard on Internal Audit "Basic Principles of Internal Audit" of ICAI:

"The internal auditor should plan his work to enable him to conduct an effective internal audit in a timely and efficient manner, ensuring that appropriate attention is devoted to significant areas of audit, identification of potential problems and appropriate utilisation of skills and time of the staff".

To this end, the article is an attempt to delve into some critical controls/areas at branches to be evaluated by internal auditors considering the probability of occurrence of significant errors, irregularities or non-compliances. Associated risks with non-existence, inadequacy and ineffectiveness of controls have also been discussed in the headings in the box on next page:

S.No.	Controls/areas and suggested evaluation	Yes/No	Associated Risk
1	Compliance policy & procedures		
	1. Has the compliance policy in terms of RBI guidelines spelling out the roles & responsibilities for various functionaries been documented and copy duly circulated among operational staff held at branch? 2. Are compliance manuals/check-lists on various compliance obligations under various statutes/regulations/government directives/bank's internal guidelines held, duly circulated among operational staff and compliance recorded? For instance, i. RBI (KYC Norms, Prudential IRAC Norms, Prudential Norms on Capital Adequacy etc.) ii. ICAI (Applicable accounting standards) iii. CBDT/CBEC (TDS, BCTT, FBT, Service Tax) iv. Prevention of Money Laundering Act, 2002 (Submission of CTR & STR to FIU, GOI) v. IBA vi. SEBI vii. IRDA viii. FEMA ix. RTI Act x. Various government directives xi. Various committee recommendations, such as Mitra committee, Ghosh & Jilani committee etc. xii. Guidelines for government business xiii. Codes prescribed by BCSBI as well as internal codes of bank xiv. HO instructions/guidelines xv. Compliance of various audit/inspection reports etc.		1. In terms of BCBS paper, compliance risk is sometimes referred to as integrity risk for the banks. 2. Non- compliances may result in to material losses /misstatements such as punitive/administrative actions and loss of revenue/reputation to the bank. 3. Non-maintenance of clear & documented policy may lead to compliance breaches and accountability could not be fixed in case of failures/ breaches.
2	Day-begin procedure		
	1. Is User-arrangement done daily and recorded? 2. Have user-ids been created with the recorded approval of competent authority? 3. Are all User-IDs unique and not generic (not related to any specific user)? 4. Are User-IDs of "on-leave"/"transferred" employees deactivated promptly? 5. Are users access privileges for different menus and financial powers for different types of transactions i.e., cash, clearing and transfer, duly authorised as per bank's operational guidelines? 6. Is power of authorising exceptions limited to competent officials only and recorded? 7. Has no transaction power allowed to system administrator for its administrative user-ID? 8. Have guidelines relating to creation of user-ids, been adhered? To check guest/temporary IDs are deactivated after use. For instance, auditors/vendors/ consultants etc.		1. Virtually, principle of independent check (maker-checker) compromised if multiple user-ids had by the single user at different access levels and is exposed to the risk of incompetent authorisation of transactions. 2. Making/authorisation of transactions by generic/commonly shared user-IDs leave chances for not tracing the person in case of investigation.

3.	Day-end procedure		
	1. Are day-end reports as per bank's operational guidelines, including the following vital reports, taken printed and checked for correctness, completeness and authenticity of the transactions of the day as per bank's guidelines and no anomalies exist? i. Exceptional transactions report. ii. Access log iii. Rejected/cancelled transactions. iv. G L affected balances v. Transactions authorised by single user. vi Long books of different departments. vii. Audit trail on financial and non-financial trans actions. viii. Special reports, such as Report on large cash transactions/KYC compliance etc. 2. Are all exceptions duly scrutinised, authenticated and disposal documented?		1. Incorrect, incomplete /incompetent authorisation of transactions may go unnoticed and is exposed to the risk of errors/irregularities. 2. Duplication/missing of any voucher, anomalies/ unusual features/large cash transactions may not be detected at early stage. Thus, exposed with the risk of compromising with data integrity/compliance risk. 3. Non-availability of fall –back reports, in situations of need, may disrupt business continuity.
4	Business Continuity Planning		
	1. Is a copy of documented business continuity/disaster recovery plan held at branch? 2. Is it current in accordance with the environment? 3. Is it tested regularly and audited? 4. Are roles & responsibilities of all different team members adequately communicated?		In today's 24*7 globally networked environments, discontinuity of business/non-availability of systems may not only cause tangible losses but may also tarnish the public image of the banks.
5	Updates, periodical follow-up & system generated transactions		
	1. Are periodical reports on updates including updates on master files taken, checked for correctness and held on records? For instance, a) Updations in security master (primary & collateral) b) Updations in operating instructions of account. c) Updations in TDS master. d) Linking & Updation of interest tables, such as linking of rate of interest on loan against term deposits with rate of interest on respective term deposit accounts etc. 2. Are periodic follow-up reviews carried out by taking print copies and authenticated copies held on records? For instance, i) fresh valuations of land & buildings held as securities in NPA accounts due. ii) reviews/renewals of limits/loan documents due iii) inspections due. iv) insurances due. v) ROC search cases due etc. 3. Are system generated reports e.g., interest/service charges applied/failure reports taken, checked for correctness and held on records?		1. Inadequate control over updations and follow-up reviews may result into risk of data integrity and other adverse impacts on: i. Asset classification & provisioning ii. Fresh slippage into NPAs iii. Turning of accounts into time-barred. iv. TDS compliance v. Calculation of capital adequacy ratio etc. 2. Non-scrutiny of reports may result into short/excess recovery of revenue consequently resulting into financial/ reputation loss to the bank.

6	Balancing & Reconciliation of GL control accounts with subsidiary ledgers		
	1. Are all GL heads and sub-heads as per bank's approved scheme and all accounts opened under these sub-heads as per bank's guidelines? Have these been verified and documented on records? 2. Are periodical-balancing reports on subsidiary ledgers taken printed, verified and authenticated copies held on records? 3. Are balances of GL control accounts reconciled with balances of subsidiary ledgers and authenticated copies of reconciliations held on records? 4. Are outstanding entries analysed for reasons and procedures documented?		1. Unreconciled control accounts and non-balancing of subsidiary ledgers may result into compromise with data integrity. 2. Un-located/un-reconciled entries may go unnoticed and is exposed with the risk of errors/irregularities.
7	Office accounts		
	1. Are all office- accounts opened under various GL sub-heads as per bank's approved scheme and duly authorised with competent authority? To check especially whether all accounts opened under GL Sub-head "Suspense" and "Sundries" are as per bank's guidelines. 2. Are report on such accounts scrutinised and authenticated copies held on records? To check outstanding entries are promptly pruned/adjusted. 3. Are reasons for long pending entries analysed and recorded? 4. Are un-located differences parked under these sub-heads and analysed for reasons?		1. Long pending entries, such as in suspense accounts, may attract provisioning and other implications. 2. Instances of using incorrect head of account even under the same GL sub-head may lead to misstatements. For instance, crediting tax collection into TDS account.
8	Inter-Office accounts		
	1. Are outstanding balances in inter-office accounts verified periodically with respective statements of reconciliation departments and authenticated copies held on records? 2. Are drafts paid without advice (DPWA) periodically reconciled and follow-up recorded and huge/old balances not parked? 3. Are bankers' cheques/drafts ledger balanced and reconciled periodically and period-wise analysis of outstanding balances held? 4. Are long/huge outstanding entries in clearing accounts analysed for reasons and adjusted promptly? 5. Are inter-branch reconciliations held and statements of HO reconciliation departments attended promptly and follow up recorded? 6. Are inter-bank reconciliations held and actions taken for prompt adjustment of outstanding entries recorded?		1. Debit balances outstanding in inter-office accounts may have adverse impact on capital adequacy. 2. Errors/irregularities may go unnoticed.

9	Sensitive stationeries		
	1. Are duties segregated i.e., custody and recording functions separated? 2. Is periodic verification carried out as per bank's guidelines and procedures documented? To check verification is carried out by person other than custodians. 3. Is daily movement of sensitive stationeries duly accounted for and authenticated? 4. Are undelivered chequebooks kept under dual custody and recorded? 5. Are all sensitive stationeries marked with branch name & code no?		Uncontrolled/loss of sensitive stationeries may leave chances for perpetration of fraud.
10	In-operative accounts & staff accounts		
	1. Are transactions in inoperative accounts allowed under competent authority as per bank's guidelines? To check transactions are monitored for unusualness. 2. Are signatures of inoperative accounts blanked out from database and signature cards kept separate in dual custody? 3. Is identification/classification of inoperative accounts done periodically as per bank's guidelines and reports on such classification taken, checked for correctness and authenticated copies held on records? 4. Are transactions in staff accounts monitored and monitoring procedures documented by the branch? To check only one S/B account is maintained by the staff. If yes, to check for justification recorded.		1. Transactions allowed incompetently in inoperative accounts may go unnoticed till long time and is fraught to the risk of misappropriations. 2. Non-identification/classification of inoperative accounts may, virtually lead to transactions in inoperative accounts and risk of non-applying incidental charges may also result into loss of revenue to the bank. 3. Having unjustified multiple S/B accounts by the staff is fraught to the risk of irregularities.
11	Rotation of duties		
	1. Has the rotation of duties been done periodically in accordance with the bank's guidelines and recorded in the office order defining the duties clearly? 2. Are temporary delegations duly authorised?		1. Non-rotation of duties leaves the chances of non-detection of errors/irregularities of one person till long time. 2. Exercising authority-exceeding delegations may lead to injudicious exercise of authority.

12	Control registers		
	1. Are all control registers as per bank's operational guidelines including following vital registers, maintained and updated promptly? i Register for all breaches of compliances. ii. Complaints register iii. Register for claims against the bank and by the bank against parties. iv. Loan applications received/rejected register. v. Registers applicable to computerised environments as per bank's guidelines, including following vital: a) user-arrangement register b) parameter updation register c) vendor visit register d) software updation register etc. 2. Are various manuals, including the following, updated? i. Operational Manual ii. Manual of Instructions iii. Copies of policies on different functions e.g., Information security policy, credit policy, credit monitoring policy etc. iv. Power delegation charts (lending & non-lending) v. Foreign Exchange Manual vi. FEDAI guidelines etc.		Non-maintenance of control registers may not facilitate adequate follow-up and may result into several adverse consequences including: i. Non-recurrence of breaches. ii. Non-compliances of regulatory obligations. iii. Time-barring of documents. iv. Delays in reviews/renewals of limits & documents, insurances. v. Slippage into NPA etc.
13	Due date diaries cum calendars of submission of returns/statements		
	1. Are due date diaries cum calendars of returns/statements maintained and dates of submission recorded? To check & comment whether habitual/inordinate delays are monitored for non-recurrences. 2. To check & comment on procedures of preparation and to ensure accuracy of returns/statements submitted. 3. To check & comment whether supporting computer print reports, if used to prepare returns/statements, are checked for correctness and authenticated copies held on records. For instance, RBI returns, TDS returns, various periodical statements to controlling offices such as NPA statement, reviews overdue etc.		1. Non/delayed submission of returns may lead to administrative/punitive actions. For instance, RBI returns, TDS returns etc. 2. Inaccuracy of returns/statements may lend into several adverse implications for the bank.
14	Opening & operation of deposit accounts		
	1. Is verification of features of identity and address of customers carried out by obtaining documentary evidences as prescribed by RBI guidelines on KYC Norms? 2. Are reports on transactions in newly opened accounts printed and scrutinised for unusualness? For instance, unusual credits of cheques/drafts etc.		It may not achieve compliance of KYC norms and may lead to punitive /administrative actions.

15	Remittances		
	1. Are remittances of rupees fifty thousand and above not in cash? To check & comment whether requirement of quoting PAN on such applications complied with. 2. Are laid down systems & procedures for remittances followed upon and adequate care taken while effecting payment of demand drafts.		1. It may not achieve compliance of KYC norms and may lead to punitive /administrative actions. 2. Inadequacy of control is exposed to the risk of errors/irregularities/ perpetration of fraud.
16	Advances		
	a) New accounts 1. Have appraisal/pre-sanction skills been applied as per bank's credit policy/guidelines? Such as, i) obtaining duly filled loan applications in prescribed forms. ii) analysis of financial statements. iii) obtaining market confidential report. iv) conducting pre-sanction inspection and report containing the findings of inspecting official, held on records? 2. Has the check-list/certificate from competent official confirming compliance of bank's guidelines been held on records? Such as: i. usual security documents ensuring legal enforceability ii. compliance of sanction terms iii. recommendations of advocate's search r port iv. obtaining valuation report from approved professionals. v. recovery of applicable charges etc. 3. Have the post-disbursement inspection reports, confirming the verification of end-use of funds by the competent official, been held on records? a) Existing accounts 1. Are all existing accounts monitored for follow up as per credit monitoring policy of the bank? 2. Are reports on irregular accounts scrutinised for follow-up and duly authenticated copies held on records? 3. Are inspections carried out at stipulated frequencies, especially in irregular accounts and inspection reports containing the findings of inspecting officials, held on records? 4. Are reasons for long arrears adequately analysed and follow-up recorded? 5. Is it ensured by the branch that all bills purchased /discounted are within sanction limits?		Inadequacy of controls in appraisal, sanction, documentation & disbursement process may lead to several adverse consequences including 1. Adverse impacts on legal enforceability of documents. 2. Diversion of funds 3. Slippage into NPAs 4. Non-detection of perpetrated frauds at early stage. Non-reversal of entries of BG and LC may have adverse impact on capital adequacy.

	6. Are laid down systems & procedures followed and adequate care taken to verify the genuineness of bills and unusual features looked into? Such as, bills drawn in single party/few parties, receipts of a single lorry company, frequent return etc b) Non-fund based business: 1. Has the balancing been carried out periodically as per bank's guidelines? 2. Have expired BG/LC limits been reversed promptly?		
17	Foreign Exchange Business		
	1. To check & comment whether laid down systems & procedures including RBI's circulars on foreign exchange business are adhered to-- such as: i) Adherence of KYC Norms. ii) Obtaining applications in Form-1 from persons, firms and companies making payments exceeding USD 500 or its equivalent, towards imports into India. iii) Obtaining prescribed documentary evidence of import where value of foreign exchange remitted exceeds USD 100000 or its equivalent 2. Are all prescribed returns submitted promptly? Such as R-return, SOX, BEF, EBW, ECB-2. To check & comment on habitual/inordinate delays and actions taken to regularise these. 3. Conducting verification of the import documents by the internal auditors/inspectors including external auditors as appointed by AD Bank (in terms of para 9(i) of RBI's master circular No. 8/2007-08 dated July 02, 2007).		It is exposed to the risk of losses as well as administrative/punitive actions from the regulator.

Communication of Audit Conclusions

On one hand, senior managements look internal audit for value-addition and assurance for mitigation of risks, while operational managements for actionable comments. Among its day-to-day priorities, senior managements find it difficult to go through the bulky/descriptive internal audit reports. Internal Audit findings against the criteria/condition tested, analysed into causes and effects with associated risks and combined with recommended corrective measures, would make the audit reporting more effective. This would help managements focusing on high risk/critical areas, gauge the level/significance of non-compliances and draw a plan for corrective actions. This would also help auditors while audit follow-up review and to assess the effectiveness of corrective actions initiated by the managements. On the next page is an illustrating checklist to communicate the audit conclusions.

Control/Area reviewed	Internal Auditors Findings	Internal Auditors Recommendations
Compliance policy/manuals/check-lists.	1. Documented compliance policy/function-wise manuals/check-lists held but, as interviewed with the staff, it is not communicated to them adequately and awareness level about compliance obligations found inadequate. 2. Compliance checklists not updated since last six months, while in last six months compliance obligations have amended substantially. 3. Compliance failures/breaches not recorded. Consequently, these have resulted into non-compliance of TDS laws/KYC Norms attracting punitive actions. In abse sons could not be analysed and further recurrences could not be checked. Risk- High	1. Documented compliance policy/compliance checklists narrating the compliance obligations under various laws, regulations, standards etc. must be circulated among all operational staff to seek voluntary commitment to comply. 2. Checklists should be regularly and promptly updated duly noting the date of updations as well as the approval of competent authority/departmental heads. 3. Periodic, at least quarterly, training work-shops/orientation programmes on compliance obligations e.g., KYC Norms, tax laws; implementation of accounting-standards, banking codes & standards etc. would help keep them updated with the requirement. 4. Compliance breaches/failures must be duly recorded and reasons to be analysed to check further recurrences.
Day - begin & day- end procedures	1. User-arrangement is not done daily. User-IDs of employees "on leave" not deactivated promptly. Temporary/adhoc delegations of financial powers not updated promptly. Few users enjoyed financial powers beyond their delegated powers. This leaves fair chances of incompetent authorisation of transactions. 2. Day-end reports as per operational guidelines printed but not scrutinised adequately. Large number of accounts has been shown in the report as "limit expired". But, how these disposed off, not recorded. Simultaneously, annual review charges due applicable as per bank's norms, were also not applied promptly resulting into revenue loss to the bank. Risk- High	1. User-arrangement to be carried out daily updating their powers. Information security guidelines need to be documented/ communicated to all operational staff. Various users need to be trained in their operational areas especially in information security aspect. 2. All day end reports including the exceptions and audit trails (financial & non-financial) should be duly taken printed, scrutinised by competent official and authenticated by the departmental heads in token of their approval. 3. Disposal of day-end reports including the exceptions should be noted with date and actions initiated under approval of branch head/departmental heads.

Availability of Business Continuity/Disaster Recovery Plan	1. No such documented plan held at branch. 2. BCP/DRP held but not updated/not communicated to the staff adequately. As interviewed, various members of the disaster recovery team are not aware about their responsibilities incase of emergency. Risk-High	1. Copy of current and approved BCP/DRP need to be held at branch. 2. This should be regularly updated conforming to the operating environment and communicated to all concerned. 3. This should be regularly tested, at least annually, and should be independently audited by I. S Auditors.

In order to comply legal/regulatory requirements meticulously and in their endeavor to manage the risks effectively, managements, sometimes, seek cent-percent checking/absolute assurances/certifications from internal auditors. Besides, rising instances of non-compliances/perpetration of frauds, particularly with the involvement of employees at branches, have also led to seek internal auditor's comments on vigilance aspect/personal investigations of the employees. For instance,

a) Abuse of official position.

b) Acquiring assets disproportionate to one's known sources.

c) Whether an employee maintains a style of living, which is beyond his/her income?

d) Cheating etc.

Instead, managements should develop mechanism of management review, such as obtaining Statements of Assets & Liabilities periodically from the employees etc. Together, all these need to be looked into appropriately to make them conforming to the:

a) engagement objectives, and

b) auditing regulator's technical & ethical standards/assurance framework.

Conclusion

Today's business environment need focused attention and devotion of much time & effort on the part of auditors to concentrate on critical/high risk areas as well as use of attitude to consider the probability of significant errors, irregularities/non-compliances. None of the checklists could be a panacea to meet all situations. Instances have highlighted those even slight deficiencies in internal control systems are enough to bring the whole security of the systems as well as the public trust of the bank down. Managements need to invest adequate time and resources to take remedial actions. Entrusting the task as compliance reviewer, the banking regulator has reposed overt trust as well as profound responsibilities on the audit function to assure managements in achieving the compliance and managing the risks. Its significance could be gauged from the fact that instances of non-compliances & administrative actions initiated against will be disclosed in annual reports of the banks. In view to implement the banking regulator's guidelines on compliance within deadlines of six months, managements need to have a re-look on their compliance mechanism. Simultaneously, it is need of the hour for auditors to keep abreast of the changes/implications on audit function and to respond to any change in the related environment proactively. ❑

B. INDIRECT TAXES

EXCISE

1. With effect from 01.04.2008, ***Notification No. 10/2008 CE (NT) dated 01.03.2008*** has amended the following CENVAT Credit Rules, 2004:

(i) Rule 2: Clause (l) defining "input service" has been amended so as to substitute the words "clearance of final products, *upto* the place of removal" for the words "clearance of final products from the place of removal".

With effect from 01.03.2008, clause (p) defining "output service" has been amended so as to exclude "goods transport agency service" from the scope of output service.

(ii) Rule 3: With effect from 01.03.2008, sub-rule (4) has been amended to provide that in case of National Calamity Contingent Duty (NCCD) payable on mobile phones, credit of any duty of excise other than NCCD will not be utilised for payment of the said NCCD.

The first proviso to sub-rule (5) has been amended to allow removal of capital goods outside the premises of the provider of the output service without any time restriction, if the same are used for providing output service. Consequently, second proviso to rule 3(5) has been omitted.

(iii) Rule 6: In sub-rule (1) the words "exempted goods or for provision of exempted services" have been substituted for the words "exempted goods or exempted services".

Sub-rule (3) has been substituted by the following new sub-rule:

Notwithstanding anything contained in sub-rules (1) and (2) the manufacturer of goods or the provider of output service, opting not to maintain separate accounts, shall follow either of the following options, as applicable to him, namely:

(i) the manufacturer of goods shall pay an amount equal to ten percent of the value of the exempted goods and the provider of output service shall pay an amount equal to eight percent of the value of the exempted services; or

(ii) the manufacturer of goods or the provider of output service shall pay an amount equivalent to the CENVAT credit attributable to inputs and input services used in, or in relation to, the manufacture of exempted goods or for provision of exempted services subject to the conditions and procedure specified in sub-rule (3A).

Sub-rule (3A) prescribes the conditions and procedure for determination and payment of amount payable under clause (ii) of sub-rule (3) above.

(iv) A new rule 7A has been inserted to prescribe a procedure to enable the provider of output services to take credit on inputs and capital goods on the basis of an invoice/challan/bill issued by its other office.

(v) With effect from 01.03.2008, a new rule 15A has been inserted to provide for general penalty upto Rs.5000/- in case of contravention of any of the provisions of the CENVAT Credit Rules, 2004, for which no specific penal provision exists.

The complete text of the above-mentioned notification can be downloaded from the following link:

http://www.cbec.gov.in/excise/cx-act/notfns-2k8/cent10-2k8.pdf

2. ***Notification No. 13/2008 CE (NT) dated 01.03.2008*** has introduced "Central Excise (Determination of Retail Sale Price of Excisable Goods) Rules, 2008" to determine the retail sale price of any excisable goods under sub-section (4) of section 4A of the Act.

The complete text of the above-mentioned notification can be downloaded from the following link:

http://www.cbec.gov.in/excise/cx-act/notfns-2k8/cent13-2k8.pdf

3. With effect from 01.04.2008, ***Notification No. 15/2008 CE (NT) dated 01.03.2008*** has amended Form ER-1 & ER-3. The table at Sl. No. 3 of returns relating to – 'details of the manufacture, clearance and duty payable' have been amended to insert two new columns

to seek information in respect of opening and closing balance of quantity of goods manufactured and cleared. Two new rows have been inserted in the tables (Sl no. 8 of ER-1 & Sl. No. 6 of ER-3) relating to - 'details of CENVAT Credit taken and utilised' to seek information on (i) credit utilised for payment of amounts in terms of rule 6 of CENVAT Credit Rules, 2004 and (ii) credit utilised for other payments.

A new column has been added for inserting serial numbers to the existing rows. Similarly, in the tables relating to - 'details of other payments made' a new row has been inserted in the table for seeking the 'total' of various payments made. These changes have been made for ease of calculation at the time of scrutiny of returns.

The complete text of the above-mentioned notification can be downloaded from the following link:

http://www.cbec.gov.in/excise/cx-act/notfns-2k8/cent15-2k8.htm

4. *Notification No. 16/2008 CE (NT) dated 04.03.2008* has amended Notification No. 35/2001 CE (NT) dated 26.06.2001, which prescribes the conditions, safeguards, and procedures for excise registration and exemption thereof. The format of Registration Certificate has been amended to incorporate the name of the proprietor or the Hindu Undivided Family (HUF) in the Registration Certificate issued under rule 9 of the Central Excise Rules, 2002. Further, relevant instructions of the Application Form for Central Excise registration have also been amended. These amendments are being carried out to ensure that in case of a proprietary concern or HUF, the names of the persons who are actually responsible for manufacture, clearance etc., are available with the Department.

The complete text of the above-mentioned notification can be downloaded from the following link:

http://www.cbec.gov.in/excise/cx-act/notfns-2k8/cent16-2k8.htm

In this regard, ***Instruction F. No. 201/14/07-CX-6 dated 17.03.2008*** has clarified that the proprietorship firms that are already registered with the Department do not have to file a fresh application. Since the name of the person seeking registration is available at Sl. No. 2(iii) & 13 of the application form, fresh registration incorporating the name of the proprietor may be issued *suo moto*. In case of partnership firm, no new registration certificate is to be issued. However, the name of all the partners are to be incorporated in the application form.

5. *Notification No. 20/2008 CE (N.T.) dated 27.03.2008* has appointed Chief Commissioners of Income Tax, Large Tax payer unit as central excise officers and invested them with all the powers of Chief Commissioner of Central Excise which can be exercised throughout the territory of India.

The complete text of the above-mentioned notification can be downloaded from the following link:

http://www.cbec.gov.in/excise/cx-act/notfns-2k8/cent20-2k8.htm

6. *Notification No. 11/2008 CE (NT) dated 01.03.2008* has amended Notes of certain Chapters in the Central Excise Tariff Act, 1985 so as to align the definition of processes amounting to manufacture with the definition of manufacture in section 2f(iii) of the Central Excise Act, 1944. The words "labelling or relabelling of containers **or** repacking" have been substituted for the words "labelling or relabelling of containers and repacking."

The complete text of the above-mentioned notification can be downloaded from the following link:

http://www.cbec.gov.in/excise/cx-act/notfns-2k8/cent11-2k8.pdf

SERVICE TAX

1. *Notification No. 4/2008 ST dated 01.03.2008* has amended the following Service Tax Rules, 1994:

(i) Rule 6: After sub-rule (1) a new sub-rule (1A) has been inserted so as to facilitate the assessee to make advance payment of service tax on his own volition and adjust the amount so paid against the service tax which he is liable to pay for the subsequent period. Such facility shall be

available when the assessee shall (i) intimate the details of the amount of service tax paid in advance, to the Jurisdictional Superintendent of Central Excise within a period of 15 days from the date of such payment, and (ii) indicate the details of the advance payment made, and its adjustment, if any in the subsequent return to be filed under section 70.

Sub-rule (4B) has been amended so as to provide that where an assessee has paid to the credit of Central Government any amount in excess of the amount required to be paid towards service tax liability for a month or a quarter, as the case may be, the assessee may adjust such excess amount paid by him subject to 1 lakh rupees [prior to this amendment, such limit was Rs.50,000] against his service tax liability for the succeeding month or quarter, as the case may be.

(ii) Rule 7B has been amended so as to increase the period of submission of revised return from "60 days" to "90 days" from the date of submission of the return under rule 7.

(iii) Rule 7C has been amended by inserting third proviso after second proviso. The new proviso provides that where the gross amount of service tax payable is nil, the Central Excise officer may, on being satisfied that there is sufficient reason for not filling the return, reduce or waive the penalty.

The complete text of the above-mentioned notification can be downloaded from the following link:

http://www.servicetax.gov.in/notifications/notfns-2k8/st04-2k8.pdf

2. *Notification No. 5/2008 ST dated 01.03.2008* has amended the "Export of Services Rules, 2005" by inserting a second proviso after the first proviso to clause (ii) of sub-rule (1) of rule 3. The new proviso provides that where the following taxable services: -

(i) Management, maintenance or repair service - sub-clause (zzg)

(ii) Technical testing and analysis agency's service - sub-clause (zzh) and

(iii) Technical inspection and certification service - sub-clause (zzi)

are provided in relation to any goods or material or any immovable property, as the case may be, situated outside India at the time of provision of service, through internet or an electronic network including a computer network or any other means, then such taxable service, whether or not performed outside India, shall be treated as the taxable service performed outside India.

Similarly, ***Notification No. 6/2008 ST dated 01.03.2008*** has amended the "Taxation of Service (Provided from Outside India and Received in India) Rules, 2006" by inserting a second proviso after the first proviso to clause (ii) of rule 3. The new proviso provides that where the above-mentioned three taxable services are provided in relation to any goods or material or any immovable property, as the case may be, situated in India at the time of provision of service, through internet or an electronic network including a computer network or any other means, then such taxable service, whether or not performed in India, shall be treated as the taxable service performed in India.

The complete text of the above-mentioned notifications can be downloaded from the following links:

http://www.servicetax.gov.in/notifications/notfns-2k8/st05-2k8.pdf

http://www.servicetax.gov.in/notifications/notfns-2k8/st06-2k8.pdf

3. *Notification No. 7/2008 ST dated 01.03.2008* has amended sub-rule (1) of rule 3 of "Works Contract (Composition Scheme for Payment of Service Tax) Rules, 2007" so as to increase the optional rate of service tax from "two" percent of the gross amount charged for the works contract to "four" percent of the gross amount charged for the works contract.

The complete text of the above-mentioned notification can be downloaded from the following link:

http://www.servicetax.gov.in/notifications/notfns-2k8/st07-2k8.pdf

4. The annual threshold limit of service tax exemption for small service providers has been increased from Rs.8 lakh to Rs.10 lakh with effect from 01.04.2008 by amending *Notification No.6/2005-ST dated 01.03.05* vide ***Notification No. 8/2008 ST dated 01.03.08.***

Consequent upon the increase in the threshold exemption limit from Rs.8 lakh to Rs.10 lakh, the annual turnover limit for obtaining service tax registration has also been increased from Rs.7 lakh to Rs.9 lakh with effect from 01.04.2008 by amending *Notification Nos.26/2005-ST and No.27/2005-ST,* both *dated 07.06.05* vide ***Notification Nos. 9/2008 ST and 10/2008 ST, both dated 01.03.08*** respectively.

The complete text of the above-mentioned notifications can be downloaded from the following links:

http://www.servicetax.gov.in/notifications/notfns-2k8/st08-2k8.pdf

http://www.servicetax.gov.in/notifications/notfns-2k8/st09-2k8.pdf

http://www.servicetax.gov.in/notifications/notfns-2k8/st10-2k8.pdf

5. In case of services provided for the transport of goods by road in a goods carriage, generally the service tax is required to be paid by certain categories of persons who pay the freight instead of the service provider namely Goods Transport Agency. The actual amount of service tax payable is computed on 25% of the amount of freight i.e., 75% of the amount of freight is provided as abatement, subject to the condition that no CENVAT credit of the duty paid has been availed of under CENVAT Credit Scheme.

Notification No.13/2008 ST dated 01.03.08 has exempted such service from the payment of service tax unconditionally to the extent of 75% of the freight. In other words, service tax shall be required to be paid only on 25% of the freight irrespective of who pays the service tax. Simultaneously, the benefit of CENVAT credit has been withdrawn to GTA service under CENVAT Credit scheme by deleting the said service from the scope of output service in the CENVAT Credit Rules, 2004. Hence-

forth, the person who is required to pay service tax under reverse charge method on GTA service can pay service tax on 25% of the freight unconditionally. Recipient of GTA service paying service tax under reverse charge method is no more required to prove non availment of CENVAT credit by the GTA service provider.

The complete text of the above-mentioned notification can be downloaded from the following link:

http://www.servicetax.gov.in/notifications/notfns-2k8/st13-2k8.pdf

6. ***Notification No. 14/2008 ST dated 01.03.2008*** has exempted the taxable services provided by a person, having his place of business, fixed establishment, permanent address or usual place of residence, in a country other than India, and which is received by a hotel located in India, in relation to booking of an accommodation in the said hotel, for a customer, who has his place of business, fixed establishment, permanent address or usual place of residence, in a country other than India, from the whole of the service tax leviable thereon. Hotel has been defined to mean a place that provides boarding and lodging facilities to public on commercial basis.

The complete text of the above-mentioned notification can be downloaded from the following link:

http://www.servicetax.gov.in/notifications/notfns-2k8/st14-2k8.pdf

7. ***Notification No. 15/2008 ST dated 01.03.2008*** has introduced "Service Tax (Publication of Names) Rules, 2008" empowering the Central Government to publish in the Official Gazette, print media, electronic media or by any other means, the names and particulars of the (a) persons, who have been adjudged to have contravened any of the provisions of the Chapter or the rules made thereunder, with intent to evade payment of service tax, and (b) persons who have been adjudged to pay but have not paid any amount, payable under the provisions of section 73A.

The complete text of the above-mentioned notification can be downloaded from the following link:

http://www.servicetax.gov.in/notifications/notfns-2k8/st15-2k8.pdf

8. ***Notification No. 16/2008 ST dated 11.03.2008*** has amended *Notification No. 30/2005 ST dated 10.08.2005* which prescribes the monetary limits of Central Excise Officers at various levels for adjudication of cases under section 83A of the Finance Act, 1994, for adjudging a penalty under the provisions of the said Act or the rules made there under. The monetary limit of adjudication of cases by Joint Commissioners has been enhanced to make it equal to that of Additional Commissioners. Accordingly, now the monetary limit for adjudication of cases under section 83A for a Joint Commissioner will be Rs.5 lakh to Rs.50 lakh. Prior to the amendment, such limit for Joint Commissioner was Rs.5 lakh to Rs. 20 lakh.

The complete text of the above-mentioned notification can be downloaded from the following link:

http://www.servicetax.gov.in/notifications/notfns-2k8/st16-2k8.htm

9. Section 73D of the Finance Act, 1994 empowers the Central Government to publish information relating to the names of the assessees or any other particulars relating to any proceedings under the Finance Act, 1994 in respect of such persons, in the manner as may be prescribed, if it is considered necessary and expedient in the public interest to do so. ***Circular No. 100/3/2008 ST dated 12.03.2008*** has prescribed guidelines regarding the type of cases to be covered, and the manner/procedure of such publication under section 73D read with the Service Tax (Publication of Names) Rules, 2008 since the power to publish names or other particulars of proceedings lies with the Central Government.

The complete text of the above-mentioned circular can be downloaded from the following link:

http://www.servicetax.gov.in/st-cirmainpg.htm

Legal Decisions[1]

DIRECT TAXES[2]

1. Should payment made towards non-compete fee be treated as a revenue expenditure or a capital expenditure?

CIT, Delhi-IV, New Delhi vs. Eicher Limited, (Previously Royal Enfield Motors Limited), Commercial Complex, New Delhi (DEL) 20 Mar 2008

A full time employee of the assessee had acquired, during the course of his employment, specialised knowledge of technology in the two-wheeler industry as well as of managing the dealership of the market place and other specialised knowledge relating to the two-wheeler business. He entered into an agreement with a company X to the effect that he would promote X and collaborate with it to set up manufacturing facilities for two-wheelers upon his retirement from the assessee.

The assessee negotiated a non-compete agreement with X and the employee whereby the assessee paid a sum so that they would not carry out any business activity with regard to two wheelers. The assessee claimed this amount as business expenditure but it was disallowed by the Assessing Officer.

The assessee preferred an appeal to the Commissioner of Income-tax (Appeals), who set aside the assessment order and held that the expenditure incurred was a business expenditure, which was upheld by the Tribunal.

The issue is whether the payment made towards non-compete fee is a business expenditure or a capital expenditure.

The High Court held that whether the expenditure is a capital expenditure or not, would depend on the facts of the case. However, it is necessary to know whether the advantage derived by the payer is of an enduring nature, and for this, one of the considerations is the length of time for which the non-compete agreement would operate although that is not decisive. While the length of time for which competition is eliminated may not strictly be decisive in all cases, yet, at the same time, it should not be so brief as to virtually be transitory.

The Court further held that the assessee did not acquire any capital asset by making the payment of non-compete fee. It merely eliminated competition in the two wheeler business for a while. The advantage was not of an enduring nature. Further, there is also nothing to show that the amount was drawn out of the capital of the assessee. On a cumulative appreciation of these facts, it must be held that the CIT (A) and the Tribunal did not err in concluding that the payment of the non-compete fee by the assessee was a business expenditure and not a capital expenditure.

2. Should the provisions relating to the carry forward and set-off of losses be applied before allowing any deduction under Chapter VI-A ?

Synco Industries Limited vs. Assessing Officer, Income Tax, Mumbai and Another (SC) 13 Mar 2008

The appellant-assessee is a company incorporated under the provisions of the Companies Act, 1956. The appellant had earned profit in both of its units. However, the appellant had suffered losses in one of the units in earlier years. The appellant claimed deductions under sections 80HH and 80-I, claiming that each unit should be treated separately and the loss suffered by one of the units in earlier years should not be adjustable against the profits of other units while considering the question of whether deductions under sections 80HH and 80-I were allowable. The Assessing Officer concluded that the assessee was not entitled to the benefit of deductions under Chapter VIA.

[1] These cases have been compiled and contributed by *www.Indlaw.com*. In most of the cases, citation has not been given because these cases are yet to be published elsewhere. Readers are invited to send in their comments on the selection of cases and their utility at *eboard@icai.org*. For the convenience of readers, the 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*

[2] Edited by CA. Mukta Kathuria, Secretary, Direct Taxes Committee of ICAI.

On appeal, the Commissioner of Income-tax (Appeals) confirmed the view of the Assessing Officer. Therefore, the appellant preferred appeals before the Income Tax Appellate Tribunal. The Tribunal, dismissing the appeal, held that the gross total income of the appellant has got to be computed in accordance with the Act before allowing deduction under any section falling under Chapter VI-A, and as the gross total income of the appellant after setting off the business losses of the earlier years, was 'Nil', the appellant was not entitled to any deduction either under section 80HH or 80-I. The appellant invoked jurisdiction of the High Court. The High Court dismissed the appeals.

The issue under consideration is whether the losses suffered by one of the units in earlier years can be adjusted against the profits of the two units while considering the question of grant of deduction under S. 80-I.

The Supreme Court held that while working out gross total income of the assessee, the losses suffered have to be adjusted. If the gross total income of the assessee is determined as 'Nil', then there is no question of any deduction being allowed under Chapter VI-A in computing the total income.

3. Can the payment of interest for delayed payment of purchase consideration be treated as a business expenditure on the grounds that the income corresponding to such payment has been treated as business income?

Kerala Road Lines vs. CIT, Cochin (SC) 12 Mar 2008

The assessee entered into an agreement for purchase of a land with buildings thereon. The buildings standing on the land were demolished and the scrap material was sold. This income was treated as business income. Under the agreement, the assessee had to pay an interest for delayed payment of purchase consideration. The assessee claimed this amount as a revenue expenditure. The assessing authority disallowed the claim of the assessee on the grounds that the payment of interest on the purchase of the property would be in the nature of a capital expenditure and not as a revenue expenditure. This order of the assessing authority was confirmed by the Commissioner of Income-tax (Appeals).

On appeal, the Tribunal set aside the order passed by the CIT (Appeals). The Tribunal held that the payment of interest was to be viewed as an expenditure under section 37, especially when the sale proceeds of the scrap material from the demolished structures had been treated as a business income and ultimately allowed the claim of the assessee for deduction of interest.

The Supreme Court held that the Tribunal was right in observing that the payment of interest which was a contractual obligation would also be a business expenditure. Once the Revenue had accepted the income from selling scrap material as business income, then correspondingly the assessee would be entitled to claim interest on the delayed payment of the purchase consideration as a revenue expenditure.

4. Can consideration received for the relinquishment of right in property be subject to capital gains tax, even if the assessee had not become the owner of the property due to litigation?

J. K. Kashyap vs. Assistant CIT (DEL) 11 Mar 2008

The assessee, engaged in the real estate business, filed his return of income. During the course of assessment proceedings, it was noted by the Assessing Officer that apart from the profit declared by the assessee in the real estate business, the assessee received a sum for extinguishing his rights in a certain property and as this transfer had taken place as per section 2(47), he is liable to capital gain tax under section 45.

The CIT (A) has in his order held that since the possession of the property has not been given to the buyer, and the transfer has not taken place as such, the transactions are not complete. Hence, there cannot be any liability to charge of capital gains, either short term or long term. On appeal, the Tribunal set aside the order passed by CIT (A).

The issue under consideration is whether the assessee is liable to capital gains tax.

The High Court held that the transfer of capital assets is not confined to the transfer of

immovable property only, but its scope is much wider for the purpose of the Act. Section 45(1) would apply even if the consideration is received from a party other than the one in whose favour the transfer is effected.

The Court further observed that even if the assessee has not become the owner of the property due to litigation, the fact remains that he received consideration for acquiring interest in the property and that the interest was ultimately relinquished by him in favour of the new vendor. The consideration received by him for relinquishing his right in the property, thus attract the provisions of section 45(1), making him liable to capital gains tax.

5. Should depreciation be restricted proportionally, if there is a transfer of a portion of the sales to another person in lieu of materials and labour supplied by the person?

L.P. Hospitality Private Limited, New Delhi vs. Assistant CIT, Circle-4(1), New Delhi (DEL) 10 Mar 2008

The assessee company entered into an agreement with X by virtue of which it transferred 85% of its daily restaurant and bar sales in lieu of materials and labour supplied by it. No written agreement to this effect was executed between the parties. The Assessing Officer restricted the assessee's claim of depreciation to 18% of the depreciation claimed by the assessee.

On appeal, the CIT (A) allowed the appeal. On further appeal by the Revenue, the Tribunal accepted the appeal filed by the Revenue holding that the Assessing Officer rightly invoked the provisions of section 38(2), since the assessee did not use its fixed assets exclusively for its own business purposes.

The High Court observed that as X was carrying away 85% of the gross receipts of the assessee, it clearly showed that the assessee did not use its fixed assets exclusively for its own business purposes. Hence, section 38(2) is attracted.

6. If satisfaction to the effect that undisclosed income belonged to the appellant was not recorded, can the assumption of jurisdiction by the Assessing Officer under section 158BD be legal?

New Delhi Auto Finance Private Limited, New Delhi vs. CIT, New Delhi (DEL) 22 Feb 2008

A search was conducted at various premises belonging to the assessee and the residence of the Directors of the assessee. During the block assessment proceedings, the Assessing Officer found some incriminating documents relating to the assessee. However, since he did not have jurisdiction in the matter, the Assessing Officer sent a letter to the Assessing Officer having jurisdiction over the assessee. An order was passed under section 127, transferring the jurisdiction over the assessee to the Assessing Officer. An improper notice was sent to the assessee.

The issue that arises for consideration is whether the Income Tax Appellate Tribunal was correct in law in holding that assumption of jurisdiction under section 158 BD, was not illegal, even though the mandatory requirement of recording "satisfaction to the effect that undisclosed income belonged to the appellant was patently lacking on the face of record".

The High Court observed that the notice issued to the assessee was vague and that such a vague notice shows "a patent non-application of mind". The Revenue should not exercise its powers in a mechanical power but should be circumspect while taking action under the provisions of Chapter XIV-B.

INDIRECT TAX[3]

Excise & Customs

1. Whether a Non-Resident Indian on transfer of his residence to India, can bring more than one firearm under the provisions of the Arms Act, 1969 or the Baggage Rules?

Anirudh Singh Katoch vs. UOI and Others (DEL) 20 Mar 2008

The appellant, who is a citizen of India, has been residing in the USA as a Non-Resident Indian (NRI). Due to some reasons, the appellant decided to return to India for good. He applied for, and obtained three gun licenses in India under the

[3] Edited by CA. Smita Mishra, Secretary, Indirect Taxes Committee of ICAI.

Arms Act, 1959. On the appellant's arrival in India, he was told that he would be permitted to take only one firearm under the Transfer of Residence Rules. The appellant was further told by the custom officials that with regard to the two other firearms, he will have to obtain import licenses from the Director General of Foreign Trade. The appellant filed an application before the Director General of Foreign Trade for grant of permission to bring in the remaining two firearms, but the same was refused. The appellant made various representations to various authorities, but to no avail. Ultimately, the respondents replying to the legal notice served by the appellant held that as per the existing policy, there was a ban on the import of firearms under the 'Gift Scheme' as well as the 'Baggage Rules' and that the appellant could not be allowed to import more than one firearm.

The issue that arises under consideration is whether an NRI on transfer of his residence to India, can be permitted to bring more than one firearm under the provisions of the Arms Act, 1959, or the rules framed there under, or the existing Baggage Rules.

The High Court observed that a plain reading of rule 8, Baggage Rules, 1998 shows that on transferring his residence to India, a person shall be allowed, in addition to what he is allowed under rule 3 or under rule 4, depending upon the category of passenger, articles free of duty in his bona fide baggage to the extent mentioned in Column 1 of Appendix 'F'. Entry 1 of Annexure-1 mentions firearms and accordingly firearms are not permitted to be imported free of duty. But, this by no stretch of imagination can be understood to mean that there is no limitation to bringing any number of firearms into the country, and that the only effect would be that they are dutiable items.

The Court further observed that the Arms Act, 1959, though permits the appellant to hold three valid firearm licenses and to possess the three firearms, it is altogether silent about the import thereof, as the import of firearms is governed by the EXIM Policy. It is no doubt true that no person is entitled to bring into India or take out of India any arms unless he holds in this behalf a valid license issued in accordance with the provisions of the Arms Act, 1959 and the Rules framed there under, but this is as far as it goes. A person is not entitled by virtue of the Arms Act, 1959 or the Rules framed there under to bring into India such licensed firearms if any provision of law prohibits or restricts the bringing of arms into India. It is nowhere laid down in the Baggage Rules that any firearm or firearms can form part of the baggage on payment of duty thereon. Thus, quite clearly, for provisions with regard to import and export, it is the import policy which has to be looked into.

The Court also held that only upto one firearm can be cleared on production of a valid license under the Arms Act, 1959 and on payment of the appropriate duty on the firearm, in view of exclusion of firearms under rule 8 read with Appendix 'F' of the Baggage Rules and paragraph 2 of the notification No.137/90 Cus. dated 20-03-1990. The release of this one firearm is by virtue of the exercise of powers by the Central Government, as vested in the Central Government under section 11 of the Arms Act, 1959, and the Central Government vide circular No.63/95-Cus. dated 07-06-1995 permitted the release of one firearm under the 'Transfer of Residence Form Revision' to the person concerned.

2. Can the extended period of limitation be invoked in a second notice, where the first notice did not resort to the same?

Geo Technology Foundations and Construction vs. C. C. Ex., Pune (SC) 7 Mar 2008

The appellant manufactured PSC girders at site to be used in the construction of railway bridges. The articles were cleared without payment of central excise duty under Central Excise Act, 1944. A show cause notice was issued which was withdrawn and the second notice was issued subsequently. When the first show cause notice was issued, the extended period of limitation was not resorted to.

The Court observed that prior to the amendment by Act 10 of 2000 w.e.f. 12-05-2000; the extended period of limitation was one year. After the 2000 amendment, the period has become 5 years.

The Court further observed that a notice should ordinarily be issued within a period of six months (as the law stood in the given case) i.e. within

the prescribed period of limitation, but only in exceptional cases the period could be extended to one year or five years, as the case may be. When in the original notice, such an allegation had not been made; the same could not have been made subsequently as the facts alleged to have been suppressed by the appellant were known to them. Extended period of limitation under S. 11-A, Central Excise Act, 1944 has no application.

The appeals were allowed.

3. Can SSI exemption be claimed in respect to goods which bear the brand name of another person?

C. C. Ex., Jaipur vs. Dugar Tetenal India Limited (SC) 7 Mar 2008

The assessee is engaged in the manufacture of photographic chemicals. The assessee cleared its products under a brand name without payment of duty, claiming the benefit of exemption under Notification No. 175/86-CE dated 01-03-1986. Benefit was denied on the grounds that they had cleared their product affixed with the brand name of another person. The assessee's main contention is that the use of a brand name on finished goods was duly declared in their classification list and that they were under a bona fide belief that they were entitled to SSI benefit treating the brand name as their own property. On investigation the claim of the assessee was found to be false.

The Commissioner confirmed the demand of duty against the assessee by invoking the extended period of limitation prescribed under the proviso to section 11A (1), Central Excise Act, 1944, and also imposed a penalty under erstwhile rule 173Q, Central Excise Rules, 1944.

The Supreme Court observed that the brand name was owned by a foreign collaborator and that they were paying royalty as per a written agreement between them. Thus, it is established beyond reasonable doubt that the assessee had wrongly been giving a declaration in various classification lists that the brand name was owned by them.

The Court observed that Notification No. 175/86-CE stipulates that the benefit of exemption will not be available to the goods on which the brand name of another manufacturer is affixed and the said manufacturer is not entitled to the small scale exemption, so that the benefit of small scale exemption should not be misused by manufacturers manufacturing goods for different persons.

4. Can the Settlement Commission grant immunity against interest payable under the bond furnished before the Director General of Foreign Trade?

Rexnord Electronics and Controls Limited vs. UOI and Others (SC) 4 Mar 2008

The appellant is an exporter and two licenses under the Export Promotion Capital Goods (EPCG) Scheme were issued to it. It imported capital goods against the licenses availing the benefit of the Notification dated 20-04-1992. The appellant could not meet its export liability. The appellant was required to furnish a bond and undertaking before the Director General of Foreign Trade, an authority created under the Foreign Trade (Development and Regulation) Act, 1992. The appellant had also undertaken to pay interest on the differential amount. On the appellant's failure to meet its export obligations in terms of the licenses and also the Scheme, a demand notice was issued for payment of duty along with interest. The appellant filed applications before the Settlement Commission for settlement of its case. The case of the appellant was settled by the Settlement Commission with a direction to pay duty amount together with interest while granting immunity from prosecution and penalty to the appellant.

The present appeal deals with the question as to whether the term "interest" used in section 127H, Customs Act, 1962, would include within its fold interest payable under the bond furnished by the appellant before the Director General of Foreign Trade.

The Supreme Court held that if any interest became payable under the Act, indisputably the Settlement Commission will have the requisite jurisdiction to grant immunity in respect thereof either wholly or in part. All penalties, fines and interest, must however, be enforceable under the Act. The interest payable under the bond is not an interest payable under the Act.

The Court further observed that the power of the

Settlement Commission is relatable to waiver of partial or full amount of interest only under the Act.

Service Tax

5. Whether two flats would be considered as a single unit and be liable to be charged service tax separately?

S. Rangarajan vs. Oyester Co-Operative Housing Society Limited and Another (BOM) 12 Feb 2008

The petitioner is a member of the respondent society, and is the owner of two flats. According to the petitioner as the flats were inter-connected and as he had purchased the same on the understanding that the two flats would be considered as a single unit, he is not liable to pay service charges for two flats. The issue regarding the service charges came up before the General Body of the Society in the Annual General Meeting held on 23-05-2004, and a resolution was passed by a majority of the members that each flat purchaser would have to pay separate service charges for each of the flats owned by them as per the bye-laws of the Society. It is this resolution dated 23-05-2004 which is the subject matter of dispute in this petition.

The Supreme Court observed that the agreements in respect of the two flats were separate. There were two electric meters in respect of the two flats. Further, the modifications/alterations in the flats were made by the builders at the instance of the petitioner himself. The petitioner cannot now be heard to say that the two flats should be treated as a single unit and that service charges should be levied as a single unit. The fact that the petitioner had managed to get approval of the Municipal Corporation for amalgamation of two flats, is not reason enough to take a different view of the matter.

6. Whether appellant is liable to service tax as manpower recruitment agency in view of definition under section 65(68)?

Institute of Banking Personnel Selection vs. Commissioner of Service Tax, Mumbai (CESTAT) 6 Sep 2007 [2007 (8) STR 579]

The appellants are engaged in the activity of conducting examinations for recruitment of clerical staff, officers and specialist officers cadre in banks, financial institutions and other organisations. They carry out a detailed job analysis, identify and develop suitable selection tools, conduct confidential printing of test material, make arrangements for conducting examinations, assess test papers and finalise results of written tests and short list candidates for interview by their clients. They also handle recruitment projects on a turnkey basis right from the release of advertisements, receipt of applications, scrutiny and construction of test items, conduction of examinations and the processing of final results. They charge fees as per candidate basis to each user organisation for the services rendered by them.

The issue that arises for consideration is whether the appellant is not a commercial concern and hence not liable to service tax as a manpower recruitment agency in view of the definition under S. 65(68), Finance Act, which defines "Manpower Recruitment Agency" as "any commercial concern engaged in providing any service, directly or indirectly, in any manner for recruitment of manpower to a client".

The Supreme Court held that an organisation that does not declare dividend or distribute surplus/profits to its shareholders, trustees and/or members but ploughs back the surplus for the purpose of an object of the organisation would be a charitable organisation, if the object thereof is of a charitable nature.

The Court further observed that as per CBEC Circular F.No. 137/71/2006-CX dated 01-11-2006, a commercial concern is an institution or an establishment that is primarily engaged in commercial activities. The Board clarified that the principal activity of institutes like IITs or IIMs is to impart education without the objective of making profit, and therefore, such institutes cannot be called commercial concerns, even if they charge for some of their activities. In the light of the above circular, the mere charging of fees will not alter the position that the appellant-institute is not a commercial concern.

The Court concluded that the appellants were not a commercial concern and therefore not liable to service tax under the taxable head of manpower recruitment agency services.

The appeal was allowed.

INTERNATIONAL TAX

1. When is an enterprise deemed to constitute a Permanent Establishment in India?

Galileo International Inc. vs. DCIT, ITAT Delhi Bench, 30 Nov 2007

Galileo Inc. has maintained a CRS (Computer Reservation System) in USA. Various airlines use this CRS to upload their information/ product, for which they pay Galileo a booking fee. This booking fee is not a fixed amount, sbut varies according to the number of bookings concluded. Thus, in order to maximise its revenue from bookings, Galileo entered into an agreement with various marketing companies throughout the globe. In India, it entered into a Distribution Agreement (DA) with Interglobe. Interglobe would market the information/products uploaded on the CRS. By virtue of the DA, Interglobe was authorised to enter into agreements with TAs (Travel Agents). The system worked as follows:

Whenever a person intending to undertake a travel, approached the TA, the TA's request for information from the CRS was routed through Interglobe. This connectivity was provided by SITA. Galileo paid SITA for the connectivity provided. The Tribunal held that there was a business connection within the meaning of section 9(1) (i), because, it is not the server in USA alone which constitutes the CRS, but the CRS extends to the network and computers provided to the TAs in India also.

Now coming to the DTAA between India & the USA, the Tribunal held as follows:

1. Fixed place PE is constituted as the computers cannot be moved from one place to another without the permission of Galileo.
2. The activities carried out in India are not preparatory or auxiliary in character, so as to be excluded from the meaning of the term PE.
3. Installation PE is constituted under article 5(2) (k) by the network in India.
4. DAPE is constituted by the virtue of article 5(4) (a), as Interglobe has the authority to conclude contracts with the TAs.
5. However, DAPE is not constituted under article 5(4) (b), because though Interglobe maintains a stock of computers to be delivered to the TAs on behalf of Galileo, these are not goods dealt with by Galileo in its regular course of business.
6. Now that PE is constituted by virtue of article 5, only the profit attributable to the activities of the PE in India will be deemed to accrue or arise in India.
7. Applying FAR analysis, 15% of the income from the bookings is attributable to the activities of Galileo in India and hence taxable in India.
8. However, as per Cir. 23 upheld in Morgan Stanley's case, which applies not only to goods but also to services, the income accruing /arising in India is fully consumed by the payment made to Interglobe; therefore nothing remains to be taxed in India.

DISCIPLINARY CASE

Summary of a disciplinary case - A. R. Chitlangi V. P. L. Tapdiya[1] (Chartered Accountant Reference case No. 4 of 1988) decided on 06.08.2004 by the Bombay High Court under Section 21 (6) of the Chartered Accountants Act, 1949.

Facts of the Case:

Mr. A. R. Chitlangi (hereinafter referred to as 'Complainant') filed a complaint against Mr. P. L. Tapdiya (hereinafter referred to as 'Respondent'), under Section 21 of the Chartered Accountants Act, 1949 (hereinafter referred as the 'Act') to the Institute of Chartered Accountants of India (hereinafter referred to as the 'Institute') alleging, inter alia, that he was articled clerk with the Respondent for the period from 1st January, 1976 to 4th February, 1977 but during that period he was not paid monthly stipend. The Respondent was alleged to have committed breach of Regulation 32B of the Chartered Accountants Regulation, 1964. The Respondent filed a written statement and set up the defence that the complainant used to remain absent from his duties frequently without informing the office, he was undisciplined and had irregular behaviour. During the pendency of the proceedings before the Disciplinary Authority, the Respondent remitted the entire amount of stipend to the complainant without prejudice to his contentions.

The Council of the Institute prima facia opined that the Respondent was guilty of professional 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 submissions made on behalf of the parties came to the conclusion 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 clause (i) of part II of Second Schedule to the Act for having contravened Regulation 32B of the Chartered Accountants Regulation, 1964.

The Council considered the report of the Disciplinary Committee alongwith the written representation of the Respondent and found that the Respondent was guilty of professional misconduct falling within the meaning of Section 21 read with Section 22 of the Chartered Accountants Act, 1949 and clause (i) of part II of Second Schedule to the Act and recommended to the High Court that the Respondent be reprimanded. As required under Section 21 (5) of the Act, the matter was referred to the High Court of Bombay with the recommendations of the Council.

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

Decision of the Hon'ble High Court:

The Hon'ble Court observed that there appears to be no challenge to the aspect that the complainant was working as articled clerk with the Respondent and there is also no challenge that during the article period, the complainant was not paid stipend. It was also not in dispute that under Regulation 32B the Respondent as a Member of the Institute was required to pay monthly stipend to the complainant.

The Court also observed that the explanation of the Respondent for non-payment of stipend, on the ground that the complainant was absent from his duties frequently without any information, was not acceptable in view of the admitted position that the Respondent had given to the complainant the 'form' i.e. the period during which the complainant worked with the respondent. If complainant used to remain absent from his duties frequently without informing the office, he was undisciplined and had irregular behaviour, these facts should be found in the form 20 but that is not so and the only thing which the Respondent recorded in form No. 20 was that the performance of the complainant was not satisfactory.

On overall consideration of the matter, the Court accepted the findings of the disciplinary authority and the recommendation of the Council and ordered that the Respondent be reprimanded.

[1]For full text of the judgement, please see Institute's publication viz. Disciplinary Case Volume VIII, Part 1, pp 508 -520.

Determination of Arm's Length Price

Traditionally Arm's Length Price is associated with transfer pricing, which has been defined as the price at which goods are transferred from one division/department of an enterprise to another division/department of the same enterprise. With the passage of time the transactions between related parties have come to occupy the centre stage on the issue of transfer pricing & consequently Arm's Length Price.

The sheer complexity of the determination of Arm's Length Price has made it a widely debated topic among accounting professionals. Traditionally Arm's Length Price is associated with transfer pricing, which has been defined as the price at which goods are transferred from one division/department of an enterprise to another division/department of the same enterprise. With the passage of time the transactions between related parties have come to occupy the centre stage on the issue of transfer pricing and consequently Arm's Length Price. This Article deals with the principles and methods of apportionment of determination of Arm's Length Price.

— CA. S.P. Santhanam

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Determination of Arm's Length Price Under Section 92C of Income Tax Act

Rule 10B. (1) For the purposes of sub-section (2) of section 92C, the Arm's Length Price in relation to an international transaction shall be determined by any of the following methods:

(a) Comparable Uncontrolled Price Method, by which—

(i) The price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;

(ii) Such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market;

(iii) The adjusted price arrived at under sub-clause *(ii)* is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction;

Annexure 1: Comparable Uncontrolled Price Method (CUP) illustrated

Arms Length Price – Comparable Uncontrolled Price Method
MANUFACTURING SECTOR

Example 1:

XYZ of Japan sells to ABC of India (related) and to MNO of UK (unrelated) its CD players. The product is identical. The terms are one year warranty for India and a 6 months warranty for UK. The cost of one-year services is estimated as Rs.500/- per piece in India and UK. Sales to ABC are CIF and to MNO are FOB. As the products are identical, warranty, insurance and freight will have to be normalised for comparison of both the prices. We have to determine the ALP on CUP basis for sales from XYZ to ABC.

Calculation:

Particulars	XYZ to ABC Rs.	XYZ to MNO Rs.
Selling Price (converted to Rs. on the date of invoices for ABC)	5000.00	4000.00
Less: Cost of service	500.00	250.00
	4500.00	3750.00
Add: Insurance & freight (actual)	Nil	250.00
Normal comparable price	4500.00	4000.00

No. of pieces purchased by ABC		10000
Arm's Length Price		Rs.4000/-
Transfer price charged to ABC	Rs.4500/-	
Excess TP charged per piece	Rs.500/-	
Total excess income of ABC under CUP method	Rs.50 lakhs	

Arms Length Price – Comparable Uncontrolled Method

SERVICES SECTOR FINANCIAL

Example 2:

A Ltd. a bank promotes B Ltd. a merchant-banking subsidiary jointly with a foreign collaborator. B Ltd. wants a loan from A Ltd. at the Prime Lending Rate (PLR) of A Ltd. A Ltd. normally lends at PLR to its borrowers having the highest credit rating score as per its internal rating score. B Ltd. being a new company does not have the highest score but will qualify as "Average" if credit rated. The foreign collaborator is a company having an excellent credit score. The foreign collaborator offers to give a guarantee to B Ltd.'s borrowing from A Ltd. or any other bank.

A Ltd.: Details

Rate of interest charged to B Ltd. (Throughout the year)		10% p.a.
Frequency	Quarterly interval	
PLR charged by A Ltd to 'A+' customers	10% p.a. for 6 months	
(rate charged during the mid year)	12% p.a. for 6 months	
Average PLR	11% p.a. (weighted average for the period)	
Credit rating of B Ltd. as per internal score		Average
Lending rate of A Ltd to "average" borrowers	11% p.a. for 6 months 13% p.a. for 6 months	
Average Lending Rate of A Ltd for "Average" Rated Borrowers	12% p.a. (weighted)	
PLR of Bank 'C Ltd.' (independent) Average for the year		11.5% p.a.
PLR of Bank 'C Ltd.' charged out of pocket expenses, cost of inspection, etc. for all corporates		0.5% p.a.
Total interest costs charged by A Ltd. for B Ltd.		Rs.5 lakhs p.a.
Out of pocket expenses recovered by A Ltd. from B Ltd.		Nil

Comparable Uncontrolled Price	A Ltd. To B Ltd. (Related party)	Other Bank
Interest rate applied	10% p.a.	11.5% p.a.
Add: Out of pocket expenses	Nil	1.0% p.a.
Effective Rate	10% p.a.	12% p.a.

Transfer Price advantage passed to B Ltd.	2% p.a.	
However, ARMS LENGTH PRICE is PLR charged by A Ltd. for all other "Average" customers (unrelated)		12% p.a.
Transfer Price advantage as per CUP		2% p.a.
Actual interest paid		Rs.5,00,000/-
Transfer price advantage passed to B Ltd. @ 2% as per CUP - 5,00,000 x 2/10		Rs.1,00,000/-
Interest earning of A Ltd. as per CUP		Rs.6,00,000/-

(b) Resale Price Method, by which —

(i) The price at which a property is purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise is identified;

(ii) Such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions;

(iii) The price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of a property or obtaining of services;

(iv) The price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market;

(v) The adjusted price arrived at under sub-clause (iv) is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise;

Annexure 2: Resale Price Method illustrated

Arms Length Price under Resale Price Method

PHYSICAL GOODS

This method is ideally used for enterprises doing only marketing, sales and distribution functions with an insignificant value addition.

Example 1:

UK Company 'A' sells a cosmetic perfume to its related enterprise 'B' at Rs.60/- per piece. 'B' resells to unrelated parties at Rs.100/-. The total cost of the product to 'B' is Rs.80/- including administration and selling and distribution cost of Rs.20 per piece. In this trade, the normal gross margin is 25%.

ALP is resale price Rs.100/- less Gross Profit Rs.25	-	Rs.75
Less: Costs incurred for administration	-	Rs.20
ALP per unit	-	Rs.55

The Transfer Price of Rs.60/- under controlled condition is in excess by Rs.5/- per unit reducing the profit of 'B' causing revenue leakage to the country.

Here, the costs incurred for unrelated parties require proper analysis and record. The CAS-1 6.3.5 to 6.3.9 should be applied for determining the cost of administration, selling and distribution. It may be noted that the resale price method does not envisage incurring of costs under the head 'Research & Development'.

Example 2:

X Ltd. markets imported injection sets of insulin

Imports are made from A Ltd. (Related enterprise) and B Ltd. (Unrelated enterprise)

Additional Information available:

1. A Ltd.'s supplies are in packs of 100 on CIF basis (Insurance Rs.2,00,000/- for 1,00,000 units and freight Rs.5,00,000/- for 2,00,000 units)
2. B Ltd.'s supplies are in packs of 50 on FOB basis
3. A Ltd.'s supplies are at Rs.15,000/- per pack of 100
4. B Ltd.'s supplies are at Rs.6,000/- per pack of 50
5. Actual freight incurred for supplies from B Ltd. – Rs.50,000/- for 10000 packs
6. Actual insurance incurred for supplies from B Ltd. – Rs.30,000/- for 10000 packs
7. Actual purchases by X Ltd. during the year - 25000 packs from A Ltd.
   - 10000 packs from B Ltd.
8. Costs incurred by X Ltd. for the year

Rent of premises	Rs.60,000/-	
Office expenses	Rs.50,000/-	
Wages paid for repacking		Rs.1,50,000/-
Packing materials for repacking		Rs,1,50,000/-
Freight and Insurance outward		Rs.30,000/-
Free samples for marketing		Rs.50,000/-
Wastage (broken) not allowed by Insurance	Rs.5,000/-	

9. Selling Price Rs.200/- per unit
10. All the units purchased are sold in the same year and no stock is left (If stocks are left they should be valued at cost excluding selling and distribution overheads)

Computation of ALP under Resale Price Method

Particulars	From A Ltd.	From B Ltd.	Total
No. of units purchased & sold	25,00,000	5,00,000	30,00,000
Resale price per unit	Rs.200/-	Rs.200/-	Rs.200/-
Sales value (Rs. In lakhs)	5000.00	1000.00	6000.00
Costs incurred (Rs. In lakhs)			
Purchases	3750.00	600.00	4350.00
Freight	Nil	0.50	0.50
Insurance	Nil	0.30	0.30
Administrative Expenses Rent Rs.60,000/- Office exp. Rs.50,000/- Total Rs.1,10,000/- (distributed in the proportion of Net Sales Value as per IAS 7.2)	0.92	0.18	1.10
Selling Costs Repacking materials 1,50,000 Wages for repacking 1,50,000 Freight & Insurance 30,000 Free samples 50,000 Wastage 5,000 Total 3,85,000 (distributed based on Net Sales Value as per IAS 7.2)	3.21	0.64	3.85
TOTAL COSTS	3754.13	601.62	4355.75
GROSS PROFIT	1245.87	398.38	1644.25
GROSS PROFIT % on SALES	24.92	39.83	
Independent Enterprise GP %		39.83	

ALM Calculation:

Resale Price of X Ltd. for purchases from A Ltd. (related) per unit Rs.200.00

Total sales of purchased from A Ltd. (25000X100X200) Rs.5000.00 lakhs

Less: Normal Gross Profit on independent transaction @39.83% Rs.1991.50 lakhs

Normal Cost of Sales Rs.3008.50 lakhs

Less: Other specific costs

Administration cost Rs.0.92
Selling costs Rs.3.21

Total		Rs.4.13 lakhs
Purchase Cost as per Resale Price method	Rs.3004.37 lakhs	
For purchases from A Ltd.		
ALM Purchase cost per pack of 100's (Rs.3004.37 lakhs –25000)	Rs.12,017.48	
Actual Purchase cost per pack of 100's	Rs.15,000.00	
Extra purchase cost per pack paid to A Ltd.	Rs.2,982.52	
There by making X Ltd. to suffer a disadvantage		
Income additionally chargeable to X Ltd. as per	Rs.745.63 lakhs	
Transfer Price Margin in Resale Price Method		
(i.e. loss of income to X Ltd. and undue benefit passed on		
To A Ltd. due to related party transaction)		

(c) Cost Plus Method, by which—

(i) the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise are determined;

(ii) the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolledtransaction, or a number of such transactions, is determined;

(iii) the normal gross profit mark-up referred to in sub-clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market;

(iv) the costs referred to in sub-clause (i) are increased by the adjusted profit mark-up arrived at under sub-clause (iii);

(v) the sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provision of services by the enterprise;

Annexure 3: Arms Length Price under Cost Plus Method illustrated

Arms Length Price under Cost plus Method

MANUFACTURING

This method is useful in the case of services, transfer of goods requiring further processing or long-term agreements for buying/selling are applicable.

Explanation: If ABC Ltd. is transferring goods/services to XYZ Ltd., a related enterprise; the total costs incurred by ABC Ltd. are determined.

If similar/same goods or services are transferred to unrelated parties or such transfer is done by an unrelated enterprise in comparable uncontrolled transaction, the normal Gross Profit mark-up to costs will be determined. The normal GP mark-up will be adjusted for the differences materially affecting such profit mark-up in the open market.

ALP = Total cost of production + Adjusted Gross Profit mark-up.

Here, cost bases are to be comparable in both transactions. An adjustment to costs may be neces-

sary to make it comparable.

Costs may be classified as per CAS 1, 2, 3 & 4		
Illustration:	ABC Ltd. transfers goods to	
	XYZ Ltd. (related party) Rs./unit	MN Ltd. (comparable transaction) Rs./unit
Direct Material	10.00	10.00
Direct Wages	15.00	15.00
Direct Expenses	10.00	10.00
Prime Cost	35.00	35.00
Factory Overheads	5.00	5.00
Administrative Overheads	3.00	3.00
Cost of Production	43.00	43.00
Gross Profit Mark-up	8.60 (@ 20%)	17.20 (@ 40%)
Selling Price	51.60	60.20
Gross Profit Mark-up %	20%	40%
Gross Profit Mark-up	8.60	17.20
Less: Selling costs	Nil	1.40
Less: Distribution costs	4.20	2.00
Adjusted GP Margin	4.40	13.80
Adjusted GP Margin % on cost	10.23%	32.09%
Adjusted GP Margin (comparable independent)		32.09%
Adjusted GP Margin (actual)		10.23%
Difference in GP Margin		21.86%
Actual cost of production per unit		Rs.43.00
Increased GP per unit		Rs.9.40
Actual selling price		Rs.51.60
Arms Length Price per unit		Rs.61.00
Actual revenue booked for XYZ Ltd. (50000 x 51.60)		Rs.25,80,000/-
Sales at ALP (50000 x 61.00)		Rs.30,50,000/-
Increased income as per ALP under Cost Plus Method		Rs.4,70,000/-

(d) Profit Split Method, which may be applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction, by which—

(i) the combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined;

(ii) the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances;

(iii) the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated under sub-clause (ii);

(iv) the profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the international transaction:

Provided that the combined net profit referred to in sub-clause (i) may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution in the manner specified under sub-clauses (ii) and (iii), and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction.

Annexure 4: Arms Length Price under Profit Split Method illustrated

Arms Length Price under Profit Split Method

This method is suitable for those transactions where integrated services are provided by more than one enterprise or in case of multiple inter-related transactions, which cannot be separately evaluated.

It is necessary to identify the total profit and split it based on the activities performed, assets employed and risks assumed by each party with a comparison of valuation of such activities done by unrelated enterprises on a comparable basis.

Illustration 1 (services sector)

A Ltd. and B Ltd. (related parties) jointly do an assignment of computerisation together with an unrelated party C Ltd. A Ltd. is the main contractor and B Ltd. and C Ltd. are the sub-contractors.

A Ltd. supplies all hardware and B Ltd. supplies a portion of the software and C Ltd. supplies another portion of the software.

The total gross earnings received by A Ltd. is Rs.100 lakhs and it pays Rs.10 lakhs to B Ltd. and Rs.20 lakhs to C Ltd. This has to be adjusted to calculate the Arms Length Price from A Ltd. to B Ltd. Under this situation Profit Split Method could be adopted.

The total profit earned by A Ltd. and B Ltd. in this transaction is determined as follows:

	A Ltd.	B Ltd.	C Ltd.	Total
Earnings (Rs. in lakhs)	70.00	10.00	20.00	100.00
Costs (Direct+Indirect as per) Rs. in lakhs	30.00	7.00	10.00	47.00
Profits before ALP	40.00	3.00	10.00	53.00
Return on costs in %	133%	43%	100%	
Basic Return (surplus to be split)	6.00 @ 20%	7.00 @ 100%	10.00 @ 100%	23.00
Surplus return to be shared				30.00
Share of contribution for the job	50%	25%	25%	
Surplus return distributed in the ratio of share of contribution to the job	15.00	7.50	7.50	30.00
Total share of surplus	21.00	14.50	17.50	53.00
ALP from A Ltd. to B Ltd.		21.00		
Actual earnings for B Ltd.		10.00		
Additional revenue as per ALP		11.00		

Here assuming the C Ltd. transaction is more or less similar and comparable, the return of 100% on costs may be applied to find out the ALP for B Ltd.'s transaction with A Ltd.

This method has a limitation as to availability of the costs/revenue from the main contractor to ascertain the overall profits, etc. Because of this limitation, this method is not widely used.

A normal return for each industry/task may have to be determined involving detailed backup for each assumption. Collection of cost input details for each job/transaction as prescribed under CAS 1 to 4 will be helpful giving proper backup for the assumptions on cost inputs, capital employed, risks assumed etc. to determine the relative contribution.

Illustration 2: (Rs. In lakhs)

Total Earnings	In a Contract	100.00	
Share of:	A Ltd.		70.00
	B Ltd.		10.00
	C Ltd.		20.00
Costs:	A Ltd.		30.00 X1
	B Ltd.		7.00 X2
	C Ltd.		10.00 X3
	Total		47.00 ΣX

Normal Return on Costs:	A Ltd. 30%	9.00 Y1	
	B Ltd. 20%	1.40 Y2	
	C Ltd. 20%	2.00 Y3	
	Total	12.40 ΣY	
Costs + Normal return		59.40 ΣX + ΣY	
Excess surplus (Total Earnings – Costs – Normal Return)		40.60	
Excess surplus distributed in the ratio of costs incurred:			
	A Ltd. 40.60 x 30/47	25.91	
	B Ltd. 40.60 x 7/47	6.05	
	C Ltd. 40.60 x 10/47	8.64	
Aggregate Profits:	A Ltd.		34.91
	B Ltd.		7.45
	C Ltd.		10.64
Earnings based on ALP:	A Ltd.		64.91
	B Ltd.		14.45
	C Ltd.		20.64
ALP for B Ltd.:	ALP Earnings		14.45
	Actual Earnings		10.00
Excess to be recognised as Earnings under ALP through profit split method			4.45

(e) Transactional Net Margin Method by which—

(i) the net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;

(ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;

(iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;

(iv) the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);

(v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction.

Annexure 5: Transactional Net Margin Method (TNMM) illustrated

Arms Length Price – Transactional Net Margin Method (TNMM)

SERVICES SECTOR

This method is suited for transfer of semi-finished goods and distribution of certain services where the resale price method is difficult to apply.

Illustration

A Ltd. is an international bank engaging B Ltd. a related party for call centre services. B Ltd. also does call centre services for other banks. According to this method, the net margin for related party and comparable unrelated party should be arrived at. The net margin could be based on the total costs incurred, capital employed, number of man-hours spent for each bank by MIS, etc.. A weighted return could be arrived at as under:

Facts of the case:			(Rs. In lakhs)
Total Fixed Assets employed (Gross value)			100.00
(Building on Rent)			
Risks involved: Obsolescence, Fire, Loss of life, etc.. Of the above, obsolescence is the high risk factor requiring the Fixed Assets to be fully recovered in 2 years.			
Therefore, return expected on Fixed Assets is 100%,			
i.e., 50% for costs excluding depreciation and profit			100.00
and 50% for depreciation.			
No. of persons employed (3 shifts–24 hrs.)	200		
Maximum human hours 200 x 6 x 365 per year	4,38,000		
Salary & Perks costs per person	Rs.20,000/-		
Total salary costs per year			40.00
Other costs: Rent (Rs.1,00,000/- p.m.)		12.00	
Insurance		5.00	
Electricity		10.00	
Local taxes		2.50	
Other expenses (transport, etc.)		5.00	
Total			34.50
TOTAL WEIGHTED COSTS			174.50

Total Revenue billed			300.00
Net Margin (Aggregate)			125.50
Net Margin % on weighted costs			71.92%
Activity spread: (No. of calls attended)			
A Ltd. (related party)		5000	
X Bank (unrelated)		2000	
Y Bank (unrelated)		2500	
Z Bank (unrelated)		3000	
Total		12500	
Billing: (Rs. in lakhs)			
A Ltd. (related party)		100.00	
X Bank (unrelated)		60.00	
Y Bank (unrelated)		70.00	
Z Bank (unrelated)		70.00	
Total			300.00
Total costs distributed to customers on Activity basis:			
A Ltd. (related party)	69.80		
X Bank (unrelated)	27.92		
Y Bank (unrelated)	34.90		
Z Bank (unrelated)	41.88		
Total		174.50	
Net Margin (Billing minus distributed costs):			
A Ltd. (related party)	30.20		
X Bank (unrelated)	32.08		
Y Bank (unrelated)	35.10		
Z Bank (unrelated)	28.12		
Total		125.50	

Net Margin % on distributed costs:

A Ltd. 3020/6980 x 100			43.27%
Comparable (X, Y & Z) 95.30/104.70 x 100	91.02%		

Applying the comparable Net Margin of 91.02% on the costs incurred in respect of A Ltd.

A Ltd. costs		69.80	
Add: Net Margin @ 91.02%	63.53		
Total		133.33	
Arms Length Price (Earning)			133.33
Actual Billing			100.00
Excess to be taken as income for B Ltd. Based on the ALP Under Transactional Net Margin Method			33.33

Most Appropriate Method

Rule 10C. (1): For the purposes of sub-section (1) of section 92C, the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular international transaction, and which provides the most reliable measure of an arm's length price in relation to the international transaction.

(2) In selecting the most appropriate method as specified in sub-rule (1), the following factors shall be taken into account, namely: —

(a) the nature and class of the international transaction;

(b) the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;

(c) the availability, coverage and reliability of data necessary for application of the method;

(d) the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;

(e) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;

(f) the nature, extent and reliability of assumptions required to be made in application of a method.❑

Amendment to Payment of Bonus Act, 1965

The retrospective amendment for the year 2006-07 would result in excess payment to some people and short payment to some others where ever the allocable surplus after the amendment is less than 20% of salary eligible for bonus.

Recently the Government of India through an ordinance has amended the Payment of Bonus Act with retrospective effect from 1-4-2006. As such, the industries will have to rework out the bonus payable for the year 2006-07 and pay the difference to the eligible employees. In case of excess payments whether recoveries can be effected should be examined legally. This article examines various amendments to Payment of Bonus Act, 1965.

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The Government of India has recently amended the Payment of Bonus Act, 1965 in respect of the following with restrospective effect from 1st April 2006:

- Amendment to Section 2(13), raising the monthly salary eligibility limit of the employees for the payment of bonus from Rs. 3,500 to Rs. 10,000/-

- Amendment to Section 12, raising the ceiling for salary or wages from Rs. 2,500 to Rs. 3,500/- for calculation purposes.
- Deletion to Section 32(vi)-- this deletion helps the employees employed through contractors on building operations, earlier not eligible for bonus, now becoming eligible for bonus.

The detailed examination of each of the amendment is given below:

Retrospective Amendment From 1-4-2006

All companies who are liable for payment of bonus would have finalised and paid bonus for the year ended 31-3-2007 based on the salary limit of Rs. 3,500/- and subject to a bonus limit of Rs. 2,500/-. Now all the companies have to recalculate bonus to the employees who were in the salary bracket of Rs. 3,501 to Rs. 10,000/- during the year 2006-07 and also calculate bonus based on the revised salary limit of Rs. 3,500/-. The following example will explain the above amendment.

Prior To Amendment				After Amendment		
Employee No	*Monthly Salary*	*Salary For The Purpose Of Bonus*	*Maximum Bonus @ 20%*	*Salary Limit*	*Maximum Bonus @ 20%*	*Minimum Bonus @ 8.33%*
1.	2,500	2,500	6,000	2,500	6,000	2,500
2.	3,500	2,500	6,000	3,500	8,400	3,500
3.	5,500			3,500	8,400	3,500
4.	7,500			3,500	8,400	3,500
5.	12,500					
Total			12,000		31,200	13,000

In case the amount equal to 60 per cent or 67 per cent, as the case may be, of available surplus allocable as bonus is Rs. 12,000 for the accounting year 2006-07 then the company for the year 2006-07 would have paid bonus to the employees 1 and 2 at the rate of 20% whereas as per the amendment because of addition of a few more employees eligible for bonus the bonus percentage comes down to 8.33% resulting in an excess payment to employees 1 and 2 while employees 3 and 4 become eligible for minimum bonus of 8.33%. The amendment does not make it clear whether excess payment can be recovered while employees 3 and 4 will definitely claim their due share of their minimum bonus and even hire bonus in case no recovery is done from employees 1 and 2.

Assuming there are three different situations where the amount equal to 60 per cent or 67 per cent, as the case may be, of available surplus allocable as bonus is equal to Rs. 12,000/-, Rs. 60,000/-, Rs. 20,000/- then the bonus payable for the year 2006-07 under the different situations is given below:

Employee No	Salary	Prior To Amendment (Allocable Surplus)			After Amendment (Allocable Surplus)		
		12,000	60,000	20,000	12,000	60,000	20,000
		20%	20%	20%	8.33%	20%	12.82%

1.	2,500	6,000	6,000	6,000	2,500	6,000	3,848
2.	3,500	6,000	6,000	6,000	3,500	8,400	5,384
3.	5,500				3,500	8,400	5,384
4.	7,500				3,500	8,400	5,384
5.	12,500						
Total		12,000	12,000	12,000	12,000	31,200	20,000
Set On (Off)		Nil	12,000	8,000	Nil	12,000	Nil

From the above example it is clear that the retrospective amendment for the year 2006-07 would result in excess payment to some people and short payment to some others where ever the allocable surplus after the amendment is less than 20% of salary eligible for bonus.

The above retrospective amendment will also necessitate recalculation of set on and set off as per IV Schedule to the payment of Bonus Act 2006-07.

In view of the recovery from some people and payment to some others, the Government need not have gone for retrospective amendment from 1-4-2006. However, there is another argument that Parliament has power to legislate with retrospective effect and create fiscal liabilities. The legislative power conferred on the appropriate legislatures to enact laws in respect of topics covered by the several entries in the three lists can be exercised both prospectively and retrospectively. – *Union of India v. Madan Gopal Kabra 1954 SCR 451*. In this respect, the only safeguard is that the law should be reasonable. It is up to the legislature to ascertain as to what should be the maximum salary of an employee who should be brought under the applicability of the Payment of Bonus Act and from which date, he should be entitled to. There is no vested right, vested in the employer to say that initially he was paying bonus to the employees with a lesser wage and because of the revision of the pay, and despite the high cost of living the scope should not be enlarged to certain other section of employees drawing wages up to Rs.3, 500/-.

Deletion of Sec 32(VI): Removal of Ineligibility for Bonus To Building Workers

The bonus commission in its report has observed that the problem relating to workers on building construction engaged through contractors was one of evolving and enforcing a proper wage structure. It was considered not feasible to apply the bonus formula to such workers engaged through contractors on building construction work and recommended accordingly. The payment of Bonus Act thus exempts the employees employed through contractors on building operation.

However, the proposed audiences have withdrawn the above benefit to the industry effective from 1-4-2006 all the employees employed through contractors on building operation will become eligible for payment of bonus. One difficulty will be as to who has to pay the bonus and if the same contractor has employed the same person in three different establishments for differing periods, the calculation of bonus and payment of bonus becomes a difficult job. Instead the Government should have made the contractors liable to pay the bonus to its employees treating the contractor as a separate employer under Section 2(14) of the Payment of Bonus Act.

AS 5 and Amendment To Bonus Act

Any additional payment for the year 2006-07 will become current year expense in the year of payment namely 2007-2008 and not a prior period item. ❑

Exchange Traded Funds - A Financial Innovation

ETFs allow long-term investors to diversify their portfolios at one shot at low cost & insulate them from short-term trading activity due to the unique "in-kind" creation/redemption process. They also provide liquidity for investors with a shorter-term horizon as they can trade intra-day and can have quotes near NAV during the course of a trading day.

Exchange Traded Funds (ETFs) are just what their name implies: baskets of securities that are traded, like individual stocks, on an exchange. Unlike regular open-end mutual funds, ETFs can be bought and sold throughout the trading day like any stock. Most ETFs charge lower annual expenses than index mutual funds. However, as with stocks, one must pay a brokerage to buy and sell ETF units, which can be a significant drawback for those who trade frequently or invest regular sums of money. The article presents an overview of the concept.

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ETFs first came into existence in the US in 1993. It took several years for them to attract public interest. But once they did, the volumes took off with a vengeance. About 60% of trading volumes on the American Stock Exchange are from ETFs. The most popular ETFs are QQQs (Cubes) based on the Nasdaq-100 Index, SPDRs (Spiders) based on the S&P 500 Index, iSHARES based on MSCI Indices and TRAHK (Tracks) based on the Hang Seng Index. The average daily trading volume in QQQ is around 89 million shares.

Their passive nature is a necessity: the funds rely on an arbitrage mechanism to keep the prices at which they trade roughly in line with the net asset values of their underlying portfolios. For the mechanism to work, potential arbitragers need to have full, timely knowledge of a fund's holdings.

Creations & Redemptions

ETFs are different from Mutual funds in the sense that ETF units are not sold to the public for cash. Instead, the Asset Management Company that sponsors the ETF (Fund) takes the shares of companies comprising the index from various categories of investors like authorised participants, large investors and institutions. In turn, it issues them a large block of ETF units. Since dividend may have accumulated for the stocks at any point in time, a cash component to that extent is also taken from such investors. In other words, a large block of ETF units called a "Creation Unit" is exchanged for a "Portfolio Deposit" of stocks and "Cash Component".

The number of outstanding ETF units is not limited, as with traditional mutual funds. It may increase if investors deposit shares to create ETF units; or it may reduce on a day if some ETF holders redeem their ETF units for the underlying shares. These transactions are conducted by sending creation/redemption instructions to the Fund. The Portfolio Deposit closely approximates the proportion of the stocks in the index together with a specified amount of Cash Component. This "in-kind" creation/redemption facility ensures that ETFs trade close to their fair value at any given time.

Some investors may prefer to hold the creation units in their portfolios. While others may break-up the creation units and sell on the exchanges, where individual investors may purchase them just like any other shares.

ETF units are continuously created and redeemed based on investor demand. Investors may use ETFs for investment, trading or arbitrage. The price of the ETF tracks the value of the underlying index. This provides an opportunity to investors to compare the value of underlying index against the price of the ETF units prevailing on the Exchange. If the value of the underlying index is higher than the price of the ETF, the investors may redeem the units to the Sponsor in exchange for the higher priced securities. Conversely, if the price of the underlying securities is lower than the ETF, the investors may create ETF units by depositing the lower-priced securities. This arbitrage mechanism eliminates the problem associated with closed-end mutual funds viz. the premium or discount to the Net Asset Value.

Advantages of ETFs

While many investors have similar outlooks, no two are exactly alike. Due to the unique structure of ETFs, all types of investors, whether retail or institutional, long-term or short-term, can use it to their advantage without being at a disadvantage to others. They allow long-term investors to diversify their portfolio at one shot at low cost and insulate them from short-term trading activity due to the unique "in-kind" creation/redemption process. They provide liquidity for investors with a shorter-term horizon as they can trade intra-day and can have quotes near NAV during the course of trading day. As initial investment is low, retail investors find it simple and convenient to buy/sell. They facilitate FIIs, Institutions and Mutual Funds to have easy asset allocation, hedging, equitising cash at a low cost. They enable arbitrageurs to carry out arbitrage between the Cash and the Futures markets at low impact cost.

ETFs provide exposure to an index or a basket of securities that trade on the exchange like a single stock. They offer a number of advantages over traditional open-ended index funds as follows:

- While redemptions of Index fund units takes place at a fixed NAV price (usually end of day), ETFs offer the convenience of intra-day purchase and sale on the Exchange, to take advantage of the prevailing price, which is close to the actual NAV of the scheme at any point in time.

- They provide investors a fund that closely tracks the performance of an index throughout the day with the ability to buy/sell at any time, whereby trading opportunities that arise during a day may be better utilised.
- They are low cost.
- Unlike listed closed-ended funds, which trade at substantial premia or more frequently at discounts to NAV, ETFs are structured in a manner which allows Authorised Participants and Large Institutions to create new units and redeem outstanding units directly with the fund, thereby ensuring that ETFs trade close to their actual NAVs.
- ETFs are like any other index fund, wherein, subscription/redemption of units work on the concept of exchange with underlying securities instead of cash (for large deals).
- Since an ETF is listed on an Exchange, costs of distribution are much lower and the reach is wider. These savings in cost are passed on to the investors in the form of lower costs. Further, the structure helps reduce collection, disbursement and other processing charges.
- ETFs protect long-term investors from inflows and outflows of short-term investors. This is because the fund does not incur extra transaction cost for buying/selling the index shares due to frequent subscriptions and redemptions.
- Tracking error, which is divergence between the NAV of the ETF and the underlying Index, is generally observed to be low as compared to a normal index fund due to lower expenses and the unique in-kind creation/redemption process.
- ETFs are highly flexible and can be used as a tool for gaining instant exposure to the equity markets, equitising cash or for arbitraging between the cash and futures market.

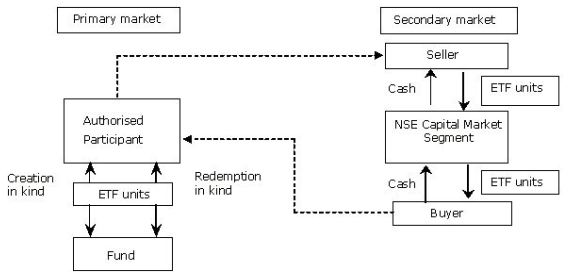
The first ETF in India, "Nifty BeEs (Nifty Benchmark Exchange Traded Scheme) based on S&P CNX Nifty, was launched in January 2002 by Benchmark Mutual Fund. It may be bought and sold like any other stock on NSE. Its symbol on NSE is "NIFTYBEES".

Applications of ETFs

- Efficient Trading: ETFs provide investors a convenient way to gain market exposure viz. an index that trades like a stock. In comparison to a stock, an investment in an ETF index product provides a diversified exposure to the market. Depending on the index, investors may obtain exposure to countries/markets or sectors.
- Equitising Cash: Investors with idle cash in their portfolios may want to invest in a product tied to a market benchmark like an index as a temporary investment before deciding which stocks to buy or waiting for the right price.
- Managing Cash Flows: Investment managers who see regular inflows and outflows may use ETFs because of their liquidity and their ability to represent the market.
- Diversifying Exposure: If an investor is not sure about which particular stock to buy but likes the overall sector, investing in shares tied to an index or basket of stocks provides diversified exposure and reduces stock specific risk.
- Filling Gaps: ETFs tied to a sector or industry may be used to gain exposure to new and important sectors. Such strategies may also be used to reduce an overweight or increase an underweight sector.
- Shorting or Hedging: Investors who have a negative view on a market seg-

ment or specific sector may want to establish a short position to capitalise on that view. ETFs may be sold short against long stock holdings as a hedge against a decline in the market or specific sector.

Structure of ETF



Comparison of ETFs With Other Mutual Funds

In essence, ETFs trade like stocks and therefore offer a degree of flexibility unavailable with traditional mutual funds. Specifically, investors can trade ETFs throughout the trading day as in stocks. In comparison, in a traditional mutual fund, investors can purchase units only at the fund's NAV, which is published at the end of each trading day. In fact, investors cannot purchase ETFs at the closing NAV. This difference gives rise to an important advantage of ETFs over traditional funds: ETFs are immediately tradable and consequently, the risk of price differential between the time of investment and time of trade is substantially less in the case of ETFs.

ETFs are cheaper than traditional mutual funds and index funds in terms of fees. However, while investing in an ETF, an investor pays a commission to the broker. The tracking error of ETFs is generally lower than traditional index funds due to the "in-kind" creation/redemption facility and the low expense ratio. This "in-kind" creation/redemption facility ensures that long-term investors do not suffer at the cost of short-term investor activity.

ETFs can be bought/sold through trading terminals anywhere across the country. Table No. 1 presents a comparative view ETFs vis-à-vis other funds.

Table 1. ETFs vs. Open Ended Funds vs. Close Ended Funds

Parameter	Open Ended Fund	Closed Ended Fund	Exchange Traded Fund
Fund Size	Flexible	Fixed	Flexible
NAV	Daily	Daily	Real Time
Liquidity Provider	Fund itself	Stock Market	Stock Market/Fund itself
Sale Price	At NAV plus load, if any	Significant Premium/ Discount to NAV	Very close to actual NAV of Scheme
Availability	Fund itself	Through Exchange where listed	Through Exchange where listed/Fund itself.
Portfolio Disclosure	Monthly	Monthly	Daily/Real-time
Uses	Equitising cash	-	Equitising Cash, Hedging, Arbitrage
Intra-Day Trading	Not possible	Expensive	Possible at low cost

SMEs in India, Key Challenges and Credit Ratings

Banks in India lend mainly against collateral. SMEs, by nature, are short on the same. The need is to increase the comfort level of the banks in lending even in the absence of the level of collateral being presently sought for. A need is also felt to assess a proposal sans the collaterals so that the independent appraisal of the viability of the proposal can be ascertained.

Only 17% of the SME units are able to access institutional finance and most of them depend more on internally generated funds or informal financing channels for their expansion and modernisation requirements. The other major challenges faced by small enterprises are global competition with the integration of global economy, lack of infrastructure and obsolete technology, retention of good quality manpower and asymmetry of information. These problems can be remedied to a large extent if the bottleneck problem of finance is taken care of. A third party independent assessment of SMEs in the form of a credit rating can help in easy availability of finance to them. The article provides an overview

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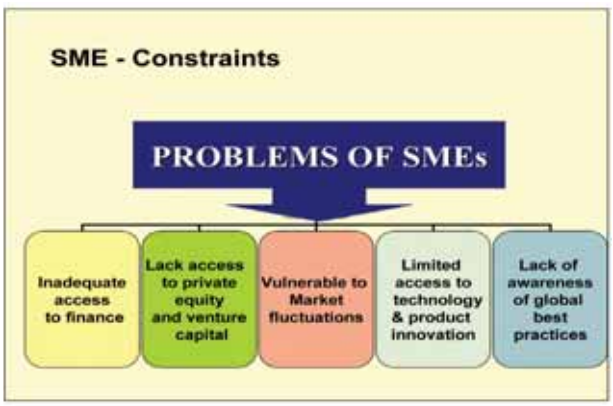
The SME Market in India though growing at a fast pace, is highly fragmented. Despite the fact that SME sector contributes around 7% to GDP of the economy and is a major contributor to the employment (rupee one lakh of investment has a potential to employ 4 people in the unorganised SME sector), it remains a largely neglected and under-serviced sector, from the banking and formal funding point of view. Most SMEs in India are promoted by enterprising technocrats. The small and medium sized businesses (SMBs) are ingenious in seizing new opportunities and adapting to environmental changes, provided that the growth opportunities are

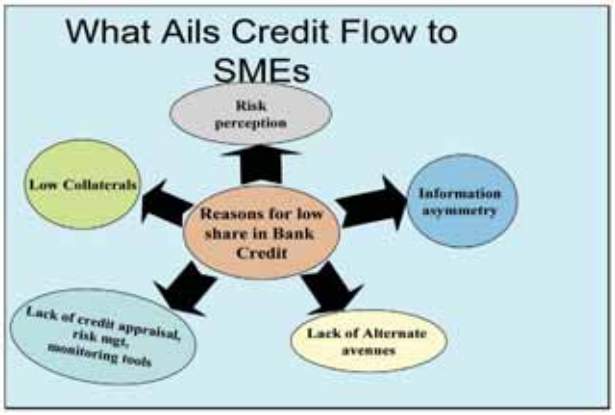
supported by good infrastructure and the financing requirements are met. However, like anywhere else in the world, Indian SMEs too face challenges in accessing adequate funds on time from the banks and financial institutions. Only 17% of the SME units are able to access institutional finance and most of them depend more on internally generated funds and/or informal financing channels for their expansion and modernisation requirements. This means that majority of the SMEs are deprived of the cheaper institutional credit and have to depend more on the informal credit or own capital, which needless to mention, have high cost which in turn negatively impact the competitiveness of SMEs. SMEs with access to institutional credit at competitive rates are more likely to significantly increase their contribution to the GDP and they would be in better position to take on the global competitive pressures. The issue also needs to be assessed from the macro perspective.

The other major challenges faced by small enterprises are global competition with the integration of global economy, lack of infrastructure and obsolete technology, retention of good quality manpower and asymmetry of information. These problems can be remedied to a large extent if the bottleneck problem of finance is taken care of.



Going back to the problem relating to access of institutional finance for SMEs, it would be unfair to say that the banks in India have been wholly responsible for the limited increase in lending to the SMEs. We need to appreciate that it is not very easy on part of banks in assessing credit requirements of SMEs and providing them with adequate and timely credit in view of highly fragmented nature of the SMEs, information asymmetry, multiple segments, multiple needs, lack of transparency and limited financial disclosures in the financial statements of SMEs, Non-Performing Asset (NPA) legacy effect, etc. In the late 90s (before the start of the current upswing), banks faced NPA of over 20% in respect of their SSI portfolio. However, with the India Growth Story continuing unabated since the start of the current millennium, the banking sector also has witnessed a significant decline in the NPA from the SME segment and increase in lending to the sector in absolute terms. The increased lending to SMEs has also been made possible due to SMEs willingness to be more transparent in financial statements, introduction of VAT and reduced NPA in SME space. Most of these contributory factors are interrelated. However, the lending to SSI as a percentage of non-food gross bank credit has declined from over 14% in 1999-00 to about 7% in 2005-06, though in absolute value terms, it has registered a robust growth. The reasons, inter alia, are - availability of other lending options (retail, realty and consumer loans) for banks where the process-driven approach in lending makes it easier in assessing credit requirements, and dispensing credit; demand for credit from other segments.

Banks in India lend mainly against collateral. SMEs, by nature, are short on the same. While some help is being extended by government arms such as Credit Guarantee Fund Trust for Small Industries (CGTSI), but the cover is only upto Rs. 25 lakhs. This is likely to increase to Rs. 50 lakhs. The need is to increase the comfort level of the banks in lending even in the absence of the level of collateral being presently sought for. A need is also felt to assess a proposal sans the collaterals so that the independent appraisal of the viability of the proposal can be ascertained.



In this backdrop, proper assessment of SMEs' credit need and proper analysis of their Balance Sheets – inter-firm and inter-size comparisons, etc. is not possible in a cost effective manner in the absence of information. The typical characteristics of SMEs like multiple segments and multiple needs and the fine granularities among the SMEs arising out of different combinations due to ownership, regional, industrial, product and process, etc further pose limitations on the lending banks. The knowledge required for such a wide arena demands that one has some sort of expertise to do justice to the SMEs. Further, the ticket size of an individual deal being low, does not justify a detailed assessment on part of the lender.

Assessments take substantial part of the time of the banker and when the amount of time spent on any assessment is more or less same – irrespective of the ticket size – the banker will undeniably have a tendency to concentrate his energies on the larger ticket size. The most important factor in any kind of assessment is the information at one's disposal. SMEs are hit both ways by information asymmetry. While on the one hand the lenders do not have information and at times knowledge about them, on the other hand SMEs are themselves not abreast with the latest happenings in the finance world. Information asymmetry has other ramifications as well. The lack of knowledge of suppliers and customers also at times hampers the growth of SMEs. SMEs typically operate out of a geographical area and are at times completely unaware of the opportunities existing in other parts of the world. The SME borrower is also not adept in presenting his business successes or future requirements in the form of financial statements as may be required by the banks. Another aspect that is pertinent and needs to be taken care of is the factor of time. The credit needs have to be timely met. The credit needs of the SMEs are subject to their ability to procure orders- whether domestic or international. The deadline of delivery for such orders is really short and unavailability of funds often results in breach of the deadlines affecting competitiveness and goodwill of the SMEs. Here, Chartered Accountants play an important role as consultants or interface between banks and SME units, and comply with the requirements with regard to the financial documents and projections of the SME units. However, the neutrality of the consultant who is representing his SME client, inter alia, for fund syndication may be a point, which the Bank may consider while considering the projections provided. Again, the background of diverse nature of SMEs and the low-ticket size of individual unit's fund requirement has to be considered, which makes any detailed analysis and investigation financially unfeasible.

How does one address this situation? Perhaps, a third party independent assessment in the form of a credit rating is the answer. Rating brings out the worthiness of the unit by highlighting its strengths and weaknesses. It serves as a very effective tool for self-assessment. This also can be used as an effective tool by the rated subject in adopting corrective measures and / or enhancing its competitiveness. While dealing with banks and other trade associates, it provides a fillip in raising the overall credibility of the enterprise in the market place. Financial consultants use ratings from credit rating agencies as a tool for making their SME clients' proposals better acceptable to the lenders.

About SME Rating Agency of India Ltd. (SMERA)

SME Rating Agency (SMERA), a joint initiative by SIDBI, Dun & Bradstreet Information Services (D&B), Credit Information Bureau of India Limited (CIBIL), and 11 other leading banks in the country, was inaugurated

by Finance Minister, Shri P. Chidambaram on September 5, 2005. The setting up of an exclusive rating agency for the SME segment was one of the 4-pronged strategies of the Government to increase the flow of credit to the SME segment. It is the country's first rating agency that focuses primarily on the Indian SME segment. With banks themselves being the stakeholders and being founded by SIDBI, SMERA enjoys the confidence of the banking industry as well as that of the entrepreneur class at large.

SMERA rating is an independent, third party assessment of the overall condition of an SME organisation, which takes into account both financial as well as non-financial parameters and further aids the organisation in suggesting ways for business enhancement. Moreover, the rating by SMERA has wider acceptance within the entire banking and financial system of the country. Besides, registered SSI units rated by SMERA can avail of government subsidies to the extent of 75% on the rating fee, thus, making it possible for small SSI units to get an external rating at a nominal cost of around Rs. 5000/-. The cost of rating is more than compensated through interest rate reduction from banks for SME units having better ratings. In this regard, SMERA has entered into MoU with 20 banks and lending institutions. SMERA has also undertaken mapping projects with leading banks of the land. A mapping project is undertaken to relate the SMERA Ratings with the ratings being provided by the internal rating models of the banks.

SMERA rating pinpoints toward the overall health of entity and explains exactly how the business will fit in relation to competitors, and how to deal with it.

Highlights and Benefits of SMERA -Credit Ratings

The request for rating an enterprise by SMERA is either given by a Bank for its SME client or by the SME unit itself. In either case, a written confirmation to the effect is taken from the SME unit as ratings done by SMERA are solicited ratings only. Before the rating process can commence, some minimum information is required by SMERA from the SME unit. These largely comprise of past financial statements, current performance related statements and the future plans of the entity. SMERA makes an assessment based on the information provided and further clarifications as may be considered necessary. SMERA also undertakes a site inspection and interaction with the promoters through its correspondent network of reputed Chartered Accountant firms across the length and breadth of the country. The Chartered Accountant firms can be seen as the local intelligence arm of SMERA. With all the information, clarifications and site inspection report, SMERA undertakes the rating exercise and before finalising the rating, gets a final confirmation from the SME unit with regard to the correctness of the information provided. On getting the confirmation, the rating is finally assigned and afterwards a peer review is released finally to the customer SME or Bank. Well rated companies receive several benefits from lending institutions like reduction in interest rates, relaxation in collaterals, enhancement of borrowing limits, lesser processing time of loan application, etc. Companies are better placed in creating export opportunities in the international market if they receive good rating.

Some salient features of credit ratings by SMERA are as under:

- Independent third-party comprehensive assessment of the overall condition of the SME.
- Takes into account the financial condition and several qualitative factors that have bearing on credit worthiness of the SME.
- Consists of two parts, a Composite Appraisal/Condition indicator and a size indicator.
- Categorises SMEs based on size, so as to enable fair evaluation of each SME amongst its peers.
- Provides additional comfort to the lenders in the form of Independent third party transparent assessment process.
- Supplements and supports internal decision making through third party validation.

- Validation with the internal existing rating models.
- Rating robustness enhanced with CIBIL score.

Cluster Risk Profiling Studies

The term 'cluster' indicates a sectoral and geographical concentration of enterprises, which produce and sell a range of related products and are, thus, faced with common challenges and opportunities. When SMEs operate in a cluster, they are able to overcome the peculiar difficulties that they face as a group and benefit from the opportunities that exist for them.

Associated with the existence of cluster is presence of the synergies between the groups of SMEs. Cluster studies are studies directed towards studying the SMEs operating in a given business space. Extensive studies involving a particular industrial cluster help to gain an understanding primarily of the following:

- Market opportunities existing in the geographic space.
- Hindrances related to harmonisation of operations.
- Handicaps associated with small individual size of the SMEs.

The SMEs share significant constraints like technological obsolescence, relatively poor product quality, information deficiencies, poor market linkages and inadequate management systems. These problems, along with information asymmetries, prevent the banks and other financial institutions from extending finance to the SMEs. However, cluster based approach for financing SME sector offers possibilities of reduction in transaction costs, mitigation of risk and also provide an appropriate scale for improvement in infrastructure. But for being able to undertake cluster based financing approach, it is imperative to identify risks associated with lending to SMEs. Since risks associated with the SMEs operating in a cluster tend to be identical, in-depth study of the cluster offers possibilities to identify risks and opportunities associated with lending to SMEs in a cluster and thereby ensure greater flow of finance to the SME units.

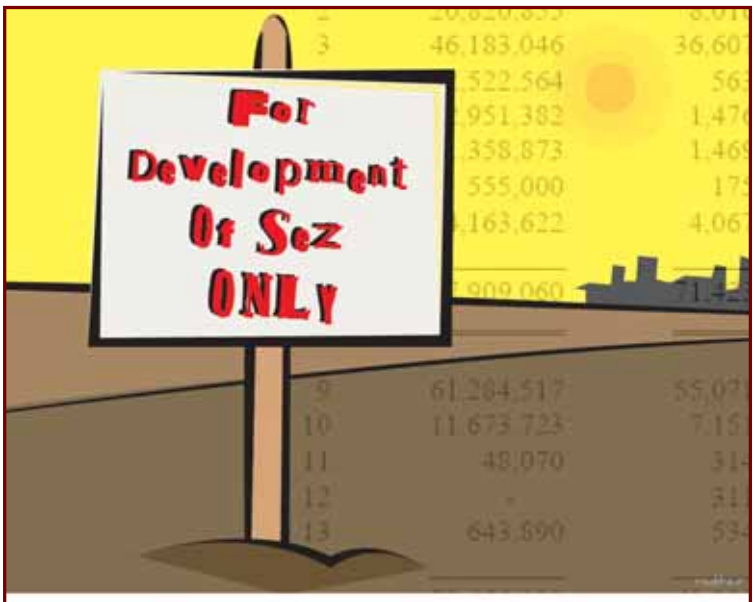
SMERA undertakes studies that profile the risk associated with particular industrial clusters. The findings of the study serve as valuable inputs for banks, large corporate houses, international delegations that look for suitable business opportunities in the country and to many other stakeholders.

SMERA's Association with Chartered Accountants

The Chartered Accountants play an important role as interface between SMEs and banks thereby enabling SMEs access institutional credit. SMERA recognises Chartered Accountants as key players and business associates possessing high level of professional discipline, pro-active approach and strong analytical skills. SMERA employs Chartered Accountants widely in the organisation as Analysts, in Finance and in General Management positions. SMERA also associates with Chartered Accountant firms not only for Audit and Taxation requirements but also for carrying out survey and preparing site reports both for its Credit Rating services and well as for its Cluster Risk Profiling studies. SMERA looks for professional firms across the length and the breadth of the country and the ones located near important industrial clusters. It further looks upto Chartered Accountants as the ones who can create awareness among the SMEs about adopting best practices and build awareness about the various products, developments and innovations in lending, banking and financial service industries. SMERA has already established a wide network and anticipates it to grow bigger considering the manifold increase in lending to SMEs and the growth opportunities being encashed by Indian SMEs.

SMERA has the highest regard for Chartered Accountant professionals as it believes that they are emerging as professionals who possess intricate knowledge in the fields of Finance, Valuations, Accounting, Risk Management, Establishing Systems and Controls, Legal Compliances, Taxation, Auditing and other Value added services.❐

Special Economic Zones: Does the Act ensure what the policy intends?



The land required for the SEZ is to be purchased by the Developer & obviously the Developer has to invest considerable amount for the same. The Act/Rules should ensure that the land so purchased by the Developer for SEZ, is used for development of SEZ only & that too in a certain time frame.

The Special Economic Zone policy has been adopted to develop world class infrastructure by private sector, attract foreign investment, increase employment opportunities, boost the exports and thereby expand economic activities in the country. The experiment of SEZ has proven right in many countries provided that the Act & Rules passed to implement the SEZ policy are free of flaws & deficiencies. This article analyses SEZ Act 2005 & SEZ Rules 2006.

— Dr. V. M. Govilkar

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Exports as Real Contributor to Forex Reserve

India has recently become one of the few countries in the world which have foreign exchange reserve of more than 200 billion dollars. However, India has never had a trade surplus during past six decades and the exports have always been less than the imports. Hence, though there is quantitative increase in forex reserves, qualitative improvement is yet to be seen. The foreign investors have found India as a relatively safe and profitable destination to park their funds in. That's all! Long-term improvement in forex reserves is achieved only by positive trade surplus of considerable amount for considerably long period. Obviously all the countries try to increase their exports on one hand and minimise their imports on the other.

Limiting imports may not be possible due to many reasons viz. the stage of development of the economy, the development of technology, availability of natural resources etc. Hence, to achieve positive trade surplus what is needed is maximisation of exports. Indian Government has been trying to increase exports by announcing and implementing many schemes and policies. A few of them include export financing at concessional interest rates, income tax exemption for export income, transport & storage facilities at concessional rates, etc. The latest policy adopted and largely debated for export promotion is that of 'Special Economic Zones'.

The following are some of the factors limiting exports:

i. Insufficient and low quality infras truture.
ii. Limited domestic capital formation and restrictions on foreign capital.
iii. Administrative hurdles and complexities.
iv. Complicated and Labour friendly labour laws.
v. Many taxes and high rates of taxes.

These hurdles cannot be removed at once from the country but certain geographical islands can be identified where such hurdles can be done away with. Such geographical islands are called as SEZs. The Commerce Ministry in its Press Release on 10/05/2005 said: "The objectives of SEZ are making available goods and services free of taxes and duties supported by integrated infrastructure for export production, quick approval mechanisms and packages of incentives to attract foreign investments for promoting exports."

The Government of India adopted SEZ policy in 2000 and passed SEZ Act 2005 & made SEZ Rules 2006 to implement the same. The Act & the Rules have to ensure that the expected results of SEZ policy are achieved and that there are no negative implications of the policy. While analysing the Act & Rules from this angle, two issues need some attention.

1. Do the SEZ Act 2005 and SEZ Rules 2006 ensure establishment and development of SEZs?

The developer has to apply for approval of SEZ. In-principle approval and the formal/final approval are the two stages involved in the process. The land required for the SEZ is to be purchased by the Developer and obviously the Developer has to invest considerable amount for same. The argument, therefore, is if:

Policy of SEZ has been adopted & implemented with the objective that it will develop sufficient & high quality infrastructure by private sector, will attract considerable foreign investment, will increase employment opportunities, will boost the exports & thereby will expand economic activities in the country. The industrial islands could become engines of growth. India, to get better share in world trade must undertake special efforts, when the global export opportunities are increasing.

(i) The Developer has willingly applied for establishment of SEZ and
(ii) The Developer has invested considerable amount and has put substantial efforts and precious time for purchase of land, he will, without doubt, establish and develop the SEZ.

A counter argument can also be made that if

(i) The developer can purchase hundreds of hectares of land with the assistance of the Govt. without the application of the provisions barring purchase of agriculture land by a non-agriculturist etc. and
(ii) There is no compulsion in the SEZ Act to develop the SEZ,

There is every possibility that the developer will simply buy the land, hold it in full or in part and transfer the same at profit (with the assistance of Govt.) After considering the rise in the prices of land in the recent past, it may prove to be a wise proposal to hold the land as it is, not to invest further on its development and wait for the customers to buy the constructed property.

Under such circumstances, the Act/Rules, should ensure that the land so purchased by developer for SEZ, is used for development of SEZ only and that too in a certain time frame.

Now the question is whether the SEZ Act 2005 and SEZ Rules 2006 do ensure so? The relevant sections and Rules are as under-

1. The Proviso to Rule 5(2)(a) says, "Provided also that at least..... % of the area shall be earmarked for developing processing area".
2. Sec.6 of SEZ Act reads, "The areas falling within the SE Zones may be demarcated by the Central Government or any authority specified by it as – (a) the processing area....."
3. Rule 11(2) "Processing and non-processing area – The processing area and Free Trade and Warehousing Zone shall be fully secured by boundary wall or wire mesh fencing having a height of at least two meters and forty centimeters above plinth level with top sixty centimeters being barbed wire fencing with mild steel angle with specified entry and exit points".
4. Rule 11(3) "The Development Commissioner shall ensure compliance of the requirements of sub-rule(2)."
5. Form – B (FORMAT FOR LETTER OF APPROVAL FOR SEZ DEVELOPER)(See rule 6) item (ix) "This approval is valid for a period of three years within which time the Developer shall implement the project. The project implementation progress report will be submitted to Government of India every six months".

The verb used in rule 5(2) (a) is to "earmark" and Section 6 is 'to demarcate', and in Rule 11(2) is to "secure". Will the provisions of the law be complied if the developer does not actually develop the processing area but only earmarks, demarcates the same and provides fencing? Is there any other provision in the law to make the developer develop the SEZ in general and the processing area in particular?

Sec.10 of the Act is regarding Suspension of letter of approval and transfer of SEZ in certain cases. The main provisions of Sec.10 may be summed up as under –

i. The Board may suspend the letter of Approval granted to the Developer [under 4 circumstances specified in Sec.10(1)] for a period not exceeding one year and appoint an Administrator.

ii. The Administration for discharging the functions of the Developer and the management of the SEZ shall vest in the Administrator for a period not exceeding one year or up to the date of transfer of the letter of approval whichever is earlier.

iii. For transfer of letter of approval, sub-section 9 lays down the following procedure –

   a. The Board to invite application for transferring LOA & select the person or persons.

   b. Upon selection of the transferee, the Board may by notice in writing require the Developer to transfer his LOA.

These provisions apparently may be found sufficient to ensure the development of SEZ, either by Original Developer or by the Transferee".

However, clause b of Sub Sec.9 of Sec.10 clearly states, "..... on such terms and conditions and consideration as may be agreed upon between the Developer and the transferee."

The meaning and implications of this clause are very clear. Unless the terms, conditions and consideration of the Developer are agreed by the transferee, the LOA cannot be transferred by the Board.

The law, therefore, must be suitably amended to ensure the Development of SEZ. The Developer may develop (by availing all tax concessions) only the non processing area, lease it, earn substantially because of low cost of construction & development due to tax concessions. The processing area may only be earmarked and demarcated to comply Sec.6 and Rule 5(2)(a) and the Board does not have the power to compel the Developer to develop the processing area nor to transfer the LOA unless the Developer agrees to the deal.

This possibility gets strength if one considers the following –

i. Special Secretary, Ministry of Commerce Mr. Gopalkrishna Pillai says: "Promoters will have to develop SEZs within 3 years from the date of final approval, but we cannot take any action if they don't. It is

their land, so they are free to do whatever they want with it. But in such cases, they will not get tax benefits".

ii. Notification of RBI dated 21.9.2006 says: "keeping in view current market conditions, it has been decided that the exposure of banks to entities for setting up SEZ or for acquiring units in SEZs, which include real estate, would be treated as real estate sector with immediate effect.

iii. The Governor, RBI, Mr.Y.V.Reddy says: "Like any other land, SEZ is real estate."

On this background the following points need to be looked into:

i. Land purchased for SEZ must be developed and developed in a time frame, for SEZs only (Processing + Non processing area, both)

ii. At the time of leasing out area in SEZ by the Developer, there should be a linkage of processing area and non processing area in SEZ.

iii. In case the SEZ is not developed, the land should go back to the farmers at appropriate price for which a formula should be developed.

(II) SEZ as Foreign Territory

The Central Govt. modified the Foreign Trade policy for the period 2004-2009 incorporating the Exim Policy for the period 2002-2007 on 31.08.2004. Chapter 7 of this policy was relating to SEZ. Clause 7.3.1 of the policy defined SEZ as, "SEZ is a specifically delineated duty free enclave and shall be deemed to be foreign territory for the purposes of trade operations and duties and tariffs."

There has been a hot discussion about the words "Foreign Territory" included in 7.3.1 of the Policy. However, many argue that one need not worry about the status of SEZ as Foreign Territory because -

i. SEZ Act 2005 and SEZ Rules 2006 now govern the policy relating to SEZ and in the Act or Rules these words "Foreign Territory" are not used any where, and

ii. Clause 7.3.1 of the policy though uses the words Foreign Territory but that is only "for the purposes of trade operations and duties and tariffs".

These arguments, no doubt, hold some strength. But there are some provisions in the Act/Rules granting such special status to SEZs. They are –

i. Sec.20 Agency to inspect – Notwithstanding anything contained in any other law for the time being in force, the Central Government may, by notification, specify any officer or agency to carry out surveys or inspections for securing of compliance with the provisions of any Central Act by a Developer or an entrepreneur, as the case may be, and such officer or agency shall submit verification and compliance reports, in such manner and within such time as may be specified in the said notification.

ii. Sec.21 (1) iii) and (2) – The Central Government may, by general or special order, authorise any officer or agency to be the enforcement officer or agency in respect of any notified offences or committed in a Special Economic Zone.

iii. Sec.22 – Provided that no investigation, search or seizure shall be carried out in a Special Economic Zone by any agency or officer other than those referred to in sub-section(2) or sub-section of section 21 without prior approval of the Development Commissioner concerned.

iv. Sec.23. Designated Courts to try suits and notified offence.—1) The State Government, in which the Special Economic Zone is situated, may, with the concurrence of the Chief Justice of the High Court of that State, designate one or more courts-

a) to try all suits of a civil nature arising in the Special Economic Zone; and

b) to try notified offences committed in the Special Economic Zone.

No court, other than the court designated under sub-section (1), shall try any suit or conduct the trial of any notified offence referred to in that sub-section:

v. Rule 70 (1) – Identity Card :- (1) The entry

of persons to the processing area of the Special Economic Zone shall be regulated by the Development Commissioner through issue of identity cards.

These provisions raise some questions-

i. Will the acts or omissions punishable under other Indian Laws be not punishable in SEZ unless notified?

ii. Cannot the officers authorised under other Acts use their powers of enquiry, inspection, survey, investigation and Seizure in SEZs?

iii. Will the residents of India outside SEZs require a sort of visa to enter into SEZs?

Further, the SEZ policies declared by passing resolutions by various state governments also include the words 'Foreign Territory'. Maharashtra has gone one step further and has clarified the status of SEZ in its Resolution No.SEZ 2001/(152)/IND-2 Dt.12/10/2001 as under-

SEZs as Industrial Townships:

"The State Govt. shall take appropriate steps to declare the SEZs as Industrial Townships to enable SEZs to function as Self governing, autonomous, Municipal Bodies".

One has to find answer to following questions-

i) Will the administration of SEZs be by the representatives elected through elections as in normal local Self-Governments? or will there be a situation where the developer will have absolute power?

ii) Does this situation contradict Constitution?

iii) Does it violate integrity and sovereignty of the country? (Refer Sec.5 guideline No.6....)

iv) Does the SEZ Act attack fundamental rights to equality and freedom of movment?

v) How far will the Citizens enjoy rights established through the 73rd Amendment to Constitution in those territories?

Conclusion

Policy of SEZ has been adopted & implemented with the objective that it will develop sufficient and high quality infrastructure by private sector, will attract considerable foreign investment, will increase employment opportunities, will boost the exports and thereby will expand economic activities in the country. The industrial islands could become engines of growth. India, to get better share in world trade, must undertake special efforts, when the global export opportunities are increasing. SEZ could be prominent policy for the same. Therefore, the experiments of SEZ, which has proven its worth in many countries, may be adopted & implemented, but at the same time the Act & Rules passed to implement the SEZ policy must be free of flaws & deficiencies. This article is an attempt to point out two such deficiencies so that the experts and policy makers will consider them for improvements. ❑

Committee on Internal Audit

Mission

The Committee on Internal Audit was constituted in the year 2004 as a non-standing Committee of the Council of the Institute. The prime objective of the Committee, as approved by the Council in its terms of reference, is to reinforce the primacy of the Institute of Chartered Accountants of India as a promoter, source and purveyor of the knowledge of internal audit in the country. The basic idea was to enable the members of the Institute to provide more effective and efficient value added services related to the field of internal audit so as to enable the clients to systematise and strengthen their governance process by systematising and strengthening their control and risk management process.

Objectives

To achieve its above mentioned mission, the Committee has set the following as its objectives in its terms of reference:

- To review the existing internal audit practices in India
- To develop Standards on Internal Audit (SIAs) to be issued under the authority of the Council of the Institute.
- To develop Guidance Notes on issues relating to internal audit, including those arising from SIAs, to be issued under the authority of the Council of the Institute.
- To issue Clarifications on issues arising from SIAs, to be issued under the authority of the Council of the Institute.
- To develop studies, reports, etc., on issues arising from SIAs, to be issued under the authority of either the Council or the Committee.
- To undertake research in the field of internal audit.
- To organize conferences, workshops, etc., on topics related to internal audit.

The Strategy for 2008-2009

The Committee on Internal Audit will adopt a three pronged strategy for 2008-09 for achieving its objectives. The first part of the strategy focuses on ***imparting knowledge*** to the members. This, the Committee plans to achieve through issuance of more Standards on Internal Audit. The Committee would also endeavour to bring out more contemporary literature on critical aspects of internal audit, such as enterprise risk management, forensics, internal control assessment, etc., as well as industry specific internal audit guides. The second leg of the strategy is ***reinforcing knowledge***, by way of more and more seminars, conferences and other such CPE programmes. The Committee, in that line, is also planning to launch courses/ training programmes on due diligence, internal audit, concurrent audit, etc.. The third part of the Committee's strategy rests on ***reiterating presence*** by way of conclaves on internal audit, meetings with regulators, etc. ❑

Committee on Trade Laws and WTO

Over the past few years, globalisation has altered the pattern of economics the world over. No economy can now remain insular to the winds of change that gather around us. The service sector has become the largest and the most rapidly expanding sector in most economies, accounting for well over 60% of the world's GDP. Services account for a large share of production and employment in most economies and they are also coming to dominate the economic activities of countries at virtually every stage of development, making services trade liberalization a necessity for the integration of the world economy.

Developing countries have been striving hard, often at a considerable cost, to integrate more closely into the world economy. While a certain amount of adjustments and compromises are inevitable, the negotiations have to be guided by a trade-off between the issues of market access and domestic concerns so that the new world trade order does not result in deleterious consequences for the less-developed nations. Behind a backdrop of pulls and pressures, of tough negotiations and bargaining postures, the question naturally arises as to how our economy will respond to the rapidly evolving international trading environment. The task ahead is difficult and would require the deliberate and conscious effort and cooperation of all sections of Indian society. As a qualified professional, the Indian Chartered Accountant is in an advantageous position to provide the skills and services to different sections engaged in international trade. To perform this role effectively, the Chartered Accountant needs to understand the WTO regime and assess the importance and implications of various rules that could impinge on the country's trade activities and relations. The Chartered Accountant has to be aware of the consequences of implementation or non-implementation of particular trade laws on the Indian economy. It is in this wider context, that the Institute had constituted a Committee on Trade Laws and WTO as a non-standing Committee in the year 2001.

The Committee on Trade Laws and WTO had been formed with the mission to establish and assure the expertise and authority of the Institute of Chartered Accountants of India in all matters concerning Laws of Trade including Trade in Goods and Services in particular, and the implementation of international trade regimes including the WTO regime in general, both nationally and internationally, and to create and expand a base of expertise in these matters among the membership of the Institute through such ways and means as are considered to be most effective so as to fulfil national stated and unstated aspirations, concerns, and needs in all these regards.

The Committee's composition includes members of the Council of the ICAI, members co-opted to the Committee from various parts of the country and other experts invited from time to time at the deliberations of the Committee. Moving ahead with it's mission, the Committee continues to strive for capacity building of members in the rapidly changing world trade scenario in order to technically equip the members of the Institute to face the challenges and derive advantages to broaden the scope of their expertise in the new world trading regime and to contribute towards the economic development of India.

The Committee had introduced a Post Qualification Course in International Trade Laws and World Trade Organisation to orient Chartered Accountants towards developing the necessary and desirable capabilities to adapt and respond to the dynamic and challenging international economic environment. This Course has also been receiving a good response from the members. After the successful launch of the Post Qualification Course in International Trade Laws & WTO (ITL & WTO) in November 2004, a total of 288 members have been registered in the course from across the country. One of the prominent components of the course involves a 30 days Personal Contact Programme (PCP) which is

being conducted from time to time each year. Eminent faculty consisting of Senior Government Officials from different Ministries/Departments, such as the Ministry of Commerce, the Ministry of Finance, the Ministry of Small Scale Industries, the Directorate General of Safeguards, the Directorate General of Foreign Trade, the Competition Commission of India, the Export Inspection Council of India, the Copyright Board, faculty from Indian Institute of Foreign Trade, Indian Institute of Public Administration, University of Delhi, Delhi School of Economics, Confederation of Indian Industry, noted law firms, people from trade and industry, professionals, consultants and other research based organisations in the field of International Trade and WTO make presentations and deliver lectures during the PCP. Now, the syllabus, course structure, study material and the framework of the Post Qualification Course in International Trade Laws and WTO are proposed to be realigned with a view to give a focused outlook to the overall structure of the Course. The scheme is, however, pending for approval by the Government. The Committee has decided to take efforts to popularise the Course amongst members throughout the country and also to promote the Course in the industry, the Government and other potential user-groups to create professional avenues for members so equipped in International Trade Laws and the WTO field.

With the basic objective of providing guidance to Chartered Accountants in practice and in service and others concerned with having an insight in various fields and on issues of relevance to International Trade Laws and WTO, the Committee has released the following publications during the period 2007-08:-

- A Handbook on Anti-Dumping, Anti-Subsidy and Safeguard Measures
- A Handbook on Laws Relating to Intellectual Property Rights in India
- A Handbook on Valuation of Intellectual Property in Emerging Countries Like India – Accounting to take lead role now
- A Handbook on Special Economic Zones
- Study on Tax Havens
- Canadian Advantage – A Research Study on Canadian Business Opportunities

Other Research Initiatives/Projects in Progress:

- Study on International Commercial Arbitration
- Study on Cross- Border Acquisitions and Mergers
- Study on Benefits of Preferential Trade Agreements
- Country specific research studies for various countries for (a) setting-up businesses in such countries; and (b) operating as professional accountants in such countries

In this era of globalisation, there has been a lot of FDI coming to India as well as going to other countries from India. Hence, the Committee has also been exploring the possibility of offering assistance to all major foreign business delegations relating to the accountancy sector coming to India in order to create more avenues of professional development for it's Members. In pursuance of this, the Committee had organized an interaction with the Trade Counsellors of various embassies in India on March 26, 2008 at New Delhi.

The Committee has decided to strengthen the 'WTO Technical Desk' to provide responses to technical queries on issues related to International Trade Laws and the World Trade Organisation vis-à-vis the accounting profession in India and professional opportunities arising there from.

The Knowledge sharing page developed by the Committee and displayed at the website of the Institute continues to provide useful and relevant information on the basic understanding of WTO. The page intends to keep the members abreast of latest development in the ever-changing global trading environment. Now, the Committee also proposes to develop a separate portal on WTO to meet the emerging needs of the members in this regard. ❑

ICAI's Post-Budget Memorandum–2008

The ICAI has recently submitted the Post Budget Memorandum-2008 on Direct taxes and Indirect taxes to the Ministry of Finance. The following is the summary of suggestions made by ICAI. The detailed memoranda are available on ICAI website www.icai.org.

DIRECT TAXES

1. Clause 3 – Insertion of Explanation 3 to section 2(1A)

(a) Explanation 3 may be modified to provide that income derived from saplings or seedlings grown in a nursery shall be deemed to be agricultural income, whether or not the basic operations are carried out on land.

(b) Explanation 3 may be clarified and thereby given retrospective effect.

(c) Definition of sapling and seedling may be provided.

2. Clause 3 - Substitution of section 2(15)

(a) The scope of applicability of section 11(4A) may be increased appropriately instead of amending section 2(15).

(b) In the alternative, the proviso to section 2(15) may be suitably modified to exclude services rendered to members/ constituents from its scope.

3. Clause 5 – Insertion of clause (ii.a) in section 35(1)

(a) Weighted deduction of 125% of the amount contributed should be available for contribution made for both research and development. It should not be restricted to contribution made for research alone.

(b) Contributions made to foreign institutions for scientific research should also be eligible for deduction. A condition can be imposed that the Intellectual Property Rights should belong to the contributing entity in India. The eligible foreign institutions may also be specified by the Central Government for this purpose.

4. Clause 6 – Amendment of section 35D

(a) Fees paid for increase in authorised capital should be included under the expenses qualifying for deduction in the case of a company under section 35D(2)(c).

(b) The words "or in connection with the increase in capacity of his existing business" may be added at the end of clause (ii) of section 35D (1).

5. Clauses 7, 97 to 116 - Amendment of section 36(1) – Insertion of new clause (xvi)

(a) Clause 99 of Chapter VII of the Finance Bill, 2008 providing for charge of commodities transaction tax should be suitably amended to provide that commodities transaction tax would not be attracted in cases where the option is exercised.

(b) An eligible transaction of trading in commodity derivatives should be excluded from the ambit of speculative transaction defined in section 43(5).

The eligible transaction of trading in commodity derivatives may be included as item (e) in the proviso to section 43(5), which excludes certain transactions from the definition of speculative transaction. Further, the definition of "eligible transaction" in the Explanation to section 43(5) should be amended to include a transaction of trading in commodity derivatives also.

6. Clause 9 - Amendment of section 40A – Substitution of new sub-sections (3) and (3A) for existing sub-section (3).

(a) This amendment should be made effective in respect of payments made after the specified date i.e. 1.6.2008.

(b) Consequential changes should be made in the disclosure requirement in tax audit report.

7. Clause 15 – Amendment of section 80-IB – Insertion of sub-section (11C)

(a) The requirement of minimum number of beds should be reduced from 100 to 50.

(b) The assessee should be permitted to avail the benefit of tax holiday in any 5 consecutive years out of the initial 8 years beginning from the year of setting up the

hospital.

8. Clause 16 - Amendment of section 80-ID – Insertion of new clause (iii) in sub-section (2)

The assessee should be permitted to avail the benefit of tax holiday in any 5 consecutive years out of the initial 8 years beginning from the year of setting up the hotel.

9. Clause 18 – Amendment of section 111A

(a) Marginal relief may be provided for in section 111A

(b) The last proviso to section 48 should be removed so that securities transaction tax paid may be allowed as a deduction while computing short-term capital gains.

(c) The proviso to section 111A (1) should also be correspondingly amended to increase the rate of tax on the balance of short-term capital gains to 15%.

10. Clause 20 – Amendment of section 115JB

It should be clarified that the following are to be deducted from net profit, if the same have been credited to the profit and loss account

- Deferred tax asset and
- Reversal of deferred tax liability or provision therefore.

11. Clause 21 – Amendment of section 115-O – Insertion of sub-section (1A)

(a) The condition that the holding company should not be a subsidiary of any other company may be removed.

(b) The deduction may be allowed to all companies which have received dividend from another company, on which dividend distribution tax is paid. In other words, this concession should not be restricted only to dividend received from a subsidiary company.

(c) If a company has invested in a mutual fund and has received income from such mutual fund on which dividend distribution tax is paid under section 115R, the said income should also be deductible from dividend distributed by the company for the purpose of payment of dividend distribution tax under section 115O. This will avoid double taxation of the income received from the mutual fund.

12. Clause 22 – Amendment of section 115WB

(a) Expenditure on in-house training, expenditure on any conference for skill development etc. should be excluded from the purview of FBT.

(b) Surcharge on FBT should be attracted only in the case of those companies/ firms where the value of fringe benefits exceeds Rs.1 crore.

13. Clauses 24 & 27 – Amendment of sections 115WD and 139(1)

(a) The definition of "specified date" in section 44AB should be amended to have the same meaning as in Explanation 2 to section 139(1).

(b) In case of non-corporate assesses subject to audit, the due date may be further advanced to 31st August of the assessment year. Further, in the case of non-corporate assesses not subject to audit, the due date may be advanced to 30th June of the assessment year.

14. Clause 26 – Insertion of new section 115WKB

The stock option benefit enjoyed by an employee should be treated as his salary. Consequently, the employer can withhold the FBT in relation to such benefits from such employee's salary. The employer should accordingly record this in the TDS certificate issued by him to his employee. This would help the employee to claim credit of such deemed payment of FBT in a country outside India.

15. Clause 30 – Amendment of section 147 – Insertion of second proviso

The Assessing Officer should be required to specifically state the details of income which has escaped assessment in the notice issued by him, and assessment/reassessment should be restricted to such specified income alone.

16. Clause 40 – Amendment of section 194C – Insertion of clause (ja) in sub-section (1)

Only those AOPs and BOIs, which are liable to get their accounts audited under section 44AB, should be required to deduct tax under section 194C.

17. Clause 46 – Amendment of section 254(2A) – Substitution of third proviso

(a) In the third proviso, the words "if the delay

in disposing of the appeal is attributable to the assessee" may be substituted for the words "even if the delay in disposing of the appeal is not attributable to the assessee".

(b) Alternatively, responsibility should be vested with the Tribunal to dispose of the appeal during the period of stay.

(c) Time barring provisions, similar to the provisions contained in section 153 for completion of assessments, should be made applicable in cases where stay has been granted.

18. Clause 52 – Insertion of new section 292BB

(a) Clause (b) of section 292BB relating to non-service of notice in time should be removed.

(b) The language of the section may be suitably modified to provide that where the assessee fails to raise preliminary objection during the course of assessment proceedings that notice is not served upon him or that notice is served in an improper manner, then he cannot raise such an objection at the appellate or later stage.

INDIRECT TAXES

A. Amendments to Customs Act and Central Excise Act

1. Issue

Section 129EE is proposed to be inserted in the Customs Act, 1962 and Section 35FF is proposed to be inserted in Central Excise Act, 1944.

The proposed amendment is a welcome move as it provides for payment of interest on delayed refund of the amount deposited under proviso to Section 129E and 35F respectively.

The proposed section provides for payment of interest after expiry of three months from the date of communication of the order of the appellate authority till the date of refund of such amount except in cases where the operation of the order of the appellate authority is stayed by a Superior Court or Tribunal. This exception creates practical difficulties as the said order of the Superior Court or Tribunal may come late and if the reference is proposed, the order of the appellate authority may not be communicated to the assessee till such time as the appeal is filed to the Superior Court or Tribunal and the Superior Court or Tribunal issues the order. Further, this results in denial of interest on appellant's amount during the period of stay even though the matter is ultimately decided in favour of the tax payer.

Also, a strict reading of the section indicates that if a stay is granted against the operation of the order by a Superior Court or Tribunal, there would be no interest payment at all even if finally the matter is decided in favour of the tax payer and the deposited amount is refunded.

Further, the interest on the refund is sought to be provided from the expiry of three months from the date of communication of the order of the appellate authority till the date refund of such amount which results in denial of interest from the date of deposit made by the tax payer. The section requires determination of the date of communication of the order to the appellate authority which creates difficulties as against the date of passing of the order which is simpler, identifiable measure.

Suggestions

a) Interest on refund of the deposit amount be provided from the date of deposit of the amount.

b) Alternatively, the period of three months be reckoned from the date of passing of the order by the appellate authority.

c) Interest on delay in granting refund be provided in all cases irrespective of the state of operation in all cases even if the operation of the order of appellate authority is stayed by a Superior Court of Tribunal.

2. Issue

An exception is proposed to be added to Section 2(d) of Central Excise Act, 1944 explaining the meaning of the term "goods". It provides that any article, material or substance, which is capable of being bought or sold for a consideration, shall be deemed to be marketable.

For goods to be excisable, the same ought to result from a process of manufacture which term is again defined only in an inclusive manner. The courts have interpreted the term to mean *"a process leading to change in the name, character or use of the material processed"* and have, in some cases, also added the marketability element as well as a criteria for determining whether the goods emerging from the process could be regarded as manufactured. As will appreciate the terms

"goods" and "manufacture" have been explained and read together for the purpose of determining excisability of manufactured goods.

It may, therefore, be necessary to also modify the definition of "manufacture" [Section 2(f)] to avoid possible disputes especially in relation to taxability of waste and scrap arising in the course of manufacture which is not arising as a result of manufacture per se but in the course of manufacture of primary goods.

Suggestion

An appropriate sub-clause to the effect that any process by which goods arise / come into existence at any time during the course of manufacture of any goods and which are bought and sold for a consideration shall be deemed to be a process of manufacture.

B. Amendments to Service Tax Law

Banking and Financial Services - Foreign Exchange Broking

3. Issue

Service rendered in relation to the activity of purchase and sale of foreign currency in the capacity of principal is proposed to be brought into the service tax net by substitution of sub clause (iv) (a) to S 65(12) which is not the case with any other goods.

The activity of purchase and sale of goods is within the domain of the State Government and, therefore, we believe that the provision to tax the activity relating to purchase and sale of foreign currency would be ultra virus.

We, however, understand that what is sought to be taxed is only the service being provided by foreign exchange brokers (agents) for purchase and sale of foreign currency. This is also clear from the fact that 0.25% of the purchase or sale price is sought to be treated as the service element.

The tax is sought to be levied on both legs of the transaction i.e. purchase as well as sale of foreign currency. If the transaction is between two brokers, it would amount to double taxation as the purchase as well as sale transaction would be taxed separately. Further, service provided by "any person" is taxable under the category of banking and financial services. Thus, an individual who sells foreign currency or buys foreign currency may also be held to be liable to service tax.

Suggestions

a) Appropriate amendment/clarification be issued to the effect that the tax is on the service provided by brokers/agents in relation to purchase or sale of foreign currency.

b) One leg of the transaction either the purchase or the sale may be taxed or appropriate amendment be made/exemption notification be issued to the effect that the tax is leviable only on the broker and not on the purchaser or seller of the foreign currency.

4. Information Technology Service

We welcome the proposal for the consolidation and introduction of new entry relating to Information Technology Software service and also note that the definition of the term "Information Technology Software" is the same as that adopted for Customs and Central Excise Duty purposes to maintain uniformity.

There are few areas of concern in this regard:

1. The new category proposes to bring to charge taxation of software supplied electronically and as we read the language, it appears to cover both customised and packaged software. Packaged software delivered on media from outside of India is today exempt from charge of customs duty. The reason for taxing the same when delivered electronically is not clear to us.
2. Some of the services relating to information technology software are still covered under other categories like repair and maintenance of software and technical testing. Since the tax treatment is the same, all the categories are taxable, there does not seem to be a justifiable reason to keep them under other categories.
3. It is not clear as to how the same are to be treated for the purpose of import and export of Service Rules.
4. Many states impose tax (VAT) on software which includes customised and packaged software. The states do not distinguish between the modes of delivery and therefore, even if the packaged software is delivered electronically, they would tax it. Thus, there will be double taxation and spate of litigation.

Suggestions

a) ***Tax incidence ought not to be different based on the mode of delivery and, therefore, we suggest that either customs duty entry be amended or service tax entry be amended. As per our understanding, based on the Geneva Agreement/Convention to which India is also a party, the cross border movement of software is to be at zero duty. If that be so, it will be necessary to amend the service tax law or make appropriate provision in the Import of Service Rules.***

b) ***All the services relating to information technology software be brought under one entry only for the sake of simplicity and clarity***

c) ***Determination of place of supply for cross border transactions in software services ought to be based on the location and status/use (business or personal) of the recipient as the most appropriate one.***

d) ***There is need to clarify that if any transaction is treated as a transaction of "service" for the purpose of charge of service tax, it ought not to be treated as "goods" of "deemed goods" by states. A more appropriate measure will be to define "service" as "other than goods or deemed goods" so as to avoid disputes and litigation and harassment of the service providers.***

5. Associated Enterprises

Clause (c) of Explanation to Section 67 is proposed to be substituted by providing that "…..any amount debited or credited…. in the books of account of a person liable to pay service tax where the transaction of taxable services is with an associated enterprise".

Section 67 is the valuation provision and the amount debited or credited by way of book adjustment constitutes gross value of consideration for the purpose of levy of service tax. The term "book adjustment" even before the amendment included book entries between two types of enterprises and the addition of "the transactions with associated enterprises" does not really explain the scope.

Further, the way the clause is drafted; it may be interpreted to cover within its scope exempt or non taxable services as it refers to book adjustment of "**any** amount……" where the transaction of taxable service is between associated enterprises.

As we understand, what is sought to be achieved is that in cases of transactions between associated enterprises, any debit or credit of amount towards taxable service to the account of the associated enterprise is to be deemed to be receipt of the gross value of consideration and that such an entry would trigger liability to pay service tax.

Suggestion

If that be the intention, the appropriate amendment is required in Rule 6 of Service Tax Rules.

6. Issue

Further, the term "associated enterprise" is quite complex to understand and will be quite difficult to apply for the Central Excise officers who carry out audit of these enterprises.

Suggestion

The objective of the Service tax law would be achieved even if this term "associated enterprise" is replaced by the term "subsidiary and / or associate of an enterprise". A "subsidiary" is an entity in which another company (called parent/ holding company) holds 51% or more of the share capital or controls 51% or more of the Board of Directors or the management group. "Associate" is an enterprise on which another entity exercises significant influence and which, in turn, is ordinarily measured by a shareholding of 20% or more of the other enterprise.

All these terms are used in accounting standards and any transactions between holding/parent and subsidiary and associates are required to be separately disclosed in the financial statements of an enterprise. This might be simpler and easier to apply as also verify.

7. Issue

If the associated enterprises are Indian and foreign entities and if entries are made in respect of services received outside India for use in business outside India, it may need to be excluded from the purview of taxation e.g. an Indian Bank having a subsidiary/branch outside India and receiving services outside India for the purpose of carrying on business outside India.

Suggestion

Appropriate amendment be made or clarification be added to avoid possible uncertainty and litigation.

8. Issue

Any service to constitute "export" under the Export of Service Rules, 2005 ought to satisfy a condition of receipt of convertible foreign exchange in India. If the book adjustment is deemed to be receipt of consideration for rendering service, appropriate amendment is also required in the Export of Service Rules.

Suggestions

Export of Service Rules may be amended to provide that receipt of convertible foreign exchange will include book adjustment as defined in the Act.

Alternatively, if the intention is to apply the book adjustment rule only to the import of services, appropriate amendment be made in the Act itself.

9. Best Judgment Assessment

Issue

Section 72 is proposed to be inserted to provide for the best judgement assessment. This applies in cases where a person has failed to furnish return or fails to assess tax correctly.

A best judgment assessment is required when the tax payer or person liable to pay tax fails to provide details, furnish documents and like, to enable the assessing officer to make an assessment.

Suggestion

This provision be amended to add "and the person fails to produce books/documents….." to enable the assessing officer.

Alternatively, if the intention is to adopt a system where, if an assessee fails to furnish return or pay tax, an automatic demand is generated based on tax paid in the past (it cannot be left totally open to the judgment of the assessing officer as that can be arbitrary), appropriate amendment needs to be made in the provisions.

10. Penalty – Section 77

Issue

Section 77 is proposed to be replaced and failure to **"take"** registration is sought to be made liable to penalty. A person cannot "take" registration but only "seek" registration.

The offence referred to in the section is continuous one and there is need to provide for cap on the amount of liability and it ought to be provided that it shall not exceed the amount of service tax that is not paid. Too harsh a penalty leads to corrupt practises and the aim of the department/ revenue authorities ought to be to collect taxes and not penalties.

Suggestions

a) The word "take" be replaced by the word "seek"

b) A cap on penalty amount that can be imposed for the offences referred to in the section be introduced which ought not to exceed the amount of service tax.

11. Penalty- electronic payment of taxes

Issue

We support the initiative of the Government to move to an e-regime and welcome steps to facilitate the same. However, to introduce a penalty for not doing so at this stage would be very harsh.

Suggestion

Postpone the applicability of penal measure by a year till such time as the assessees and the departmental systems are well established.

ICAI will be happy to work with government and facilitate greater use of electronic measures for tax payment and return filing.

12. Service Tax Dispute Resolution Scheme

The Scheme is a welcome move to clear up the system of the backlog especially relating to small amounts of demands.

There is however, need to clarify issues for which clarity is required for the Scheme to be successful.

Also, there may be tax payers who have not paid taxes or whose returns are not yet taken up for verification and demand notices are not issued. It will be useful to provide for some time to the department to complete verification of cases up to a particular date and also for the assessees to voluntarily obtain registration, file returns for the past period for which they may not have done so and demand could be raised and then covered in the Scheme.

This Scheme could cover specified services where the tax payers are usually small and not so well educated.

The Scheme may also be extended to cover all the demands arising out of CENVAT Credit irrespective of the amount of demand as there were areas where there was confusion. ❑