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The Chartered Accountant **STUDENT**

Your monthly guide to CA news, information and events

**SPECIAL ISSUE ON
ECONOMICS
FOR
FINANCE**



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SWACHH BHARAT - A STEP TOWARDS CLEANLINESS

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Dear Students,

At the outset, I would like to extend my best wishes to all of you as you gear up for the forthcoming May 2018 examinations. This communication reaches you amidst your exam preparations. As you have reached the last phase of your preparation, you must invest all your productive energy towards studies. Sincere efforts coupled with a disciplined approach will help you attain the desired results. The preparation time before the examinations is very valuable therefore, you will have to plan each day meticulously and work accordingly to achieve success. You must calibrate your efforts for all papers and apportion your time to achieve best results. **Prepare an action plan, a regimen** and judiciously follow the same. Remember, *"The backbone of success is...hard work, determination, good planning, and perseverance."*

Pursuit of Excellence: The driving force behind success

You must seek excellence by striving hard and pushing your limits to gradually improve upon your capabilities day after day to deserve the success you desire. Remember, *"The secret of joy in work is contained in one word - excellence. To know how to do something well is to enjoy it."* Similarly, you must enjoy studying hard to be able to accomplish more in the given time. **Create/Customize your own knowledge and learning systems focusing on your strengths.** Prepare **summary/notes** encompassing all the essential aspects of the topic as given in the **study material**. Adopt a target-oriented approach and track your progress weekly. Set achievable and measurable targets. **Revision** is important for retention, so you must allocate some time for revision before you make a fresh start daily. Study in a tranquil environment. Planning for the next day in advance helps to better organize and utilize your time to accommodate important tasks, helping you to meet daily targets, enhancing your productivity.

BOS your mentor, your guide

Board of Studies (BOS) of ICAI provides a complete array of published study material such as **Practice Manuals, Revisionary Test Papers and Suggested Answers** to help you to streamline your preparation. Apart from the regular publications, BOS also publishes a **20 page revision capsule** on a subject in the **Students' Journal**. This issue includes an exclusive feature on 'Economics for Finance'. This would help you to revise the subject in minimal time just before the

exams. We shall continue to bring in many more innovative learning resources to guide you to excel in your efforts.

Extensive digital content is also available online such as **video lectures** on all the subjects in the Revised Scheme, **Guidance Notes and webcasts** on topical subjects such as **GST and Ind AS** to supplement your preparation through an integrated and guided approach. These help in bringing learning solutions and classroom teaching to your doorstep, and most importantly helping those of you residing in mofussil areas.

The institute is mindful of your efforts and values your time immensely. We, at ICAI, are undertaking best efforts to provide you the best learning resources and opportunities. To prepare you for the first examination in the **Revised Scheme, Mock Tests** are being organized for all the subjects of CA Foundation, Intermediate and Final as well as CA IPC and Final in the **Old scheme**. These are scheduled from **March 17 until April 8, 2018**. Thereafter, **Counselling Sessions** will be organized for all the subjects of CA Intermediate, Final in the New Scheme and CA IPC and Final in the old scheme from **April 16 till April 18, 2018**, to provide valuable tips and cues to prepare and present your answers. The schedule is uploaded on the link: <https://resource.cdn.icai.org/49149bos32890.pdf>.

I earnestly advise you to take **Mock tests** with utmost sincerity and attempt past test papers in the stipulated time limit under exam conditions in a simulated environment. This exercise will not only apprise you about the paper pattern in the Revised scheme, but also enable you to assess your performance and identify learning gaps, guiding you to make necessary changes in strategy/style, preparing you psychologically for the examination by alleviating your anxiety.

One of the important elements of Chartered Accountancy course is the articles training through which you comprehend the theoretical concepts by applying the same in the real life professional situations. It is a learning ground which aptly helps you to prepare not only for the examinations but also for your professional journey ahead. Thus, it is of utmost important that the practical training is undertaken with full sincerity and dedication.

The great saint and philosopher **Vivekananda** had said: ***Take up one idea. Make that one idea your life - think of it, dream of it, live on that idea. Let the brain, muscles, nerves, every part of your body, be full of that idea, and just leave every other idea alone. This is the way to success.***

It is my firm belief that if you give your best with undeterred focus and singleness of purpose, and will come out with flying colors in the forthcoming exams.

CA. NAVEEN N. D. GUPTA
PRESIDENT, ICAI, NEW DELHI

VICE PRESIDENT'S COMMUNICATION ||



Dear Students,

With about a month left for the examinations, it is time for the students to gear up their efforts. It is not only how much you study but what you study and how well you study that determines your success in the examinations. The Chartered Accountancy course is challenging

and demands your complete dedication, focus, hard work and a burning desire to be successful. If you are preparing for exams in a systematic and consistent manner, success will chase you.

I urge all of you to use the Study Material/Suggested Answers/ Revision Test Papers/ Mock Test Papers of our Institute in a well planned and cohesive manner. Take the optimum utilization of the facilities that are being provided to you by our Institute. E-learning will also serve as a supplement to our distance learning programme and through this facility you will have the benefits of learning at your convenience and also assessing your learning through self assessment quizzes.

The Students are the key concern of the Institute and it is our endeavor to provide them the best infrastructure, educational opportunities and exposure that would

sharpen their skills and mould them into excellent professionals. The CA Profession is very dynamic, demanding and rewarding. The profession is growing on stupendous scale and it has stretched its value added services in the wide spectrum. The Chartered Accountants play a very vital role in the society promoting reliable and transparent information both in the public and private domain. Chartered Accountants are not delimited to performing mere traditional duties in the realm of Auditing, accounting, taxation, etc. They are now expected to have a greater understanding of and exposure in the fields of business finance, information technology, corporate management, etc. Hence, the opportunities for the accounting professionals are vast and wide.

As more and more students decide to pursue CA as their profession, it is our utmost responsibility to provide them an easy access to the best education possible. I extend my best wishes to all the aspirants of CA Course and do hope that they will achieve grand success in their set objective.

CA. PRAFULLA P. CHHAJED
VICE PRESIDENT, ICAI, NEW DELHI

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Board of Studies

The Institute of Chartered Accountants of India





Dear Students,

Student years are wonderful years. Study with passion and planning to achieve your potential. To succeed in the professional course of Chartered Accountancy you need proper planning and adherence to plans. Complete learning efforts well in advance and do a lot of practice. Reading, assimilation and writing are equally important. With around two months left for May 2018 examinations, the students who are intending to take these examinations must put in extra efforts. I sincerely hope that these students must have completed at least one round of learning all the topics by now and they would be in the process of revising, reinforcing what they have already learnt. Practice by writing one or two question papers every day. Make full use of study material, revision test papers, mock test papers, papers set in previous examinations and cloud campus.

May 2018 examinations will also be first under the new scheme of education and training. The new scheme was launched last year to introduce relevant and contemporary topics in the syllabus. The Board of Studies periodically reviews its scheme of education and training. This is done with a focus on the overall changes in business and economy. There are several path breaking features in the new scheme. In the new scheme weightage of topics, expected skills required have been clearly defined. The introduction of an elective paper based on Case Studies is going to bring a paradigm shift in the education pedagogy of the Board of Studies of ICAI. To assist students in their preparation, sample cases have been hosted on the cloud campus. To guide the students, online mentoring is also being done in all the elective papers. Case Studies will bring a new practical dimension to the education system of ICAI. The students who have taken their articleship training seriously will be in better position to understand, analyse and answer the questions asked in the Case Studies.

While Board of Studies has continuously worked to provide best of the services to the students, it is simultaneously realised that there is always scope for improvement. We are highly concerned about the educational inputs being provided to the students. A major impetus is being planned in education to students by providing live virtual classes of reputed faculty to the students.

We are providing printed material, organising events and harnessing technology to reach out to the students who are spread in every nook and corner of the country, even beyond. It is natural that in the process of providing quality education there will be expectation gaps. We would like to have your views and suggestions to identify the gaps and the methods to bridge these gaps. Please feel free to write to us with your inputs.

The life poses several challenges and it is for us to decide how to react to these challenges. Abraham Lincoln, the 16th President of the United States said *"We can complain because rose bushes have thorns, or rejoice because thorn bushes have roses."* Having a positive approach will not only make you happy but also give you necessary confidence to bring out your true potential. On the other hand, negativity will make you lose your confidence. I suggest the students should keep following points in their mind:

1. A belief in yourself.
2. Trust in your decisions
3. Planning and action go together
4. Discuss issues and challenges with parents, teachers and mentors for solutions.
5. Pursue a hobby for leisure.
6. Eat, exercise for a healthy body.
7. Avoid things that bring negativity.

Have a positive approach and believe in yourself. *"We are what our thoughts have made us; so take care about what you think. Words are secondary. Thoughts live; they travel far."* - Swami Vivekananda.

With best wishes,

Yours truly,

A handwritten signature in black ink, appearing to read 'Dhinal A. Shah'.

CA. DHINAL A. SHAH
CHAIRMAN, BOARD OF STUDIES, ICAI

ECONOMICS FOR FINANCE: A CAPSULE FOR QUICK RECAP

At the Intermediate level, students are expected to not only acquire professional knowledge but also the ability to apply such knowledge in problem solving. In this capsule for students, an attempt has been made to capture the significance and importance of the subject of Economics for Finance with the intention to assist you in revision of concepts discussed in the study material.

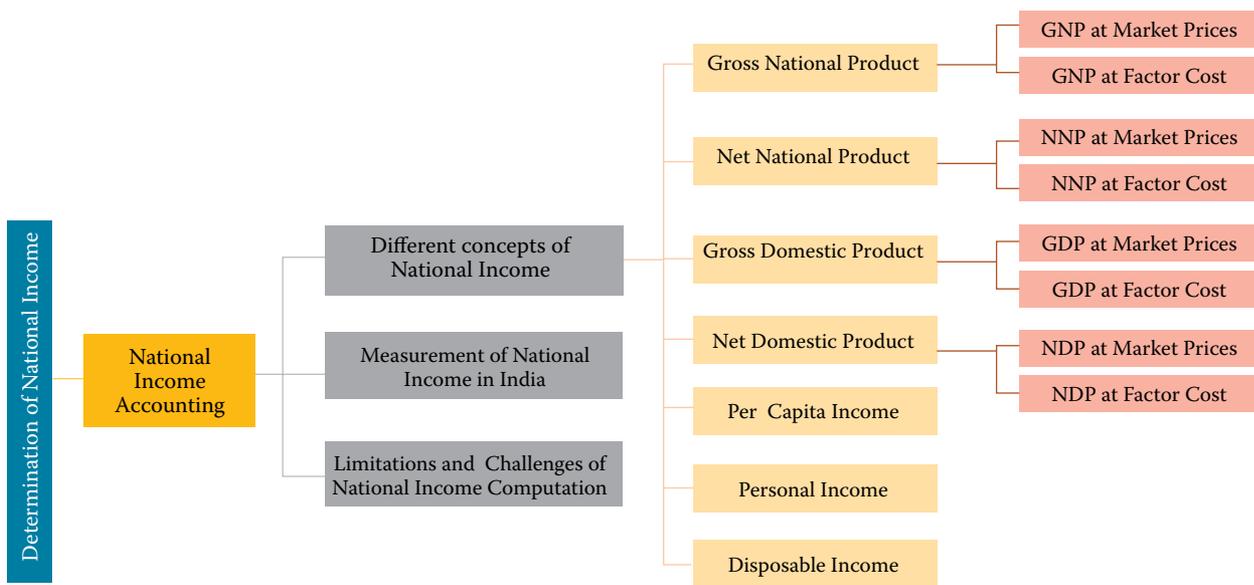
CHAPTER I: UNIT-I NATIONAL INCOME

National Income

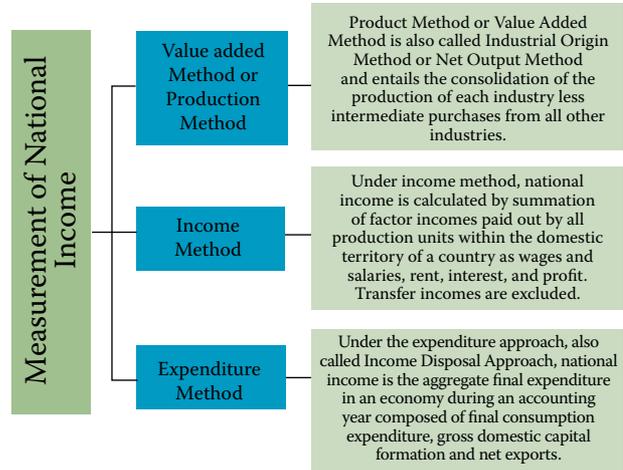
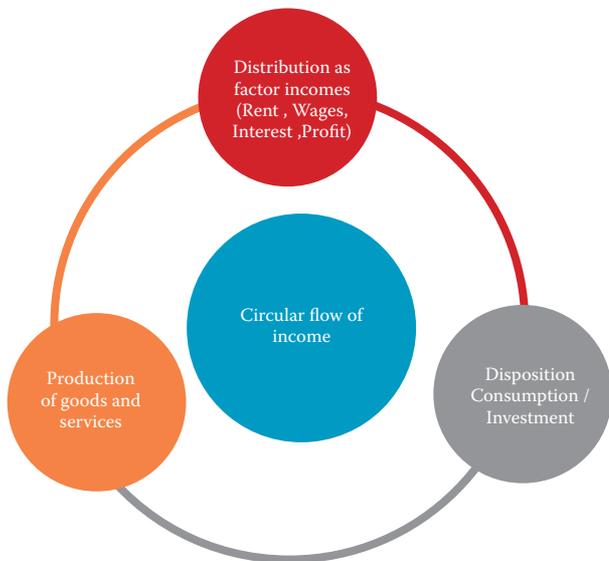
Net Value of all economic goods and services produced within the domestic territory of a country in an accounting year plus net factor income abroad.

Usefulness of National Income Accounts

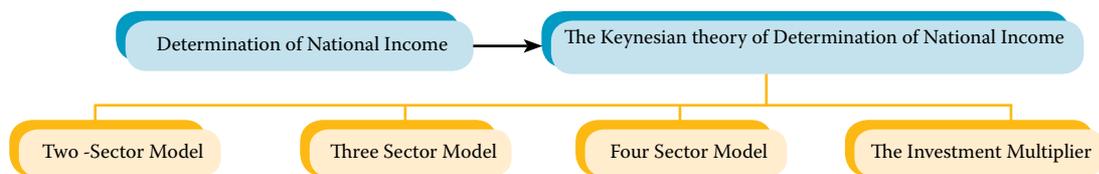
- For analyzing and evaluating the performance of an economy,
- Knowing the composition and structure of the national income,
- Income distribution, economic forecasting and for choosing economic policies and evaluating them.



GNP_{MP} • GDP_{MP} + Net Factor Income from Abroad	NDP_{MP} • GDP_{MP} - Depreciation • NNP_{MP} - Net Factor Income from Abroad	NNP_{MP} • GNP_{MP} - Depreciation • $NNP_{MP} = NDP_{MP} +$ Net Factor Income from abroad • $NNP_{MP} = GDP_{MP} +$ Net Factor Income from Abroad - Depreciation	Market Price • Factor Cost + Net Indirect Taxes = Factor Cost + Indirect Taxes - Subsidies
Factor Cost = Market Price - Net Indirect Taxes = Market Price - Indirect Taxes + Subsidies	Gross Domestic Product at Factor Cost (GDP_{FC}) • GDP_{MP} - Indirect Taxes + Subsidies • Compensation of employees + Operating Surplus (rent + interest + profit) + Mixed Income of Self - employed + Depreciation	Net Domestic Product at Factor Cost (NDP_{FC}) is defined as the total factor incomes earned by the factors of production. • $NDP_{FC} = NDP_{MP}$ - Net Indirect Taxes = Compensation of employees + Operating Surplus (rent + interest + profit) + Mixed Income of Self - employed	Net National Product at Factor Cost (NNP_{FC}) or National Income • NNP_{FC} = National Income • FID (factor income earned in domestic territory) + NFIA.
Personal income is a measure of the actual current income receipt of persons from all sources. • $PI = NI$ + income received but not earned - income earned but not received	Disposable Personal Income (DI) that is available for their consumption or savings $DI = PI -$ Personal Income Taxes		

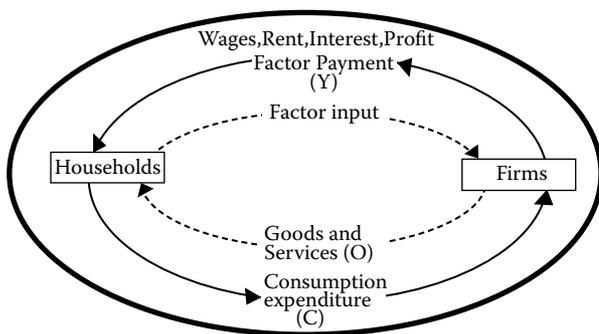


UNIT-II: THE KEYNESIAN THEORY OF DETERMINATION OF NATIONAL INCOME



- John Maynard Keynes in his masterpiece *'The General Theory of Employment Interest and Money'* published in 1936 put forth a comprehensive theory to explain the determination of equilibrium aggregate income and output in an economy.
- The equilibrium analysis is best understood with a hypothetical simple two-sector economy which has only households and firms with all prices (including factor prices), supply of capital and technology constant; the total income produced Y , accrues to the households and equals their disposable personal income.
- The equilibrium output occurs when the desired amount of output demanded by all the agents in the economy exactly equals the amount produced in a given time period.
- In the two-sector economy, Aggregate Demand (AD) or aggregate expenditure consists of only two components: aggregate demand for consumer goods and aggregate demand for investment goods / being determined exogenously and constant in the short run.

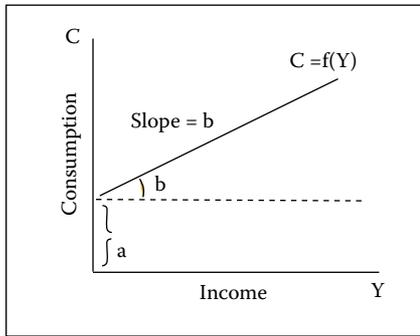
Circular Flow in a Two Sector Economy



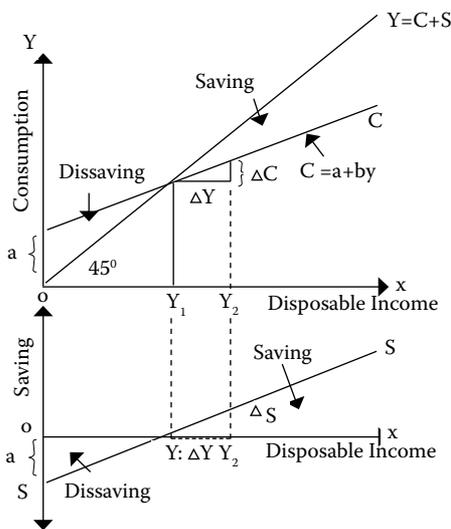
- ◆ Consumption function expresses the functional relationship between aggregate consumption expenditure and aggregate disposable income, expressed as $C = f(Y)$. The specific form consumption function, proposed by Keynes $C = a + bY$
- ◆ The value of the increment to consumer expenditure per unit of increment to income (b) is termed as Marginal Propensity to Consume (MPC).

- ◆ The Keynesian assumption is that consumption increases with an increase in disposable income ($b > 0$), but that the increase in consumption will be less than the increase in disposable income ($b < 1$).
- ◆ The propensity to consume refers to the proportion of the total and the marginal incomes which people spend on consumer goods and services.
- ◆ The proportion or fraction of the total income consumed is called 'average propensity to consume' (APC) = $\text{Total Consumption} / \text{Total Income}$
- ◆ Since $Y = C + S$, consumption and saving functions are counterparts of each other. The condition for national income equilibrium can thus be expressed as $C + I = C + S$
- ◆ Changes in income are primarily from changes in the autonomous components of aggregate demand, especially from changes in the unstable investment component.
- ◆ The investment multiplier k is defined as the ratio of change in national income (ΔY) due to change in investment (ΔI)
- ◆ The marginal propensity to consume (MPC) is the determinant of the value of the multiplier. The higher the marginal propensity to consume (MPC) the greater is the value of the multiplier.
- ◆ The more powerful the leakages are, the smaller will be the value of multiplier.

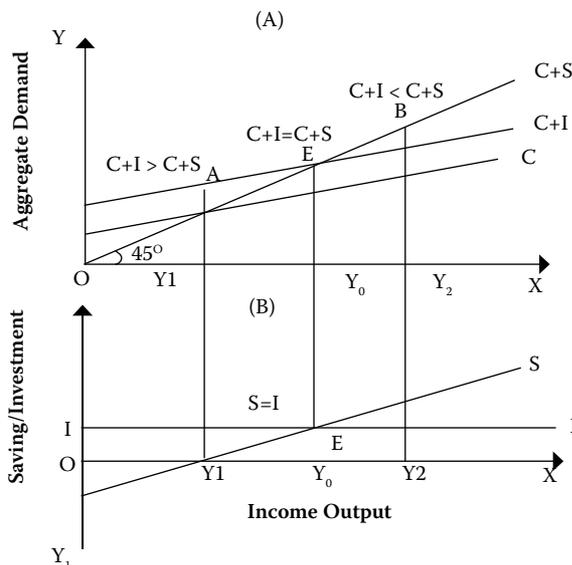
Keynesian Consumption Function



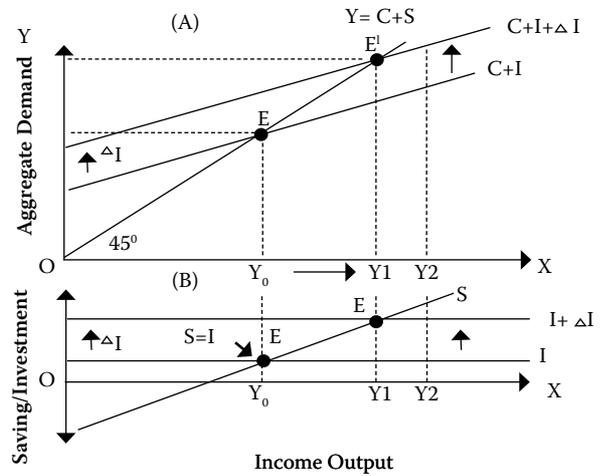
Consumption and Saving Function



Determination of Equilibrium Income: Two Sector Model



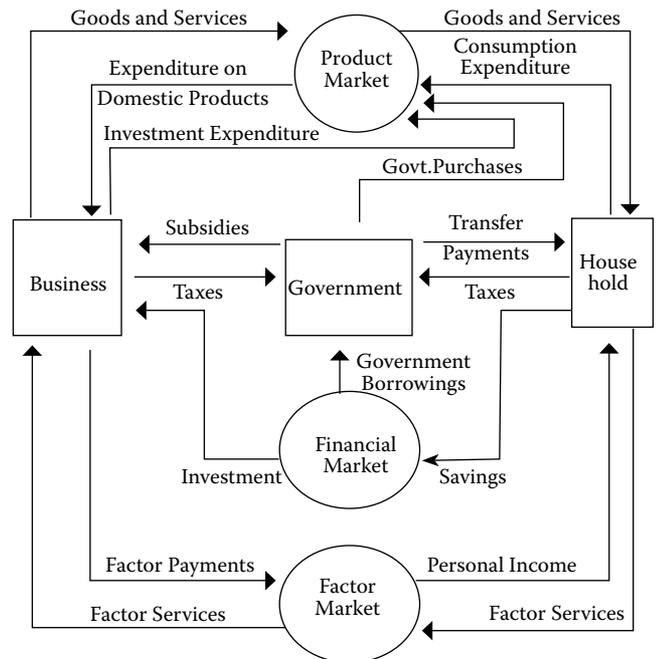
Effects of Changes in Autonomous Income



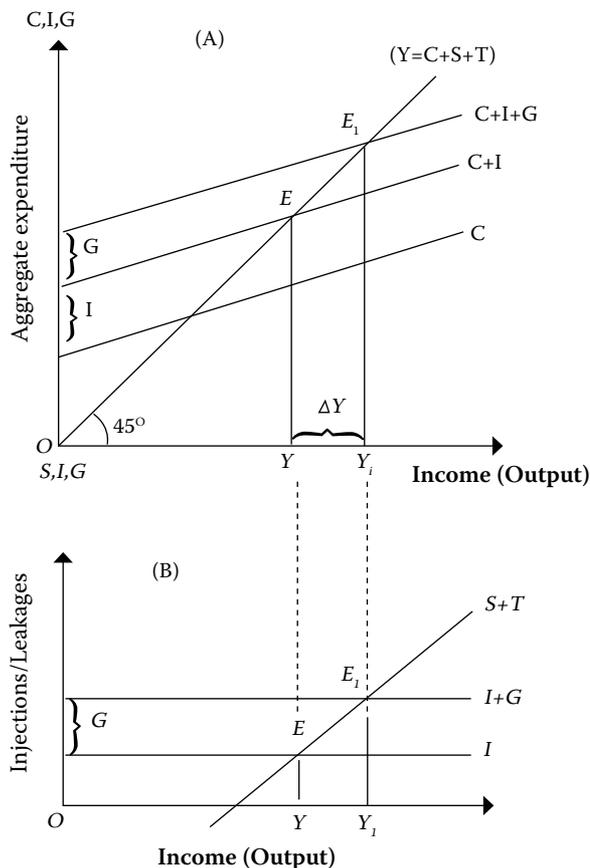
Three Sector Model

- Aggregate demand in the three sector model of closed economy (neglecting foreign trade) consists of three components namely, household consumption (C), desired business investment demand (I) and the government sector's demand for goods and services (G).
- The government sector imposes taxes on households and business sector, effects transfer payments to household sector and subsidy payments to the business sector, purchases goods and services and borrows from financial markets.
- In equilibrium, it is also true that the $(S+T)$ schedule intersects the $(I+G)$ horizontal schedule.

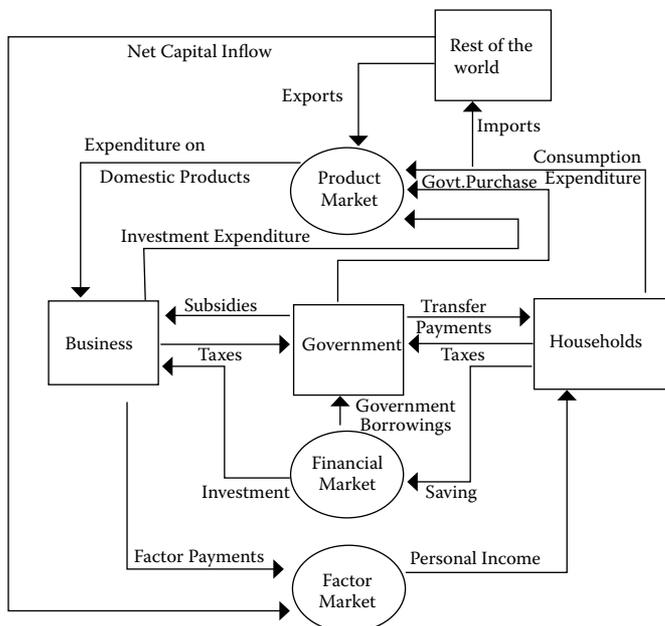
Circular Flow in Three Sector Model



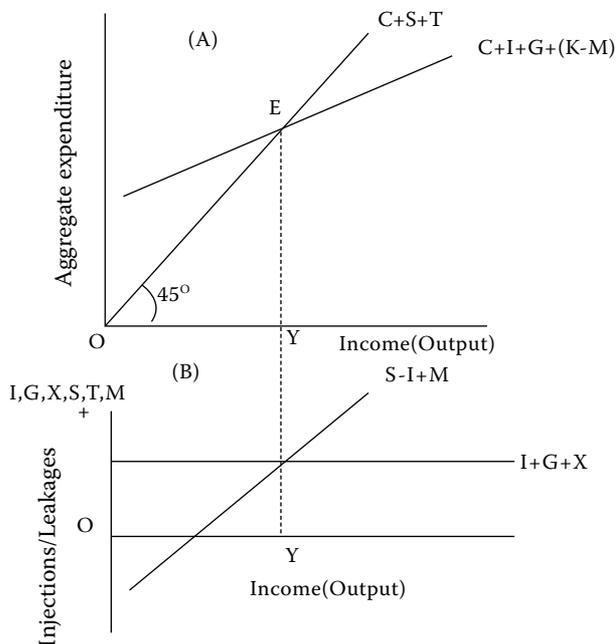
Determination of Equilibrium Income: Three Sector Model



Circular Flow in Four Sector Model



Determination of Equilibrium Income: Four Sector Model



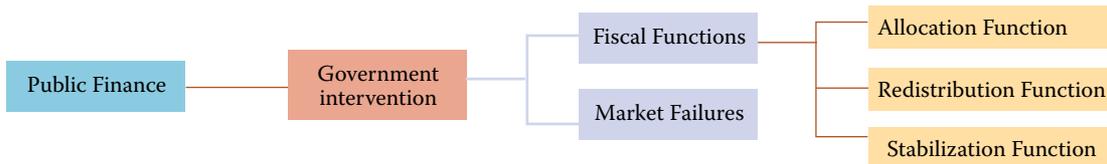
Four Sector Model

The four sector model includes all four macroeconomic sectors, the household sector, the business sector, the government sector, and the foreign sector and in equilibrium, we have $Y = C + I + G + (X - M)$

- ◆ The domestic economy trades goods with the foreign sector through exports and imports.
- ◆ Imports are subtracted from exports to derive net exports, which is the foreign sector's contribution to aggregate expenditures. If net exports are positive ($X > M$), there is net injection and national income increases. Conversely, if $X < M$, there is net withdrawal and national income decreases.
- ◆ The autonomous expenditure multiplier in a four sector model includes the effects of foreign transactions and is stated as $\frac{1}{1-(b+v)}$ against $\frac{1}{(1-b)}$ in a closed economy.
- ◆ The greater the value of v , the lower will be the autonomous expenditure multiplier.
- ◆ An increase in the demand for exports of a country is an increase in aggregate demand for domestically produced output and will increase equilibrium income just as would an increase in government spending or an autonomous increase in investment.

CHAPTER -II PUBLIC FINANCE Unit-I Fiscal Functions: An Over View

Broadly speaking, Public Finance is the study of role of the Government in a market economy with regards to allocation, income redistribution and market stabilization.



Allocation Function

- ◆ The allocation responsibility of the government involves appropriate corrective action when private markets fail to provide the right and desirable combination of goods and services.
- ◆ A variety of allocation instruments are available by which governments can influence resource allocation in the economy such as, direct production, provision of incentives and disincentives, regulatory and discretionary policies etc.

Stabilization Function

- ◆ One of the key functions of fiscal policy and aims at eliminating macroeconomic fluctuations arising from suboptimal allocation.
- ◆ Concerned with the performance of the aggregate economy in terms of labour employment and capital utilization, overall output and income, general price levels, economic growth and balance of international payments.
- ◆ Government's stabilization intervention may be through monetary policy as well as fiscal policy. Monetary policy has a singular objective of controlling the size of money supply and interest rate in the economy, while fiscal policy aims at changing aggregate demand by suitable changes in government spending and taxes.

Distribution Function

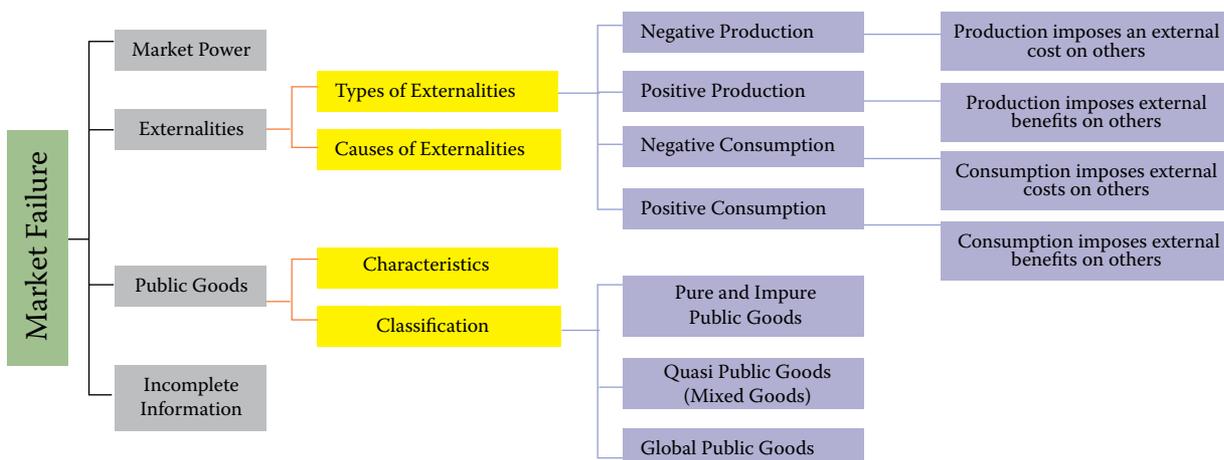
- ◆ Aims at redistribution of income so as to ensure equity and fairness to promote the wellbeing of all sections of people and is achieved through taxation, public expenditure, regulation and preferential treatment of target populations.

Fiscal Policy Challenges

- ◆ Conflicting goals of budgetary policy.
- ◆ Designing the budgetary policy in a way that the pursuit of one does not jeopardize the other.

Unit-II Market Failure

Market Failure is a situation in which the free market fails to allocate resources efficiently in the sense that there is either overproduction or underproduction of particular goods and services leading to less than optimal market outcomes.

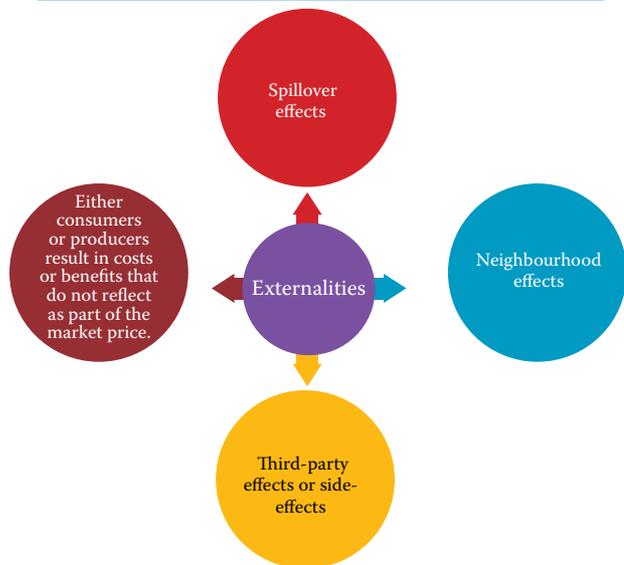


Market Power

Excess market power causes the single producer or small number of producers to produce and sell less output than would be produced in a competitive market.

Externalities

Externalities are initiated and experienced, not through the operation of the price system, but outside the market and therefore are external to the market.



Externalities cause market inefficiencies because they hinder the ability of market prices to convey accurate information about how much to produce and how much to buy. Since externalities are not reflected in market prices, they can be a source of economic inefficiency.

Examples of Externalities

Negative Production Externalities

When a factory which produces aluminum discharges untreated waste water into a nearby river and pollutes the water causing health hazards for people who use the water for drinking and bathing. Pollution of river also affects fish output as there will be less catch for fishermen due to loss of fish resources.

Positive Production Externalities

A firm which offers training to its employees for increasing their skills. The firm generates positive benefits on other firms when they hire such workers as they change their jobs. Another example is the case of a beekeeper who locates beehives in an orange growing area enhancing the chances of greater production of oranges through increased pollination.

Negative consumption externalities

Smoking cigarettes in public place causing passive smoking by others, creating litter and diminishing the aesthetic value of the room and playing the radio loudly obstructing one from enjoying a concert.

Positive consumption externalities

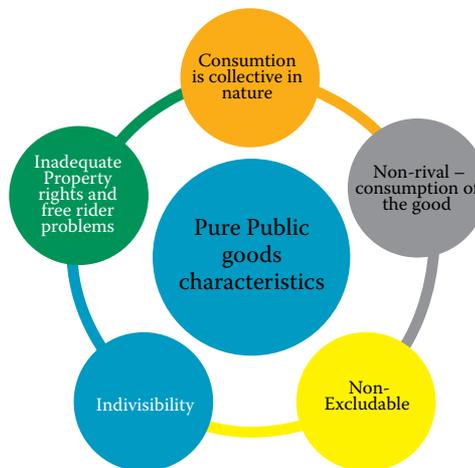
Consumption of the services of a health club by the employees of a firm would result in an external benefit to the firm in the form of increased efficiency and productivity.

Public Goods

A public good (also called collective consumption good or social good) is one which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction of such a good leads to no subtraction from any other individual's consumption of that good.

Asymmetric Information

- ◆ Asymmetric information occurs when there is an imbalance in information between buyer and seller i.e. when the buyer knows more than the seller or the seller knows more than the buyer. This can distort choices. With asymmetric information, low-quality goods can drive high-quality goods out of the market.
- ◆ Asymmetric information, adverse selection and moral hazard affect the ability of markets to efficiently allocate resources and therefore lead to market failure because the party with better information has a competitive advantage.



Classification of Public Goods

	Excludable	Non-excludable
Rivalrous	A Private goods food, clothing, cars	B Common resources such as fish stocks, forest resources, coal
Non-rivalrous	C Club goods, cinemas, private parks, satellite television	D Pure public goods such as national defence

Quasi Public Goods

- ◆ The quasi-public goods or services, also called a near public good (for e.g. education, health services) possess nearly all of the qualities of the private goods and some of the benefits of public good. They exhibit market failure as incomplete markets.

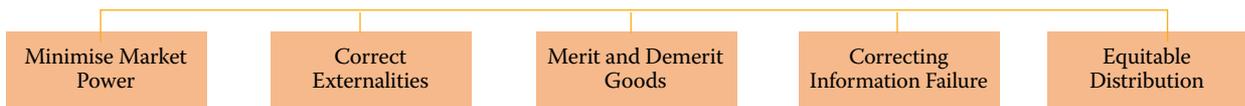
Private Good

- ◆ Private goods are 'rivalrous' 'and excludable' and less likely to have the free rider problem. Additional resource costs are involved for providing to another.

Unit-III Government Interventions to minimise Market Failure

- ◆ Governments intervene in various ways to correct the distortions in the market which occur when there are deviations from the ideal perfectly competitive state.
- ◆ Government initiatives towards combating market failures due to negative externalities are either direct controls or market-based policies that would provide economic incentives.
- ◆ Direct controls prohibit specific activities that explicitly create negative externalities or require that the negative externality be limited to a certain level, for instance limiting emissions.

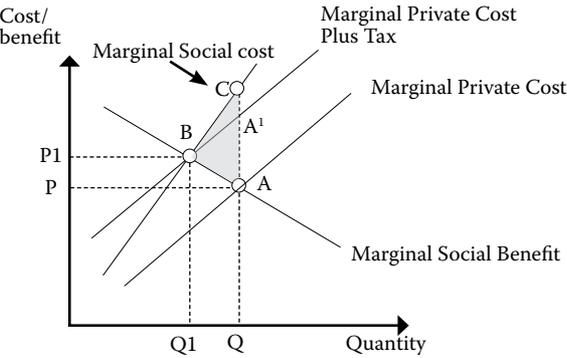
Government intervention to correct Market Failure



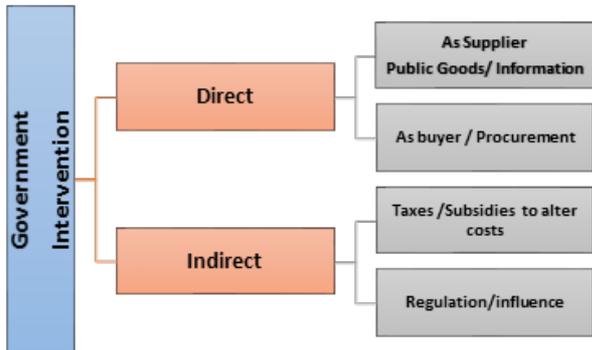
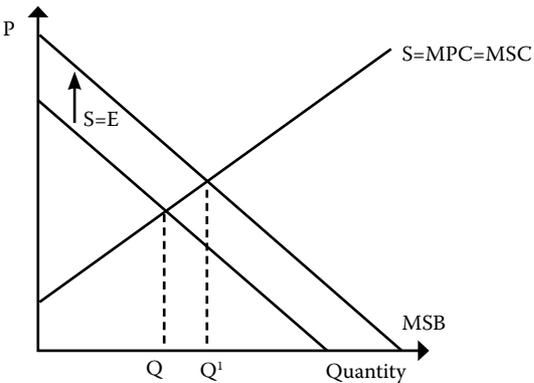
- Government interventions to Minimise Market Power**
- ◆ Because of the social costs imposed by monopoly, governments intervene by establishing rules and regulations designed to promote competition and prohibit actions that are likely to restrain competition.
 - ◆ E.g. Competition Act, 2002 (as amended by the Competition (Amendment) Act, 2007).
 - ◆ Natural Monopolies such as electricity, gas and water supply are subject to price control.

- Government interventions to correct Externalities**
- ◆ One method of ensuring internalization of negative externalities is imposing pollution taxes. Pigouvian taxes by 'making the polluter pay', seek to internalize external costs into the price of a product or activity.
 - ◆ Pollution taxes are difficult to determine and administer due to difficulty to discover the right level of taxation, problems associated with inelastic nature of demand for the good and the problem of possible capital flight.
 - ◆ Tradable emissions permits are marketable licenses to emit limited quantities of pollutants and can be bought and sold by polluters. The high polluters have to buy more permits and the low polluters receive extra revenue from selling their surplus permits.

Market Outcomes of Pollution Tax



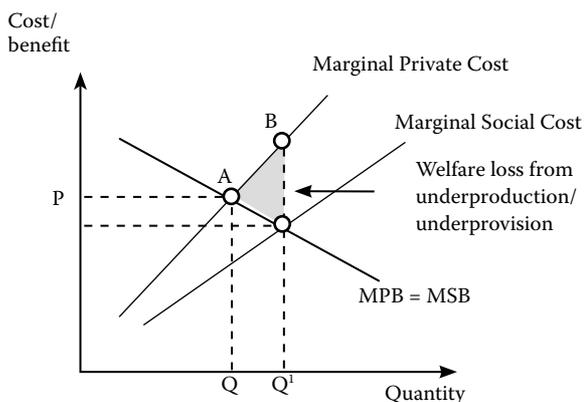
Effect of Subsidy on Output



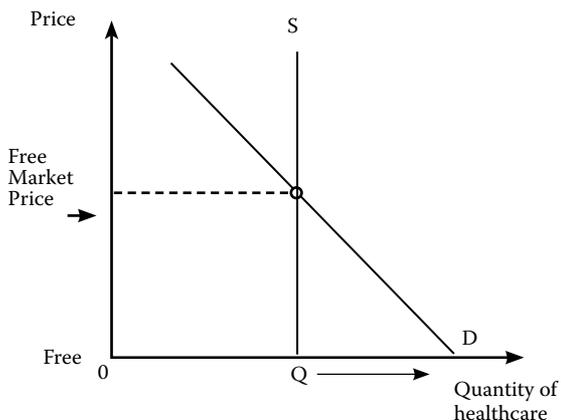
Government Intervention in the case of Merit Goods:

- ◆ Merit goods such as education, health care etc are socially desirable and have substantial positive externalities. They are rival, excludable, limited in supply, rejectable by those unwilling to pay, and involve positive marginal cost for supplying to extra users.
- ◆ Left to the market, merit goods are likely to be under-produced and under-consumed so that social welfare will not be maximized.
- ◆ The possible government responses to under-provision of merit goods are regulation, legislation, subsidies, direct government provision and a combination of government provision and market provision.
- ◆ When governments provide merit goods, it may give rise to large economies of scale and productive efficiency and there will be substantial demand for the same.

Market Outcome for Merit Goods



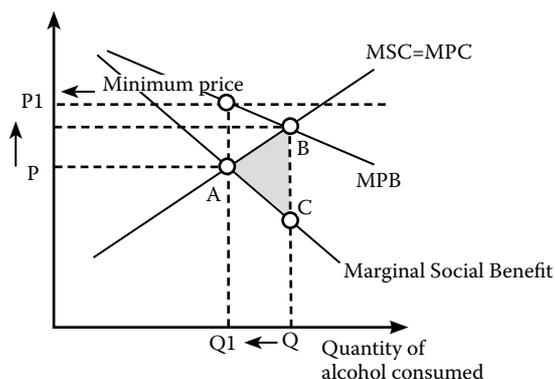
Consumption of Merit Goods at Zero Price



Government Intervention in the case of Demerit Goods

- ◆ Demerit goods are goods which impose significant negative externalities on the society as a whole and are believed to be socially undesirable.
- ◆ The production and consumption of demerit goods are likely to be more than optimal under free markets. The government should therefore intervene in the marketplace to discourage their production and consumption.

Outcomes of Minimum Price for a Demerit Good



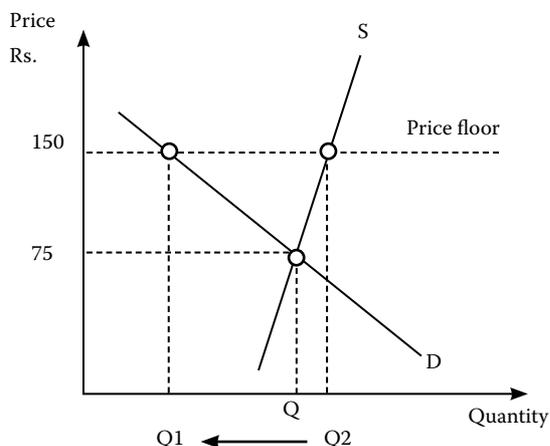
Government Intervention in the Case of Public Goods

- ◆ In the case of pure public goods where entry fees cannot be charged, direct provision by governments through the use of general government tax revenues is the only option. Excludable public goods can be provided by government and the same can be financed through entry fees.

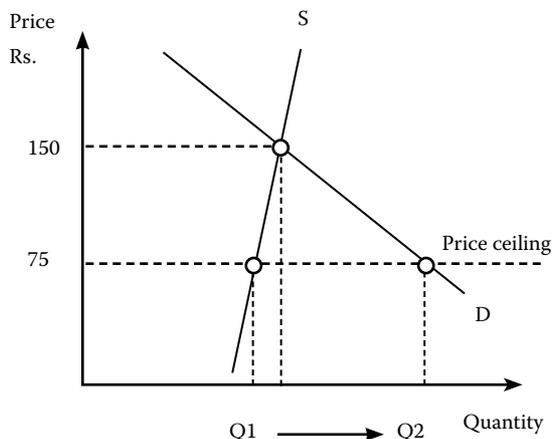
Price Intervention : Non-Market Pricing

- ◆ Price controls may take the form of either a price floor (a minimum price buyers are required to pay) or a price ceiling (a maximum price sellers are allowed to charge for a good or service).
- ◆ When prices of certain essential commodities rise excessively government may resort to controls in the form of price ceilings (also called maximum price) for making a resource or commodity available to all at reasonable prices.
- ◆ With the objective of ensuring stability in prices and distribution, governments often intervene in grain markets through building and maintenance of buffer stocks.

Market Outcome of Minimum Support Price



Market Outcome of Price Ceiling



Government Intervention for correction Information Failure

- ◆ Government makes it mandatory to have accurate labeling and content disclosures by producers. For example: SEBI requires that accurate information be provided to prospective buyers of new stocks.
- ◆ Public dissemination of information to improve knowledge and subsidizing of initiatives in that direction.
- ◆ Regulation of advertising and setting of advertising standards to make advertising more responsible, informative and less persuasive.

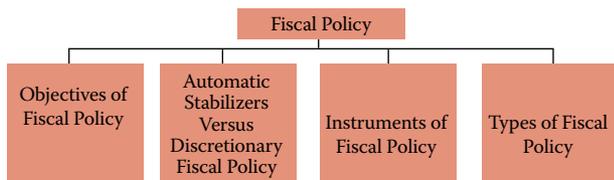
Government Intervention for Equitable Distribution

- ◆ One of the most important activities of the government is to redistribute incomes so that there is equity and fairness in the society.
- ◆ Some common policy interventions include: progressive income tax, targeted budgetary allocations, unemployment compensation, transfer payments, subsidies, social security schemes, job reservations, land reforms, gender sensitive budgeting etc.
- ◆ Government also intervenes to combat black economy and market distortions associated with a parallel black economy

Unit-IV Fiscal Policy

Fiscal Policy: The focus of fiscal policy is on the aggregate economic activity of governments, aggregate expenditure, taxes, transfers and issues of government debts and deficits and their effects on aggregate economic variables such as total output total employment, unemployment rate, inflation, overall economic growth etc.

Through the use of budgetary instruments such as public revenue, public expenditure, public debt and deficit financing, governments intend to favourably influence the level of economic activity of a country.



The objectives of Fiscal Policy

- ◆ Achievement and maintenance of full employment.
- ◆ Maintenance of price stability.
- ◆ Acceleration of the rate of economic development and equitable distribution of income and wealth.

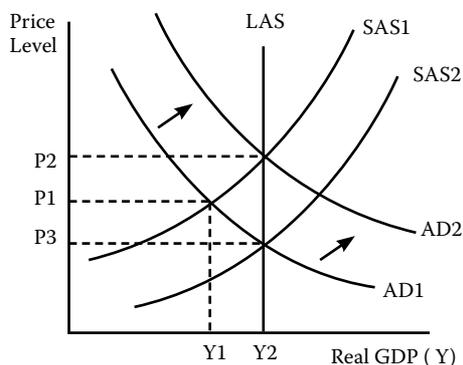
Types of Fiscal Policy

- ◆ Expansionary Fiscal Policy
- ◆ Contractionary Fiscal Policy

Expansionary Fiscal Policy

An expansionary fiscal policy is used to address recession and the problem of general unemployment on account of business cycles.

Expansionary Fiscal policy for Combating Recession



Instruments of Fiscal Policy

- ◆ Government Expenditure : Generates income and also effect of multiplier.
- ◆ Taxes : Determine the size of the disposable income of public.
- ◆ Budget : A widely used tool to stimulate or contract aggregate demand.
- ◆ Public Debt: Public Borrowing and Debt Repayment system.

Fiscal Policy for long term Economic Growth

- ◆ A well designed tax policy that rewards innovation and entrepreneurship, without discouraging incentives will promote private businesses who wish to invest and thereby help the economy grow.

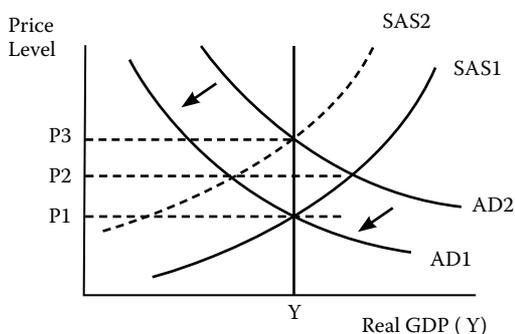
Contractionary Fiscal Policy : Eliminating an inflationary gap

- ◆ Decrease in government spending.
- ◆ Increase in personal income taxes and/or business taxes.
- ◆ A combination of decrease in government spending and increase in personal income taxes and/or business taxes.

Fiscal Policy for Inequalities of Income and Wealth

- ◆ A progressive direct tax system
- ◆ Indirect taxes can be differential
- ◆ A carefully planned policy of expenditure

Contractionary Fiscal policy for Combating inflation



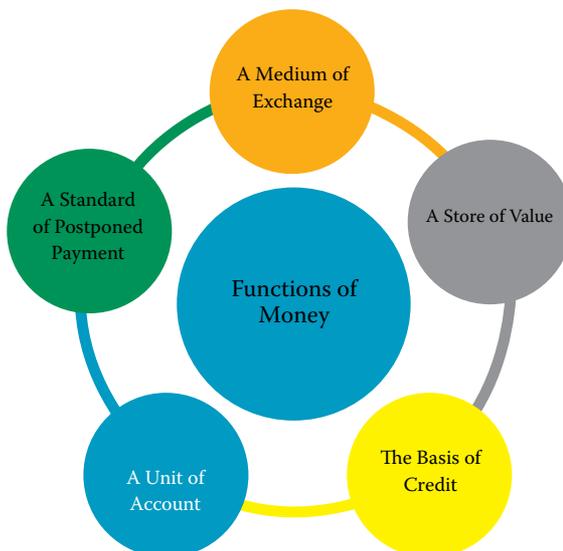
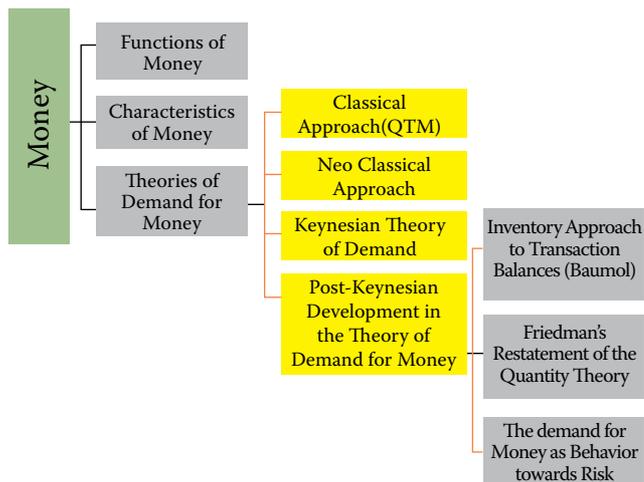
Fiscal Policy Limitations

- ◆ In respect of choice of appropriate policy
- ◆ Recognition lag
- ◆ Decision lag
- ◆ Implementation lag
- ◆ Impact lag

CHAPTER-III MONEY MARKET

Unit-I The concept of Money Demand: Important theories

Money refers to assets which are commonly used and accepted as a means of payment or as a medium of exchange or of transferring purchasing power.



ECONOMICS FOR FINANCE ||

Characteristics of Money

- ◆ Generally acceptable
- ◆ Durable or long-lasting
- ◆ Difficult to counterfeit i.e. not easily reproducible by people
- ◆ Relatively scarce, but has elasticity of supply
- ◆ Portable or easily transported
- ◆ Possessing uniformity
- ◆ Divisible into smaller parts in usable quantities or fractions without losing value
- ◆ Effortlessly recognizable

Demand for Money

The demand for money is derived demand and is a decision about how much of one's given stock of wealth should be held in the form of money rather than as other assets such as bonds

Classical Approach : The Quantity Theory of Money

- ◆ One of the oldest theories of Economics, was first propounded by Irving Fisher of Yale University in his book '*The Purchasing Power of Money*' published in 1911.
- ◆ There is strong relationship between money and price level and the quantity of money is the main determinant of the price level or the value of money.

Fishers version of Equation : Equation of Exchange of Transaction approach : $MV = PT$

- ◆ Where, M= the total amount of money in circulation (on an average) in an economy.
- ◆ V = transactions velocity of circulation i.e. the average number of times across all transactions a unit of money (say Rupee) is spent in purchasing goods and services.
- ◆ P = average price level ($P = MV/T$).
- ◆ T = the total number of transactions.

Fishers Extended version : Equation of Exchange to include demand (bank) deposits (M') and Velocity in the total supply of Money : $MV + M'V' = PT$

The Neo classical Approach: The Cambridge approach

- ◆ In the early 1900s, Cambridge Economists Alfred Marshall, A.C. Pigou, D.H. Robertson and John Maynard Keynes (then associated with Cambridge) put forward a fundamentally different approach to quantity theory, known neo classical theory or cash balance approach.

Money increases utility in the following two ways

- ◆ Enabling the possibility of split-up of sale and purchase to two different points of time rather than being simultaneous.
- ◆ Being a hedge against uncertainty.

Cambridge equation = $M_d = kPY$

- ◆ Where M_d = is the demand for money, Y = real national income, P = average price level of currently produced goods and services, PY = nominal income, k = proportion of nominal income (PY) that people want to hold as cash balances.

The Keynesian Theory of Demand for Money

- ◆ Keynes' theory of demand for money is known as 'Liquidity Preference Theory'. 'Liquidity preference', a term that was coined by John Maynard Keynes in his masterpiece '*The General Theory of Employment, Interest and Money*' (1936), denotes people's desire to hold money rather than securities or long-term interest-bearing investments.

People hold money (M) in cash for three motives

Transactions motive

- ◆ The transactions motive for holding cash relates to 'the need for cash for current transactions for personal and business exchange'.
- ◆ $L_t = kY$, Where, L_t is the transactions demand for money, k is the ratio of earnings which is kept for transactions purposes and Y is the earnings.
- ◆ The aggregate transaction demand for money is a function of national income.

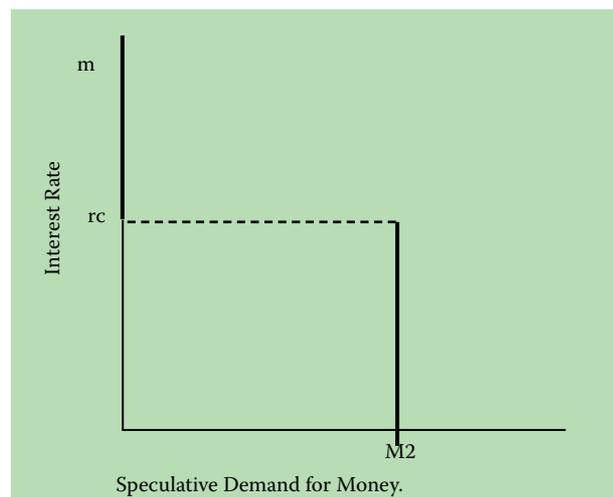
Precautionary motive

- ◆ Precautionary motive is to meet unforeseen and unpredictable contingencies involving money payments and depends on the size of the income, prevailing economic as well as political conditions and personal characteristics of the individual such as optimism/ pessimism, farsightedness etc.

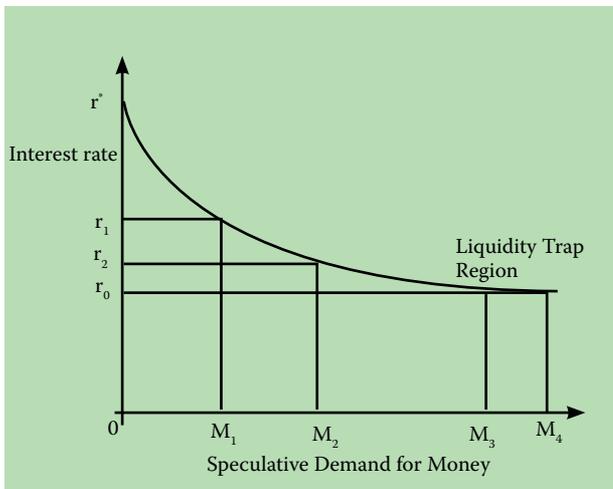
Speculative motive

- ◆ The speculative motive reflects people's desire to hold cash in order to be equipped to exploit any attractive investment opportunity requiring cash expenditure.
- ◆ The speculative demand for money and interest are inversely related.

Individual's Speculative Demand for Money



Aggregate Speculative Demand for Money



An increase in income increases the transaction and precautionary demand for money and also a rise in the rate of interest decreases the demand for speculative demand money.

The Demand for Money as Behavior toward Risk

- ◆ The Demand for Money as Behavior toward as 'aversion to risk' propounded by Tobin states that money is a safe asset but an investor will be willing to exercise a trade-off and sacrifice to some extent the higher return from bonds for a reduction in risk.
- ◆ According to Tobin, rational behaviour induces individuals to hold an optimally structured wealth portfolio which is comprised of both bonds and money and the demand for money as a store of wealth depends negatively on the interest rate.

Unit -II Concept of Money Supply

The measures of money supply vary from country to country, from time to time and from purpose to purpose.

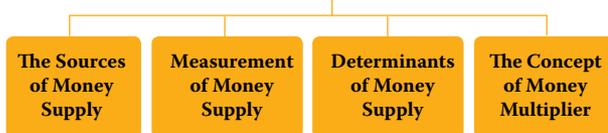
Post-Keynesian Development in the Theory of Demand for Money

- ◆ Inventory Approach to Transaction Balances (Baumol)
- ◆ Baumol (1952) and Tobin (1956) developed a deterministic theory of transaction demand for 'real cash balance', known as Inventory Theoretic Approach, in which money is essentially viewed as an inventory held for transaction purposes.
- ◆ People hold an optimum combination of bonds and cash balance, i.e., an amount that minimizes the opportunity cost.
- ◆ The optimal average money holding is: a positive function of income Y , a positive function of the price level P , a positive function of transactions costs c , and a negative function of the nominal interest rate i .

Friedman's Restatement of the Quantity Theory

- ◆ Milton Friedman (1956) extending Keynes' speculative money demand within the framework of asset price theory holds that demand for money is affected by the same factors as demand for any other asset, namely, permanent income and relative returns on assets.
- ◆ The nominal demand for money is positively related to the price level, P ; rises if bonds and stock returns, r_b and r_e , respectively decline and vice versa; is influenced by inflation; and is a function of total wealth.

The Concept of Money Supply



Importance of Money Supply



Sources of Money Supply

- ◆ The central banks of all countries are empowered to issue currency and therefore, the central bank is the primary source of money supply in all countries. In effect, high powered money is the source of all other forms of money.
- ◆ The supply responses of the commercial banking system of the country to the changes in policy variables initiated by the central bank to influence the total money supply in the economy. In India, RBI is the Central Bank.

Measurement of Money Supply

- ◆ The measures of money supply vary from country to country, from time to time and from purpose to purpose.
- ◆ Measurement of money supply is essential as it enables a framework to evaluate whether the stock of money in the economy is consistent with the standards for price stability, to understand the nature of deviations from this standard and to study the causes of money growth.
- ◆ In India RBI has been publishing data on four alternative measures of money supply denoted by M_1 , M_2 , M_3 , M_4 besides the reserve money.

- M1 = Currency and coins with the people + demand deposits of banks (Current and Saving accounts) + other deposits with the RBI.
- M2 = M1 + savings deposits with post office savings banks.
- M3 = M1 + net time deposits with the banking system.
- M4 = M3 + total deposits with the Post Office Savings Organization (excluding National Savings Certificates).

New Monetary Aggregates

- ◆ Based on the recommendations of the Working Group on Money (1998), the RBI has started publishing a set of four new monetary aggregates on the basis of the balance sheet of the banking sector in conformity with the norms of progressive liquidity. The new monetary aggregates are :
 - ❖ Reserve money, also known as central bank money, base money or high powered money, determines the level of liquidity and price level in the economy.

Reserve Money = Currency in circulation + Bankers' deposits with the RBI + Other deposits with the RBI
 = Net RBI credit to the Government + RBI credit to the Commercial sector + RBI's Claims on banks + RBI's net Foreign assets + Government's Currency liabilities to the public - RBI's net non-monetary Liabilities

NM1 = Currency with the public + Demand deposits with the banking system + 'Other' deposits with the RBI.

NM2 = NM1 + Short-term time deposits of residents (including and up to contractual maturity of one year).

NM3 = NM2 + Long-term time deposits of residents + Call/Term funding from financial institutions

Liquidity aggregates

- L1 = NM3 + All deposits with the post office savings banks (excluding National Savings Certificates).
- L2 = L1 + Term deposits with term lending institutions and refinancing institutions (FIs) + Term borrowing by FIs + Certificates of deposit issued by FI's.
- L3 = L2 + Public deposits of non-banking financial companies

Determinants of Money Supply : Two Theories

- ◆ Determined exogenously by central bank.
- ◆ Determined endogenously by changes in the economic activities which affect peoples desire to hold currency relative to deposits, rate of interest etc.

The concept of money multiplier

The money supply is defined as

$$M = m \times MB$$

Where M is the money supply, *m* is money multiplier and MB is the monetary base or high powered money.

$$\text{Money Multiplier (} m \text{)} = \frac{\text{Money Supply}}{\text{Monetary Base}}$$

Current Practice : Money Multiplier Approach to Supply of Money

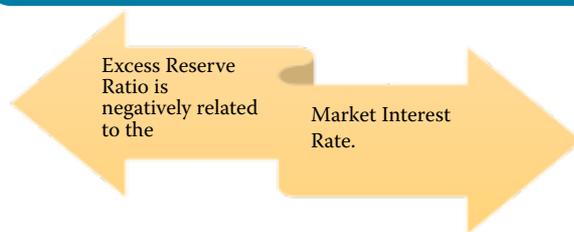
- ◆ The money multiplier is a function of the currency ratio which depends on the behaviour of the public, excess reserves ratio of the banks and the required reserve ratio set by the central bank.

The money multiplier approach to money supply propounded by Milton Friedman and Anna Schwartz, (1963) considers three factors as immediate determinants of money supply

- a) the stock of high-powered money (H)
- b) the ratio of deposit to reserve, $e = \{ER/D\}$ and
- c) the ratio of deposit to currency, $c = \{C/D\}$

The additional units of high powered money that goes into 'excess reserves' of the commercial banks do not lead to any additional loans and therefore, these excess reserve do not lead to the creation of deposits.

When the required ratio falls, there will be multiple expansions for demand deposits



Effect of Government Expenditure on Money supply

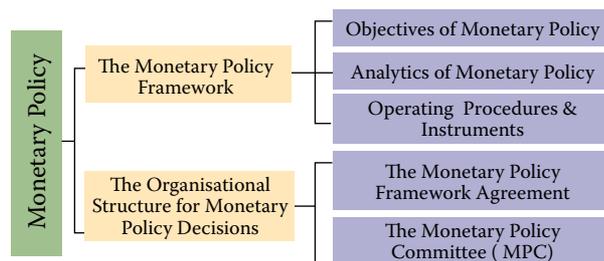
- ◆ When the Reserve Bank lends to the governments under WMA /OD it results in the generation of excess reserves (i.e. excess balances of commercial banks with the Reserve Bank).

The Credit Multiplier

- ◆ The Credit Multiplier also referred to as the deposit multiplier or the deposit expansion multiplier, describes the amount of additional money created by commercial bank through the process of lending the available money it has in excess of the central bank's reserve requirements.

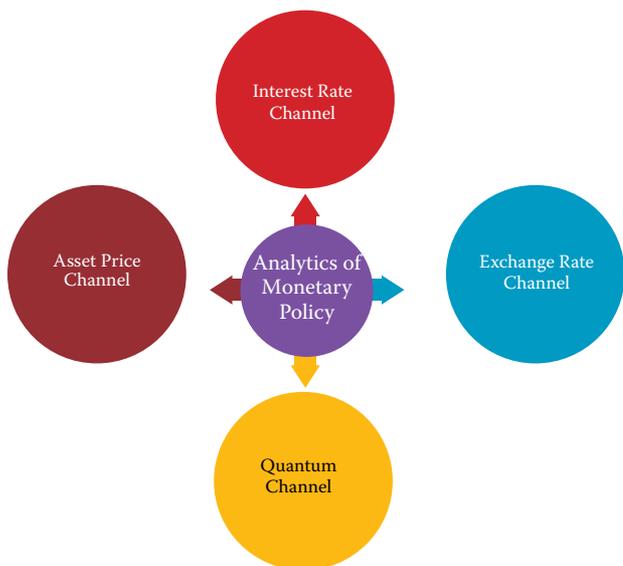
Unit -III Monetary Policy

Monetary policy refers to the use of monetary policy instruments which are at the disposal of the central bank to regulate the availability, cost and use of money and credit to promote economic growth, price stability, optimum levels of output and employment, balance of payments equilibrium, stable currency or any other goal of government's economic policy.



Objectives of Monetary Policy

- ◆ Price Stability
- ◆ Economic Growth
- ◆ Ensuring an adequate flow of credit
- ◆ Creation of an efficient market for government securities

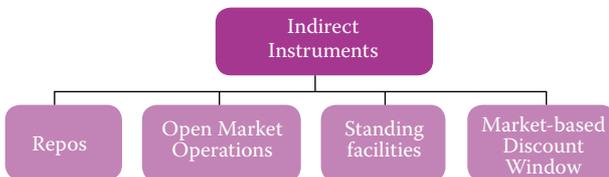
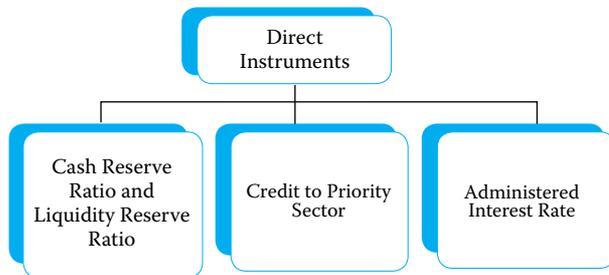
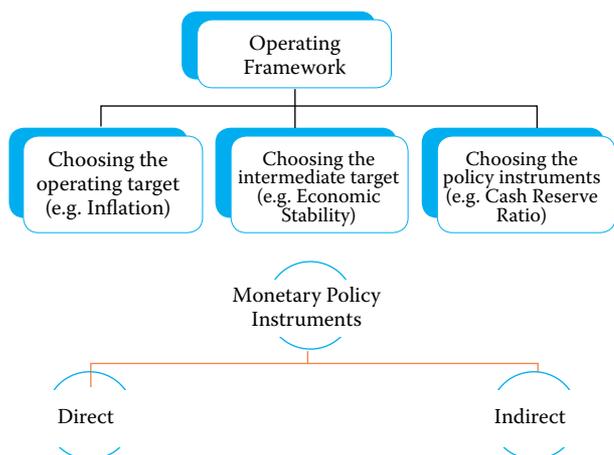


A contractionary monetary policy-induced increase in interest rates increases the cost of capital and the real cost of borrowing for firms and households who respond by cutting back on their investment and purchase expenditures respectively.

The exchange rate channel works through expenditure switching between domestic and foreign goods on account of appreciation / depreciation of the domestic currency with its impact on net exports and consequently on domestic output and employment.

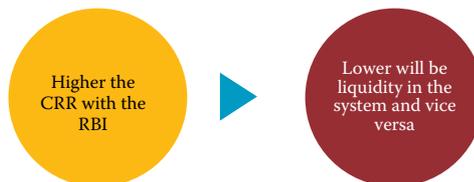
Two distinct credit channels- the bank lending channel and the balance sheet channel- operate by altering access of firm and household to bank credit and by the effect of monetary policy on the firm's balance sheet respectively.

Asset prices generate important wealth effects that impact, through spending, output and employment.



Cash Reserve Ratio

- ◆ The Cash Reserve Ratio (CRR) refers to the fraction of the total net demand and time liabilities (NDTL) of a scheduled commercial bank in India which it should maintain as cash deposit with the Reserve Bank irrespective of its size or financial position.

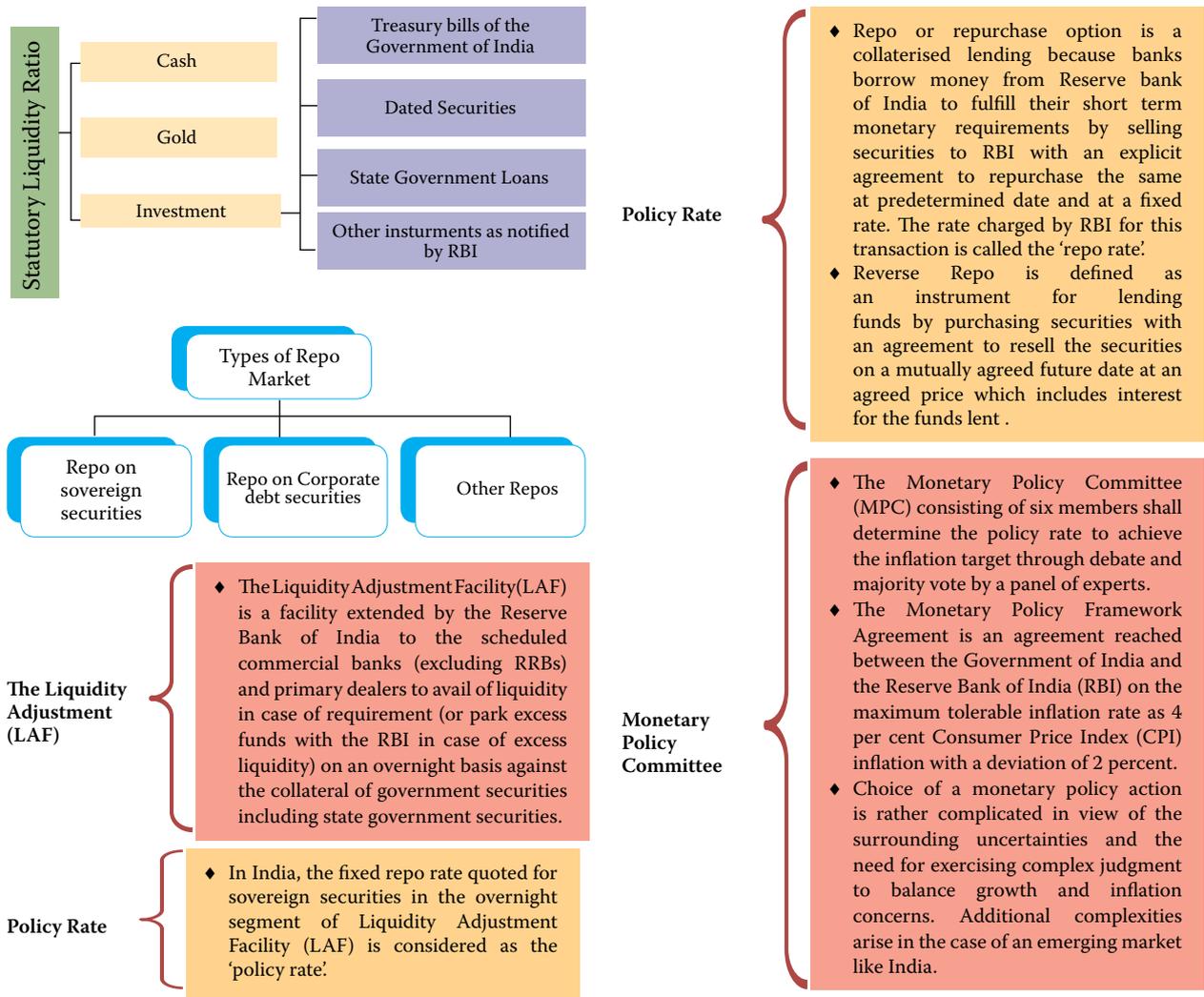


Statutory Liquidity Ratio

- ◆ The Statutory Liquidity Ratio (SLR) is what the scheduled commercial banks in India are required to maintain as a stipulated percentage of their total Demand and Time Liabilities (DTL) / Net DTL (NDTL) in Cash, Gold or approved investments in securities.
- ◆ The SLR is also a powerful tool for controlling liquidity in the domestic market by means of manipulating bank credit. Changes in the SLR chiefly influence the availability of resources in the banking system for lending.

A rise in the SLR which is resorted to during periods of high liquidity, tends to lock up a rising fraction of a bank's assets in the form of eligible instruments, and this reduces the credit creation capacity of banks.

A reduction in the SLR during periods of economic downturn has the opposite effect. The SLR requirement also facilitates a captive market for government securities.



CHAPTER-IV INTERNATIONAL TRADE

Unit-I: Theories of International Trade

International trade is the exchange of goods and services as well as resources between countries and involves greater complexity compared to internal trade

International Trade

- Theories
- Important Theories of International Trade

Arguments in favour of International Trade

- Contributes to economic growth and rising incomes
- Enlarges manufacturing capabilities
- Ensures benefits from economies of large scale production
- Enhances competitiveness and profitability by adoption of cost reducing technology business practices
- Deployment of productive resources
- Domestic monopolies
- Cost-effective sourcing of inputs and components internationally

- Innovative products at lower prices
- Wider choice in products and services for consumers are also claimed as benefits of trade
- Enhanced foreign exchange reserves
- Increased scope for mechanization and specialisation, research and development
- Creation of jobs
- Reduction in poverty
- Raising standards of livelihood
- Increase in overall demand for goods and services
- Prospects of employment generating investments
- Improvement in the quality of output
- Labour and environmental standards
- Broadening of productive base
- Development and strengthening of bonds between nations.

Arguments against International Trade

- ◆ Negative labour market outcomes
- ◆ Economic exploitation
- ◆ Exhaustion of Natural Resources
- ◆ May result in consumerism
- ◆ Dependence
- ◆ May result in Inflation
- ◆ Disregard for welfare of people
- ◆ Quick transmission of trade cycles
- ◆ Rivalries and risks in trade associated with changes in governments' policies of participating countries

Important Theories of International Trade

The Mercantilist View of International Trade

- ◆ Mercantilism advocated maximizing exports in order to bring in more precious metals and minimizing imports through the state imposing very high tariffs on foreign goods.

The Theory of Absolute Advantage: Adam Smith

- ◆ According to Adam Smith's Absolute Cost Advantage theory, a country will specialize in the production and export of a commodity in which it has an absolute cost advantage.

The Theory of Comparative Advantage : Ricardo

- ◆ Ricardo's theory of comparative advantage states that a nation should specialize in the production and export of the commodity in which its absolute disadvantage is smaller (this is the commodity of its comparative advantage) and import the commodity in which its absolute disadvantage is greater (this is the commodity of its comparative disadvantage).

The Heckscher-Ohlin Theory of Trade

- ◆ The Heckscher-Ohlin theory of trade, also referred to as Factor-Endowment Theory of Trade or Modern Theory of Trade, states that comparative advantage in cost of production is explained exclusively by the differences in factor endowments.

Factor-Price Equalization Theorem

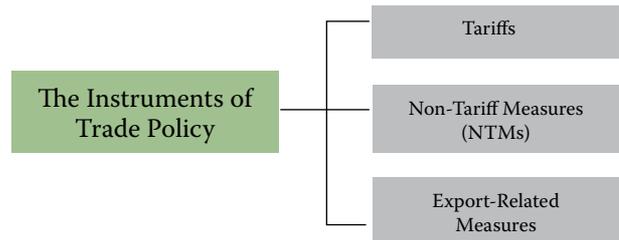
- ◆ The Factor-Price Equalization Theorem states that international trade equalizes the factor prices between the trading nations. Therefore, with free trade, wages and returns on capital will converge across the countries.

New Trade Theory

- ◆ New Trade Theory is the latest entrant to explain the rising proportion of world trade in the developed world and bigger developing economies (such as BRICS) which trade in similar products. These countries constitute more than 50% of world trade. According to this theory, two key concepts
- ◆ Economies of Scale and Network effects, affects international trade in a major way.

Unit-II The Instruments of Trade Policy

Trade policy encompasses all instruments that governments may use to promote or restrict imports and exports



Tariff

- ◆ Tariff, also known as customs duty is defined as a financial charge in the form of a tax, imposed at the border on goods going from one customs territory to another. Tariffs are the most visible and universally used trade measures.

Forms of Import Tariffs

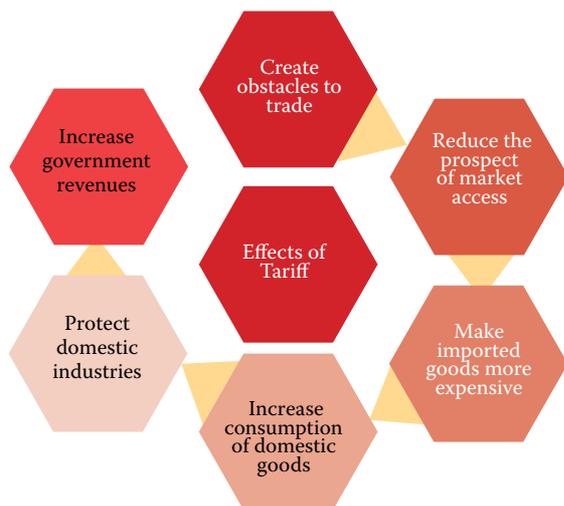
Specific Tariff	}	◆ A specific tariff is an import duty that assigns a fixed monetary tax per physical unit of the good imported whereas an <i>ad valorem</i> tariff is levied as a constant percentage of the monetary value of one unit of the imported good.
Ad valorem tariff	}	◆ An ad valorem tariff is levied as a constant percentage of the monetary value of one unit of the imported good.
Other Tariff	}	<ul style="list-style-type: none"> ◆ Mixed Tariff ◆ Compound Tariff or a Compound Duty ◆ Technical/Other Tariff ◆ Tariff Rate Quotas ◆ Most-Favored Nation Tariffs ◆ Variable Tariff ◆ Preferential Tariff ◆ Bound Tariff ◆ Applied Tariffs ◆ Escalated Tariff ◆ Prohibitive Tariff ◆ Important subsidies ◆ Tariffs as a Response

Anti-dumping Duties

- ◆ Dumping occurs when manufacturers sell goods in a foreign country below the sales prices in their domestic market or below their full average cost of the product. It hurts domestic producers
- ◆ Anti-dumping measures are additional import duties so as to offset the foreign firm's unfair price advantage.

Countervailing Duties

- ◆ Countervailing duties are tariffs to offset the artificially low prices charged by exporters who enjoy export subsidies and tax concessions offered by the governments in their home country.



Non-Tariff Measures

- ◆ Non-tariff measures (NTMs) are policy measures, other than ordinary customs tariffs, that can potentially have an economic effect on international trade in goods, changing quantities traded or prices or both

Category of Non-Tariff Measures

Technical Measures

- ◆ Sanitary and Phytosanitary (SPS) measures : applied to protect human, animal or plant life from risks arising from addition, pests, contaminants, toxins or disease causing organisms.
- ◆ Technical Barriers to Trade specifying details such as size, shape, design, labelling/marketing etc.

Non-Technical Measures

- ◆ Non-technical measures relate to trade requirements; for example; shipping requirements, custom formalities, trade rules, taxation policies, etc.
- ◆ Import Quotas: Restrictions on physical amount of imported goods.
- ◆ Price Control Measures : Imposing taxes on charges.
- ◆ Non Automatic Licensing and Prohibitions: limiting or prohibiting certain types of import.
- ◆ Financial Measures : Regulating access to and cost of foreign exchange.
- ◆ Measures Affecting Competition : Granting exclusive or special preferences to one or a few limited group of economic operations.

Non-Technical Measures

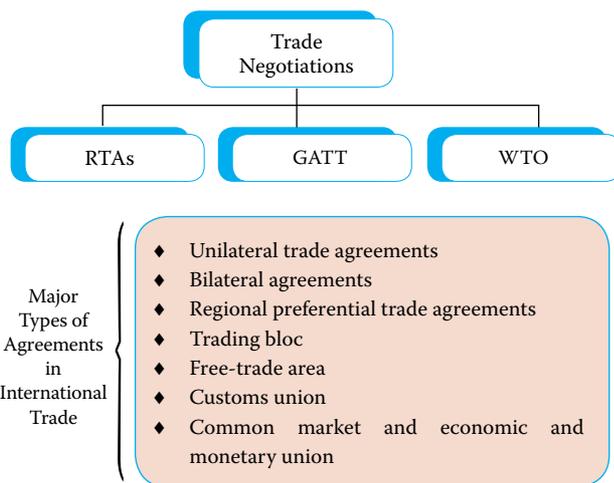
- ◆ Government Procurement Policies : Govt. may lay down policies w.r.t procurements.
- ◆ Trade-Related Investment Measures : May include rules on local content requirements of production.
- ◆ Distribution Restrictions.
- ◆ Restriction on Post-sales Services.
- ◆ Administrative Procedures.
- ◆ Rules of Origin : To determine the national source of a product.
- ◆ Safeguard Measures : Initiated by countries to restrict imports of a product temporarily if its domestic industry is injured.
- ◆ Embargos : Total ban on import or export of some commodity to a particular country or region for some or indefinite period.

Export Related Measures

- ◆ Ban of Export : Exports of certain items may be banned during shortages.
- ◆ Export Taxes : An export tax is a tax collected on exported goods and may be either specific or ad valorem and an export subsidy includes financial contribution to domestic producers in the form of grants, loans, equity infusions also usually provide etc. or give some form of income or price support. Both distort trade
- ◆ Export subsidies and Incentives: Given by government to boost exports
- ◆ Voluntary Export-Restraints : Voluntary Export Restraints (VERs) refer to a type of informal quota administered by an exporting country voluntarily restraining the quantity of goods that can be exported out of a country during a specified period of time, imposed based on negotiations to appease the importing country and to avoid the effects of possible trade restraints

Unit-III Trade Negotiations

International trade negotiations, especially the ones aimed at formulation of international trade rules, are complex interactive processes engaged in by countries having competing objectives.



GATT

- ◆ The General Agreement on Tariffs and Trade (GATT) provided the rules for much of world trade for 47 years from 1948 to 1994.
- ◆ Eight multilateral negotiations known as trade rounds held under the GATT auspices.
- ◆ The 8th of the Uruguay Round of 1986-94 was last under GATT and culminated in the birth of WTO.

WTO

The eighth of the Uruguay Round of 1986-94, was the last and most consequential of all rounds and culminated in the birth of WTO and a new set of agreements replacing the General Agreement on Tariffs and Trade (GATT).

The principal objective of the WTO

To facilitate the flow of international trade smoothly, freely, fairly and predictably.

The WTO does its functions by acting as a forum for trade negotiations among member governments, administering trade agreements, reviewing national trade policies, cooperating with other international organizations and assisting developing countries in trade policy issues through technical assistance and training programmes.

The WTO Activities

are supported by the Secretariat located in Geneva, headed by a Director General. It has a three-tier system of decision making. The top level decision-making body is the Ministerial Conference, followed by councils namely, the General Council and the Goods Council, Services Council and Intellectual Property (TRIPS) Council.

Members

The WTO currently has 164 members, of which 117 are developing countries or separate customs territories accounting for about 95% of world trade.

The major guiding principles of the WTO

- ◆ Trade without discrimination, most-favoured-nation treatment(MFN)
- ◆ The National Treatment Principle (NTP)
- ◆ Freer trade
- ◆ Predictability
- ◆ General prohibition of quantitative restrictions
- ◆ Greater competitiveness
- ◆ Tariffs as legitimate measures for protection
- ◆ Transparency in decision making
- ◆ Progressive liberalization
- ◆ Market access
- ◆ A transparent, effective and verifiable dispute settlement mechanism.

Important Agreements under WTO

- ◆ Agriculture
- ◆ SPS measures
- ◆ Textiles and clothing
- ◆ Technical barriers to trade (TBT)
- ◆ Trade-related investment measures (TRIMs)
- ◆ Anti-dumping
- ◆ Customs valuation
- ◆ Pre-shipment inspection (PSI)

Important Agreements under WTO

- ◆ Rules of origin
- ◆ Import licensing procedures
- ◆ Subsidies and countervailing measures
- ◆ Safeguards, Trade in Services (GATS)
- ◆ Intellectual Property Rights (TRIPS)
- ◆ Settlement of Disputes (DSU)
- ◆ Trade Policy Review Mechanism (TPRM)
- ◆ Plurilateral trade agreements on trade in civil aircraft and government procurement.

A Few concerns of WTO

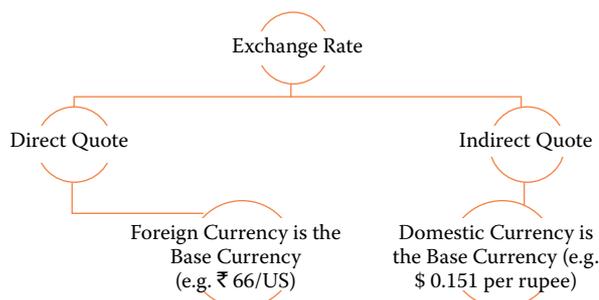
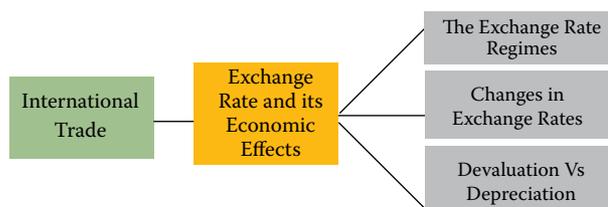
- ◆ Slow progress of multilateral negotiations
- ◆ Uncertainties resulting from regional trade agreements
- ◆ Inadequate or negligible trade liberalisation
- ◆ Those which are specific concerns to the developing countries
- ◆ Protectionism and lack of willingness among developed countries to provide market access
- ◆ Difficulties that they face in implementing the present agreements
- ◆ Apparent north-south divide
- ◆ Exceptionally high tariffs
- ◆ Tariff escalation, erosion of preferences and difficulties with regard to adjustments.

The Doha Round, formally the Doha Development Agenda

- ◆ The ninth round since the Second World War was officially launched at the WTO's Fourth Ministerial Conference in Doha, Qatar, in November 2001.
- ◆ Sought to accomplish major modifications of the International trading system through lower trade barriers and revised trade rules
- ◆ Include 20 areas of trade.

Unit-IV Exchange Rate and its Economic Effects

Exchange rate is the rate at which the currency of one country exchanges for the currency of another country.



Cross rate

- ◆ The rate between Y and Z which is derived from the given rates of another set of two pairs of currency (say, X and Y, and, X and Z) is called cross rate.

Exchange Rate Regime

- ◆ An exchange rate regime is the system by which a country manages its currency in respect to foreign currencies.

Floating Exchange Rate Regime

- ◆ The equilibrium value of the exchange rate of a country's currency is market determined i.e the demand for and supply of currency relative to other currencies determines the exchange rate.
- ◆ A floating exchange rate allows a government to pursue its own independent monetary policy and there is no need of market intervention or maintenance of reserves. But, volatile exchange rates generate a lot of uncertainties in relation to international transactions.
- ◆ Examples : Advanced economies like U.S.A, New -Zealand, Sweden.

Fixed Exchange Rate

- ◆ Also referred to as pegged exchanged rate, is an exchange rate regime under which a country's government announces, or decrees, what its currency will be worth in terms of either another country's currency or a basket of currencies or another measure of value, such as gold.
- ◆ A central bank may implement soft peg policy under which the exchange rate is generally determined by the market, or a hard peg where the central bank sets a fixed and unchanging value for the exchange rate.
- ◆ A fixed exchange rate avoids currency fluctuations and eliminates exchange rate risks and transaction costs, enhances international trade and investment and lowers the levels of inflation. But, the central bank has to maintain an adequate amount of reserves and be always ready to intervene in the foreign exchange market.
- ◆ Examples : Cuba, Hongkong, Diji bouti.

Nominal Vs Real Exchange Rate

- ◆ Nominal Echange Rate states how much of one currency can be traded for a unit of another currency.
- ◆ Real Exchange Rate : The 'real exchange rate' incorporates changes in prices and describes 'how many' of a good or service in one country can be traded for 'one' of that good or service in a foreign country.
- ◆ Real exchange rate =
$$\frac{\text{Domestic price Index}}{\text{Foreign price Index}} \times \text{Nominal exchange rate X}$$
- ◆ Real Effective Exchange Rate (REER) is the nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies) divided by a price deflator or index of costs.

Usually, the supply of and demand for foreign exchange in the domestic foreign exchange market determine the external value of the domestic currency, or in other words, a country's exchange rate.

Changes in exchange rates

- ◆ portray depreciation or appreciation of one currency.
- ◆ The terms, 'currency appreciation' and 'currency depreciation' describe the movements of the exchange rate.

Appreciation & Depreciation of Currency

- ◆ when its value increases with respect to the value of another currency or a basket of other currencies. On the contrary, currency depreciates when its value falls with respect to the value of another currency or a basket of other currencies.

Effect of Depreciation

- ◆ Exchange rate depreciation lowers the relative price of a country's exports, raises the relative price of its imports, increases demand both for domestic import-competing goods and for exports, leads to output expansion, encourages economic activity, increases the international competitiveness of domestic industries, increases the volume of exports and promotes trade balance.

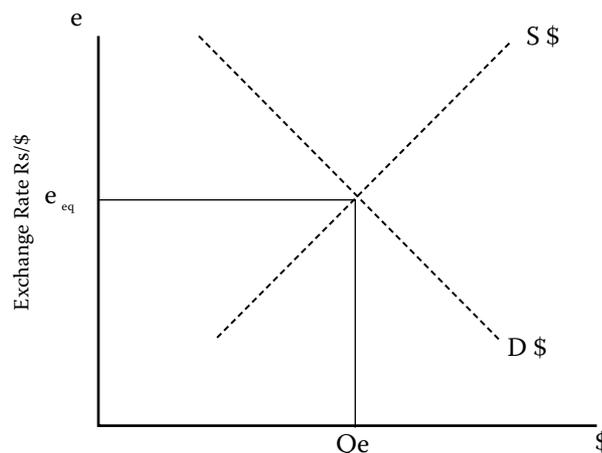
Effect of Appreciation

- ◆ An appreciation of a country's currency changes in import and export prices will lead to changes in import and export volumes, causing changes in import spending and export revenue
- ◆ adversely affect the competitiveness of domestic industry, cause larger deficits and worsen the current account

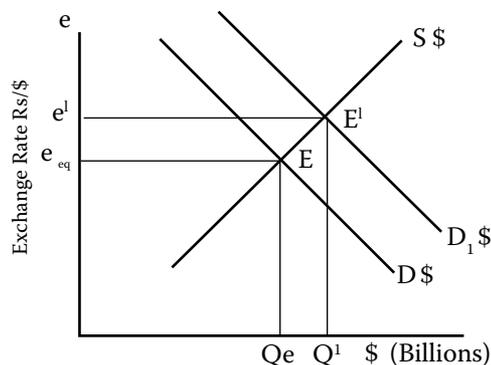
Devaluation

- ◆ is a deliberate downward adjustment in the value of a country's currency relative to another currency, group of currencies or standard.

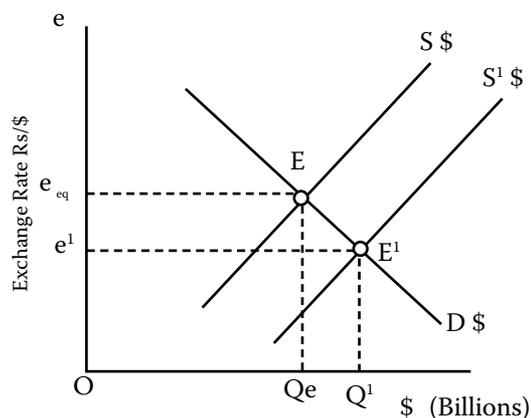
Determination of Nominal Exchange Rate



Home-Currency Depreciation under Floating Exchange Rates



Home-Currency Appreciation under Floating Exchange Rates



Foreign Exchange Market

The wide-reaching collection of markets and institutions that handle the exchange of foreign currencies is known as the foreign exchange market.

Being an over-the-counter market, it is not a physical place; rather, it is an electronically linked network bringing buyers and sellers together and has only very narrow spreads.

On account of arbitrage, regardless of physical location, at any given moment, all markets tend to have the same exchange rate for a given currency. Arbitrage refers to the practice of making risk-less profits by intelligently exploiting price differences of an asset at different dealing places.

Types of transactions in a forex market

Spot Market

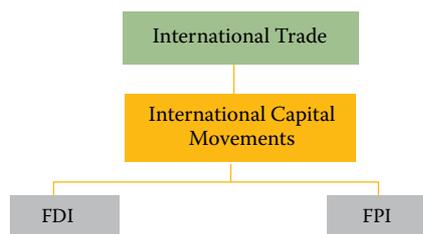
- ◆ Current transactions which are carried out in the spot market and exchange involves immediate delivery

Forward and /or Future Market

- ◆ Contracts buy or sell currencies for future delivery which are carried out in forward and/or future
- ◆ Current transactions which are carried out in the spot market and contracts to buy or sell currencies for future delivery which are carried out in forward and futures markets

Unit-V International Capital Movements

Foreign capital may flow into an economy in different ways, such as foreign aid, grants, borrowings, deposits from non resident Indians, investments in the form of Foreign Portfolio Investment (FPI) and Foreign Direct Investment (FDI)



Foreign direct investment is defined as a process whereby the resident of one country (i.e. home country) acquires ownership of an asset in another country (i.e. the host country) and such movement of capital involves ownership, control as well as management of the asset in the host country.

Direct investments are real investments in factories, assets, land, inventories etc. and have three components, viz., equity capital, reinvested earnings and other direct capital in the form of intra-company loans. FDI may be categorized as horizontal, vertical or conglomerate. Two- way direct foreign investments reciprocal investments.

Foreign portfolio investment is the flow of 'financial capital' with stake in a firm at below 10 percent, and does not involve manufacture of goods or provision of services, ownership management or control of the asset on the part of the investor.

The main reasons for foreign direct investment are

- ◆ Profits
- ◆ Higher rate of return
- ◆ Possible economies of large-scale operation
- ◆ Risk diversification
- ◆ Retention of trade patents
- ◆ Capture of emerging markets
- ◆ Lower host country environmental and labour standards,
- ◆ Bypassing of non tariff and tariff barriers
- ◆ Cost-effective availability of needed inputs and tax and investment incentives.

Foreign direct investment takes place through

- ◆ Opening of a subsidiary or associate company
- ◆ Equity injection
- ◆ Acquiring a controlling interest
- ◆ Mergers and acquisitions (M&A)
- ◆ Joint venture and green field investment

Benefits of foreign direct investment

- ◆ Include positive outcomes of competition such as cost-reducing and quality-improving innovations
- ◆ Higher efficiency
- ◆ Huge variety of better products and services at lower prices
- ◆ Welfare for consumers, multiplier effects on employment
- ◆ Output and income, relatively higher wages
- ◆ Better access to foreign markets
- ◆ Control of domestic monopolies and betterment of balance of payments position
- ◆ Potential problems of foreign direct investment
- ◆ Include use of inappropriate capital-intensive methods in a labour-abundant country
- ◆ Increase in regional disparity
- ◆ Crowding-out of domestic investments
- ◆ Diversion of capital resulting in distorted pattern of production and investment
- ◆ Instability in the balance of payments and exchange rate and indiscriminate repatriation of the profits.
- ◆ Anti-ethical market distortions
- ◆ Off-shoring or shifting of jobs
- ◆ Overexploitation of natural resources causing environmental damage

Benefits of foreign direct investment

- ◆ Exercising monopoly power
- ◆ Decrease competitiveness of domestic companies
- ◆ Potentially jeopardize national security and sovereignty
- ◆ Worsen commodity terms of trade and cause emergence of a dual economy

FDI in India

- ◆ Mostly a post reform phenomenon is a major source of non-debt financial resource for economic development.
- ◆ The government has at different stages, liberalized FDI by increasing sectoral caps, bringing in more activities under automatic route and easing of conditions for foreign investment.
- ◆ Overseas direct investments by Indian companies, made possible by progressive relaxation of capital controls and simplification of procedures for outbound investments from India, have undergone substantial changes in terms of size, geographical spread and sectoral composition. Outward Foreign Direct Investment (OFDI) from India stood at US\$ 1.86 billion in the month of June 2016.

Stringent Action Against Adoption of Unfair Means

Cases of adoption/attempt to adopt unfair means are reported in respect of the examinations held every time. In respect of the Examinations held in November 2017, over 90 cases of infringement/ violation of Instructions to Examinees, which tantamounts to adoption of unfair means, were reported. The nature of infringement/ violation in these cases, inter alia, included the following.

- (1) Writing/jotting on the question paper [other than Roll Number at the specified place].
- (2) Writing in the answer book or additional book of, e.g. Roll Number [other than at the specified space]/ Registration Number, Name, Mobile number, unwarranted Remarks, irrelevant notes etc.
- (3) Possession of material inside the examination hall/room/washroom, e.g. writing/copying material / books / notes / writing on desk/writing on writing pad/geometric box/admit card (relevant for the day of the examination or otherwise), mobile phone [in switched off mode or otherwise], I Pod etc.
- (4) Seeking sympathy/making appeal, e.g. parent or relative passed away, met with accident /was hospitalized/ award marks/minimum required marks, inducement to examiner/writing irrelevant / unrelated remarks etc.
- (5) Writing/making in the answer book or additional answer book distinguishing marks - e.g. religious symbols, prayers, Om, Swastika, 786, etc.
- (6) Others, e.g. not handing over the answer book at the conclusion of the specified time, taking away the answer book, misbehaving with the examination functionaries, use of different inks/highlighter, availing of the services of an ineligible person as a writer by candidates with permanent disability.

The above cases were considered by the Examination Committee in accordance with the provisions of Regulation 41, read with Regulation 176, of the Chartered Accountants Regulations, 1988. The decision taken by the Committee included cancellation of result and debarment from appearing in the examination in future.

In view of the above, students are advised to download the Instructions to Examinees supplied along with the admit card, from the website, read them carefully and familiarize themselves with the same to avoid falling within the ambit of unfair means leading to avoidable difficulties.

Examination Department

ECONOMIC SURVEY 2017-2018



The Economic Survey 2017-2018 says the real GDP growth to clock 6.75 per cent this fiscal. The survey tabled in Parliament by the Finance Minister, Mr. Arun Jaitley predicts 7-7.5 per cent growth in 2018-19. Employment, Education & Agriculture to be the focus areas in medium term, says the Survey.

Over-all Growth

The Economic Survey puts the GDP growth to be 6.5% in 2017-18 as compared to 7% in 2016-17. The average GDP growth rate from 2014-15 till 2017-18 is expected to be 7.3% as compared to the average 7.5% between 2014-15 and 2016-17. The survey points out that India can be rated as among the best performing economies in the world as the average growth during last three years is around 4 percentage points higher than global growth and nearly 3 percentage points higher than that of Emerging Market and Developing Economies. That this growth has been achieved in a milieu of **lower inflation, improved current account balance and notable reduction in the fiscal deficit to GDP ratio makes it all the more creditable.**

The survey underlines that due to the launch of transformational Goods and Services Tax (GST) reform on July 1, 2017, resolution of the long-festering Twin Balance Sheet (TBS) problem by sending the major stressed companies for resolution under the new Indian Bankruptcy Code, implementing a major recapitalization package to strengthen the public sector banks, further liberalization of FDI and the

export uplift from the global recovery, the economy began to accelerate in the second half of the year and can clock 6.75 percent growth this year. The survey points out that as per the quarterly estimates there was a reversal of the declining trend of GDP growth in the second quarter of 2017-18, led by the industry sector. The Gross Value Added (GVA) at constant basic prices is expected to grow at the rate of 6.1 per cent in 2017-18 as compared to 6.6 per cent in 2016-17.

Sectoral Growth

- ❖ **Agriculture and allied sectors** - Growth rates of agriculture and allied sectors have been fluctuating: 1.5% in 2012-13, 5.6% in 2013-14, -0.2% in 2014-15, 0.7% in 2015-16, and 4.9% in 2016-17. It is expected to grow at the rate of 2.1 per cent in 2017-18.
- ❖ **Industry:** The overall industrial sector growth was 5.8% in the second quarter of 2017-18 as compared to 1.6% in the first quarter. As per the estimate of national income 2017-18, industrial sector grew at 4.4% and the manufacturing sector grew at 4.6%. The eight core industries (coal, crude oil, natural gas, petroleum refinery products, fertilizers, steel, cement, and electricity) grew by 4.8% in 2016-17 as

ECONOMIC SURVEY ||

compared to 3% in 2015-16.

- ❖ As per the CSO the growth of the services sector is expected to be 8.3% in 2017-18 as compared to 7.7% in 2016-17. With a share of 3.4%, India is the eighth largest exporter of commercial services.

Foreign Trade

The survey adds that after remaining in negative territory for a couple of years, growth of exports rebounded into positive one during 2016-17 and expected to grow faster in 2017-18 to 12.1%. Similarly, merchandise imports also recorded positive growth in 2016-17 after registering negative growth. India's CAD increased from 0.4% of GDP in 2016-17 to 1.8% of GDP in the first half of 2017-18. This has been attributed to an increase in merchandise imports relative to exports.

Forex reserves

India can be rated as among the best performing economies in the world with its foreign exchange reserves shooting to \$409.4 billion.

Fiscal discipline

The fiscal deficit as percentage to GDP to remain stable at 3.2%, indicating that government's priority still lies in fiscal consolidation.

Inflation

Inflation remained moderate during 2017-18. Average inflation based on Wholesale Price Index (WPI) stood at 2.9% in 2017-18 (Apr-Dec) as compared to 0.7% in 2016-17 (Apr-Dec). WPI based food inflation declined to 2.3% in 2017-18 (Apr-Dec) from 6.3% in the corresponding period of 2016-17. For the year as a whole, lower CPI inflation average to 3.33% may be seen.

Savings and Investment

Similarly, despite the robust economic growth, the savings and investment as a ratio of GDP generally declined. The major reduction in investment rate occurred in 2013-14, although it declined in 2015-16 too. Within this the share of household sector declined, while that of private corporate sector increased. There needs to be a focus on revival of investment. However, the decline in investment will be difficult to reverse because: (i) it stems from the balance sheet stress of companies, and (ii) its large magnitude. Easing the cost of doing

business, creating a transparent, stable tax and regulatory environment, and supporting small and medium industries will help revive private investment.

Way Forward

Though concerns have been expressed about growing protectionist tendencies in some countries but it remains to be seen as to how the situation unfolds. Some of the factors could have dampening effect on GDP growth in the coming year viz. the possibility of an increase in crude oil prices in the international market. However, with world growth likely to witness moderate improvement in 2018, expectation of greater stability in GST, likely recovery in investment levels, and ongoing structural reforms, among others, should be supporting higher growth. On balance, country's economic performance should witness an improvement in 2018-19.

The survey highlights that against the emerging macroeconomic concerns, policy vigilance will be necessary in the coming year, especially if high international oil prices persist or elevated stock prices correct sharply, provoking a "sudden stall" in capital flows. The agenda for the next year consequently remains full: stabilizing the GST, completing the TBS actions, privatizing Air India, and staving off threats to macro-economic stability. The TBS actions, noteworthy for cracking the long-standing "exit" problem, need complementary reforms to shrink unviable banks and allow greater private sector participation. The

GST Council offers a model "technology" of cooperative federalism to apply to many other policy reforms.

Over the medium term, three areas of policy focus stand out:

- Employment: finding good jobs for the young and burgeoning workforce, especially for women.
- Education: creating an educated and healthy labour force.
- Agriculture: raising farm productivity while strengthening agricultural resilience. Above all, India must continue improving the climate for rapid economic growth on the strength of the only two truly sustainable engines—private investment and exports.



TOPPERS SPEAK...

A set of questions were asked to the first three rank holders of the CA Final Examination- November 2017. The questions and their responses, which are included in these pages, would be helpful to the students to crack the Examinations smoothly and with good scoring.



Mohit Gupta
First Rank – CA Final
November 2017

Q. How does it feel to be at the top?

A. I can't describe the feeling in words. Getting a call from ICAI President to congratulate is the best thing that has happened to me. I am feeling very happy as this achievement made my mother proud. I am overwhelmed with the love and best wishes that I have received after topping the exams. Also I would like to mention that the celebrations got doubled when we came to know that my real brother Shubham also cleared CA – Final examinations with AIR 44. I am very grateful to my mother, family, friends and relatives who provided me with the much needed confidence and support to crack the CA exams.

Q. According to you, what are the intrinsic and external factors contributing to your outstanding success in the final exam.

A. My positive energy, passion, confidence, concentration power and concept clarity are the few things that helped me to achieve this platform. I knew my capabilities and I explored them to the fullest. But all these would have gone in vain had it not been for my mother's hard work and inspirational talks. Equally important were the wishes of my family, relatives & friends and the hard work I had put in during my articleship period.

Q. What strategy/study plan did you follow while preparing for the exam?

A. First of all, I tried to complete my syllabus in the first two years of the articleship in which I succeeded. We have 8 subjects to study and everybody can complete one subject in 3 months by studying 3-4 hours on daily basis. Firstly, I completed all the practical subjects like Financial Reporting, Advanced Management Accounting and Strategic Financial Management. Then I finished the Direct Taxes and Indirect Taxes as there used to be amendments in these subjects and finally the theory subjects. During exam leaves, I prepared my time table in such a way that I could complete 3 revisions for practical subjects and around 5 revisions for theory subjects. Revising each theory subject for 2 hours daily can easily increase the confidence of any

student. Along with theory subjects, I took two subjects in a day (One Tax and one other practical). In this way, I planned and executed my preparations.

Q. How have been the inputs provided by the Institute contributed to your success in the examinations?

A. First of all, I would like to thank Board of Studies for providing us such comprehensive material to prepare for the examinations in such easy language. It goes without saying that the material provided by the institute helped me travel the extra mile in achieving the top spot. I referred the Revision Test Papers and Practice Manual for each subject which helped me to boost my confidence that I have gone through the complete syllabus. Also I attempted at least 2 Mock Test Papers for each paper. Also the suggested answers for past examinations helped me to understand how to present the solutions in the examinations as presentation plays an important role in the examinations.

Q. What are your aspirations for the future? Do you have any specific career choice?

A. I do not have an inclination towards a particular career as yet. However, I want to explore the available opportunities that come on my way. My long term aspiration is to gain a wealth of experience by working on challenging assignments and contributing my part for the organization I would work in.

Q. Do you think the Chartered Accountancy Course is the gateway to achieving professional excellence?

A. Yes, I believe this course provides an enabling platform for achieving professional excellence. To achieve professional excellence, one should do hard work in the initial stages and also to update the knowledge on regular basis. The hard work of a Chartered Accountancy student is known to everyone. Getting up at 5 am in the morning for the classes, then going to office to apply the theoretical understanding of the concepts to the real world and the revision of the subject after office hours creates the habit of hard work in the students. Also the mandatory CPE hours helps to update the knowledge on regular basis.

Q. How would you motivate the youngsters joining this course?

A. I would like to say that the respect you get from the society after becoming a CA is priceless. The respect is because of our diversified knowledge, hard work and is rightfully earned so. CA is seen as 'doctor of the economy'. The articleship period is the most pivotal part of this course. In this period, you can learn about time management skills, leadership skills, communication skills and inter-personal skills. All these skills go a long way in helping you taste professional and personal success in the life.



Prashant
Second Rank- CA Final
November 2017

Q. How does it feel to be at the top?

A. It feels great! Something inexplicable. It is still not sinking in that I have achieved this feat.

Q. According to you, what are the intrinsic and external factors contributing to your outstanding success in the final examination?

A. As far as intrinsic factors are concerned determination was the most important. It requires a lot of patience to consistently put in everything you have got for 2 long years. Family and friends also played a vital role. They provide you the confidence whenever you are going through a rough phase.

Q. What strategy/study plan did you follow while preparing for the exam?

A. I had a comprehensive plan in place for the last 4 months. Within the broad plan I had subject wise targets and within those I also had topic wise targets. I used to

strictly adhere to my plans. I would suggest all the students to follow an organised approach.

Q. How have been the inputs provided by the Institute contributed to your success in the examinations?

A. The Institute's reference materials such as practice manuals, revision test papers and model test papers are a must before you sit for the exam. I would suggest everyone, not to overlook these and go through them atleast once.

Q. What are your aspirations for the future? Do you have any specific career choice?

A. I am still exploring different career choices and find the best suit for me.

Q. Do you think the Chartered Accountancy Course is the gateway to achieving professional excellence?

A. Definitely. The course is structured in such a way that you get a complete understanding of the diverse financial aspects of an enterprise. It teaches you discipline & increases your grasping ability and thus providing you the thrust to achieve excellence.

Q. How would you motivate the youngsters joining this course?

A. I would suggest everyone to take up this course if you wish to have in-depth knowledge and are looking for something challenging. The course tests you to the fullest and thus demands patience.

Be organised, work hard, and you will be through. And yes, the end result is definitely something to look forward to.



Aditya Mittal
Third Rank- CA Final
November 2017

Q. How does it feel to be at the top?

It feels great. The kind of appreciation that has been received from everyone after securing AIR 3 has been immense. It is a new feeling and I am really enjoying it. It also feels great to guide the students who are pursuing CA from all over India who contact me for any support or guidance. I feel grateful to God as well as my family who have supported me a lot at every point of time in my life.

Q. According to you, what are the intrinsic and external factors contributing to your outstanding success in the final examination?

Intrinsic factors:

My determination and dedication towards achieving great heights are the contributing factors to my success. I always give my 100 percent in anything I do as I want to do it in the best possible manner. I always aim to achieve high and that is the biggest contributor to my success in CA Finals.

External factors:

The support of my family and friends has been the major contributor in my success. The kind of involvement that my family has had in my study plan especially my mother has been immense. Also all my friends believed that I was definitely going to secure really good marks in the exams and that belief of everyone worked very positively for me everytime. I got more motivated due to that. Also the teachers from whom I have studied also played a major role in my success.

Q. What strategy/study plan did you follow while preparing for the exam?

The strategy was simple. Start early preparation for the exams and make a plan and ensure that I am able to execute them efficiently and effectively. The plan was to finish all my classes well before the exams date. I got four months of leaves for preparation from PwC where I am doing my articleship. I planned my classes in a manner that they were over before June'17. Then during those four months I planned each subject as to how many days are to be devoted to each of them so that I am able to do sufficient number of revisions as to the level of my satisfaction. I managed to achieve the targets set by me for each month, each day and even for each hour during the day. I did one subject each day always and picked up another one after completing the previous one.

Q. How have been the inputs provided by the Institute contributed to your success in the examinations?

The study material provided by the Institute has helped a lot as a whole in preparation for the exams. Mainly I would say the Practice Manual has been of great help as it helped me in knowing the manner in which questions are asked and even the manner of answering them. Solving those questions always boosted up the confidence and helped in complementing the regular books that I used to study for the subjects. Also the RTP and the mock tests uploaded on website are a genuine content to know about the level of our preparation towards the end of our studies and just before the exams. Overall, the inputs provided by the Institute served as a major contributor towards my success.

Q. What are your aspirations for the future? Do you have any specific career choice?

I aspire to work as an employee in a growing organisation where I am able to handle a position of responsibility and maybe one day attain the highest position in a particular Company. I want to apply the immense knowledge as gained during this CA course in my work and thereby grow further in my career ahead. If I talk about any specific career choice that I have, I would like to mention that I want to pursue my career in the field of finance.

Q. Do you think the Chartered Accountancy Course is the gateway to achieving professional excellence?

Yes I definitely think and truly believe that the Chartered Accountancy Course is the gateway to achieving professional excellence. I believe so because I find this course very challenging and of a very high repute. I think the level of knowledge and content that this course provides to the students like us is the highest amongst all the other courses. This kind of knowledge will definitely contribute towards achieving professional excellence as it helps in building and grooming young students into bright professionals in the future.

Q. How would you motivate the youngsters joining this course?

I would motivate youngsters to join the course by just mentioning that this is the only course where we are given truly a wide range of opportunities to make our career into. We are provided with so much knowledge along with the opportunity of working as a trainee for three years so as to gain experience into the field as well. That is unique about this course. Also it helps us in building a bright career while offering so many fields where we can work.

CROSSWORD SOLUTION – MARCH 2018

¹ S	² I	³ P								⁴ I	
⁵ D	R	A	⁶ W	⁷ I	⁸ N	⁹ G	¹⁰ S		¹¹ R	R	¹² B
¹³ R	E	C	E	S	S	I	O	¹⁴ N	E	R	Y
S		¹⁵ M	E	R	C	O	S	U	R		P
		A						T	A		R
¹⁶ R	¹⁷ U	N	A	¹⁸ S	¹⁹ T	²⁰ I	²¹ C	S		²² D	O
²³ E	T			²⁴ A	O	N	E		²⁵ O	L	D
²⁶ P	I	²⁷ N		²⁸ A	D	D	S		²⁹ D	I	U
O		I		³⁰ V	O	I	S		D		C
		³¹ G	³² U	N		A		³³ B	L	³⁴ O	T
³⁵ D	³⁶ O	H	A		³⁷ O		³⁸ D	O	O	R	
³⁹ E	X	T	E	R	N	A	L	I	T	Y	

1. Whether rental income earned from letting out of premises is to be treated as business income or as income from house property?

Raj Dadarkar and Associates v. Assistant Commissioner of Income Tax [2017] 394 ITR 592 (SC)

Facts of the case: The assessee had acquired the right to conduct a market on certain land from Municipal Corporation, Greater Bombay under an auction on May 28, 1993. The premises allotted to the appellant was a bare structure and it was for the appellant to make the premises fit to be used as a market. The appellant spent substantial sums to construct 95 shops and 30 stalls. From the years 1999 to 2004, the assessee treated income from sub-letting of such shops and stalls as business income. The return of the assessee for assessment year 2000-2001 was reopened by Assessing Officer by issuing notice under section 148.

Issue: Whether the income earned by the appellant is to be taxed under the head 'Income from house property' or 'Profits and gains from the business or profession'?

Supreme Court's Observations: The Supreme Court held that wherever there is an income from leasing out of premises, it is to be treated as income from house property. However, it can be treated as business income if letting out of the premises itself is the business of the assessee. The question has to be decided based on the facts of each case as was held in *Sultan Brothers Pvt Ltd. v. CIT [1964] 51 ITR 353 (SC)*.

In the given facts, it was an undisputed fact that the assessee would be considered to be a deemed owner under section 27(iiiB) read with section 269UA(f) as it had a leasehold right for more than 12 years. The only evidence adduced for proving that letting out and earning rents is the main business activity of the appellant was the object clause of the partnership deed. The clause provided that "*The Partnership shall take the premises on rent to sub-let or do any other business as may be mutually agreed by the parties from time to time.*" The Supreme Court held the clause to be inconclusive and observed that the assessee had failed to produce sufficient material to show that its entire or substantial income was from letting out of the property.

Supreme Court's Decision: The Supreme Court, accordingly, held that, in this case, the income is to be assessed as "Income from house property" and not as business income, on account of lack of sufficient material to prove that the substantial income of the assessee was from letting out of the property.

Note - In *Chennai Properties and Investments Ltd. v. CIT (2015) 373 ITR 673*, the Supreme Court observed that holding of the properties and earning income by

letting out of these properties is the main objective of the company. Further, in the return of income filed by the company and accepted by the Assessing Officer, the entire income of the company comprised of income from letting out of such properties. The Supreme Court, accordingly, held that such income was taxable as business income. Likewise, in *Rayala Corporation (P) Ltd. v. Asst. CIT (2016) 386 ITR 500*, the Supreme Court noted that the assessee was engaged only in the business of renting its properties and earning rental income therefrom and accordingly, held that such income was taxable as business income. In this case, however, on account of lack of sufficient material to prove that substantial income of the assessee was from letting out of property, the Supreme Court held that the rental income has to be assessed as "Income from house property".

2. Whether the nature of an expenditure can be considered debatable for not invoking prima facie adjustment under section 143(1)(a), where the jurisdictional High Court has taken a view that the expenditure is capital in nature even though some other High Courts have held that the same is revenue in nature?

Deputy Commissioner of Income Tax v Raghuvir Synthetics Ltd. [2017] 394 ITR 1 (SC)

Facts of the case: The assessee is a public limited company. For the relevant assessment year, it had filed its return claiming revenue expenditure of ₹ 65,47,448 on advertisement and public issue. The company claimed that if the sum cannot be considered as revenue expenditure, then, alternatively, the said expenditure may be allowed under section 35D by way treating such expenditure as preliminary expenses. The Assessing Officer issued an intimation under section 143(1)(a) disallowing a sum of ₹ 58,92,700 incurred on public issue.

Appellate Authorities' Views: The first appellate authority allowed the assessee's appeal by holding that the concept of "prima facie adjustment" under section 143(1)(a) cannot be invoked as there could be more than one opinion on whether public issue expenses were covered by section 35D or 37. The Tribunal as well as the Division Bench of the High Court dismissed the appeal of the Revenue on the ground that the issue was debatable and hence, the expenditure cannot be disallowed while processing return of income under section 143(1)(a).

Supreme Court's Observations: The Supreme Court noted that there was divergence of opinion amongst the various High Courts on the nature of the expenses incurred on raising share capital. While the High Courts of Madras, Andhra Pradesh and Karnataka had held the preliminary expenses to be revenue in nature, High Courts of Allahabad, Himachal Pradesh, Delhi, Calcutta, Bombay, Punjab and Haryana, Gujarat and Rajasthan had held the expenses to be capital in nature.

Supreme Court's Decision: The Supreme Court held that, in the case of the assessee, the issue was not debatable. Since the registered office of the assessee is in Gujarat, the law laid down by the Gujarat High Court is binding on the assessee.

3. Whether payments made by the agents in India responsible for booking cargo and acting as clearing agents, to use a centralized communication system maintained by the assessee-company engaged in shipping business, can be treated as fees for technical services?

Director of Income-Tax (International Taxation) v. A.P. Moller Maersk [2017] 392 ITR 186 (SC)

Facts of the case: The assessee was a foreign company engaged in shipping business and was a tax resident of Denmark. The assessee had agents working for it across the globe, who booked cargo and acted as clearing agents. In India, the assessee had three agents. The assessee had set up and maintained a vertically integrated communication system called Maersk net system in order to help all its agents. The agents paid for the system on a *pro rata* basis. The Assessing Officer contended that the amounts paid by the Indian agents were fees for technical services taxable under Article 13(4) of the India and Denmark DTAA. The assessee argued that the arrangement was merely a cost sharing system and the payments were only a reimbursement of expenses.

Supreme Court's Observations: The Supreme Court observed that, for the sake of convenience of its agents, the assessee had set up a centralised communication system which was an integral part of the international shipping business of the assessee. The expenditure incurred for running this system was shared by all the agents and payments to assessee were merely as reimbursement of expenses incurred. The payments could not be treated as fees for technical services. Moreover, the Revenue authorities had accepted that assessee's freight income in the relevant assessment years was not chargeable to tax as it arose from the operation of ships in international waters in terms of Article 9 of the India and Denmark DTAA. Once that was accepted and it was found that the communication system was an integral part of the shipping business, payments received from agents could not be treated as in lieu of any technical services.

Supreme Court's Decision: The Supreme Court, accordingly, held that amounts paid by Indian agents to the non-resident company would not be liable to tax as fee for technical services under Article 13(4) of the India and Denmark DTAA.

4. Is loan to HUF who is a shareholder in a closely held company chargeable to tax as deemed dividend?

Gopal & Sons (HUF) v. CIT (2017) 391 ITR 1 (SC)

Facts of the case: The assessee is a HUF which holds 37.12% shares in M/s. G.S. Fertilizers (P.) Ltd., a closely held company. During the relevant previous year, it received loans and advances from the company. Its return was scrutinized by the Assessing Officer who treated the loans and advances as deemed dividend under section 2(22)(e). The company declared in its annual return that the advances were given to the HUF but the share certificates were issued in the name of the HUF's Karta, Shri Gopal Kumar Sanei.

Appellate Authorities' views: The CIT (Appeals) confirmed the order of the Assessing Officer. The Tribunal, however, observed that since a HUF cannot be a registered or beneficial shareholder of a company, the amount cannot be taxed as deemed dividend. The High Court restored the order of the Assessing Officer by observing that the assessee did not dispute that the karta is a member of HUF which has taken the loan from the company and, therefore, the case is covered by section 2(22)(e).

Issue: Whether loan given by a closely held company to a HUF is chargeable to tax as deemed dividend under section 2(22)(e) despite the stated position of law being that a HUF cannot be a shareholder in a company?

Supreme Court's Observations: When a loan is given by a closely held company, it is chargeable to tax as deemed dividend if the loan was given to a shareholder (having more than 10% shares in the company) or to a concern in which the shareholder has substantial interest (having more than 20% share in the concern). 'Concern' includes HUF.

In the instant case, loans were given to the HUF. There was some dispute as to who was the shareholder - the Karta or the HUF as share certificates were issued in the name of the former but the annual return mentioned the latter. The Court observed that in either scenario, section 2(22)(e) would be attracted. If the HUF was the shareholder, as it held more than 10% shares, situation was covered. If the Karta was the shareholder, the HUF would be the concern in which the Karta has substantial interest.

Further, on the issue whether a HUF can be a shareholder or not, it was observed that on account of *Explanation 3* to section 2(22)(e), a concern includes a HUF.

Supreme Court's Decision: The Supreme Court, accordingly, held that the loan amount is to be assessed as deemed dividend under section 2(22)(e).

5. Whether omission to issue notice under section 143(2) is a defect not curable in spite of section 292BB?

Travancore Diagnostics (P) Ltd v. Asstt. CIT (2017) 390 ITR 167 (Ker)

Facts of the case: The assessee had a diagnostic laboratory in Kollam and a branch at Kottarakara. A survey under Section 133A was conducted, consequent to which the assessee filed its return of income. On the basis of certain incriminating documents and materials unearthed during the survey, a notice under section 148 was issued. Subsequently, the incomes were assessed for assessment years 2009-10 and 2010-11 under section 143(3) read with section 147.

The assessee raised additional jurisdictional grounds before the Appellate Tribunal. The assessee contended that for the assessment year 2009-10, the assessment was completed under section 143(3) read with section 147. However, a notice under section 143(2) was not issued. The Tribunal held that in view of section 292BB, the assessee's participation in the reassessment proceedings would condone the omission to issue a notice.

Issue: Whether failure to issue notice under section 143(2) would vitiate the assessment notwithstanding the assessee's participation in the proceedings? Would section 292BB come to the rescue of the Revenue authority if they omit to issue notice under section 143(2)?

High Court's Decision: The Apex Court had, in *Asstt. CIT v. Hotel Blue Moon (2010) 321 ITR 362*, held that without the statutory notice under section 143(2), the Assessing Officer could not assume jurisdiction. Here, Assessing Officer recorded his inability to generate a notice as the return was not filed electronically. Such defect cannot be cured subsequently, since it is not procedural but one that goes to the root of the jurisdiction. Even though the assessee had participated in the proceedings, in the absence of mandatory notice, section 292BB cannot help the Revenue officers who have no jurisdiction, to begin with. Section 292BB helps Revenue in countering claims of assesseees who have participated in proceedings once a due notice has been issued.

6. Is interest on enhanced compensation under section 28 of the Land Acquisition Act, 1894 assessable as capital gains or as income from other sources?

Movaliya Bhikhubhai Balabhai v. ITO (TDS) (2016) 388 ITR 343 (Guj)

Facts of the case: The petitioner's agricultural lands were compulsorily acquired for undertaking an irrigation project. The petitioner challenged the

compensation awarded by the Collector which led to award of additional compensation of ₹ 5,01,846 and interest amounting to ₹ 20.74 lakhs under section 28 of the Land Acquisition Act, 1894. The petitioner filed an application in the prescribed form to the Assessing Officer for issuance of a certificate with 'nil' tax deduction at source.

The application was rejected by the Assessing Officer on the ground that the interest amount is taxable at source as per section 57(iv) read with sections 56(2) (viii) and 145A(b). Aggrieved with the rejection of application, the assessee filed a writ before the High Court.

High Court's Observations: The High Court observed that the assessee has received interest under section 28 of the Land Acquisition Act, 1894 which represents enhanced value of land and thus, partakes the character of compensation and not interest. Hence, the interest under section 28 is liable to be taxed under the head of 'Capital Gains' and not under 'Income from Other Sources'. On the other hand, interest under section 34 of the Land Acquisition Act, 1894 is for the delay in making payment after the compensation amount is determined. Such amount is liable to be taxed under the head 'Income from Other Sources'.

High Court's Decision: The High Court held that the interest awarded under section 28 of the Land Acquisition Act, 1894 was not liable to tax under the head of 'Income from other sources' and thus, was not deductible at source. The Revenue authority had erred in refusing to grant a certificate under section 197 to the petitioner for non-deduction of tax at source.

Note: *The Land Acquisition Act, 1894 has now been repealed and replaced by the Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement Act, 2013. Section 72 and Section 80 of the new legislation have similar provisions regarding award of interest.*

7. Is the increase in gross total income consequent to disallowance under section 40(a)(ia) eligible for profit-linked deduction under Chapter VI-A?

CIT v. Sunil Vishwambharnath Tiwari (2016) 388 ITR 630 (Bom)

Facts of the case: The assessee engaged in development of housing projects filed his return of income for the relevant assessment year after claiming deduction of ₹ 16.82 lakhs under section 80-IB(10) [now, section 80-IBA]. The return was selected for scrutiny. In the assessment, a sum of ₹ 83 lakhs towards sub-contract payment; ₹ 1.75 lakh as commission payment and ₹ 7.96 lakhs towards advertisement expenses were disallowed for non-deduction of tax at source by invoking section 40(a)(ia). While based on the assessment, the total income was fixed at ₹ 92.71 lakhs,

the Revenue authority limited the deduction under section 80-IB(10) to the original amount claimed by the assessee.

Appellate Authorities' Views: The CIT (Appeals) held in favour of the assessee by stating that there cannot be a separate treatment for addition to income and deductions from gross total income i.e., the amount which is added to gross total income would be eligible for corresponding deduction from gross total income. The Tribunal affirmed the view of CIT (Appeals).

Issue: Whether the increase in gross total income on account of disallowance of expenditure under section 40(a)(ia) must be considered for the purpose of deduction under section 80-IB in the absence of any explicit restriction therein?

High Court's Observations: The High Court observed that the fact that the assessee had not deducted tax at source was undisputed. On account of such non-deduction, expenses had been disallowed under section 40(a)(ia) which goes on to increase the income chargeable under the head 'Profits and gains of business or profession.' As deduction under section 80-IB(10) is with reference to the assessee's gross total income, such enhanced income becomes eligible for deduction. Disallowance under section 40(a)(ia) would, thus, be tax neutral for the assessee, on account of the enhanced profit-linked deduction available to him.

High Court's Decision: Affirming the Tribunal's order, the High Court held that the assessee is entitled to claim deduction under section 80-IB(10) in respect of the enhanced gross total income as a consequence of disallowance of expenditure under section 40(a)(ia).

Notes:

- (1) Section 80-IB(10) allows deduction at 100% of the profits in respect of housing projects approved before 31.03.2008. Students may note that, presently, section 80-IBA provides for such deduction @100% of the profits and gains from housing project subject to satisfaction of the conditions mentioned therein.
- (2) The CBDT has, in its Circular No.37/2016 dated 2.11.2016, mentioned that the courts have generally held that if the expenditure disallowed is related to the business activity against which the Chapter VI-A deduction has been claimed, the deduction needs to be allowed on the enhanced profits. Thus, the settled position is that the disallowances made under sections 32, 40(a)(ia), 40A(3), 43B, etc. and other specific disallowances, relating to the business activity against which the Chapter VI-A deduction has been claimed, result in enhancement of the profits of the eligible business, and that deduction under Chapter VI-A is admissible on the profits so enhanced on account of such disallowance.

Final Paper 1 : Financial Reporting

AMENDMENTS TO COMPANIES (ACCOUNTS) RULES, 2014

MCA has notified the Companies (Accounts) Amendment Rules, 2018 through GSR (E) dated 27th February, 2018, which shall come into force on the date of their publication in the Official Gazette i.e 27.02.2018.

As per the said notification, a proviso has been added after Rule 10 in the Companies (Accounts) Rules, 2014. According to the proviso, all companies which are required to comply with Companies (Indian Accounting Standards) Rules, 2015 shall also forward their statement in Form AOC-3A.

In the Annexure of the principal Rules, after Form AOC-3, Form AOC-3A have been added. Form AOC-3A is a Statement containing salient features of the financial statements under Division II- Schedule III to the Companies Act, 2013.

This 'Form of Abridged Financial Statements' is divided into three parts viz:

- ❖ Part I : Abridged Balance Sheet (includes Abridged Statement of Changes in Equity)
- ❖ Part II : Abridged Statement of Profit and Loss
- ❖ Part III : Abridged Cash Flow Statement
- ❖ Notes to the Abridged Financial Statements

Further, the company presenting the abridged consolidated financial statements has to follow the requirements of Division II of Schedule III.

As per the notification, Abridged Financial Statements (whether Individual or consolidated) shall include Director's Report and Auditor's Report.

The abridged financial statements should be certified in the same manner as the main financial statements are certified.

(Source: www.mca.gov.in)

CROSSWORD - APRIL 2018

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37						38			
39				40		41			

ACROSS:

1. Stool Pigeon
3. Bar (Legally)
6. Carry out
7. The new cess@4% proposed from A.Y.2019-20 is called "..... and Education cess"
9. For instance (Latin)
10. In order to address the challenges of digital economy in line with BEPS Action Plan 1, the Finance Bill, 2018 proposes that significant..... presence of a non-resident in India would constitute business connection.
14. Everything is fair in love and ____.
15. Affirmative signal
17. With effect from A.Y.2019-20, salaried persons would be entitled for a deduction of upto Rs.40,000
19. Impulsive
21. In a project management, ____ is a support -type project activity that must be done to support other work activities or the entire project effort.
22. Threatening words : or ----
23. Budget in India presented by _____
24. An explosive material
25. A Roman numeral for 6.
26. ____: the gain or loss on an investment over a specified time period, expressed as a percentage of the investment's cost.
28. Wager
31. A computer network that interconnects computers within a limited area such as a residence, school, laboratory, university campus or office building.
32. Narrow inlet
34. An article
35. Part of NAFTA
37. Dispatched.

38. A credit facility in respect of which the interest and/ or instalment of principal has remain 'past' due for a specific period of time.
39. An ____ is required to collect tax on taxable supplies made through it.
40. Latin clarifier
41. A fraudulent investment scheme either by individual or corporation

DOWNWARD

1. A spurious imitation
2. ----- is a project management planning tool.
3. A Latin abbreviation which means 'and similar other thing'.
4. The student was ----- the door for his unfair means.
5. ----- is a form of signal modulation where the message information is encoded in the amplitude of a series of signal pulse.
6. Art ____
8. The relaxation of minimum period of employment from 240 days to 150 days is proposed to be extended to -----industry with effect from A.Y.2019-20.
11. A digital Depository initiative of GOI facilitated by MHRD providing a platform to students, academic institutions and verifiers to access, store and verify Academic awards.
12. A type of communication
13. To make out an order or requisition
16. Lair
17. A state run social insurance programme to workers in the private, professional,

- and informal sectors.
18. Mechanical or habitual repetition of something to be learned
 19. GST is payable under ____ charge in case of supply of silk yarn.
 20. Muhammad ____: Name of a world famous boxer.
 23. The first country to introduce VAT is -----
 27. A taxi app.
 29. An expression of encouragement.
 30. A unit prefix meaning "one billionth"
 33. Import and export under the Foreign Trade Policy without -----is not permitted unless specifically exempted.
 35. ____ refers to total market value of all final goods and services produced by the factors of production of a country.
 36. Also ____: a loser in a race or other contest.

