CMA Students Newsletter (For Intermediate Students)

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ACCOUNTING OF INSURANCE COMPANIES

The Insurance Laws (Amendment) Act, 2015 (Relevant Sections)

(1) Forms for final accounts [Sec11(1)]. Every insurer, on or after the date of the commencement of the Insurance Laws (Amendment) Act,2015, in respect of insurance business transacted by him and in respect of his shareholders' funds, shall at the expiration of each financial year, prepare with reference to that year, balance sheet, a profit and loss account, a separate account of receipts and payments, a revenue account in accordance with the regulations as may be specified.

(2) Audit. The Act provides that the company carrying on general insurance business be audited as per the requirements of the Companies Act, 2013.

(3) Register of policies [Sec 14 (1)(a)] Every insurer shall maintain a record of policies, in which shall be entered, in respect of every policy issued by t5he insurer, the name and address of the policyholder, the date when the policy was effected and a record of any transfer, assignment or nomination of which the insurer has notice.

(4) Register of claims. The insurer must also maintain a register of claims for record of claims, every claim made together with the date of the claim, the name and address of the claimant and the date on which the claim was discharged, or in the case of a claim which is rejected, the date of rejection and the grounds thereof.

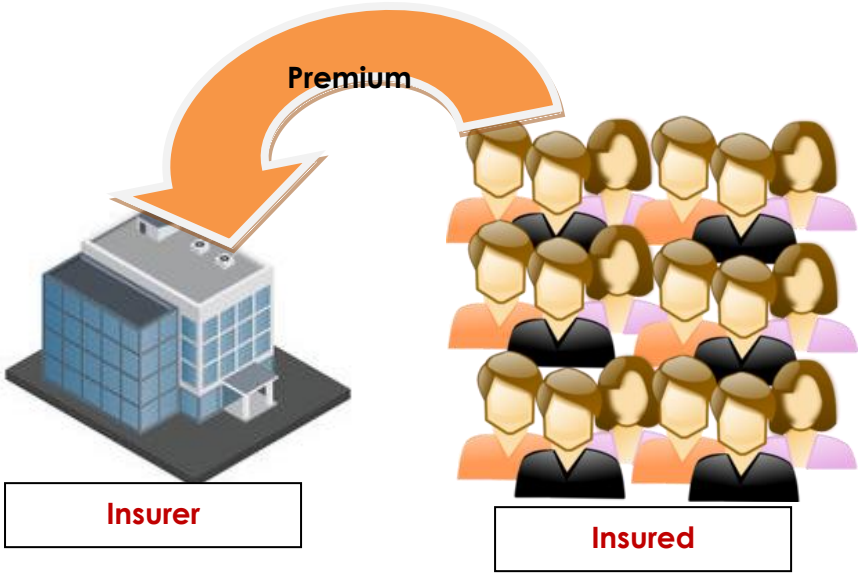
(5) Approved investments [Sec 27B] All assets of an insurer carrying on general insurance business shall subject to such conditions, if any, as may be prescribed, be deemed to be assets invested or kept invested in approved investments specified in this section.

(6) Payment of commission to authorized agents [Sec 40]. No person shall, pay or contract to pay any remuneration or reward, whether by way of commission or otherwise for soliciting or procuring insurance business in India to any person except an insurance agent or an intermediary or insurance intermediary in such manner as may be specified by the regulations.

(7) [Sec 40 (c)].Every insurer transacting insurance business in India shall furnish to the Authority, the details of expenses of management in such manner and form as may be specified by the regulations made under this Act.

(8) [Sec 64VA] Every insurer and re-insurer shall at all times maintain an excess of value of assets over the amount of liabilities of, not less than fifty per cent of the amount of minimum capital as stated under Section 6 and arrived at in the manner specified by the regulations.

Important Terms



Premium: Premium shall be recognized as income when due. For linked business the due date for payment may be taken as the date when the associated units are created.

Premium Deficiency: Premium deficiency shall be recognized if the sum of expected claim costs, related expenses and maintenance costs exceeds related unearned premiums.

Acquisition Costs: Acquisition costs, if any, shall be expensed in the period in which they are incurred. Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. The most essential test is the obligatory relationship between costs and the execution of insurance contracts (i.e., commencement of risk).

Claims Cost: The ultimate cost of claims shall comprise the policy benefit amount and claims settlement costs, wherever applicable.

Actuarial Valuation: The estimation of liability against life policies in force shall be determined by the appointed actuary of the insurer pursuant to his annual investigation of the life insurance business. Actuarial assumptions are to be disclosed by way of notes to the account. The liability shall be so calculated that together with future premium payments and investment income, the insurer can meet all future claims (including bonus entitlements to policyholders) and expenses.

Loans: Loans shall be measured at historical cost subject to impairment provisions. The insurer shall assess the quality of its loan assets and shall provide for impairment. The impairment provision shall not be less than the aggregate amount of loans which are subject to defaults of the nature mentioned below:

(i) interest remaining unpaid for a period of six months; and
(ii) instalment(s) of loan falling due and remaining unpaid during the last six months.

Funds for Future Appropriation: The funds for future appropriation shall be presented separately. The funds for future appropriation represent all funds, the allocation of which, either to the policyholders or to the shareholders, has not been determined by the end of the financial year.

Reversionary Bonus: In the case of life policies with profits, policyholders are given the right to participate in the profits of the business. After nationalization, policyholders are given 95% of profits of L.I.C. by way of bonus. Bonus can be paid in cash, adjusted against the future premiums due from the policy holders or it can be paid on the maturity of the policy, together with the policy amount. Bonus paid in the end along with the policy amount is called Reversionary Bonus.

Interim Bonus: It is a bonus declared between dates of two valuation Balance Sheets. It is for a period for which valuation is not complete.

Re-insurance: Sometimes the insurer considers a particular risk too much for his capacity and may re-insure a part of the risk with some other insurer. Such an arrangement between two insurers is referred to as reinsurance. In such a case the first insurer cannot retain all the premium on the policy for himself. Depending on the share of risk undertaken by the second insurer, proportionate premium must be ceded by the first insurer. Likewise if such a policy matures, the claim will have to be shared by both the insurers in the agreed ratio. These adjustments will have to be shown in the accounts of both the insurers. In the accounts of the first insurer amount of claim recovered from the second insurer has to be deducted from the total claim payable by him. Similarly, the premium ceded to the second insurer has to be deducted from the total premium received. In the accounts of the second insurer, claims paid include claims paid on account of Re-insurance and premiums received include premium received on re-insurance business.

Commission on re-insurance ceded /accepted: The business of the company is fetched through its agents who are paid commission according to the amount of business they are getting for the company. When company gets re-insurance business it has to pay commission to some other company. This commission is called 'commission on re-insurance accepted' and is shown as an expense in the revenue account. When a company passes on a part of business to some other company then this company (which gives business) gets commission from the company to whom such business is given. This commission is called 'commission on re-insurance ceded' and is a gain to the company surrendering the business. It appears on the credit side of revenue account.

Reserve for unexpired risk: This is applicable in General Insurance business only. This is in the nature of provision for claims that may arise in respect of policies which are subsisting on the date of balance sheet. Since premium has already been received in respect of such policies, provision must be made for the claims that may arise out of such policies. Insurance business is peculiar in that the premium is received in advance but the risk can arise on any day. In general insurance the policy is issued for a year which means the risk is covered for a year. Chances of the risk covered occurring do not come down proportionately with the passage of time.

For example, if on the balance sheet date the unexpired period of a particular policy is one month (eleven months having expired) we cannot say that the risk on the policy is reduced to 1/ 12th of the total risk. Even on the last day of the policy company's risk is as high as it was on the day the policy was issued. Therefore, insurance companies must provide for the risks associated with all such policies for which the premia has been received and the policies are still in force. Thus a large portion of the premia collected must be kept in reserve for unexpired risk. Keeping in view the nature of the business, the Executive Committee of the General Insurance Council (which has been set up under the Insurance Act to supervise general insurance companies) has laid down that in the case of marine insurance the provision for unexpired risk should be 100% of the net premium and in the case of other businesses (like accident, fire, theft, etc.) the provision should be 50% of the net premium. The provision made on the balance sheet date will be shown on the debit side of the revenue account instead of subtracting from premia. The balance of provision also appears in the balance sheet on the liabilities side under the heading 'balance of funds and accounts'. This provision will be transferred to the credit side of next year's revenue account. Thus in the revenue account the balance of the previous year appears on the credit side and the balance provided for the current year appears on the debit side.

Additional reserve for unexpired risk: In a particular year the management may feel that the percentage of premia recommended by the General Insurance Council is not sufficient to meet the unexpired risks. In such a situation they may provide additional reserve. Such additional reserve will also be debited to the revenue account. The balance will be shown in the balance sheet as in the case of normal reserve, and will be transferred to the credit of next year's revenue account.

INCOME COMPUTATION AND DISCLOSURE STANDARDS

Central Government vide **Notification No. 32/2015, dated 31-3-2015** has notifies the "Income Computation and Disclosure Standards" as specified below to be followed by all assessees, following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head **"Profit and Gains of Business or Profession"** or **"Income from Other Sources"**. This notification shall come into force with effect from 1st day of April, 2015, and shall accordingly apply to the assessment year 2016-17 and subsequent assessment years.

List of Standards are as follows:

(1) Income Computation and Disclosure Standard I relating to accounting policies Preamble

(2) Income Computation and Disclosure Standard II relating to valuation of inventories

(3) Income Computation and Disclosure Standard III relating to construction contracts

(4) Income Computation and Disclosure Standard IV relating to revenue recognition Preamble

(5) Income Computation and Disclosure Standard V relating to tangible fixed assets Preamble

(6) Income Computation and Disclosure Standard VI relating to the effects of changes in foreign exchange rates

(7) Income Computation and Disclosure Standard VII relating to government grants Preamble

(8) Income Computation and Disclosure Standard VIII relating to securities Preamble

(9) Income Computation and Disclosure Standard IX relating to borrowing costs Preamble

(10) Income Computation and Disclosure Standard X relating to provisions, contingent liabilities and contingent assets

(1) Income Computation and Disclosure Standard I relating to accounting policies Preamble

This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of the Income-tax Act, 1961 ('the Act') and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.

1. Scope

This Income Computation and Disclosure Standard deals with significant accounting policies.

2. Fundamental Accounting Assumptions

The following are fundamental accounting assumptions, namely:—

(a) Going Concern

"Going concern" refers to the assumption that the person has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the business, profession or vocation and intends to continue his business, profession or vocation for the foreseeable future.

(b) Consistency

"Consistency" refers to the assumption that accounting policies are consistent from one period to another.

(c) Accrual

"Accrual" refers to the assumption that revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the previous year to which they relate.

3. Accounting Policies

The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by a person.

4. Considerations in the Selection and Change of Accounting Policies

Accounting policies adopted by a person shall be such so as to represent a true and fair view of the state of affairs and income of the business, profession or vocation. For this purpose,—

(i) the treatment and presentation of transactions and events shall be governed by their substance and not merely by the legal form; and
(ii) marked to market loss or an expected loss shall not be recognised unless the recognition of such loss is in accordance with the provisions of any other Income

5. Computation and Disclosure Standard

An accounting policy shall not be changed without reasonable cause.

6. Disclosure of Accounting Policies

All significant accounting policies adopted by a person shall be disclosed.

7. Any change in an accounting policy which has a material effect shall be disclosed. The amount by which any item is affected by such change shall also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact shall be indicated. If a change is made in the accounting policies which has no material effect for the current previous year but which is reasonably expected to have a material effect in later previous years, the fact of such change shall be appropriately disclosed in the previous year in which the change is adopted and also in the previous year in which such change has material effect for the first time.

8. Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item.

9. If the fundamental accounting assumptions of Going Concern, Consistency and Accrual are followed, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact shall be disclosed.

10. Transitional Provisions

All contract or transaction existing on the 1st day of April, 2015 or entered into on or after the 1st day of April, 2015 shall be dealt with in accordance with the provisions of this standard after taking into account the income, expense or loss, if any, recognised in respect of the said contract or transaction for the previous year ending on or before the 31st March, 2015.

(2) Income Computation and Disclosure Standard II relating to valuation of inventories

Preamble

This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head "Profits and gains of Business or profession" or "Income from other sources" and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of Income Tax Act, 1961 ('the Act') and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.

1. Scope

This Income Computation and Disclosure Standard shall be applied for valuation of inventories, except:

(a) Work-in-progress arising under 'construction contract' including directly related service contract which is dealt with by the Income Computation and Disclosure Standard on construction contracts;

(b) Work-in-progress which is dealt with by other Income Computation and Disclosure Standard;

(c) Shares, debentures and other financial instruments held as stock-in-trade which are dealt with by the Income Computation and Disclosure Standard on securities;

(d) Producers' inventories of livestock, agriculture and forest products, mineral oils, ores and gases to the extent that they are measured at net realizable value;

(e) Machinery spares, which can be used only in connection with a tangible fixed asset and their use is expected to be irregular, shall be dealt with in accordance with the Income Computation and Disclosure Standard on tangible fixed assets.

2. Definitions

(1) The following terms are used in this Income Computation and Disclosure Standard with the meanings specified:

(a) "Inventories" are assets:

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

(ii) in the process of production for such sale;

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

(b) "Net realisable value" is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

(2) Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meanings assigned to them in that Act.

3. Measurement

Inventories shall be valued at cost, or net realisable value, whichever is lower.

4. Cost of Inventories

Cost of inventories shall comprise of all costs of purchase, costs of services, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

5. Costs of Purchase

The costs of purchase shall consist of purchase price including duties and taxes, freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates and other similar items shall be deducted in determining the costs of purchase.

6. Costs of Services

The costs of services in the case of a service provider shall consist of labour and other costs of personnel directly engaged in providing the service including supervisory personnel and attributable overheads.

7. Costs of Conversion

The costs of conversion of inventories shall include costs directly related to the units of production and a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads shall be those indirect costs of production that remain relatively constant regardless of the volume of production. Variable production overheads shall be those indirect costs of production that vary directly or nearly directly, with the volume of production.

8. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion shall be based on the normal capacity of the production facilities.

Normal capacity shall be the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production shall be used when it approximates to normal capacity. The amount of fixed production overheads allocated to each unit of production shall not be increased as a consequence of low production or idle plant. Unallocated overheads shall be recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above the cost. Variable production overheads shall be assigned to each unit of production on the basis of the actual use of the production facilities.

9. Where a production process results in more than one product being produced simultaneously and the costs of conversion of each product are not separately identifiable, the costs shall be allocated between the products on a rational and consistent basis. Where by-products, scrap or waste material are immaterial, they shall be measured at net realisable value and this value shall be deducted from the cost of the main product.

10. Other Costs

Other costs shall be included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.

11. Interest and other borrowing costs shall not be included in the costs of inventories, unless they meet the criteria for recognition of interest as a component of the cost as specified in the Income Computation and Disclosure Standard on borrowing costs.

12. Exclusions from the Cost of Inventories

In determining the cost of inventories in accordance with paragraphs 4 to paragraphs 11, the following costs shall be excluded and recognised as expenses of the period in which they are incurred, namely:—

(a) Abnormal amounts of wasted materials, labour, or other production costs;

(b) Storage costs, unless those costs are necessary in the production process prior to a further production stage;

(c) Administrative overheads that do not contribute to bringing the inventories to their present location and condition;

(d) Selling costs.

13. Cost Formulae

The Cost of inventories of items—

(i) that are not ordinarily interchangeable; and

(ii) goods or services produced and segregated for specific projects shall be assigned by specific identification of their individual costs.

14. 'Specific identification of cost' means specific costs are attributed to identified items of inventory.

15. Where there are a large numbers of items of inventory which are ordinarily interchangeable, specific identification of costs shall not be made.

16. First-in First-out and Weighted Average Cost Formula

Cost of inventories, other than the inventory dealt with in paragraph 13, shall be assigned by using the First-in First-out (FIFO), or weighted average cost formula. The formula used shall reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

17. The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average shall be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances.

18. Retail Method

Where it is impracticable to use the costing methods referred to in paragraph 16, the retail method can be used in the retail trade for measuring inventories of large number of rapidly changing items that have similar margins. The cost of the inventory is determined by reducing from the sales value of the inventory, the appropriate percentage gross margin. The percentage used takes into consideration inventory, which has been marked down to below its original selling price.

19. Net Realisable Value

Inventories shall be written down to net realisable value on an item-by-item basis. Where 'items of inventory' relating to the same product line having similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line, such inventories shall be grouped together and written down to net realisable value on an aggregate basis.

20. Net realisable value shall be based on the most reliable evidence available at the time of valuation. The

estimates of net realisable value shall also take into consideration the purpose for which the inventory is held. The estimates shall take into consideration fluctuations of price or cost directly relating to events occurring after the end of previous year to the extent that such events confirm the conditions existing on the last day of the previous year.

21. Materials and other supplies held for use in the production of inventories shall not be written down below the cost, where the finished products in which they shall be incorporated are expected to be sold at or above the cost. Where there has been a decline in the price of materials and it is estimated that the cost of finished products will exceed the net realisable value, the value of materials shall be written down to net realisable value which shall be the replacement cost of such materials.

22. Value of Opening Inventory

The value of the inventory as on the beginning of the previous year shall be—

(i) the cost of inventory available, if any, on the day of the commencement of the business when the business has commenced during the previous year; and

(ii) the value of the inventory as on the close of the immediately preceding previous year, in any other case.

23. Change of Method of Valuation of Inventory

The method of valuation of inventories once adopted by a person in any previous year shall not be changed without reasonable cause.

24. Valuation of Inventory in Case of Certain Dissolutions

In case of dissolution of a partnership firm or association of person or body of individuals, notwithstanding whether business is discontinued or not, the inventory on the date of dissolution shall be valued at the net realisable value.

25. Transitional Provisions

Interest and other borrowing costs, which do not meet the criteria for recognition of interest as a component of the cost as per para 11, but included in the cost of the opening inventory as on the 1st day of April, 2015, shall be taken into account for determining cost of such inventory for valuation as on the close of the previous year beginning on or after 1st day of April, 2015 if such inventory continue to remain part of inventory as on the close of the previous year beginning on or after 1st day of April, 2015.

26. Disclosure

The following aspects shall be disclosed, namely:—

(a) the accounting policies adopted in measuring inventories including the cost formulae used; and

(b) the total carrying amount of inventories and its classification appropriate to a person.

(3) Income Computation and Disclosure Standard III relating to construction contracts

Preamble

This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of the Income-tax Act, 1961 ('the Act') and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.

1. Scope

This Income Computation and Disclosure Standard should be applied in determination of income for a construction contract of a contractor.

2. Definitions

(1) The following terms are used in this Income Computation and Disclosure Standard with the meanings specified:

(a) "Construction contract" is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use and includes:

(i) contract for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects;

(ii) contract for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

(b) "Fixed price contract" is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which may be subject to cost escalation clauses.

(c) "Cost plus contract" is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a mark up on these costs or a fixed fee.

(d) "Retentions" are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified.

(e) "Progress billings" are amounts billed for work performed on a contract whether or not they have been paid by the customer.

(f) "Advances" are amounts received by the contractor before the related work is performed.

(2) Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meaning respectively assigned to them in the Act.

3. A construction contract may be negotiated for the construction of a single asset. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

4. Construction contracts are formulated in a number of ways which, for the purposes of this Income

Computation and Disclosure Standard, are classified as fixed price contracts and cost plus contracts. Some construction contracts may contain characteristics of both a fixed price contract and a cost plus contract, for example, in the case of a cost plus contract with an agreed maximum price.

5. Combining and Segmenting Construction Contracts

The requirements of this Income Computation and Disclosure Standard shall be applied separately to each construction contract except as provided for in paragraphs 6, 7 and 8 herein. For reflecting the substance of a contract or a group of contracts, where it is necessary, the Income Computation and Disclosure Standard should be applied to the separately identifiable components of a single contract or to a group of contracts together.

6. Where a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

(a) separate proposals have been submitted for each asset;

(b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

(c) the costs and revenues of each asset can be identified.

7. A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

(a) the group of contracts is negotiated as a single package;

(b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

(c) the contracts are performed concurrently or in a continuous sequence.

8. Where a contract provides for the construction of an additional asset at the option of the customer or is amended to include the construction of an additional asset, the construction of the additional asset should be treated as a separate construction contract when:

(a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

(b) the price of the asset is negotiated without having regard to the original contract price.

9. Contract Revenue

Contract revenue shall be recognised when there is reasonable certainty of its ultimate collection.

10. Contract revenue shall comprise of:

(a) the initial amount of revenue agreed in the contract, including retentions; and

(b) variations in contract work, claims and incentive payments:

(i) to the extent that it is probable that they will result in revenue; and
(ii) they are capable of being reliably measured.

11. Where contract revenue already recognised as income is subsequently written off in the books of accounts

as uncollectible, the same shall be recognised as an expense and not as an adjustment of the amount of contract revenue.

12. Contract Costs

Contract costs shall comprise of:

(a) costs that relate directly to the specific contract;

(b) costs that are attributable to contract activity in general and can be allocated to the contract;

(c) such other costs as are specifically chargeable to the customer under the terms of the contract; and

(d) allocated borrowing costs in accordance with the Income Computation and Disclosure Standard on Borrowing Costs. These costs shall be reduced by any incidental income, not being in the nature of interest, dividends or capital gains, that is not included in contract revenue.

13. Costs that cannot be attributed to any contract activity or cannot be allocated to a contract shall be excluded from the costs of a construction contract.

14. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. Costs that are incurred in securing the contract are also included as part of the contract costs, provided

(a) they can be separately identified; and

(b) it is probable that the contract shall be obtained.

When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period.

15. Contract costs that relate to future activity on the contract are recognised as an asset. Such costs represent an amount due from the customer and are classified as contract work in progress.

16. Recognition of Contract Revenue and Expenses

Contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date.

17. The recognition of revenue and expenses by reference to the stage of completion of a contract is referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed.

18. The stage of completion of a contract shall be determined with reference to:

(a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or

(b) surveys of work performed; or

(c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers are not determinative of the stage of completion of a contract.

19. When the stage of completion is determined by reference to the contract costs incurred upto the reporting date, only those contract costs that reflect work performed are included in costs incurred upto the reporting date. Contract costs which are excluded are:

(a) contract costs that relate to future activity on the contract; and

(b) payments made to subcontractors in advance of work performed under the subcontract.

20. During the early stages of a contract, where the outcome of the contract cannot be estimated reliably contract revenue is recognised only to the extent of costs incurred. The early stage of a contract shall not extend beyond 25 % of the stage of completion.

21. Changes in Estimates

The percentage of completion method is applied on a cumulative basis in each previous year to the current estimates of contract revenue and contract costs.

Where there is change in estimates, the changed estimates shall be used in determination of the amount of revenue and expenses in the period in which the change is made and in subsequent periods.

22. Transitional Provisions

Contract revenue and contract costs associated with the construction contract, which commenced on or before the 31st day of March, 2015 but not completed by the said date, shall be recognised as revenue and costs respectively in accordance with the provisions of this standard. The amount of contract revenue, contract costs or expected loss, if any, recognised for the said contract for any previous year commencing on or before the 1st day of April, 2014 shall be taken into account for recognising revenue and costs of the said contract for the previous year commencing on the 1st day of April, 2015 and subsequent previous years.

23. Disclosure

A person shall disclose:

(a) the amount of contract revenue recognised as revenue in the period; and

(b) the methods used to determine the stage of completion of contracts in progress.

24. A person shall disclose the following for contracts in progress at the reporting date, namely:—

(a) amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;

(b) the amount of advances received; and

(c) the amount of retentions.

METHODS OF CAPITAL BUDGETING OR EVALUATION OF INVESTMENT PROPOSALS

(Investment Appraisal Techniques)

The various commonly used methods are as follows.

I. Traditional methods

(1) Payback period method or pay out or pay off method.(PBP)

(2) Accounting Rate of Return method or Average Rate of Return. (ARR)

II. Time adjusted method or discounted method

(3) Net Present Value method.(NPV)

(4) Profitability Index method (PI)

(5) Internal Rate of Return method (IRR)

(6) Net Terminal Value method (NTV)

(1) Payback period method or pay out or pay off method.(PBP)

The basic element of this method is to calculate the recovery time, by year wise accumulation of cash inflows (inclusive of depreciation) until the cash inflows equal the amount of the original investment. The time taken to recover such original investment is the "payback period" for the project.

"The shorter the payback period, the more desirable a project".

The payback period can be calculated in two different situation as follows-

(a) When annual cash inflow are equal

$$\text{Payback period} = \frac{\text{Original cost of the project (cash outlay)}}{\text{Annual net cash inflow (net earnings)}}$$

Example-: A project cost ₹ 1,00,000 and yields an annual cash inflow of ₹ 20,000 for 8 years, calculate payback period.

$$\text{Payback period} = \frac{\text{Original cost of the project (cash outlay)}}{\text{Annual net cash inflow (net earnings)}} = \frac{1,00,000}{20,000} = 5 \text{ years.}$$

(b) When annual cash inflows are unequal

It is ascertained by cumulating cash inflows till the time when the cumulative cash inflows become equal to initial investment.

$$\text{Payback period} = Y + \frac{B}{C}$$

Y = No of years immediately preceding the year of final recovery.
B = Balance amount still to be recovered.
C = Cash inflow during the year of final recovery.

Example:
Initial Investment = ₹ 10,000 in a project
Expected future cash inflows ₹ 2000, ₹ 4000, ₹ 3000, ₹ 2000
Solution:

Calculation of Pay Back period.

Year	Cash Inflows (₹)	Cumulative Cash Inflows (₹)
1	2,000	2,000
2	4,000	6,000
3	3,000	9,000
4	2,000	11,000

The initial investment is recovered between the 3rd and the 4th year.

Payback period = $Y + \frac{B}{C} = 3 + \frac{1000}{2000}$ years = $3 + \frac{1}{2}$ years = 3 year 6 months.

Merits of Payback period:

- No assumptions about future interest rates.
- In case of uncertainty in future, this method is most appropriate.
- A company is compelled to invest in projects with shortest payback period, if capital is a constraint.
- It is an indication for the prospective investors specifying the payback period of their investments.
- Ranking projects as per their payback period may be useful to firms undergoing liquidity constraints.

Demerits of Payback period:

- Cash generation beyond payback period is ignored.
- The timing of returns and the cost of capital is not considered.
- The traditional payback method does not consider the salvage value of an investment.
- Percentage Return on the capital invested is not measured.
- Projects with long payback periods are characteristically those involved in long-term planning, which are ignored in this approach.

(2) Accounting Rate of Return method or Average Rate of Return (ARR)

This method measures the increase in profit expected to result from investment.

It is based on accounting profits and not cash flows.

$$\textbf{ARR} = \frac{\text{Average income or return}}{\text{Average investment}} \times 100$$

$$\textbf{Average investment} = \frac{\text{Original investment} + \text{Salvage value}}{2}$$

Example:
A project costing ₹ 10 lacs. EBITD (Earnings before Depreciation, Interest and Taxes) during the first five years is expected to be ₹ 2,50,000; ₹ 3,00,000; ₹ 3,50,000; ₹ 4,00,000 and ₹ 5,00,000. Assume 33.99% tax and 30% depreciation on WDV Method.

Solution:

Computation of Project ARR:

Particulars	Yr1	Yr2	Yr3	Yr4	Yr5	Average
	₹	₹	₹	₹	₹	₹
EBITD	2,50,000	3,00,000	3,50,000	4,00,000	5,00,000	3,60,000
Less : Depreciation	3,00,000	2,10,000	1,47,000	1,02,900	72,030	1,66,386
EBIT	(50,000)	90,000	2,03,000	2,97,100	4,27,970	1,93,614
Less: Tax @ 33.99%	---	13,596	69,000	1,00,984	1,45,467	65,809
Total	(50,000)	76,404	1,34,000	1,96,116	2,82,503	1,27,805
Book Value of Investment:						
Beginning	10,00,000	7,00,000	4,90,00	3,43,000	2,40,100	
End	7,00,000	4,90,000	3,43,000	2,40,100	1,68,070	
Average	8,50,000	5,95,000	4,16,500	2,91,550	2,04,085	**4,71,427**

ARR = $\frac{\text{Average income or return}}{\text{Average investment}} \times 100 = \frac{127805}{471427} \times 100 = 27.11\%$

Note: Unabsorbed depreciation of Yr. 1 is carried forward and set-off against profits of Yr. 2. Tax is calculated on the balance of profits = 33.99% (90,000 - 50,000) = 13,596/-

Merits of ARR

- This method considers all the years in the life of the project.
- It is based upon profits and not concerned with cash flows.
- Quick decision can be taken when a number of capital investment proposals are being considered.

Demerits of ARR

- Time Value of Money is not considered.
- It is biased against short-term projects.
- The ARR is not an indicator of acceptance or rejection, unless the rates are compared with the arbitrary management target.
- It fails to measure the rate of return on a project even if there are uniform cash flows.

(3) Net Present Value method. (NPV)

NPV= Present Value of Cash Inflows - Present Value of Cash Outflows

The discounting is done by the entity's weighted average cost of capital.

The discounting factors is given by: n $\frac{(1+i)}{1}$

Where
i = rate of interest per annum
n = no. of years over which discounting is made.

Example:

Z Ltd. has two projects under consideration A & B, each costing ₹ 60 lacs.
The projects are mutually exclusive. Life for project A is 4 years & project B is 3 years. Salvage value NIL for both the projects. Tax Rate 33.99%. Cost of Capital is 15%.

Net Cash Inflow (₹ in Lakhs)

At the end of the year	Project A	Project B	P.V. @ 15%
1	60	100	0.870
2	110	130	0.756
3	120	50	0.685
4	50	---	0.572

Solution:

Computation of Net Present Value of the Projects. Project A (₹ in Lakhs)

Particulars	Yr1	Yr. 2	Yr. 3	Yr. 4
1. Net Cash Inflow	60.00	110.00	120.00	50.00
2. Depreciation	15.00	15.00	15.00	15.00
3. PBT (1–2)	45.00	95.00	105.00	35.00
4. Tax @ 33.99%	15.30	32.29	35.70	11.90
5. PAT (3–4)	29.70	62.71	69.30	23.10
6. Net Cash Flow (PAT + Deprn)	44.70	77.71	84.30	38.10
7. Discounting Factor	0.870	0.756	0.685	0.572
8. P.V. of Net Cash Flows	38.89	58.75	57.75	21.79
9. Total P.V. of Net Cash Flow		= 177.18		
10. P.V. of Cash outflow (Initial Investment)		= 60.00		
Net Present Value		**= 117.18**		

Project B

Particulars	Yr. 1	Yr. 2	Yr. 3
1. Net Cash Inflow	100.00	130.00	50.00
2. Depreciation	20.00	20.00	20.00
3. PBT (1–2)	80.0	110.00	30.00
4. Tax @ 33.99%	27.19	37.39	10.20
5. PAT (3–4)	52.81	72.61	19.80
6. Next Cash Flow (PAT + Dep.)	72.81	92.61	39.80
7. Discounting Factor	0.870	0.756	0.685
8. P.V. of Next Cash Flows	63.345	70.013	27.263
9. Total P.V. of Cash Inflows	= 160.621		
10. P.V. of Cash Outflows (Initial Investment)	= 60.00		
Net Present Value	**= 100.621**		

As Project "A" has a higher Net Present Value, it has to be taken up.

Merits of Net Present Value method

- It recognises the Time Value of Money.
- It considers total benefits during the entire life of the Project.
- This is applicable in case of mutually exclusive Projects.
- Since it is based on the assumptions of cash flows, it helps in determining Shareholders Wealth.

Demerits of Net Present Value method

- This is not an absolute measure.
- Desired rate of return may vary from time to time due to changes in cost of capital.
- This Method is not effective when there is disparity in economic life of the projects.
- More emphasis on net present values. Initial investment is not given due importance.

(4) Profitability Index method (PI)

$$\text{Profitability Index} = \frac{\text{P.V. of cash outflow}}{\text{P.V. of cash inflow}}$$

If P.I. > 1, project is accepted
P.I. < 1, project is rejected

The Profitability Index (PI) signifies present value of inflow per rupee of outflow. It helps to compare projects involving different amounts of initial investments.

Example:

Initial investment ₹ 20 lacs. Expected annual cash flows ₹ 6 lacs for 10 years. Cost of Capital @ 15%. Calculate Profitability Index.

Solution:

Cumulative discounting factor @ 15% for 10 years = 5.019
P.V. of inflows = 6.00 × 5.019 = ₹ 30.114 lacs.

$$\text{Profitability Index} = \frac{\text{P.V. of cash outflow}}{\text{P.V. of cash inflow}}$$

$$\text{Profitability Index} = \frac{30.114}{20} = 1.51$$

Decision: The project should be accepted.

(5) Internal Rate of Return method (IRR)

Internal Rate of Return is a percentage discount rate applied in capital investment decisions which brings the cost of a project and its expected future cash flows into equality, i.e., NPV is zero.

Example:

Project Cost ₹ 1,10,000

Cash Inflows:

Year 1	₹ 60,000
" 2	₹ 20,000
" 3	₹10,000
" 4	₹50,000

Calculate the Internal Rate of Return.

Solution:

Internal Rate of Return will be calculated by the trial and error method. The cash flow is not uniform. To have an approximate idea about such rate, we can calculate the "Factor". It represent the same relationship of investment and cash inflows in case of payback calculation i.e.

F = I/C
Where F = Factor
I = Original investment
C = Average Cash inflow per annum

Factor for the project = $\frac{110000}{35000}$ = 3.14.

The factor will be located from the table "P.V. of an Annuity of ₹ 1" representing number of years corresponding to estimated useful life of the asset.

The approximate value of 3.14 is located against 10% in 4 years.

We will now apply 10% and 12% to get (+) NPV and (-) NPV [Which means IRR lies in between]

Year	Cash Inflows (₹)	P.V. @ 10%	DCFAT (₹)	P.V. @ 12%	DCFAT (₹)
1	60,000	0.909	54,540	0.893	53,580
2	20,000	0.826	16,520	0.797	15,940
3	10,000	0.751	7,510	0.712	7,120
4	50,000	0.683	34,150	0.636	31,800
P.V. of Inflows			**1,12,720**		**1,08,440**
Less : Initial Investment			1,10,000		1,10,000
NPV			**2,720**		**(1,560)**

Graphically,

For 2%, Difference = 4,280

	10%	12%
NPV	2,720	(1560)

IRR may be calculated in two ways:

Forward Method: Taking 10%, (+) NPV

$$IRR = 10\% + \frac{\text{NPV at } 10\%}{\text{Total Difference}} \times \text{Difference in rate}$$

$$IRR = 10\% + \frac{2720}{4280} \times 2\%$$

$$= 10\% + 1.27\% = 11.27\%$$

Backward Method: Taking 12%, (-) NPV

$$IRR = 12\% + \frac{(1560)}{4280} \times 2\%$$

$$= 12\% - 0.73\% = 11.27\%$$

The decision rule for the internal rate of return is to invest in a project if its rate of return is greater than its cost of capital.

For independent projects and situations involving no capital rationing, then:

Situation	Signifies	Decision
IRR = Cost of Capital	the investment is expected not to change shareholder wealth.	Indifferent between Accepting & Rejecting
IRR > Cost of Capital	The investment is expected to increase shareholders wealth	Accept
IRR < Cost of Capital	The investment is expected to decrease shareholders wealth	Reject

Merits of Internal Rate of Return method:

- The Time Value of Money is considered.
- All cash flows in the project are considered.

Demerits of Internal Rate of Return method

- Possibility of multiple IRR, interpretation may be difficult.
- If two projects with different inflow/outflow patterns are compared, IRR will lead to peculiar situations.
- If mutually exclusive projects with different investments, a project with higher investment but lower IRR contributes more in terms of absolute NPV and increases the shareholders' wealth.

When evaluating mutually exclusive projects, the one with the highest IRR may not be the one with the best NPV.

The conflict between NPV & IRR for the evaluation of mutually exclusive projects is due to the reinvestment assumption:

- NPV assumes cash flows reinvested at the cost of capital.
- IRR assumes cash flows reinvested at the internal rate of return.

The reinvestment assumption may cause different decisions due to:

- Timing difference of cash flows.
- Difference in scale of operations.
- Project life disparity.

(6) Net Terminal Value method (NTV)

Assumption:

- Each cash flow is reinvested in another project at a predetermined rate of interest.
- Each cash inflow is reinvested elsewhere immediately after the completion of the project.

Decision-making

If the P.V. of Sum Total of the Compound reinvested cash flows is greater than the P.V. of the outflows of the project under consideration, the project will be accepted otherwise not.

Example:

Original Investment	₹ 40,000
Life of the project	4 years
Cash Inflows	₹ 25,000 for 4 years
Cost of Capital	10% p.a.

Expected interest rates at which the cash inflows will be reinvested:

Year-end	1	2	3	4
%	8	8	8	8

Solution:

First of all, it is necessary to find out the total compounded sum which will be discounted back to the present value.

Year	Cash Inflows (₹)	Rate of Int. (%)	Years. of Investment	Compounding Factor	Total Compounding Sum (₹)
1	25,000	8	3	1.260	31,500
2	25,000	8	2	1.166	29,150
3	25,000	8	1	1.080	27,000
4	25,000	8	0	1.000	25,000
					1,12,650

Present Value of the sum of compounded values by applying the discount rate @ 10%

$$\frac{\text{Compounded Value of Cash Inflow}}{(1+i)n} = \frac{112650}{(1.10)4} = 1,12,650 \times 0.683 = 76,940/-$$

[0.683 being the P.V. of ₹ 1 receivable after 4 years]

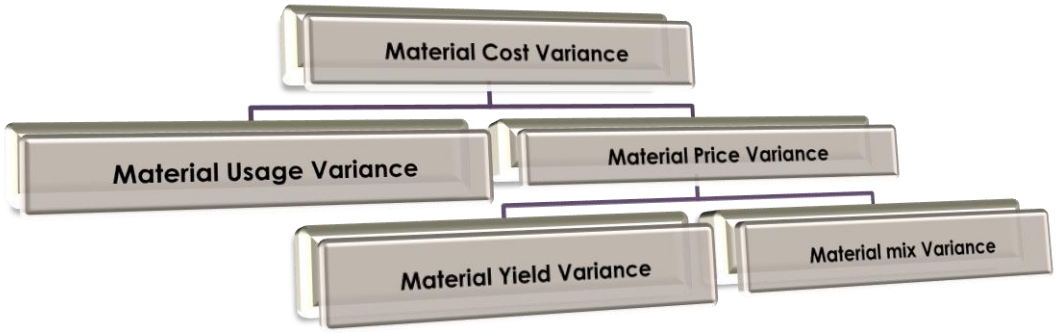
NTV = 76,940 - 40,000 = 36940

Decision: The present value of reinvested cash flows, i.e., ₹ 76,940 is greater than the original cash outlay of ₹ 40,000.

The project should be accepted as per the Net terminal value criterion.

MATERIAL VARIANCES

Material Variances mainly arise due to the efficiency in the use of materials and/ or change in Actual Price and Standard Price of materials. These can be summarized as follows:



Terms useful for Computation of Material Variances

One must know the following terms before knowing how to compute Material Variances:

1. Standard Quantity for Actual Output	**(a)** It represents the Quantity of Material which should have been consumed to produce Actual Output as per standard. **(b)** It is calculated as follows: $= \frac{\text{Standard Quantity of Material}}{\text{Standard Output}} \times \text{Actual Output}$ Or =Standard Quantity of Material required per unit of Output x Actual Output
2. Standard Cost of Standard Quantity for Actual Output	**(a)** It represents the Standard Cost of Standard Quantity for Actual Output **(b)** It is calculated as follows: = Standard Quantity of Material for Actual Output x Standard Price = SQ x SP
3. Standard Cost of Actual Quantity for Actual Output	**(a)** It represents the standard Cost of Actual Quantity for Actual Output. **(b)** It is calculated as follows: =Actual Quantity of Material x Standard Price = AQ x S P
4. Revised Quantity	**(a)** It represents the Total Actual Quantity of all Materials in a Standard Material Mix Ratio. **(b)** It is calculated by dividing the Total Actual Quantity of all Materials in a Standard Mix Ratio as follows: $= \frac{\text{Standard Quantity of one Material}}{\text{Total Standard Quantity of all Materials}} \times \text{Total Actual Quantity of all Materials}$
5. Standard Cost of Revised Quantity	**(a)** It represents the Standard Cost of Revised Quantity. **(b)** It is calculated as follows: = Revised Quantity x Standard Price = RQ x SP
6. Standard Yield	**(a)** It represents the yield (i.e. Output) which should have been obtained from Acttual

	Quantity of all Materials. **(b)** It is calculated as follows: $= \frac{\text{Standard Output}}{\text{Total Standard Quantity of all Materials}} \times \text{Total Actual Quantity of all Materials}$
7. Average Standard Price	**(a)** It represents Standard Material Cost per unit of Standard Output **(b)** It is calculated as follows: $= \frac{\text{Standard Cost of Standard Quantity of all Materials for Actual Output}}{\text{Standard Output}}$

Direct Material Cost Variance (DMCV)

Material Cost Variance is the difference between the standard cost of direct material specified for the output achieved and the actual cost of direct material consumed.

How to Calculate?

Material Cost Variance is calculated as follows:

MCV = Standard of cost of standard quantity of materials for actual output – Actual cost of actual quantity of materials consumed for actual output

Or = (Standard quantity for Actual Output x Standard Price) – (Actual Quantity x Actual Price)

Or = (SQ x SP) – (AQ x AP)

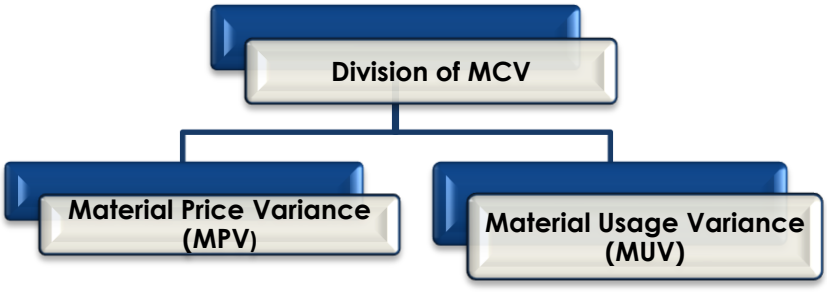
Nature

- **Favourable (F)** if the effect of the variance is to increase the profit (i.e. where actual cost is less than the standard cost.)
- **Adverse (A)** if the effect of the variance is to decrease the profit (i.e. where actual cost is more than the standard cost.)

Why arises?

MCV may arise due to:

- Change in price of material, or
- Change in quantity of material, or
- Change in price and quantity of material



Direct Material Price Variance is that portion of the material cost variance which is due to the difference between the standard price specified and the actual price paid.

How to Calculate?

Material Price Variance (MPV) is calculated as follows:
MPV = (Standard Price – Actual Price) x Actual Quantity
Or = (SP – AP) x AQ

Nature

- **Favourable (F)** if the effect of variance is to increase the profit (i.e. where AP < SP)
- **Adverse (A)** if the effect of variance is to decrease the profit (i.e. where AP > SP)

Why arises?

MPV may arise due to:

- Change in the market prices of materials.
- Change in the quantity of materials, thereby leading to lower/higher quantity discount.
- Not availing cash discounts, when standards set took into account such discounts
- Change in the delivery costs.
- Purchase of a substitute material on account of non-availability of the material specified.
- Off-season purchasing for certain seasonal products like jute, cotton etc.
- Change in the rates of excise duty, purchased tax etc.

Direct Material Usage Variance (MUV)

Direct Material Usage Variance is that portion of the material cost variance which is due to the difference between the standard quantity specified and the actual quantity consumed.

How to Calculate?

Material Usage Variance (MUV) is calculated as follows:
MUV = (Standard Quantity for Actual Output – Actual Quantity) x Standard Price
Or = (SQ – AQ) x SP

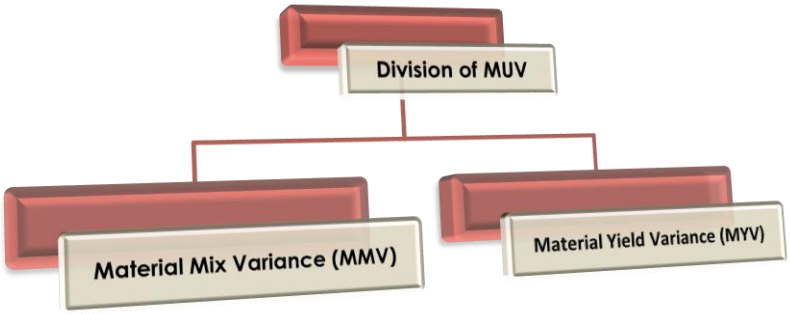
Nature

- **Favourable (F)** if the effect of variance is to increase the profit (i.e. where AQ < SQ)
- **Adverse (A)** if the effect of variance is to decrease the profit (i.e. where AQ > SQ)

Why arises?

MUV may arise due to:

- Use of non-standard materials.
- Use of non-standard material mixture.
- Use of substitute materials.
- Inefficiency in the use of material.
- Change in the equality of materials.
- Change in the design or specification of yhe product.
- Change in method of production
- Yield from materials in excess of or less than standard yield.
- Pilferage
- Defect in plant and machinery.



Direct Material Mix Variance (MMV)

Direct Material Mix Variance (MMV) is that portion of the material usage variance which is due to the difference between standard and actual composition of materials.

How to Calculate?

Material Mix Variance is calculated as follows:
MMV = Standard Cost of Revised Qty of Actual Material consumed – Standard Cost of Actual Qty of Material Consumed
Or = (RSQ x SP) – (AQ x SP)
Or = (RSQ – AQ) x SP

Nature

- **Favourable (F)** if the effect of the variance is to increase the profit (I.e. where AQ < RSQ)
- **Adverse (A)** if the effect of the variance is to decrease the profit (i.e. where AQ > RSQ)

Why arises?

- MMV arises only when the actual two or more materials are mixed in a ratio different from the standard material mix ratio. Change from standard mix may be due to the non-availability of one or more components of material mix.

Direct Material Yield Variance (MYV)

MYV is that portion of the material usage variance which is due to the difference between standard yield specified for actual quantity used and actual yield obtained. The standard yield is the output expected to be obtained from the actual usage of materials. MYV is an output variance which represents a gain or loss on output in terms of finished production.

How to Calculate?

Material Yield Variance (MYV) is calculated as follows:
MYV = (Actual Yield – Standard Yield) x Average Standard Output Price

Nature

- **Favourable (F)** if the effect of the variance is to increase the profit (I.e. where AY > SY)
- **Adverse (A)** if the effect of the variance is to decrease the profit (i.e. where AY < SY)

Why arises?

- MYV arises only when the actual loss as % of total actual input differs from the standard loss as % of total standard input.

S.V.Ltd. Manufacturers by mixing three raw materials. For every batch of 100Kg. of BXE, 125 Kg. of raw Materials are used. In April, 2015, 60 batches were prepared to produce an output of 5,600 Kg. of BXE. The standard and actual particulars for April, 2015 are as under:-

RAW MATERIAL	MIX %	PRICE PER kg	MIX %	PRICE PER kg	QUANTITY OF RAW MATERIALS PURCHASED Kg
A	50	20	60	21	5,000
B	30	10	20	8	2,000
C	20	5	20	6	1,200

Calculate Material Variances.
Answer:

	Standard data			Actual data		
	Kg.	Rate	Amount	Kg.	Rate	Amount
A	3750	20	75000	4500	21	94500
B	2250	10	22500	1500	8	12000
C	1500	5	7500	1500	6	9000
	60x125=7500		105000	7500		115500
(-)standard	60x25=1500			1900		

loss						
	6000		105000	5600		115500

DMCV = Standard cost for Actual output – Actual cost

$$= \frac{1,05,000}{6,000} \times 5,600 - 1,15,500$$

$$= 98,000 - 1,15,5000 = 17,500 (A)$$

DMPV = Actual Qty. x (SR – AR)

A = 4,500 x (20-21) = 4,500(A)

B = 1,500 x (10 – 8) = 3,000 (F)

C = 1,500 x (5 – 6) = 1,500 (A)

3,000 (A)

DMUV = Standard Rate x (Std. qty. for actual output – Actual qty.)

$$A = 20 \times \left(\frac{3,750}{6,000} \times 5,600 - 4,500 \right)$$ = 20,000 (A)

$$B = 20 \times \left(\frac{2,250}{6,000} \times 5,600 - 1,500 \right)$$ = 6,000 (F)

$$C = 5 \times \left(\frac{1,500}{6,000} \times 5,600 - 1,500 \right)$$ = 500 (A)

14,500 (A)

DMMV = Standard Rate x (Revised Std. Qty. – Actual Qty.)

A = 20 x (3,750 – 4,500) = 15,000 (A)

B = 10 x (2,250 – 1,500) = 7,500 (F)

C = 5 x (1,500 – 1,500) = -------

7,500 (A)

DMYV = SR x (Standard Qty. for actual output – Revised Std. Qty.)

A = 20 x (3,500 – 3,750) = 5,000 (A)

B = 10 x (2,100 – 2,250) = 1,500 (A)

C = 5 x (1,400 – 1,500) = 500 (A)

7,000 (A)

SMALL SERVICE PROVIDER EXEMPTION IN SERVICE TAX

Small service provider: Small service provider means a service provider, the "aggregate value" of taxable services rendered by whom, from one or more premises, does not exceed ₹ 10 lakhs in the preceding financial year.

[Aggregate Value means -

- the sum total of value of taxable services
- charged in the first consecutive invoices
- issued during a financial year

but does not include value charged in invoices issued towards such services which are exempt from whole of service tax leviable thereon u/s 66B of Finance Act, 1994]

Quantum of exemption: Exemption for aggregate value upto ₹ 10 lakhs [Notification No. 33/2012-ST, dated 20-6-2012]**.** Small service provider is entitled 100% exemption from service tax of aggregate value of taxable services upto ₹ 10 lakhs provided during the financial year. If the "aggregate value" in any financial year exceeds ₹ 10 lakhs, then such excess over ₹ 10 lakhs shall be chargeable to service tax.

Exemption is optional: The provider of taxable service has the option not to avail the exemption contained in this notification and pay service tax on the taxable services provided by him and such option, once exercised in a financial year, shall not be withdrawn during the remaining part of such financial year.

Exemption to apply service-provider wise, not for each taxable service or each premise: Where a taxable service provider provides one or more taxable services from one or more premises, this exemption shall apply to the "aggregate value" of all such taxable services and from all such premises and not separately for each premises or each services.

Small scale exemption and multiple service providers using same premises - Value of services not clubbable: One of the conditions for availing small scale service provider exemption under Notification No. 33/2012-ST, dated 20-6-2012, is that the exemption is applicable to a service provider rendering one or more services from one or more premises. Therefore, such exemption is person-specific and will be admissible even when more than one service provider uses the same premises.

Branded services - Exemption shall not apply: Taxable services provided by a person under a brand name or trade name, whether registered or not, of another person, this exemption shall not apply.

Person liable to pay service tax as recipient under Reverse Charge - Not eligible to claim this exemption: Nothing contained in this notification shall apply to such value of taxable services in respect of which service tax shall be paid by such person and in such manner as specified u/s 68(2) read with Service Tax Rules, 1994.

No CENVAT credit on input services and capital goods: The provider of taxable service shall not avail the CENVAT credit of service tax paid on any input services, under the CENVAT Credit Rules, 2004, used for providing the said taxable service, for which exemption from payment of service tax is availed of.

The provider of taxable service shall not avail the CENVAT credit under rule 3 of the said rules, on capital goods received, during the period in which the service provider avails exemption from payment of service tax under this notification.

Payment of CENVAT credit on inputs in stock on date of opting for exemption and lapsing of balance credit: The provider of taxable service who starts availing this exemption shall, -

(i) be required to pay an amount equivalent to the CENVAT credit taken by him, if any, in respect of such inputs lying in stock or in process on the date on which the provider of taxable service starts availing this exemption; and

(ii) the balance of CENVAT credit lying unutilised in the account of the taxable service provider after deducting the amount referred to in (i) above, if any, shall not be utilised and shall lapse on the day such service provider starts availing this exemption.

Computation of ₹10 lakh for goods transport agency (GTA) - Sums where person liable to pay service tax is person other than GTA not to be included: For purposes of determining aggregate value not exceeding ₹ 10 lakh, to avail exemption, in relation to taxable service provided by a goods transport agency, the payment received towards the gross amount charged by such GTA for which the person liable for paying service tax is as specified u/s 68(2) of the Finance Act, 1994 shall not be taken into account.

Illustration 1: A GTA service provider provided services valuing ₹ 20 lakh in 2014-15 and services valuing ₹ 30 lakhs in 2015-16. Out of the said sums, 60% relates to cases where the person liable to pay service tax was other than GTA. Whether GTA is eligible for this exemption in 2015-16.

Solution: Yes. Value of services provided in 2014-15 = ₹ 20 lakhs - 60% towards sum received where person liable to pay service tax was other than GTA = ₹ 8 lakh.

Hence, GTA is eligible for exemption in year 2015-16.

Aggregate value of services in 2015-16 = ₹ 30 lakhs - 60% = ₹ 12 lakhs. Out of this ₹ 10 lakhs will be exempt and balance ₹ 2 lakhs will be liable to service tax in hands of GTA. This benefit is not available to other service providers.

Points to be considered in determining the aggregate value:

(a) Aggregate value of taxable service not to include value of goods or value of material supplied by recipient of service: If goods are sold along with services, value of such goods is not includible while computing the aggregate value of ₹ 10 lakhs. Similarly, value of materials supplied by recipient of service is not required to be included while calculating the exemption limit.

(b) Activities not amounting to service - Value not includible: The aggregate value is computed for the 'taxable services'. Thus, any sum received for an activity carried out, which doesn't amount to service, cannot form part of the aggregate value, as the same is not for any service.

(c) Only service portion includible in case of declared services: In case of service providers providing declared services, only portion of service declared under section 66E will be considered.

For example, in case of service portion in execution of works contract, only the value of service portion as determined under Rule 2A of Valuation Rules, 2006 will be included in determining the value of taxable services.

(d) Services specified in negative list - Value not to be included in aggregate value: In case of service providers providing services specified in the negative list, the value of such services shall not form part of aggregate

value of taxable services under Notification No. 33/2012-ST, as the said services are not 'taxable services'.

(e) **Services wholly exempt from tax - Value not to be included in aggregate value**: The definition of aggregate value itself excludes the value of services wholly exempted under any other notification. Hence, value of wholly exempt service cannot form part of 'aggregate value' under this notification.

(f) **Abatements - Whole of the amount includible**: If any service is eligible for abatement, then, whole of the amount of value of service would be considered for computing aggregate value without excluding the abatement. For example, renting of hotel is eligible for abatement of 40% under Notification No. 26/2012-ST. In this case, even if rent charged is ₹ 100 and value after abatement is ₹ 60, the aggregate value under Notification No. 33/2012-ST will be computed by including ₹ 100.

(g) **Service provided outside Taxable territory - Not includible:** Services provided outside India are not chargeable to service tax under section 66B and are, therefore, not taxable service. Such services will not form part of aggregate value under this Notification.

Illustration 2: Mr. Thakur has provided the following services during the year 2014-15. Determine whether he is eligible for threshold exemption during the year 2015-16:

(1) Services provided outside India : ₹ 3 lakh ;
(2) Services falling under negative list: ₹ 1 lakh ;
(3) Services fully exempt under other notifications : ₹ 5 lakh ;
(4) Declared Services (Sum charged ₹ 3 lakh, but, value determined as per the valuation rules is 60% i.e., ₹ 1,80,000);
(5) Services where amount charged is ₹ 1,20,000, but, after abatement, value is ₹ 40,000;
(6) Other services provided: ₹ 7 lakh (including ₹ 1 lakh towards services where whole of the service tax was payable by the service recipient)

Solution:

Mr. Thakur would be eligible for threshold exemption under Notification No. 33/2012-ST, if the "aggregate value" of taxable services provided during the year 2014-15 is upto ₹ 10 lakhs. The relevant computations are shown below —

Case	Particulars	₹
(1) Services provided outside India	Not taxable service, as not liable to service tax u/s 66B of the Finance Act, 1994 - Not includible	NIL
(2) Services (falling under negative list)	Not taxable service, as not liable to service tax u/s 66B of the Finance Act, 1994 - Not includible	NIL
(3) Services fully exempt under other notifications	Specifically excluded in determination of aggregate value	NIL
(4) Declared Services	Value as determined as per section 67 of the Finance Act, 1994 and Valuation Rules is to be taken	1,80,000
(5) Services eligible for abatement	Abatement is a form of partial exemption. Value as per section 67 of the Finance Act, 1994 viz. ₹ 60,000 shall be taken.	1,20,000

(6) Other Services	Includible (Even services covered under reverse charge are includible) (It is assumed that Mr. Sharma is not a GTA service provider).	7,00,000
Aggregate Value under Notification No. 33/2012-ST for financial year 2014-15		10,00,000
Since the aggregate value is ₹ 10 lakhs (i.e., not exceeding ₹ 10 lakhs) during financial year 2014-15, Mr. Thakur is eligible for threshold exemption during the financial year 2015-16.		Eligible for exemption

Illustration 3: ABC Ltd. commenced its business on 1st July, 2015, in Jaipur. It has provided the following services upto 31st March, 2016, determine its service tax liability for Financial Year 2015-16:

(1) Service provided under its own brand name ₹ 23,00,000 (out of which services of ₹ 7,80,000 has been wholly exempt under Notification No. 25/2012, dated 20-06-2012).

(2) Service provided with brand name of PQR Ltd. ₹ 2,00,000, It also availed services of goods transport agency and paid freight of ₹ 2,50,000.

Solution:

Since ABC Ltd. has commenced its operations w.e.f. 1st July, 2015, it is eligible for small service providers exemption, 100% exemption from service tax is provided upto value of services of ₹ 10,00,000. Besides this, services which are wholly exempt under other notification are not included for determining eligibility limit of ₹ 10,00,000.

Such exemption shall not be applicable in the following cases:

(1) Services provided under brand name or trade name of another person.
(2) Service received from goods transport agency.

Hence, the service tax liability shall be determined as under:

	(amount in ₹)
Service provided under own brand name	23,00,000
Less: Value of services which are exempt under other notification	7,80,000
	15,20,000
Less: Small service provider exemption	10,00,000
Taxable value of services	5,20,000
Services provided under brand name of another person	2,00,000
Total Value of Services	7,20,000
Service tax @ 14.5%	1,04,400
Service tax in respect of services received from GTA – ₹2,50,000 × 30% × 14.5%	10,875
Total Service Tax	**1,15,275**

Working Note: Abatement of 70% of the amount charged by the goods transport agency is admissible. Further, entire service tax is payable by service receiver since the person liable to pay freight is a company and small service providers' exemption is not available in respect of such services.

Thank You