CMA Students Newsletter (For Final Students)

Vol.5C: March 15, 2016

SIMULATION

According to T.H. Naylor: Simulation is a numerical technique for conducting experiments on a digital computer which involves certain types of mathematical and logical relationships necessary to describe the behavior and structure of complex real world system over extended period of time."

It is a quantitative technique that utilizes a computerized mathematical model in order to represent actual decision making under conditions of uncertainty for evaluating alternative courses of action based upon facts and assumptions.

Simulation provides a trial and error movement toward the optimal solution. The decision maker selects an alternative, experiences the effect of the selection, and then improves the selection. In this way, the selection is adjusted until it approximates the optimal solution.

Simulation can serve as a preservice test to try out new policies and decision rules for operating a system, before running the risk of experimenting on the real system.

Reasons for Simulation

Major reasons for applying simulation:

1. Simulation applications have broadened in scope
2. Simulation softwares have become easy to use.
3. Cost of simulation is much less than the real life experiments.
4. Sometimes real life experiment is not feasible. For example, if we have to find the effects of different types of car accidents, doing actual experiments with the passengers in the car will be in feasible.
5. Sometimes the real life experiments are quite unsafe. For example, we have to study the effect of radiation leakage.
6. Simulation's greatest strength is its ability to answer "what if" questions.

Steps of Simulation Process

Main steps in Simulation Method

Step-1 Preliminary survey is performed to know the past behavior of the system.

Step- 2 Flow diagram is drawn to have the general idea of the system.

Step- 3 Sample observations are drawn to choose some suitable model of the system.

Step-4 Probability distributions for the variables of interest are determined and then converted into cumulative distribution function.

Step-5 A set of random numbers is drawn from random number tables.

Step-6 Determine the sequence of values of the variable of interest with the set of random numbers drawn in step 5.

Step-7 Fit some standard mathematical function to the values obtained in step 6.

Monte Carlo Simulation

Monte Carlo Method of Simulation

The Monte Carlo method is a very significant method of simulation. It is also the earliest method of simulation. Its significance can also be known from the fact that the term often use interchangeably with simulation. The Monte Carlo simulation is a numerical technique that employs random numbers and is used to solve problems that depend upon probability, where physical experimentation is impracticable and the creation of a mathematical formula impossible. It is method of Simulation by the sampling technique.

The Monte Carlo technique of simulating events breaks down into four simple steps.

1. Setting up a probability distribution for possible outcomes.
2. Establishing an interval of random numbers for each outcome.
3. Generating random numbers.
4. Actually simulating a series of trials.

The basis of Monte Carlo simulation is the generation of values for the variables comprising the model under study. Examples of variables whose outcomes we may want to simulate include

- Times between machines breakdowns
- Times between arrivals at a service facility
- Service times
- Inventory demand on a daily or weekly basis.
- Lead time for inventory orders to arrive
- Project completion times.

Advantages of Simulation

Some of the important advantages of simulation are summarized as below:

1. Simulation is a flexible model and can be modified to adjust different variations.
2. It can be used for strategic planning models.
3. It is easier technique to use than other mathematical models.
4. Training people on simulation model is easier.
5. This technique removes the requirement of costly trial and error methods of trying out new idea on new machines, equipment etc.

Disadvantages of Simulation

Disadvantages of using simulation techniques are summarized as below:

1. Simulation is not a precise method.
2. It cannot be applied in all situations.
3. Simulation model package may be very expensive.
4. It is a non-optimizing technique.

PROBLEM : SOLUTION

1. ADS Cooperative Bank receives and disburses different amount of cash in each month. The bank has an opening cash balance of ₹15 crores in the first month. The pattern of receipts and disbursements from the past data is as follows:

Monthly cash receipts		Monthly cash payments	
₹ crores	**Probability**	**₹ crores**	**Probability**
30	0.20	33	0.15
42	0.40	60	0.20
36	0.25	39	0.40
99	0.15	57	0.25

(i) Calculate probability that the ADS Cooperative Bank will fall short in payments.

(ii) Calculate average monthly shortfall.

(iii) If the ADS Cooperative Bank can get an overdraft facility of ₹45 crores from some other bank, what is the probability that they will fall short in monthly payments?

Use the following sequence of paired random numbers:

17,78	**43,16**	**74,35**	**31,23**	**72,44**	**46,92**
51,58	**68,08**	**93,58**	**54,78**	**96,54**	**09,77**

Solution:

Probability Distribution (cash receipts)

Cash Receipts	Probability	Cum. Probability	Range	Range for simulation
30	0.20	0.20	0 - 0.20	0 - 0.19
36	0.25	0.45	0.20 – 0.45	0.20 – 0.44
42	0.40	0.85	0.45 – 0.85	0.45 – 0.84
99	0.15	1.00	0.85 -1.00	0.85 - 0.99

Probability Distribution (cash payments)

Cash Payments	Probability	Cum. Probability	Range	Range for simulation
33	0.15	0.15	0 – 0.15	0 - 0.14
39	0.40	0.55	0.15 - 0.55	0.15 - 0.54
57	0.25	0.80	0.55 - 0.80	0.55 – 0.79
60	0.20	1.00	0.80 -1.00	0.80 - 0.99

Month wise Cash Flow projections (₹ crores)

Month	Opening balance	Receipts	Payments	Closing Balance
1	15	30	57	-12
2	-12	36	39	-15
3	-15	42	39	-12
4	-12	36	39	-15
5	-15	42	39	-12
6	-12	42	60	-30
7	-30	42	57	-45
8	-45	42	33	-36
9	-36	99	57	6
10	6	42	57	-9
11	-9	99	39	51
12	51	30	57	24

(i) Probability of falling short of cash = No. of short balance projected months/total number of months = 9/12=0.75.

(ii) Average monthly shortfall = (12+15+12+15+12+30+45+36+9)/9= ₹20.67 crores.

(iii) In this situation, there shall be no shortfall. As such the probability of cash shortfall (with overdraft facility) = nil

2. A single counter ticket booking centre employs one booking clerk. A passenger on arrival immediately goes to the booking counter for being served if the counter is free. If, on the other hand, the counter is engaged, the passenger will have to wait. The passengers are served on first come first served basis. The time of arrival and the time of service varies from one minute to six minutes. The distribution of arrival and service time is as under:

Arrival/Service Time (Minutes)	Arrival (Probability)	Service (Probability)
1	0.05	0.10
2	0.20	0.20
3	0.35	0.40
4	0.25	0.20
5	0.10	0.10
6	0.05	0

(i) Simulate the arrival and service of 10 passengers starting from 9 A.M. by using the following random numbers in pairs respectively for arrival and service. Random numbers 60 09, 16 12, 08 18, 36 65, 38 25, 07 11, 08 79, 59 61, 53 77, 03 10.

(ii) Determine the total duration of:
(1) Idle time of booking clerk and (2) waiting time of passengers.

Solution:

Probability Distribution (Arrival)

Time	Probability	Cum. Probability	Range	Range for simulation
1m	0.05	0.05	0 – 0.05	0 – 0.04
2m	0.20	0.25	0.05 – 0.25	0.05 – 0.24
3m	0.35	0.60	0.25 – 0.60	0.25 – 0.59
4m	0.25	0.85	0.60 – 0.85	0.60 -0.84
5m	0.10	0.95	0.85 – 0.95	0.85 – 0.94
6m	0.05	1.00	0.95 – 1.00	0.95 -0.99

Probability Distribution (Service)

Time	Probability	Cum. Probability	Range	Range for simulation
1m	0.10	0.10	0 – 0.10	0 – 0.09
2m	0.20	0.30	0.10 - 0.30	0.10 - 0.29
3m	0.40	0.70	0.30 - 0.70	0.30 – 0.69
4m	0.20	0.90	0.70 – 0.90	0.70 -0.89
5m	0.10	1.00	0.90- 1.00	0.90 – 0.99

Passenger S. No.	Arrival time	Service begins	Service completes	Waiting time	Idle time
1	9.04	0.04	9.05	Nil	4m
2	9.06	9.06	9.08	Nil	1m
3	9.08	9.08	9.10	Nil	Nil
4	9.11	9.11	9.14	Nil	1m
5	9.14	9.14	9.16	Nil	Nil
6	9.16	9.16	9.18	Nil	Nil

7	9.18	9.18	9.22	Nil	Nil
8	9.21	9.22	9.25	1m	Nil
9	9.24	9.25	9.29	1m	Nil
10	9.25	9.29	9.31	4m	Nil
Total				6m	6m

3. An investment corporation wants to study the investment project based on three factors: market demand in units, contribution (sales price- variable cost) per unit and investment required. These factors are felt to be independent of each other. In analyzing a new consumer product for a washing powder factory the corporation estimates the following probability distributions:

Annual demand		**Contribution per unit**		**Required investment**	
Units	**Probability**	**₹**	**Probability**	**₹**	**Probability**
20,000	**0.05**	**3.00**	**0.10**	**17,50,000**	**0.25**
25,000	**0.10**	**5.00**	**0.20**	**20,00,000**	**0.50**
30,000	**0.20**	**7.00**	**0.40**	**25,00,000**	**0.25**
35,000	**0.30**	**9.00**	**0.20**		
40,000	**0.20**	**10.00**	**0.10**		
45,000	**0.10**				
50,000	**0.05**				

Using Monte-Carlo simulation for 10 runs, estimate the percentageof return on investment (ROI%) defined by

$$ROI\,\% = \frac{\text{Cash inflow}}{\text{Investment}} \times 100$$

For each run, recommend an optimum investment strategy based on model value of ROI %.
Use the following sets of random numbers:
28,57,60,17,64,20,27,58,61,30; 19,07,90,02,57,28,29,83,58,41 and 18,67,16,71,43,68,47,24,19,97 respectively for each of the 10 simulation run.

Solution:

To determine a cumulative probability distribution corresponding to each of the three factors, appropriate set of random numbers representing each of the three factors are assigned below:

Annual demand	Probability	Cum. Probability	Random Numbers
20,000	0.05	0.05	00-04
25,000	0.10	0.15	05-14
30,000	0.20	0.35	15-34
35,000	0.30	0.65	35-64
40,000	0.20	0.85	65-84
45,000	0.10	0.95	85-94
50,000	0.05	1.00	95-99

Contribution per unit (₹)	Probability	Cum. Probability	Random Numbers
3.00	0.10	0.10	00-09
5.00	0.20	0.30	10-29
7.00	0.40	0.70	30-69
9.00	0.20	0.90	70-89
10.00	0.10	1.00	90-99

Investment required (₹)	Probability	Cum. Probability	Random Numbers
17,50,000	0.25	0.25	00-24
20,00,000	0.50	0.75	25-74
25,00,000	0.25	1.00	75-99

New simulated work sheet for 10 trials. The simulated return on investment (ROI) is also calculated by using formula for ROI %. The results of simulation are shown in the table given below:

Trials	RN for demand	Simulated Demand('000)	RN for Contribution	Simulated Contribution (₹)	RN for investment	Simulated Investment ('000)	Simulated return ROI %
1	28	30	19	5.00	18	1750	8.57*
2	57	35	07	3.00	67	2000	5.25
3	60	35	90	10.00	16	1750	20.00
4	17	30	02	3.00	71	2000	4.50
5	64	35	57	7.00	43	2000	12.25
6	20	30	28	5.00	68	2000	7.50
7	27	30	29	5.00	47	2000	7.50
8	58	35	83	9.00	24	1750	18.00
9	61	35	58	7.00	19	1750	14.00
10	30	30	41	7.00	97	2500	8.40

*Simulated Return on Investment $ROI\,\% = \frac{\text{Cash inflow}}{\text{Investment}} \times 100$ **=** $[(30\times5)/1750]\times100 = 8.57\%$

Rests of the values have been worked out similarly.

The above table shows the highest likely ROI % of 20%, which is corresponding to the annual demand of 35,000 units resulting in a profit of ₹10 per unit and the required investment will be ₹17,50,000.

THANK YOU

STRATEGIC ALLIANCE

A strategic alliance is a partnership of two or more corporations or business units to achieve strategically significant objectives that are mutually beneficial. Alliances between companies or business units have become a fact of life in modern business. More than 20,000 alliances occurred between 1992 and 1997, quadruple the total five years earlier. Some alliances are very short term, only lasting long enough for one partner to establish a beachhead in a new market. Over time, conflicts over objectives and control often develop among the partners. For these and other reasons, between 30% and 50% of all alliances perform unsatisfactorily. Others are more long lasting and may even be the prelude to a full merger between two companies. A study by Cooper and Lybrand found that firms involved in strategic alliances had 11% higher revenue and 20% higher growth rate than did companies not involved in alliances.

Companies or business units may form a strategic alliance for a number of reasons, including:

(a) To obtain technology and/or manufacturing capabilities: For example, Intel formed a partner-ship with Hewlett-Packard to use HP's capabilities in RISC technology in order to develop the successor to Intel's Pentium microprocessor.

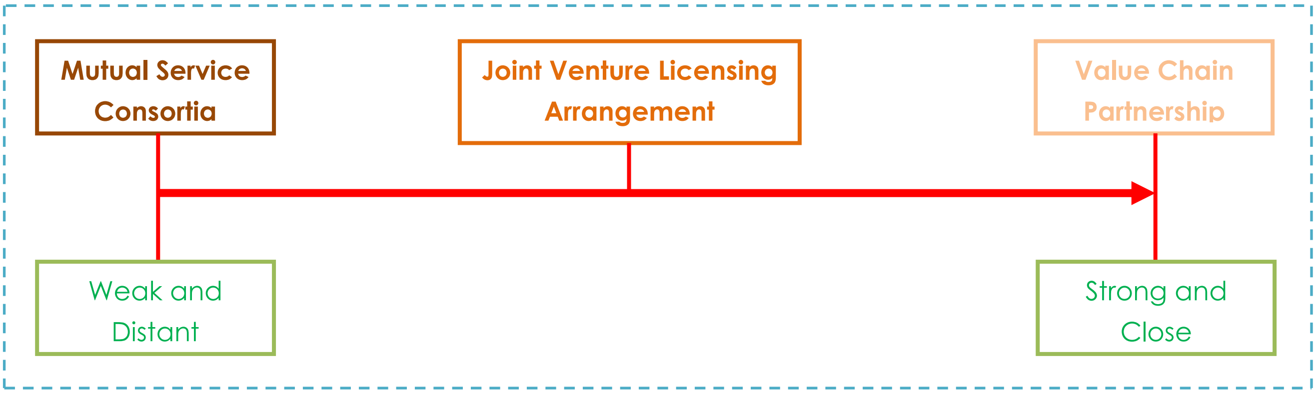
(b) To obtain access to specific markets: Rather than buy a foreign company or build its own manufacturing facilities, P&G licensed the Old Spice trademark and business to a Goa based company for a period of ten years to manufacture, sell, distribute and market the Old Spice products in India, Sri Lanka and Bangladesh.

(c) To reduce financial risk: For example, because the costs of developing a new large jet airplane were becoming too high for any one manufacturer, Boeing, Aerospatiale of France, British Aerospace, Construcciones Aeronauticas of Spain, and Deutsche Aerospace of Germany planned a joint venture to design such a plane.

(d) To reduce political risk: To gain access to Srilanka while ensuring a positive relationship with the often sensitive Srilankan government, Indian Oil Corporation formed a MoC (Memorandum of Collaboration) with Ceylon Petroleum Corporation for Indian Oil's entry into the downstream petroleum sector.

(e) To achieve or ensure competitive advantage: General Motors and Toyota formed Nummi Corporation as a joint venture to provide Toyota a manufacturing facility in the United States and GM access to Toyota's low-cost, high-quality manufacturing expertise.

Cooperative arrangements between companies and business units fall along a continuum from weak and distant to strong and close. (See Figure below) The types of alliances range from mutual service consortia to joint ventures and licensing arrangements to value-chain partnerships.



Mutual Service Consortia

A mutual service consortium is a partnership of similar companies in similar industries who pool their resources to gain a benefit that is too expensive to develop alone, such as access to advanced technology. For example, IBM of the United States, Toshiba of Japan, and Siemens of Germany formed a consortium to develop new generations of computer chips. As part of this alliance, IBM offered Toshiba its expertise in chemical mechanical polishing to help develop a new manufacturing process using ultraviolet lithography to etch tiny circuits in silicon chips. IBM then transferred the new technology to a facility in the United States. The mutual service consortia is a fairly weak and distant alliance—appropriate for partners who wish to work together but not share their core competencies. There is very little interaction or communication among the partners.

Joint Venture

A joint venture is a "cooperative business activity, formed by two or more separate organizations for strategic purposes, that creates an independent business entity and allocates ownership, operational responsibilities, and financial risks and rewards to each member, while preserving their separate identity/autonomy." Along with licensing arrangements, joint ventures lay at the midpoint of the continuum and are formed to pursue an opportunity that needs a capability from two companies or business units, such as the technology of one and the distribution channels of another.

Joint ventures are the most popular form of strategic alliance. They often occur because the companies involved do not want to or cannot legally merge permanently. Joint ventures provide a way to temporarily combine the different strengths of partners to achieve an outcome of value to both. For example, Indian Oil Corporation (IOC) and Oil tanking GmbH formed a joint venture in 1996 in the name of Indian Oil tanking Limited with equal equity stake to build and operate terminal ling services for petroleum products.

Extremely popular in international undertakings because of financial and political-legal constraints, joint ventures are a convenient way for corporations to work together without losing their indepen-dence. Disadvantages of joint ventures include loss of control, lower profits, probability of conflicts with partners, and the likely transfer of technological advantage to the partner. Joint ventures are often meant to be temporary, especially by some companies who may view them as a way to rectify a competitive weakness until they can achieve long-term dominance in the partnership. Partially for this reason, joint ventures have a high failure rate. Research does indicate, however, that joint ventures tend to be more successful when both partners have equal ownership in the venture and are mutually dependent on each other for results.

Licensing Arrangement

A licensing arrangement is an agreement in which the licensing firm grants rights to another firm in another country or market to produce and/or sell a product. The licensee pays compensation to the licensing firm in return for technical expertise. Licensing is an especially useful strategy if the trademark or brand name is well known, but the MNC does not have sufficient funds to finance its entering the country directly. P&G licensed the Old Spice trademark and business to a Goa based company, Menezes Cosmetics Pvt Ltd ,for a period of ten years to manufacture, sell, distribute and market the Old Spice products in India, Sri Lanka and Bangladesh. This strategy also becomes important if the country makes entry via investment either difficult or impossible. The danger always exists, however, that the licensee might develop its competence to the point that it becomes a competitor to the licensing firm. Therefore, a company should never license its distinctive competence, even for some short-run advantage.

Value-Chain Partnerships

The value-chain partnership is a strong and close alliance in which one company or unit forms a long-term arrangement with a key supplier or distributor for mutual advantage. To improve the quality of parts it purchases, companies in the U.S. auto industry, for example, have decided to work more closely with fewer suppliers and to involve them more in product design decisions. Activities that had been previously done internally by an auto maker are being outsourced to suppliers specializing in those activities.

Such partnerships are also a way for a firm to acquire new technology to use in its own products. For example, Maytag Company was approached by one of its suppliers, Honeywell's Microswitch Division, which offered its expertise in fuzzy logic technology—a technology Maytag did not have at that time. The resulting partnership in product development resulted in Maytag's new IntelliSense™ dishwasher. Unlike previous dishwashers that the operator had to set, Maytag's fuzzy logic dishwasher automatically selected the proper cleaning cycle based on a series of factors such as the amount of dirt and presence of detergent. According to Paul Ludwig, business development manager for Honeywell's Microswitch division, "Had Maytag not included us on the design team, we don't believe the two companies would have achieved the same innovative solution, nor would we have completed the project in such a short amount of time." The benefits of such relationships do not just accrue to the purchasing firm. Research suggests that suppliers who engage in long-term relationships are more profitable than suppliers with multiple short-term contracts.38 For an example of an Internet value-chain partnership between Cisco Systems and its suppliers.

All forms of strategic alliances are filled with uncertainty. There are many issues that need to be dealt with when the alliance is initially formed and others that emerge later. Many problems revolve around the fact that a firm's alliance partners may also be its competitors, either now or in the future. According to Peter Lorange, an authority in strategy, one thorny issue in any strategic alliance is how to cooperate without giving away the company or business unit's core competence. "Particularly when advanced technology is involved, it can be difficult for partners in an alliance to cooperate and openly share strategic know-how, but it is mandatory if the joint venture is to succeed."39 It is therefore important that a company or business unit that is interested in joining or forming a strategic alliance consider the different strategic alliance success factors.

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

G. Income Computation and Disclosure Standard VII relating to government grants 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 account.

In 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 the treatment of Government grants. The Government grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, waiver, concessions, reimbursements, etc.

2. This Income Computation and Disclosure Standard does not deal with:—

(a) Government assistance other than in the form of Government grants; and

(b) Government participation in the ownership of the enterprise.

3. Definitions

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

(a) "Government" refers to the Central Government, State Governments, agencies and similar bodies, whether local, national or international.

(b) "Government grants" are assistance by Government in cash or kind to a person for past or future compliance with certain conditions. They exclude those forms of Government assistance which cannot have a value placed upon them and the transactions with Government which cannot be distinguished from the normal trading transactions of the person.

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

4. Recognition of Government Grants

(1) Government grants should not be recognised until there is reasonable assurance that (i) the person shall comply with the conditions attached to them, and (ii) the grants shall be received.

(2) Recognition of Government grant shall not be postponed beyond the date of actual receipt.

5. Treatment of Government Grants

Where the Government grant relates to a depreciable fixed asset or assets of a person, the grant shall be deducted from the actual cost of the asset or assets concerned or from the written down value of block of assets to which concerned asset or assets belonged to.

6. Where the Government grant relates to a non-depreciable asset or assets of a person requiring fulfillment of certain obligations, the grant shall be recognised as income over the same period over which the cost of meeting such obligations is charged to income.

7. Where the Government grant is of such a nature that it cannot be directly relatable to the asset acquired, so much of the amount which bears to the total Government grant, the same proportion as such asset bears to all the assets in respect of or with reference to which the Government grant is so received, shall be deducted from the actual cost of the asset or shall be reduced from the written down value of block of assets to which the asset or assets belonged to.

8. The Government grant that is receivable as compensation for expenses or losses incurred in a previous financial year or for the purpose of giving immediate financial support to the person with no further related costs, shall be recognised as income of the period in which it is receivable.

9. The Government grants other than covered by paragraph 5, 6, 7, and 8 shall be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate.

10. The Government grants in the form of non-monetary assets, given at a concessional rate, shall be accounted for on the basis of their acquisition cost.

11. Refund of Government Grants

The amount refundable in respect of a Government grant referred to in paragraphs 6, 8 and 9 shall be applied first against any unamortised deferred credit remaining in respect of the Government grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount shall be charged to profit and loss statement.

12. The amount refundable in respect of a Government grant related to a depreciable fixed asset or assets shall be recorded by increasing the actual cost or written down value of block of assets by the amount refundable. Where the actual cost of the asset is increased, depreciation on the revised actual cost or written down value shall be provided prospectively at the prescribed rate.

13. Transitional Provisions

All the Government grants which meet the recognition criteria of para 4 on or after 1st day of April, 2015 shall be recognised for the previous year commencing on or after 1st day of April, 2015 in accordance with the provisions of this standard after taking into account the amount, if any, of the said Government grant recognised for any previous year ending on or before 31st day of March, 2015.

14. Disclosures

Following disclosure shall be made in respect of Government grants, namely:—

(a) nature and extent of Government grants recognised during the previous year by way of deduction from the actual cost of the asset or assets or from the written down value of block of assets during the previous year;

(b) nature and extent of Government grants recognised during the previous year as income;

(c) nature and extent of Government grants not recognised during the previous year by way of deduction from the actual cost of the asset or assets or from the written down value of block of assets and reasons thereof; and

(d) nature and extent of Government grants not recognised during the previous year as income and reasons thereof.

H. Income Computation and Disclosure Standard VIII relating to securities 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 account.

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 securities held as stock in-trade.

2. This Income Computation and Disclosure Standard does not deal with:

(a) the bases for recognition of interest and dividends on securities which are covered by the Income Computation and Disclosure Standard on revenue recognition;

(b) securities held by a person engaged in the business of insurance;

(c) securities held by mutual funds, venture capital funds, banks and public financial institutions formed under a Central or a State Act or so declared under the Companies Act, 1956 or the Companies Act, 2013.

3. Definitions

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

(a) "Fair value" is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

(b) "Securities" shall have the meaning assigned to it in clause (h) of section 2 of the Securities Contract (Regulation) Act, 1956, other than Derivatives referred to in sub-clause (Ia) of that clause.

(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.

4. Recognition and Initial Measurement of Securities

A security on acquisition shall be recognised at actual cost.

5. The actual cost of a security shall comprise of its purchase price and include acquisition charges such as brokerage, fees, tax, duty or cess.

6. Where a security is acquired in exchange for other securities, the fair value of the security so acquired shall be its actual cost.

7. Where a security is acquired in exchange for another asset, the fair value of the security so acquired shall be its actual cost.

8. Where unpaid interest has accrued before the acquisition of an interest-bearing security and is included in the price paid for the security, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion of the interest is deducted from the actual cost.

9. Subsequent Measurement of Securities

At the end of any previous year, securities held as stock-in-trade shall be valued at actual cost initially recognised or net realisable value at the end of that previous year, whichever is lower.

10. For the purpose of para 9, the comparison of actual cost initially recognised and net realisable value shall be done categorywise and not for each individual security. For this purpose, securities shall be classified into the following categories, namely:

(a) shares;

(b) debt securities;

(c) convertible securities; and

(d) any other securities not covered above.

11. The value of securities held as stock-in-trade of a business as on the beginning of the previous year shall be:

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

(b) the value of the securities of the business as on the close of the immediately preceding previous year, in any other case.

12. Notwithstanding anything contained in para 9, 10 and 11, at the end of any previous year, securities not listed on a recognised stock exchange; or listed but not quoted on a recognised stock exchange with regularity from time to time, shall be valued at actual cost initially recognised.

13. For the purposes of para 9, 10 and 11 where the actual cost initially recognised cannot be ascertained by reference to specific identification, the cost of such security shall be determined on the basis of first-in-first-out method.

I. Income Computation and Disclosure Standard IX relating to borrowing costs 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 account.

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

(1) This Income Computation and Disclosure Standard deals with treatment of borrowing costs.

(2) This Income Computation and Disclosure Standard does not deal with the actual or imputed cost of owners' equity and preference share capital.

2. Definitions

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

(a) "Borrowing costs" are interest and other costs incurred by a person in connection with the borrowing of funds and include:

(i) commitment charges on borrowings;

(ii) amortised amount of discounts or premiums relating to borrowings;

(iii) amortised amount of ancillary costs incurred in connection with the arrangement of borrowings;

(iv) finance charges in respect of assets acquired under finance leases or under other similar arrangements.

(a) "Qualifying asset" means:

(i) land, building, machinery, plant or furniture, being tangible assets;

(ii) know-how, patents, copyrights, trade marks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets;

(iii) inventories that require a period of twelve months or more to bring them to a saleable condition.

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

3. Recognition

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset shall be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation shall be determined in accordance with this Income Computation and Disclosure Standard. Other borrowing costs shall be recognised in accordance with the provisions of the Act.

4. For the purposes of this Income Computation and Disclosure Standard, "capitalisation" in the context of inventory referred to in item (iii) of clause (b) of sub-paragraph (1) of paragraph 2means addition of borrowing cost to the cost of inventory.

5. Borrowing Costs Eligible for Capitalisation

To the extent the funds are borrowed specifically for the purposes of acquisition, construction or production of a qualifying asset, the amount of borrowing costs to be capitalised on that asset shall be the actual borrowing costs incurred during the period on the funds so borrowed.

6. To the extent the funds are borrowed generally and utilised for the purposes of acquisition, construction or production of a qualifying asset, the amount of borrowing costs to be capitalised shall be computed in accordance with the following formula namely:—

$$A \times \frac{B}{C}$$

Where

A = borrowing costs incurred during the previous year except on borrowings directly relatable to specific purposes;

B = (i) the average of costs of qualifying asset as appearing in the balance sheet of a person on the first day and the last day of the previous year;

(ii) in case the qualifying asset does not appear in the balance sheet of a person on the first day or both on the first day and the last day of previous year, half of the cost of qualifying asset;

(iii) in case the qualifying asset does not appear in the balance sheet of a person on the last day of previous year, the average of the costs of qualifying asset as appearing in the balance sheet of a person on the first day of the previous year and on the date of put to use or completion, as the case may be, other than those qualifying assets which are directly funded out of specific borrowings; or

C = the average of the amount of total assets as appearing in the balance sheet of a person on the first day and the last day of the previous year, other than those assets which are directly funded out of specific borrowings;

7. Commencement of Capitalisation

The capitalisation of borrowing costs shall commence:

(a) in a case referred to in paragraph 5, from the date on which funds were borrowed;

(b) in a case referred to in paragraph 6, from the date on which funds were utilised.

8. Cessation of Capitalisation

Capitalisation of borrowing costs shall cease:

(a) in case of a qualifying asset referred to in item (i) and (ii) of clause (b) of subparagraph (1) of paragraph 2, when such asset is first put to use;

(b) in case of inventory referred to in item (Hi) of clause (b) of sub-paragraph (1) of paragraph 2, when substantially all the activities necessary to prepare such inventory for its intended sale are complete.

9. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalization of borrowing costs in relation to a part shall cease:—

(a) in case of part of a qualifying asset referred to in item (i) and (ii) of clause (b) of sub-paragraph (1) of paragraph 2, when such part of a qualifying asset is first put to use;

(b) in case of part of inventory referred to in item (Hi) of clause (b) of sub-paragraph (1) of paragraph 2, when substantially all the activities necessary to prepare such part of inventory for its intended sale are complete.

10. Transitional Provisions

All the borrowing costs incurred on or after 1st day of April, 2015 shall be capitalized for the previous year commencing on or after 1st day of April, 2015 in accordance with the provisions of this standard after taking into account the amount of borrowing costs capitalised, if any, for the same borrowing for any previous year ending on or before 31st day of March, 2015.

11. Disclosure

The following disclosure shall be made in respect of borrowing costs, namely:—

(a) the accounting policy adopted for borrowing costs; and

(b) the amount of borrowing costs capitalised during the previous year.

J. Income Computation and Disclosure Standard X relating to provisions, contingent liabilities and contingent assets

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 provisions, contingent liabilities and contingent assets, except those:

(a) resulting from financial instruments;

(b) resulting from executory contracts;

(c) arising in insurance business from contracts with policyholders; and

(d) covered by another Income Computation and Disclosure Standard.

2. This Income Computation and Disclosure Standard does not deal with the recognition of revenue which is dealt with by Income Computation and Disclosure Standard - Revenue Recognition.

3. The term 'provision' is also used in the context of items such as depreciation, impairment of assets and doubtful debts which are adjustments to the carrying amounts of assets and are not addressed in this Income Computation and Disclosure Standard.

4. Definitions

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

(a) "Provision" is a liability which can be measured only by using a substantial degree of estimation.

(b) "Liability" is a present obligation of the person arising from past events, the settlement of which is expected to result in an outflow from the person of resources embodying economic benefits.

(c) "Obligating event" is an event that creates an obligation that results in a person having no realistic alternative to settling that obligation.

(d) "Contingent liability" is:

(i) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the person; or

(ii) a present obligation that arises from past events but is not recognised because:

A. it is not reasonably certain that an outflow of resources embodying economic benefits will be required to settle the obligation; or

B. a reliable estimate of the amount of the obligation cannot be made.

(e) "Contingent asset" is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the person.

(f) "Executory contracts" are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

(g) "Present obligation" is an obligation if, based on the evidence available, its existence at the end of the previous year is considered reasonably certain.

(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.

Recognition

5. Provisions

A provision shall be recognised when:

(a) a person has a present obligation as a result of a past event;

(b) it is reasonably certain that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision shall be recognised.

6. No provision shall be recognised for costs that need to be incurred to operate in the future.

7. It is only those obligations arising from past events existing independently of a person's future actions, that is the future conduct of its business, that are recognised as provisions.

8. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is enacted.

9. Contingent Liabilities

A person shall not recognise a contingent liability.

10. Contingent Assets

A person shall not recognise a contingent asset.

11. Contingent assets are assessed continually and when it becomes reasonably certain that inflow of economic benefit will arise, the asset and related income are recognised in the previous year in which the change occurs.

Measurement

12. Best Estimate

The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the previous year. The amount of a provision shall not be discounted to its present value.

13. The amount recognised as asset and related income shall be the best estimate of the value of economic benefit arising at the end of the previous year. The amount and related income shall not be discounted to its present value.

14. Reimbursements

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognised when it is reasonably certain that reimbursement will be received if the person settles the obligation. The amount recognised for the reimbursement shall not exceed the amount of the provision.

15. Where a person is not liable for payment of costs in case the third party fails to pay, no provision shall be made for those costs.

16. An obligation, for which a person is jointly and severally liable, is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

17. Review

Provisions shall be reviewed at the end of each previous year and adjusted to reflect the current best estimate. If it is no longer reasonably certain that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

18. An asset and related income recognised as provided in para 11 shall be reviewed at the end of each previous year and adjusted to reflect the current best estimate. If it is no longer reasonably certain that an inflow of economic benefits will arise, the asset and related income shall be reversed.

19. Use of Provisions

A provision shall be used only for expenditures for which the provision was originally recognised.

20. Transitional Provisions

All the provisions or assets and related income shall be recognised for the previous year commencing on or after 1st day of April, 2015 in accordance with the provisions of this standard after taking into account the amount recognised, if any, for the same for any previous year ending on or before 31st day of March, 2015.

21. Disclosure

(1) Following disclosure shall be made in respect of each class of provision, namely:

(a) a brief description of the nature of the obligation;

(b) the carrying amount at the beginning and end of the previous year;

(c) additional provisions made during the previous year, including increases to existing provisions;

(d) amounts used, that is incurred and charged against the provision, during the previous year;

(e) unused amounts reversed during the previous year; and

(f) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

(2) Following disclosure shall be made in respect of each class of asset and related income recognised as provided in para 11, namely:—

(a) a brief description of the nature of the asset and related income;

(b) the carrying amount of asset at the beginning and end of the previous year;

(c) additional amount of asset and related income recognised during the year, including increases to assets and related income already recognised; and

(d) amount of asset and related income reversed during the previous year.

TAXATION OF COMPANIES

Company [Sec. 2(17)]

Indian co. or Foreign Co. or company notified by CBDT.

Domestic Company [Sec. 2(22A)]

Indian Company or Other Company liable to pay tax and made arrangements for declaration and payment of dividend within India out of such Income.

Foreign Company [Sec. 2(23A)]

Company which is not a Domestic Company.

Indian Company [Sec. 2(26)]

Company formed under Companies Act, 1956 or under Central or State Provincial Act or notified by CBDT to be a Company or in case of state of J&K, Union Territories, a Company formed and registered under any law in force in that State or Union Territory.

NOTE: In all cases Principal or Registered Office should be in India.

Company in which Public are substantially interested [Sec. 2(18)]

(a) Not less than 40% of Shares held by Government or RBI.
(b) Company under Sec.25 of Companies Act. [Sec.8 of Companies Act, 2013.]
(c) Company having no Share Capital notified by the Board.
(d) Mutual Benefit Company under the Companies Act.
(e) Not less than 50% voting power held by Co-operative Societies for whole year.
(f) Public Company which is -(i) Listed Company on the last day of RPY, or (ii) Not less than 50% voting power held by Government or Corporation or Other Company in which Public are substantially interested.

Substantial Interest [Sec. 2(32)]

(a) **For Company:** Not less than 20% of Voting Power,
(b) **For Non-Corporate:** Not less than 20% of the Share of Profits.

Amalgamation [Sec. 2(IB)]

Merger with conditions - (a) All Assets transfer, (b) All Liabilities transfer, (c) not less than 75% in Value to become Shareholders of Amalgamated Company.

Demerger [Sec. 2(19AA)]

Conditions - (a) All Assets transfer, (b) All Liabilities transfer, (c) Transfer at Book Value, (d) Consideration = own Shares, (e) not less than 75% in Value Shareholding, (f) Going Concern, (g) Govt. Guidelines.

Residence of a Company [Sec. 6(3)]

Indian Company: Resident.
Other Company: (a) If Control & Management wholly in India -Resident, (b) Otherwise - Non-Resident.

Losses for Closely Held Companies [Sec. 79)]

51% Voting Power to be held by the same persons shall continue in the year of incurring loss to the last day of year of set-off of loss. (Not applicable for Unabsorbed Depreciation.)

Minimum Alternate Tax [Sec. 115JB]

Tax on Total Income, or 18.5% Tax on Book Profit, whichever is **higher.**

Dividend Income of an Indian Company [Sec. 115BBD]

Income by way of Dividend declared, distributed or paid by a Specified Foreign Company shall be taxed at 15% w.e.f 01.04.2012. Specified Foreign Company means a Foreign Company in which Indian Company holds not less than 26% of Nominal Value of Equity Share Capital.
Note: w.e.f 01.04.2015 Sec.115BBD extended without restriction as to time periods.

Dividend Tax / Dividend Distribution Tax (DDT) [Sec. 115-0]

1. Only Domestic Companies are liable. W.e.f 01.06.2011, Dividend Distribution Tax should be paid on Dividend declared by SEZ Developers.
2. Dividends includes all Dividends except u/s 2(22)(e).
3. Dividends subject to DDT shall be reduced by -
   - Dividend received from its Subsidiary if Subsidiary has paid DDT, or Sec.115BBD case,
   - Dividend paid to New Pension Trust u/s 10(44)
4. **Rate:** 15% of Dividend declared or distributed or paid, + SC + EC and SHEC, i.e 16.995%.
5. **Quantum of Tax: [w.e.f 01.10.2014]:**
   - Net Dividend to which Sec.115-O applies [i.e. as above] is called **Net Distributed Profits.**
   - For determining Tax Payable u/s 115-0, Net Distributed Profits shall be increased by =

   Dividend Distributed $\times \dfrac{100\%}{100\% - 15\%}$ Thus, Dividend includes Dividend Distribution Tax.
6. **Time limit:** Within 14 days from declaration/distribution / payment, whichever is **earlier.**

Buyback of Shares (not listed on RSE), by Domestic Co. [S.115QA]

- Tax = 20% on Distributed Income, i.e. Consideration paid on Buy-back **less** Amount received by the Company for issue of shares.
- Tax Payment within 14 days of payment of consideration for buy-back.

Dividend Tax on Mutual Funds [Sec.115R]

Nature of the fund	Amount distributed to	
	Individual/HUF	Any Person
Money Market Mutual Fund/Liquid Fund	25%	30%
Other than Money Market Mutual Fund/Liquid Fund	12.5%/25%	30%

W. e. f 01.10.2014 for determining the Additional Income tax payable u/s 115 – R the amount of Distributed Income shall be increased by the amount .

$$= \text{Income distributed} \times \frac{100\%}{100\% - \text{Rate}}$$

Distribution by Securitization Trusts [S.115TA]

1. Payment to Individual / HUF: 25%, Any Other Person - 30%.
2. Securitization Trust is as per SEBI / RBI Regulations.

Income received from Venture Capital Cos. [Sec.115U]

- Venture Capital Co. not liable u/s 115-0 / 115R. Income chargeable in the hands of Investor. Person responsible for making payment shall furnish Form 64 within 30th Nov of FY following the PY in which income is distributed.
- Any income accruing, arising or received by a person out of investments made in a VCC or VCF shall be chargeable to Income Tax, as if the Income were received by such person directly in the VCU. Income is deemed as of same nature, extent & proportion.

Special Provisions relating to Business Trust [Sec.115UA] [w.e.f 01.10.2014]

1. Income distributed by a Business Trust to its Unit Holders, shall be deemed to be of the same nature and in the same nature in the hands of the Unit Holder, as it had been received by, or accrued to the Business Trust.
2. Taxability for Business Trust at the **Maximum Marginal Rate.** [Subject to Sec.111A and Sec.112]
3. **Taxability for Unit Holder:** Distributed Income or any part thereof received by a Unit Holder from the Business Trust, being of the nature referred in Sec.10(23C)
4. **Furnishing of Statement:**
   (a) By Person responsible for making payment of income distributed on behalf of a Business Trust, to a Unit Holder.
   (b) To the Unit Holder, and Prescribed Authority.
   (c) Nature of Income paid during the PY, and other prescribed details.

Liquidator's Liability [Sec.148]

1. Intimation to AO within 30 days of appointment.
2. Set aside amount notified by AO and not part with any assets or properties of Company.
3. Exceptions for payment under Court Order, Tax, Priority Debts and Cost of winding up.

Directors of Pvt. Co in Liquidation [Sec.179]

1. Director is liable to all the sums due under the Act for any previous year during which he was a Director.
2. Company liable for punishment with Fine. Directors liable for prosecution / imprisonment.

COMPUTATION OF BOOK PROFIT U/S 115Jb FOR COMPANIES

Particulars	Rs.	Rs.
Net Profit: (a) For Companies governed by Companies Act: Profit & Loss Account as per Part II of Schedule III (b) For Sec. 211(2) Proviso Companies: Profit and Loss Account prepared in accordance with the provisions of the Act governing such Company.		xx
Add: If debited to Profit and Loss Account		
1. Income Tax Paid / Payable or Provision for Tax **including** (i) Dividend Distribution Tax u/s 115-0 / 115R, (ii) Interest, (iii) SC, (iv) EC, and (v) SHEC **(excluding** Fringe Benefits Tax, BCTT)	xx	
2. Amount credited to Reserves by whatever name called, other than Sec.33AC Reserve for Shipping Business	xx	
3. Provision for Unascertained Liabilities	xx	
4. Provision for Losses of Subsidiary Companies	xx	
5. Dividends Paid / Proposed	xx	
6. Expenditure related to Exempt Incomes u/s 10/11/12 **[except 10(38)]**	xx	
7. Depreciation	xx	
8. Deferred tax including Provision therefor	xx	
9. Provision for Diminution in value of Assets	xx	
Add: If not credited to profit and Loss Account: Amount standing in revaluation reserve relating to revalued asset, on the retirement or disposal of such asset.	xx	xx
Sub Total		**xx**
Less: If credited to Profit and Loss Account		
1. Amount withdrawn from any Reserves / Provisions (See Notes (a) & (b) below)	xx	
2. Income Exempt u/s 10 / 11 / 12 **[except 10(38)]**	xx	
3. Brought Forward Loss (other than Depreciation) or Unabsorbed Depreciation, whichever is **less,** as per books of accounts **[Note:** No deduction in case either Brought Forward Loss or Unabsorbed Depreciation is **NIL]** as per Books.	xx	
4. Profits derived from Sick Industrial Undertakings.	xx	
5. Depreciation debited excluding Depreciation on account of revaluation of asset	xx	
6. Withdrawal from Revaluation Reserve to the extent it does not exceed the amount of Depreciation on account of revaluation	xx	
7. Profits of a Tonnage Tax Company (as per books) [Though Sec.115JB does not require this deduction, Sec. 115-VO specifically provides for exclusion of profits as per books from Tonnage Activities from Book Profit u/s 115JB]	xx	
8. Deferred Tax	xx	
BOOK PROFIT		**xx**

Note:

(a) The amount withdrawn from any Reserve which was created before 01.04.97 otherwise than by way of a debit to the Profit and Loss Account shall not be reduced from the Book Profits.

(b) The amount withdrawn from Reserves created on or after 01.04.97, which are credited to the Profit and Loss Account, shall not be reduced from the Book Profits, unless the Book Profits were increased by the amount transferred to such reserves in the year of creation of such Reserves (out of which the said amount was withdrawn).

COMPUTATION OF MAT CREDIT

Step	Description
1	Compute Total Income of the Company (ignoring the provisions of Section 115JB).
2	Compute Book Profit under the provisions of Section 115JB.
3	Find out Tax Payable on (1).
4	Find out Tax Payable on (2) at **18.5%.**
5	Minimum Alternate Tax Credit (MAT Credit) = (4) **Less** (3).

MAT Credit computed under the above steps can be carried forward and set-off against future tax liability for **subsequent 10 years,** provided the tax payable is more than MAT u/s 115JB in the subsequent assessment years.

Important case Decisions

1	**Provision for Foreign Income Tax:** Sec. 115JA makes no distinction between Income Tax Payable in India and that payable abroad. So Provision for Taxation made by Foreign Branches should be added back to arrive at Book Profits. **Bank of India 165 Taxman 627 (AAR)**
2	**Advance against Depreciation** cannot be deducted from the Sale Price, for computation of Book Profit u/s 115JB. **National Hydroelectric Power Corpn. Ltd [2005] TIOL 7 (ARA)**
3	**Treatment of Revaluation Reserve:** Revaluation Reserve not credited to P&L A/c at the time of creation will not be allowed as a deduction at the time of withdrawal. **Indo Rama Synthetics vs CIT 330 ITR 363**
4	**Uniformity of policy:** Manner of setting of (or reducing) b/fd Business Loss or Unabsorbed Depreciation should be the same for both determinations of Book Profit u/s 115JB for the current year as well as c/fd u/s 115JB of unadjusted Business Loss and Unabsorbed Depreciation to the subsequent years. Therefore, for computing Tax Payable u/s 115JB, where a Company has reduced least of Unabsorbed Depreciation and b/fd Business Loss against Book Profit, then while c/fd the unadjusted portion of Business Loss or Unabsorbed Depreciation, it cannot adjust the higher of these two amounts in its books, thereby creating an opportunity to claim higher amount of reduction against subsequent year's Book Profit, thereby paying lower amount of tax. **Rashtriya ISPAT Nigam Ltd 285 ITR (AAR) 1**
5	**Tax Effect of Amalgamation:** The Income of the Amalgamating Company from such date of transfer shall be assessed as the Income of the Amalgamated Company. **[Marshall Sons and Co. (India) Ltd. (SC) 223 ITR 809]**
6	**Power of AO to verify the correctness of Book Profit as laid down in the case of Apollo Tyres Ltd 174 CTR 521 (SC) and Malayala Manorama Co Ltd vs CIT 300 ITR 251(SC):** While Assessing a Company's Income u/s 115JB, the correctness of the P&L A/c prepared by the Assessee Company and certified by the Statutory Auditors of the Company as having been prepared in accordance with the requirements of Parts II and III of Schedule VI to the Companies Act **cannot** be examined by the Assessing Officer.

	The Assessing Officer does **not** have the jurisdiction to go behind the Net Profit shown in the P&L Account, except to the extent provided in explanation to Section 115JB.
7	**Advance Tax & 234B/C Interest on MAT:** All other provision of the Act shall apply to every Assessee being a Company **[115JB(5)].** Based on this provision, the liability of Advance Tax is attracted on MAT. So, if a Company defaults in payment of Advance Tax, it would be liable for 234B and 234C Interest. **[JCIT Vs Rolta India Ltd 330 ITR 470 (SC)] [Circular No.13/2001] [Kotak Mahindra Finance Ltd. 265 ITR 114 (Bom)]**
8	**Set off of MAT Credit before 234B/C Interest** MAT Credit admissible in terms of Section 115JAA has to be set-off against the tax payable (Assessed Tax) before calculating Interest u/s 234A/234B/234C and not after calculation of such interest. **[CIT vs Tulsyan NEC Limited (SC)]** Interest cannot be charged u/s 234B on brought forward MAT Credit Balance.**[CIT vs Sage Metals Ltd 26 Taxmann 258 (SC)]**
9	**No Concealment**: If Book Profit u/s 115JB is higher than the Total Income computed under normal procedures, Book Profit is regarded as Total Income and tax is payable on such income. In such case, there is no concealment at all and no penal consequences would follow u/s 271(1)(c). **[Nalwa Sons Investment Ltd (SC)]**
10	**No separate notice for prosecution of Directors of a Company:** Prosecution against a Company or its Directors in default of deducting tax at source or paying the tax deducted to the account of the Central Government within the time allowed is envisaged u/s 276B and 278B. The Company is a juristic person means that the substantive sentence cannot be imposed other consequences like payment of fine will ensue. As Directors are considered 'Principal Officer' u/s 2(35), they are **liable for prosecution** for any default in complying with statutory provisions. **No separate notice** to treat them as such is **required. [Madhumilan Syntex Ltd. & ORS Vs UOI 290 ITR 199 (SC)]**
11	**Prosecution via Fine only for Companies = No Imprisonment:** Company or any Corporate Body can be prosecuted and punished. Where there is mandatory imprisonment, prosecution can be done by **imposing fine only. [Standard Chartered Bank [2005] 275 ITR 81 (SC)]** **Note: Directors are still liable for prosecution u/s 278B above.**

REGISTRATION UNDER CENTRAL EXCISE

Category of Persons Required to Obtain Registration: The persons required to obtain registration as per Section 6 of the Central Excise Act, 1944 and Rule 9 of the Central Excise Rules, 2002, are as follows –

(1) Every manufacturer of dutiable excisable goods (including Central/State Government undertakings or undertakings owned or controlled by autonomous corporations).
(2) First and second stage dealers (including manufacturer's depots and importers) desiring to issue Cenvatable invoices.
(3) Persons holding warehouses for storing non-duty paid goods.
(4) Persons who obtain excisable goods for availing end use based exemption.
(5) An importer who issues an invoice on which CENVAT Credit can be taken.
(6) Exporters manufacturing or processing export goods - (i) by using duty paid inputs and intending to claim rebate of such duty; or (ii) by using inputs received without payment of duty, and exporting the finished goods.
(7) 100% EOU's who procure goods from domestic tariff area or removes goods in domestic tariff area.

Person Exempt from Obtaining Registration: The following categories of persons are exempt from obtaining registration under Central Excise —

(1) Persons who manufacture the excisable goods, which are chargeable to nil rate of excise duty or are fully exempt from duty by a notification.
(2) SSI manufacturers having annual turnover below the specified exemption limit. However, in case of SSIs wholly exempted from duty under Notification No. 8/2003-CE, declaration is required only if value of clearances computed as per the said Notification during the preceding financial year was ₹ 90 lakhs or more or, in case of new unit, such clearances are expected to be ₹ 90 lakhs or more during current financial year.
(3) A principal manufacturer who gets his goods manufactured on his account from any other person (viz. job worker), if job work undertakes to discharge all liabilities under Act. In certain cases, job worker is exempted from registration if principal manufacturer is made liable to pay duty and undertakes to discharge all liabilities under Act.
(4) Persons manufacturing excisable goods by following the warehousing procedure under the Customs Act, 1962.
(5) The person who carries on wholesale trade or deals in excisable goods (except first and second stage dealer, as defined in CENVAT Credit Rules, 2004 and the depots of a registered manufacturer).
(6) A 100% Export Oriented Undertaking or a unit in Free Trade Zone or SEZ, is licensed or appointed, as the case may be, under the provisions of the Customs Act, 1962 other than having dealings with domestic tariff area.
(7) Persons who use excisable goods for any purpose other than for processing or manufacture of goods availing benefit of concessional duty exemption notification.
(8) Unregistered premises used solely for affixing a sticker or re-printing or re-labeling or re-packing of pharmaceutical products falling under Chapter 30 of the First Schedule to the Central Excise Tariff Act, 1985 with lower ceiling price to comply with the notifications issued by the National Pharmaceutical Pricing Authority under Drugs (Prices Control) Order, 2013 subject to the conditions specified in the Notification No. 22/2013-CE exempting the pharmaceutical products from payment of Central Excise duty.
(9) Every manufacturing unit engaged in the manufacture of aluminium roofing panels falling under tariff

item 7610 90 10 of the First Schedule to the Central Excise Tariff Act, 1985, subject to the conditions that such roofing panels are consumed at the site of manufacture for execution of the project and the manufacturer of such goods has a centralised billing or accounting system in respect of such goods manufactured by different manufacturing units and opts for registering only the premises or office from where such centralised billing or accounting is done.

Registration for Manufacturer Manufacturing Wholly Exempted Goods: According to Section 6 of the Central Excise Act, 1944, every person who produces or manufactures excisable goods will have to get himself registered. The goods that are exempt from duty of excise by virtue of provisions of Section 5A of the Central Excise Act, 1944 do not become non-excisable goods.

However, an exemption notification has been issued exempting manufacturers who manufacture wholly exempted goods or goods chargeable with NIL rate of duty, subject to fulfillment of conditions specified in the notification.

Thus, as per the current provisions, a manufacturer manufacturing wholly exempted goods need not obtain registration under the Central Excise law.

Procedure for Registration: The procedures for registration are as under:

(1) Application for registration: Every person required to take registration shall get himself registered with jurisdictional Deputy/Assistant Commissioner of Central Excise by applying in the form provided for registration in the website www.aces.gov.in.

(2) Registration of different premises of the same registered person:

- If the person has more than one premises requiring registration, separate registration certificate shall be obtained for each of such premises.
- If two or more premises of the same factory are separated by public road, railway line or canal, the Principal Commissioner or Commissioner of Central Excise may, subject to proper accountal of the movement of goods from one premise to other and such other conditions and limitations, allow single registration.
- Separate registration is required for each depot, godown, etc.
- Textile manufacturers/traders may obtain a single registration for all premises falling within the jurisdiction of one Principal Commissioner or Commissioner.
- CNG Manufacturers may obtain a single registration for all premises within the jurisdiction of single Principal Chief Commissioner or Chief Commissioner with any of the Principal Commissioner or Commissioner of Central Excise, subject to the condition that prior intimation shall be given before starting any additional premises subsequent to obtaining such registration. If he is registered under the existing provision, he may apply for fresh registration or file amendment to the registration.
- Every mine engaged in the production or manufacture of goods falling under chapter headings 2701, 2702, 2703, 2704 and 2706 (coal, coke or tar) would be exempt from registration, if the producer or manufacturer of such goods has a centralized billing or accounting system in respect of such goods produced by different mines and opts for registering only the premises or office from where such centralized billing or accounting is done.

(3) Online filing of application: Application for registration or de-registration or amendment of the registration application shall be filed only online on the website www.aces.gov.in, in the forms provided in the website.

(4) PAN based Registration:

- Applicant for registration shall mandatorily quote Permanent Account Number (PAN) of the proprietor or the legal entity being registered in the specified column in the application form.

- Government Departments are exempt from the requirement of quoting the PAN in their online application.
- Existing temporary registrants, except Government Departments shall apply online for conversion of temporary registration to PAN based registration within three months from the date of publication of this notification [Notification No. 35/2001-CE (N.T.), dated 26.06.2001], failing which the temporary registration shall stand cancelled. [Further extension can be granted for one month].

(5) Applicant to quote e-mail address and mobile number: Applicant shall quote his e-mail address and mobile number in the requisite column of the application form for communication with the Department.

(6) Business Transaction Numbers: Business transaction numbers obtained from other Government departments or agencies such as Customs Registration No (BIN No), Import Export Code (IEC) Number, State Sales Tax / (VAT) Number, Central Sales Tax Number, Company Index Number (ON), Service Tax Registration Number, which have been issued prior to the filing of Central Excise Registration application, shall be filled in the form and for the numbers subsequently obtained, the application shall be amended.

(7) Registration Number and Certificate: Pending post-facto verification of premises and documents by the authorized Officers, registration application shall be approved by the Deputy Commissioner or Assistant Commissioner within two days of the receipt of duly completed online application form.

[Registration No. or Excise Control Code -15 digit Alphanumeric Code =10 digits PAN + XM (for manufacturers) or XD (for dealers) + 001 or 002 (for No. of premises)].

(8) Submission of documents: The applicant shall tender self attested copies of the following documents at the time of verification of the premises:

(i) Plan of the factory premises;
(ii) Copy of the PAN Card of the proprietor or the legal entity registered;
(iii) Photograph and Proof of the identity of the applicant;
(iv) Documents to establish possession of the premises to be registered;
(v) Bank account details;
(vi) Memorandum or Articles of Association and List of Directors; and
(vii) Authorization by the Board of Directors or Partners or Proprietor for filing the application by a third party.

(9) Physical verification:

- The authorized officer shall verify the premises physically within seven days from the date of receipt of application through online. Where errors are noticed during the verification process or any clarification is required, the authorized Officer shall immediately intimate the same to the assessee for rectification of the error within fifteen days of the receipt of intimation failing which the registration shall stand cancelled. The assessee shall be given a reason opportunity to represent his case against the proposed cancellation, and if it is found that the reasons given by the assessee are reasonable, the authorized Officer shall not cancel the registration to the premises.
- On the physical verification of the premises, if it is found to be non-existent, the registration shall stand cancelled. The assessee shall be given a reason opportunity to represent his case against the proposed cancellation, and if it is found that the reasons given by the assessee are reasonable, the authorized Officer shall not cancel the registration to the premises recording the complete and correct address.

(10) Transfer of Business or acquisition of factory: Where a registered person transfers his business to another person, the transferee shall get himself registered afresh. Where an applicant has acquired an old factory from a Bank or a Financial Institution, he shall get himself registered afresh.

(11) Change in the Constitution: Where a registered person is a firm or a company or association of persons, then in the event of any change in the constitution of the firm leading to change in PAN, he shall get himself registered afresh.

(12) De-registration: Every registered person, who ceases to carry on the business for which he is registered, shall de-register himself by making an online application in the website, in the specified form. Where there are no dues pending recovery from the assessee, application for de-registration shall be approved within thirty days from the date of filing of online declaration and the assessee shall be informed, accordingly.

(13) Cancellation of registration: A registration certificate granted under rule 9 may be cancelled after giving a reasonable opportunity to the assessee to represent his case against the proposed cancellation by the Deputy Commissioner or Assistant Commissioner of Central Excise, in any of the following situations, namely:—

- where on verification, the premises proposed to be registered is found to be nonexistent;
- where the assessee does not respond to request for rectification of error noticed during the verification of the premises within fifteen days of intimation;
- where there is substantial mis-declaration in the application form; and
- where the factory has closed and there are no dues pending against the assessee.

Validity of Registration Certificate: Registration certificate once granted, assumes a permanent characteristic i.e. it is valid throughout, unless it has been suspended or revoked by the authorities in pursuance of the Central Excise law or it has been surrendered by the assessee or ceases to be valid on the death of the assessee.

Effect of certain events on validity of registration certificate -

- **Death of the individual:** Registration certificate shall cease to be valid.
- **Death of a director of a limited company:** Company, being an entity distinct from its members and having perpetual succession, hence death of any director/member shall not affect the validity of the certificate.
- **Death of a partner of a partnership firm:** If the death of a partner results in dissolution of firm and consequent dissolution of business, the registration certificate will cease to be valid. However, if the remaining partners continue to carry on same business in the same name, then the registration certificate shall remain valid.

Penal Provisions: The penal provisions for non obtaining registration are as under –

(1) Fine and Imprisonment: person who fails to obtain registration when he is so required to do so shall be punishable –

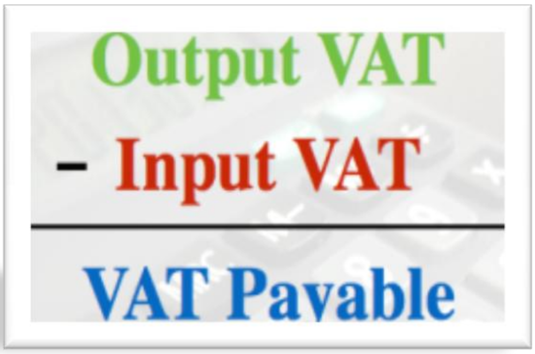
- **Where the duty leviable on excisable goods exceeds ₹ 50,00,000:** Imprisonment for a term, which may extend to 7 years and with fine. (However, in absence of special and adequate reasons to the contrary to be recorded in judgment of the Court, such imprisonment shall not be for less than 6 months.)
- **In any other case:** Imprisonment for a term extending to 3 years or with fine or with both.

(2) Confiscation and penalty: Where any manufacturer or producer engages in manufacture, production or storage of any excisable goods without having applied for registration certificate, then, all such goods shall be liable to confiscation. Moreover, such manufacturer or producer shall also be liable to a penalty not exceeding -

(a) the duty on such excisable goods, or

(b) ₹ 5,000, whichever is greater.

VAT ACCOUNTING



Salient Features of VAT:

(a) VAT Credit: A registered dealer (trader/manufacturer) is entitled to an input tax credit (called as VAT Credit), in respect of taxes paid on purchases made during the period, where the purchases arise in the course of his activities as a dealer.

(b) Set Off Facility: VAT Credit is allowed for purchase of inputs/supplies meant for sale, or for utilization in the process of production for such sale, irrespective of when these are utilized/ sold, and reduces the immediate tax liability of the dealer.

(c) Purchase within State: VAT Credit is available for all for purchase of inputs/supplies in a State, meant for sales within the State or sale in other States. VAT Credit is not allowable for taxes paid on purchases from other States.

(d) Refund of Excess VAT Credit: Where VAT Credit exceeds the tax payable on sales in a month, the excess credit is carried over to the future month(s). Any excess unadjusted VAT Credit at the end of the specified period, is eligible for refund.

VAT Credit in case of Inputs/Supplies:

Suggested Accounting Treatment

Transaction and Entry	Debit	Credit
Purchase of Inputs (with VAT thereon) Purchases A/c (different category items) Dr. VAT Credit Receivable (Inputs) A/c Dr. To Suppliers / Sundry Creditors / Bank A/c	 Purchase Price net of VAT VAT Paid on Purchases	 Purchase Price incl. VAT
Sale of goods Bank/Sundry Debtors A/c Dr. To Sales A/c (different category items) To VAT Payable A/c	 Price incl. VAT on Sales	 Price excl. VAT VAT on Sales
Set-off of VAT Credit VAT Payable A/c Dr. To VAT Credit Receivable (Inputs) A/c	VAT Credit available or VAT payable, whichever is less	
Payment of balance VAT (if credit receivable is less) VAT Payable A/c Dr. To Bank A/c	To be passed at the time of payment To the extent of VAT actually paid in cash, i.e. when Credit Receivable < VAT Payable on Sales	

- **Common Inputs:**

(a) Where common inputs are used for making taxable sales as well as exempt sales, the dealer should, on the date of purchase, estimate the inputs expected to be used for making the taxable sales and for making exempt sales,
(b) VAT Credit should be recognized only in respect of inputs which are expected to be used in making taxable sales. No VAT Credit should be recognized on inputs which are expected to be used in making exempt sales,
(c) Where the actual use is different from the estimated use, an adjustment entry should be passed.

Stock Transfer/Consignment Sale:

In case of Stock Transfer/Consignment Sale of goods outside the state where VAT Credit is available only to an extent of input tax paid, the dealer should estimate the expected Stock Transfers/Consignment Sales and account for accordingly.

Example:

The details of purchases made by a Registered Dealer during March are –

Particulars	Total Purchase Value	Input Tax Paid	Net Balance Amount
4% VAT Goods	`10,40,000	` 40,000	`10,00,000
12.5% VAT Goods	`9,00,000	`1,00,000	` 8,00,000
VAT Exempt Goods	` 2,00,000	–	` 2,00,000
Total	`21,40,000	`1,40,000	`20,00,000

The above input tax paid is fully eligible for VAT Credit. The details of Sales during this month are –

Particulars	Total Purchase Value	Input Tax Paid	Net Balance Amount
4% VAT Goods	`11,44,000	` 44,000	`11,00,000
12.5% VAT Goods	`10,12,500	`1,12,500	` 9,00,000
VAT Exempt Goods	` 2,50,000	–	` 2,50,000
Total	`24,06,500	`1,56,500	`22,50,000

Suggest the accounting treatment for the above.

Solution:

Date	Particulars	Debit (₹)	Credit (₹)
	4% VAT Goods Purchase A/c Dr.	10,00,000	
	12.5% VAT Goods Purchase A/c Dr.	8,00,000	
	VAT Exempt Goods Purchase A/c Dr.	2,00,000	
	VAT Credit Receivable (Inputs) A/c Dr.	1,40,000	
	To Bank/Suppliers/Sundry Creditors A/c		21,40,000
	(Being purchases of various goods and input tax thereon paid)		
	Bank/Customers/Sundry Debtors A/c Dr.	24,06,500	
	To 4% VAT Goods Sales A/c		11,00,000
	To 12.5% VAT Goods Sales A/c		9,00,000
	To VAT Exempt Sales A/c		2,50,000
	To VAT Payable A/c		1,56,500
	(Being sale of various goods and VAT collection thereon)		
	VAT Payable A/c Dr.	1,40,000	

	To VAT Credit Receivable (Inputs) A/c (Being set-off of VAT Credit against liability for VAT payment)		1,40,000
	• At the end of this month, the balance in VAT Payable A/c ` 16,500 will be displayed in the B/Sheet under the head "Current Liabilities". • The dealer may include the following disclosures in the Notes: (a) Cost of Inventories is net of VAT Credit; (b) Sales are exclusive of VAT.		
	For payment of VAT in the subsequent month VAT Payable A/c Dr. To Bank A/c (Being liability for VAT of previous month, now settled)	16,500	16,500

Capital Goods:

Suggested Accounting Treatment

Transaction and Entry	Debit	Credit
Purchase of Capital Goods (with VAT thereon) Fixed Assets A/c Dr. VAT Credit Deferred (Capital Goods) A/c Dr. To Asset Vendor / Bank A/c	 Purchase Price net of VAT VAT paid on Purchases	 Purchase Price incl. VAT
Transfer of VAT Credit Receivable during the year VAT Credit Receivable (Capital Goods) A/c Dr. To VAT Credit Deferred (Capital Goods)	Credit available during the year as per the relevant State VAT Law	

Note:

• Depreciation on Machinery will be charged on the Purchase Price net of VAT.

Adjustment (i.e. Debit) to VAT Credit Receivable A/c

Situation	Treatment	Other Points
(a) Set-off of VAT Payable on Sales	VAT Payable A/c Dr. To VAT Credit Receivable	No change in Input Stock Valuation.
(b) Disallowance of VAT Credit on purchases during the period	Purchases / Raw Material A/c Dr. To VAT Credit Receivable	RM Inputs Cost to be increased to include VAT
(c) Disallowance of VAT Credit on purchases of previous periods	If such inputs are used/sold during the year; (prior period item) Profit and Loss A/c Dr. To VAT Credit Receivable If such inputs are still in stock at the end of year: Same entry in (b) above.	RM Inputs Cost to be increased to include VAT
(d) Disallowance of VAT Credit on Capital Goods (See Note below)	If asset is still in use: Relevant Asset A/c Dr. To VAT Credit Receivable If asset no longer exists: Profit and Loss A/c Dr. To VAT Credit Receivable	Deprn to be charged on revised amt, incl. VAT Appropriate disclosure to be made in a/cs.

Note:

In situation (d) above, where the VAT Credit disallowed on Capital Goods is VAT Credit Deferred (Capital Goods) Account and has not be transferred to VAT the former account shall be credited while passing the Journal Entries.

Example:

On 1st June, a Registered Dealer purchased a Machinery for ₹93,60,000 which includes State VAT of ₹3,60,000. As per the State VAT Laws, the input VAT on Capital Goods is adjustable in 36 equal monthly instalments beginning from 1st July of the year. During the financial year, the dealer has set-off a sum of ₹25,000 from the VAT Credit Receivable on Capital Goods, against VAT payable on the sales made by him. The dealer charges 10% p.a. depreciation on Machinery. Suggest the accounting treatment for the above.

Solution:

Date	Particulars	Debit (₹)	Credit (₹)
	Machinery A/c Dr. VAT Credit Deferred (Capital Goods) A/c Dr. To Bank/Asset Vendor (Being machinery purchased and input tax thereon paid)	90,00,000 3,60,000	 93,60,000
	VAT Credit Receivable (Capital Goods) A/c Dr. To VAT Credit Deferred (Capital Goods) A/c (Being VAT Credit available on Capital Goods for the current period i.e. 1st July to 31st March = ₹3,60,000 x 9/36 = ₹90,000)	90,000	 90,000
	VAT Payable A/c Dr. To VAT Credit Receivable (Capital Goods) A/c (Being set-off of VAT Credit against liability for VAT payment)	25,000	 25,000
	Depreciation A/c Dr. To Machinery A/c (Being Depreciation on Machinery = ₹90,00,000 x 10% x 10/12)	7,50,000	 7,50,000

Balance Sheet (Extracts)

	Particulars	Note	This Year	Prev. Year
I	**EQUITY AND LIABILITIES**			
(1)	**Shareholders' funds**		____	
(2)	**Share application money pending allotment**		____	
(3)	**Non-Current Liabilities**		____	
(4)	**Current Liabilities**		____	
	Total			
II	**ASSETS**			
(1)	**Non-Current Assets**			
	Tangible Fixed Assets (₹90,00,000 - ₹7,50,000)		82,50,000	
	Other Non-current Assets			
	VAT Credit Deferred (Capital Goods)		2,70,000	
(2)	**Current Assets**			
	Short-term loans and advances			
	VAT Credit Receivable (Capital Goods)		65,000	
	Total			

STANDARDS ON INTERNAL AUDIT (SIA)

Meaning

In general terms, SIA are set of systematic guidelines used by internal auditors to ensure the accuracy, consistency and verifiability of their actions and reports.

Like any other standard, they provide the guidance in determining the nature, timing and extent of audit procedures that should be applied to fulfill the objective of Internal Audit.

They are the criteria or yardsticks against which the quality of the internal audit results is evaluated.

Framework of SIA:

The Framework on Standards on Internal Audit comprises four components viz,

- The Code of Conduct
- The Competence Framework
- The Body of Standards and
- The Technical Guidance

Purpose of SIA:

a. To provide a benchmark for quality of services during an internal audit.

b. To codify the best practices in internal audit services.

SIA issued by ICAI

ICAI has totally issued 17 SIA. The list of this is as under:

SIA No.	Name of SIA
1.	Planning an Internal Audit
2.	Basic Principles Governing Internal Audit
3.	Documentation
4.	Reporting
5.	Sampling
6.	Analytical Procedures
7.	Quality Assurance in Internal Audit
8.	Terms of Internal Audit Engagement
9.	Communication with Management
10.	Internal Audit Evidence
11.	Consideration of Fraud in an Internal Audit
12.	Internal Control Evaluation
13.	Enterprise Risk Management
14.	Internal Audit in an Information Technology Environment

15.	Knowledge of the Entity and its Environment
16.	Using the work of an Expert
17.	Consideration of Laws and Regulations in an Internal Audit

SIA 1-6 has already been discussed in earlier e-newsletter. The remaining SIA 7-17 has been discussed as under:

SIA 7: Quality Assurance in Internal Audit

A system for assuring the quality in internal audit should provide reasonable assurance that the internal auditors comply with professional standards, regulatory and legal requirements so that the reports issued by them are appropriate in the circumstances. In the case of the in–house internal audit or a firm carrying out internal audit, the person entrusted with the responsibility for the quality in internal audit should ensure that the system of quality assurance include policies and procedures addressing each of the following elements:

1. Leadership Responsibilities for quality in internal audit
2. Ethical Requirements
3. Acceptance and continuance of client relationship and specific engagement, as may be applicable
4. Human Resources
5. Engagement Performance
6. Monitoring

This Standard also provides the extensive knowledge about the internal quality reviews, external quality reviews and communicating the results thereof.

SIA 8: Terms of Internal Audit Engagement

The internal auditor and the auditee should agree on the terms of the engagement before commencement.

The terms of the engagement should contain a statement in respect of the scope of the internal audit engagement. It should clearly delineate the broad areas of function of internal audit like evaluating internal controls, review of business process cycle controls, risk management and governance.

The terms of engagement should clearly mention that the internal auditor would not, ordinarily, be involved in the preparation of the financial statements of the auditee. It should also be made clear that the internal audit would not result in the expression, by the internal auditor, of an opinion, or any other form of assurance on the financial statements or any part thereof of the auditee.

The terms of the engagement should clearly mention the responsibility of the auditee vis-a-vis the internal auditor.

Ideally, terms of engagement should clearly define the scope, authority, responsibility, confidentiality, limitations, reporting requirements and compensation.

SIA 9: Communication with Management

- Internal auditor while performing audit should communicate clearly the responsibilities of internal auditor and an overview of the planned scope and timing of audit with the management.
- Communication regarding the planned scope and timing of internal audit may assist the management to understand better the objectives of internal auditor's work, to discuss issues of risk and materiality with internal auditor and to identify any areas in which they may request the internal auditor to undertake additional procedures, assist the internal auditor to understand the entity and its environment better.
- Different stages of communication and discussion should be: discussion of draft; exit meeting; formal draft; and final report.
- Clear communication of internal auditor's responsibilities, planned scope and timing of internal audit and expected general content of communications helps establishing the basis for effective two–way communication.
- Appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include significance and nature of the matter, and the action expected to be taken by management.
- Where matters required by this SIA to be communicated, are orally communicated, internal auditor shall document them and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of internal audit documentation.

SIA 10: Internal Audit Evidence

Paragraph 14 of the SIA 2, Basic Principles Governing Internal Audit, states:

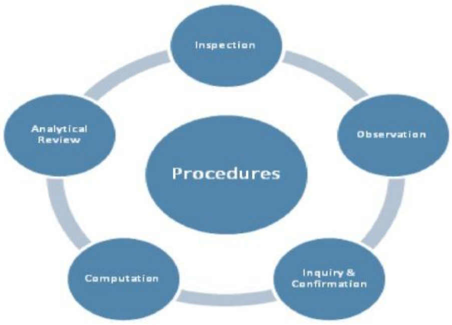
"14. The internal auditor should, based on his professional judgment, obtain sufficient appropriate evidence to enable him to draw reasonable conclusions therefrom on which to base his opinion or findings."

Now let us discuss the concept of sufficiency and appropriateness:

Sufficiency – It refers to the quantity of audit evidence. It is affected by the auditor's assessment of the risk of material misstatements and also by the quality of such audit evidence.

Appropriateness – It refers to the measure of the quality of such evidence i.e. its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Following are the general procedures used for obtaining internal audit evidence.



SIA 11: Consideration of Fraud in an Internal Audit

Fraud may be defined as an intentional act by one or more individuals among management, TCWG, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage. Following are the possible sources of misstatements and their instances:

a) Misstatements arising from fraudulent financial reporting

- Manipulation, falsification or alteration of accounting records or supporting documentation.
- Misrepresentation or intentional omission.
- Intentional misapplication of accounting principles.

b) Misstatements resulting from misappropriation of assets

- Embezzling receipts
- Stealing physical assets or intellectual property
- Causing an entity to pay for goods and services not received
- Using an entity's assets for personal use

A system of internal control comprise of following five elements:

a. the control environment

b. entity's risk assessment process

c. information system and communication

d. control activities

e. monitoring of controls

It is essential for the internal auditor to gain an understanding of the components of the system of internal control for consideration of fraud in an entity's environment.

Normally, an internal auditor is not expected to possess skills and knowledge of a person expert in detecting and investigating frauds, he should, however, have reasonable knowledge of factors that might increase the risk of opportunities for frauds in an entity and exercise reasonable care and professional skepticism while carrying out internal audit.

SIA 12: Internal Control Evaluation

The purpose of this Standard on Internal Audit is to establish standards and provide guidance on the procedures to be followed by the internal auditor in evaluating the system of internal control in an entity and for communicating weaknesses therein to those charged with governance. The Standard also extensively deals with aspects such as meaning and inherent limitations of internal controls, control environment, risk assessment, tests of control and communication of weaknesses. The SIA also describes role of the internal auditor in evaluating internal controls.

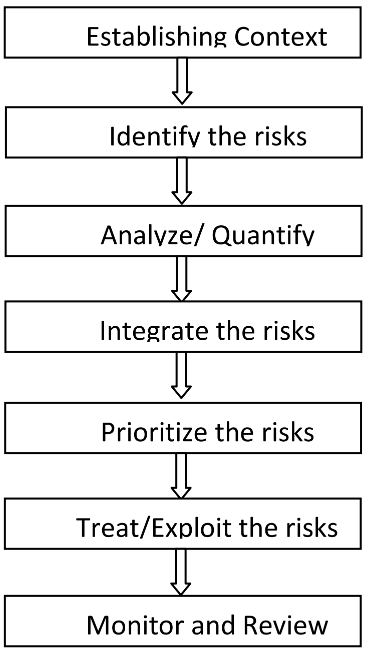
SIA 13: Enterprise Risk Management

ERM is a structured, consistent and continuous process of measuring or assessing risk and developing strategies to manage risk within the risk appetite. It involves identification, assessment, mitigation, planning and implementation of risk and developing an appropriate risk response policy. Management is responsible for establishing and operating the risk management framework.

The ERM framework is deviced to achieve an entity's objectives, set forth in the following 4 categories:

- Strategic: High level goals, aligned with and supporting its mission.
- Operations: Effective and efficient use of its resources.
- Reporting: Reliability of reporting.
- Compliance: Compliance with applicable laws and regulations.

Process of ERM:



According to this SIA, an internal auditor should inter alia:

a. Review the maturity of an ERM structure by considering whether the framework so developed, protects the enterprise against surprises, stabilizes overall performance with less volatile earnings, operates within established risk appetite, protects ability of the enterprise to attend to its core business and creates a system to proactively manage risks.

b. Review whether the ERM coordinators in the entity report on the results of assessment of key risks at appropriate levels.

c. Submit his report to the Board or its relevant Committee as a result of the review, Tests conducted, Samples covered and Observations and recommendations.

SIA 14: Internal Audit in an Information Technology Environment

The overall objective and scope of an internal audit does not change in an IT environment. However, the use of a computer changes the processing, storage, retrieval and communication of financial information and the interplay of processes, systems and control procedures. This may affect the internal control systems employed by the entity. Accordingly, IT environment may affect the procedures followed by the internal auditor in obtaining a sufficient understanding of the processes, systems and internal control system and the auditor's review of the entity's risk management and continuity systems.

When the information technology systems are significant, the internal auditor should also obtain an understanding of IT environment and whether it influences the assessment of inherent and control risks. The nature of risks and internal control characteristics in IT environments include the Lack of transaction trails, Uniform processing of transactions, Lack of segregation of functions, Potential for errors and irregularities, Initiation or execution of transactions, Dependence of other controls over computer processing, Potential for increased management supervision, Potential for the use of computer–assisted audit techniques.

SIA 15: Knowledge of the Entity and its environment

a. To obtain knowledge of the economy, entity's business and its operating environment, including its regulatory environment and the industry in which it operates, sufficient to enable him to review the key risks and entity–wide processes, systems, procedures and controls. To identify sufficient, appropriate, reliable and useful information to achieve the objectives of the engagement.

b. Prior to accepting an engagement, the internal auditor should obtain a preliminary knowledge of the industry and of the nature of ownership, management, regulatory environment and operations of the entity subjected to internal audit, and should consider whether a level of knowledge of the entity's business adequate to perform the internal audit can be obtained.

c. Following the acceptance of the engagement, further and more detailed information should be obtained. To the extent practicable, the internal auditor should obtain the required knowledge at the commencement of the engagement. As the internal audit progresses, that information should be assessed, enhanced, updated, refined and validated as the internal auditor and the engagement team obtain more knowledge about the entity's business.

d. In case of continuing engagements, internal auditor should update and re–evaluate information gathered previously, including information in the prior year's working papers. The internal auditor should also perform procedures designed to identify significant changes that have taken place in the operations, control environment, technology and strategic processes since the last internal audit.

e. To obtain sufficient, appropriate information about the entity. An understanding of business risks facing the entity increases the likelihood of identifying risks of material misstatement in the information subject to internal audit.

f. Knowledge of the entity's business is a frame of reference within which the internal auditor exercises professional judgment in reviewing the processes, controls and risk management procedures of the entity.

SIA 16: Using the work of an Expert

The purpose of this Standard is to establish standards and provide guidance where the internal auditor uses the work performed by an expert. The Standard also explains situations in which the need for using the work of an expert might arise, factors to be considered when deciding whether to use the work of an expert or not, evaluating the skills and competence and objectivity of an expert, procedures for evaluating the work of an expert, references to an expert in the internal auditor's report, etc.

Cases where auditor can use Expert's work:

1. Valuation of complex financial instruments, fixed assets, etc.
2. Actuarial valuation of liabilities associated with insurance contracts or employee benefit plans.
3. Estimation of oil and gas reserves.
4. Valuation of environmental liabilities.
5. Interpretation of contracts, laws and regulations.
6. Analysis of complex or unusual tax compliance issues.

SIA 17: Consideration of Laws and Regulations in an Internal Audit

a. It is the primary responsibility of management, with the oversight of TCWG to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations.

b. The objectives of the internal auditor are to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations that have a direct effect on the determination of material amounts and disclosures in the financial statements.

c. The internal auditor shall request management and wherever appropriate to TCWG to provide written representations that all known instances of non–compliance or suspected non–compliance with laws and regulations which impact the functioning of the entity, have been disclosed to him.

d. If the internal auditor becomes aware of information concerning an instance of non-compliance or suspected non- compliance with laws and regulations, he shall obtain its understanding and also of the understanding in which it has occurred and shall evaluate its possible impact on the functioning of the entity.

e. If the internal auditor concludes that non–compliance has a significant impact on the functioning of an entity and has not been adequately dealt with by the management, the internal auditor shall report the same in accordance with SIA 4, "Reporting".