CMA Students Newsletter (For Intermediate Students)

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RETIREMENT OF PARTNERS - PART III

ADJUSTMENT OF REMAINING PARTNER'S CAPITAL ACCOUNT AFTER RETIREMENT

After retirement of a partner the remaining partners may decide to adjust their capital. Often the remaining partners determine the total amount of capital of the reconstituted firm and decide to keep their respective capital accounts in proportion to the new profit sharing ratio. The total capital of the firm may be more or less than the total of their capital at the time of retirement. The new capitals of the partners are compared with the balance standing to the credit of respective partner's capital account. If there is a surplus in the capital account, the amount is withdrawn by the concerned partner. The partner brings cash in case the balance in the capital account is less than the calculated amount.

Example

Roopa, Sunder and Shalu are partners sharing profit in the ratio of 5: 3: 2. Roopa retired, when their capitals were: ₹46,000, ₹42,000 and ₹38,000 respectively after making all adjustments on retirement. Sunder and Shalu decided to have a total capital of the firm at ₹84,000 in the proportion of 7 : 5. Calculate actual cash to be paid or brought in by each Partner and make necessary journal entries.

Answer:

Total Capital of the New firm = ₹84,000

Sunder's share in the new capital = ₹84,000 × 7/12 = ₹49,000

Shalu's share in the new capital = ₹84,000 × 5/12 = ₹35,000

On comparing Sunder's share in the new capital of the firm with the amount standing to the credit of his capital, It is observed that he has to bring ₹7,000 the deficit amount (₹49,000 – 42,000) in Cash.

Similarly, Shalu's share in the new capital of the firm is ₹35,000 while ₹38,000 stand credited to her capital account. So she is allowed to withdraw ₹3,000, the surplus amount (₹38,000 – ₹35,000) from the firm so as to make her capital in proportion to her new profit share ratio.

Journal

Date	Particulars	L. f.	Amount (₹)	Amount (₹)
	Bank A/c Dr. To, Sunder's Capital A/c (being the deficit amount brought in by the partner)		7,000	 7,000
	Shalu's Capital A/c Dr. To, Bank A/c (being the surplus amount withdrawn by the partner)		3,000	 3,000

Adjustment of remaining partner's capital in their profit sharing ratio, when the total capital of the new firm is not pre-determined.

In this case the total amount of adjusted capital of the remaining partners is rearranged as per agreed proportion in which they share profit of the reconstituted firm. The following steps may be adopted:

(i) Add the balance standing to the credit of the remaining partners' capital accounts.

(ii) The total so obtained is the total capital of the firm.

(iii) This capital is divided according to the new profit sharing ratio.

Example

Sumit, Amit and Neha are partners sharing profit in the ratio of 4 : 3 : 1. When Amit retired, their adjusted capitals were ₹ 76,000; ₹ 45,000 and ₹ 34,000 respectively. Sumit and Neha decided to have their total capital of the firm in the ratio of 3: 2. The necessary adjustments were to be made in cash only. Calculate actual cash to be paid off or brought in by each partner.

Answer:

Total of the adjusted capitals of the remaining partners.

Sumit = ₹ 76,000

Neha = ₹ 34,000

Total = ₹ 1,10,000

Total capital of the firm which is divided in the new ratio of 3 : 2.

New capital of Sumit = 1,10,000 x 3/5 = ₹ 66,000

New Capital of Neha = 1,10,000 x 2/5 = ₹ 44,000

Sumit's share in the new capital of the firm is ₹ 66,000 while ₹ 76,000 stands credited to his capital account. So he will withdraw ₹ 10,000 (₹ 76,000 - ₹ 66,000) from the firm so as to make his capital in proportion to his new profit sharing ratio.

Similarly, Neha's share in the new capital of the firm is ₹ 44,000 while ₹ 34,000 stands credited to her capital account, She has to bring ₹ 10,000 (₹ 44,000 - 34,000) in Cash to make up the deficit in the capital account.

Example

The Balance Sheet of Rohit, Nisha and Sunil who are partners in a firm sharing profits according to their capitals as on 31st March 2015 was as under:

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Creditors		25,000	Machinery		40,000
Bills Payable		13,000	Building		90,000
General Reserve		22,000	Debtors	30,000	
Capital			Less: Provision for Bad debts	1,000	29,000
Rohit	60,000		Stocks		23,000
Nisha	40,000		Cash at Bank		18,000
Sunil	40,000	1,40,000			
		2,00,000			2,00,000

On the date of Balance Sheet, Nisha retired from the firm, and following adjustments were made:

(i) Building is appreciated by 20%.
(ii) Provision for bad debts is increased to 5% on Debtors.
(iii) Machinery is depreciated by 10%.
(iv) Goodwill of the firm is valued at ₹56,000 and the retiring partner's share is adjusted.
(v) The capital of the new firm is fixed at ₹ 1,20,000.

Prepare Revaluation Account, Capital Accounts of the partner and Balance sheet of the new firm after Nisha's retirement.

Answer:

Revaluation Account

Dr. **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
Provision for Bad debt A/c	500	Building A/c	18,000
Machinery A/c	4,000		
Profit transferred to Capital Accounts (3:2:2)			
Rohit 5,786			
Nisha 3,857			
Sunil 3,857	13,500		
	18,000		**18,000**

Capital account

Dr. Particulars	Rohit (₹)	Nisha (₹)	Sunil (₹)	Particulars	Rohit (₹)	Nisha (₹)	Sunil (₹) Cr.
Sunil Capital	9,600	---	6,400	Balance b/d	60,000	40,000	40,000
Bank		66,143		General : Reserve	9,428	6,286	6,286
Balance c/d	72,000	---	48,000	Revaluation (Profit)	5,786	3,857	3,857
				Rohit Capital	---	9,600	---
				Sunil Capital		6,400	
				Bank	6,386		4,257
	81,600	**66,143**	**54,400**		**81,600**	**66,143**	**54,400**

Balance Sheet as on 31st March 2015

Liabilities		Amount (₹)	Assets		Amount (₹)
Creditors		25,000	Building		1,08,000
Bank overdraft		37,500	Machinery		36,000
Bills Payable		13,000	Debtors	30,000	
Capital:			Less: Provision for Bad debts	1,500	28,500
Rohit	72,000		Stock		23,000
Sunil	48,000	1,20,000			
		1,95,500			**1,95,500**

Working Notes:

(i) (a) Profit sharing ratio is 60,000:40,000:40,000 i.e. = 3:2:2

(b) Gaining Ratio: Rohit = 3/5 - 3/7 = 21/35 - 15/35 = 6/35

Sunil = 2/5-2/7 = 14/35 - 10/35 = 4/35

= 6/35 : 4/35

=6:4=3:2

(c) Nisha Share of Goodwill = 56,000 x 2/7 = ₹ 16,000.

Share of Goodwill in the gaining ratio by the existing partner, i.e.

Rohit = 16,000 x 3/5 = ₹9,600

Sunil = 16,000 x 2/5 = ₹6,400

The journal entry is

Rohit's Capital A/c	Dr	9,600	
Sunil's Capital A/c	Dr	6,400	
To Nisha's Capital A/c			16,000
(Share of Goodwill divided into gaining ratio)			

Bank account

Dr Particulars	Amount (₹)	Particulars	Amount (₹) Cr
Balance b/d	18,000	Nisha's Capital A/c	66,143
Rohit's Capital A/c	6,386		
Sunil's Capital A/c	4,257		
Balance c/d	37,500		
(Bank overdraft)			
	66,143		**66,143**

(ii) Bank overdraft is taken to pay the retiring partner amount.
(iv) New Capital of the firm is fixed at ₹ 1,20,000.

	Rohit (₹)	Sunil (₹)
New Capital (₹ 1,20,000 in the ratio of 3 : 2)	72,000	48,000
Existing Capital (After Adjustments) i.e. partner capitals	65,614	43,743
Cash to be brought by the remaining partners	6,386	4,257

Example

Chauhan Triphati and Gupta are partners in a firm sharing profit and losses in the ratio of 1/2, 1/6 and 1/3 respectively. The Balance Sheet on March 31, 2015 was as follows:

Liabilities	Amount (₹)	Amount (₹)	Assets		Amount (₹)
Sundry Creditors		36,000	Freehold Premises		80,000
Bills Payable		24,000	Machinery		60,000
General Reserve		24,000	Furniture		24,000
Capitals:			Debtors	40,000	
Chauhan	60,000		Less: Provision for Bad debts	2,000	38,000
Triphati	60,000		Stock		
Gupta	56,000	1,76,000	Cash		44,000
		2,60,000			2,60,000

Gupta retires from the business and the partners agree to the following revaluation:

(a) Freehold premises and stock are to be appreciated by 20% and 15%. respectively

(b) Machinery and furniture are to be depreciated by 10% and 7% respectively

(c) Bad debts reserve is to be increased to ₹ 3,000.

(d) On Gupta retirement, the goodwill is valued at ₹ 42,000.

(e) The remaining partners have decided to adjust their capitals in their new profit sharing ratio after retirement of Gupta. Surplus/deficit, if any in their capital account will be adjusted through cash.

Prepare necessary ledger accounts and Balance Sheet of reconstituted firm.

Answer:

Revaluation Account

Dr. **Cr.**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)
Provision for Bad debts		1,000	Freehold Premises	16,000
Machinery		6,000	Stock	6,600
Furniture		1,680		
Profit transferred to				
Capital Accounts:				
Chauhan	6,960			
Triphati	2,320			
Gupta	4,640	13,920		
		22,600		**22,600**

Capital Account

Dr | Cr.

Particulars	Chauhan (₹)	Triphati (₹)	Gupta (₹)	Particulars	Chauhan (₹)	Triphati (₹)	Gupta (₹)
Gupta Capital	10,500	3,500	---	Balance b/d	60,000	60,000	56,000
Gupta Loan			82,640	General Reserve	12,009	4,000	8,000
Cash		30,000		Revaluation (Profit)	6,960	2,320	4,640
Balance c/d	98,460	32,820		Chauhan Capital	---	---	10,500
				Tirphati Capital			3,500
				Cash	30,000		
	1,08,960	**66,320**	**82,640**		**1,08,960**	**66,320**	**82,640**

Balance Sheet as on March 31, 2015

Liabilities	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Creditors	36,000	Freehold Premises		96,000
Bills Payable	24,000	Machinery		54,000
Gupta's Loan	82,640	Furniture		22,320
Capital:		Debtors	40,000	
Chauhan 98,460	1,31,280	**Less:** Provision for Bad debts	3,000	37,000
Tirphati 32,820		Stock		50,600
		Cash		14,000
	2,73,920			**2,73,920**

Working Note:

(a) In the absence of agreement, retiring partner's capital account is transferred to his loan account.

(b) In the absence of agreement, existing ratio of remaining partners is gaining ratio i.e. 3 : 1

(c) Calculation of Cash brought in (or paid off) by remaining partner.

	Chauhan	Tirphati
(a) Total Capital of Chauhan and Tirphati (₹68,460 + 62,820 = ₹1,31,280 in the ratio of 3 : 1)	98,460	32,820
Adjusted existing Capital	68,460	62,820
Excess or Deficit	(Excess) 30,000	(Deficit) 30,000

SOME TYPICAL ISSUES RELATING TO FIXED ASSETS (ACCOUNTING STANDARD -10)

- These are held with an intention of being used for the purpose of producing or providing goods and service.
- These are not held for sale in the normal course of business and expected to be used for more than one accounting period.

Fixed assets shall be shown in financial statement either at historical cost or revalued price.

The historical cost of acquired fixed assets consists of:

- Purchase price
- Import duties and other non-refundable taxes
- Any directly attributable cost of bringing the asset to the working condition for its intended use
  - Site preparation
  - Delivery and handling cost
  - Installation cost
  - Professional fees
  - Expenditure incurred on start up and commission of the project (including the expenditure on test runs less income by sale of products)
  - Administrative and other general overheads are specifically attributable for construction/acquisition etc.
  - Amount of Govt, grants received/receivable against fixed asset should be deducted from the cost
  - Loss/gain on deferred payment of foreign currency liability
  - Price adjustment, changes in duties or other similar factors.

Historical cost of self-constructed fixed assets includes the following:

- All costs which are directly related to the specific asset.
- All costs that are attributable to the construction activity should be allocated to the specific assets.
- Any internal profit included in the cost should be eliminated.

Example:

A Ltd. is constructing a fixed asset. The cost of project is given below:

Materials	**₹ 10,00,000**	
Direct Expenses	**₹ 2,50,000**	
Total Wages of the company during	**₹2,40,000**	**(1 /12 is chargeable to Project the year)**
Total Administrative Exp. of the	**₹16,00,000**	**(5% is chargeable to Project company during the year)**
Depreciation on asset used for the project	**₹ 20,000**	

Calculate the cost of fixed assets

Answer:

Cost of Fixed Asset	**₹**
Material	10,00,000
Direct Expenses	2,50,000
Wages	20,000
Administration Overhead	80,000
Depreciation	20,000
Total:	13,70,000

The cost of acquisition of fixed assets is determined under the different situations differently as under:

Fixed Assets exchanged not similar - Assets acquired should be recorded either at fair market value of asset given up or fair market value of asset acquired, if this is more clearly evident.

♦ **Fixed Assets exchanged are similar** - Fixed assets acquired are recorded at fair market value of asset given up or Fair market value of asset acquired, if this is more clearly evident or Net Book value of the asset given up.

♦ **Fixed Assets acquired in exchange of share or other securities** -
If payment of fixed assets is made in shares or securities, Assets should be recorded either at fair market value of asset purchased or Fair market value of share or securities, whichever is more clearly available.

Example:

On March 31, 2015, M Ltd. traded in an old machine having a carrying amount of ₹33,600, and paid cash difference of ₹12,000 for a new machine having a total cash price of ₹41,000. On March 31, 2015, what amount of loss should Winn Company recognize on this exchange?

Answer:

As per AS-10, when a fixed asset is acquired in exchange or in part exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration.

The cash price of the new machine represents its fair market value.

The fair market value of the old machine can be determined by subtracting the cash portion of the purchase price (₹ 12,000) from the total cost of the new machine. ₹ 41,000 - ₹12,000 = ₹ 29,000. Since the book value of the machine (₹ 33,600) exceeds its fair market value on the date of the trade in (₹ 29,000), the difference of ₹ 4,600 must be recognized as a loss, however, if the fair market value of the old machine had exceeded its book value, the gain would not be recognized.

Improvements and Repair

There are two accounting treatments of cost of improvement and repairs.

These are —

- If, after the improvements and repairs, expected future benefits from fixed assets do not change. The expenses of improvements and repairs are charged to profit & loss account; and
- If, after the improvement and repairs, expected future benefits from fixed asset will increase beyond the previously assessed standard performance. These expenses on improvements and repairs are included in the gross book value of fixed asset.

Addition or extension of capital nature to an existing asset

- If it is an integral part of existing asset then it is added to gross book value of existing assets.
- If it has a separate identity and capable to be used after the disposal of existing asset then it is accounted for separately.

Example:

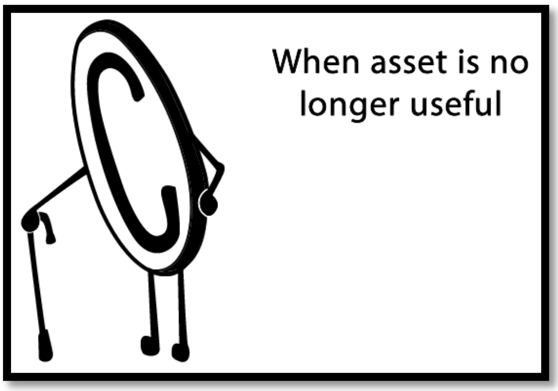
A company undertook repair and overhauling of its machinery at a cost of ₹ 12 lakhs to maintain them in good condition and capitalized the amount, as it is more than 25% of the original cost of the machinery. As an auditor, what would you do in this situation?

Answer:

Size of the expenditure is not the criteria to decide whether to capitalized subsequent expenditure or not. The important question is whether the expenditure increases the expected future benefits from the asset beyond its pre-assessed standard of performance as per AS-10. Only then it should capitalize.

In this case, only the benefits are maintained at existing level, that expenditure should not be capitalized. If under the circumstances the amount is material the auditor should qualify his report.

Retirement and disposals



- Fixed assets are deleted from the financial statement either on disposal or on expected economic benefit is over.
- Gains or losses arising on disposal are generally recognized in profit & loss account.

Example:

ABC Ltd. expects that a plant has become useless which is appearing in the bonks at₹ 30 lakhs gross value. The company charges straight line method of depreciation on a period of 10 years estimated life and estimated scrap value of 3%. At the end of 7th year the plant has been assessed as useless. Its estimated net realisable value is ₹9,30,000. Determine the loss/gain on retirement of the fixed assets.

Answer:

Cost of the plant ₹30,00,000

Estimated realisable value ₹ 90,000

Depreciable amount ₹ 29,10,000

Depreciation per year ₹ 2,91,000

Written down value at the end of 7th Year = 30,00,000 - (2,91,000 × 7) = ₹ 9,63,000.

As per AS-10, items of fixed assets that have been retired from active use and are held for disposal are stated at the lower of their net book value and net realisable value and are shown separately in the financial statements. Any expected loss is recognized immediately in the profit and loss statement. Accordingly, the loss of ₹ 33,000 (9,63,000 – 9,30,000) to be shown in the profit and loss account and asset of ₹9,30,000 to be shown in the balance sheet/" separately.

Fixed assets are retired from active use and held for disposal —

- Such asset is stated at the lower of net book value and net realisable value in the financial statement.
- Any expected loss is recognized immediately in the profit & loss statement.
- It should be separately shown in financial statement *i.e.,* balance sheet.

CONTRACTS INVOLVING SEA ROUTES

In contracts of sale which involve sea routes, certain special clauses and conditions are to be found. The meaning of these clauses has been standarised to an extent in accordance with the international customs and practices of merchants. Some of these clauses which are quite often found in such contracts and their legal effects are discussed below:

F.A.S. contracts: F.A.S. stands for "free alongside ship". The property in goods sold under an F.A.S. contract passes from the seller to the buyer when the goods are delivered alongside the ship named by the buyer under a contract of carriage.

Seller's duties.

1. To deliver the goods alongside the ship.
2. To notify the buyer immediately that the goods have been delivered alongside the ship.

Buyer's duties.

1. To arrange for the contract of affreightment
2. To give the seller sufficient notice of the name of the ship and time for delivery alongside the ship.
3. To pay all charges and to bear all risks from the time the goods are delivered alongside the ship.

F.O.B. contracts: F.O.B. stands for "free on board". If A of Delhi agrees to sell 100 tons of sugar, F.O.B. Mumbai, to B of Manchester, this would mean that A must put the goods on board a ship at Mumbai at his own expense under a contract of carriage by sea, to be made by or on behalf of the buyer, for the purpose of transmission to the buyer.

Seller's duties.

1. To deliver the goods on board the ship named by the buyer. When once the goods are put on board the ship, they are at the risk of the buyer. The duty of the seller ends when he delivers the goods at his own expense to the ship at the port of shipment [Colley v. Overseas Exporters, (1921) 3 K.B. 302]. Such delivery transfers the possession, property and risk to the buyer.
2. To give notice of the shipment to the buyer so as to enable him to protect himself by insurance against loss during the sea transit ; if the seller fails to do this, the goods will be at his risk.

Buyer's duties.

1. To arrange for the contract of affreightment.
2. To name the ship to which the goods are to be delivered or to authorise the seller to select the ship.
3. To pay all charges and bear all risks subsequent to delivery of the goods on board the ship.

The property in the goods does not pass to the buyer until the goods are delivered on board the ship. If the seller is prevented from putting the goods on board the shin by the failure of the buyer to name a ship, the seller can sue for damages for non-acceptance and not for the price.

C.I.F. contracts: C.I.F. stands for "cost, insurance and freight". If A of Delhi agrees to sell 100 bags of rice at ₹ 2,450 per bag, C.I.F. Manchester, the sum of ₹ 2,45,000 (100 x 2,450) includes (1) the price of goods, (2) the cost of insurance, and (3) the freight up to Manchester.

A C.I.F. contract is performed by the delivery of documents (bill of lading, insurance policy, invoice, certificate of origin, etc.) representing the goods to the buyer, through a bank. The documents are usually delivered by the bank against payment of the price, or against acceptance of a draft (bill of exchange). This protects both the seller and the buyer. The seller continues to be the owner of the goods until the buyer pays for the goods and gets the documents. If, in the meantime, the goods are lost at sea, the buyer or the seller, whoever is the owner at the time of the loss, can recover the amount from the insurer. If, on receiving the goods, the buyer finds that they are not according to the contract, he may reject them and recover the price paid by him.

Seller's duties.

1. To make out an invoice of the goods sold.
2. To ship at the port of shipment goods of the description contained in the contract.
3. To procure a contract of affreightment, under which the goods will be delivered at the destination contemplated by the contract.
4. To arrange for an insurance upon the terms current in the trade which will be available for the benefit of the buyer. If the seller does not effect insurance, the buyer is not bound to accept and pay for the goods even if the goods arrive safely at the destination.

5. To tender, within a reasonable time after shipment, the bill of lading, the policy of insurance and the invoice and other documents to the buyer, so that he may obtain delivery of the goods, if they arrive, or recover for their loss if they are lost on the voyage.

The bill of lading tendered must correctly state the date of shipment of the goods, otherwise the buyer can reject the goods.

Buyers duties.

1. To accept the documents if they are complete and regular, and pay the price less the freight, on delivery of the documents. 'The buyer is bound to do so even if the goods have been destroyed, for he has a remedy against the insurer of the goods.
2. To pay the unloading, wharfage charges, etc., at the port of destination.
3. To pay all customs and import duties.

In the case of a C.I.F. contracts, the buyer has the right to reject (1) the documents if they are not in order, and (2) the goods if they do not conform to the contract of sale.

C.I.F. contract - Is it a contract for the sale of documents?

In a C.I.F. contract, as already observed, the buyer has got to accept the documents, and pay the price even if the goods are destroyed, for he has a remedy against the insurer for the recovery of the loss. It is for this reason that a C.I.F. contract is described as a contract for the sale of documents rather than for the sale of goods. Scrutton J. observed, in this regard, in Arnhold Karberg & Co. v. Blythe, etc., (1916) 1 K.B. 495 : A C.I.F. sale is not a sale of goods, but a sale of documents relating to goods. This view is however not correct. A C.I.F. contract may better be described as a contract for the sale of goods to be performed by the delivery of documents, or a contract for the sale of goods through documents. Chalmers has observed that a C.I.F. contract is not a contract for the sale of documents but a contract for the sale of insured goods, to be implemented by the delivery of proper documents.

Chakravarti, C.J. has also rightly observed in Joseph Pyke & Son v. Kedarnath, A.I.R. (1959) Cal. 328, that "a person who purchases goods under a C.I.F. contract does not intend to purchase mere paper and does not expect to get merely some documents but he intends to purchase and get goods ... It is a total misconception to think that C.I.F contracts are altogether divorced from delivery of the goods." The learned judge further observed, "It cannot be said that a C.I.F. contract is not a contract for the delivery of any article. Even after the shipping documents have been presented to the buyer and even after he has paid out the invoice price, he still retains the right to examine the goods shipped to him and to reject them, if he finds any deficiency in regard to either quantity or quality. It is thus impossible to see how it can be said that under a C.I.F. contract delivery of the goods to the buyer is not material or is not contemplated."

To conclude, we may say that a C.I.F. contract is a contract for the sale of insured goods, lost or not lost, to be implemented by transfer of proper documents.

Transfer of property. In a C.I.F. contract, the property in the goods passes from the seller to the buyer when the goods are shipped unless, as usually happens, the seller reserves the right of disposal. If the seller parts with control over the disposal of the goods, the property in the goods passes to the buyer. The seller may do this by indorsing the bill of lading to the buyer. But if the seller indorses the bill of lading in blank and sends it to his agent to be delivered to the buyer only against payment of the price, or acceptance of the draft, he retains the disposal of the goods under his control. And till the price is paid or the draft is accepted, the property in the goods does not pass to the buyer.

Ex-ship contracts: These are contracts under which the seller causes the delivery of the goods to be made to the buyer from a ship which has arrived at the port of destination at his (seller's) expense. In such contracts, the property in the goods does not pass to the buyer until the goods are actually delivered to him.

Seller's duties.

1. To deliver the goods to the buyer from a ship which has arrived at the port of destination at a place from which it is usual for goods of that kind to be delivered.
2. To pay the freight or otherwise release the ship owner's lien.
3. To furnish the buyer with a delivery order, or some other effectual direction to the ship owner to deliver.

In the case of an ex-ship contract, the property and risk in the goods do not pass to the buyer until they are delivered at the port of destination. The goods are at the seller's risk during the voyage and there is no obligation on him to effect an insurance on behalf of the buyer.

SPECIFIED DOMESTIC TRANSACTION

Meaning of specified domestic transaction [Sec 92BA]

For the purposes of this section and sections 92, 92C, 92D and 92E, "specified domestic transaction" in case of an assessee means any of the following transactions, not being an international transaction, namely:

(i) any expenditure in respect of which payment has been made or is to be made to a person referred to in clause (b) of sub-section (2) of section 40A;

(ii) any transaction referred to in section 80A;

(iii) any transfer of goods or services referred to in sub-section (8) of section 80-IA;

(iv) any business transacted between the assessee and other person as referred to in sub-section (10) of section 80-IA;

(v) any transaction, referred to in any other section under Chapter VI-A or section 10AA, to which provisions of sub-section (8) or sub-section (10) of section 80-IA are applicable; or

(vi) any other transaction as may be prescribed, and where the aggregate of such transactions entered into by the assessee in the previous year exceeds a sum of five crore rupees.]

Applicability of section 92BA

Section 92BA shall apply where the aggregate of all transactions mentioned above entered into by the assessee in the previous year exceeds a sum of five crore rupees.

Section 40A(2) empowers the A.O. to disallow unreasonable expenditure incurred between related parties.

Further, under Chapter VI-A and section 10AA, the A.O. is empowered to recompute the income (based on fair market value) of the undertaking to which profit linked deduction is provided if there are transactions with the related parties or other undertaking of the same entity.

However, no specific method to determine reasonableness of expenditure or fair market value to recompute the income in such related transaction is provided under this section.

Therefore, the transfer regulations have also been extended to the transactions entered into by domestic related parties or by an undertaking and other undertaking of the same entity.

Determination of aggregate value of ₹ 5 crores

(1) It may be observed that threshold limit of ₹5 crore is applicable to aggregate of all six limits of domestic transactions referred to above.

(2) The value to be adopted for such transactions should be as per books of account. Hence book value is to be adopted even if the transactions are ALP compliant.

Example:

Transaction	Value as per books	Value as per ALP	
		Situation 1	Situation 2
40A(2)(b) payments	3.2 crores	4.0 crores	4.1 crores
Inter unit payment as per 80-IA	1.3 crores	1.3 crores	1.2 crores
	4.5 crores	5.3 crores	5.3 crores

Aggregate book value is ₹ 4.5 crores. Transfer pricing provisions shall not be applicable.

(3) The threshold limit of 5 crores can be computed either on net basis (i.e. without including indirect taxes like service tax, excise duty, VAT, etc. if the assessee is claiming Cenvat/VAT credit of the same). If the assessee is not availing Cenvat/VAT credit, the amount be taken an gross basis.

Detailed analysis of specified domestic transaction

Transaction with relative or close associates being person referred to in section 40A(2)(A) [Section 40A(2)]

According to section 40A(2)(a), where the assessee incurs any expenditure in respect to which payment has been made to a relative or close associates of the assessee referred to in section 40A(2)(&) and the Assessing Officer is of the opinion that such expenditure is excessive and unreassanable having regard to—

(a) the fair market value of the goods services or facilities for which the payment is made; or

(b) the legitimate needs of the business; or

(c) the benefit derived by or accruing to thereof

so much of the expenditure as is considered by him to be excessive or unreasonable shall not be allowed as deduction.

However, no disallowance, on account of any expenditure being excessive or unreasonable having regard to the fair market value, shall be made in respect of a specified domestic transaction referred to in section 92BA, if such transaction is at arm's length price as defined in clause (ii) of section 92F.

Specified persons referred to section 40A(2)(b)

The specified persons, in case of various assessees are as under—

	Assesse		Relatives or close associates of the assessee
i)	Where the assessee is an Individual	(a)	any relative (i.e., spouse, brother, sister, any lineal ascendant or descendant) of such individual;
	substantial interest	(b)	any person in whose business or profession the assessee (i.e. individual) himself or his relative has substantial interest.
ii)	Where the assessee is a Company, firm, AOP or HUF	(a)	(i) any director of the company, partner of the firm, or member of the association, or family, as the case may be, or (ii) any relative of such director, partner or member as the case may be;
	substantial interest	(b)	any person in whose business or profession, the assessee or director, or partner or member of the assessee or any relative of such person, as the case may be, has a substantial interest.
	substantial interest	(c)	any individual who has substantial interest in the business or profession of the assessee:
	substantial interest	(d)	(i) a company, firm, AOP or HUF, as the case may be, having a substantial interest in business or profession of the assessee; or (ii) any director, partner or member of any such person or any relative of any such director, partner or member, or any other company carrying on business or profession in which the first mentioned company has substantial interest1 as the case may be;
	substantial interest	(e)	(i) a company, firm, AOP or HUF of which a director, partner or member, as the case may be, has a substantial interest in the business or profession of the assessee; or (ii) any director, partner or member of any such person or any relative of any such director, partner or member, as the case may be.

Meaning of substantial interest:

A person shall be deemed to have a substantial interest in a business or profession if,—

(a) in a case where the business or profession is carried on by a company, such person is, at any time during the previous year, the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) carrying not less than 20% of the voting power; and

(b) in any other case, such person is, at any time during the previous year beneficially entitled to not less than 20% of the profits of such business o profession.

Example:

A Ltd. holds 25% shares in B Ltd. A Ltd. sold goods to B Ltd. for aggregate amount of ₹ 42 crores during the previous year 2013-14. The fair market value of such goods is ₹ 31 crore.

In this case, purchase of goods is an expense in the hands of B Ltd. Hence by applying fair market value B Ltd. shall be allowed deduction of expense of ₹ 31 crore instead of ₹ 42 crores.

However, there will be no effect in the hands of the seller i.e. A Ltd. Its income shall be computed by taking sale price of ₹ 42 crore and not ₹ 31 crore which is allowed a deduction to B Ltd. on the basis of fair market value.

NOTE:-

1. **Section 40A(2) covers transaction in the nature of expenditure and not income.**
2. **Some of the transactions not covered under section 40A(2) are as under:**
   - **(a) grant of interest free loan to an associate.**
   - **(b) corporate guarantee on behalf of subsidiaries.**
   - **(c) sale of goods at less than the fair market value.**
   - **(d) allowing use of trade mark or know how or common services by group entities at nil or nominal charge.**
   - **(e) dividends or dividends distribution paid as it is not an expenditure.**
   - **(f) payment of loan or share capital as it is not an expenditure.**
   - **(g) payment for purchase of an asset.**
3. **Section 40A(2) is inapplicable if the expense incurred is lower than the market value.**
4. **Section 40A(2) shall be applicable in case of the following capital expenditure:**
   - **(a) capital expenditure on scientific research allowed as deduction under section 35.**
   - **(b) capital expenditure allowed as deduction under section 35AD.**
   - **(c) 1/5th of the capital expenditure allowed as a deduction to a company assessee in case of family planning amongst employee.**
5. **Expenditure claimed as deduction under income from other sources are also covered under specified domestic transaction as section 58(2) states that provisions of section 40A are also applicable for computation of income under the head income from other sources.**

Inter unit/undertaking/business transfer [Section 80A(6)]

Where any goods or services held for the purposes of the undertaking or unit or enterprise or eligible business are transferred to any other business carried on by the assessee or where any goods or services held for the purposes of any other business carried on by the assessee are transferred to the undertaking or unit or enterprise or eligible business and, the consideration, if any, for such transfer as recorded in the accounts of the undertaking or unit or enterprise or eligible business does not correspond to the market value of such goods or services as on the date of the transfer, then, for the purposes of any deduction under this Chapter, the profits and gains of such undertaking or unit or enterprise or eligible business shall be computed as if the transfer, in either case, had been made at the market value of such goods or services as on that date.

As per clause (iii) to Explanation to section 80A, for the purpose of section 80A(6) the expression 'market value' in relation to any goods or services sold, supplied or acquired means the arm's length price as defined in section 92F(ii) of such goods or services, if it is a specified domestic transaction referred to in section 92BA.

Inter business transfers to be at market value [section 80-IA(8)]

Where any goods or services held for the purposes of the eligible business are transferred to any other business carried on by the assessee, or where any goods or services held for the purposes of any other business carried on by the assessee are transferred to the eligible business and, in either case, the consideration, if any, for such transfer as recorded in the accounts of the eligible business does not correspond to the market value of such goods or services as on the date of the transfer, then, for the purposes of the deduction under this section, the profits and gains of such eligible business shall be computed as if the transfer, in either case, had been made at the market value of such goods or services as on that date.

NOTE:-

For the purposes of this sub-section, "market value", in relation to any goods or services, means—

(i) the price that such goods or services would ordinarily fetch in the open market; or

(ii) the arm's length price as defined in clause (ii) of section 92F, where the transfer of such goods or services is a specified domestic transaction referred to in section 92BA.

Transfer to/from a person who has close connection with the assessee [Section 80-IA(10)]

Where it appears to the Assessing Officer that, owing to the close connection between the assessee carrying on the eligible business to which this section applies and any other person, or for any other reason, the course of business between them is so arranged that the business transacted between them produces to the assessee more than the ordinary profits which might be expected to arise in such eligible business, the Assessing Officer shall, in computing the profits and gains of such eligible business for the purposes of the deduction under this section, take the amount of profits as may be reasonably deemed to have been derived therefrom.

However, in case the aforesaid arrangement involves a specified domestic transaction referred to in section 92BA, the amount of profits from such transaction shall be determined having regard to arm's length price as defined in clause (ii) of section 92F.

NOTE:-

The provisions of section 80-IA(8) and (10) are also applicable to sections 80-IAB, 80-IB, 80-IC, 80-ID and 80-IE and section 10AA of the Income-tax Act.

Illustration:

R Ltd. has two units. One of these units is situated in Uttrakhand for which A Ltd. is claiming 100% deduction of profits under section 80-IC. A Ltd. filed the return of income as under:

Business income	₹
Profit from non-eligible business	54,00,000
Profit for business eligible for deduction u/s 80-IC	32,00,000
Gross total income	86,00,000
Less: Deduction u/s 80-IC	32,00,000
	54,00,000

Eligible unit has purchased goods worth ₹ 6 crores from non-eligible unit whose fair market value as determined by A.O. is ₹ 6.30 crore.

Compute the total income of R Ltd.

Solution:

Gross total income as computed above	86,00,000
Less: Deduction u/s 80-IC (32,00,000 - 30,00,000) (Lower value of purchase price due to which excess profit has been computed)	2,00,000
Total income	84,00,000

Illustration:

Q Ltd. furnishes the following return of income for the previous year 2013-14.

Business income of a unit eligible for deduction u/s 80-IE	49,00,000
Profit from other unit B	81,00,000
	1,30,00,000
Less: Deduction u/s 80-IE	49,00,000
Total income	81,00,000

Unit A made a sale of ₹ 8.4 crores to unit B. Assessing Officer referred the determination of FMV to TPO. TPO determines the arm's length price to be 8.1 crore.

Determine the total income of the assessee.

Solution:

	₹
Gross total income as computed	1,30,00,000
Less: Deduction u/s 80-IE (49,00,000 - 30,00,000) (Overstated sale price 8.4-8.1 crores = 30,00,000)	19,00,000
Total income	1,11,00,000

Provisions of transfer pricing made applicable to Specified Domestic Transaction

Section 92(2) & (3) made applicable to specified domestic transaction

(1) Mutual agreement or arrangement for the allocation or apportionment of any contribution cost or expense [Section 92(2)]

Where in a specified domestic transaction, two or more associated enterprises enter into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be.

(2) Allowance for an expenditure or interest, etc. shall be computed at arm's length price [Section 92(2A)]

Section 92(2A) has been specifically inserted by Finance Act, 2012 w.e.f. A.Y. 2013-14 only for specified domestic transaction which provides as under:

Any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the specified domestic transaction shall be computed having regard to the arm's length price.

(3) Provision of arm's length price not apply if these result into reduction of income or increase of loss [Section 92(3)]

The provisions of section 92 relating to determination of arm's length price shall not apply where the computation of income under section 92(2A) or determination of allowance for any expense or interest under sub-section (2A) or the determination of cost or expense allocated or apportioned as the case may, contributed under sub-section (2A) has the effect of reducing the income chargeable to tax or increasing the loss computed on the basis of entries made in the books of account in respect of the previous year in which the specified domestic transaction was entered into.

However, in case of unit/assessee claiming deduction under section 80A(6) or 80IA(8) or 80IA(10), the determination of arm length price should not lead to higher income of tax holiday qualifying units/assessee.

Meaning and computation of arm's length price [Section 92C and Section 92F(ii)]

Section 92C(1) and (2) along with two provisos relating to computation of arm's length price by following the most appropriate method in case of an international transaction have also been made applicable to specified domestic transaction.

(1) Meaning of arm's length price [Section 92F(ii)]: "Arm's length price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

In other words, it is the price that would have prevailed if the enterprises were at arm's length from each other i.e. where the enterprises involved were not controlled, influenced by or associated with another enterprise. It is the price that would have existed between enterprises, not associated or related with each other.

(2) Computation of arm's length price [Section 92C]: As per section 92C(1), the arm's length price in relation to an specified domestic transaction shall be determined by any of the following methods, being the most appropriate method:

(a) comparable uncontrolled price method (CUPM);
(b) resale price method (RPM);
(c) cost plus method (CPM);
(d) profit split method (PSM);
(e) transactional net margin method (TNMM);
(f) such other method as may be prescribed by the Board.

Before we choose any of above the methods of determination of arm's length price, the following procedure should be followed:

(i) Identify the specified domestic transaction;
(ii) Also identify an uncontrolled transaction. As per rule 10A(a), uncontrolled transaction means a transaction between enterprises other than associated enterprises, whether resident or non-resident;
(iii) Compare the specified domestic transactions with uncontrolled transactions on the basis of guidelines given in rule 10B(2) and situation mentioned in rule 10B(3);
(iv) Ascertain the most appropriate method by taking into account the factors discussed in rule 10C. The rule states that the method to be selected shall be the one best suited to the facts and circumstances of each international transaction and that which provides the most reliable measure of the arm's length price;
(v) Finally determine the arm's length price by applying the most appropriate method chosen. [Section 92C(2)]

However, where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices. [Proviso to section 92C(2)].

Further, if the variation between: (a) the arm's length price so determined, and (b) price at which international transaction has been actually undertaken, does not exceed such percentage not exceeding 3% of the latter (i.e. price at which international transaction has been actually undertaken) as may be notified by the Central Government in the Official Gazette in this behalf, then the price at which international transaction has actually been undertaken shall be deemed to be the arm's length price and no adjustment is required to be made. [Proviso 2 to section 92C(2)].

If the arithmetic means is not within the percentage as may be notified (maximum however is 3%) of price at which the international transaction has actually been undertaken, then arithmetical mean of arms length price shall be treated as arm's length price and accordingly adjustment will be required to be made.

Amendment made by the Finance (No. 2) Act, 2014

Determination of arm's length price where more than one price is determined by the most appropriate method [Section 92C] [W.e.f. A.Y. 2015-16]

The following third proviso has been inserted in section 92C(2):

Provided also that where more than one price is determined by the most appropriate method, the arm's length price in relation to an international transaction or specified domestic transaction undertaken on or after 1-4-2014, shall be computed in such manner as may be prescribed and accordingly the first and second proviso shall not apply.

In other words, for any international transaction or specified domestion transaction undertaken on or after 1-4-2014, third proviso shall be applicable instead of proviso first and second.

Illustration:

R Ltd. an Indian company sold goods to S Ltd. in which R Ltd. has substantial interest @ 1425 per piece. As per the most appropriate method the following arms length prices have been determined:

Situation 1	**1475**
Situation 2	**1425**
Situation 3	**1375**
Situation 4	**1525**

(a) Compute the arm's length price assuming the Central Government has notified the variation to be 3%.

(b) What will be your answer if actual price charged for the specified domestic transaction is ₹ 1,375 instead of ₹ 1,425.

Solution:

(a) Arithmetical mean of prices determined by most appropriate method:

$$\frac{1475+1425+1375+1525}{4} = \frac{5800}{4} = ₹1450$$

3% of actual specified domestic transaction price = $\frac{1425 \times 3}{100}$ = ₹ 42.75

Difference between the Arithmetic mean of arms length price - actual specified domestic transaction price i.e. ₹ 1,450 - 1,425 = ₹ 25

The arm's length price shall be taken as ₹ 1,425 since the difference between the arm's length price and the actual transaction price does not exceed 3% of actual transaction price. Hence, arm's length price shall be taken as ₹ 1,425.

(b) 3% of actual transaction price = $\frac{1375 \times 3}{100}$ = ₹ 41.25

Difference between the arithmetic means of arms length price - Actual specified domestic transaction price i.e. ₹ 1,450 - 1,375 = ₹ 75

In this case arm's length price shall be taken as ₹ 1,450 since the difference between the arm's length price and the actual transaction price exceeds 3% of actual specified domestic transaction price.

Illustration:

R Ltd. an Indian company purchased goods from S Ltd. another Indian company which is, an associated enterprises as per section 40A(2)(6), at ₹ 1,485 per price. The following arm's length prices have been determined by the most appropriate method.

Situation1 — ₹ 1,445

Situation2 — ₹ 1,525

Situation3— ₹ 1,350

Situation 4 — ₹ 1,470

(a) Compute the arm's length price assuming the Central Government has notified the variation to be 3%

(b) What will be your answer if above goods were purchased by R Ltd. at ₹ 1,500 instead of ₹1,485.

Solution:

(a) Arithmetic means of prices determined by most appropriate method.

$$= \frac{1445+1525+1350+1470}{4} = \frac{5790}{4} = ₹\ 1,447.50$$

3% of Actual specified domestic transaction price = ₹ 1,485 × $\frac{3}{100}$ = ₹ 44.55

Difference between actual price - Arithmetic mean ₹ 1,485 - 1,447.50 = ₹ 37.50.

In this case, ₹ 1,485 shall be arm's length price as the difference between the actual transaction price and the arm's length price does not exceed 3% of the actual transaction price.

(b) In this case of 3% of actual domestic transaction price 1,500 x 3 = ₹ 45

Difference between actual transaction price - Arithmetic mean ₹ 1,500 - 1,447.50 = ₹ 52.50.

∴ In this case arms length price shall be taken as ₹ 1,447.50 because the difference between the actual transaction price and the arm's length price is more than 3% of actual transaction price.

Arm's length price may be determined by the Assessing Officer in certain cases [Section 92C(3)]

Section 92C(3) which has been made applicable to specified domestic transaction empowers the Assessing Officer, in the situation specified therein, to proceed to determine the arm's length price in relation to the said specified domestic transaction in accordance with sub-section (1) and (2). Where during the course of my proceeding for the assessment of income, the Assessing Officer is, on the basis of material or information or document in his possession, of the opinion that—

(a) the price charged or paid in an specified domestic transaction has not been determined in accordance with the most appropriate method; or

(b) any information and document relating to an specified domestic transaction have not been kept and maintained by the assessee in accordance with the provisions contained in section 92D(1) and the rules made in this behalf; or

(c) the information or data used in computation of the arm's length price is not reliable or correct; or

(d) the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under section 92D(3),

the Assessing Officer may proceed to determine the arm's length price in relation to the said specified domestic transaction in accordance with section 92(1) and (2), on the basis of such material or information or document available with him:

However, before determining such arm lengths price, an opportunity shall be given by the Assessing Officer by serving a notice calling upon the assessee to show cause, on a date and time to be specified in the notice, why the arm's length price should not be so determined on the basis of material or information or document in the possession of the Assessing Officer.

Note:-

If the assessee has determined the arm's length price in accordance with the statutory requirements and the data used for determining the arm's length price is reliable and correct, there can be no intervention by the Assessing Officer. The Assessing Officer can intervene only if any of the above circumstances exist.

Conditions to be satisfied before Assessing Officer can determine arm's length price

(1) The Assessing Officer must form his opinion about the existence of the situations mentioned above during the course of any proceedings for the assessment of income.

(2) Such situation must be shown by the Assessing Officer to exist on the basis of material or information or document in his possession.

(3) A proper opportunity must be given to the assessee to show why the arm's length price must not be so determined by the Assessing Officer.

(4) The arm's length price must also be determined on the basis of such material, information or document which he has in his possession.

Computation of total income where arm lengths price is determined by the Assessing Officer [Section 92C(4)]

Where an arm's length price is determined by the Assessing Officer under section 92C(3), the Assessing Officer may compute the total income of the assessee having regard to the arm's length price so determined:

Consequences if total income is determined by the Assessing Officer section 92C(4):

(1) No deduction under section 10AA under Chapter VIA shall be allowed in respect of the amount of income by which the total income of the assessee is enhanced after computation of income under this sub-section.

(2) Where the total income of an associated enterprise is computed under this sub-section on determination of the arm's length price paid to another associated enterprise from which tax has been deducted or was deductible, under the provisions of Chapter XVIIB, the income of the other associated enterprise shall not be recomputed by reason of such determination of arm's length price in the case of the first mentioned enterprise.

Reference to Transfer Pricing Officer (TPO) [Section 92CA]

(A) Reference to Transfer Pricing Officer (TPO) [Section 92CA(1)]:

Where any person, being the assessee, has entered into an specified domestic transaction in any previous year, and the Assessing Officer considers it necessary or expedient so to do, he may, with the previous approval of the Commissioner, refer the computation of the arm's length price in relation to the said specified domestic transaction under section 92C to the Transfer Pricing Officer. [Section 92CA(1)]

(B) Procedure to be followed by TPO when reference is made to him

(1) Service of notice [Section 92CA(2)]: Where a reference is made to the TPO, the TPO shall serve a notice on the assessee requiring him to produce or cause to be produced on a date to be specified therein, any evidence on which the assessee may rely in support of the computation made by him of the arm's length price in relation to such specified domestic transaction.

(2) TPO to pass order in writing [Section 92CA(3)]: On the date specified in the above notice, or as soon thereafter as may be,—

(a) after hearing such evidence as the assessee may produce, including any information or documents referred to in section 92D(3) and after considering such evidence as the Transfer Pricing Officer may require on any specified points; and

(b) after taking into account all relevant materials which he has gathered, the Transfer Pricing Officer shall, by order in writing, determine the arm's length price in relation to the specified domestic transaction in accordance with section 92C(3) and send a copy of his order to the Assessing Officer and to the assessee.

(3) TPO to pass order at any time before 60 days prior to limitation period referred to in section 153 or 153B [Section 92CA(3A)]: Where a reference under section 92CA(1) is made, an order under section 92CA(3) may be made at any time before 60 days prior to the date on which the period of limitation referred to in section 153, or as the case may be, in section 153B for making the order of assessment or reassessment or recomputation or fresh assessment, as the case may be, expires.

(4) Powers of TPO for the purpose determining arm's length price [Section 92(CA)(7)]: The Transfer Pricing Officer may, for the purposes of determining the arm's length price under this section, exercise all or any of the powers specified in clauses (a) to (d) of section 131(1) or section 133(6) or survey under section 133 A. Thus, TPO shall now have power to conduct on the spot enquiry and verification.

(5) Rectification of order passed by TPO [Section 92CA(5) and (6)]: With a view to rectifying any mistake apparent from the record, the Transfer Pricing Officer may amend any order passed by him, and the provisions of section 154 shall, so far as may be, apply accordingly.

Where any amendment of such order is made by the Transfer Pricing Officer, he shall send a copy of his order to the Assessing Officer who shall thereafter proceed to amend the order of assessment in conformity with such order of the Transfer Pricing Officer.

(C) Steps to be taken by the Assessing Officer on receipt of order of the TPO [Section 92CA(4)]

On receipt of the order under section 92CA(3), the Assessing Officer shall proceed to compute the total income of the assessee under section 92C(4) in conformity with the arm's length price as so determined by the Transfer Pricing Officer.

It may be observed from the above that it will be mandatory for the Assessing Officer to compute the total income on the basis of arm's length price determined by the Transfer Pricing Officer.

Note:-

"Transfer Pricing Officer" means a Joint Commissioner or Deputy Commissioner or Assistant Commissioner authorized by the Board to perform all or any of the functions of an Assessing Officer specified in sections 92C and 92D in respect of any person or class of persons."

Maintenance, keeping of information and document by persons entering into an Specified Domestic Transaction [Section 92D and Rule 10D]

1. **Responsibility of the enterprise to maintain record [Section 92D(1)]:** Every person who has entered into an specified domestic transaction shall keep and maintain such information and document in respect thereof, as may be prescribed (See rule 10D).
2. **Period for which records shall be kept maintained [Section 92D(2)]:** The Board may prescribe the period for which the information and document shall be kept and maintained under that sub-section. The Board, vide rule 10D(5) has prescribed that the information and documents shall be kept and maintained for a period of 8 years from the end of the relevant assessment year.

Note:-

Failure to keep and maintain any such information and document shall attract a penalty under section 271AA which shall be a sum equal to 2% of the value of each specified domestic transaction entered into by the person.

3. **Furnishing of information or documents relating to specified domestic transaction [Section 92D(3)]:** The Assessing Officer or the Commissioner (Appeals) may, in the course of any proceeding under this Act, require any person who has entered into an specified domestic transaction to furnish any information or document in respect thereof, as may be prescribed under section 92D(1), within a period of thirty days from the date of receipt of a notice issued in this regard.

   However, the Assessing Officer or the Commissioner (Appeals) may, on an application made by such person, extend the period of thirty days by a further period not exceeding thirty days.

Note:-

Failure to furnish such information and documents shall attract a penalty under section 271G which shall be a sum equal to 2% of the value of specified domestic transaction.

Report from an accountant to be furnished by persons entering into Specified Domestic Transaction [Section 92E and Rule 10E]

Every person who has entered into an specified domestic transaction during a previous year shall obtain a report from an accountant (not necessary from statutory auditor) and furnish such report on or before the specified date in the prescribed form (i.e. Form No. 3CEB) duly signed and verified in the prescribed manner by such accountant and setting forth such particulars as may be prescribed. Such report has to be filed electrically.

It may be observed that transfer price documentation forms the basis for certification of Form 3CEB. The certificate 3CEB contains defects such as—

- Compliance by tax payer with transfer pricing documentation requirements.
- Nature/quantum of transaction and method used to determine arm's length price. The above report aims at assisting tax officer in assessee proceedings.

Note:-

"Specified date" shall have the same meaning as assigned to "due date" in Explanation 2 below section 139(1).

As per Explanation 2 to section 139(1), w.e.f. A.Y. 2012-13 due date in case of an assessee who is required to furnish report referred to section 92E shall be 30th November of the assessment year.

Penalty provisions applicable to the above Chapter

The following new penalty provisions have been inserted in connection with the aforesaid specified domestic transaction.

(1) Penalty for concealment of income: Explanation 7 has been inserted to section 271(1)(c) to provide that in case of an assessee who has entered into an specified domestic transaction, if any amount is added or disallowed by the Assessing Officer in computing the total income under section 92C(4), then the amount so added or disallowed shall be deemed to represent the income in respect of which particulars have been concealed or inaccurate particulars have been furnished and thus penalty of concealment shall not be less than 100% but not more 300% of tax sought to evaded.

(2) Penalty for non-maintenance of records and documents [Section 271AA]: Without prejudice to the provisions of section 271 or section 271BA, if any person in respect of an specified domestic transaction,—

(i) fails to keep and maintain any such information and document as required by sub-section (1) or sub-section (2) of section 92D;

(ii) fails to report such transaction which he is required to do so; or

(iii) maintains or furnishes an incorrect information or document,

the Assessing Officer or Commissioner (Appeals) may direct that such person shall pay, by way of penalty, a sum equal to 2% of the value of each specified domestic transaction entered into by such person.

(3) Penalty for failure to furnish report of an accountant: Section 271BA provides for a penalty of ₹1,00,000 if any person fails to furnish the report from a chartered accountant as required by section 92E.

(4) Failure to furnish information or documents or required under section 92D: Section 271G provides that if a person who has entered into specified domestic transaction fails to furnish any such information or documents as required by Assessing Officer or Commissioner (Appeal) as required under section 92D, a penalty of a sum equal to 2% of the value of the specified domestic transaction can be imposed for each such failure.

However, sections 271AA, 271BA and 271G have also been included under section 273B so as to provide that no penalty shall be impossible for any failure referred to in these sections if the assessee proves that there was reasonable cause for such failure.

LABOUR TURNOVER

The ratio of the number of employees that leave a company through attrition, dismissal, or resignation during a period to the number of employees on payroll during the same period.

Labour Turnover of an organisation is change in the labour force during a specified period measured against a suitable index. The rate of Labour Turnover in an industry depends upon several factors such as, nature of the industry, its size, location and composition of the labour force. A controlled level of Labour Turnover is considered desirable because it helps the firm to adjust the size of its labour force in response to needs such as for seasonal changes or changes in technology.

Causes of Labour Turnover:

The various causes of labour turnover can be classified under the following three heads:

1. Personal causes;
2. Unavoidable causes; and
3. Avoidable causes.

1. Personal Causes:

Workers may leave the organization purely on personal grounds, e.g.

- Domestic troubles and family responsibilities.
- Retirement due to old age.
- Accident making workers permanently incapable of doing work.
- Women workers may leave after marriage in order to take up household duties.
- Dislike for the job or place.
- Death.
- Workers finding better jobs at some other places.
- Workers may leave just because of their roving nature.
- Cases involving moral turpitude.

In all such cases, labour turnover is unavoidable and the employer can practically do nothing to reduce the labour turnover.

2. **Unavoidable Causes:**

In certain circumstances it becomes necessary for the management to ask some of the workers to leave the organization.

These circumstances may be as follows:

- Workers may be discharged due to insubordination or inefficiency.
- Workers may be discharged due to continued or long absence.
- Workers may be retrenched due to shortage of work.

3. **Avoidable Causes:**

- Low wages and allowances may induce workers to leave the factory and join other factories where higher wages and allowances are paid.
- Unsatisfactory working conditions e.g., bad environment, inadequate ventilation etc. leading to strained relations with the employer.
- Job dissatisfaction on account of wrong placement of workers may become a cause of leaving the organization.
- Lack of accommodation, medical, transport and recreational facilities.
- Long hours of work.
- Lack of promotion opportunities.
- Unfair methods of promotion.
- Lack of security of employment.
- Lack of proper training facilities.
- Unsympathetic attitude of the management may force the workers to leave.

Effects of Labour Turnover:

There must be some labour turnover due to personal and unavoidable causes. It has been observed by employers that a normal labour turnover, which is between 3% and 5%, need not cause much anxiety. But a high labour turnover is always detrimental to the organization. The effect of excessive labour turnover is low labour productivity and increased cost of production.

This is due to the following reasons:

- Frequent changes in the labour force give rise to interruption in the continuous flow of production with result that overall production is reduced.
- New workers take time to become efficient. Hence lower efficiency of new workers increases the cost of production.

- Selection and training costs of new workers recruited to replace the workers who have left increase the cost of production.
- New workers being unfamiliar with the work give more scrap, rejects and defective work which increase the cost of production.
- New workers being inexperienced workers cause more depreciation of tools and machinery. Due to faulty handling of new workers, breakdown of tools and machinery may also occur very often and hamper production.
- New workers being inexperienced workers are more prone to accidents. Consequently, all costs associated with accidents such as loss on account of output lost, compensation for the injured workers, damage of materials and equipment due to accidents etc. increase the cost of production.

Reduction of Labour Turnover:

As already pointed out, normal labour turnover is advantageous because it allows injection of fresh blood into the firm. But excessive labour turnover is not desirable because it shows that labour force is not contended. Therefore, every effort should be made to remove the avoidable causes which give rise to excessive labour turnover.

Following steps may be taken to reduce the labour turnover:

- A suitable personnel policy should be framed for employing the right man for the right job and giving a fair and equal treatment to all workers.
- Good working conditions which may be conducive to health and efficiency should be provided.
- Fair rates of pay and allowances and other monetary benefits should be introduced.
- Maximum non-monetary benefits (i.e., fringe benefits) should be introduced.
- Distinction should be made between efficient and inefficient workers by introducing incentive plans whereby efficient workers may be rewarded more as compared to inefficient workers.
- An employee suggestion box scheme should be introduced whereby workers who suggest improvements in the method of production should be suitably rewarded.
- Men-management relationships should be improved by encouraging labour participation in management.

In addition to the above steps, the personnel department should prepare periodical reports on the labour turnover listing out the various reasons due to which workers have left the organization. The report should be sent to the management with the necessary recommendations so that corrective measures may be taken to reduce labour turnover.

Cost of Labour Turnover:

The cost of labour turnover can be divided under two heads:

(i) Preventive Costs.

(ii) Replacement Costs.

(i) Preventive Costs:

These are costs which are incurred to prevent excessive labour turnover. The aim of these costs is to keep the workers satisfied so that they may not leave the factory.

These costs may include:

- Cost of providing good working conditions.
- Cost of providing medical, housing and recreational facilities to workers.
- Cost of providing educational facilities to the children of the workers.
- Cost of providing subsidized meals.
- Cost of providing other welfare facilities.
- Cost of providing safety measures against working conditions.
- Measures of security and retirement benefits such as pension, gratuity, employer's contribution to provident fund and other measures over and above the compulsory legal provisions.

As "prevention is better than cure" preventive cost should be incurred to prevent excessive labour turnover. This cost of labour turnover should be apportioned among different departments on the basis of average number of employees in each department and justifiably treated as overhand.

If preventive cost is incurred for reasons of image or status of the employer or non-economical corporate goals, it may be debited to the Costing Profit and Loss Account. If preventive cost is incurred for a particular department, it may be taken as overhead of that department.

(ii) Replacement Costs:

These costs are associated with replacement of workers and include:

- Cost of recruitment of new workers.
- Cost of training new workers.
- Loss of production due to
  - Interruption in production, and
  - Inefficiency of new workers.
- Loss of profit due to loss of production.
- Loss in fixed overhead cost because of less production on account of new inexperienced workers.
- Wastage due to excessive spoilage on account of inept handling of machines, tools and materials by new workers recruited as a result of labour turnover.
- Cost of accidents because of new workers having more proneness to accidents.

These costs should be distributed among different departments on the basis of actual number of workers replaced in each department and treated as overhead.

Measurement of Labour Turnover

- Additions Method
- Separation Method
- Replacement Method
- Flux Method

Additions Method

Under this method, number of employees added during a particular period is taken into consideration for computing the Labour Turnover.

$$\text{Additional Method/Rate} = \frac{\text{No. of addition}}{\text{Av. no. of workers during the period}} \times 100$$

$$\text{Average No.} = \frac{\text{No. of employees at start} + \text{No. of employees at end}}{2}$$

Separation Method

In this method, instead of taking the number of employees added, number of employees left during the period is taken into consideration.

$$\text{Separation Method} = \frac{\text{No. of employees separated in a period}}{\text{Av. No. of employees in the period}} \times 100$$

Replacement Method

In this method neither the additions nor the separations are taken into consideration. The number of employees replaced is taken into consideration for computing the Labour turnover.

$$\text{Replacement Method} = \frac{\text{No. of employees replaced in a period}}{\text{Av. No. of employees in the period}} \times 100$$

Flux Method

Under this method Labour Turnover is computed by taking into consideration the additions as well as separations. The turnover can also be computed by taking replacements and separations also.

$$\text{Flux Method} = \left[\frac{\frac{1}{2}(\text{No. of additions} + \text{No. of Separation})}{\text{Av. No. of workers during the period}}\right] \times 100$$

$$\text{Flux Method} = \left[\frac{\frac{1}{2}(\text{No. of Replacement} + \text{No. of Separation})}{\text{Av. No. of employees in the period}}\right] \times 100$$

Example 1:

From the following information, calculate the labour turnover by different methods.

No. of workers as on 01.01.2014	7,600
No. of workers as on 31.12.2014	8,400

During the year 80 workers left while 320 workers were discharged. 1,800 workers were engaged out of which only 500 were appointed in the vacancy created by the number of workers separated and the rest on account of expansion scheme.

Answer:

$$\text{Average no. of workers} = \frac{7,600 + 8,400}{2} = 8,000$$

$$\text{1. Additions Method} = \frac{1,800}{8,000} \times 100 = 22.50\%$$

$$\text{2. Separation Method} = \frac{(80 + 320)}{8,000} \times 100 = 5\%$$

$$\text{3. Replacement Method} = \frac{500}{8,000} \times 100 = 6.25\%$$

$$\text{4. Flux Method} = \frac{\frac{1}{2}(1,800 + 400)}{8,000} \times 100 = 13.75\%$$

Example 2:

The management of Sunshine Ltd. wants to have an idea of the profit lost/foregone as a result of labour turnover last year.

Last year sales amounted to Rs 66, 00,000 and the P/V Ratio was 20%. The total number of actual hours worked by the direct labour force was 3.45 lakhs. As a result of the delays by the Personnel Department in filling vacancies due to labour turnover, 75,000 potentially productive hours were lost. The actual direct labour hours included 30,000 hours attributable to training new recruits, out of which half of the hours were unproductive.

The costs incurred consequent on labour turnover revealed on analysis the following:

	₹
Settlement cost due to leaving	27,420
Recruitment costs	18,725
Selection costs	12,750
Training costs	16,105

Assuming that the potential production lost due to labour turnover could have been sold at prevailing prices, ascertain the profit foregone/lost last year on account of labour turnover.

SOLUTION

Calculation of Actual Productive Hours

	Actual hours worked	3,45,000
Less:	Hours lost due to training workers (unproductive hours *i.e.* $\frac{1}{2}$ of 30,000 hours)	15,000
	Actual Productive Hours	3,30,000

Sales per Productive Hour $= \frac{\text{Total Sales}}{\text{Actual Productive Hours}} = ₹\ \frac{66,00,000}{3,30,000} = ₹\ 20$

Potential productive hours lost as a result of labour turnover	75,000 hours.
Sales forgone @ ₹ 20 per hour (75,000 × ₹ 20)	₹ 15,00,000
P/V Ratio	20%
Contribution forgone (₹ 15,00,000 × 20%)	₹ 3,00,000

STATEMENT OF PROFIT FOREGONE
(as a result of labour turnover)

		₹
Contribution foregone		3,00,000
Add :	Settlement cost due to leaving	27,420
	Recruitment costs	18,725
	Selection costs	12,750
	Training costs	16,105
Total Profit foregone as a result of labour turnover		3,75,000

PERT/CPM (BASICS)

PERT and CPM are network techniques or models especially useful for planning, scheduling and executing large time-bound projects which involve careful co-ordination of a variety of complex and inter-related activities and resources.

PERT stands for Programme Evaluation and Review Technique and CPM stands for Critical Path Method.

Both the techniques have been applied successfully to improve efficiency of execution of large projects within pre-determined time and cost limits.

The application of PERT and CPM is intended to answer the following questions:

- How soon will the project be completed?
- When is each individual phase of the project scheduled to start and finish?
- Which are the critical phases of the project to be finished on time and require close managerial attention to avoid delay?

Advantages of PERT/CPM:

- ✓ Forces management to plan a project before it begins.
- ✓ Requires an analytical approach to planning.
- ✓ Separates the planning and scheduling functions.
- ✓ Permits the planner to concentrate on the relationship of items of work without considering their occurrence in time.

- ✓ Allows the planner to develop a more detailed plan, since he is concerned with how the work will be performed, not when.
- ✓ Results in a more realistic schedule.
- ✓ Clearly shows dependency relationships between work tasks.
- ✓ Facilitates control of a project
- ✓ Simplifies maintenance of the plan and schedule.
- ✓ Informs management of the current status of the project.
- ✓ Focuses management's attention on critical items of work.
- ✓ Gives management the ability to assess consequences of anticipated changes to the plan.
- ✓ Makes it easy to relate other functions of project control to the basic planning and scheduling functions.
- ✓ Meets contractual requirements of government, private industry and customers.

Distinction between PERT and CPM

SL. No.	PERT	CPM
1.	Time estimate is probabilistic with uncertainty in time duration, three time estimates.	Time estimate is deterministic with known time duration, Single time estimate.
2.	Event oriented	Activity oriented
3.	Focused on time	Focused on time –cost trade off
4.	More suitable for new projects	More suited for repetitive projects
5.	Most costly to maintain	Easy to maintain
6.	Suitable for complex projects where uncertain timing is like research programmes	Suitable where problems of resource allocation exist like construction projects
7.	Dummy activity required for proper sequencing	Use of dummy activity not necessary.

Assumptions of PERT/CPM

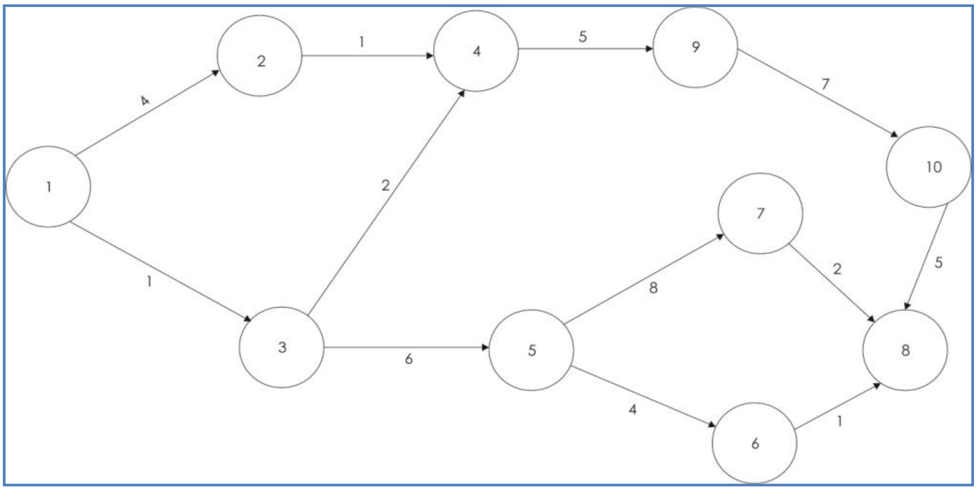
- A project can be sub-divided into a set of predictable and independent activities.
- The precedence relationships of project activities can be completely represented by a non-cyclical network graph in which each activity connects directly into its immediate successors.
- Activity items may be estimated either as single-point estimates or as three point PERT estimates and are independent of each other.

- In CPM, the duration of an activity is linearly (and inversely) related to the cost of resources applied to the activity.
- Cost time trade off for deriving the cost curve slopes are subjective again and call for great deal of expertise of the technology as well as genuine efforts to estimate.

1. A project schedule has the following characteristics:

Activity	Time	Activity	Time
1-2	4	5-6	4
1-3	1	5-7	8
2-4	1	6-8	1
3-4	2	7-8	2
3-5	6	8-10	5
4-9	5	9-10	7

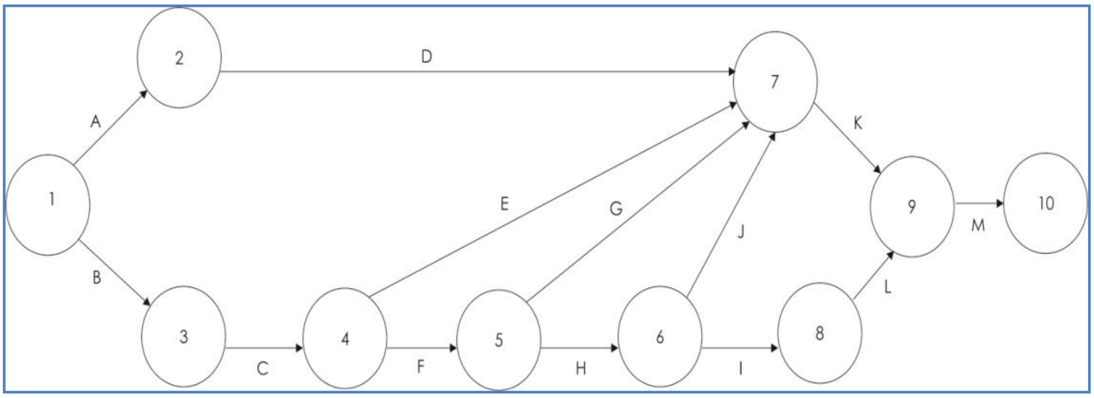
Construct a network diagram.



2. The activities involved in the computer installation process are detailed below. You are required to draw the network:

	Activity	Predecessor activities
A	Physical preparation	None
B	Organizational planning	None
C	Personnel selection	B
D	Equipment installation	A
E	Personnel training	C
F	Detailed systems design	C
G	File conversion	F
H	Establish standards and controls	F
I	Programme preparation	H
J	Programme testing	I

K	**Parallel operations**	**D, E, G, J**
L	**Finalise system documentation**	**I**
M	**Follow up**	**K, L**



Thank You

BILL OF ENTRY: A PART OF CUSTOMS PROCEDURE

The Importer of any goods (other than those intended for transit or transshipment) shall make entry by presenting a Bill of Entry (w.e.f. 08.04.2011) electronically to the Proper Officer –

(a) for home consumption, i.e. clearance of goods into General Indian Territory (called as Domestic Tariff Area) or

(b) for warehousing, i.e. deposit of goods temporarily in a Warehouse, for later clearing from the Warehouse.

Where it is not feasible to make an entry by presenting electronically, the Commissioner of Customs may, allow an entry to be presented in any other manner.

Types of Bill of Entry:

- For Home Consumption — Bill of Entry (General)
- For Warehousing — Into Bond Bill of Entry
- For Home Consumption from Warehouse — Ex-Bond Bill of Entry

Time of Presentation of Bill of Entry:

- In case of Vessel / Aircraft (i.e. Sea / Air): Any time after delivery of Import Manifest.
- In case of Land Customs Station (i.e. Vehicles): Any time after delivery of Import Report.

However, a bill of entry may be presented even before the delivery of such manifest or report, if the vessel or the aircraft or the vehicle by which the goods have been shipped for importation into India is expected to arrive within 30 days from the date of such presentation. [Amended by Finance (No. 2) Act, 2014 w.e.f. 06-08-2014]

In case if the vessel or aircraft or vehicle do not arrive within 30 days of presentation of the bill of entry, the bill of entry so presented shall stand cancelled.

Contents of Bill of Entry:

(a) Bill of Entry shall include all goods mentioned in Bill of Lading or other receipt given by the Carrier to the Consignor.

(b) The Importer shall make a declaration as to the truth of the contents of bill of entry, i.e. "Contents True" Certificate.

(c) Importer shall produce the Invoice relating to imported goods to the Proper Officer in support of such declaration.

Bill of Entry (Electronic declaration) Regulations, 2011:

The Bill of Entry (Electronic declaration) Regulations, 2011 have been made effective from 25-11-2011.

- Regulation 3: An importer or his authorised custom house agent, may enter electronic declaration (i.e. Bill of Entry) in ICEGATE (Indian Customs Electronic Data Interchange Gateway) by himself or through data operators.

- Regulation 4: The bill of entry is deemed to be filed and self-assessment of duty is completed, when, after entry of the electronic declaration in the Indian Customs Electronic Data Interchange System (ICEDIS) or by way of data entry through the service centre, a bill of entry number is generated by the ICEDIS for the said declaration.

- Regulation 5: After completion of assessment, the importer presents original bill of entry (customs copy) and duty-paid challan and supporting import documents to the proper officer of customs for making an order permitting clearance, after examination of imported goods if so required.

- Regulation 6: After making an order permitting clearance, the proper officer shall generate duplicate bill of entry (importer's copy) and the triplicate bill of entry (exchange control copy).

- Regulation 7: The original bill of entry (customs copy) along with supporting import documents shall be retained by the proper officer of customs and after suitable endorsements, the duplicate bill of entry (importer's copy) and the triplicate bills of entry (exchange control copy) shall be handed over to the authorised person.

Substitution of Bill of Entry: According to Section 46(5) of the Customs Act, a bill of entry for home consumption can be substituted for bill of entry for warehousing or vice versa. Such substitution is permissible only if proper officer is satisfied that the interest of revenue is not prejudicially affected and there was no fraudulent intention.

Duty applicable on the date of filing substituted bill of entry shall apply: In case of substitution of bill of entry, the date of submission of revised bill of entry will be the relevant date for determination of rate of duty and tariff valuation. In case importer seeks to substitute bill of entry originally filed, he has to file a new bill of entry in the prescribed form again along with the application for substitution.

Case Study 1: Bill of Entry for Home Consumption was substituted with bill of entry for Warehousing on a date when it was known that the rate of customs duty applicable was reduced. Such substitution is not permissible, since, allowing it would have caused loss of revenue. **[Bharat Commerce & Industries Ltd. 93 ELT 653 (SC)]**

Amendment of Bill of Entry: Amendment of bill of entry can be made in accordance with provisions of Section 149 of the Customs Act, 1962. In case of the imported goods which have been cleared for home consumption or deposited in a warehouse, no amendment of a bill of entry shall be so authorised, except on the basis of documentary evidence which was in existence at the time the goods were cleared or deposited. Amendment relates back to the date of presentation of original bill of entry. Therefore, the date of filing of bill of entry for determination of rate of customs duty shall be such original date on which the original bill of entry was filed.

Deposit without Warehousing: Where the Importer makes a declaration to the Proper Officer that he is unable to furnish all the particulars of the goods u/s 46 of the Customs Act (for bill of entry), for want of information, the Proper Officer may, prior to the entry permit the Importer to –

(a) examine the goods in the presence of an Officer of Customs, or
(b) deposit the goods in a Public Warehouse appointed u/s 57 without warehousing the same.

Declaration as to truth of the contents & submission of Invoice: The importer while presenting a bill of entry shall make and subscribe to a declaration as to the truth of the contents of such bill of entry and shall, in support of such declaration, produce to the proper officer the invoice relating to the imported goods.

Bill of entry to be filed even if goods exempt: Section 46 applies in case of import of all goods. Therefore, even if some goods are exempt and no duty is payable on import thereof, a bill of entry u/s 46 is required to be filed in respect of such import.

Confiscated goods purchased in Auction are not same as importation of goods.

Case Study 2: Ocean going vessel was confiscated by Customs and sold in auction to the Assessee. The Assessee is not required to file Bill of Entry. The vessel has not been imported by the Assessee, but has been purchased by them in an auction held by the Customs Department. The vessel was not imported by the Petitioners but was sold as a property of the Central Government within the territory of India. **[Chaudhary Industries vs UOI (2012)(281) – ELT-0216-GCT].**

SHARE BASED PAYMENT

Share-Based Payments cover all forms of Share-Based Payment for goods and services supplied to the Reporting Entity including —

(a) Employee Share or Share Option Schemes.

(b) Share-based payments to parties other than Employees that have supplied goods or services to the Entity.

(c) Payments to be settled in cash or other assets at amounts that depend on Share Values.

Types —

(a) In case of **Equity Settled Share Based Plans** entity receives goods or services in return for Equity Instruments, such as Shares or Options.

(b) In case of **Cash Settled Share Based Plans** entity receives goods or services in return for incurring liabilities to the Supplier for amounts based on the price of the Entity's Shares or other Equity Instruments.

(c) In case **Share Based Plans with Cash alternatives** transactions that may be **settled either in Equity Instruments or Cash** at either the Entity's or Supplier's discretion.

Forms of Share-based Payment Plans —

- **Employee Stock Option Plan (ESOP)** is a contract that gives the Employees of an enterprise the right, but not obligation for a specified period to purchase or subscribe to the specified number of Shares of the Enterprise at a fixed or determinable price, called the Exercise Price.
- **Employee Stock Purchase Plans (ESPP)** is a plan under which the enterprise offers Shares to its Employees at a discounted price **as part of Public Issue or otherwise.**
- **Stock Appreciation Right (SAR)** are rights that entitle the Employees to receive Cash or Shares for an

amount equivalent to the excess of Market Price on Exercise Date over a stated price.

Employee Share Based Payments

- Employee Share-Based Payments are incentive payments to employees in form of Shares. It also includes Cash Incentives quantum of which is linked with value of Shares.

(a) Exercise Price: Payment in the form of Shares generally involve grant of Options to Employees to subscribe Shares of the Employer at a concessional rate called Exercise Price.

(b) Extent of Gain: Employees gain to the extent of the excess of Market Price of Share at the time of exercise, in excess of the specified Exercise Price.

(c) Cash Incentives: Incase of Employee Share-based Payments in form of Cash Incentive, the excess of Market Price on specified future date and a stated price is paid in Cash.

Important Terms:

- **Grant Date:** Day on which Share-based payment plan is announced and accepted by Employees.
- **Vesting Date:** Day when the Employees become entitled to such payments.
- **Vesting Period:** Period between these Grant Date and Vesting Date.
- **Exercise Period:** Period between the Vesting Date and Exercise Date.

Accounting for Employees Stock Option Plan

A. Amount of benefit under an Option is determined either at Intrinsic Value or Fair Value, and recognized as an Expense over the Vesting Period as follows —

Employees' Compensation Expense A/c Dr.

To Stock Options Outstanding A/c

ABC Ltd. grants 180 Share Options to each of its 600 Employees. Each grant containing condition on the employees working for ABC Ltd. over the next 4 years. ABC Ltd. has estimated that the Fair Value Option is ₹15. ABC Ltd. also estimated that 30% of Employees will leave during the four year period and hence forfeit their rights to the Share Option. If the above expectations are correct, what amount of Expenses to be recognized during vesting period?

1.	Total Number of Options Granted (Employees 600 × Options per Employee 180)	1,08,000
2.	Total Number of Options Expected to Vest [1,08,000 × 70%] (i.e. after 30% Employees leaving)	32,400 Shares
3.	Fair Value per Option (Given)	₹15
4.	Fair Value of Options Expected to Vest at the end of Vesting Period = (2) × (3)	₹ 4,86,000
5.	Amount to be expensed in year 1 = $\frac{\text{Total value of option}}{\text{Vesting Period 4 years}} = \frac{4,86,000}{4}$	₹ 1,21,500

B. On exercise of the Option, the Enterprise issues Shares on receipt of the Exercise Price. The consideration for such Shares comprises of the Exercise Price and the aggregate value of Option recognized as expense, standing to the credit of Stock Options Outstanding A/c.

Stock Options Outstanding A/c Dr. (Value of Options expensed over the vesting period)
Bank A/c Dr. (Exercise Price)
To Share Capital A/c
To Securities Premium A/c

C. Where the right to obtain Shares or Stock Options expires unexercised that means lapses, the balance standing to the credit of the relevant Equity Account should be transferred to General Reserve.

Stock Options Outstanding A/c Dr.
To General Reserve A/c

PP Ltd. granted 500 Options to each of its 2,500 Employees in 2009-2010, at an Exercise Price of ₹ 50, when the Market Price was the same. The contractual life (Vesting and Exercise Period) of the options granted is 6 Years with the Vesting Period and Exercise Period being 3 Years each.

The expected life is 5 Years and the expected annual forfeitures are estimated at 3%. The Fair Value per Option is arrived at ₹ 15.

Actual forfeitures in 2009-2010 were 5%. However, at the end of 2009-2010, the Management of PP Ltd still expects the actual forfeitures would average only 3% over the entire vesting period. During 2010- 2011, the Management revises its estimated forfeiture rate to 10% per annum.

Of the 2,500 Employees, 1,900 Employees have completed the 3 Year vesting period. 1,000 Employees exercised their right to obtain Shares vested in them in pursuance of ESOP at the end of 2013-2014 and 500 Employees exercised their right at the end of 2014-2015. The rights of the remaining employees expire unexercised at the end of 2014- 2015. The Face Value per Share is ₹ 10.

Show the necessary Journal Entries with suitable narrations. Workings should form part of the answer.

A. Computation of Expense to be Recognized

Details	FY 2009-2010	FY 2010-2011	FY 2011-2012
(a) Number of Employees at year end	2,500 - 5% of 2,500 = 2,375	2,375 - 3% of 2,375 (assumed actual) = 2,303	Given 1,900
(b) Annual Forfeiture Expected in future	3%	10%	NA
(c) Total Number of Options Expected to Vest on Exercise Date (Note)	11,17,318.75 [(a) × 500 Shares × 97% × 97%)]	10,36,350 [(a) × 500 Shares × 90%)]	9,50,000 [(a) × 500 Shares]
(d) Total Value of Options Expected to Vest at the end of Vesting Period = [(c) × FV of Option]	11,17,318.75 × ₹ 15 = ₹ 1,67,59,780	10,36,350 × ₹ 15 = ₹ 1,55,45,250	9,50,000 × ₹ 15 = ₹ 1,42,50,000
(e) Total Cumulative Cost of Options	[(d) × 1/3] = ₹ 55,86,594	[(d) × 2/3] = ₹ 1,03,63,500	[(d) × 3/3] = ₹ 1,42,50,000
(f) Less: Already recognized in Previous Years	0	(₹ 55,86,594)	(₹ 1,03,63,500)
(g) Amount to be Expensed this Year	**₹ 55,86,594**	**₹ 47,76,906**	**₹ 38,86,500**

B. Journal Entries

Date	Particulars	Debit (₹)	Credit (₹)
31.03.10	Employee Compensation Expense A/c Dr.	55,86,594	
	To Employees Stock Options Outstanding A/c		55,86,594
	[Being Employee Compensation Expense recognized for the year]		

31.03.11	Employee Compensation Expense A/c Dr. To Employees Stock Options Outstanding A/c [Being Employee Compensation Expense recognized for the year]	47,76,906	 47,76,906
31.03.12	Employee Compensation Expense A/c Dr. To Employees Stock Options Outstanding A/c [Being Employee Compensation Expense recognized for the year]	38,86,500	 38,86,500
31.03.14	Bank A/c [1,000 × 500 × ₹ 50] Dr. Employee Stock Options Outstanding A/c [1000 × 500 × ₹ 15] Dr. To Equity Share Capital A/c [1000 × 500 × ₹ 10] To Securities Premium A/c [(₹ 65 – ₹ 10)× 1000 × 500] [Being exercise of Options by 1,000 Employees for 500 Options each and subscription of Equity Shares at a total price of ₹ 65 per Share i.e. payment of ₹ 50 per Share and ₹ 15 per Share through Stock Option Outstanding]	2,50,00,000 75,00,000	 50,00,000 2,75,00,000
31.03.15	Bank A/c [500 × 500 × ₹ 50] Dr. Employee Stock Options Outstanding A/c [500 × 500 × ₹ 15] Dr. To Equity Share Capital A/c [500 × 500 × ₹ 10] To Securities Premium A/c [(₹ 65 – ₹ 10)× 500 × 500] [Being exercise of Options by 500 Employees for 500 Options each and subscription of Equity Shares at a total price of ₹ 65 per Share i.e. payment of ₹ 50 per Share and ₹ 15 per Share through Stock Option Outstanding]	1,25,00,000 37,50,000	 25,00,000 1,37,50,000
31.03.15	Employee Stock Option Outstanding A/c Dr. To General Reserve A/c [Being Balance in Employee Stock Option Outstanding A/c transferred to General Reserve upon their expiry without exercise (400 Employees × 500 Options per Employee × ₹ 15 Fair Value)]	30,00,000	 30,00,000

Note: Balance in Employee Compensation Expense is transferred to Profit and Loss A/c, every year, as Expense