CMA Students Newsletter (For Final Students)

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Management of Producer Company (Section 5810 to 581X of Companies Act, 1956)

Producer Company [581 A(l)]

Producer Company means a body corporate having objects or activities specified in section 581B and registered as Producer Company under Companies Act, 1956.

Section 581B lays down the objectives for which a producer company may be formed. Accordingly, a Producer Company may be formed only if its objects relate to all or any of the following matters:

(a) Production, harvesting, procurement, grading, pooling, handling, marketing, selling, export of primary produce of the Members or import of goods or services for their benefit.
The Producer Company may carry on any of these activities either by itself or through any other institution.

(b) Processing including preserving, drying, distilling, brewing, vinting, canning and packaging of produce of its Members.

(c) Manufacture, sale or supply of machinery, equipment or consumables mainly to its Members.

(d) Providing education on the mutual assistance principles to its Members and others.

(e) Rendering technical services, consultancy services, training, research and development and all other activities for the promotion of the interests of its Members.

(f) Generation, transmission and distribution of power, revitalisation of land and water resources, their use, conservation and communications relatable to primary produce.

(g) Insurance of producers or their primary produce.

(h) Promoting techniques of mutuality and mutual assistance.

(i) Welfare measures or facilities for the benefit of Members as may be decided by the Board.

(j) Any other activity, ancillary or incidental to any of the activities referred to in above clauses or other activities which may promote the principles of mutuality and mutual assistance amongst the Members in any other manner.

(k) Financing of procurement, processing, marketing or other activities specified in above clauses which include extending of credit facilities or any other financial services to its Members.

Dealings of a Producer Company

Every Producer Company shall deal primarily with the produce of its active Members for carrying out any of its objects specified in this section.

Active Member

Active Member means a Member who fulfils the quantum and period of patronage of the Producer Company as may be required by the articles.

Member

Member means a person or Producer institution (whether incorporated or not) admitted as a Member of a Producer Company and who retains the qualifications necessary for continuance as such.

The provisions relating to management of a Producer Companies are explained as under:

1. **Number of directors (Section 581O)**
   (a) Every Producer Company shall have at least 5 and not more than 15 directors.
   (b) Where an inter-state co-operative society is incorporated as a Producer Company, such company may have more than 15 directors for a period of 1 year from the date of its incorporation as a Producer Company.

2. **Appointment of directors (Section 581P)**
   (a) The subscribers to memorandum and the articles may designate therein the Board of directors (not less than 5) who shall govern the affairs of the Producer Company until the directors are elected in accordance with the provisions of this section.
   (b) The election of directors shall be conducted within 90 days from the date of registration of the Producer Company.
   (c) Where an inter-state co-operative society is registered as a Producer Company, the election of directors shall be conducted within 365 days from the date of registration of the Producer Company.
   (d) Every person shall hold office of a director for a period not less than 1 year but not exceeding 5 years, as may be specified in the articles.
   (e) Every director, who retires in accordance with the articles, shall be eligible for re-appointment as a director.
   (f) The directors shall be elected or appointed by the Members in the annual general meeting.
   (g) The Board may co-opt one or more expert directors or an additional director not exceeding 1 /5th of the total number of directors. The expert directors shall not have the right to vote in the election of the chairman but shall be eligible to be elected as chairman, if so provided by its articles. The tenure of the expert director or the additional director shall not exceed such period as may be specified in the articles.

3. **Vacation of office by directors (Section 581Q)**
   The office of a director of a Producer Company shall become vacant in the following cases:
   (a) Where he is convicted by a Court of any offence involving moral turpitude and sentenced in respect thereof to imprisonment for not less than 6 months.
   (b) Where he has made a default in repayment of any advances or loans taken from the Producer

Company in which he is a director.

(c) Where the Producer Company, in which he is a director, has made a default in repayment of any advances or loans taken from any company or institution or any other person and such default continues for 90 days.

(d) Where the Producer Company, in which he is a director -

  (i) has not filed the annual accounts and annual return for any continuous 3 financial years commencing on or after the 1st day of April, 2002; or

  (ii) has failed to, repay its deposit or withheld price or patronage bonus or interest thereon on due date, or pay dividend and such failure continues for 1 year or more.

(e) Where default is made in holding election for the office of director, in the Producer Company in which he is a director, in accordance with the provisions of this Act and articles.

(f) Where the annual general meeting or extraordinary general meeting of the Producer Company, in which he is a director, is not called in accordance with the provisions of this Act except due to natural calamity or such other reason.

The above provisions shall also apply to a director of a producer institution which is a Member of a Producer Company.

4. Powers and functions of Board (Section 581R)

(a) Subject to the provisions of the Act and the articles, the Board of directors of a Producer Company shall exercise such powers and to do all such acts and things, as the Producer Company is authorised to do.

(b) In particular and without prejudice to the generality of the foregoing powers, such powers may include all or any of the following matters.

- Determination of the dividend payable.
- Determination of the quantum of withheld price and recommend patronage to be approved at general meeting.
- Admission of new Members.
- Pursue and formulate the organisational policy, objectives, establish specific long-term and annual objectives and approve corporate strategies and financial plans.
- Appointment of a Chief Executive and such other officers of the Producer Company, as may be specified in the articles.
- Exercise superintendence, direction and control over Chief Executive and other officers appointed by it.
- Cause proper books of account to be maintained; prepare annual accounts to be placed before the annual general meeting with the auditor's report and the replies on qualifications, if any, made by the auditors.
- Acquisition or disposal of property of the Producer Company in its ordinary course of business.
- Investment of the funds of the Producer Company in the ordinary course of its business.
- Sanction any loan or advance, in connection with the business activities of the Producer Company to any Member, not being a director or his relative.
- Take such other measures or do such other acts as may be required in the discharge of its functions or exercise of its powers.

(c) All the powers shall be exercised by the Board, by passing a resolution at Board meetings.

5. Matters to be transacted at general meeting (Section 581S)

The Board of directors of a Producer Company shall exercise the following powers only by means of passing resolutions at the annual general meeting:

(a) approval of budget and adoption of annual accounts of the Producer Company;
(b) approval of patronage bonus;
(c) issue of bonus shares;
(d) declaration of limited return and decision on the distribution of patronage;
(e) specify the conditions and limits of loans that may be given by the Board to any director; and
(f) approval of any transaction of the nature as is to be reserved in the articles for approval by the Members.

6. Liability of directors (Section 581T)

(a) Anything done by the directors (whether by way of voting on a resolution or approving by any other means) in contravention of the provisions of this Act or any other law for the time being in force or the articles, shall make them jointly and severally liable to the company. Accordingly -
   (i) where the Producer Company has incurred a loss or damage as a result of the contravention, the directors shall be liable to make good such loss or damage;
   (ii) where such director has made any profit as a result of a contravention, the Producer Company shall have the right to recover from its director an amount equal to the profit so made.
(b) The liability imposed under this section shall be in addition to and not in derogation of a liability imposed on a director under this Act or any other law for the time being in force.

7. Committee of directors (Section 581U)

(a) The Board may constitute such number of committees as it may deem fit for the purpose of assisting the Board in the efficient discharge of its functions. However, the Board shall not delegate any of its powers or assign the powers of the Chief Executive, to any committee. The Chief Executive or a director of the Producer Company shall be a Member of such committee.
(b) A committee of the Board may, with the approval of the Board, co-opt such number of persons as it deems fit.
(c) Every such committee shall function under the general superintendence direction and control of the Board, for such duration, and in such manner as may be directed by the Board.
(d) The fee and allowances to be paid to the Members of the committee shall be such as may be determined by the Board.
(e) The minutes of each meeting of the committee shall be placed before the Board at its next meeting.

8. Meetings of Board and quorum (Section 581V)

(a) At least one Board meeting shall be held in every 3 months and at least 4 Board meetings shall be held in every year.
(b) Notice of every Board meeting shall be given in writing to every director for the time being in India, and at his usual address in India to every other director.
(c) It shall be the duty of the Chief Executive to give notice of all the Board meetings. If he fails to do so, he shall be punishable with fine which may extend to ₹ 1,000.
(d) The notice of every Board meeting shall be given by the Chief Executive at least 7 days prior to the

date of the Board meeting. If a Board meeting is called at a shorter notice, the reasons thereof shall be recorded in writing by the Board.

(e) The quorum for a Board meeting shall be l/3rd of the total strength of directors, or 3 directors, whichever is higher.

(f) The directors including the co-opted director, may be paid such fees and allowances for attending the Board meetings, as may be decided by the Members in the general meeting.

9. Chief Executive and his functions (Section 581W)

(a) Every Producer Company shall have a full time Chief Executive, by whatever name called, to be appointed by the Board from amongst persons other than Members.

(b) The Chief Executive shall be ex officio director of the Board and such director shall not retire by rotation.

(c) The qualifications, experience and the terms and conditions of service of the Chief Executive shall be such as may be determined by the Board. However, the articles of the Producer Company may otherwise provide.

(d) The Chief Executive shall be entrusted with substantial powers of management as the Board may determine. His powers and functions shall include -

- to do administrative acts of a routine nature including managing the day-to-day affairs of the Producer Company;
- operate bank accounts or authorise any person, subject to the general or special approval of the Board in this behalf, to operate the bank account;
- make arrangements for safe custody of cash and other assets of the Producer Company;
- sign such documents as may be authorised by the Board, for and on behalf of the company;
- maintain proper books of account; prepare annual accounts and audit thereof; place the audited accounts before the Board and in the general meeting of the Members;
- furnish Members with periodic information to appraise them of the operation and functions of the Producer Company;
- make appointments to posts in accordance with the powers delegated to him by the Board;
- assist the Board in the formulation of goals, objectives, strategies, plans and policies;
- advise the Board with respect to legal and regulatory matters concerning the proposed and on going activities and take necessary action in respect thereof;
- exercise the powers as may be necessary in the ordinary course of business;
- discharge such other functions, and exercise such other powers, as may be delegated by the Board.

(e) The Chief Executive shall manage the affairs of the Producer Company under the general superintendence, direction and control of the Board and be accountable for the performance of the Producer Company.

10. Secretary of Producer Company (Section 581X)

(a) Every Producer Company having an average annual turnover exceeding ₹ 5 crores in each of 3 consecutive financial years shall have a whole-time secretary.

(b) No individual shall be appointed as whole-time secretary unless he possesses Membership of the Institute of Company Secretaries of India constituted under the Company Secretaries Act, 1980.

(c) Failure to appoint a secretary shall be punishable with fine upto ₹ 500 for every day during which the

default continues. However, it shall be a defence to prove that -

(i) all reasonable efforts were made to appoint a whole-time secretary; or

(ii) the financial position of the company was such that it was beyond its capacity to engage a whole-time secretary.

A director or a group of directors, who do not constitute the Board, shall not exercise any of the powers exercisable by it (Explanation to section 581R).

Practical Question 1:

A Producer Company was incorporated on 1st April, 2003. At present it has got 200 members and its Board consists of 10 directors. The Board of directors of the company seeks your advice on the following proposal:

- Appointment of one expert director and one additional director by the Board for a period of four years. Advise the Board of directors explaining the relevant provisions of the Companies Act, 1956.

Answer:

As per section 581P, the Board may co-opt one or more expert directors or an additional director not exceeding l/5th of the total number of directors. Further, every person shall hold the office of a director for a period not less than 1 year but not exceeding 5 years, as may be specified in the articles. The total number of directors in the present case is 10. The number of expert directors and additional directors shall not exceed 2. Therefore, it is permissible for the Board to appoint one expert director and one additional director for a period of four years.

Practical Question 2:

The promoters of Balaji Producer Company Ltd., proposed to be registered under Section 581C of the Companies Act, 1956 desire to have the following information:

- **What is the minimum number of directors required to be appointed?**

Answer:

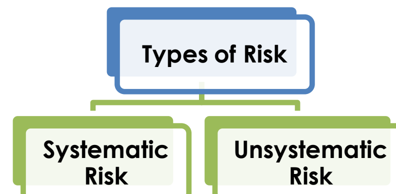
As per section 5810 -

(a) Every Producer Company shall have at least 5 and not more than 15 directors.

(b) Where an inter-state co-operative society is incorporated as a Producer Company, such company may have more than 15 directors for a period of 1 year from the date of its incorporation as a Producer Company.

In the given case, the Producer Company is proposed to be incorporated afresh, and not to be incorporated by way of conversion of an inter-state co-operative society into a producer company. Therefore, it shall have a minimum of 5 directors.

SYSTEMATIC RISK & UNSYSTEMATIC RISK



Systematic Risk or Non- Diversifiable Risk arise out of external and uncontrollable factors, which are not specific to a security or industry to which such security belongs. They arise out of general and system-wide factors, like economic,political and social changes.

These risks affect a large number of securities simultaneously, and are considered macro in nature.

These risks are absolute, i.e. they cannot be eliminated by diversification.

These are further sub-classified into –

- Market Risk
- Interest Rate Risk
- Purchasing Power Risk

- These are risks that are triggered due to social, political and economic events.
- These risks arises due to changes in demand and supply,expectations of the investors, information flow, investor's risk perception, etc. consequent to the social, political or economic events.

- Uncertainty of future market values and extent of income in the future, due to fluctuations in the general level of interest, is known as Interest Rate Risk.
- These are risks arising due to fluctuating rates of interest and cost of Corporate Debt. The cost of Corporate Debt depends on the interest rates prevailing, maturity periods, credit worthiness of the borrowers, monetary and credit policy of RBI, etc.

Purchasing Power Risk / Inflationary Risk

- Purchasing Power Risk is the erosion in the value of money due to the effects of inflation.
- In inflationary conditions, Purchasing Power Risk is felt more in Bonds and Fixed Income Securities.

UNSYSTEMATIC RISK

Unsystematic Risk or Diversifiable Risk are risks that emanate from known and controllable factors, which are unique and or related to a particular security or industry. These are in addition to Systematic Risk that affects that particular security/ industry.

These are internal/specific to particular security/ industry and are considered micro in nature.

These risks can be eliminated by diversification of portfolio. As the number of securities in the portfolio increases,unsystematic risk is eliminated and only systematic risk of those securities remains.

These are further sub-classified into –

- Business Risk
- Financial Risk
- Default Risk

- It is the volatility in revenues and profits of particular company due to its market conditions, product mix, competition, etc.
- It may arise due to external reasons or Government policies specific to that kind of industry ,internal reasons labour efficiency, management , etc.
- Business risk also emanates from sale and purchase of securities affected by business cycles,technological changes etc.

FINANCIAL RISK

- Financial Risk or Leverage Risk are risks that are associated with the capital structure of a company. A company with no debt financing, has no financial risk. Higher the financial leverage, higher the financial risk.
- These may arise due to short-term liquidity problems, shortage in working capital due to funds locked in Working Capital and Receivables etc.

- Default Risk or Maturity Risk arise due to default in meeting the financial obligations on time. Non-payment of financial dues on time increases the insolvency and bankruptcy costs.
- Maturity Risk is the risk associated with the likelihood of issuer/Government issuing a new security in place of redeeming the existing security. In case of Corporate Securities, it is called as Credit Risk.

1.

Security	β	Rndom Error σ_{ei}	Weight
L	1.60	7	0.25
M	1.15	11	0.30
N	1.40	3	0.25
K	1.00	9	0.20

You are required to find out the Risk of the portfolio if the Standard Deviation of the Market Index (σ_m) is 18%.

Computation of Risk of Portfolio

Security	β	Weight	Product	Unsystematic Risk (SD) = σ_{ei}	Unsystematic Risk (Variance Approach)	Product = Unsys. Risk × $(Weight)^2$
(1)	**(2)**	**(3)**	**(4) =(2)× (3)**	**(5)**	**(6) = $(5)^2$**	**(7) = (6) × $(3)^2$**
L	1.60	0.25	0.40	7	49	49 × 0.25 × 0.25 = 3.06
M	1.15	0.30	0.345	11	121	121 × 0.30 × 0.30 = 10.89
N	1.40	0.25	0.35	3	9	9 × 0.25 × 0.25 = 0.56
K	1.00	0.20	0.20	9	81	81 × 0.20 × 0.20= 3.24
Total		1.00	1.295			∑Unsystematic Risk = 17.75

1. Beta of the Portfolio β = 1.295
2. Systematic Risk (Variance Approach) of the portfolio = $\beta^2 \times \sigma_M^2 = (1.295)^2 \times (18)^2 = 543.35$
3. Total Risk (Variance Approach) = Systematic Risk + Unsystematic Risk = 543.35 + 17.75 = 561.11

2. The following are the returns of share S and the market M for the last 6 years –

Year	Return S (%)	Return M (%)
1	18	15
2	9	7
3	20	16
4	-10	-13
5	5	4
6	12	7

(I) **Calculate the covariance and correlation co-efficient of returns.**

(II) **Determine the Beta co-efficient for S.**

(III) **What is S's Total Risk?**

(IV) **How much is Systematic Risk?**

Computation of Covariance and Correlation Co-efficient

Years	R_M	R_S	$D_M = (R_M - \overline{R_M})$	$D_S = (R_S - \overline{R_S})$	D_M^2	D_S^2	$D_M \times D_S$
(1)	(2)	(3)	(4) = [(2) – 6]	(5) = [(3) -9]	(6) = $(4)^2$	(7) = $(5)^2$	(8) = (4) × (5)
1	15	18	9	9	81	81	81
2	7	9	1	0	1	0	0
3	16	20	10	11	100	121	110
4	-13	-10	-19	-19	361	361	361
5	4	5	-2	-4	4	16	8
6	7	12	1	3	1	9	3
	36	54	0	0	548	588	563

	Market Portfolio	Shares of S
Mean	$\overline{R_M} = \frac{\Sigma R_M}{n} = \frac{36}{6} = 6$	$\overline{R_S} = \frac{\Sigma R_S}{n} = \frac{54}{6} = 9$
Variance	$\sigma_M^2 = \frac{\Sigma D_M^2}{n} = \frac{548}{6} = 91.33$	$\sigma_S^2 = \frac{\Sigma D_S^2}{n} = \frac{588}{6} = 98$
Standard Deviation	$\sigma_M = \sqrt{91.33} = 9.56$	$\sigma_S = \sqrt{98} = 9.90$

Computation of Covariance and Correlation

Combination	Market and S	Combination	Market and S
Covariance	$Cov_{M,S} = \frac{\Sigma[D_M - D_S]}{n} = \frac{563}{6} = 93.83$	Correlation	$\rho_{M,S} = \frac{Cov_{M,S}}{\sigma_M \times \sigma_S} = \frac{93.83}{9.56 \times 9.90} = 0.99$

Computation of Beta : Beta of Security = $\beta_S = \frac{Cov_{M,S}}{\sigma_M^2} = \frac{93.83}{91.33} = 1.03$

Computation of Systematic and Unsystematic Risk

Particulars	Standard Deviation Approach	Variance Approach
Total Risk	9.90	98%
Systematic Risk	$\beta \times \sigma_M$= 1.03 × 9.56= 9.847%	$\beta^2 \times \sigma_M^2$ =1.03^2 × 9.56^2= 96.96%
Unsystematic Risk = Total Risk less Systematic Risk	9.90% - 9.847% = 0.053%	98% - 96.96% = 1.04%

COST-VOLUME-PROFIT RELATIONSHIP

Profit is always a matter of primary concern to management. The volume of sale never remains constant. It fluctuates up and down and income also goes up and down with fluctuations in volume. Profit is actually the result of interplay of different factors like cost, volume and selling price. Effectiveness of a manager depends on his capability to make right predictions about future profits. This can be done when correct relationship existing between cost, volume and profit is known. For this reason, knowledge of relationship among Cost-Volume and Profit is of immense help to management. This knowledge of Cost-Volume Profit relationship helps management to find out right solution for such problems as are given below:

- What should be the volume to be attempted for obtaining a desired profit?
- How will the change in selling price affect the profit position of the company?
- How will the change in cost affect profit
- What should be the optimum mix of the company?

These basic questions present themselves to management for solution in different forms. The conventional income and expenditure statement does not provide any answer to all these questions. The answer to all these questions is sought by analysis of cost-volume-profit relationship. Cost-Volume-Profit Analysis spotlights the relationship existing among factors like cost-volume and profit.

DEFINITION of 'Cost-Volume Profit Analysis'

A method of cost accounting used in managerial economics. Cost-volume profit analysis is based upon determining the breakeven point of cost and volume of goods. It can be useful for managers making short-term economic decisions, and also for general educational purposes.

- Cost-volume-profit (CVP) analysis is a key step in many decisions. CVP analysis involves specifying a model of the relations among the prices of products, the volume or level of activity, unit variable costs, total fixed costs, and the sales mix. This model is used to predict the impact on profits of changes in those parameters.
  - **Contribution Margin.** Contribution margin is the amount remaining from sales revenue after variable expenses have been deducted. It contributes towards covering fixed costs and then towards profit.

- **Unit Contribution Margin.** The unit contribution margin can be used to predict changes in total contribution margin as a result of changes in the unit sales of a product. To do this, the unit contribution margin is simply multiplied by the change in unit sales. Assuming no change in fixed costs, the change in total contribution margin falls directly to the bottom line as a change in profits.
- **Contribution Margin Ratio.** The contribution margin (CM) ratio is the ratio of the contribution margin to total sales. It shows how the contribution margin is affected by a given rupees change in total sales. The contribution margin ratio is often easier to work with than the unit contribution margin, particularly when a company has many products. This is because the contribution margin ratio is denominated in sales rupees, which is a convenient way to express activity in multi-product firms.

- **Some Applications of CVP Concepts.** CVP analysis is typically used to estimate the impact on profits of changes in selling price, variable cost per unit, sales volume, and total fixed costs. CVP analysis can be used to estimate the effect on profit of a change in any one (or any combination) of these parameters.

Use of Cost-Volume-Profit Analysis:

- This relation enables management to predict profit over a wide range of volume. This knowledge is very useful in preparing flexible budget.
- In a lean business season, company has to determine the price of the products very careful. It becomes necessary sometimes to bring down the price to boost the sale of a product. For all decisions like this, management must determine, by cost-volume-profit analysis, what impact this reduction in price is going to have on profit position of a company.
- Analysis of cost-volume-profit relationship helps in decision-making. There are situation when management has to decide whether it should add to its capacity or not. With the knowledge of cost-volume-profit analysis, a manager can easily take decision showing. In its report how utilization of available capacity will lead to increase in profit.

The following example will illustrate the point.

M/s. Dhriti & Dhriti Ltd., manufacturers of a wide range of cold drinks, submit the following cost data relating to their product '77'.

	Per Unit	
Selling Price		**₹5.20**
Variable expenses		
Cost of Drink	**4.00**	
Variable selling expenses	**0.30**	**4.30**
Contribution		**0.90**

Fixed expenses for the year are ₹ 60,000 and at present company is producing 1,00,000 bottles of product '77'.

The Sales Manager has made following suggestions:

The situation will improve, if sale is increased by 25,000 units. Company is not working at peak capacity and fixed expenses are not going to be affected by volume change. Prepare a chart showing validity of Sales Manager's suggestions.

Answer:

Statement Showing Profit at different levels of Activity

Particulars	B.E. Point	At level of 1,00,000 bottles	For 25,000 bottles	Position after change, i.e., 1,25,000 bottles
Sales value (units)	66,667	1,00,000	25,000	1,25,000
Sales volume in ₹	₹3,46,668	₹5,20,000	₹1,30,000	₹6,50,000
Marginal cost	2,86,668	4,30,000	1,07,500	5,37,500
Contribution	60,000	90,000	22,500	1,12,500
Fixed Expenses	60,000	60,000	--	60,000
Profit	Nil	30,000	22,500	52,5000

Following points are highlighted by the above working:

(i) By a mere change of 25% increase in sales volume, profit increases by 75%, i.e., profit figure goes up from ₹ 30.000 to ₹ 52,500.

(ii) Fixed expenses have already been recovered at present level and are not affected by volume change

The suggestion of Sales Manager should be accepted. However, the validity of this approach to this specific decision depends on the facts of the case, i.e., the fixed expenses will not be affected by volume change.

Analysis of cost-volume-profit relationships helps in evaluating profit performance. Following example will illustrate the point:

Example 2:

Cost data (for last year)

Sales	**60,00,000**	**(Operating at 75% capacity)**
Marginal cost (50% of sale)	**30,00,000**	
Contribution	**30,00,000**	
Fixed cost	**20,00,000**	
Profit	**10,00,000**	
Percentage of profit over sales 16.70%		
A report on the performance for the year states:		
Sales	**₹80,00,000**	
Profit	**₹16,00,000**	
Percentage of profit on sale	**20%**	

Should the performance of current year be commended? What opinion should be conveyed to the Managing Director on the basis of Cost-Volume-Profit analysis?

Answer:

Statement showing profit for last year and profit at a sale of ₹ 80,00,000

Particulars	Last year performance 75% capacity	Performance at present activity level. i. e., 100% capacity
Sales	₹60,00,000	₹80,00,000
Marginal cost (50% of sales)	30,00,000	40,00,000
Contribution	30,00,000	40,00,000
Fixed cost	20,00,000	20,00,000
Profit	10,00,000	20,00,000

The cost-volume-Profit analysis leads to the conclusion that result of current year's performance is not commendable. The profit should have been 25% of sales after operating at 100% capacity, whereas the profit achieved is only 20% of sales. The report to the Managing Director should contain that performance of current year is not commended.

Cost-Volume-Profit analysis helps in profit planning. Under profit planning, company first declares the profit that it wants to make during the ensuing year. Thereafter, sales level necessary to yield that profit is attempted. Cost-volume-profit analysis helps in profit planning in the following ways.

(a) It helps in estimating income at a particular sales level.

(b) It helps to determine change in profit due to change in sales volume.

(c) It helps to execute the idea of profit planning. In other words, we arrive at the sales level to be attempted for a desired profit by the knowledge of relationship existing between cost, volume and profit.

(d) It helps to find out the sales required to meet proposed expenditure.

The knowledge of cost-volume-profit relationship can be of substantial help in pricing. The studies based on cost-volume-profit relationship make it possible to visualise the probable results of proposed or expected changes on cost, volume or price. Companies are often tempted to reduce prices on existing products in an effort to increase volume. This is done to spread fixed costs over a larger volume of production. For taking any decision for reduction of prices the management should know the relationship between decrease in price and increase in volume. Any price decision has to take into account short-run and long-run considerations i.e.; possibility of spoiling the market and the probable action of competitors.

Presentation of cost -Volume-Profit Relationship: The result of analysis of cost-volume-profit relationship can be presented in any of the following manners:

(i) Algebraical formulae (ii) Reports/Statements, (iii) Graphic Charts.

(i) Algebraical formulae. Presentation of cost-volume-profit analysis by algebraical formulae has involves finding out different values by use of basic marginal cost equation.

(ii) Reports and statements. A statement showing how the relationship is presented through statement is being given below.

Forecast of Cost- Volume-Profit Analysis at Different Activity Levels

Plant Capacity	**70%**	**80%**	**90%**	**100%**
Sales (in units)	7,000	8,000	9,000	10,000
Price per unit (₹)	1.00	1.00	0.90	0.80
Sales value	₹7,000	₹8,000	₹8,100	₹8,000
Variable Costs				
Direct labour	700	800	900	1,000
Direct material	1,400	1,600	1,800	2,000
Factory overhead	700	800	900	1,000
Admin. and selling overhead	350	400	450	500
Total variable costs	3,150	3,600	4,050	4,500
Contribution Margin	3,850	4,400	4,050	3,500
Fixed factory overhead	1,000	1,000	1,000	1,000
Admins. And Selling overhead	500	500	500	500
Total Fixed Cost	1,500	1,500	1,500	1,500
Profit	2,350	2,900	2,550	2,000
P/V Ratio (Contribution/Sales)	0.55	0.55	0.50	0.44
Return on sales (Profit/Sales)	0.34	0.36	0.31	0.25
Capital employed	20,000	21,000	22,000	25,000
Return on capital	11.75%	13.81%	11.59%	8.00%
Turnover Ratio (Sales/Capital employed)	35%	38%	37%	32%

(iii) Graphic Presentation of Cost-Volume-Profit Relationship. Graphic charts furnish an effective means of presenting cost-volume-profit relationship. In graphic presentation, a diagram of the relationship among various factors, like cost, volume and profit is presented. This pictorial presentation makes this relationship easy to understand. Following are the important charts for portraying this relationship :

1. Break-even Charts, 2. Profit/Volume Charts and 3. Sequential Profit graph.

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.

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.

Case Study 2: Where the Goods had left the Customs control, and are not available for verification, the amendment of bill of entry by the Assessee and production of a completely different declaration is not allowed. **[Prem Nath Diesels P Ltd. 91 ELT 130 (Tribunal)]**

Case Study 3: If Purchase Price is reduced through negotiation with Foreign Supplier after clearance of goods, such reduced price cannot be treated as Transaction Value. Amendment of bill of entry cannot be taken to have authorized re-assessment of a bill of entry. **[Ashok Leyland Ltd 173 ELT 518 (Tri-Chennai)]**

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 4: 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].**

RAROC (RISK ADJUSTED RETURN ON CAPITAL)

A basic premise of finance is that capital should only be invested if the probable future return on that capital will exceed its cost. The potential investment that requires the apportionment of existing capital or the generation of incremental capital, should meet such a test. Risk-adjusted return on capital (RAROC) is a relatively new tool for applying this test in the lending and credit risk management context. It is known as return on risk-adjusted capital (RORAC) or risk-adjusted return on risk-adjusted capital (RARORAC).

In financial analysis, riskier projects and investments must be evaluated differently from their risk less counterparts. By discounting risky cash flows against less risky cash flows RAROC accounts for changes in the profile of the investment Thus, when companies need to compare and contrast two different projects or investments, it is important to take into account these possibilities.

During the 1980s, Bankers Trust developed a firm wide RAPM that they called risk-adjusted return on capital (RAROC). Bankers Trust was a commercial bank that had adopted a business model much like that of an investment bank. It had divested its retail deposit and lending businesses. It actively dealt in exempt securities and had an emerging derivatives business. Such wholesale activities are easier to model than the retail businesses Bankers Trust had divested, and this certainly facilitated the development of the system. RAROC was well publicized, and during the 1990s, a number of other banks developed their own firm wide systems.

Today, many banks have built such models, and some use them as decision-making tools at the heart of their lending processes. RAROC systems allocate capital for two basic reasons: (1) risk management and (2) Performance evaluation. For risk management purposes, the overriding goal of allocating capital to individual

business units is to determine the bank's optimal capital structure. This process involves estimating how much the risk (volatility) of each business unit contributes to the total risk of the bank and, hence, to the bank's overall capital requirements. For performance evaluation purposes, RAROC systems assign capital to business units as part of a process for determining the risk- adjusted rate of return and, ultimately, the economic value added to each business unit. The objective in this case is to measure a business unit's contribution to shareholder value and, thus, to provide a basis for effective capital budgeting and incentive compensation at the business unit level.

Risk is looked upon as any phenomenon that creates potential volatility in the economic cash flows of the bank. The purpose of risk capital is to provide comprehensive coverage of losses for the organization as a whole. By 'comprehensive,' they mean coverage of all sources of risk with a very high degree of confidence.

Computation of RAROC

RAROC measures performance on a risk-adjusted basis. It is calculated as the economic return divided by economic capital. RAROC helps determine if a company has the right balance between capital, returns and risk. The central concept in RAROC is economic capital: the amount of capital a company should put aside needs to be based on the risk it runs.

The calculation of RAROC is relatively simple once all the risk calculations have been completed. RAROC is computed by dividing risk-adjusted net income by the total amount of economic capital assigned based on the risk calculation. Risk adjusted net income is determined by taking the financial data allocation to the businesses and adjusting the income statement for expected loss.

$$\textbf{RAROC} = \frac{\text{Revenues - Cost - Expected Loss}}{\text{Economic Capital}}$$

Economic Profit = Revenues - Cost - Expected Loss - RoEC x Economic Capital

RAROC = Risk Adjusted Return On Capital

RoEC = required return on Economic Capital RAROC and EP are equivalent measures, as RAROC > RoEC if and only if EP > 0.

Where expected loss is the mean of the loss distribution associated with some activity, most typically it represents expected loss from defaulting loans or from operational risk. The original Bankers Trust RAROC system provided results on an after-tax basis. Today, systems typically perform calculations before tax.

Advantages of RAROC

The primary advantage that can be provided by a RAROC model lies in the discipline it can bring to lending decisions. The model itself is not the objective because it will only be as good as its builders. RAROC is not an end in itself. Its advantages are more in the way that it ensures that risk and reward remain linked and in the consistency of decision thinking that it forces.

Having a calculated RAROC for a transaction does not obviate the need for a careful review of all new credits and a senior screening (whether by committee or some other means) of deals that bring a lot of incremental risk. However, a RAROC model provides a number of advantages to a discriminating user, including the following:

- It provides a platform to calculate both risk and return and thereby, remove the bias from one objective or the other. A RAROC calculation can bring an added dimension by showing the use and return on capital.
- If provided to all commercial/corporate lenders and used appropriately, a RAROC model can almost ensure that decisions made in different locations, at different times, with different relationship managers will be made using the same principles and calculation methodology. Banks have many decision-makers in the lending business, and their negotiation skills can vary substantially. A RAROC model tends to level the playing field and gives all staff the chance for a common comparison of their transactions.
- A RAROC model emphasizes that risk must be compensated for, while ensuring that the risk is both measured and appropriately considered through the enforced completion of the calculation.
- A RAROC model can provide a 'what if capability to the user. In most cases, the relationship manager or the credit officer can solve for the price or the risk and rebalance by adjusting one or the other.

Although these benefits can provide some improvement to the traditional credit process, it must be repeated that the RAROC calculation is not an end in itself. One of the realities of RAROC is that the calculation is certain to change because risk changes as time passes. As such, it is not a solution in itself, nor is it more than a measure at a point in time (albeit a critical point in time).

The critical question is whether its introduction will improve the existing lending process, the decision-making ability, and the performance of corporate lending. The answer is specific to each institution. RAROC is not an off-the-shelf technology one can apply, but a complicated set of rules that needs to be calibrated for each bank's unique set of products; incentive compensation plans, pricing models, and, most importantly, information systems. Those who build the RAROC models, however, tend to learn a great deal about their management of loan assets. They tend to improve on their rating and they put more consistency into structuring and pricing, and they are often forced to upgrade their management information systems. This is why the production of a RAROC model can be a rewarding journey.

SOME TYPICAL ISSUES ON 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 year)	**₹2,40,000**	**(1 /12 is chargeable to Project the**
Total Administrative Exp. of the company	**₹16,00,000**	**(5% is chargeable to Project 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:

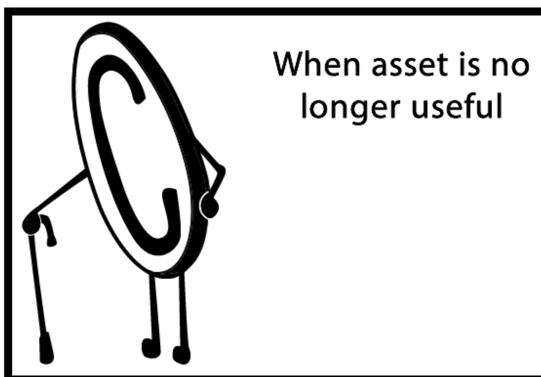
A company undertook repair and overhauling of its machinery at a cost of ₹ 12 lakhs to maintain them in good condition and capitalized the amount, as it is more than 25% of the original cost of the machinery. As an auditor, what would you do in this situation?

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.

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

Example:

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?

Answer:

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

Example:

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.

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.	47,76,906	
	To Employees Stock Options Outstanding A/c			47,76,906
	[Being Employee Compensation Expense recognized for the year]			
31.03.12	Employee Compensation Expense A/c	Dr.	38,86,500	
	To Employees Stock Options Outstanding A/c			38,86,500
	[Being Employee Compensation Expense recognized for the year]			
31.03.14	Bank A/c [1,000 × 500 × ₹ 50]	Dr.	2,50,00,000	
	Employee Stock Options Outstanding A/c [1000 × 500 × ₹ 15]	Dr.	75,00,000	
	To Equity Share Capital A/c [1000 × 500 × ₹ 10]			50,00,000
	To Securities Premium A/c [(₹ 65 – ₹ 10)× 1000 × 500]			2,75,00,000
	[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]			
31.03.15	Bank A/c [500 × 500 × ₹ 50]	Dr.	1,25,00,000	
	Employee Stock Options Outstanding A/c [500 × 500 × ₹ 15]	Dr.	37,50,000	
	To Equity Share Capital A/c [500 × 500 × ₹ 10]			25,00,000
	To Securities Premium A/c [(₹ 65 – ₹ 10)× 500 × 500]			1,37,50,000
	[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]			
31.03.15	Employee Stock Option Outstanding A/c	Dr.	30,00,000	
	To General Reserve A/c			30,00,000
	[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)]			

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

ANALYSIS OF CASH FLOW STATEMENT

The primary purpose of a cash flow statement is to provide information about the cash receipts and cash payments of the firm during a period and their impact on the ending cash balance. As per AS-3, a cash flow statement is to be classified into three heads, viz: operating activities, investing activities and financing activities. It may be noted that operating activities section of the cash flow statement is converted from an accrual basis to a cash basis. This conversion may be done by:

- direct method;
- indirect method.

Under direct method, informations about major classes of gross cash receipts and gross cash payments may be obtained either from accounting records of the company or by adjusting sale, cost of sales and other items in the Profit & Loss Account for:

- changes during the period in inventories and operating receivables and payables;
- other non-cash items; and
- other items for which the cash effects are investing or financing cash flows.

Under indirect method, net income as per the income statement is taken as the starting point and adjustments to net income are made in respect of non-cash items appearing in the income statement as also in respect of changes in current assets and current liabilities during the year to reconcile net income to net cash provided by operating activities.

Practically, an analyst acquires a very little information from a Cash Flow Statement prepared with the help of simple absolute figures. Because, absolute figures can never present the true position and is not helpful for the purpose of comparison also. Proper comparison is possible with the help of ratio analysis. Thus, if we analyse the Cash Flow Statement with the help of some ratios (i.e. ratio analysis), it would be very significant and will help the analyst to understand the true cash position. For the purpose, we hereby explain some related ratios relating to Cash or Cash Equivalent.

(a) Rate of Dividend to Operating Cash Flow:

$$\text{Rate of Dividend to Operating cash Flow} = \frac{\text{Dividend}}{\text{Operating Cash Flow}} \times 100$$

It indicates the amount of cash generated through operational activities of the firm and the same is distributed in the form of dividend to the shareholders. Naturally, if the ratio is found to be high, more cash will go out.

(b) Ratio of Depreciation to Cash Flow for New Assets acquired:

$$\text{Ratio of Depreciation to Cash Flow for New Asset} = \frac{\text{Depreciation}}{\text{Cash Flow (for new asset)}} \times 100$$

This ratio reveals the percentage of cash used for the replacement of new assets. It helps the management at the time of purchasing new assets.

(c) Debt Coverage Ratio:

$$\text{Debt Coverage ratio} = \frac{\text{Operating Cash Flow (after interest)}}{\text{Total Debt (long term or short term)}}$$

This ratio is a very important indicator which reveals that existing debt can be redeemed immediately by the amount of net cash generated from the operation for the period. If it is found to be high, it will indicate sound liquidity position although too high ratio is not considered good as the same invites that the firm is very conservative to use debt capital in proper manner.

(d) Interest Coverage Ratio:

$$\text{Interest coverage Ratio} = \frac{\text{Cash Flow from operating Activities}}{\text{Interest Payment}}$$

This ratio highlights the firm's ability to pay interest and indicates the proportion of interest to the generation of cash from operational activities and, as such, a high ratio is usually preferred. But a too high ratio will again create the problem of having the merits of trading on equity.

(e) Return of cash to Total Assets ratio:

$$\text{Return of cash to Total Assets ratio} = \frac{\text{Operating Cash Flow}}{\text{Total Assets}} \times 100$$

This ratio explains how far the firm is able to utilise properly its total asset for the purpose of generating cash which may be utilised for different purposes. A high ratio indicates the proper utilisation of total assets to generate cash.

(f) Cash flow (Liquidity) Ratio:

$$\text{Cash Flow (Liquidity) ratio} = \frac{\text{Operating Cash Flow}}{\text{Current Liabilities}}$$

We know that current ratio is used to measure the short-term liquidity position of a firm. But Cash Flow Ratio presents a better picture about the liquidity position. Thus, higher the ratio, higher the debt-paying capacity.

(g) Cash Burn Ratio:

$$\text{Cash Burn ratio} = \frac{\text{Cash Available from Investors}}{\text{Average Daily Expenses to Start the Business}}$$

Every firm, at its initial stage, may not have any revenue. For this purpose, a firm maintains its cash position taking the proceeds from the investors. The primary object of the ratio is to measure the number of days the firm can survive/exist taking the funds raised from these investors.

(h) Cash Flow Margin:

$$\text{Cash Flow Margin} = \frac{\text{Cash Flows from Operating Activities}}{\text{Net Sales}}$$

This ratio reveals the ability of a firm to convert its sales ultimately into cash. It is also used as a measure of profitability. Higher the ratio, greater will be the cash-generating capacity.

(i) Ratio of External Funds to Capital Investment:

Ratio of External Funds to Capital Investment

$$= \frac{\text{Fresh External Fund} - \text{Redemption of Debt}}{\text{Investing Cash Flow}}$$

Higher the ratio, greater will be the dependence on internal debt, and vice versa.

(j) Dependence of Capital Investment on Internal Fund Ratio:

Dependence of Capital Investment on Internal Fund Ratio

$$= \frac{\text{Operating Cash Flow} - \text{Increase in cash Balance}}{\text{Investting Cash Flow}} \times 100$$

If the ratio is found to be high, it will indicate that the firm is stable.

(k) Return of cash on Net Worth Ratio:

$$\text{Return of cash on Net Worth ratio} = \frac{\text{Operating Cash Flow} - \text{Interest}}{\text{Net Worth}} \times 100$$

It is expressed in terms of percentage. It reveals how the Shareholders' Fund has effectively and efficiently been utilised to earn Cash and Cash equivalent.

(l) Earning Cash Flow Ratio:

$$\text{Earning cash Flow Ratio} = \frac{\text{Operating Cash Flow}}{\text{Operating Profit}} \times 100$$

This ratio reveals how far the operating profit has been realised in cash. A high ratio indicates sound liquidity and solvency position of a firm.

(m) Cash Flow per Share:

$$\text{Cash Flow per Share} = \frac{\text{Operating Cash Flow} - \text{Interest}}{\text{No. of Shares}}$$

It explains the capacity or ability of the firm to generate cash on per share basis.

An illustration:

From the information provided you are required to prepare a statement explaining how A Ltd. improved cash position as per recommendation of AS-3, in the year ended 31st March, 2015. The informations are related to the summarised Balance Sheets of the company as on 31st March, 2014 and 2015 were:

Liabilities	2014 ₹	2015 ₹
Shareholders' Fund:		
Issued Share Capital	1,00,000	1,50,000
Securities Premium	15,000	35,000

Profit and Loss A/c	28,000	70,000
(-) Premium on Redemption of Debentures	_	1,000
Non-current Liabilities:		
Debentures	70,000	30,000
Current Liabilities:		
Bank Overdraft	14,000	—
Creditors	34,000	48,000
Proposed Dividends	15,000	20,000
Depreciation :		
Plant	45,000	54,000
Fixtures	13,000	15,000
Non-current Assets:		
Freehold Property at cost	1,10,000	1,30,000
Plant & Machinery at cost	1,20,000	1,51,000
Furniture and Fixture at cost	24,000	29,000
Current Assets:		
Stocks	37,000	51,000
Debtors	43,000	44,000
Bank	—	16,000

The following additional information's are also relevant:

(i) There had been no disposal of freehold property in the year.

(ii) The Machine tool which has cost ₹ 8,000, and in respect of which ₹ 6,000 depreciation has been provided, was sold for ₹ 3,000, and fixtures, which had cost ₹ 5,000 in respect of which depreciation of ₹ 2,000 has been provided, were sold for ₹ 1,000. The Profit and Losses on these transactions had been dealt with through the Profit and Loss Account.

(iii) The actual premium on the redemption of debentures was ₹ 2,000 of which ₹ 1,000 had been written-off to the Profit and Loss A/c.

(iv) No interim dividend has been paid.

(v) Interest paid on debentures amounted to ₹4,500.

Comment on the financial position.

Solution:

Workings:

Dr. **Plant & Machinery A/c** **Cr.**

	₹		₹
To Balance b/d	1,20,000	By Bank A/c—Sale	3,000

To P&L A/c—Profit on Sale	1,000	By Prov. for Depreciation	6,000
To Bank A/c—Purchase	39,000	By Balance c/d	1,51,000
	1,60,000		1,60,000

Dr. Furniture and Fixture A/c Cr.

	₹		₹
To Balance b/d	24,000	By Bank A/c—Sale	1,000
To Bank A/c—Purchase	10,000	By P & L A/c – Loss on Sale	2,000
		By Prov. For Depreciation	2,000
		By Balance c/d	29,000
	34,000		34,000

Dr. Prov. For Dep. on Plant & Machinery A/c Cr.

	₹		₹
To P & M A/c	6,000	By Balance c/d	45,000
To Balance b/d	54,000	By P & L A/c	15,000
	60,000		60,000

Dr. Prov. For Dep. on Furniture and Fixture A/c Cr.

	₹		₹
To Furniture & Fixture	2,000	By Balance c/d	13,000
To Balance b/d	15,000	By P & L A/c	4,000
	17,000		17,000

Cash Flow statement
For the year ended 31st March, 2015

		₹	₹	₹
	Cash Flows from Operating Activities			
	Net Profit during the year :			
	Net Profit for the year 2014-15	70,000		
Less:	Net Profit for the year 2013-14	28,000		
			42,000	
Add:	Non-Operating Expenses			
	Depreciation (₹ 15,000 + ₹ 4,000)	19,000		
	Loss on Sale of Fixtures	2,000		
	Discount on Debenture	1,000		
	Proposed Dividend	20,000		
	Debenture Interest	4,500		
			46,500	
			88,500	
Less:	Non-Operating Income			
	Profit on Sale of Plant		1,000	
			87,500	
Add:	Decrease in Current Assets or Increase in Current Liabilities			

	Decrease in Current Assets		Nil	
	Increase in Current Liabilities			
	Increase in Creditors	14,000		
			14,000	
			1,01,500	
Less:	Increase in Current Assets or Decrease in Current Liabilities			
	Increase in Current Assets			
	Increase in Stock	1,000		
	Increase in Debtors	14,000		
			15,000	
	New Cash Flows from Operating Activities			86,500
	Cash Flows from Investing Activities			
	Sale of Plant & Machinery	3,000		
	Sale of Furniture and Fixture	1,000		
			4,000	
Less:	Purchase of Plant & Machinery	39,000		
	Purchase of Fixture & Fittings	10,000		
	Purchase of Freehold Properties	20,000		
			69,000	
	Net Cash Flows from Investing Activities			(–)65,000
	Cash Flows from Financing Activities			
	Issue of Share		70,000	
Less:	Redemption of Debenture (including Premium)	42,000		
	Dividend Paid	15,000		
	Debenture Interest	4,500		
			61,500	
	Net Cash Flows from Financing Activities			8,500
	Net Increase in Cash or Cash Equipment			30,000
Less:	Cash and Cash equivalent at the beginning — Bank Overdraft			(–)14,000
	Cash or Cash equivalent at the end — Cash at Bank			16,000

First, we are to ascertain the following related ratios as follows:

(a) Ratio of Dividend to Operating Cash Flow (OCF) $= \frac{\text{Dividend}}{\text{Operating Cash Flows (OCF)}} \times 100$

$$= \frac{₹15,000}{₹86,500} \times 100 = 17.34\%$$

(b) Ratio of Depreciation to Cash Flow $= \frac{\text{Depreciation}}{\text{Operating Cash Flows (OCF)}} \times 100$

$$= \frac{₹19,000}{₹86,500} \times 100 = 21.97\%$$

(c) Debts Coverage Ratio $= \frac{\text{OCF-Interest-Dividend}}{\text{Debts}}$

$$= \frac{₹86,500 - ₹4,500 - ₹15,000}{₹30,000}$$

$$= \frac{₹67,000}{₹30,000} = 2.23 \text{ times}$$

(d) Interest Coverage ratio $= \frac{\text{Operating Cash Flows (OCF)}}{\text{Interest payment}}$

$$= \frac{₹86,000}{₹4,500} = 19.22 \text{ times}$$

(e) Return of Cash to Total Assets $= \frac{\text{Operating Cash Flow}}{\text{Total Assets}} \times 100$

$$= \frac{₹86,500}{₹4,21,000} \times 100 = 20.55\%$$

(f) Dependence of capital Investment on Internal Fund

$$= \frac{\text{Opera. Cash Flow-Incr. in Cash Balance}}{\text{Investing Cash Flow}}$$

$$= \frac{₹86,500 - ₹30,000}{₹65,000} \times 100 = 86.93\%$$

(g) Return of Cash on Net Worth $= \frac{\text{Operating Cash Flow-Interest}}{\text{Net Worth}} \times 100$

$$= \frac{₹86,500 - ₹4,500}{(₹1,50,000 + ₹35,000 + ₹70,000 - ₹1,000)}$$

$$= \frac{₹82,000}{₹2,54,000} \times 100 = 32.28\%$$

(h) Dependence of Extra Funds for capital Expenditure ratio $= \frac{\text{Financing Cash Flow}}{\text{Investing Cash Flow}} \times 100$

$$= \frac{₹8,500}{₹65,000} \times 100 = 13.08\%$$

Comments and Interpretation:

Ratio of Dividend to Operating Cash Flow is found to be 17.34% which indicates that percentage of cash generated through operational activities which may be considered as good. But if it is found to be 'good', more cash will be required for paying dividend.

Similarly, Ratio of Depreciation of Operating Cash Flow ratio is computed as only 21.97% which reveals percentage of cash used to replace fixed assets. It may be considered as normal. But Debt Coverage Ratio is found to be 2.23 times which is very poor and the same is used to redeem the existing debts by the amount of net cash generated from operation.

Interest Coverage Ratio, on the other hand, is found to be 19.22 times. It means ability of the firm to repay interest and also indicates the proportion of interest of 'cash generated from operation'. This ratio is high which invites obstruction to take the benefit of trading on equity. Return of cash to total assets ratio is found to be satisfactory, i.e. percentage of OCF to total assets is 20.55% which is considered as good. Similarly, dependence of capital investments on internal funds ratio is taken as 86.93% which reveals that percentage of OCF to Investing Cash Flow is 86.93% i.e. 86.93%, of capital expenditure has been founded out of cash to be generated from internal funds.

Return of Cash to Net Worth Ratio is found to be 32.28% which may be considered as good, and it indicates that shareholders' fund is efficiently used. Dependence of External Funds to Capital Expenditure Ratio is found to be 13.08% which reveals that external funds are used only a little portion and the rest is used as Working Capital.

From the discussion made so far, it may be concluded that the overall position to be measured in terms of Cash Flow Statement may be considered as sound. But whether such ratios are satisfactory or not can be measured by making proper comparison with the industry average ratio.