LEASING

Conceptually a lease may be defined as,

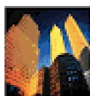
- a contractual arrangement / transaction in which a party owning an asset /equipment (lessor)
- provides the asset for use to another / transfer the right to use the equipment to the user (lessee)
- over a certain / for an agreed period of time
- for consideration in form of/ inj-eturn for periodic payment (rentals)
- with or without further payment (premium).

At the end of the period of contract (Lease period), the asset/equipment reverts to the lessor unless there is a provision for renewal of contract. Thus leasing is a device for financing the cost of an asset. The real function of lessor is not renting the asset but financing/funding the asset, which the lessee wants for his use. The lessor does riot take recourse to the asset / equipment as long as the rentals are regularly paid to him.

Parties to a Lease Agreement: There are two principal parties to any lease transaction as under:

Lessor: Who is actual owner of equipment permitting use to the other party on payment of periodical amount.

Lessee: Who acquires the right to use the equipment on payment of periodical amount.



Types of Leasing

A lease transaction has many variants relating to the type and nature of leased equipment, amortisation period, residual value of equipment, period of leasing, option for termination of lease etc. Various types of leasing transactions are, therefore, operating in the market on the basis of these variants. The different leasing options may however, be grouped in categories as under:

Operating Lease: In this type of lease transaction, the primary lease period is short and the lessor would not be able to realize the full cost of the equipment and other incidental charges thereon during the initial lease period. Besides the cost of machinery, the lessor also bears insurance, maintenance and

repair costs etc. These agreements may generally be preferred by the lessee in the following circumstances:

- When the long-term suitability of asset is uncertain.
- When the asset is subject to rapid obsolescence.
- When the asset is required for immediate use to tide over a temporary problem.

Computers and other office equipments are the very common assets which form subject matter of many operating lease agreements.

Financial Lease: Financial lease agreement is a long-term arrangement, which is irrevocable during the primary lease period which is generally the full economic life of the leased asset. Under this arrangement lessor is assured to realize the cost of purchasing the leased asset, cost of financing it and other administrative expenses as well as his profit by way of lease rent during the initial (primary) period of leasing itself. Financial lease involves transferring almost all the risks incidental to ownership and benefits arising therefrom except the legal title to the lessee against his irrevocable undertaking to make unconditional payments to the lessor as per agreed schedule. This is a closed end arrangement with no option to lessee to terminate the lease agreement subsequently. The choice of asset and its supplier is generally left to the lessee in such transactions. The variants under financial lease are as under:

- Lease with purchase option-where the lessee has the right to purchase the leased assets after the expiry of initial lease period at an agreed price.
- Lease with lessee having residual benefits-where the lessee has the right to share the sale proceeds of the asset after expiry of initial lease period and/or to renew the lease agreement at a lower rental.

In a few cases of financial lease, the lessor may not be a single individual but a group of equity participants and the group borrows a large amount from financial institutions to purchase the leased asset. Such transaction is called 'leveraged lease'.

- The first and foremost advantage of a lease agreement is its flexibility. The leasing company in most of the cases would be prepared to modify the arrangement to suit the specific requirements of the lessee.
- The leasing company may finance 100% cost of the equipment without insisting for any initial disbursement by the lessee, whereas 100% finance is generally never allowed by banks/financial institutions.
- Banks/financial institutions may involve lengthy appraisal and impose stringent terms and conditions to the sanctioned loan. The process is time consuming. In contrast leasing companies may arrange for immediate

purchase of equipment on mutually agreeable terms.

- Lengthy and time consuming documentation procedure is involved for term loans by banks/institutions. The lease agreement is very simple in comparison.
- In short-term lease (operating lease) the lessee is safeguarded against the risk of obsolescence. It is also an ideal method to acquire use of an asset required for a temporary period.
- The use of leased assets does not affect the borrowing capacity of the lessee. This neither affects the debt equity ratio or the current ratio of the lessee.
- Leased equipment is an 'off the balance sheet' asset being economically used by the lessee and does not affect the debt position of lessee.
- Tax benefits may also sometimes accrue to the lessee depending upon his tax status.

Disadvantages of Leasing

- The lease rentals become payable soon after the acquisition of assets and no moratorium period is permissible as in case of term loans from financial institutions.
- The leased assets are purchased by the lessor who is the owner of equipment. The seller's warranties for satisfactory operation of the leased assets may sometimes not be available to lessee.
- Lessor generally obtain credit facilities from banks etc. to purchase the leased equipment which are subject to hypothecation charge in favour of the bank. Default in payment by the lessor may sometimes result in seizure of assets by banks causing loss to the lessee.
- Lease financing has a very high cost of interest as compared to interest charged on term loans by financial institutions/banks.

Leasing and Hire Purchase

	LEASE	HIRE PURCHASE
Ownership	Lessor is the owner and the lessee is entitled to the economic use of the asset. Lessee never becomes the owner.	Hirer becomes owner after payment of last installment.
Depreciation	Charged in the books of Lessor	Hirer is entitled to depreciation benefits
Magnitude	Magnitude of funds involved are usually large	Cost of acquisition in the case of hire-purchase is relatively low

Extent	Lease financing is invariably 100% financing and no payment of margin money/down payment/ deposits are involved	In a hire-purchase transaction a margin equal to 20-25% may be payable and at times deposits are collected by the finance company repayable after payment of the last installment.
Maintenance	In a financial lease the lessor bears the cost of maintenance	Always the hirer has to bear the cost of maintenance
Tax Benefits	Lessor is allowed to claim the depreciation and the lessee is allowed to claim tax benefits on rentals and maintenance cost if any.	Hirer is allowed to claim depreciation and the finance charge and the seller may claim any interest on borrowed funds to acquire the asset for tax purposes

1. For each of the loan amounts, interest rates, loan terms, and annual payments shown in the following table, calculate the present value of annual interest paid each year over the term of the loan, assuming that the discount rate is 10%.

	Loan	Interest Rate	Loan Terms	Annual Payments	Additional Remarks
A	**20,000**	**8%**	**Equated Annual**	**4**	**Paid in Arrears**
B	**35,500**	**7%**	**Equated Annual**	**6**	**Paid in Advance**
C	**1,52,500**	**9%**	**Equal Principal**	**5**	**Paid in Arrears**
D	**1,52,500**	**9%**	**Equated Principal**	**5**	**Paid in Advance**

Solution:

a. $EAI = \frac{20,000}{PVIFA(8\%,4)} = 6,038$

Year	1	2	3	4
Principal	₹20,000	₹15,562	₹10,769	₹5,593
Interest	1,600	1,245	862	445
Payment	6,038	6,038	6,038	6,038
Principal paid	4,438	4,793	5,176	5,593
Principal remaining	15,562	10,769	5,593	0
PV Factor	0.909	0.826	0.751	0.683
PV of Interest	1454	1028	647	305

b. $EAI = \frac{35,000}{(1+PVIFA(7\%,5)} = 6,961$

Year	0	1	2	3	4	5
Principal	35,500	28,539	23,576	18,265	12,583	6,503
Interest	0	1,998	1,650	1,279	881	458
Payment	6,961	6,961	6,961	6,961	6,961	6,961
Principal paid	6,961	4,963	5,311	5,682	6,080	6,503
Principal remaining	28,539	23,576	18,265	12,583	6,503	0
PV Factor	1	0.909	0.826	0.751	0.683	0.621
PV of Interest	0	1816	1363	961	602	284

c. $\text{Equated Principals} = \frac{152500}{5} = 30,500$

Year	1	2	3	4	5
Principal	1,52,500	1,22,000	91,500	61,000	30,500
Interest	13,725	10,980	8,235	5,490	2,745
Principal Paid	30,500	30,500	30,500	30,500	30,500
Total Amount	44,225	41,480	38,735	35,990	33,245
Principal remaining	1,22,000	91,500	61,000	30,500	0
PV Factor	0.909	0.826	0.751	0.683	0.621
PV of Interest	12476	9069	6184	3749	1704

d. $\text{Equated principal} = \frac{152500}{5} = 30,500$

Year	0	1	2	3	4
Principal	1,52,500	1,22,000	91,500	61,000	30,500
Interest	0	10,980	8,235	5,490	2,745
Principal Paid	30,500	30,500	30,500	30,500	30,500
Total Amount	30,500	41,480	38,735	35,990	33,245
Principal remaining	1,22,000	91,500	61,000	30,500	0
PV Factor	1	0.909	0.826	0.751	0.683
PV of Interest	0	9,980	6,802	4,122	1,874

2. ABC Finance Ltd. is a hire purchase and leasing company. It has been approached by a small business firm interested in acquiring a machine through leasing. The quoted price of the machine is ₹5,00,000, 10% sale tax is extra. The lease will be for a primary lease period of 5 years.

The finance company wants 8% post-tax return on the outlay. Its effective tax rate is 35%. The income tax rate of depreciation on the machine is 25% (WDV). Lease rents are payable in arrear at the end of each year.

Calculate the annual rent to be charged by ABC Finance Ltd.

Solution:

Determination of cash outflows|: (Amount in rupees)

Cost of machine inclusive sale tax (10%)	5,50,000
Less: Tax saving on Depreciation (Tax shied Relief)	1,22,284
Present value of cash outflows for purchase	4,27,716

Computation of tax saving on Depreciation of the Machine

Year	Cost/WDV	Depreciation @ 25%	Tax @ 35%	PV factor @8%	P.V. of Dep. tax shield
1	5,50,000	1,37,500	48,125	0.926	44,564
2	4,12,500	1,03,125	36,094	0.857	30,933
3	3,09,375	77,344	27,070	0.794	21.494
4	2,32,031	58,008	20,303	0.735	14,923
5	1,74,023	43,506	15,227	0.681	10,370
				3.993	**1,22,284**

Calculation of Leasing Rent

Let, the required lease rent per year be 'R'

∴ Post-tax rental income p.a. (1- 0.35) = 0.65R

P.V. of 5 year's post-tax rental income = 0.65R × 3.993

This sum should be equal to ₹ 4,27,716

0.65R × 3.993 = 4,27,716

R = 4,27,716/2.59545 = 1,64,795

Hence, the annual rent to be charged by ABC Finance Ltd. is ₹1,64,795.

3. Modern Outlook Ltd. (MOL), a small manufacturing firm, is considering the acquisition of a machine. After evaluating equipments offered by seven different manufacturers, it has come to the conclusion that Z' was the most suitable machine for its needs. Consequently, it has asked the manufacturer's sales personnel to provide information on alternative financing plans available through their financing subsidiary. The subsidiary presented the two alternatives.

Alternative I was to lease the Z' equipment for 7 years, which was the machine's expected useful life. The annual lease payment would be ₹ 14,700 and would include service and maintenance. Lease payments would be due at the beginning of the year. Lease payments would be fully tax-deductible on the year of payment.

Alternative II would be to purchase the 'Z' equipment through 100% loan from the financing subsidiary. The cost of the machine is ₹50,000. It would make seven annual payments of? 9,935 each to repay the loan of ₹50,000. Payments would be, at the end of each year.

The MOL's marginal tax rate is 44%. It has estimated that the equipment has an expected salvage value of ₹1,000. The company plans to depreciate the equipment by using straight-line method. The service and maintenance would cost ₹ 3,700 annually.

You are required to advice MOL on the desirability of the alternative plans, assuming that the rate of interest is 9% p.a.

Note: The relevant PV factors are:

Year	0	1	2	3	4	5	6	7
PVF	1.00	0.952	0.907	0.864	0.823	0.784	0.746	0.711

PVF for salvage value is 0.452.

Solution:

Alternative I – Lease Decision

Year	Lease Rent (₹)	After tax Lease rent (₹)	P.V. Factor @ 9% (1 - 0.44) = 5.04%	Present values (₹)
0	14,700	8,232	1.000	8,232
1	14,700	8,232	0.952	7,837
2	14,700	8,232	0.907	7,466
3	14,700	8,232	0.864	7,112
4	14,700	8,232	0.823	6,775
5	14,700	8,232	0.784	6,454
6	14,700	8,232	0.746	6,141
Present value of cash flow				**= ₹ 50,017**

Alternative II - Buy Decision

Year	Loan Payment	Interest	Balance	Repayment (2)-(3)	Maintenance	Depreciation	Tax shield (3+6+7) × 0.44	Outflow (2+6-8)	P.V. Factor @9%	PV
1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**
1	9,935	4,500	50,000	5,435	3,700	7,000	6,688	6,947	0.952	6,614
2	9,935	4,011	44,565	5,924	3,700	7,000	6,473	7,162	0.907	6,496
3	9,935	3,478	38,641	6,457	3,700	7,000	6,238	7,397	0.864	6,391
4	9,935	2,897	32,184	7,038	3,700	7,000	5,983	7,652	0.823	6,298
5	9,935	2,263	25,146	7,672	3,700	7,000	5,704	7,931	0.784	6,218
6	9,935	1,573	17,474	8,362	3,700	7,000	5,400	8,232	0.746	6,143
7	9,935	823	9,112	9,112	3,700	7,000	5,070	8,565	0.711	6,090
7	Salvage							(1,000)	0.711	(711)
Present value of cash out flows										**₹43,539**

Since the present value of cash flow is lower for Alternative II, it is suggested to purchase the machine.

Thank You...

GROWTH STRATEGIES FOR CORPORATES

What is Corporate Strategy?

Corporate strategy defines the markets and the businesses in which an organisation chooses to operate. It is the Strategy that will affect the overall direction of the organisation and establish its future working environment. Competitive or business strategy defines the basis on which it will compete. Corporate Strategy is quintessential for a firm's survival and success.

Corporate strategy deals with three key issues facing the corporation as a whole.

1. The firm's overall orientation toward growth, stability, or retrenchment (directional strategy)
2. The industries or markets in which the firm competes through its products and business units (portfolio strategy)
3. The manner in which management coordinates activities, transfers resources, and cultivates capabilities among product lines and business units (parenting strategy)

Corporate strategy is primarily about the choice of direction for the firm as a whole. This is true whether the firm is a small, one-product company or a large multinational corporation. In a large multi-business company, however, corporate strategy is also about managing various product lines and business units for maximum value. In this instance, corporate headquarters must play the role of the organizational "parent," in that it must deal with various product and business unit "children." Even though each product line or business unit has its own competitive or cooperative strategy that it uses to obtain its own competitive advantage in the marketplace, the corporation must coordinate these different business strategies so that the corporation as a whole succeeds as a "family."

Corporate strategy, therefore, includes decisions regarding the flow of financial and other resources to and from a company's product lines and business units. Through a series of coordinating devices, a company transfers skills and capabilities developed in one unit to other units that need such resources. In this way, it attempts to obtain synergies among numerous product lines and business units so that the corporate whole is

greater than the sum of its individual business unit parts. All corporations, from the smallest company offering one product in only one industry to the largest conglomerate operating in many industries with many products must, at one time or another, consider one or more of these issues.

To deal with each of the key issues, the process may be organized into three parts that examine corporate strategy in terms of directional strategy (orientation toward growth), portfolio analysis (coordination of cash flow among units), and corporate parenting (building corporate synergies through resource sharing and development). Today we will learn about the growth strategies undertaken by corporates.

So what are the strategies that an organization undertakes for its growth?

Ans: Growth Strategy.

By far the most widely pursued corporate directional strategies are those designed to achieve growth in sales, assets, profits, or some combination. Companies that do business in expanding industries must grow to survive. Continuing growth means increasing sales and a chance to take advantage of the experience curve to reduce the per-unit cost of products sold, thereby increasing profits. This cost reduction becomes extremely important if a corporation's industry is growing quickly and competitors are engaging in price wars in attempts to increase their shares of the market. Firms that have not reached "critical mass" (that is, gained the necessary economy of large-scale production) will face large losses unless they can find and fill a small, but profitable, niche where higher prices can be offset by special product or service features. That is why Motorola, Inc., continued to spend large sums on the product development of cellular phones, pagers, and two-way radios, despite a serious drop in market share and profits. According to Motorola's Chairman George Fisher, "What's at stake here is leadership." Even though the industry was changing quickly, the company was working to avoid the erosion of its market share by jumping into new wireless markets as quickly as possible. Being one of the market leaders in this industry would almost guarantee Motorola enormous future returns.

A corporation can grow internally by expanding its operations both globally and domestically, or it can grow externally through mergers, acquisitions, and strategic alliances. A merger is a transaction involving two or more corporations in which stock is exchanged, but from which only one corporation survives. Mergers usually occur between firms of somewhat similar size and are usually "friendly." The resulting firm is likely to have a name derived from its composite firms. One example in the Pharma Industry is the merging of Glaxo and Simthkline Williams to form Glaxo Smithkline. An acquisition is the purchase of a company that is completely absorbed as an operating subsidiary or division of the acquiring corporation. Examples are Procter & Gamble's acquisition of Richardson-Vicks, known for its Oil of Olay and Vicks brands, and Gillette, known for shaving products.

Acquisitions usually occur between firms of different sizes and can be either friendly or hostile. Hostile acquisitions are often called takeovers. A strategic alliance is a partnership of two or more corporations or business units to achieve strategically significant objectives that are mutually beneficial.

Growth is a very attractive strategy for two key reasons:

1. Growth based on increasing market demand may mask flaws in a company (flaws that would be immediately evident in a stable or declining market. A growing flow of revenue into a highly leveraged corporation can create a large amount of organization slack (unused resources) that can be used to

quickly resolve problems and conflicts between departments and divisions. Growth also provides a big cushion for a turnaround in case a strategic error is made. Larger firms also have more bargaining power than do small firms and are more likely to obtain support from key stakeholders in case of difficulty.

2. A growing firm offers more opportunities for advancement, promotion, and interesting jobs. Growth itself is exciting and ego-enhancing for CEOs. The marketplace and potential investors tend to view a growing corporation as a "winner" or "on the move." Executive compensation tends to get bigger as an organization increases in size. Large firms are also more difficult to acquire than are smaller ones; thus an executive's job is more secure.

The two basic growth strategies are concentration on the current product line(s) in one industry and diversification into other product lines in other industries.

Concentration

If a company's current product lines have real growth potential, concentration of resources on those product lines makes sense as a strategy for growth. The two basic concentration strategies are vertical growth and horizontal growth. Growing firms in a growing industry tend to choose these strategies before they try diversification.

Vertical Growth

Vertical growth can be achieved by taking over a function previously provided by a supplier or by a distributor. The company, in effect, grows by making its own supplies and/or by distributing its own products. This may be done in order to reduce costs, gain control over a scarce resource, guarantee quality of a key input, or obtain access to potential customers. This growth can be achieved either internally by expanding current operations or externally through acquisitions. Henry Ford, for example, used internal company resources to build his River Rouge Plant outside Detroit. The manufacturing process was integrated to the point that iron ore entered one end of the long plant and finished automobiles rolled out the other end into a huge parking lot. In contrast, Cisco Systems, the maker of Internet hardware, chose the external route to vertical growth by purchasing Radiata, Inc., a maker of chip sets for wireless networks. This acquisition gave Cisco access to technology permitting wireless communications at speeds previously possible only with wired connections.

Vertical growth results in vertical integration (the degree to which a firm operates vertically in multiple locations on an industry's value chain from extracting raw materials to manufacturing to retailing. More specifically, assuming a function previously provided by a supplier is called backward integration (going backward on an industry's value chain). The purchase of Pentasia Chemicals by Asian Paints Limited for the chemicals required for the manufacturing of paints is an example of backward integration. Assuming a function previously provided by a distributor is labeled forward integration (going forward on an industry's value chain). Arvind Mills, for example, used forward integration when it expanded out of its successful fabric manufacturing business to make and market its own branded shirts and pants.

Vertical growth is a logical strategy for a corporation or business unit with a strong competitive position in a highly attractive industry, especially when technology is predictable and markets are growing. To keep and even improve its competitive position, the company may use backward integration to minimize resource

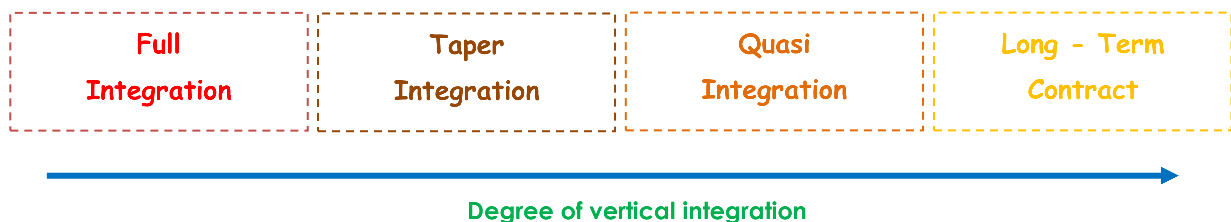
acquisition costs and inefficient operations as well as forward integration to gain more control over product distribution. The firm, in effect, builds on its distinctive competence by expanding along the industry's value chain to gain greater competitive advantage.

Although backward integration is usually more profitable than forward integration, it can reduce a corporation's strategic flexibility. The resulting encumbrance of expensive assets that might be hard to sell could create an exit barrier, preventing the corporation from leaving that particular industry. When sales of its autos were declining, Hindustan Motors (the makers of Ambassdor cars), for example, resorted to offering outside parts suppliers the use of its idle factories and workers.

Transaction cost economics proposes that vertical integration is more efficient than contracting for goods and services in the marketplace when the transaction costs of buying goods on the open market become too great. When highly vertically integrated firms become excessively large and bureaucratic, however, the costs of managing the internal transactions may become greater than simply purchasing the needed goods externally, thus justifying outsourcing over vertical integration.

Harrigan proposes that a company's degree of vertical integration can range from total ownership of the value chain needed to make and sell a product to no ownership at all.

Vertical Integration Continuum



Under **full integration**, a firm internally makes 100% of its key supplies and completely controls its distributors. Large oil companies, such as BP Amoco and Royal Dutch Shell, are fully integrated. They own the oil rigs that pump the oil out of the ground, the ships and pipelines that transport the oil, the refineries that convert the oil to gasoline, and the trucks that deliver the gasoline to company-owned and franchised gas stations. If a corporation does not want the disadvantages of full vertical integration, it may choose either taper or quasi-integration strategies.

With **taper integration**, a firm internally produces less than half of its own requirements and buys the rest from outside suppliers. In case of Asian Paints Limited, its purchase of Pentasia Chemicals allows it to produce the basic chemicals it needs to process into interior paints. In terms of distributors, a firm sells part of its goods through company-owned stores and the rest through general wholesalers. Both Xerox and IBM have experimented (unsuccessfully) with selling their products through their own stores.

With **quasi-integration**, a company does not make any of its key supplies but purchases most of its requirements from outside suppliers that are under its partial control. For example, by purchasing 20% of the common stock of a key supplier, In Focus Systems, Motorola guaranteed its access to In Focus' technology and

enabled Motorola to establish a joint venture with In Focus to manufacture flat-panel video displays.An example of forward quasi-integration would be a large pharmaceutical firm that acquires part interest in a drugstore chain in order to guarantee that its drugs have access to the distribution channel. Purchasing part interest in a key supplier or distributor usually provides a company with a seat on the other firm's board of directors, thus guaranteeing the acquiring firm both information and control. A company may not want to invest in suppliers or distributors, but it still wants to guarantee access to needed supplies or distribution channels. In this case, it may use contractual agreements.

Long-term contracts are agreements between two separate firms to provide agreed-upon goods and services to each other for a specified period of time. This cannot really be considered to be vertical integration unless the contract specifies that the supplier or distributor cannot have a similar relationship with a competitive firm. In this case, the supplier or distributor is really a captive company that, although officially independent, does most of its business with the contracted firm and is formally tied to the other company through a long-term contract.

Recently there has been a movement away from vertical growth strategies (and thus vertical integration) toward cooperative contractual relationships with suppliers and even with competitors. These relationships range from outsourcing, in which resources are purchased from outsiders through long-term contracts instead of being made in-house (for example, Hewlett-Packard buys all its laser engines from Canon for HP's laser jet printers), to strategic alliances, in which partnerships, technology licensing agreements, and joint ventures supplement a firm's capabilities (for example, Tata Consultancy Services (TCS) integrates and resells Adobe products as part of its enterprise solution offerings, addressing the document generation, collaboration and process management challenges organizations face as they move paper-based processes online. In addition, TCS sells Adobe's enterprise products as part of its offering and will provide first level customer support.).

Horizontal Growth

Horizontal growth can be achieved by expanding the firm's products into other geographic locations and/or by increasing the range of products and services offered to current markets. In this case, the company expands sideways at the same location on the industry's value chain. For example, Ranbaxy Labs followed a horizontal growth strategy when it extended its pharmaceutical business to Europe and to U. S. A company can grow horizontally through internal development or externally through acquisitions or strategic alliances with another firm in the same industry.

Horizontal growth results in horizontal integration—the degree to which a firm operates in multiple geographic locations at the same point in an industry's value chain. Horizontal integration for a firm may range from full to partial ownership to long-term contracts. For example, IBM, purchased the Indian BPO major Daksh to obtain access to American and Asian markets. Many commuter airlines engage in long-term contracts with other airlines in order to offer a complete arrangement for travelers. For example, Jet Airways provides world-class frequent flyer benefits to the customers, through their alliances with British Airways, KLM Royal Dutch Airlines and Northwest Airlines and provides flight reservations directly from the destinations outside India for domestic travel.

Diversification Strategies

When an industry consolidates and becomes mature, most of the surviving firms have reached the limits of growth using vertical and horizontal growth strategies. Unless the competitors are able to expand internationally into less mature markets, they may have no choice but to diversify into different industries if they want to continue growing. The two basic diversification strategies are concentric and conglomerate.

Concentric (Related) Diversification

Growth through **concentric diversification** into a related industry may be a very appropriate corporate strategy when a firm has a strong competitive position but industry attractiveness is low. By focusing on the characteristics that have given the company its distinctive competence, the company uses those very strengths as its means of diversification. The firm attempts to secure strategic fit in a new industry where the firm's product knowledge, its manufacturing capabilities, and the marketing skills it used so effectively in the original industry can be put to good use. The corporation's products or processes are related in some way: They possess some common thread. The search is for **synergy,** the concept that two businesses will generate more profits together than they could separately. The point of commonality may be similar technology, customer usage, distribution, managerial skills, or product similarity. This is the rationale taken by Titan Industries Limited when it diversified out of watches into designer jewellery and sun glasses. The company was changing from a watch company to a lifestyle product company.

The firm may choose to diversify concentrically through either internal or external means. Gujarat Cooperative Milk Marketing Federation (GCMMF), the makers of Amul, for example, has diversified both internally and externally out of the simple dairy and dairy products business into a series of related businesses leading it to become a food products marketing organization.

Conglomerate (Unrelated) Diversification

When management realizes that the current industry is unattractive and that the firm lacks outstanding abilities or skills that it could easily transfer to related products or services in other industries, the most likely strategy is **conglomerate diversification**—diversifying into an industry unrelated to its current one. Rather than maintaining a common thread throughout their organization, strategic managers who adopt this strategy are primarily concerned with financial considerations of cash flow or risk reduction.

The emphasis in conglomerate diversification is on financial considerations rather than on the product-market synergy common to concentric diversification. A cash-rich company with few opportunities for growth in its industry might, for example, move into another industry where opportunities are great but cash is hard to find. Another instance of conglomerate diversification might be when a company with a seasonal and, therefore, uneven cash flow purchases a firm in an unrelated industry with complementing seasonal sales that will level out the cash flow. ITC Limited (which is mainly in Tobacco Products) diversified into paper products, Hotel business, agro products due to the constant threat it has in the cigarettes business.

INTERNATIONAL ENTRY OPTIONS:

In today's world, growth usually has international implications. Research indicates that going international is positively associated with firm profitability." A corporation can select from several strategic options the most appropriate method for it to use in entering a foreign market or establishing manufacturing facilities in another country. The options vary from simple exporting to acquisitions to management contracts. As in the case of Asian Paints Limited's purchase of stock in Berger International Limited, Singapore , this can be a part of the corporate strategies previously discussed. Some of the more popular options for international entry are as follows:

- **Exporting:** A good way to minimize risk and experiment with a specific product is **exporting,** shipping goods produced in the company's home country to other countries for marketing. The company could choose to handle all critical functions itself, or it could contract these functions to an export management company. Exporting is becoming increasingly popular for small businesses because of the Internet, fax machines, 800 numbers, and overnight air express services, which reduce the once formidable cost of going international.
- **Licensing:** Under a **licensing** agreement, the licensing firm grants rights to another firm in the host country to produce and/or sell a product. The licensee pays compensation to the licensing firm in return for technical expertise. This is an especially useful strategy if the trademark or brand name is well known, but the company does not have sufficient funds to finance its entering the country directly. Fedex uses this strategy for its operations in India through its license to Prakash Air Freight Couriers in India. This strategy also becomes important if the country makes entry via investment either difficult or impossible. The danger always exists, however, that the licensee might develop its competence to the point that it becomes a competitor to the licensing firm. Therefore, a company should never license its distinctive competence, even for some short-run advantage.

- **Franchising: Under a franchising** agreement, the franchiser grants rights to another company to open a retail store using the franchiser's name and operating system. In exchange, the franchisee pays the franchiser a percentage of its sales as a royalty. Franchising provides an opportunity for firms to establish a presence in countries where the population or per capita spending is not sufficient to support a major expansion effort. Franchising accounts for 40% of total U.S. retail sales. Approximately 44% of U.S. franchisers, such as Toys "R" Us, are currently franchising internationally while an additional 31% are planning to do so. In India, McDonald's India represented by two joint ventures has now begun exploring the option of developing a franchisee model. Further, it has also firmed up plans to open 20 new eateries (55 currently) and enhance its dine-in capacity from the current 5,800 seats to around 8,050-8,300 seats by 2004.

- **Joint Ventures:** The rate of **joint venture** formation between U.S. companies and international partners has been growing 27% annually since 1985. It is the most popular strategy used to enter a new country. Companies often form joint ventures to combine the resources and expertise needed to develop new products or technologies. It also enables a firm to enter a country that restricts foreign ownership. The corporation can enter another country with fewer assets at stake and thus lower risk. For example, IBM entered India way back in 1992 through a joint venture with the Tata Group. The joint venture company is christened Tata Information Systems Limited (TISL). Later in 1999, IBM India Limited formally launched Tata's

divestment plan after government approval. A joint venture may be an association between a company and a firm in the host country or a government agency in that country. A quick method of obtaining local management, it also reduces the risks of expropriation and harassment by host country officials.

- **Acquisitions:** A relatively quick way to move into an international area is through **acquisitions** (purchasing another company already operating in that area. Synergistic benefits can result if the company acquires a firm with strong complementary product lines and a good distribution network. Asian Paints Limited's acquisition of SCIB Chemical SAE gave it entry into Egypt. To expand into North America, the Swedish appliance maker, A.B. Electrolux, purchased the major home appliance operations of White Consolidated Industries and renamed the unit Frigidaire. Research does suggest that wholly owned subsidiaries are more successful in international undertakings than are strategic alliances, such as joint ventures.[17] This is one reason why firms more experienced in international markets take a higher ownership position when making a foreign investment.[18] In some countries, however, acquisitions can be difficult to arrange because of a lack of available information about potential candidates. Government restrictions on ownership, such as the Indian requirement that limits foreign ownership of Indian domestic airlines to 40% FDI without direct or indirect equity participation, can also discourage acquisitions.

- **Green-Field Development:** If a company doesn't want to purchase another company's problems along with its assets (as Japan's Bridgestone did when it acquired Firestone in the United States) it may choose **green-field development** (building its own manufacturing plant and distribution system. This is usually a far more complicated and expensive operation than acquisition, but it allows a company more freedom in designing the plant, choosing suppliers, and hiring a workforce. For example, Nissan, Honda, and Toyota built auto factories in rural areas of Great Britain and then hired a young workforce with no experience in the industry.

- **Production Sharing:** Coined by Peter Drucker, the term **production sharing** means the process of combining the higher labor skills and technology available in the developed countries with the lower cost labor available in developing countries. The current trend is to move data processing and programming activities "offshore" to places such as Ireland, India, Barbados, Jamaica, the Philippines, and Singapore where wages are lower, English is spoken, and telecommunications are in place.

- **Turnkey Operations: Turnkey operations** are typically contracts for the construction of operating facilities in exchange for a fee. The facilities are transferred to the host country or firm when they are complete. The customer is usually a government agency of, for example, a Middle Eastern country that has decreed that a particular product must be produced locally and under its control. For example, ECC (a L&T Company) built a urea prilling tower and storage silo for State Fertilizer Manufacturing Corporation of Srilanka. MNCs that perform turnkey operations are frequently industrial equipment manufacturers that supply some of their own equipment for the project and that commonly sell replacement parts and maintenance services to the host country. They thereby create customers as well as future competitors.

- **BOT Concept:** The **BOT** (Build, Operate, Transfer) **concept** is a variation of the turnkey operation. Instead of turning the facility (usually a power plant or toll road) over to the host country when completed, the company operates the facility for a fixed period of time during which it earns back its investment, plus a profit. It then turns the facility over to the government at little or no cost to the host country.

- **Management Contracts:** A large corporation operating throughout the world is likely to have a large amount of management talent at its disposal. **Management contracts** offer a means through which a corporation may use some of its personnel to assist a firm in a host country for a specified fee and period of time. Management contracts are common when a host government expropriates part or all of a foreign-owned company's holdings in its country. The contracts allow the firm to continue to earn some income from its investment and keep the operations going until local management is trained.

CONTROVERSIES IN DIRECTIONAL GROWTH STRATEGIES

Is vertical growth better than horizontal growth? Is concentric diversification better than conglomerate diversification? Although the research is not in complete agreement, growth into areas related to a company's current product lines is generally more successful than is growth into completely unrelated areas. For example, one study of various growth projects examined how many were considered successful, that is, still in existence after 22 years. The results were: vertical growth, 80%; horizontal growth, 50%; concentric diversification, 35%; and conglomerate diversification, 28%.

In terms of diversification strategies, research suggests that the relationship between relatedness and performance is curvilinear in the shape of an inverted U-shaped curve. If a new business is very similar to that of the acquiring firm, it adds little new to the corporation and only marginally improves performance. If the new business is completely different from the acquiring company's businesses, there may be very little potential for any synergy. If, however, the new business provides new resources and capabilities in a different, but similar, business, the likelihood of a significant performance improvement is high.

Is internal growth better than external growth?

Corporations can follow the growth strategies of either concentration or diversification through the internal development of new products and services or through external acquisitions, mergers, and strategic alliances. The value of global acquisitions and mergers has steadily increased from around $300,000 billion in 1991 to $3.5 trillion in 2000. Although not yet conclusive, the research indicates that firms that grow through acquisitions do not perform financially as well as firms that grow through internal means. Studies do reveal that over two-thirds of acquisitions are failures primarily because the premiums paid were too high for them to earn their cost of capital. Other research indicates, however, that acquisitions have a higher survival rate than do new internally generated business ventures. It is likely that neither strategy is best by itself and that some combination of internal and external growth strategies is better than using one or the other exclusively.

INCOME COMPUTATION AND DISCLOSURE STANDARDS

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

List of Standards are as follows:

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

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

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

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

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

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

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

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

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

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

D. Income Computation and Disclosure Standard IV relating to revenue recognition Preamble

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

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

1. Scope

(1) This Income Computation and Disclosure Standard deals with the bases for recognition of revenue arising in the course of the ordinary activities of a person from

(i) the sale of goods;
(ii) the rendering of services;
(iii) the use by others of the person's resources yielding interest, royalties or dividends.

(1) This Income Computation and Disclosure Standard does not deal with the aspects of revenue recognition which are dealt with by other Income Computation and Disclosure Standards.

2. Definitions

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

(a) "Revenue" is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of a person from the sale of goods, from the rendering of services, or from the use by others of the person's resources yielding interest, royalties or dividends. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

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

3. Sale of Goods

In a transaction involving the sale of goods, the revenue shall be recognised when the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership. In a situation, where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership, revenue in such a situation shall be recognised at the time of transfer of significant risks and rewards of ownership to the buyer.

4. Revenue shall be recognised when there is reasonable certainty of its ultimate collection.

5. Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim for escalation of price and export incentives, revenue recognition in respect of such claim shall be postponed to the extent of uncertainty involved.

6. Rendering of Services

Revenue from service transactions shall be recognised by the percentage completion method. Under this method, revenue from service transactions is matched with the service transactions costs incurred in reaching the stage of completion, resulting in the determination of revenue, expenses and profit which can be attributed to the proportion of work completed. Income Computation and Disclosure Standard on construction contract also requires the recognition of revenue on this basis. The requirements of that Standard shall mutatis mutandis apply to the recognition of revenue and the associated expenses for a service transaction.

7. The Use of Resources by Others Yielding Interest, Royalties or Dividends

Interest shall accrue on the time basis determined by the amount outstanding and the rate applicable. Discount or premium on debt securities held is treated as though it were accruing over the period to maturity.

8. Royalties shall accrue in accordance with the terms of the relevant agreement and shall be recognised on that basis unless, having regard to the substance of the transaction, it is more appropriate to recognise revenue on some other systematic and rational basis.

9. Dividends are recognised in accordance with the provisions of the Act.

10. Transitional Provisions

The transitional provisions of Income Computation and Disclosure Standard on construction contract shall mutatis mutandis apply to the recognition of revenue and the associated costs for a service transaction undertaken on or before the 31st day of March, 2015 but not completed by the said date.

11. Revenue for a transaction, other than a service transaction referred to in Para 10, undertaken on or before the 31st day of March, 2015 but not completed by the said date shall be recognised in accordance with the provisions of this standard for the previous year commencing on the 1st day of April, 2015 and subsequent previous year. The amount of revenue, if any, recognised for the said transaction for any previous year commencing on or before the 1st day of April, 2014 shall be taken into account for recognising revenue for the said transaction for the previous year commencing on the 1st day of April, 2015 and subsequent previous years.

12. Disclosure

Following disclosures shall be made in respect of revenue recognition, namely:—

(a) in a transaction involving sale of good, total amount not recognised as revenue during the previous year due to lack of reasonably certainty of its ultimate collection along with nature of uncertainty;
(b) the amount of revenue from service transactions recognised as revenue during the previous year;
(c) the method used to determine the stage of completion of service transactions in progress; and
(d) for service transactions in progress at the end of previous year:
   (i) amount of costs incurred and recognised profits (less recognised losses) upto end of previous year;
   (ii) the amount of advances received; and
   (iii) the amount of retentions.

E. Income Computation and Disclosure Standard V relating to tangible fixed assets Preamble

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

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

1. Scope

This Income Computation and Disclosure Standard deals with the treatment of tangible fixed assets.

2. Definitions

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

(a) "Tangible fixed asset" is an asset being land, building, machinery, plant or furniture held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

(b) "Fair value" of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

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

3. Identification of Tangible Fixed Assets

The definition in clause (a) of sub-paragraph (1) of paragraph 2 provides criteria for determining whether an item is to be classified as a tangible fixed asset.

4. Stand-by equipment and servicing equipment are to be capitalised. Machinery spares shall be charged to the revenue as and when consumed. When such spares can be used only in connection with an item of tangible fixed asset and their use is expected to be irregular, they shall be capitalised.

5. Components of Actual Cost

The actual cost of an acquired tangible fixed asset shall comprise its purchase price, import duties and other taxes, excluding those subsequently recoverable, and any directly attributable expenditure on making the asset ready for its intended use. Any trade discounts and rebates shall be deducted in arriving at the actual cost.

6. The cost of a tangible fixed asset may undergo changes subsequent to its acquisition or construction on account of—

(i) price adjustment, changes in duties or similar factors; or
(ii) exchange fluctuation as specified in Income Computation and Disclosure

7. Standard on the effects of changes in foreign exchange rates.

Administration and other general overhead expenses are to be excluded from the cost of tangible fixed assets if they do not relate to a specific tangible fixed asset.

Expenses which are specifically attributable to construction of a project or to the acquisition of a tangible fixed asset or bringing it to its working condition, shall be included as a part of the cost of the project or as a part of the cost of the tangible fixed asset.

8. The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, shall be capitalised. The expenditure incurred after the plant has begun commercial production, that is, production intended for sale or captive consumption, shall be treated as revenue expenditure.

9. Self-constructed Tangible Fixed Assets

In arriving at the actual cost of self-constructed tangible fixed assets, the same principles shall apply as those described in paragraphs 5 to 8. Cost of construction that relate directly to the specific tangible fixed asset and costs that are attributable to the construction activity in general and can be allocated to the specific tangible fixed asset shall be included in actual cost. Any internal profits shall be eliminated in arriving at such costs.

10. Non-monetary Consideration

When a tangible fixed asset is acquired in exchange for another asset, the fair value of the tangible fixed asset so acquired shall be its actual cost.

11. When a tangible fixed asset is acquired in exchange for shares or other securities, the fair value of the tangible fixed asset so acquired shall be its actual cost.

12. Improvements and Repairs

An Expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is added to the actual cost.

13. The cost of an addition or extension to an existing tangible fixed asset which is of a capital nature and which becomes an integral part of the existing tangible fixed asset is to be added to its actual cost. Any addition or extension, which has a separate identity and is capable of being used after the existing tangible fixed asset is disposed of, shall be treated as separate asset.

14. Valuation of Tangible Fixed Assets in Special Cases

Where a person owns tangible fixed assets jointly with others, the proportion in the actual cost, accumulated depreciation and written down value is grouped together with similar fully owned tangible fixed assets. Details of such jointly owned tangible fixed assets shall be indicated separately in the tangible fixed assets register.

15. Where several assets are purchased for a consolidated price, the consideration shall be apportioned to the various assets on a fair basis.

16. Transitional Provisions

The actual cost of tangible fixed assets, acquisition or construction of which commenced on or before the 31st day of March, 2015 but not completed by the said date, shall be recognised in accordance with the provisions of this standard. The amount of actual cost, if any, recognised for the said assets for any previous year commencing on or before the 1st day of April, 2014 shall be taken into account for recognising actual cost of the said assets for the previous year commencing on the 1st day of April, 2015 and subsequent previous years.

17. Depreciation

Depreciation on a tangible fixed asset shall be computed in accordance with the provisions of the Act.

18. Transfers

Income arising on transfer of a tangible fixed asset shall be computed in accordance with the provisions of the Act.

19. Disclosures ;

Following disclosure shall be made in respect of tangible fixed assets, namely:—

(a) description of asset or block of assets;

(b) rate of depreciation;

(c) actual cost or written down value, as the case may be;

(d) additions or deductions during the year with dates; in the case of any addition of an asset, date put to use; including adjustments on account of—

(i) Central Value Added Tax credit claimed and allowed under the CENVAT Credit Rules, 2004;
(ii) change in rate of exchange of currency;
(iii) subsidy or grant or reimbursement, by whatever name called;

(e) depreciation Allowable; and
(f) written down value at the end of year.

F. Income Computation and Disclosure Standard VI relating to the effects of changes in foreign exchange rates

Preamble

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

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

1. Scope

This Income Computation and Disclosure Standard deals with:

(a) treatment of transactions in foreign currencies;

(b) translating the financial statements of foreign operations;

(c) treatment of foreign currency transactions in the nature of forward exchange contracts.

2. Definitions

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

(a) "Average rate" is the mean of the exchange rates in force during a period.

(b) "Closing rate" is the exchange rate at the last day of the previous year.

(c) "Exchange difference" is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency of a person at different exchange rates.

(d) "Exchange rate" is the ratio for exchange of two currencies.

(e) "Foreign currency" is a currency other than the reporting currency of a person.

(f) "Foreign operations of a person" is a branch, by whatever name called, of that person, the activities of which are based or conducted in a country other than India.

(g) "Foreign currency transaction" is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when a person:—

 (i) buys or sells goods or services whose price is denominated in a foreign currency; or
 (ii) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or
 (iii) becomes a party to an unperformed forward exchange contract; or
 (iv) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

(h) "Forward exchange contract" means an agreement to exchange different currencies at a forward rate, and includes a foreign currency option contract or another financial instrument of a similar nature;
(i) "Forward rate" is the specified exchange rate for exchange of two Currencies at a specified future date;
(j) "Indian currency" shall have the meaning as assigned to it in section 2 of the Foreign Exchange Management Act, 1999;
(k) "Integral foreign operation" is a foreign operation, the activities of which are an integral part of the operation of the person;
(l) "Monetary items" are money held and assets to be received or liabilities to be paid in fixed or determinable amounts of money. Cash, receivables, and payables are examples of monetary items;
(m) "Non-integral foreign operation" is a foreign operation that is not an integral foreign operation;
(n) "Non-monetary items" are assets and liabilities other than monetary items. Fixed assets, inventories, and investments in equity shares are examples of non-monetary items;
(o) "Reporting currency" means Indian currency except for foreign operations where it shall mean currency of the country where the operations are carried out.

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

Foreign Currency Transactions

3. Initial Recognition

(1) A foreign currency transaction shall be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

(2) An average rate for a week or a month that approximates the actual rate at the date of the transaction may be used for all transaction in each foreign currency occurring during that period. If the exchange rate fluctuates significantly, the actual rate at the date of the transaction shall be used.

4. Conversion at Last Date of Previous Year

At last day of each previous year:—

(a) foreign currency monetary items shall be converted into reporting currency by applying the closing rate;

(b) where the closing rate does not reflect with reasonable accuracy, the amount in reporting currency that is likely to be realised from or required to disburse, a foreign currency monetary item owing to restriction on remittances or the closing rate being unrealistic and it is not possible to effect an exchange of currencies at that rate, then the relevant monetary item shall be reported in the reporting currency at the amount which is likely to be realised from or required to disburse such item at the last date of the previous year; and

(c) non-monetary items in a foreign currency shall be converted into reporting currency by using the exchange rate at the date of the transaction.

5. Recognition of Exchange Differences

(i) In respect of monetary items, exchange differences arising on the settlement thereof or on conversion thereof at last day of the previous year shall be recognised as income or as expense in that previous year.

(ii) In respect of non-monetary items, exchange differences arising on conversion thereof at the last day of the previous year shall not be recognised as income or as expense in that previous year.

6. Exceptions to Paragraphs 3,4 and 5

Notwithstanding anything contained in paragraph 3, 4 and 5; initial recognition, conversion and recognition of exchange difference shall be subject to provisions of section 43A of the Act or Rule 115 of Income-tax Rules, 1962, as the case may be.

Financial Statements of Foreign Operations

7. Classification of Foreign Operations

(1) The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to a person. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations".

(2) The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:—

(a) while the person may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from the activities of the person;

(b) transactions with the person are not a high proportion of the foreign operation's activities;

(c) the activities of the foreign operation are financed mainly from its own operations or local borrowings;

(d) costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency;

(e) the foreign operation's sales are mainly in currencies other than Indian currency;

(f) cash flows of the person are insulated from the day-to-day activities of the foreign operation;

(g) sales prices for the foreign operation's products or services are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local

government regulation;

(h) there is an active local sales market for the foreign operation's products or services, although there also might be significant amounts of exports.

8. Integral Foreign Operations

The financial statements of an integral foreign operation shall be translated using the principles and procedures in paragraphs 3 to 6 as if the transactions of the foreign operation had been those of the person himself.

9. Non-integral Foreign Operations

(1) In translating the financial statements of a non-integral foreign operation for a previous year, the person shall apply the following, namely:—

(a) the assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation shall be translated at the closing rate;

(b) income and expense items of the non-integral foreign operation shall be translated at exchange rates at the dates of the transactions; and

(c) all resulting exchange differences shall be recognised as income or as expenses in that previous year.

(2) Notwithstanding anything stated in sub-paragraph 1, translation and recognition of exchange difference in cases referred to in section 43A of the Act or Rule 115 of Income-tax Rules, 1962 shall be carried out in accordance with the provisions contained in that section or that Rule, as the case may be.

10. Change in the Classification of a Foreign Operation

(1) When there is a change in the classification of a foreign operation, the translation procedures applicable to the revised classification should be applied from the date of the change in the classification.

(2) The consistency principle requires that foreign operation once classified as integral or non-integral is continued to be so classified. However, a change in the way in which a foreign operation is financed and operates in relation to the person may lead to a change in the classification of that foreign operation.

11. Forward Exchange Contracts

(1) Any premium or discount arising at the inception of a forward exchange contract shall be amortised as expense or income over the life of the contract. Exchange differences on such a contract shall be recognised as income or as expense in the previous year in which the exchange rates change. Any profit or loss arising on cancellation or renewal shall be recognised as income or as expense for the previous year.

(2) The provisions of sub-para (1) shall apply provided that the contract:

(a) is not intended for trading or speculation purposes; and

(b) is entered into to establish the amount of the reporting currency required or available at the settlement date of the transaction.

(3) The provisions of sub-para (1) shall not apply to the contract that is entered into to hedge the foreign

currency risk of a firm commitment or a highly probable forecast transaction. For this purpose, firm commitment, shall not include assets and liabilities existing at the end of the previous year.

(4) The premium or discount that arises on the contract is measured by the difference between the exchange rate at the date of the inception of the contract and the forward rate specified in the contract. Exchange difference on the contract is the difference between:

(a) the foreign currency amount of the contract translated at the exchange rate at the last day of the previous year, or the settlement date where the transaction is settled during the previous year; and

(b) the same foreign currency amount translated at the date of inception of the contract or the last day of the immediately preceding previous year, whichever is later.

(5) Premium, discount or exchange difference on contracts that are intended for trading or speculation purposes, or that are entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction shall be recognised at the time of settlement.

12. Transitional Provisions

(1) All foreign currency transactions undertaken on or after 1st day of April, 2015 shall be recognised in accordance with the provisions of this standard.

(2) Exchange differences arising in respect of monetary items or non-monetary items, on the settlement thereof during the previous year commencing on the 1st day of April, 2015 or on conversion thereof at the last day of the previous year commencing on the 1st day of April, 2015, shall be recognised in accordance with the provisions of this standard after taking into account the amount recognised on the last day of the previous year ending on the 31st March,2015 for an item, if any, which is carried forward from said previous year.

(3) The financial statements of foreign operations for the previous year commencing on the 1st day of April, 2015 shall be translated using the principles and procedures specified in this standard after taking into account the amount recognised on the last day of the previous year ending on the 31st March, 2015 for an item, if any, which is carried forward from said previous year.

(4) All forward exchange contracts existing on the 1st day of April, 2015 or entered on or after 1st day of April, 2015 shall be dealt with in accordance with the provisions of this standard after taking into account the income or expenses, if any, recognised in respect of said contracts for the previous year ending on or before the 31st March, 2015.

EXEMPTION TO SMALL SERVICE PROVIDER

Exemption for aggregate value upto ₹ 10 lakhs [Notification No. 33/2012-ST, dated 20-6-2012]:

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

Aggregate value: "Aggregate Value" means,-

(a) the sum total of value of taxable services charged in the first consecutive invoices issued or required to be issued, as the case may be, during a financial year,

(b) but does not include value charged in invoices issued towards such services which are exempt from whole of service tax leviable thereon under section 66B of the Act.

For example, if Mr X has provided taxable services during financial year 2015-16 from its Jaipur Branch of ₹6.5 lakhs and of ₹ 3.5 lakh from his Ajmer Branch, then, since total aggregate value = ₹10 lakhs, hence, he is eligible for this exemption for the year 2016-17.

Conversely, if the value of services provided from Jaipur branch were ₹ 6.6 lakhs, then, since the total aggregate value would be ₹ 10.10 lakhs (exceeding ₹ 10 lakhs), hence, he would not be eligible to avail this exemption in the financial year 2016-17.

(2) **Quantum of exemption** : Small service provider is entitled 100% exemption from service tax of aggregate value of taxable services upto ₹ **10 lakhs** provided during the financial year.

If the **"aggregate value"** in any financial year exceeds ₹ 10 lakhs, **then such excess over ₹ 10 lakhs shall be chargeable to service tax.**

Example 1 : Mr. X provided services of ₹ 10 lakhs in 2015-16 and provides services of ₹ 18 lakhs in 2016-17 (out of which services of ₹ 9 lakhs are wholly exempt under mega exemption notification), then, -

(a) he would be eligible for this exemption in 2016-17 (as aggregate value of services in 2015-16 were upto ₹ 10 lakhs); and

(b) he can claim exemption for aggregate value of ₹ 9 lakhs (₹ 18 lakh - ₹ 9 lakhs already exempt under mega exemption notification); and

(c) therefore, he would not be liable to pay any service tax in 2016-17.

Example 2 : If, however, in example 1, value of services exempted is only ₹ 6 lakh out of ₹ 18 lakh, then, aggregate value = ₹ 18 - 6 = ₹ 12 lakh, out of which first consecutive invoices of ₹ 10 lakh shall be exempt and he will be liable to pay service tax on invoices issued after ₹ 10 lakhs value i.e. invoices having value of ₹ 2 lakh.

Example 3 : Mr. X is eligible for this exemption in 2016-17 and has provided services of value of ₹9,75,000 upto January, 2016 and claimed exemption under this notification. He raises a bill of value ₹ 50,000 in February, 2016. Out of this bill of ₹ 50,000, value of ₹ 25,000 shall be exempt (to make exemption to ₹ 10

lakhs) and balance ₹5,000 shall be chargeable to tax. Amount to be charged in invoice = ₹ 50,000 + Service Tax @ 14% of ₹ 25,000 = ₹ 53,500.

(3) Determination of value in case of Goods Transport Agency (GTA) : In relation to taxable service provided by a goods transport agency, the payment received towards the gross amount charged by such goods transport agency for which the person liable for paying service tax is a person other than the goods transport agency, shall not be taken into account.

Example 4: A GTA service provider provided services valuing ₹ 20 lakh in 2015-16 and services valuing ₹ 25 lakhs in 2016-17. Out of the said sums, 50% relates to cases where the person liable to pay service tax was other than GTA. Whether GTA is eligible for this exemption in 2016-17.

Ans: Yes. Value of services provided in 2015-16 = ₹ 20 lakhs - 50% towards sum received where person liable to pay services tax was other than GTA = ₹ 10 lakh.

Hence, GTA is eligible for exemption in year 2016-17.

Aggregate value of services in 2016-17 = ₹ 25 lakhs - 50% = ₹ 12.5 lakhs. Out of this ₹ 10 lakhs will be exempt and balance ₹ 2.5 lakhs will be liable to service tax in hands of GTA.

Note: This benefit is not available to other service providers.

(4) Other Considerations in determining the aggregate value :

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

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

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

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

(d) Services specified in negative list - Value not to be included in aggregate value : In case of service providers providing services specified in the negative list, the value of such services shall not form part of aggregate value of taxable services under Notification No. 33/2012-ST, as the said services are not 'taxable services'.

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

(f) Abatements from service tax - Exempt amount not includible: If any service is eligible for abatement, then,the amount after abatement would be considered for computing aggregate value.

For example, renting of guest house is eligible for abatement of 40% under Notification No. 26/2012-ST. In this case, if rent charged is ₹ 100 and the value after abatement is ₹ 60, the aggregate value under Notification No. 33/2012-ST will be computed by including ₹ 60 only.

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

(5) Exemption shall not apply in following cases : This exemption shall not apply to,-

(a) Branded services : Taxable services provided by a person under a brand name or trade name, whether registered or not, of another person; or

(b) Where Service provider is not person liable to pay service tax : Such value of taxable services in respect of which service tax shall be paid by such person and in such manner as specified under section 68(2) of the said Finance Act read with Service Tax Rules,1994.

Meaning of Brand name or Trade name : "Brand name" or "trade name" means brand name or trade name, whether registered or not i.e. to say, a name or a mark, such as symbol, monogram, logo, label, signature, or an invented word or writing which is used in relation to such specified services for the purpose of indicating or so as to indicate a connection in the course of trade between such specified services and some person using such name or mark with or without any indication of the identity of that person.

(6) Conditions to be fulfilled : This exemption shall apply subject to the following conditions,-

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

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

(c) No CENVAT credit on capital goods : The provider of taxable service shall not avail the CENVAT credit under rule 3 of the said rules, on capital goods received, during the period in which the service provider avails exemption from payment of service tax under this notification.

(d) CENVAT credit on inputs and input services only when service provider starts paying service tax : The provider of taxable service shall avail the CENVAT credit only on such inputs or input services received, on or after the date on which the service provider starts paying service tax, and used for the provision of taxable services for which service tax is payable.

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

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

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

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

Example 5: Mr. A provides Service X (₹ 7 lakhs) and Service Y (₹ 2 lakh) from Jaipur and Service P (₹ 1 lakh) and Service Q (₹1 lakh) from Surat during 2015-16. Since the aggregate value of all services from all premises = ₹ 11 lakhs (exceeds ₹ 10 lakh), hence, he is not eligible for this exemption in the financial year 2016-17.

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

Example 6: Mr. A provides services of ₹ 9 lakh from a rented premises at Jaipur, Mr. B also provides services of ₹8.5 lakh from same premises. Both of them are eligible for exemption, as clubbing applies "to a service provider" for all services and all premises; there is no clubbing premises-wise. Two or more service providers may provide services from same premises.

For example 7: Mr. X provided services of ₹ 16 lakhs (exclusive of tax) during the financial year 2015-16. Such value included value of wholly exempted service amounting to ₹ 5 Lakhs and partially exempted services of ₹ 7 lakhs (such gross amount of partially exempted service is included in ₹ 16 lakhs). Partial exemption provided in respect of this service was of 40%. Whether the assessee would be eligible for small service provider exemption for the Financial Year 2016-17?

Solution:

Computation of Aggregate Value of taxable services :

S. No.	Particulars	₹
A.	Total value of services	16,00,000
B.	Value of wholly exempted service (shall not form part of "aggregate value")	5,00,000
C.	Amount of partially exempted portion of service (shall not form part of "aggregate value")	2,80,000
	Aggregate Value of taxable services (A-B-C)	**8,20,000**

Assessee would be eligible for small service provider exemption for the Financial Year 2016-17 as the aggregate value of taxable services does not exceed ₹ 10 Lakhs in the preceding financial year.

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

(1) Service provided under its own brand name ₹ 22,00,000 (out of which services of ₹ 6,80,000 has been

wholly exempt under Notification No. 25/2012, dated 20-06-2012).

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

Solution:

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

Such exemption shall not be applicable in the following cases :

(1) Services provided under brand name or trade name of another person.

(2) Service received from goods transport agency.

Hence, the service tax liability shall be determined as under : (amount in ₹)

Service provided under own brand name	22,00,000
Less: Value of services which are exempt under other notification	6,80,000
	15,20,000
Less: Small service provider exemption	10,00,000
Taxable value of services	**5,20,000**
Services provided under brand name of another person	2,00,000
	7,20,000
Service tax @ 14%	1,00,800
Service tax in respect of services received from GTA - ₹ 2,50,000 * 30% * 14% [WN]	10,500
Total Service Tax	**1,11,300**

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

Illustration 2 - Small service **provider exemption** : Mr. Rajat has provided the following services during the year 2015-16. Determine whether he is eligible for small service provider exemption during the year 2016-17:

(a)	Service exported outside India	5,00,000
(b)	Renting of residential dwelling for residence	5,00,000
(c)	Service fully exempt under mega exemption notification	8,00,000
(d)	Declared services (Value as per Section 67 read with the valuation rules is 60% of the total amount charged)	4,00,000
(e)	Total amount of Services in which 50% abatement has been provided; and	4,00,000
(f)	Other services provided (including ₹ 50,000 towards services where whole of the service tax was payable by the service recipient)	5,60,000

Solution:

Mr. Rajat would be eligible for small service providers exemption under Notification No. 33/2012-ST, if the "aggregate value" of taxable services provided during the year 2015-16 is upto ₹ 10,00,000. The relevant computations are shown below **(amount in ₹)** -

(a)	Service exported outside India - Not taxable service, as not liable to service tax u/s 66B - Not includible.	Nil
(b)	Renting of residential dwelling for residence is falling under negative list - Not taxable services - Not includible.	Nil
(c)	Services fully exempt under other mega exemption notifications - Specifically excluded in determination of aggregate value of taxable services.	Nil
(d)	Declared services - Value as determined as per section 67 read with Valuation Rules is to be taken.	2,40,000
(e)	Services eligible for abatement - Abatement is a form of partial exemption. Value after exemption viz. ₹ 2,00,000 shall be taken.	2,00,000
	Aggregate Value under Notification No. 33/2012-ST for F.Y. 2015-16	**10,00,000**
Since the aggregate value is X 10,00,000 (i.e., not exceeding ₹ 10,00,000) during F.Y. 2015-16, Mr. Rajat is eligible for small service provider exemption during the financial year 2016-17.		**Eligible for exemption**

Contract Revenue and Computation of Percentage of Completion (AS – 7)

Accounting for long-term construction contracts involves question as to when revenue should be recognized and how to measure the revenue in the books of contractor. As the period of construction contract is long, work of construction starts in one year and is completed in another year or after 4-5 years or so. AS – 7 [Construction Contracts] deals with such issues.

There may be following two ways to determine profit or loss:

- On year to year basis based on percentage of completion, or
- On completion of the contract.

Till the revision of this Accounting Standard both the methods were recommended. However, the revised standard has eliminated the existing option, by adopting only percentage of completion method for recognizing the revenue.
This method justifies the accrual system of accounting which is fundamental accounting assumption.

Construction contract —

As per this AS-Construction Contract is a contract specifically negotiated for the construction of an asset or combination of assets closely interrelated or interdependent, for example, contract for construction of bridge, building, dam, pipeline road, etc. This accounting standard further mentions that the following are also included in construction contract.

- Contracts for rendering of services which are directly related to the construction of assets, for example, service of architect, and
- Contract for destruction or restoration of asset and the restoration of the environment following the demolition of asset.

Example: If existing structure/building in a plot of land has to be demolished before new building as per new design is constructed, the destruction of building is construction contract.
Construction contracts are of two types:—

- Fixed price contracts
- Cost plus contracts
- Some construction contracts may be a mix of the both

Applicability:

- This Accounting Standard is applicable in accounting for construction contracts in contractor's financial statements.
- It does not apply to customer (Contractee).
- Accounting standard would not be applicable for the construction projects undertaken by the enterprise on its own account as a commercial venture in the nature of production activities.

A contract may provide for the construction of an additional asset at the option of the customer, such construction of additional asset should be treated as a separate construction contract if —

- ♦ Asset differs significantly as compared to original contract
- ♦ Price of the additional asset is independent of original contract.

Points to be noted:

- We need to compute the following first —
  Contract revenue
  Contract cost

- Profit or loss of construction contract is equal to Contract revenue **Less** Contract Cost.

- Contract revenue consists of the following :

  - ♦ Revenue/price agreed as per Contract.
  - ♦ Revenue arising due to escalation clause.
  - ♦ Claims - Claims is the amount that contractors seek to collect from the customer as reimbursement of cost not included in contract price.
  - ♦ Increase in revenue due to increase in units of output.
  - ♦ Increase or decrease in revenue due to change or variation in scope of work to be performed.
  - ♦ Incentive payments to the contractors.
  - ♦ Decrease in contract revenue due to penalties.

- The contract revenue and contract cost associated with the construction contract should recognize revenue and expenses respectively with reference **to Stage of Completion** of the contract activity at the reporting date. Recognition of revenue and expenses by reference to the stage of completion of a contract is generally referred as the **Percentage of Completion Method**, under this method revenue is recognized as revenue in the statement of profit/loss in the accounting period in which work is performed.

Example:

Calculate the contract revenue from the following details

(₹ In Crores)

Years

Particulars	I	II	III
1. Initial contract revenue	2000	2000	2000
2. Revenue increase due to escalation in IInd year	---	400	---
3. Claim			200
4. Incentive Payment			300
5. Penalties		100	

Solution:

Calculation of contract revenue

(₹ In Crores)

Particulars	I	II	III
Initial contract value	2000	2000	2000
Increase in revenue due to escalation	---	400	400
Claims	---	---	200
Incentive	---	---	300
Penalties	---	(100)	(100)
Contract revenue	2000	2300	2800

Determination of stage of completion

Stage of completion may be determined in a variety of ways like:

♦ Cost to cost method : The percentage of completion would be estimated by comparing total cost incurred to date with total cost expected for the entire contract —

$$\text{Percentage of Completion} = \frac{\text{Cost to date}}{\text{Cumulative cost incurred} + \text{estimated cost to complete}} \times 100\%$$

Current revenue from Contract

$= \text{Contract Price} \times \text{Percentage of Completion}$

$- \text{Revenue previously recognised}$

- By survey of work performed
- Completion of physical proportion of the contract work

Example:

Assume a ₹10,00,000 contract that requires 3 years to complete and incurs a total cost of ₹8,10,000. The following data pertain to the construction period:

Particulars	Yr. I	Yr. II	Yr. III
Cumulative costs incurred to date	3,00,000	7,20,000	8,10,000
Estimated cost yet to be incurred at year end	6,00,000	80,000	---
Progressive billing made during the year	2,00,000	7,40,000	60,000
Collections of billings	1,50,000	6,00,000	2,50,000

Calculate the percentage of completion.

Solution:

Particulars	Yr. I	Yr. II	Yr. III
Initial amount of Revenue agreed in contract	10,00,000	10,00,000	10,00,000
Variation	---	---	---
Total contract Revenue (A)	10,00,000	10,00,000	10,00,000
Contract cost incurred	3,00,000	7,20,000	8,10,000
Contract cost yet to be incurred to complete	6,00,000	80,000	---
Total Estimated contract cost (B)	9,00,000	8,00,000	8,10,000
Estimated profit (A-B)	1,00,000	2,00,000	1,90,000

Stage of completion	$\frac{3,00,000}{9,00,000} \times 100$ 33.1/3%	$\frac{7,20,000}{8,00,000} \times 100$ 90%	$\frac{8,10,000}{8,10,000} \times 100$ 100%

Exclusion from contract cost

While calculating the contract cost to date as mentioned above in formula following contract cost should be excluded

- Contract cost that relates to future activity on the contract such as cost of material that have been delivered to a contract site or set aside for use of a contract but not used and applied.
- Payment made to sub-contractors in advance of work performed under the sub-contract.

Contract costs

Contract costs consist of the following:

Specific costs to contract -

- Site labour cost including supervision
- Cost of material used in construction
- Depreciation of plant and equipments used on the contract
- Cost of moving plant, equipments and materials from contract site
- Cost of hiring plant
- Cost of design and technical assistance
- Estimated cost of rectification and guarantee work including expected warranty cost
- Claim from third parties
- Pre-contract cost. If it is probable that contact will be obtained. These costs should be reduced by incidental income if any not included in contract revenue.

Cost attributable to contract –

These costs are:

- Insurance.
- Cost of design and technical assistance that is not directly related to a specific contract.
- Construction overheads.

Cost specifically chargeable to customers under the terms of contract –

These costs are:

- Some general administration cost/for which reimbursement is specified.
- Development cost.
- Reimbursement of any other cost.

Cost excluded

Following costs are excluded from contract cost unless specifically chargeable under terms of contract :

- General administration cost
- Selling cost
- Research and development
- Depreciation cost of idle plant and equipment
- Cost incurred in securing the contract. Pre-contract cost - if it is not probable that contract will be obtained.

STANDARDS ON INTERNAL AUDIT

What is Internal Audit?

Internal Auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

Paragraph 3.1 of the Preface to the Standards on Internal Audit, issued by the Institute of Chartered Accountants of India defines internal audit as follows:

"Internal audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's risk management and internal control system."

Objectives of Internal Audit:

1. To evaluate the internal control systems and integrity of financial and operational information produced by these systems.
2. To determine whether compliance exists in accordance with policies, procedures, laws and regulations.
3. To determine whether assets are safeguarded and verifying the existence of these assets.
4. To appraise the economy and efficiency of resource utilization.
5. To review the operations and programs for consistency with established management goals and objectives.

Standards on Internal Audit (SIA)

Meaning

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

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

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

Framework of SIA:

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

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

Purpose of SIA:

- **a.** To provide a benchmark for quality of services during an internal audit.
- **b.** To codify the best practices in internal audit services.

SIA issued by ICAI

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

SIA No.	Name of SIA
1.	Planning an Internal Audit
2.	Basic Principles Governing Internal Audit
3.	Documentation
4.	Reporting
5.	Sampling
6.	Analytical Procedures
7.	Quality Assurance in Internal Audit
8.	Terms of Internal Audit Engagement
9.	Communication with Management
10.	Internal Audit Evidence
11.	Consideration of Fraud in an Internal Audit
12.	Internal Control Evaluation
13.	Enterprise Risk Management
14.	Internal Audit in an Information Technology Environment
15.	Knowledge of the Entity and its Environment
16.	Using the work of an Expert
17.	Consideration of Laws and Regulations in an Internal Audit

All these SIA are explained as under:

SIA 1- Planning an Internal Audit:

The basic objective of this SIA is to establish standards and provide guidance in respect of planning an Internal Audit and helping in achieving the objectives of an Internal Audit function.

The internal auditor should, in consultation with TCWG including the audit committee, develop and document a plan for each internal audit engagement to help him conduct the engagement in an efficient and timely manner.

Adequate planning ensures that appropriate attention is devoted to significant areas of audit, potential problems are identified and that the skills and time of the staff are appropriately utilised.

Knowledge of entity's business helps to identify areas of special focus and priorities for smooth running of business. Ideally, such knowledge can be obtained from following resources:

- Past experience
- Understanding basic documents e.g. MOA, AOA, minutes of various meetings, etc.
- Discussion with staff and management
- Policy and Procedure's Manual
- Visit to entity's Plant and Accounts department

The internal auditor should, in consultation with TCWG including the audit committee, develop and document a plan for each internal audit engagement to help him conduct the engagement in an efficient and timely manner. He should also assess the client expectations as to the assurance level on different aspect of entity's operations and controls.

In addition, the internal audit plan should also reflect the risk management strategy of the entity.

SIA 2- Basic Principles Governing Internal Audit:

Internal auditor should adhere to the basic principles governing an internal audit. Such basic principles are as under:

a. Integrity
b. Objectivity
c. Independence
d. Confidentiality
e. Due Professional Care, Skills and Competence
f. Work Performed by others
g. Documentation
h. Planning
i. Evidence
j. Internal Control and Risk Management Systems
k. Reporting

The above two words Internal Control and Risk Management Systems are heart and brain of Internal Audit. Ergo, Internal Auditor should:

- Understand the IC and RM framework.
- Assess its adequacy.
- Review its adequacy periodically.
- Perform risk-based audit.

This Risk based audit adopts following flow cycle:

SIA 3: Documentation

Paragraph 10 of the Standard on Internal Audit (SIA) 2, Basic Principles Governing Internal Audit, states as follows:

"10. The internal auditor should document matters, which are important in providing evidence that the audit was carried out in accordance with the Standards on Internal Audit and support his findings or the report submitted by him."

"Internal audit documentation" means the record of audit procedures performed, including audit planning as discussed in the Standard on Internal Audit (SIA) 1, Planning an Internal Audit, relevant audit evidence obtained, and conclusions the auditor reached.

Following should form part of Internal Audit documentation:

a. Internal audit charter

b. Internal audit plan

c. Nature, timing and extent of audit procedures performed

d. Conclusions drawn from the evidence obtained.

e. If internal audit is outsourced, the documentation should contain a copy of the internal audit engagement letter, containing the T&Cs of appointment.

To ensure the reliability and effectiveness of documentation, following requirements should be given adherence:

a. Internal audit documentation should be sufficiently complete and detailed for an internal auditor to obtain an overall understanding of the audit.

b. All the significant matters which require exercise of judgment, together with the internal auditor's conclusion thereon should be included in the internal audit documentation.

c. The documentation prepared by the internal auditor should be such that enables an experienced internal auditor (or a reviewer), having no previous connection with the internal audit to understand the audit plan, terms of reference, scope and N,T & E of audit procedures, significant issues and conclusion.

d. The extent of documentation is a matter of professional judgment since it is neither practical nor possible to document every observation, finding or conclusion in the internal audit documentation.

e. The internal audit file should be assembled within sixty days after the signing of the internal audit report. Assembly of the internal audit documentation file is only an administrative process and does not involve performance of any new audit procedures or formulation of new conclusions. Changes may be made to the audit documentation file only if such changes are administrative in nature.

SIA 4: Reporting

This standard inter alia includes the following:

- To review and assess the analysis drawn from internal audit evidence obtained as the basis for his conclusion on the efficiency and effectiveness of systems, processes and controls including items of financial statements.
- Report should clearly express significant observations, suggestions/recommendations based on the policies, processes, risks, controls and transaction processing taken as a whole and managements' responses.
- To facilitate communication and ensure that recommendations presented in final report are practical from the point of view of implementation, the internal auditor should discuss the draft with the entity's management prior to issuing the final report.
- When there is a limitation on the scope of internal auditor's work, the internal auditor's report should describe the limitation.

SIA 5: Sampling

When using either statistical or non-statistical sampling methods, the internal auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient and appropriate audit evidence to meet the objectives of the internal audit engagement unless otherwise specified by the client.

Following catch note of SIA 5 is noteworthy:

a. When designing an audit sample, internal auditor should consider specific audit objectives, the population from which internal auditor wishes to sample and the sample size

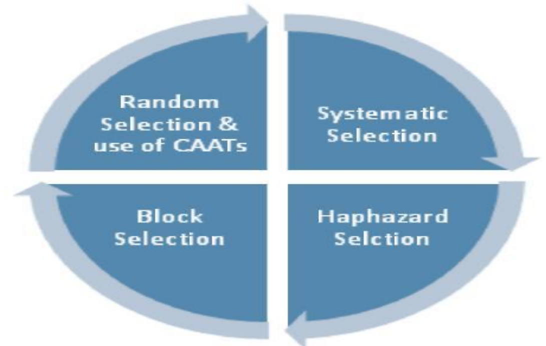
b. When determining the sample size, internal auditor should consider sampling risk, tolerable error and the expected error

c. Sample items should be selected in such a way that the sample can be expected to be representative of the population. This requires that all items or sampling units in the population have an opportunity of being selected.

Commonly Used Sampling Methods

Finally, the internal auditor should evaluate the sample results to determine whether the assessment of the relevant characteristics of the population is confirmed or whether it needs to be revised.

SIA 6: Analytical Procedures



The internal auditor should apply analytical procedures as the risk assessment procedures at the planning and overall review stages of the internal audit. It involves various comparisons as depicted below:

In determining the extent to which the analytical procedures should be used, the internal auditor should consider the following factors:

Consideration of comparisons	Consideration of relationships
Among financial information e.g. comparing Sales amount of 2 years	Among financial information e.g. Gross margin percentages
Among non-financial information e.g. Comparing no. of employees of 2 years	Between financial and relevant non-financial information e.g. Total production costs to quantity produced

a. The significance of the area being examined.

b. The adequacy of the system of internal control.

c. The availability and reliability of financial and non-financial information.

d. The precision with which the results of analytical procedures can be predicted.

e. The availability and comparability of information regarding the industry in which the organization operates.

f. The extent to which other auditing procedures provide support for audit results.