NEWSLETTER

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Chartered Accountants

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1 Accounting and Auditing

1. Expert Advisory Opinion - Accounting for rescheduling of lease rentals

Facts of the case

1. A NBFC which is a subsidiary of a listed company, for its own use takes on lease various properties for its branches across the country.

2. The Company has entered into a lease agreement with the following terms and conditions:

    a. Lease is for 9 years
    b. Rent for first 3 years is at market rate as on the date of agreement with an escalation clause applicable after every 3 years
    c. Lessee has the option to exit by giving 3 months notice

3. As a result of the changing scenario in the real estate market, property prices have gone down by 30-40%. The Company was successful in re-negotiating the lease rentals of its premises favorably. The issue has now arisen as to accounting of the lease rental with respect to the lease period.

4. The original lease deed entered into on 5-Oct-06 is as follows

Term	Rent per month
20.11.06 to 19.11.09	70,000
20.11.09 to 19.11.12	80,500 *
20.11.12 to 19.11.15	92,575 *

* escalation of 15%

Rent was paid to the lessor till 31-Dec-08. The revised supplementary lease deed entered into on 16-Feb-09 is as follows

Term	Rent per month
1.1.09 to 31.12.09	56,000
1.1.10 to 31.12.13	61,600 #
1.1.14 to 19.11.15	67,760 #

escalation of 10%

5. Under AS-19, lease term is defined as "Non-cancellable period for which the lessee has agreed to take on lease the asset together with any further period for which the lessee has the option to continue the lease, with or without further payments." Further as per para 23, lease payments under an operating lease should be recognized as an expense in P&L a/c on a straight line basis over the lease term or another systematic basis if it is more representative of the user's benefit.

6. The company so far has been accounting for the lease cost on straight line method considering the escalation clause. The Company believes that the fact that it will derive the same benefit throughout the lease term does not hold good due to the changed circumstances of a significant fall in the market rates. It can be reasonably assumed that the rent actually paid by the Company reflects the benefit that accrues to the entity and hence, the actual rent paid should be debited as expense to P&L a/c instead of accounting the rent on straight line basis. Also, there is a likelihood of renegotiating the rentals as further fall is prices is anticipated.

Query

- Whether the lease rentals should be recognized on a straight line basis over the lease term. If not, what is the correct basis?

- Whether the monthly rental should be accounted for at the value of actual lease rent paid in such a case?

Points considered by committee

- The committee notes that the basic issue of accounting for lease rentals in an operating lease, where the Company has successfully amended the lease rentals over the remaining lease period and it is expected that the terms of the lease have a high probability of being renegotiated in future.

- Any departure from the straight line basis of recognition of lease expense must reflect the time pattern of the user's benefit, which should be considered from the perspective of use of the asset in physical terms rather than benefit derived from the angle of market rates. Since the property in the instant case would be used by the lessee throughout the lease term on a consistent basis, inspite of the reduced lease rentals, the expense over the lease term should be recognized on a straight line basis. Volatility in rentals or anticipated changes in rentals does not affect physical use of property and therefore such considerations cannot form basis for a departure from the straight line basis of recognition. Since the terms of lease deed are legally binding on both parties, merely an expectation of deviation from terms of the lease deed in future should not be taken into view while accounting for lease rentals.

- The lease rentals paid under the original deed and the revised rentals payable over the remaining period of lease under the supplementary deed, both should be considered for determining the amount of annual charge to the P&L a/c. Any resultant adjustments on account of lease rent already recognized in past should be recognized in the current year's P&L a/c.

Opinion

- The principle of recognizing lease rentals over the lease term on a straight line basis is correct.

- The monthly rental cannot be accounted for at the value of actual lease rent paid.

2. Guidance Note on Audit of Property Plant & Equipment

The Institute of Chartered Accountants of India has issued a guidance note on the audit of property, plant and equipment. The guidance note has been prepared considering the revised accounting standard on 'Property, Plant and Equipment'. This guidance note deals with the inherent risks associated with the procurement and disposal of property, plant and equipment and also provides guidance on the audit procedures to be applied while conducting an audit of the said subject.

3. Clarification on Accounting Standard -30

AS 30- 'Financial Instruments-Recognition & Measurement' was issued by the Institute of Chartered Accountants of India (ICAI) in 2007 but has not yet been notified by the Government under Section 211(3C) of the Companies Act, 1956.

It is clarified that in respect of the financial statements or other financial information for the accounting periods commencing on or after 1st April 2009 and ending on or before 31st March 2011, the status of AS 30 would be as below:

- To the extent of accounting treatments covered by any of the existing notified accounting standards (for e.g. AS 11, AS 13 etc,) the existing accounting standards would continue to prevail over AS 30.
- In cases where a relevant regulatory authority has prescribed specific regulatory requirements (e.g. Loan impairment, investment classification or accounting for securitizations by the RBI, etc), the prescribed regulatory requirements would continue to prevail over AS 30.
- The preparers of the financial statements are encouraged to follow the principles enunciated in the accounting treatments contained in AS 30. The aforesaid is, however, subject to (i) and (ii) above.

From 1st April 2011 onwards,

- The entities to which converged Indian accounting standards will be applied as per the roadmap issued by MCA, the Indian Accounting Standard (IND AS) 39, Financial Instruments; Recognition and Measurement, will apply.
- For entities other than those covered under paragraph 5(i) above, the status of AS 30 will continue as clarified in above paragraph 4.

The abovementioned clarifications would also be relevant to the existing AS 31, Financial Instruments: Presentation and AS 32, Financial Instruments: Disclosures as well as for IND AS 32, Financial Instruments: Presentation and IND AS 107, Financial Instruments: Disclosures, after 1st April 2011 onwards.

4. Notification of converged accounting standard

In pursuance of G-20 commitment given by India, the process of convergence of Indian Accounting Standards with IFRS has been carried out by the government. Thirty five Indian Accounting Standards converged with International Financial Reporting Standards (henceforth called IND AS) have been notified.

2 Company Law

1. Revised Schedule VI

The government has released a revised Schedule VI (format and content of the Balance Sheet and Statement of Profit and Loss. The notification containing the effective date from which the same would be applicable is yet to be notified. Some of the key items / changes are as follows:

- **General**

  a. No possibility of conflict between Accounting Standard and Schedule VI as on modification of accounting standards prescribed under the Companies Act, Schedule VI would stand modified accordingly.
  b. The disclosure requirements of revised Schedule VI are in addition to the disclosures that are required by Accounting Standards prescribed under the Companies Act.
  c. All disclosures required by Companies Act to be made in notes to accounts.
  d. Cross-referencing each line item with notes and vice versa is required.
  e. Unit of measurement selected to be used uniformly in financial statements.
  f. The revised schedule VI has only two parts (i.e I & II) does not have Part III and Part IV.

- **Share Capital**

  a. Details of shareholder holding more than 5% shares to be given in the financial statements.
  b. Share application money – ageing and the reason why shares have not been issued to be provided.
  c. Disclosure of share held by ultimate holding company or though an associate, subsidiaries needs to be disclosed.
  d. Reconciliation of number of shares held at the beginning of the period and as at end of the period.
  e. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under ‘Óther current liabilities’ .
  f. Five years details for shares issued for consideration other than cash, bonus shares & buy back of shares.

- **Classification of Assets and liabilities**

  a. Classification of all assets and liabilities into Current and Non-current. The criteria for classification have been defined.
  b. Bank deposit with maturity period more than 12 months to be disclosed separately & classified under Cash & Cash Equivalent.
  c. cheques/draft on hand to be reflected as a specific line item

- **Reserves & Surplus**

  a. Nature and purpose of each reserve to be stated only for those aggregated under “Other Reserves”.
  b. Debit balance of Profit and Loss Account to be shown as negative figure in Surplus.
  c. Appropriation to be a part of reserve schedule as against being part of Profit & Loss

- **Loans**

  a. Period and amount of continuing default as on the balance sheet date in repayment of loans and interest to be separately specified.
  b. Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.
  c. Loans (long-term/short term) from related parties to be shown separately.
  d. The terms of repayment also needs to be disclosed.

- **Profit & Loss statement Related**

  a. In the earlier schedule VI there was no format for profit and loss statement (or account). The format has been specified in the revised schedule VI.
  b. Gain / Loss on foreign currency transaction to be separated into finance costs and other expenses.
  c. Any item of income or expenditure which exceeds one per cent of the revenue from operations or Rs.1,00,000, whichever is higher will require separate disclosure (earlier the limit was Rs 5000).
  d. Other operating income needs to be disclosed separately.
  e. Other non operating income to be net of expenses directly attributable.

- **Others**

  a. Investment in controlled Special Purpose Entity to be shown separately.
  b. The amount of dividend proposed to be distributed for the period to be shown separately under other commitments.
  c. Where securities are issued (debentures etc) with specific end purpose, how the un-utilized money has been invested to be disclosed.
  d. Stock in transit - specific requirement to include it under respective inventory item.
  e. Line items for Exception items and extraordinary items introduced.
  f. Trade receivable outstanding for period exceeding six months from the date they are due for payment are required to be shown separately. In the earlier schedule VI the requirement was based on bill date rather than due date.

The above does not represent detailed comparison of new items, changes and excluded items. The same would be required to be done for Company to ensure transition to the new schedule VI

2. Exemption u/s 211 from investment disclosures to Financial Institutions

The government has issued a notification exempting the Public Financial Institution as defined in section 4A of the Companies Act, 1956 from disclosing the investment as required by schedule VI subject to fulfillment of certain conditions. This notification shall be applicable in respect of balance sheet and profit & loss accounts prepared in respect of financial year ending on or after 31st March 2011.

3. Update on press release exempting certain disclosure in annual accounts

In our earlier newsletter we had mentioned about press release regarding exemption granted to certain category of companies from disclosing quantitative details. However in the notification one additional point has been added and accordingly exemption in respect of the manufacturing companies / multi product companies and trading companies shall be applicable only for those goods which form less than ten percent of the total value of turnover, purchase, consumption of raw material etc, as the case may be.

4. Simplification in process of issue of DIN

The government has simplified the rules for issue of Director Identification Number (DIN). The revised rules would enable the government to allot DIN on the same day

5. Simplification in process of company incorporation

The government has issued a circular simplifying the rules / procedure for Company incorporation and establishment of principal place of business in India by foreign companies. The average time taken for formation of the Company would be reduced to one day only.

6. Commission limit of 1% or 3% would be over & above sitting fees

As per the recent circular issued by the government, the companies will not be require approval of the Central Government for making payment of remuneration by way of commission to its non whole time directors in addition to the sitting fees if the commission paid to all the non whole time directors does not exceed 1% or 3% of the net profit depending on whether the Company has a managing director or a whole time director.

3 Service Tax

Based on the finance bill various changes are made / proposed to be made in the service tax. Kindly refer our budget document for analysis on the changes / amendments.

4 NBFC

1. Minimum Capital ratio for Deposit taking NBFC

In order to align the minimum capital requirement of systematically important non deposit taking NBFCs with deposit taking NBFCs, Reserve Bank of India (RBI) has directed all deposit taking NBFCs to maintain a minimum capital ratio of 15% as against the previous limit of 12% of the risk weighted assets on balance sheet and risk adjusted value of off-balance sheet items with effect from March 2012.

5 SEBI

1. Usage of load account balances by Mutual Funds

Since August 2009 mutual funds can charge its investors only exit load (earlier entry load was also being charged) on its investors. With regards to the load balances SEBI has directed the following:

- Load balances to be segregated into 2 accounts reflecting balance as on 31st July 2009 and the other reflecting accretions since 1st August 2009.
- In respect of balance as on 31st July 2009, not more than one third of the balance shall be utilized in any financial year (F.Y.) including for F.Y. 10-11 for marketing and selling expenses including distributor's / agent's commission, however the unutilized balances can be carried forward.
- The accretions after 31st July 2009 can be used for the purpose mentioned above without any restrictions.

2. Futures on 91-day Treasury Bills

SEBI has introduced futures on 91-day GOI T-Bill on the currency derivatives segment of stock exchanges. However a prior approval of SEBI needs to be taken by the eligible Stock Exchange. At present, only 10-year government bond is traded in the Interest Rate Futures market.

6 Others

1. Prudential norms on investment in Zero Coupon Bonds (ZCBs)

Reserve Bank of India has advised Banks that in view of high credit risk in investment in ZCBs as no interest / installment is paid until maturity of the bond; investment in ZCBs issued by Corporates including NBFC should not be made unless Corporates/ NBFC have created a sinking fund for all accrued interest on the ZCBs issued by them and invest the fund balance in liquid investments / securities (Government bonds)

7 Income Tax – Case Laws

1. Arm's Length Price (ALP) of slump sale

Intel Asia Electronics Inc vs. ADIT (ITAT Bangalore)

Facts:

- The assessee, a foreign company with a branch (PE) in India, decided to close down the branch and transfer all assets and liabilities of the branch as a going concern to its Associated Enterprise (AE) in India.
- The consideration was determined as the difference between the value of assets and liabilities in the books of the assessee.
- For transfer pricing purposes, the assessee had obtained a valuation report of an independent valuer and adopted "Comparable Uncontrolled Price" (CUP) method**.**
- The value of the assets held by the taxpayer was determined after considering various factors such as the nature of the asset, obsolescence, price change due to technological development, etc
- Transfer Pricing Officer (TPO) rejected the valuation on the ground that it was arbitrary and held that the "book value" of the assets and liabilities should be taken to be the ALP. This was confirmed by the CIT (A).

Issue:

Whether ALP of slump sale should be determined on the basis of valuation report and value of assets sold should be on the basis of Written Down Value as per Income Tax or Company Law?

Held:

The H'ble ITAT held that the CUP method for determining the ALP is suitable when goods of a similar type are sold by independent enterprises. In an isolated transaction of sale of the PE as a 'going concern' to the AE, there are no similar comparable independent transactions available for comparison. In order to determine the ALP in the absence of other identical transactions, the valuation by a registered valuer is the most appropriate means.

Since, the depreciation rates prescribed by company law are static, the WDV of the assets arrived as per book value will not be at par with the net present market value and, therefore, the valuation of the assets based on the book value is not justifiable**.** The only reasonable approach is to value the assets by applying the depreciation rates as provided by the Income-tax Act for it is more dynamic and brings in a notional charge on the profit and loss account to arrive at the actual income of an assessee keeping in view the depletion in the value of assets. The Tribunal set aside the matter to AO with specific direction to adopt the written down value method of assets as per Income Tax Act for determination of the ALP on transfer of business as a going concern.

2. Share sale price cannot be apportioned towards transfer of "controlling interest"

ACIT vs. R.K.B.K Fiscal Services Ltd. (ITAT Kolkata)

Facts:

- The assessee sold (off-market) shares of Gujarat Ambuja Cements Ltd to Holcim Mauritius for a consideration of Rs. 105 per share.
- The assessee claimed that the consideration for the share had (as per a valuation report) to be taken at Rs.74.20 and the balance of Rs.30.80 had to be treated as consideration "for parting with managerial control".
- The assessee claimed that the sum of Rs.30.80 was not assessable as there was no "cost of acquisition" of the "controlling interest" based on the decision of the Supreme Court in the case of B C Srinivasa Setty (128 ITR 294).
- The AO rejected the contention on the ground that managerial control is not a separate asset and assessed the entire capital gain as LTCG/STCG.
- On appeal, the CIT (A) has followed Vodafone International vs. UOI (311 ITR 46) (Bom) and held that the consideration had to be apportioned towards the transfer of the share and transfer of controlling interest (as done by the assessee) and the amount attributable to the transfer of controlling interest is not assessable to tax as there was no cost of acquisition.

Issue:

Whether sale of controlling interest is chargeable to tax as STCG/LTCG?

Held:

The H'ble Tribunal held that the controlling interest was transferred with the shares is not acceptable because:

- the assessee is not a signatory to the share purchase agreement.
- it is not known if the Power of Attorney (POA) holder who signed the said agreement was authorized to transfer the "controlling interest" as POA was not produced inspite of specific direction to produce
- share purchase agreement merely refers to the sale of shares and the non-compete covenant and fixed the consideration at Rs. 90 & Rs. 15 respectively but does not refer to any "transfer of controlling interest".

AO & CIT (A) did not notice that under Article 5 of the agreement, the assessee was to receive Rs. 15 per share towards non-compete undertaking which was included in the sale consideration. This amount is assessable as "business income" u/s 28(va);

As the agreement fixes the consideration for the share at Rs. 90, the valuation report splitting the consideration has no relevance. Thus, Rs. 90 is assessable as LTCG/STCG and Rs. 15 is assessable as "business income".

3. B/f Business Loss can be set-off against dividend assessed as "income from other sources" if shares are held as stock in trade

Gagan Trading Co. Ltd vs. DCIT (ITAT Mumbai)

Facts:

The assessee, engaged in the business of purchase and sale of shares, earned dividend income of Rs. 43.48 lakhs which it offered to tax as "income from other sources". In A.Y. 2003-04, the assessee set-off the dividend income against its brought forward business loss. The AO & CIT (A) rejected the set-off on the ground that u/s 72 carry forward business losses can only be set-off against business income.

The dividend income is being brought to tax under the head "Income from other Sources vide Sec. 56(2)(i) of the Act, even though they are held as stock in trade of business by an assessee

Issue:

Whether brought forward business losses can be set-off against dividend income assessed as "income from other sources" if shares held as stock in trades?

Held:

The H'ble Tribunal held that the assessee is entitled to the set off of its carried forward business loss against dividend income. According to the provisions of section 72(1)(i) of the Act, the brought forward business loss can be set-off against "the profits and gains of any business or profession" carried on by the assessee. Section 72(1)(i) does not use the word "assessable under the head profits & gains of business".

Though for the purpose of computation of the income, dividend is classified as "Income from other Sources", income by way of dividend was very much part of the income from business, because the shares on which dividend income was earned was stock in trade of business of trading in shares carried on by the assessee and they formed part of the trading assets. Accordingly, the assessee is eligible for set-off as claimed.

4. Obligation to charge interest on overdue payments in international transactions with Associated Enterprise

M/s. Logix Micro Systems Ltd. vs. ACIT (ITAT Bangalore)

Facts:

The assessee, an Indian company, entered into product development & professional services agreements with its Associated Enterprise ("AE") in USA. As a result of these agreements, at the year end Rs 7.73 crores was receivable from its AE out of which Rs 5.52 crores were outstanding for more than six months. The TPO observed that no interest was charged by the assessee from the AE thereby affecting the profitability of the assessee. As per the assessee this delay in collecting the receivables was due to the difference in billing patterns of the assessee and AE.

Further, the assessee contented that the reference made to the TPO relates only to the point of ALP and it does not include the potential income/loss arising from the aspect of delay in collecting the receivables. But the TPO has worked out interest income of Rs.56,60,486/- at the prime lending rate (PLR) of 10.25% on the outstanding receivables.

On appeal, CIT (A) upheld the findings of the TPO that the outstanding receivables constituted an "interest free loan" availed by the AE. However, he held that interest must be computed according to the LIBOR/US-FED rate and it should be computed for the period overflowing the reasonable time limit.

Issue:

Whether the outstanding receivables from international transactions would form part of the transfer pricing analysis for calculation of the potential interest loss?

Held:

The H'ble ITAT upheld the view of the revenue and observed that the purpose behind the ALP analysis is to curb tax evasion and therefore the transaction should be viewed holistically by the TPO and a piece meal approach cannot be adopted. The outstanding receivables are the result of the international transactions and therefore, the income effect arising, to those outstanding receivables is a relevant aspect of ALP.

The fact that huge funds parked by the assessee with the AE also leads to the conclusion that the AE was using the working capital of the assessee for its business. The general rule of taxation that the actual income is to be assessed and not the probable income is not applicable here, since under the transfer pricing, the financial impact of the international transaction is being assessed.

The H'ble ITAT held that the rate of interest should be the rate earned by the assessee on short term deposits. Hence a reasonable interest rate of 5% was fixed by the ITAT and it should be computed for the period overflowing the reasonable time limit.

5. **Profits of the eligible unit u/s 80IA has to be computed after set off of notional b/f Loss and depreciation even though they have been set of in earlier years**

Hyderabad Chemicals Supplies Ltd vs. ACIT (ITAT Hyderabad)

Facts:

The assessee engaged in business of manufacture and trading of agro chemicals, generation, distribution and sale of power, set up an eligible undertaking to claim benefits of section 80-IA of the Act in AY1999-2000. It suffered losses in A.Y. 1999-2000 and 2000-2001 which was absorbed by the other income of the assessee and deduction u/s 80-IA was Nil. In A.Y.2001-02, eligible unit made profit and assessee claimed deduction u/s 80IA without considering the notional brought forward losses or depreciation of the eligible undertaking already set off against other income of respective years. AO allowed the claim of the assessee. however, CIT revised the order u/s.263 and directed AO to work out deduction u/s 80-IA after set off of b/f loss and depreciation of eligible unit of earlier years against the profits of the current year treating the undertaking as the only source of income of the assessee.

Issue:

Whether profits of the eligible unit have to be computed after deduction of notional b/f loss and depreciation of eligible unit even though the same has been set off against other income of that year?

Held:

The H'ble ITAT following the decision of Special bench decision of ITAT Ahmedabad in the case of ACIT vs. Gold Mine Shares & Finance (P) Ltd concluded that as per section 80-IA (5) of the Act even if b/f loss and depreciation of earlier years were set off against other income of that year, for the purpose of computing deduction u/s 80-IA, notional b/f loss and depreciation have to be set off against the profits of the current year. It further observed that the decision of Rajasthan High Court in the case of Merwar Oil & General Mills Ltd did not consider the *non obstante* provision of section 80-IA of the Act and hence even though the judgment of non jurisdictional high court prevails over an order of special bench, however where the judgment of non jurisdictional high court has been rendered without having been informed about certain statutory provisions that are directly relevant, it is not to be followed.

6. **CUP method could validly be employed provided product comparability is established**

Clear Plus India Pvt Ltd vs. DCIT (ITAT Delhi)

Facts:

The assessee manufactured and sold automobile wipers to its AE located in United States (USA). The AE sells the wipers in the US Market by importing them from the assessee in India and also from Chinese Suppliers. For the purpose of

transfer pricing, Assessee treated AE as a tested party and compared the price of the goods exported by it with the price charged by the Chinese companies which was higher and claimed that as per CUP method, the transactions were at arms' length basis. TPO rejected the CUP method on the basis that the comparability of controlled and uncontrolled transactions was not established with certain degree of reasonableness and accuracy and that the conditions prevailing in the market were not established to be identical. TPO adopted the TNMM and directed that an adjustment be made by adopting the mean profit of comparables.

Issue:

Whether CUP is the most appropriate method in the case of the assessee for determining ALP?

Held:

The H'ble ITAT held that the goods were sold by the Chinese Manufacturers in the U.S.A. market. The assessee has also sold the goods in U.S.A markets. Therefore, market conditions in the territory are the same. Thus, buyer in the USA market will be more concerned with quality and price rather than economic conditions prevailing in China and India. The wipers do not require any sophisticated technology to manufacture; therefore there is no great difference in terms of quality. The focus is on the market in which product is sold therefore, the CUP method could validly be employed as product comparability is established. Thus, it would have been appropriate for the assessee to provide to the AO sale data of the AE in terms of sale price of Chinese and assessee's goods in US Market and quantitative data of purchase of Chinese and Indian wipers by the AE and terms of payment, so as to establish the comparability. Accordingly, the appeal was partly allowed in favour of assessee.

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