



N.A. Shah Associates

NEWSLETTER

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1 Accounting and Auditing

1. Expert Advisory Opinions

1. Basis of calculation of future cash flows for AS 28

Facts of the case

- A public sector enterprise, engaged in mining of bauxite, refining/manufacturing of alumina and aluminium along with captive power plant, has 3 reportable segments: (i) Chemical Segment (ii) Power Segment and (iii) Aluminum Segment
- The chemical segment has 2 value added plants for (i) special grade hydrate [SGH] and (ii) special grade alumina [SGA] which have been identified as cash-generating units (CGU) for the purpose of Accounting Standard - 28, 'Impairment of Assets' [AS-28].
- Since the past 4 financial years, the capacity utilization of SGA Plant ranged from 8.23% to 21.65% only. Considering the same, auditors advised to calculate the recoverable value of SGA plant for the purpose of testing impairment.
- The querist made estimate of future cash flows over the useful life of the SGA plant, which resulted in positive cash flow as compared to the carrying cost of the assets.
- Calcined alumina (which is produced in house) is used as raw material for SGA plant and is also sold in the open market at international prices.
- As per querist, the C&AG auditors agreed to each and every assumption taken, except the cost of raw materials. In support of their views, C&AG relied upon para 68 of AS 28: If an active market exists for the output produced by an asset or a group of assets, this asset or group should be identified as a separate CGU even if some output is used internally and suggested that raw material prices used in the estimation of cash flows should be based on market prices and instead of cost of production as used by the querist in view of provisions of Para 68 of AS 28.
- However, the management justified its calculation as per Para 31(b) of AS 28. which says estimates of future cash flows should include Projections of cash flows from:
 - continuing use of assets
 - cash outflows necessarily incurred to generate cash inflows
 - net cash flows to be received at the end of its useful life on disposal of asset
- As per the querist, C&AG auditors were of the view that there seems to be a contradiction between the provisions of Para 31 & 68 of AS 28 and advised to seek the opinion of ICAI.

Query

- The querist sought the opinion of the Expert Advisory Committee [EAC] on the issue as to whether the raw-materials' cost (internally transferred) should be taken at 'cost of production' or at 'market price' for the purpose of calculating future cash flows for ascertaining impairment as per AS 28.

Points considered by the Committee

- The Committee examined the facts of the case in the light of the provisions contained in Para 31, Para 68 and Para 69 of AS 28.
- As per the Committee, Para 31 of AS 28 is a general Para, which lays down the composition of the estimates of future cash flows whereas, Para 68 of AS 28 contains a specific requirement in cases where an active market exists for output produced even if some or all of the output is consumed internally. The para 68 further mentions that for estimating the future cash outflow, the value in use of other units of reporting enterprise will be based on management's best estimate of future market prices.
- In view of Committee there is no contradiction between Para 31 and 68 of AS 28 and accordingly specific requirement of para 68 must be complied with to determine price at which raw material which is produced by one CGU and consumed by another CGU.

Opinion

- Based on above, the Committee is of the opinion that for the purpose of calculating future cash flows for determining impairment as per AS 28, the cost of the internally transferred raw-material should be taken at the management's best estimate of future market prices instead of using cost of production of that raw material.

2. Accounting treatment of overlift / underlift quantity of crude oil

Facts of the case

- A public limited company, which is a wholly owned subsidiary of a listed government company, is in the business of exploration and production of oil and gas and other hydrocarbon related activities outside India (host countries).
- The host governments grant the rights to explore, develop and produce hydrocarbons.
- The Company has entered into an 'Offtake Agreement for Crude Oil' ('COA') to cover the offtake of crude oil produced. One of the main principles of the COA is that the Company shall have the right to offtake in each period a volume equal to its participating interest share of the total participating production of

crude oil for the period (i.e., participant's 'basic entitlement'). The Company has the right to request either a deferral of lifting of a portion of his basic entitlement (under-lift) or an overlift of his basic entitlement.

- The Company accounted for overlift quantity by reducing revenue and transferring the same to liability account. Underlift quantity is treated as inventory.
- As per C&AG auditors,
 - Accounting for overlift quantity as liability was not appropriate and contended that the company should treat overlift quantity as its own share of production and should have booked it as sales, simultaneously recognizing expenditure (cost of hydrocarbon, transportation charges and royalty etc.) on the basis of its recent cost figures.
 - Government's take of profit oil should have also been reduced from the sales on the basis of applicable percentage of government's share of profit oil, as was recognized for normal sales of the company in accordance with its practice of showing sales 'net of government share of profit oil'.

Query

- Whether the accounting policy followed by the Company for accounting of underlift/overlift quantity is appropriate or whether accounting method specified by C&AG auditors would be appropriate?
- Whether there is any other appropriate accounting treatment / disclosure of such underlift / overlift quantity?

Points considered by the Committee

Overlift Situation

- As per the definition of revenue as provided by Accounting Standard (AS) 9 – Revenue Recognition, the total amount of consideration arising from the sale of crude oil (including the quantity from the overlift of crude oil) should be recognised as revenue.
- The overlift of crude oil gives rise to an obligation on the company to transfer future economic benefits (by foregoing the right to receive equivalent future entitlement in the crude oil). Accordingly, a liability should be provided for by the company as per Accounting Standard (AS) 29 - Provisions, Contingent Liabilities and Contingent Assets by way of charge to the profit and loss account for overlift quantity which should be based on the best estimate of the expenditure required to settle the present obligation at the balance sheet date as per the requirements of paragraph 35 of AS 29.

Underlift Situation

- To the extent it is the settlement of an overlift situation of the earlier periods, it should be recognised by debiting the liability provided for under the overlift situation and crediting/reducing the company's proportionate share in the production cost.

- In respect of other underlift situations, the company should recognise a prepaid expense by crediting its proportionate share of production cost since an underlift represents a right to future economic benefit through entitlement to receive equivalent production in the future and is therefore, an asset.
- In situations where an overlift situation has arisen due to settlement of an earlier underlift, the same should be recognised by crediting the earlier recognised 'prepaid expense' for the underlift and debiting the share of production cost for the current period.

Opinion

- Accounting policy of the Company in recognising overlift quantity as liability is appropriate;
- Recognition of liability by reversing the sales/revenue of the company at the recent sales price of the crude oil is not appropriate.
- Accounting policy of recognising the underlift quantity as inventory is also not appropriate.

2. Company Law

1. ROC enhances additional fee for late filings other than Form 5 *

Existing		Revised w.e.f. 5-December-2010	
Period of Delay	Fixed rate of additional fees of normal filing fees	Period of Delay	Fixed rate of additional fees of normal filing fees
Upto 1 month	One time	Upto 30 days	Two times
1 month - 3 months	Two times	More than 30 days and upto 60 days	Four times
		More than 60 days and upto 90 days	Six times
3 months - 6 months	Four times	More than 90 days	Nine times
6 months - 1 year	Six times		
1 year - 2 years	Eight times		
More than 2 years	Nine times		

* Form 5 is for notice of consolidation, division, etc or increase in share capital or increase in number of members

2. Easy Exit Scheme 2011

To give an opportunity to the defunct companies, for getting their names strike off from the Register of Companies, the Ministry of Corporate Affairs has re-launched Easy Exit Scheme 2011 effective from 1st January to 31st January 2011.

3. Circular for reopening/ revision of annual accounts adopted at AGM

The ministry has noticed that a few companies have been filing their annual accounts under section 220 more than once resulting into filing/availability of more than one such accounts in the registry for a financial year.

The Ministry after examination of the matter has concluded that keeping in view the provisions of section 220 of the Act read with Ministry's General Circular 1/2003, a company cannot lay more than one set of annual accounts for a particular financial year unless it has reopened/revised such annual accounts after their adoption in the Annual General Meeting on the grounds specified in Ministry's circular Number 1/2003.

It has directed that ROCs should keep a watch on such kinds of repeat filings and such accounts should not be accepted except in accordance with provisions of section 220 read with Ministry's General Circular 1/2003.

2 SEBI

1. Increase in the investment limit of FII's

Current limit of Foreign Institutional Investors (FII's) investment in Government Securities of USD 5 billion and Corporate Debt Bonds of USD 15 billion has been increased to USD 10 billion and USD 20 billion respectively.

The incremental limit shall be invested only in securities with residual maturity of over 5 years and corporate bonds issued by companies in infrastructure sector.

2. Issue of Capital and Disclosure Requirement (ICDR) Regulation

SEBI has amended the ICDR Regulations. A comparison of some of the critical provisions is provided below:

Sr.	Topic	Post Amendment	Pre Amendment
1	Enhancement of Limit for application or bidding of specified security by the retail investor.	Rs. Two Lakhs.	Rs. One Lakh.
2	Draft Offer Document to be made public.	Public announcement of draft offer document by issuer in newspapers (English, Hindi and regional language newspaper)	No such requirement
3	Allocation of Net offer to public	Even if the minimum public shareholding is 10%, allocation in net offer to public shall be as under <ul style="list-style-type: none"> o 50% to QIB o 35% to Retail Investor o 15% to Non Institutional Investor 	If the minimum public shareholding is 10%, allocation in net offer to public shall be as under <ul style="list-style-type: none"> o 60% to QIB o 30% to Retail Investor o 10% to Non Institutional Investor
4	Payment option in case of Rights Issue	All investors to receive only one payment option from issuer: <ul style="list-style-type: none"> o full payment on application or o part payment on application with balance money to be paid in calls provided the necessary 	No such provisions

Sr.	Topic	Post Amendment	Pre Amendment
		regulatory approvals have been obtained	
5	Additional obligation on Public Communication	Merchant bankers to submit a compliance certificate with respect to news reports appearing in stipulated newspapers, major business magazines, print and electronic media after filing the draft offer document till the date of closure of the issue as to whether the contents are supported by disclosures in the offer document	No such provisions
6	Preferential issue	<ul style="list-style-type: none"> o Sale of equity shares by any person belonging to promoter(s) or the promoter group during the previous six months will render the promoter(s) and the promoter group ineligible for preferential issue. o Failure to exercise previously subscribed warrant by any person belonging to promoter(s) or the promoter group, shall make the promoter(s) and the promoter group ineligible for preferential issue for a period of one year from the date of expiry/cancellation of the warrants 	<ul style="list-style-type: none"> o Except for the person selling the shares, the other persons belonging to promoter(s) or the promoter group were eligible for preferential issue. o No such provision with regards to warrants
7	Additional Disclosures about the Management	Board of Directors to give details of the current as well as the past directorships in listed companies which are/were suspended from the stock exchange or are / were delisted from the exchange for five years prior to filing	No such provisions

Sr.	Topic	Post Amendment	Pre Amendment
		draft offer document.	
8	Additional Financial Disclosures	Disclosure of Proforma Financial Statement in the offer document in case of material acquisition/ divestment made by the issuer after the end of the latest disclosed annual financial results in the offer document, due to which certain companies become / cease to be direct or indirect subsidiaries of the issuer	No such provisions

3. Clarifications issued by SEBI to Portfolio Managers

- Portfolio Managers to ensure that the first single lump-sum investment amount received as funds/ securities from clients should not be less than INR 5 Lacs.
- Portfolio Managers not to organize investment portfolios as "Schemes" akin to Mutual Fund Schemes while marketing their services to clients
- Portfolio Managers to disclose the performance of the portfolios to the prospective clients as per the prescribed format provided by SEBI

4. Facilitating transaction in Mutual Fund schemes

In addition to the existing facility of transacting units of mutual fund schemes through Mutual Funds and registered stock brokers, SEBI has permitted mutual fund units to be transacted through clearing members of the registered stock exchanges.

SEBI has also permitted depository participants of registered depositories to process only redemption request of units held in demat form.

3 NBFC

1. Timelines for Finalization of Balance Sheet:

Every NBFC is required to submit a Statutory Auditor's certificate with respect to the position of the company within one month from the date of finalization of the balance sheet but not later than 30th December of that year.

As per the RBI notification, every NBFC shall finalize its balance sheet within a period of 3 months from the date to which it pertains. E.g.: Balance Sheet as on March 31st of a year shall be finalized by June 30th of the relevant year.

4 Income Tax

1. Case Laws

a. No disallowance of interest on borrowed funds on basis that assessee ought to have used own funds to repay loans & not invest in shares

Godrej Agrovet Ltd vs. ACIT (ITAT Mumbai)

Facts: The assessee earned dividend of Rs. 3 crores which was exempt u/s 10(34). As the assessee had borrowings of Rs. 31.98 crores out of total funds of Rs. 96.18 crores and investments in shares of Rs. 30.42 crores, the AO held that the interest on the borrowings had to be disallowed on a pro-rata basis u/s 14A. The AO held that the assessee ought to have used the surplus funds to repay the loans instead of investing in shares and that it was an indirect case of diversion of borrowed funds for investment in shares. This was upheld by the CIT(A).

Issue: Whether interest on borrowed funds is to be disallowed u/s 14A of the Act on pro-rata basis?

Held: The Tribunal held that in view of decision in Godrej Boyce Mfg Co 328 ITR 81 (Bom), Rule 8D is applicable only prospectively i.e. from AY 2008-09 and not for earlier years. The facts showed that the assessee had made the investment in shares out of its own funds and the borrowed funds were entirely utilized for the purpose of its business. The investment in shares in the current year was made from a separate bank account where the surplus funds generated in that year were deposited. The argument that the assessee could have utilized its surplus funds in repaying the borrowings instead of investing in shares and by not doing so, there was diversion of borrowed funds towards investment in shares to earn dividend income is not acceptable. In view of CIT vs. Hero Cycles Ltd 323 ITR 518 where it was held, distinguishing Abhishek Industries 286 ITR 1 (P&H), that if investment in shares is made by an assessee out of own funds and not out of borrowed funds, disallowance u/s 14A is not sustainable. Accordingly, the disallowance of interest on borrowed funds was deleted.

b. Large volume of purchase & sale of shares does not per se mean activity is business

DCIT vs. SMK Shares & Stock Broking (ITAT Mumbai)

Facts: The assessee, a broker in the BSE, disclosed short-term capital gains and long-term capital gains on sale of shares. The AO accepted the LTCG as such though he held that the STCG was assessable as "business profits" on the ground that the assessee was a stock broker & there was large volume and frequency (more than 300) transactions. On appeal, the CIT (A) reversed the order of the AO.

Issue: Whether capital gain arising from large volume and frequency of transaction of sales & purchase of shares is to be treated as business income?

Held: The H'ble Tribunal has held that although volume of transactions is an important indicator of the intention of the assessee whether to deal in shares as trading asset or to hold the shares as investor, however it is certainly not the sole criterion. A prudent investor always keeps a watch on the market trends and, therefore, is not barred under law from liquidating his investments in shares. The law itself has recognized this fact by taxing these transactions under the head "Short Term Capital Gains".

The fact that the assessee did not borrow funds for investment in shares is an important aspect which cannot be lost sight off while deciding the true intention of the assessee.

The fact that the AO accepted the assessee's claim in earlier years that it was an investor is material because though the principles of res judicata do not strictly apply to income tax proceedings it is well settled law that the principles of consistency should not be ignored. Uniformity in treatment and consistency under the same facts and circumstances is one of the fundamentals of the judicial principles which cannot be brushed aside without proper reason.

The fact that the AO accepted the offering of LTCG also showed that the assessee's status as investor was accepted by him

Some part of the STCG had arisen out the earlier investment which had been accepted as being on investment account. As the modus operandi of the assessee remained the same in regard to other shares purchased during the year, the assessee's claim could not be negated only on the basis of frequency of the transaction (Gopal Purohit 228 CTR 582 (Bom), Sadhana Nabera 41 DTR 393 & Jayshree Pradip Shah considered).

c. Foreign income-taxes not eligible for deduction u/s 37(1). Despite bar in DTAA, credit for State taxes to be given u/s 91 in addition to Federal taxes

DCIT vs. Tata Sons Limited (ITAT Mumbai)

Facts: In respect of AY 2000-01, the assessee earned profits on export of software which was eligible for deduction u/s 80HHE. The assessee paid **foreign income-taxes** of Rs. 60 crores on the said profits in respect of which the assessee claimed **tax credit** u/ss 90 & 91. The assessee also claimed that it was eligible for a **deduction** u/s 37(1) in respect of the said foreign income-taxes. While the AO allowed tax credit, he denied deduction u/s 37(1) on the ground that the said payment of foreign taxes was an "application of income" and that it was hit by s. 40(a)(ii). On appeal, the CIT (A) upheld the claim of the assessee by following the orders of the Tribunal in the assessee's own case.

Issue: Whether the assessee was eligible to claim the foreign taxes paid as expenses u/s 37(1) and/or claim it as tax credit u/s 90 or u/s 91 of the Act even though the foreign income earned was claimed as deduction u/s 80HHE of the Act for AY 2000-01?

Held: It was held by the tribunal that the argument that the bar of deduction in s. 40(a)(ii) is not applicable to foreign taxes is no longer acceptable in view of

Lubrizol vs CIT 187 ITR 25 (Bom) (being rendered after the lead order of the Tribunal) where it was held that foreign tax payments is an "appropriation of income" and that the words "any tax" in s. 40(a)(ii) covered foreign taxes. Further, this position is clarified by Explanation 1 to s. 40(a)(ii) inserted by FA 2006. The claim of the assessee that it is entitled to tax credit u/ss 90 & 91 in respect of the foreign taxes as well as a deduction u/s 37(1) is not justified and results in a double unintended benefit.

The argument that if deduction u/s 37(1) is not granted, credit for foreign taxes should be granted u/s 90 even in respect of income eligible for deduction u/s 80HHE is not acceptable because this would be contrary to the language of the DTAA and result in an assessee getting refund of US taxes if he had no tax liability in India. (Green Emirate Shipping 100 ITD 203 distinguished & Digital Equipments 94 ITD 340 followed);

The argument that ss. 90 & 91 are confined to USA Federal taxes and not to USA State taxes and that therefore the bar in s. 40(a)(ii) does not apply to USA State taxes is not acceptable because any payment of income-tax is an application of income as held in Inder Singh Gill 47 ITR 284. Further, the scheme of ss. 90 & 91 does not discriminate between Federal taxes and State taxes and though the India-USA DTAA confines the credit only to Federal taxes, the assessee will be entitled to relief u/s 91 in respect of both taxes as that will be more beneficial to the assessee vis-à-vis tax credit under DTAA. Consequently, the bar against deduction in s. 40(a)(ii) will apply to USA State taxes as well though the assessee will be entitled to credit in respect of USA State taxes.

**d. Income from supply of 'shrink-wrapped' software assessable as 'royalty'.
A tax-treaty can be unilaterally overridden**

M/s. Gracemac Corporation Vs ADIT (International Taxation) (ITAT Delhi)

Facts: Till 31.12.1998, Microsoft Corporation directly entered into agreements with Indian distributors for sale of Microsoft products being "off the shelf"/ "shrink wrapped" software, on principal to principal basis. The Indian Distributors, in turn, sold these Microsoft products to re-sellers/consumers. The business model was changed w.e.f. 1.1.1999. Microsoft Corp granted an exclusive license to its 100% subsidiary Gracemac Corp, USA, to manufacture and distribute in the territory the MS retail software products. Gracemac in turn, entered into a license agreement with Microsoft Operations Pte Ltd, Singapore ("MO"), under which it granted the latter a license to manufacture and distribute (reproduce) Microsoft software in Singapore in consideration of a royalty ranging from 30% to 40% of the selling price (in India). MO in turn entered into a distribution agreement with Microsoft Regional Sales Corporation, USA ("MRSC"), appointing the latter as distributor for selling the Microsoft software which were manufactured by MO. MRSC, in turn, entered into agreements with various distributors in various countries including India. The distributors distributed copies of software in their respective countries. MO sold the software copies to MRSC in Singapore. The Microsoft software copies are delivered by MRSC to the Indian Distributors "ex-warehouse" in Singapore. The distributor sold the products to re-sellers in India who, in turn, sold them to end users. Microsoft Corp entered into agreements with end users to use the software products licenced to them as per terms of agreement.

In the case of Microsoft Corp (till the change), the assessee accepted that income from licensing software to OEMs was "royalty" though it argued that income from licensing software to distributors was "sale of a copyrighted article" and not assessable in India for want of a PE. In the case of Gracemac (after the change), it was argued that as the royalty was received from a Singapore company (MO), the source of the royalty (though based on sales in India) was not in India and consequently not assessable in India. In the case of MRSC, it was argued that revenue was derived from sales of software to independent distributors and not from licensing and the revenue was not assessable to tax in India for want of a PE. The AO & CIT (A) took the view that the revenue received by all three parties was assessable as "royalty" under s. 9(1)(vi) as well as Article 12 of the India-USA DTAA. On appeal to the Tribunal,

Issue: Whether income received for supply of licensed software is assessable as "royalty" and consequently taxable u/s 9(1)(vii) in the hands of Microsoft Corporation, Gracemac Corp, MO and MRSC?

Held: It was held that the income received for supply of software is assessable as "royalty" under s. 9(1)(vi) as a copyright subsists in a computer programme and it is also a literary as also a scientific work. A computer programme is also a patent, invention or process. As end-users have made payment for transfer of rights (including the granting of a license) in respect of copyright, patent, invention, process, literary or scientific work, the payment would be in the nature of royalty. Under the Explanation to s. 9 (1) inserted by FA 2010 w.r.e.f 1.6.1976, income u/s 9(1)(vi) is deemed to accrue or arise in India even if the non-resident does not have a place of business in India;

As regards Article 12(3) of the India-USA DTAA, the definition of the term "royalty" is identical that in s. 9(1)(vi) and there is no conflict. Under both, royalties are deemed to arise in the State in which the payer is situated;

Assuming there was a conflict between the Act and the DTAA, the proposition that the DTAA will prevail over the Act is not infallible. Later domestic tax legislation can over-ride treaty provisions if there is an irreconcilable conflict (Gramophone Company of India AIR 1984 SC 667 followed). As the India-USA DTAA was entered on 20.12.1990, the subsequent retrospective amendment to s. 9 which provides that royalties will be deemed to accrue or arise in India even if the non-resident has no place of business in India will apply irrespective of any contrary provision in the India-USA DTAA;

Accordingly, the payments received by Microsoft Corporation from end users through distributors in respect of sale of computer software is taxable as royalty u/s 9(1)(vi);

As regards Gracemac, the argument that since EULA has been signed between end users and Microsoft Corp, no license was granted by Gracemac and consequently royalty payments are not chargeable to tax in the hands of Gracemac is not acceptable. As end users have made payments for grant of license in respect of copyright in computer programmes, the consideration is taxable as "royalty" in the hands of Gracemac;

However, as regards MRSC, the income ought to have been assessed as business income u/s 9(1)(i) as it had a "business connection" with distributors in India and

not as "royalty" as the royalty for grant of rights has already been assessed in the hands of Gracemac and there will be double taxation.

e. Adjustment with respect to Arm's Length Price not justified

Agnity India Technologies vs. ITO (ITAT Delhi)

Facts: The assessee company is a wholly owned subsidiary of a USA company and is engaged in the business of development of software required by the parent company in the field of tele-communication. It filed its return of income declaring total income of Rs. 8.31 lacs. The assessee had undertaken international transactions with its Associate Enterprise (AE) and hence for the determination of fair market value of the international transactions, the case was referred to the Transfer Pricing Officer (TPO). The TPO on the basis of the ratio of operating profit to total cost at 27.08% of comparable companies inter alia, including Infosys Technologies Ltd and Satyam Computers Services Ltd. made an upward adjustment in arm's length value resulting in an addition of Rs. 3.73 crores in the draft assessment order. The assessment was completed by the Assessing Officer (AO) on the directions of the TPO. The assessee filed objections with the Dispute Resolution Panel (DRP) DRP. The DRP, in its order, directed the AO to re-compute arm's length price by excluding Satyam Computers Services Ltd and taking the ratio of operating profit to the total cost at 25.6%.

Issue: Whether DRP was justified in making the addition based on analysis by TPO by rejecting otherwise comparable companies on arbitrary grounds and including incomparable companies?

Held: The H'ble Tribunal held that the case of the assessee is not comparable with Infosys Technologies Ltd., the reason being in terms of high turnover or capital in the latter case and further the latter assumes all risks, leading to higher profit. On the other hand, the assessee is a captive unit of its parent company in the USA and it assumes only limited currency risk. The assessee had selected 23 comparables and adjustment was made towards working capital. On this basis the mean of the comparables was worked out 10% against the margin of 17% shown by the assessee.

It is the accepted position of both the parties that the results of the assessee are in line with the mean margin of comparable cases even if no adjustment is made on account of capital etc. Therefore, it is held that no adjustment was required to be made to the results declared by the assessee company

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