

THE ACCOUNTANTS MANUAL

September 2009

THE ACCOUNTANTS MANUAL



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Editorial

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Accounting Academics & Auditing Fundas

Total Questions: 5

Time Allotted: 45 mins

(1 / 5) How are assets and liabilities classified under International Financial Reporting Standards?

(2 / 5) Rachita Builders is engaged in the business of renting out of properties. Few years back, it has purchased a building that has non moving tenants. In the current year, Suchita Corporation proposes Rachita Builders to take the building on lease at a price which is much higher. Rachita Builders pays a significant amount of compensation to non-moving tenants to vacate the building as it wishes to lease out the same to Suchita Corporation which will generate a higher revenue. Rachita Ltd. now wants to capitalize the amount of compensation paid to tenants. Is it allowable as per the provisions of AS—10 “Accounting for fixed assets”?

(3 / 5) What are the different types of share-based payment transactions covered by IFRS-2. Briefly explain.

A company granted options to its employees with a fair value of Rs. 30,00,000 and made the following estimates:

Estimate at grant date of the percentage of employees leaving the company before the end of the three-year vesting period	10%
Revised estimate, made in the second year, of the portion of employees leaving the company before the end of three years	5%
Actual percentage of leavers	6%

Determine the amount of expense to be recognized in each of the three years of the vesting period.

(4 / 5) What are related party transactions? What is the need for identification and disclosures of related party transactions?

ABC Ltd. is procuring the packing materials from M/S XY and Co., a partnership firm, consisting of Mr. X and Mr. Y. Mr. X is the managing director of ABC Ltd. The total value of purchases made from M/S XY and Co. by ABC Ltd. during the year 2008-09 had been Rs. 38 lacs. Discuss the auditor’s responsibility in the given situation.

(5 / 5) What do mean by the term “Audit Evidence” as referred to in Standard on Auditing (SA) 500? What are the various sources from which an audit evidence can be obtained?

Answers

Time Allotted: 45 mins

Answer: Question (1 / 5)

Under International Financial Reporting Standards (IFRS), IAS 1, “Presentation of Financial Statements”, deal with aspects of presentation of components of complete set of financial statements. Statement of Financial Position discloses all assets and liabilities which form part of financial statements. IAS 1 specifies that all assets and liabilities be class-

ified into current and non-current or on basis of liquidity on the face of the Statement of Financial Position. It also specifies that irrespective of the method of classification, an entity is required to disclose separately, the amount expected to be recovered or settled after more than twelve months of the reporting date.

Accounting Academics & Auditing Fundas

Answers

Time Allotted: 45 mins

Answer: Question (1 /5)

A **current asset** is one that is :

- Expected to be realized, or sold or consumed in the entity's normal operating cycle.
- Held primarily for trading.
- Expected to be realized within twelve months after the reporting period.
- Unrestricted cash and cash equivalents.

A **current liability** is one that is :

- Expected to be settled in its normal operating cycle.
- Held primarily for trading.
- Expected to be realized within twelve months after the reporting period.
- Not having an option to defer its settlement for at least twelve months after the reporting period.

Answer: Question (2 /5)

Paragraph 12.1 of AS -10 "Accounting for Fixed Assets" states that it is difficult to determine whether subsequent expenditure related to fixed asset represents improvements that ought to be added to the gross book value or repairs that ought to be charged to the profit and loss statement. Only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity. Further paragraph 23 states that subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance.

The expenditure on fixed assets subsequent to its installation may be categorized into repairs and maintenance, and improvements. Repairs and maintenance implies the restoration of capital asset to its full productive capacity after damage, accident

or prolonged use without increase in the previously estimated useful life or capacity. Expenditure on repairs and maintenance, including replacement cost necessary to maintain the previously assessed standard of performance, is expensed in the same period. On the other hand expenditure on improvements are expenditure that have the effect of improving the previously assessed standard of performance i.e. extension of asset's useful life, increase in capacity, or a substantial improvement in quality of output or a reduction in operating cost. Such expenditures are capitalized.

In the given case, the compensation paid to the tenants enhances the value of the building owned by Rachita Builders beyond its previously assessed standard of performance as it is generating higher revenue. Therefore the proposed accounting treatment of capitalization of compensation paid to non-moving tenants would be in accordance with AS-10 "Accounting for Fixed Assets".

Answer: Question (3 / 5)

IFRS 2 applies to all the three types of share-based payment transactions. These includes the following:

(i) **Equity-settled** : Equity settled transactions are the share-based payment transactions where an entity issues or transfers its own equity instruments¹, or those of another member of the same group, as consideration for goods or services. An example of an equity-settled transaction is the issuance of options to employees that give them the right to purchase the entity's shares at a discounted

price in exchange for their services.

(ii) **Cash-settled** : Cash-settled share-based payment transactions are where goods or services are paid for at amounts that are based on the price (or value) of the entity's shares or other equity instruments (such as share options). An example of a cash-settled transaction is share appreciation rights issued to employees. These entitle employees to cash payments equal to the increase in the share price of a specified number of the entity's shares.

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Answers

Time Allotted: 45 mins

Answer: Question (3 / 5) contd....

(iii) **Choice of equity-settled or cash-settled** : It is a share-based payment transaction where an entity or the supplier may choose whether the entity settles in cash or by issuing or transferring equity instruments.

Calculation of expense to be recognized :

Year 1 :

The expense in the first year should be Rs. 9,00,000 (Rs. 30,00,000 x 1/3 x 90%).

Year 2 :

As a result of a change in accounting estimate of the percentage of employees expected to leave, the expense to be recognized in the second year is calculated as follow:

The cumulative expense at the end of the second year will be Rs. 30,00,000 x 2/3 x 95% = Rs. 19,00,000

Less:

Expense recognized in first year = Rs. 9,00,000

Expense to be recognized in the second year = Rs. 10,00,000

Year 3 :

At the end of the third year, 94% of the options vest, so the cumulative expense over the vesting period is Rs. 28,20,000 (Rs. 30,00,000 x 3/3 x 94%).

The expense already recognized in first and second year is Rs. 19,00,000, so the expense to be recognized in the third year is Rs. 9,20,000.

Answer: Question (4 / 5)

Related party transactions refer to transfer of resources or obligations between related parties regardless of whether or not a price has been charged. Two or more parties are related parties when at any time during the period under audit one party has direct or indirect control of the other party or one party has influence over the financial and operating policies of the other party.

Auditing and Assurance Standard 23- Related Parties impose duty on auditor to identify and disclose the related party transaction in the financial statements. As per AS-23, 'Related Parties', although it is the responsibility of management to establish accounting and internal control systems to ensure appropriate identification and disclosure of related parties and transactions with them, the auditor should also do the same due to the following reasons:

(i) to ensure adherence to disclosure requirements of accounting standards (such as AS 18)

(ii) to assess the effect on financial statements.

(iii) to assess the reliability of audit evidence (eg. Management representation); and

(iv) to identify motivation for related party transactions.

AAS-23 establishes standards on auditor's responsibilities and audit procedures regarding related party transactions. In the given case of purchase made from M/S XY and Co. by ABC Ltd., the related party relationship is absolutely clear and accordingly the auditor must examine that the disclosure requirements as laid down in AS-18 (Related Party Disclosures) has been followed. Further, the auditor also has to ensure compliance with the CARO'2003 requirements, i.e. transaction required to be entered into the Register pursuant to section 301 of the Companies Act, 1956 having regard to the fact whether such prices were reasonable or not. Accordingly, the auditor has to ensure that the ABC Ltd. has made proper disclosures in financial statements and the matter has been examined and

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Answers**Time Allotted: 45 mins****Answer: Question (5 /5)**

Standard on Auditing (SA) 500 defines 'Audit evidence' as information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Audit evidence is the fundamental aspect of an audit on which the final audit opinion and the audit report is based. The quality and effectiveness of an audit is, therefore, to a large extent affected by the adequacy and appropriateness of the auditor's procedures in gathering and evaluating the audit evidence. The SA 500 contains detailed guidance for the auditors on critical aspects of audit evidence such as what constitutes sufficient appropriate audit evidence, information to be used as audit evidence, factors to consider in selecting items for testing, how to respond in case of inconsistency in or doubts over reliability of audit evidence. It contains principles and procedures to be followed by the auditors to obtain and evaluate audit evidence which is sufficient and appropriate for the purpose of their audit.

Some audit evidence is obtained by performing audit

procedures to test the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors (benchmarking data).

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The Cost Cutter & Finance Corner

Total Questions: 5

Time Allotted: 45 mins

(1 / 5) What is direct and indirect quote? Explain the link between the two?

In the following table a Mumbai broker has given some quotes. Identify whether they are direct or indirect and for each direct quote give the corresponding indirect quote and vice versa.

<u>Currency</u>	<u>Rate</u>	<u>Quote</u>
SEK	5.7500	Rs. per Kroner
Euro	0.0191	Euro per Rs.
SGD	0.0388	SGD per Rs.
AED	12.1500	Rs. per UAE Dirham

(2 / 5) Explain the purposes for which transfer pricing system can be used in divisionalized companies?

(3 / 5)) What do mean by operating and financial leverage? How combined leverage can be derived from operating and financial leverage?

Pluto Ltd. manufactures pens. The company's income statement for the year ending 31st March 2009 is as follows:

	Rs.
Sales (10,000 pens @ Rs. 50 each)	5,00,000
Less:	
Variable costs (10,000 pens @ Rs. 20 each)	2,00,000
Fixed Costs	1,50,000
	<hr/>
Earnings before interest and taxes (EBIT)	1,50,000
Interest expense	60,000
	<hr/>
Earnings before taxes (EBT)	90,000
Income tax expense (40%)	36,000
	<hr/>
Earnings after taxes (EAT)	<u>54,000</u>

Given this income statement, compute the following:

- Degree of operating leverage.
- Degree of financial leverage.
- Degree of combined leverage.
- Break-even point in units(numbers of pens).

The Cost Cutter & Finance Corner

Total Questions: 5

Time Allotted: 45 mins

(4 / 5) "The NPV and IRR methods may result in contradictory signals in case of mutually exclusive investment proposals". Comment.

Delta Ltd. is evaluating two alternative mutually exclusive projects for improving the marketing of its products namely project X and project Y. The estimated cash flows from each alternative projects are as follows:

	<i>Initial Investment outlay (Rs.)</i>	<i>Net inflow at the end of years (Rs.)</i>		
		<i>1</i>	<i>2</i>	<i>3</i>
<i>Project X</i>	7,00,000	3,43,000	3,43,000	3,43,000
<i>Project Y</i>	12,00,000	5,52,000	5,52,000	5,52,000

The company's estimated cost of capital is 10%. Which project should the company accept?

(5 / 5) Write short notes on the following:

- Master Budget
- Price-skimming policy
- Profit centres
- Total quality management

Answers

Time Allotted: 45 mins

Answer: Question (1 / 5)

A **direct quote** expresses the exchange rate in terms of home currency per unit of the foreign currency. It is the number of home currency units required to buy or sell one unit of foreign currency. For eg. Rs. 48.20 per USD is a direct quote for USD in India which means that 48.20 Indian Rupees is required to buy/sell one USD. The price comes first and the commodity comes next. The quantity of the commodity remains the same whereas the price changes. In the given example, USD is the commodity which is being bought and sold.

An **indirect quote** expresses the exchange rate in terms of foreign currency per unit of home currency. It is the number of units of foreign currency required to buy or sell one unit of home currency. In an indirect quote, domestic currency is the commodity

which is being bought and sold. For eg. 0.02 USD per Rupee is an indirect quote in India which means that in exchange of one Indian Rupee, the seller will get 0.02 USD. Here in the given example, Rupee is the commodity.

The Link

The direct quote for a given currency in one country (i.e. for \$ in India) is an indirect quote for that currency in the other country (for \$ in USA). Thus, Rs. 48.20 per dollar is a direct quote for USD in India and an indirect quote for USD in the US. On the other hand 0.02 USD per INR is an indirect quote for INR in India whereas the same is a direct quote for INR in US. Thus "an indirect quote is the reciprocal of the direct quote and vice versa".

The Cost Cutter & Finance Corner

Answers

Time Allotted: 45 mins

Answer: Question (1 / 5) contd...

In the given case, since it's a Mumbai banker the home currency in INR.

- **INR/ SEK** – INR per Kroner is the home currency per unit of foreign currency, hence it's a direct quote. The corresponding indirect quote is $1/\text{Direct quote}$ i.e. $1/ 5.7500 = 0.1739$ SEK per INR.
- **Euro/ INR** – Euro per INR is the foreign currency per unit of home currency, hence it's an indirect quote. The corresponding direct quote is

$1/\text{Indirect quote}$ i.e. $1/0.0191 = \text{Rs.}52.36$ per Euro.

- **SGD/ INR** – SGD per INR is the foreign currency per unit of home currency, hence it's an indirect quote. The corresponding direct quote is $1/\text{Indirect quote}$ i.e. $1/ 0.0388 = \text{Rs.} 25.77$ per SGD.
- **INR/ AED** – INR per UAE Dirham is the home currency per unit of foreign currency, hence it's a direct quote. The corresponding indirect quote is $1/\text{Direct quote}$ i.e. $1/ 12.1500 = 0.08$ AED per INR.

Answer: Question (2 / 5)

Transfer prices are prices that different divisions in a company charge for goods, services, tangible and intangible assets they trade with other divisions of the company. Where each division in the company is considered as a profit centre, transfer pricing is important because a change in the transfer price would affect the profits of the divisions.

A transfer pricing system can be used to meet the following purposes:

- To provide information that motivates divisional managers to make good economic decisions.
- To provide information that is useful for evaluating the managerial and economic performance of the divisions.
- To intentionally move profits between divisions or locations.
- To ensure that divisional autonomy is not undermined.

Answer: Question (3 / 5)

Operating leverage results from the presence of fixed operating costs in a firm's income stream. It is the name given to the impact on operating income of a change in the level of output. The extent of the presence of fixed operating costs in a firm's income stream is measured by the degree of operating leverage (DOL).

The degree of operating leverage (**DOL**) is defined as the percentage change in operating income (or EBIT) that results from a given percentage change in sales. It is a quantitative measure of the "sensitivity" of a firm's operating profit to a change in the firm's sales. If a high percentage of a firm's total costs are fixed, the firm is said to have a high degree of operating leverage.

$\text{DOL} = \frac{\text{Percentage Change in Earnings Before Interest and Taxes (EBIT)}}{\text{Percentage Change in Sales}}$

Financial leverage results from the presence of fixed financial costs in a firm's income stream. It is the name given to the impact on returns of a change in the extent to which the firm's assets are financed with borrowed money. The extent of the presence of fixed financial costs in a firm's income stream is measured by the degree of financial leverage (DFL).

The degree of financial leverage (**DFL**) is defined as the percentage change in earnings per share [EPS] that results from a given percentage change in earnings before interest and taxes (EBIT). It is an index

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Total Questions: 5

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Answer: Question (3 / 5) contd....

number which measures the effect of a change in earnings before interest and taxes (EBIT) on earnings per share (EPS).

$DFL = \text{Percentage Change in Net Income (NI)} / \text{Percentage Change in Earnings Before Interest and Taxes (EBIT)}$

Firm's often have both operating and financial leverage. Combined leverage results from the presence of both fixed operating and financial costs in a firm's income stream. Combined leverage is measured by the degree of combined leverage (DCL).

$DCL = \text{Percentage Change in Net Income (NI)} / \text{Percentage Change in Sales}$

Combined leverage can also be derived by multiplying financial leverage and operating leverage.

$$DCL = DFL \times DOL$$

Both operating and financial leverage result in the magnification of changes to earnings due to the presence of fixed costs in a company's cost structure. The difference is only the part of the income statement. Operating leverage is the magnification on the top half of the income statement i.e. how EBIT changes in response to changes in sales; the relevant fixed cost is the fixed cost of operating the business. Financial leverage is the magnification on the bottom half of the income statement i.e. how earnings per share changes in response to changes in EBIT; the relevant fixed cost is the fixed cost of financing, in particular interest.

Pluto Ltd.

1. Degree of operating leverage

The degree of operating leverage at any level of sales is the ratio of contribution to the earnings before interest and taxes (EBIT).

$$\begin{aligned} DOL &= \text{Contribution} / \text{EBIT} \\ &= 3,00,000 / 1,50,000 = 2 \end{aligned}$$

2. Degree of financial leverage

The degree of financial leverage at any level of EBIT is the ratio of earnings before interest and taxes (EBIT) to the earnings before taxes (EBT).

$$\begin{aligned} DFL &= \text{EBIT} / \text{EBT} \\ &= 1,50,000 / 90,000 = 1.67 \end{aligned}$$

3. Degree of combined leverage

$$\begin{aligned} DCL &= DFL \times DOL \\ &= 1.67 \times 2 = 3.33 \end{aligned}$$

4. Break-even point

Break-even point in Units

$$\begin{aligned} &= \text{Fixed Costs} / \text{Contribution margin per unit} \\ &= 1,50,000 / 30 \\ &= 5,000 \end{aligned}$$

The break even point in units is 5,000 pens.

Answer: Question (4 / 5)

A project is said to be mutually exclusive if the acceptance of one project excludes the acceptance of another project. In case of mutually exclusive projects the ranking is crucial, since only one project can be accepted and we cannot be indifferent to the outcome of applying the NPV and the IRR rules. It is possible for the NPV and the IRR methods to suggest different rankings as to which project should be given priority.

The NPV method discounts all cash flows at the cost of capital thus implicitly assuming that these cash flows can be reinvested at this rate. The IRR method implies a reinvestment rate at IRR and so the implied reinvestment rate will differ from project to project. The cost of capital is more realistic than reinvestment rate, NPV method is considered to be theoretically superior to the IRR method.

The Cost Cutter & Finance Corner

Answers

Time Allotted: 45 mins

Answer: Question (4 / 5) contd....

The NPV and IRR calculation of the two projects under consideration by Delta Ltd. are as below:

NPV = (Annual cash inflow x Annuity factor for 3 years) - Annual cash outflow

Project X = (3,43,000 X 2.487) - 7,00,000
 = 1,53,041

Project Y = (5,52,000 X 2.487) - 12,00,000
 = 1,72,824

IRR :

Equivalent annuity factor for three years
 = Investment cost / Annual cash inflow

Project X = 7,00,000 / 3,43,000
 = 2.04 i.e. 22%

Project Y = 12,00,000 / 5,52,000
 = 2.174 i.e. 18%

	<u>IRR (%)</u>	<u>NPV (Rs.)</u>
Project X	22	1,53,041
Project Y	18	1,72,824

For the projects Delta Ltd. is considering, the two methods are giving contradictory rankings. The IRR method ranks project X first whereas NPV method ranks project Y first. If the projects were independent then this would be irrelevant as the firm would be indifferent as to which project to accept but as the projects are mutually exclusive the rankings are very crucial in decision making.

Since the two methods are giving contradictory rank-

ings, one of the method must be indicating incorrect ranking. The same is evaluated by considering incremental cash flow as below:

<u>Years</u>	<u>Project Y</u>	<u>Project X</u>	<u>Incremental cash flow (Y-X)</u>
	Rs.	Rs.	Rs.
1	12,00,000	7,00,000	5,00,000
2	5,52,000	3,43,000	2,09,000
3	5,52,000	3,43,000	2,09,000
4	5,52,000	3,43,000	2,09,000

At the first instance, it is assumed that Delta Ltd. adopts IRR method and chooses project X, then it can be considered whether it is worthwhile to invest the hypothetical incremental investment (incremental investment required in project Y over project X). The initial investment in project X plus the hypothetical incremental investment is equivalent to accepting project Y. If the firm is prepared to accept the incremental investment, using the IRR rule, this is equivalent to shifting from project X to Y.

The **IRR** for incremental investment is 5,00,000/2,09,000 = 2.39 i.e. 12%.

As the IRR for incremental investment (12%) is greater than the cost of capital (10%), the incremental project should be accepted which means shifting from project X to project Y. The IRR analysis for incremental investment is contradictory to the initial IRR analysis which means that the initial ranking as per the IRR method was incorrect. The NPV method thus holds superiority over the IRR method and is assumed to give proper analysis for decision making.

Delta Ltd., therefore, should accept project Y as it has higher NPV.

Answer: Question (5 / 5)

(a) Master Budget

Budget is a financial plan for implementing various decisions that management has made. The budgets for all of the various decisions are expressed in terms of cash inflows and outflows, and revenues

and expenses. All these budgets are merged together into a single unifying statement of the organisation's expectations for future periods. This statement is known as a **"Master budget"**. Master budget is a consolidated summary of various functional budget and consists of a budgeted profit and

The Cost Cutter & Finance Corner

Answers**Time Allotted: 45 mins****Answer: Question (5 / 5) contd....**

loss account, a balance sheet and a cash flow statement. After the approval of the master budget, the budgets are passed down through the organization to the appropriate responsibility centres. The approval of the master budget is the authority for the manager of each responsibility centre to carry out the plans contained in each budget.

(b) Price-skimming policy

A price-skimming policy is an attempt to exploit those sections of the market that are relatively insensitive to price changes. For example, high initial prices may be charged to take advantage of the novelty appeal of a new product when demand is initially likely to be inelastic. The charge of high price in the initial periods serves to skim the cream of the market that is relatively insensitive to price. A skimming pricing policy offers a safeguard against high initial capital outlays, high promotional expenses, unexpected future increases in costs, or a large fall in demand after the novelty appeal has declined. This method is preferred in the beginning because in the initial periods when demand for the product is not known the price covers the initial cost of production. Once the market becomes saturated, the price can be reduced to attract that part of the market that has not yet been exploited. A skimming pricing policy should not be adopted when a number of close substitutes are already there in market. In that situation, the demand curve is likely to be elastic, and any price in excess of that being charged for the substitute product by the competitor is likely to lead to a large reduction in sales.

(c) Profit centres

Profit centre refers to division of an organization held responsible for producing its own profits. It refers to segment of a business for which costs, revenues, and profits are separately calculated, with the manager of the segment being responsible for and judged on the performance of that segment. For example a large corporation with diversified interests in paper manufacturing, trucking, and fast food may regard each of these three businesses as a profit center. Profit centers are parts of a corporation that

directly add to its profit. A profit center manager is held accountable for both revenues, and costs (expenses), and therefore, profits, which means that the manager has to drive the sales revenue generating activities which leads to cash inflows and at the same time control the cost (cash outflows) causing activities. This makes the profit center management more challenging than cost centre management. Profit center management is equivalent to running an independent business because a profit center business unit or department is treated as a distinct entity enabling revenues and expenses to be determined and its profitability to be measured. Usually different profit centers are separated for accounting purposes so that the management can follow how much profit each center makes and compare their relative efficiency and profit. Examples of typical profit centers are a store, a sales organization and a consulting organization whose profitability can be measured.

(d) Total quality management

Total quality management is a term used to describe a situation where all business functions are involved in a process of continuous quality improvement. TQM has broadened, from its early concentration on the statistical monitoring of manufacturing processes, to a customer-oriented process of continuous improvement that focuses on delivering products or services of consistent high quality in a timely fashion. TQM seeks to increase customer satisfaction by finding the factors that limit current performance. The emphasis of TQM is to design and build quality in, rather than trying to inspect it in, by focusing on the causes rather than the symptoms of poor quality. TQM culture requires quality in all aspects of the company's operations, with things being done right first time, and defects and waste eradicated from operations. It help organisations in achieving significant improvements in quality, productivity, competitiveness or financial return. The important aspects of TQM include customer-driven quality, top management leadership and commitment, continuous improvement, fast response, actions based on facts, employee participation, and a TQM culture.

Tax Teasers

Total Questions: 5

Time Allotted: 45 mins

(1 / 5) Delta Ltd. manufactures Valve Actuators and the statistical data indicated that every year a number of these actuators were found to be defective. Being a sophisticated item no customer is ready to buy it without warranty, so, Delta Ltd. sells these actuators on a standard warranty for a period and undertook to rectify or replace the defective part free of charge. This warranty is given under certain conditions stipulated in a warranty clause. During the year, based on past experience Delta Ltd. made a provision for warranty at the rate of 2% of the turnover amounting Rs. 2,53,000 which exceeded the actual expenditure. The excess provision of Rs. 1,17,000 was reversed as Reversal of Excess provision. Delta Ltd. claimed the net provision of Rs. 1,36,000 as business expenditure. Discuss whether the same is allowable as deduction under the provisions of the Income tax Act 1961.

(2 / 5) Is the service tax paid on expenditure incurred by a manufacturer on advertisement or sales promotion allowable as input stage credit? Discuss in the light of recent judicial decisions.

(3 / 5) What is "Anonymous donation"? Is it chargeable to tax under the Income Tax Act, 1961? Discuss the provisions.

(4 / 5) XYZ Corporation applied for registration of its factory in the prescribed manner under Rule 9 of the Central Excise Rules, 2002. However, the application was rejected by the department on the ground that the earlier holder of registration certificate had not paid their outstanding dues and failed to surrender their registration certificate with respect to the same factory premises. Thus, it was contended by the revenue that no other unit in the same premises could be registered under the rules unless the original registration was deregistered or cancelled or surrendered by such registrant and all excise dues cleared. Do you agree with the department?

(5 / 5) Whether the wealth tax or provision for wealth tax debited to profit and loss account needs to be added back for the calculation of book profit under section 115JB? Explain.

Answers

Time Allotted: 45 mins

Answer: Question (1 / 5)

The supreme court in the case of Rotork Controls India (P.) Ltd. held that where a standard warranty was required to be given during sell and assessee made provision for warranty which exceeded actual expenditure and excess amount was reversed, claim for deduction under section 37 of the Income tax Act of the net provision amount could not be denied. If the historical trend indicates that large number of sophisticated goods were being manufactured and in the past if the facts established show that defects existed in some of the items manufactured and sold, then the provision made for warranty in respect of such sophisticated goods would be entitled to deduction from the gross receipts under section 37. The deduction is allowable only when there is manufacture and sale of large number of items running into thousands of units of sophisticated goods. A lia-

bility on account of provision for warranty arising from manufacture and sale of one single item is construed as contingent liability not entitled to deduction under section 37.

In the given case of Delta Ltd., a large number of sophisticated goods were being produced. They were supported by historical trend of defect being detected in some of the items. There is a present obligation as a result of past events resulting in outflows of resources and a reliable estimate could be made of the amount of the obligation. All the conditions for recognizing a liability for the purposes of provisioning has been satisfied in the instant case therefore warranty provision needs to be recognized and the same is entitled to deduction under section 37 of the Income tax Act. Delta Ltd. Hence, Delta Ltd. can claim the net provision of Rs. 1,36,000 as business expenditure.

Tax Teasers

Answers

Time Allotted: 45 mins

Answer: Question (2 / 5)

Service tax paid on expenditure incurred by a manufacturer on advertisement, sales promotion, market research etc. will be allowable as input stage credit, if the same forms a part of price of final product on which excise duty is paid. In the case of Coca Cola India (P.) Ltd. vs CCE, it has been held that any input service that forms part of the value of the final product should be eligible for the benefit of the Cenvat credit.

The term 'input services' as defined in rule 2(i) of Cenvat Credit Rules uses the phrase 'activity relating to business', therefore all or any activity relating to business falls within the definition of 'input service' provided there is relation between the final product being manufactured and the activity. It is not necessary that the contents of the advertisement must be that of the final product manufactured by the person

advertising. As long as the manufacturer can demonstrate that the advertisement services availed have an effect of or impact on the manufacture of the final product and establish the relationship between the input service and the manufacturer of the final product, credit of service tax paid can be availed. Once the cost incurred by the service provider has to be added to the cost of product, and is so assessed, it is a recognition by the revenue of the advertisement cost services having a connection with the manufacture of the final product.

Service tax, therefore, paid on expenditure incurred by the assessee on advertisement, sales promotion, market research etc. will have to be allowed as input stage credit, more particularly, if the same forms a part of the price of final product of the assessee on which excise duty is paid.

Answer: Question (3 / 5)

The expression "anonymous donation" has been defined in section 115BBC of the Income tax Act, 1961 as follow:

(i) It is a voluntary contribution referred to in section 2(24)(ia).

(ii) The person receiving such contribution does not maintain a record of—(a) the identity indicating the name and address of the person making such contribution; and (b) such other records as may be prescribed.

Anonymous donations received by the following are chargeable to tax at the rate of 30 percent:

- (a) any trust or institution referred to in section 11;
- (b) any university or other educational institution referred to in section 10(23C)(iiia) and (vi);
- (c) any hospital or other institution referred to in section

10(23C)(iiiae) and (via);

(d) any fund or institution referred to in section 10(23C)(iv);and

(e) any trust or institution referred to in section 10(23C)(v).

However, from assessment year 2010-11, anonymous donation will be taxable only to the extent such donation exceeds Rs. 1,00,000 or 5 percent of total income of the trust, whichever is higher.

The following anonymous donations are not covered by the provisions of section 115BBC:

- (a) donations received by any trust or institution created or established wholly for religious purposes; and
- (b) donations received by any trust or institution created or established for both religious as well as charitable purposes.

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Tax Teasers

Answers

Time Allotted: 45 mins

Answer: Question (4 / 5)

Yes, the department is correct in not accepting the application for registration. As per Rule 9 of Central Excise Rules, 2000, every person, who produces, manufactures, carries on trade, holds private store-room or warehouse or otherwise uses excisable goods, shall get registered.

However, Rule 9(3) prescribes certain conditions for registration and one of the conditions contained therein states that, whenever a business is transferred, fresh registration is required to

be taken by the assessee and whenever a manufacturer ceases to carry on his business, he should apply for de-registration. In the given case, the earlier holder has not applied for deregistration and hence fresh registration cannot be done for the same premises. A similar judgment was given by the Bombay High court in the case of Manibhadra processors where it was held that the person holding earlier registration certificate must surrender registration certificate in respect to that premises than only a new person could get registration in respect of that premises.

Answer: Question (5 / 5)

The explanation to section 115JB lists out the amount to be disallowed for the calculation of book profit. However, it does not include the term wealth tax but provides only for the disallowance of any income tax paid or payable and the provisions for the same. Since the term 'wealth tax', chargeable under the Wealth-tax Act, 1957, cannot be held as income-tax, the provision made in the profit and loss

account for liability to pay wealth tax cannot be added back to the net profit for the purpose of computing the book profit under section 115JB. It has also been decided by the Calcutta Bench of ITAT that wealth tax cannot be considered part of income tax as it is chargeable under a different Act and hence will not be added back for the calculation of book profit under section 115JB.

Answers of Previous Issue

Issue: August 2009

Section: CPT ONLINE

Fundamentals of Accounting

1. (d) 2. (a) 3. (b) 4. (c)

Mercantile Law

1. (b) 2. (b) 3. (a) 4. (b)

Quantitative Aptitude

1. (c) 2. (d) 3. (d) 4. (d)

Economics

1. (b) 2. (a) 3. (c)



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CPT ONLINE

Fundamentals of Accounting

1. **Economic life of an enterprise is split into the periodic interval as per _____**
 - a. Money Measurement.
 - b. Matching
 - c. Going concern
 - d. Accrual
2. **Accounting policies refer to specific accounting _____**
 - a. Principles
 - b. Methods of applying those principles
 - c. Both (a) and (b)
 - d. None of the above
3. **Which of the following inventory methods will always produce the same results under both a periodic and perpetual system?**
 - a. FIFO
 - b. LIFO
 - c. Average
 - d. None of these
4. **When reconciling the ending cash balance per the bank statement to the correct adjusted cash balance, how would deposits in transit be handled?**
 - a. Added to the balance as per bank statement
 - b. Subtracted from the balance as per bank statement
 - c. Added to the balance as per company records
 - d. ignored

Mercantile Law

1. **Contract of guarantee**
 - a. is a contract to perform the promise or Matching discharge liability of the debtor in case of his default
 - b. Is a contract of Insurance Accrual
 - c. Is a contingent contract
 - d. Both (a) and (c)
2. **An offer comes to an end when :**
 - a. It is not accepted within the prescribed time
 - b. A counter offer is made
 - c. It is not accepted according to the prescribed mode
 - d. All of the above
3. **Compulsory dissolution includes**
 - a. Dissolution by the adjudication by all the partners or of all the partners but one as Insolvent
 - b. Dissolution by the business of the firm becoming unlawful.
 - c. All of the above
 - d. None of the above
4. **Agreement to share profits _____**
 - a. Implies an agreement to share losses
 - b. Does not necessarily mean an agreement to share losses
 - c. Must be coupled with an agreement to share losses
 - d. Is same as agreement to share losses

CPT ONLINE**Quantitative Aptitude**

1. Suppose 60% of a herd of cattle is infected with a particular disease. Let Y = the number of non-diseased cattle in a sample of size 5. The distribution of Y is

- binomial with $n = 5$ and $p = 0.6$
- binomial with $n = 5$ and $p = 0.4$
- binomial with $n = 5$ and $p = 0.5$
- the same as the distribution of X , the number of infected cattle.

2. Seventeen people have been exposed to a particular disease. Each one independently has a 40% chance of contracting the disease. A hospital has the capacity to handle 10 cases of the disease. What is the probability that the hospital's capacity will be exceeded?

- 0.965
- 0.035
- 0.989
- 0.011

3. In what time will Rs.85000 amount to Rs.157675 at 4.5 % p.a.

- 18 yrs
- 18.5 yrs
- 19 yrs.
- 20 yrs.

4. An Ogive can be prepared in _____ different ways

- 2
- 3
- 4
- 5

Economics

1. Cereal and milk have:

- positive income elasticity of demand with respect to each other.
- negative income elasticity of demand with respect to each other
- a positive cross-price elasticity of demand.
- a negative cross-price elasticity of demand

2. Which of the following is true of the relationship between the marginal cost function and the average cost functions?

- If MC is greater than ATC, then ATC is falling.
- The ATC curve intersects the MC curve at minimum MC.
- The MC curve intersects the ATC curve at minimum ATC.
- If MC is less than ATC, then ATC is increasing

3. The negatively-sloped part of the long-run average total cost curve is due to which of the following?

- Diseconomies of scale
- Diminishing returns
- The difficulties encountered in coordinating the many activities of a large firm
- The increase in productivity that results from specialization

*To know the correct answers of the CPT Online Quick Test
Please refer our next issue.*

CAREER LOOP

Points to take note of while preparing for examinations

1. Learn to strike a balance between work and enjoyment. Study very seriously but allot some time for any leisure activity that makes you feel relaxed.
2. Aim for a rank. That way you will at least get through with good marks.
3. Remember hard work (rather than Smart Work) always yields good results.
4. Start your preparations from Day One (Early Preparation).
5. Plan out your study methodology well in advance and stick to your plans. Keep enough time for unexpected time delays (No one plans to fail, but fails to plan).
6. If you are aiming for a Rank, read the study materials in entirety (Read Only Materials). Don't leave out any portion. Further refer to some standard text books as referred by ICAI.
7. Concentrate on the subjects that you find difficult.
8. Make notes that will help you to quickly cover the vast syllabus on the day before the exam.
9. Make writing a habit. And write legibly.
10. Get enough practice in practical subjects.
11. If you are not interested in a particular subject, then Read Some thing of every thing or Everything of some thing.
12. Don't expect a specific format of the question paper for a professional exam of such calibre. Just keep in mind the marks allotted to each subject - because that's what will not change.
13. Presentation is what matters most. Present your answers in a neat and systematic manner. Remember, the easier it is for the examiner to read your answers, the more marks you get.
14. Read a lot of related material like newspapers, periodicals, magazines, etc so that your knowledge is updated. This will help you get better marks in the exam.



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Smaller Facts Overlooked

Total Questions: 8

Time Allotted: 30 mins

An assessee company was in the business of real estate. In addition to renting out premises it also has entered into agreement with tenants for maintenance and furnishing of premises for which separate payment was charged from tenants.

Is the brokerage payable to brokers (one month's maintenance charges) who have introduced the tenants to the assessee an allowable expenditure?

maintenance charges.

In the case of

Tube Rose estates (P) Ltd v ASSTT

It has been decided that brokerage so paid to the brokers for introducing the tenants can be claimed as deduction under section 37 as the income derived from such maintenance services is being assessed as income from business. Held that brokerage in the form of commission is being paid to a party which had brought income to the assessee in the form of

Can there arise an "addition of income" during assessment proceeding on account of generations / wastages etc being generated during the manufacturing process against which no records of disposal etc is being maintained by the assessee?

generated.

It has been held in number of cases that wastages generated etc would call for addition to the income of the assessee if no records are being maintained by the assessee in respect of their disposal etc.

Hence, additions made by AOs estimating the sales turnover of those wastages can't be avoided unless assessee has maintained book of records to justify any expenses against the sale of those wastages and in regard to the sales of the wastages so

Is the money received as Insurance compensation on account of loss of goods destroyed by fire be taken into account in determining profits and gains of an industrial undertaking to which section 80 IA benefit applies?

determining the profits and gains of the industrial undertaking to which Section 80 IA applies.

It has been held by the Supreme Court that keeping in mind the intent of the provision of section 80 IA and the fact that an industrial establishment has already been established and is running, hence a restricted interpretation of the expression "derived from any business of an industrial undertaking" is not justified.

Therefore, held by the Supreme Court that there is no reason for not considering the money received as insurance compensation in

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