

PAPER – 5 : COST MANAGEMENT

Question No. 1 is compulsory. Answer any four questions from the rest.

Working notes should form part of the answer.

Question 1

- (a) State the general guidelines to be used in adopting a pricing policy in a manufacturing organization.
- (b) A company which has developed a new machine has observed that the time taken to manufacture the first machine is 600 hours. Calculate the time which the company will take to manufacture the second machine if the actual learning curve rate is (i) 80% and (ii) 90%. Explain which of the two learning rates will show faster learning.
- (c) A company manufactures three types of products namely P, Q and R. The data relating to a period are as under:

	P	Q	R
Machine hours per unit	10	18	14
Direct labour hours per unit @ Rs. 20	4	12	8
Direct Material per unit (Rs.)	90	80	120
Production (units)	3,000	5,000	20,000

Currently the company uses traditional costing method and absorbs all production overheads on the basis of machine hours. The machine hour rate of overheads is Rs. 6 per hour.

The company proposes to use activity based costing system and the activity analysis is as under:

	P	Q	R
Batch size (units)	150	500	1,000
Number of purchase orders per batch	3	10	8
Number of inspections per batch	5	4	3

The total production overheads are analysed as under:

Machine set up costs	20%
Machine operation costs	30%
Inspection costs	40%
Material procurement related costs	10%

Required:

- (i) Calculate the cost per unit of each product using traditional method of absorbing all production overheads on the basis of machine hours.
 - (ii) Calculate the cost per unit of each product using activity based costing principles.
- (d) A single product manufacturing company has an installed capacity of 3,00,000 units per annum. The normal capacity utilization of the company is 90%. The company has prepared the following budget for a year:

Variable costs:

Factory costs	Rs. 33 per unit
Selling and Administration costs	Rs. 9 per unit

Fixed costs:

Factory costs	Rs. 21,60,000
Selling and Administration costs	Rs. 7,56,000

Selling Price

Selling price per unit	Rs. 60
------------------------	--------

The actual production, sales, price and cost data relating to the year under review are as given below:

Production	2,40,000 units
Sales	2,25,000 units
Finished goods stock in the beginning of the year:	15,000 units
Actual factory variable costs exceeded the budget by	Rs. 1,20,000

Required:

- (i) Calculate the budgeted profit and break-even point in units.
- (ii) What increase in selling price was necessary during the year under review to maintain the budgeted profit?
- (iii) Prepare statements showing the actual profit during the year under review by using (1) absorption costing method and (2) marginal costing method.

(3 + 3 + 7 + 11 = 24 Marks)

Answer

- (a) The general guidelines to be used in adopting a pricing policy are as under:

- (i) The pricing policy should encourage optimum utilization of resources.
- (ii) The pricing policy should work towards a better balance between demand and supply.

- (iii) The pricing policy should promote exports.
- (iv) The pricing policy should serve as an incentive to the manufacturers to maximize production by adopting improved technology.
- (v) The pricing policy should avoid adverse effects on the rest of the economy.
- (b) (i) Actual learning curve rate is 80%.

Time taken to produce the first machine = 600 hours
 Average time taken to produce two machines = $600 \times 80\%$ hours
 = 480 hours.
 Cumulative time taken to produce two machines = 480×2 hours
 = 960 hours.
 Time taken to produce the second machine = $(960 - 600)$ hours
 = 360 hours.

- (ii) Actual learning curve rate is 90%.

Time taken to produce the first machine = 600 hours
 Average time taken to produce two machines = $600 \times 90\%$ hours
 = 540 hours.
 Cumulative time taken to produce two machines = 540×2 hours
 = 1080 hours.
 Time taken to produce the second machine = $(1080 - 600)$ hours
 = 480 hours.

The time taken to produce the second machine is lower at 80% learning rate and hence 80% learning rate shows faster learning rate.

- (c) (i) Cost per unit using traditional method of absorbing all production overheads on the basis of machine hours:

Products	P	Q	R
	Rs.	Rs.	Rs.
Direct materials	90	80	120
Direct labour (4:12:8 hours) $\times$ Rs. 20	80	240	160
Production Overheads (10:18:14 hours) $\times$ Rs. 6	<u>60</u>	<u>108</u>	<u>84</u>
Cost per unit	<u>230</u>	<u>428</u>	<u>364</u>

- (ii) 1. Cost per unit of each product using activity based costing:

Products	P	Q	R	Total
A. Production (units)	3,000	5,000	20,000	
B. Batch size (units)	150	500	1000	
C. Number of batches $[A \div B]$	20	10	20	50
D. Number of purchase order per batch	3	10	8	
E. Total purchase orders $[C \times D]$	60	100	160	320
F. Number of inspections per batch	5	4	3	
G. Total inspections $[C \times F]$	100	40	60	200

2. Total Production overhead

A. Machine hours per unit	10	18	14
B. Production units	3,000	5,000	20,000
C. Total machine hours $[A \times B]$	30,000	90,000	2,80,000

Total machine hours = 4,00,000

Total production overheads = $4,00,000 \times \text{Rs. } 6 = \text{Rs. } 24,00,000$.

3. Cost driver rates:

Cost Pool	%	Overheads Rs.	Cost Driver Units	Cost Driver Rate Rs.
Set up	20%	4,80,000	50	9,600 per set up
Inspection	40%	9,60,000	200	4,800 per inspection
Purchases	10%	2,40,000	320	750 per purchase
Machine hours	30%	7,20,000	4,00,000	1.80 per Machine Hour

4. Cost per unit of P, Q and R:

Products	P	Q	R
Production (units)	3,000	5,000	20,000
	Rs.	Rs.	Rs.
Direct Materials (90:80:120)	2,70,000	4,00,000	24,00,000
Direct Labour (80:240:160)	2,40,000	12,00,000	32,00,000

Overheads:

Machine related costs @ Rs. 1.80/hour (30,000:90,000:2,80,000)	54,000	1,62,000	5,04,000
Set-up costs @ Rs. 9600 / set up (20 : 10 : 20)	1,92,000	96,000	1,92,000
Inspection costs @ Rs. 4800 / inspection (100 :40 : 60)	4,80,000	1,92,000	2,88,000
Purchase related costs @ Rs. 750 / purchase (60 : 100 : 160)	45,000	75,000	1,20,000
Total costs	12,81,000	21,25,000	67,04,000
Cost per unit (Total cost ÷ units)	427.00	425.00	335.20

(d) (i) Contribution per unit:

	Rs.	Rs.
Selling price per unit		60
Variable costs per unit:		
Factory	33	
Selling & Administration	<u>9</u>	<u>42</u>
Contribution per unit		<u>18</u>
(Selling price – Variable cost)		

Budgeted Profit:

	Units	Rs.	Rs.
Installed capacity	3,00,000		
Normal capacity utilization (3,00,000 × 90%)	2,70,000		
Total contribution (A)			
(Contribution per unit × Normal capacity utilization) (2,70,000 × 18)			48,60,000
Fixed Costs (B)			
Factory Costs		21,60,000	
Selling and Administration costs		<u>7,56,000</u>	<u>29,16,000</u>
Profit (A – B)			<u>19,44,000</u>

$$\begin{aligned}\text{Break - even point (in units)} &= \frac{\text{Fixed costs}}{\text{Contribution per unit}} \\ &= \frac{29,16,000}{18} = 1,62,000.\end{aligned}$$

(ii)	1.	Actual variable costs per unit	Rs.	Rs.
		Budgeted factory costs	33	
		Increase in Factory costs per unit		
		$\left(\frac{1,20,000}{2,40,000} \right)$	<u>0.50</u>	33.50
		Selling and Administration costs		<u>9.00</u>
				<u>42.50</u>
	2.	Selling price required to maintain the budgeted profit:		
	A.	Total contribution required (Rs.)		48,60,000
	B.	Actual production (units)		2,40,000
	C.	Contribution desired per unit (A ÷ B) (Rs.)		20.25
	D.	Variable cost per unit (Rs.)		42.50
	E.	Selling price required to maintain budgeted profit (C + D) (Rs.)		62.75
	F.	Increase in selling price necessary Rs. (62.75 – 60)		2.75
(iii)	Fixed overhead recovery rate:			
		Fixed factory overheads		Rs. 21,60,000
		Normal Production		2,70,000 units
		Absorption Rate per unit : 21,60,000 / 2,70,000 = Rs. 8		
		Stock analysis:		
			Units	
		Opening stocks	15,000	
		Add: Production	2,40,000	
		Total	2,55,000	
		Less: Sales	2,25,000	
		Closing stocks	30,000	

1. Profitability based on Absorption Costing Method:

	Rs.	Rs.
A. Sales (2,25,000 units @ Rs. 60)		<u>1,35,00,000</u>
B. Production costs:		
Variable factory cost: (2,40,000 units × Rs. 33)	79,20,000	
Increase in cost	1,20,000	
Fixed factory costs (2,40,000 units × Rs. 8)	<u>19,20,000</u>	
Total production costs	99,60,000	
Less: Closing stock		
(30,000 units × 99,60,000) / 2,40,000	<u>12,45,000</u>	
	87,15,000	
Add: Opening stock 15,000 units × Rs. 41*	<u>6,15,000</u>	
Production cost of goods sold		93,30,000
C. Selling and Administration Costs:		
Variable costs: 2,25,000 units × Rs. 9	20,25,000	
Fixed Costs	<u>7,56,000</u>	<u>27,81,000</u>
D. Less: Total cost of goods sold (B + C)		<u>1,21,11,000</u>
		13,89,000
Less: Under absorption of factory fixed overheads		
(2,40,000 – 2,70,000 units) × Rs. 8		<u>2,40,000</u>
Profit		<u>11,49,000</u>
*Cost of opening stock (per unit) = Variable Factory cost + Fixed overhead recovery rate		
= Rs. 33 per unit + Rs. 8 per unit		
= Rs. 41 per unit.		

Profitability based on Marginal Costing Method:

	Rs.	Rs.
A Sales (2,25,000 units @ Rs. 60)		<u>1,35,00,000</u>
Production variable costs:		
Variable cost (2,40,000 units × Rs. 33)	79,20,000	
Increase in cost	<u>1,20,000</u>	
Total	80,40,000	

Less: Closing stock:	
(30,000 × 80,40,000) / 2,40,000	<u>10,05,000</u>
	70,35,000
Add: Opening Stock (15,000 units × Rs. 33)	<u>4,95,000</u>
B Production variable cost of goods sold	75,30,000
C Variable Selling & Administrative Expenses (2,25,000 × Rs. 9)	20,25,000
D Total variable costs (B + C)	<u>95,55,000</u>
E Contribution (A – D)	39,45,000
F Less: Fixed overheads: Factory	21,60,000
Selling & Administration	<u>7,56,000</u>
	<u>29,16,000</u>
G Profit (E – F)	<u>10,29,000</u>

Question 2

- (a) Discuss the benefits accruing from the implementation of a Total Quality Management programme in an organization.
- (b) Explain the concept of relevancy of cost by citing three examples each of relevant costs and non-relevant costs.
- (c) A manufacturing company has furnished the following financial data relating to the actual output of 9,600 units produced in the last quarter:

		Rs.
Sales		4,45,500
Costs:		
Direct Materials	59,400	
Direct Wages	89,400	
Variable Overheads	1,45,500	
Fixed Overheads	<u>78,000</u>	<u>3,72,300</u>
Profit		<u>73,200</u>

The standard wage rate is Rs. 4.50 per hour and the standard variable overhead rate is Rs. 7.50 per hour. The company uses a JIT system and the budgeted production and sales quantity is 10,000 units.

The following are the variances from standard costs recorded during the last quarter:

		Rs.
Direct materials	Price V	600 A
	Usage V	1,200 A
Direct Wages	Rate V	1,500 F
	Efficiency V	4,500 A
Variable Overheads	Expense V	6,000 F
	Efficiency V	7,500 A
Fixed Overheads	Expense V	3,000 A
Sales	Price V	13,500 F

You are required to:

- (i) Prepare the Original budget and Standard cost sheet per unit of output;
- (ii) Produce a statement reconciling the budgeted profit with actual profit.

(4 + 4 + 11 = 19 Marks)

Answer

- (a) The benefits accruing from the implementation of a Total Quality Management programme in an organisation are:
 - (i) There will be increased awareness of quality culture in the organization.
 - (ii) It will lead to commitment to continuous improvement.
 - (iii) It will focus on customer satisfaction.
 - (iv) A greater emphasis on team work will be achieved.
- (b) Relevant costs are those costs which are pertinent to a decision. In other words, these are the costs which are influenced by a decision. Those costs which are not affected by the decision are not relevant costs.

Examples of relevant costs are:

- (1) All variable costs are relevant costs.
- (2) Fixed Costs which vary with the decision are relevant costs.
- (3) Incremental costs are relevant costs.

Examples of non-relevant costs:

- (1) All fixed costs are generally non-relevant.
- (2) Variable costs which do not vary with the decision are not relevant costs.
- (3) Book value of the asset is not relevant.

SQ	AQ	SP	SQ × SP	AQ × SP	AP	AQ × AP
			└──────────┘		└──────────────────────────┘	
			Usage variance		Price variance	
			1200 A		600 A	
						59,400

$$AQ \times SP = 58,800^1$$

$$SQ \times SP = 57,600^2$$

Standard cost of materials for actual output of 9,600 units = Rs. 57,600.

Hence, standard cost per unit is $57,600 / 9,600 = \text{Rs. } 6.$

SH	AH	SR	SH × SR	AH × SR	AR	AH × AR
			└──────────┘		└──────────────────────────┘	
					89,400	
			Efficiency variance		Rate variance	
			4500 A		1500 F	

$$AH \times SR = 90,900^3$$

$$SH \times SR = 86,400^4$$

Standard wage cost per unit is $86,400 / 9,600 = \text{Rs. } 9.$

Standard wage rate is Rs. 4.50.

Standard time per unit is $9/4.5 = 2$ hours.

Variable Overheads:

Standard rate is Rs. 7.50 per hour

Standard cost per unit is 2 hours $\times$ Rs. 7.50 = Rs. 15.

Fixed Overheads:

Actual units	9,600
Standard time / unit 2 hours	
Standard hours produced	$9,600 \times 2 = 19,200$ hours
Actual overheads	78,000
Expense variance	3,000 A
Budgeted overheads	75,000

Cost variances:

		F	A	
Materials:	Price		600	
	Usage		1,200	
Direct Labour:	Rate	1,500		
	Efficiency		4,500	
Variable Overhead:	Efficiency		7,500	
	Expense	6,000		
Fixed Overhead:	Volume		3,000	
	Expense	<u> </u>	<u>3,000</u>	
Total variances		<u>7,500</u>	<u>19,800</u>	12,300 A
Actual profit				73,200

Working Notes:

- (1) Price Variance = $[SP - AP] AQ$
 $600 (A) = [SP \times AQ - 59,400]$
 $SP \times AQ = 58,800.$
- (2) Usage Variance = $[SQ \times SP] - [AQ \times SP]$
 $1200 (A) = SQ \times SP - 58,800$
 $SQ \times SP = 57,600.$
- (3) Rate Variance = $[SR - AR] AH$
 $1500 (F) = SR \times AH - 89,400$
 $SR \times AH = 90,900.$
- (4) Efficiency Variance = $[SH - AH] \times SR$
 $4500 (A) = SH \times SR - 90,900$
 $SH \times SR = 86,400.$
- (5) Price Variance = $(AP - SP) \times AQ$
 $13500 (F) = SP \times AQ - 4,45,500$
 $SP \times AQ = 4,59,000.$

Question 3

- (a) Describe the four types of bench marking of critical success factors.
- (b) Explain, how the implementation of JIT approach to manufacturing can be a major source of competitive advantage.
- (c) A project consists of seven activities and the time estimates of the activities are furnished as under:

Activity	Optimistic Days	Most likely Days	Pessimistic Days
1–2	4	10	16
1–3	3	6	9
1–4	4	7	16
2–5	5	5	5
3–5	8	11	32
4–6	4	10	16
5–6	2	5	8

Required:

- (i) Draw the network diagram.
- (ii) Identify the critical path and its duration.
- (iii) What is the probability that the project will be completed in 5 days earlier than the critical path duration?
- (iv) What project duration will provide 95% confidence level of completion ($Z_{0.95} = 1.65$) ?

Given

Z	1.00	1.09	1.18	1.25	1.33
Probability	0.1587	0.1379	0.1190	0.1056	0.0918

(4 + 4 + 11 = 19 Marks)

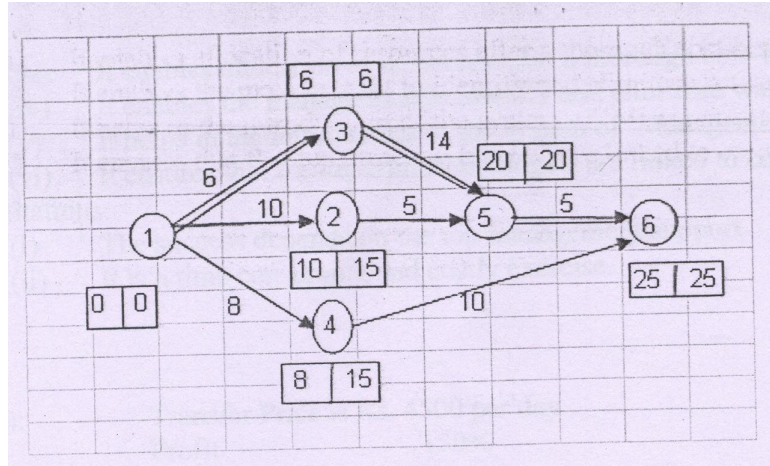
Answer

- (a) The Benchmarking is of following types:
- (i) Competitive benchmarking: It involves the comparison of competitors products, processes and business results with own.
- (ii) Strategic benchmarking: It is similar to the process benchmarking in nature but differs in its scope and depth.

- (iii) Global benchmarking: It is a benchmarking through which distinction in international culture, business processes and trade practices across companies are bridged and their ramification for business process improvement are understood and utilized.
 - (iv) Process benchmarking: It involves the comparison of an organisation critical business processes and operations against best practice organization that performs similar work or deliver similar services.
 - (v) Functional Benchmarking or Generic Benchmarking: This type of benchmarking is used when organisations look to benchmark with partners drawn from different business sectors or areas of activity to find ways of improving similar functions or work processes.
 - (vi) Internal Benchmarking: It involves seeking partners from within the same organization, for example, from business units located in different areas.
 - (vii) External Benchmarking: It involves seeking help of outside organisations that are known to be best in class. External benchmarking provides opportunities of learning from those who are at the leading edge, although it must be remembered that not every best practice solution can be transferred to others.
- (b) JIT provides competitive advantage in the following ways:
- (i) Stocks of raw materials and finished goods are eliminated, stock holding costs are avoided.
 - (ii) JIT aims at elimination of non-value added activities and elimination of cost in this direction will improve competitive advantage.
 - (iii) It affords flexibility to customer requirements where the company can manufacture customized products and the competitive advantage is thereby improved.
 - (iv) It focuses the direction of performance based production of high quality product.
 - (v) It minimize waiting times and transportation costs.
- (c) Calculation of expected time and variance of each activity:

Activity	Optimistic Days	Most likely Days	Pessimistic Days	Expected Duration	Variance
1–2	4	10	16	10	4
1–3	3	6	9	6	1
1–4	4	7	16	8	4
2–5	5	5	5	5	0
3–5	8	11	32	14	16
4–6	4	10	16	10	4
5–6	2	5	8	5	1

The network diagram is as under:



Critical Path:	1–3	3–5	5–6
Duration (days)	6	14	5 = 25 days
Standard deviation:	1 + 16 + 1 = 18		
	$\sqrt{18} = 4.24$		

Probability that the project will be completed five days earlier:

$$Z = \frac{20 - 25}{4.24} = -1.18.$$

According to probability values given in the question probability is 11.9%

To obtain 95% confidence level:

$$1.65 = \frac{X - 25}{4.24}$$

$$X - 25 = 6.996$$

$$X = 32 \text{ days}$$

Question 4

- State the methods in which initial feasible solution can be arrived at in a transportation problem.
- State the advantages and limitations of Zero Based Budgeting.
- A large business consultancy firm is organized in to several divisions. One of the divisions is the Information Technology (IT) division which provides consultancy services

to its clients as well as to the other divisions of the firm. The consultants in the IT divisions always work in a team of three professional consultants on each day of consulting assignment. The external clients are charged a fee at the rate of Rs. 4,500 for each consulting day. The fee represents the cost plus 150% profit mark up. The break up of cost involved in the consultancy fee is estimated at 80% as being variable and the balance is fixed.

The textiles division of the consultancy firm which has undertaken a big assignment requires the services of two teams of IT consultants to work five days in a week for a period of 48 weeks. While the director of the textiles division intends to negotiate the transfer price for the consultancy work, the director of IT division proposes to charge the textiles division at Rs. 4,500 per consulting day.

In respect of the consulting work of the textiles division, IT division will be able to reduce the variable costs by Rs. 200 per consulting day. This is possible in all cases of internal consultations because of the use of specialized equipment.

You are required to explain the implications and set transfer prices per consulting day at which the IT division can provide consultancy services to the textiles division such that the profit of the business consultancy firm as a whole is maximized in each of the following scenarios:

- (i) Every team of the IT division is fully engaged during the 48 week period in providing consultancy services to external clients and that the IT division has no spare capacity of consultancy teams to take up the textiles division assignment.
- (ii) IT division will be able to spare only one team of consultants to provide services to the textiles division during the 48 week period and all other teams are fully engaged in providing services to external clients.
- (iii) A new external client has come forward to pay IT division a total fee of Rs. 15,84,000 for engaging the services of two teams of consultants during the aforesaid period of 48 weeks. (3 + 5 + 11 = 19 Marks)

Answer

- (a) The methods by which initial feasible solution can be arrived at in a transportation model are as under:
 - (i) North West Corner Method.
 - (ii) Least Cost Method
 - (iii) Vogel's Approximation Method (VAM)
- (b) Advantages of zero based budgeting:
 - (i) It provides a systematic approach to the evaluation of different activities for ranking them for resource allocation.

- (ii) It ensures that the activities undertaken for achievement of the company's objectives are performed in the best possible way.
- (iii) It enables allocation of resources after a thorough cost-benefit analysis.
- (iv) It enables the management to identify and eliminate wasteful expenditure.
- (v) It helps in the introduction of the system of 'Management by Objectives'.
- (vi) It ensures that the departmental budgets are linked to corporate objectives.

Limitations:

- (i) The success of zero based budgeting depends on the top management support.
 - (ii) It is a time consuming and costly exercise.
- (c) Transfer Price is Rs. 4,500 for each consulting day.

Profit mark-up = 150%

Let cost = x

$$\text{Profit} = x \times \frac{150}{100}$$

$$= 1.5x$$

Cost + profit = Transfer price

$$\Rightarrow x + 1.5x = 4,500$$

$$\Rightarrow 2.5x = 4,500$$

$$\Rightarrow x = \frac{4,500}{2.5} = 1,800$$

$$\therefore \text{Cost} = \text{Rs. } 1,800$$

$$\begin{aligned} \text{and profit} &= 1.5x = 1.5 \times 1,800 \\ &= \text{Rs. } 2,700 \end{aligned}$$

$$\begin{aligned} \text{Variable cost (80\%)} &= \text{Rs. } 1,800 \times 80\% \\ &= \text{Rs. } 1,440 \end{aligned}$$

$$\begin{aligned} \text{Fixed cost (20\%)} &= \text{Rs. } 1,800 \times 20\% \\ &= \text{Rs. } 360. \end{aligned}$$

Scenario (i):

Every consultancy team is fully engaged. There is no idle time or spare capacity.

Hence, transfer price = Marginal cost plus opportunity cost

$$\text{Marginal cost} = \text{Rs. } 1,440$$

$$\text{Saving for internal work} = \text{Rs. } 200$$

$$\text{Net Marginal Cost} = \text{Rs. } 1,240$$

Opportunity cost is the lost contribution.

Lost contribution = Contribution from external client

= Fee charged from external client – Variable cost

= Rs. (4,500 – 1,440)

= Rs. 3,060.

∴ Transfer price = Rs. 1,240 + 3,060

= Rs. 4,300 per consulting day per team.

Scenario (ii):

One team is idle. Idle time has no opportunity cost. Variable cost for internal work is Rs. 1,240 per consulting day. Second team is busy. Hence opportunity cost is relevant in case of second team. Hence charge of second team is Rs. 4,300 per consulting day per team.

Average of charge of two teams = Rs. (1,240 + 4,300) / 2

= Rs. 2,770 per consulting day per team.

Scenario (iii):

New client offers a fee of Rs. 15,84,000

Duration: 5 days of 48 weeks × 2 teams = 480 days

Fee per day 15,84,000 / 480 = Rs. 3,300

Variable cost = Rs. 1,440

Contribution Rs. (3,300 – 1,440) = Rs. 1,860

Fee for consulting day for internal work:

Variable cost = Rs. 1,240

Contribution lost = Rs. 1,860

Fee to be charged = Rs. 3,100 per consulting day per team.

Question 5

- State the characteristic features of a database created for operational control and decision making.
- Discuss, how target costing may assist a company in controlling costs and pricing of products.
- The costs and selling prices per unit of two products manufacturing by a company are as under:

Product	A (Rs.)	B (Rs.)
Selling Price	500	450
Variable costs:		

Direct Materials @ Rs. 25 per kg.	100	100
Direct Labour @ Rs. 20 per hour	80	40
Painting @ Rs. 30 per hour	30	60
Variable overheads	190	175
Fixed costs @ Rs. 17.50/D.L.Hr.	70	35
Total costs	470	410
Profit	30	40

In any month the maximum availability of inputs is limited to the following:

Direct Materials	480 kg.
Direct Labour hours	400 hours
Painting hours	200 hours

Required:

- (i) Formulate a linear programme to determine the production plan which maximizes the profits by using graphical approach.
- (ii) State the optimal product mix and the monthly profit derived from your solution in (i) above.
- (iii) If the company can sell the painting time at Rs. 40 per hour as a separate service, show what modification will be required in the formulation of the linear programming problem. You are required to re-formulate the problem but not to solve.

(4 + 4 + 11 = 19 Marks)

Answer

- (a) The characteristic features of a data-base created for operational control and decision making are as under:
 - (i) There should be a file structure that facilitates the association of one internal record with other internal records.
 - (ii) There should be cross functional integration of files.
 - (iii) Independence of program / data file for ease of updating and maintenance of data base.
 - (iv) There must be common standards throughout with respect to data definitions, record formats and other data descriptions.
 - (v) A data dictionary should be available.
- (b) Target costing may assist control of costs and pricing of product as under:
 - (i) Target costing considers the price that ought to be charged by a company to achieve a given market share.

- (ii) Target costing should take life cycle costs in to consideration.
- (iii) If there is a gap between the target cost and expected cost, ways and means of reducing or eliminating it can be explored.
- (iv) The target cost may be used for controlling costs by comparison.

(c) Contribution analysis:

Products	A	B
	(Rs.)	(Rs.)
Selling price (A)	<u>500</u>	<u>450</u>
Variable costs:		
Direct Materials	100	100
Direct Labour	80	40
Painting	30	60
Variable Overheads	<u>190</u>	<u>175</u>
Total variable costs (B)	<u>400</u>	<u>375</u>
Contribution (A – B)	<u>100</u>	<u>75</u>
Direct Material per unit	100/25 = 4 kg.	100/25 = 4 kg.
Direct Labour hour per unit	80/20 = 4 hours	40/20 = 2 hours
Painting hour per unit	30/30 = 1 hour	60/30 = 2 hours

Let A be the units to be produced of product A and B be the units to be produced of product B.

LP Problem formulation:

Z Max 100A + 75B Maximisation of contribution

Subject to:

$4A + 4B \leq 480$	Raw material constraint
$4A + 2B \leq 400$	Direct Labour hour constraint
$A + 2B \leq 200$	Painting hour constraint
$A, B \geq 0$	Non negativity constraint

Raw Material Constraint : Put B = 0, A = 120

Put A = 0, B = 120

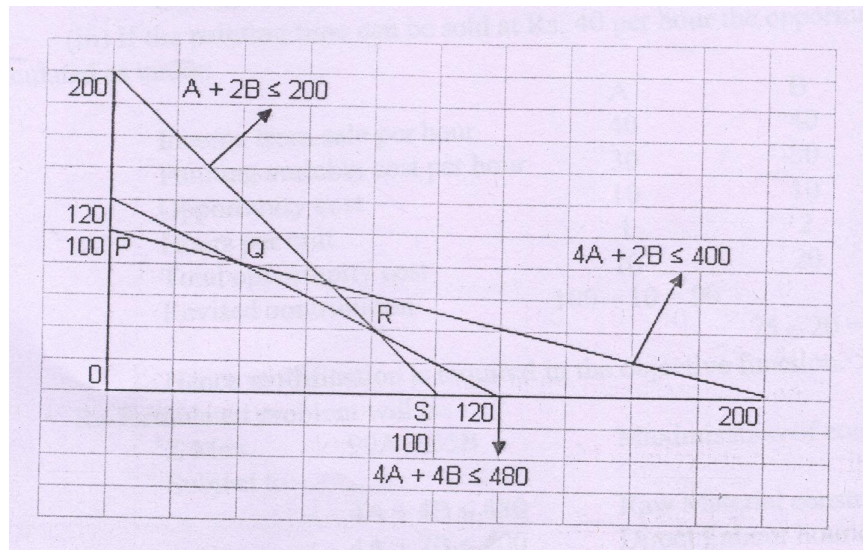
Direct Labour Constraint : Put B = 0, A = 100

Put A = 0, B = 200

Painting Constraint : Put $B = 0$, $A = 200$

Put $A = 0$, $B = 100$

The graphical representation will be as under:



Q Intersects $4A + 2B = 400$ (1)

and $4A + 4B = 480$ (2)

Subtracting (2) from (1), we get $-2B = -80$

$$\Rightarrow B = 80/2 = 40$$

Putting value of B in (1), we get $4A + 2 \times 40 = 400$

$$\Rightarrow A = \frac{400 - 80}{4} = 80$$

R Intersects $4A + 4B = 480$ (3)

and $A + 2B = 200$ (4)

Multiplying (4) by (2) and then subtracting from (3), we get

$$2A = 80$$

$$\Rightarrow A = 40$$

Putting the value of A in (4), we get $2B = 200 - 40$

$$\Rightarrow B = 80.$$

Evaluation of corner points:

Point	Products		Contribution		Total Contribution
	A	B	A (Rs.)	B (Rs.)	Rs.
			100 per unit	75 per unit	
P	0	100	0	7,500	7,500
Q	80	40	8,000	3,000	11,000
R	40	80	4,000	6,000	10,000
S	100	0	10,000	0	10,000

Optimal product mix is Q

Product	Units	Contribution
		Rs.
A	80	8,000
B	40	3,000
Total contribution		11,000
Less: Fixed costs 400 D.L. Hrs. × Rs. 17.50		7,000
Optimal Profit		4,000

- (iii) If the painting time can be sold at Rs. 40 per hour the opportunity cost is calculated as under:

	A	B
	(Rs.)	(Rs.)
Income from sale per hour	40	40
Painting variable cost per hour	30	30
Opportunity cost	10	10
Painting hours per unit	1	2
Opportunity cost	10	20
Revised contribution	100 – 10 = 90	75 – 20 = 55

Hence, modification is required in the objective function.

Re-formulated problem will be:

Z Max.	$90A + 55B$	Maximisation of contribution
Subject to:		
	$4A + 4B \leq 480$	Raw Material constraint
	$4A + 2B \leq 400$	Direct Labour hour constraint
	$A + 2B \leq 200$	Painting hour constraint
	$A, B \geq 0$	Non-negativity constraint

Question 6

- (a) Enumerate the uses of Pareto Analysis.
- (b) A single counter ticket booking centre employs one booking clerk. A passenger on arrival immediately goes to the booking counter for being served if the counter is free. If, on the other hand, the counter is engaged, the passenger will have to wait. The passengers are served on first come first served basis. The time of arrival and the time of service varies from one minute to six minutes. The distribution of arrival and service time is as under:

Arrival / Service Time (Minutes)	Arrival (Probability)	Service (Probability)
1	0.05	0.10
2	0.20	0.20
3	0.35	0.40
4	0.25	0.20
5	0.10	0.10
6	0.05	—

Required:

- (i) Simulate the arrival and service of 10 passengers starting from 9 A.M. by using the following random numbers in pairs respectively for arrival and service. Random numbers 60 09 16 12 08 18 36 65 38 25 07 11 08 79 59 61 53 77 03 10.
- (ii) Determine the total duration of
- (1) Idle time of booking clerk and
 - (2) Waiting time of passengers.
- (c) A city health centre provides health and other related services to the citizens who are covered under insurance plan. The health centre receives a payment from the insurance company each time any patient attends the centre for consultation as under:

Consultations involving	Payment from Insurance company
	Rs.
No treatment	60
Minor treatment	250
Major treatment	500

In addition, the adult patients will have to make a co-payment which is equivalent to the amount of payment for the respective category of treatment made by the insurance company. However, children and senior citizens are not required to make any such co-payment.

The health centre will remain open for 6 days in a week for 52 weeks in a year. Each physician treated 20 patients per day although the maximum number of patients that could have been treated by a physician on any working day is 24 patients.

The health centre received a fixed income of Rs. 2,25,280 per annum for promotion of health products from the manufacturers.

The annual expenditure of the health centre is estimated as under:

Materials and consumable (100% variable)	Rs. 22,32,000
Staff salaries per annum per employee (fixed):	
Physician	Rs. 4,50,000
Assistants	Rs. 1,50,000
Administrative staff	Rs. 90,000
Establishment and other operating costs (fixed)	Rs. 16,00,000

The non-financial information is as under:

(i) Staff:

Number of physicians employed	6
Assistants	7
Administrative staff	2

(ii) Patient Mix:

Adults	50%
Children	40%
Senior Citizens	10%

(iii) Mix of patient appointments (%)

Consultation requiring no treatment	70%
Minor treatment	20%
Major treatment	10%

Required:

- (i) Calculate the Net income of the city health centre for the next year;
- (ii) Determine the percentage of maximum capacity required to be utilized next year in order to break even. (3 + 8 + 8 = 19 Marks)

Answer

(a) Pareto analysis is useful to:

- (i) Prioritize problems, goals and objectives.
- (ii) Identify the root causes.
- (iii) Select and define the key quality improvement programs, key employee relations improvement programs etc.
- (iv) Verify the operating procedures and manufacturing processes.
- (v) Allocate physical, financial and human resources effectively.
- (vi) Maximise research and product development time.

(b) Random allocation tables are as under:

Time (Mts)	Arrival (Probability)	Arrivals Cumulative Probability	Random No. allocated	Time (Mts)	Service (Probability)	Service Cumulative (Probability)	Random No. allocated
1	0.05	0.05	00-04	1	0.10	0.10	00-09
2	0.20	0.25	05-24	2	0.20	0.30	10-29
3	0.35	0.60	25-59	3	0.40	0.70	30-69
4	0.25	0.85	60-84	4	0.20	0.90	70-89
5	0.10	0.95	85-94	5	0.10	1.00	90-99
6	0.05	1.00	95-99				

Simulation of ten trails:

R. No.	Arrival Mts.	Time	Start	R. No.	Time Mts.	Finish Time	Waiting Time	
							Clerk	Passanger
60	4	9.04	9.04	09	1	9.05	4	
16	2	9.06	9.06	12	2	9.08	1	
08	2	9.08	9.08	18	2	9.10	—	
36	3	9.11	9.11	65	3	9.14	1	
38	3	9.14	9.14	25	2	9.16	—	
07	2	9.16	9.16	11	2	9.18	—	
08	2	9.18	9.18	79	4	9.22	—	
59	3	9.21	9.22	61	3	9.25	—	1
53	3	9.24	9.25	77	4	9.29		1
03	1	9.25	9.29	10	2	9.31	—	<u>4</u>
Total							<u>6</u>	<u>6</u>

In half an hour trial, the clerk was idle for 6 minutes and the passengers had to wait for 6 minutes.

(c) (1) Total number of patients attended

Number of patients attended per day by a physician: 20

Number of physicians employed 6

Number of days in week 6

Number of weeks in a year 52

Total number of patients attended = $20 \times 6 \times 6 \times 52 = 37,440$.

(2) Patient Mix:

Adults (50%) $37,440 \times 50/100 = 18,720$

Children (40%) $37,440 \times 40/100 = 14,976$

Senior Citizens (10%) $37,440 \times 10/100 = \underline{3,744}$

37,440

(3) Patient Appointments:

No treatment required (70%) $37,440 \times 70/100 = 26,208$

Minor treatment (20%) $37,440 \times 20/100 = 7,488$

Major treatment (10%) $37,440 \times 10/100 = \underline{3,744}$

37,440

(4) Income from Insurance Companies:

	Number of patients	Rs.	Rs.
	(A)	(B)	(A × B)
No treatment patients	26,208	60	15,72,480
Minor treatment patients	7,488	250	18,72,000
Major treatment patients	3,744	500	<u>18,72,000</u>
Total			<u>53,16,480</u>

(5) Co-payment from adult patients:

	Number of patients	Payment (Rs.)	Total payment (Rs.)
Total number of adult patients	18,720		
No treatment patients (70%)	13,104	60	7,86,240
Minor treatment (20%)	3,744	250	9,36,000
Major treatment (10%)	1,872	500	<u>9,36,000</u>
Total			<u>26,58,240</u>

(6) Net income:

	Rs.	Rs.
Payment from Insurance companies	53,16,480	
Co-payment from adult patients	<u>26,58,240</u>	
Total	79,74,720	
Other Income (fixed)	<u>2,25,280</u>	
Total Income (A)		82,00,000
Less: Expenditure		
Variable expenses:		
Material and consumables	22,32,000	
Fixed expenses:		
Physician's salary (6 × 4,50,000)	27,00,000	
Assistants salary (7 × 1,50,000)	10,50,000	

Administrative staff's salary (2 × 90,000)	1,80,000	
Establishment and other operating costs	16,00,000	<u>55,30,000</u>
Total Expenditure (B)		<u>77,62,000</u>
Net Income (A – B)		<u>4,38,000</u>

(ii) 1. Contribution Analysis:

	(Rs.)
Total Fees from Insurance Companies and adult patients	79,74,720
Less: Variable costs	22,32,000
Contribution	57,42,720
Average contribution per patient	$\frac{57,42,720}{37,440} = 153.38$

2. Break-even patients:

	(Rs.)
Fixed costs	55,30,000
Less: Fixed income	2,25,280
Net Fixed costs	53,04,720
Break-even patients = $\frac{\text{Net fixed costs}}{\text{Contribution per patient}}$	$\frac{53,04,720}{153.38} = 34,585$

3. Percentage of maximum capacity required to be utilized in order to break-even

$$\text{Present utilization} = \frac{20 \text{ patients}}{24 \text{ patients}} = 83.33\% = 37,440$$

$$100\% \text{ patient capacity is } \frac{37,440}{0.8333} = 44,930 \text{ patients}$$

Percentage of maximum capacity required to be utilized in order to break-even

$$= \frac{\text{Break - even patients}}{100\% \text{ patient capacity}} \times 100$$

$$= \frac{34,585}{44,930} \times 100 = 76.98\% \text{ say } 77\%.$$

Assumption: Patient mix and mix of patient appointments will be same in the next year.

PAPER – 6 : MANAGEMENT INFORMATION AND CONTROL SYSTEMS

Question No. 1 is compulsory.

Answer any four questions from remaining six questions.

Question 1

- (a) Discuss various issues that are of primary concern for an auditor involved in Information System Audit.
- (b) Describe the composition and powers of Cyber Regulatory Appellate Tribunal.
- (c) Recently you have received a report from your bank client that money from one account has been unauthorisedly transferred to another account by stealing the login information of a client through Internet. How will you stop the recurrence of such events?

(8 + 4 + 8 = 20 Marks)

Answer

- (a) Auditors involved in reviewing an information system should focus their concerns on the system's control aspects. They must look at the total system environment – not just the computerized segment. This requires their involvement from the time that a transaction is initiated until it is posted to the organization's general ledger. Specifically, auditors must ensure that provisions are made for:
 - An adequate audit trail so that transactions can be traced forward and backward through the system.
 - Controls over the accounting for all data entered into the system and controls to ensure the integrity of those transactions throughout the computerized segment of the system.
 - Handling exceptions and rejections from the computer system.
 - Testing to determine whether the system performs as stated.
 - Control over changes to the computer system to determine whether the proper authorization has been given.
 - Authorization procedures for system overrides.
 - Determining whether organization and government policies and procedures are adhered to in system implementation.
 - Training users in the operation of the system.
 - Developing detailed evaluation criteria, so that it is possible to determine whether the implemented system has met predetermined specifications.
 - Adequate controls between interconnected computer systems are put in place.

- Adequate security procedures to protect the user's data. Backup and recovery procedures for the operation of the system.
 - Technologies provided by different vendors are compatible and controlled.
 - Data bases are adequately designed and controlled to ensure that common definitions of data are used throughout the organization, that redundancy is eliminated or controlled, and that data existing in multiple data bases is updated concurrently.
- (b) The Cyber Regulations Appellate Tribunal shall consist of one person only (called, the presiding officer of the Tribunal) who shall be appointed by notification of the Central Government. The person must be qualified to be a judge of a High court or is or has been a member of the Indian Legal Service in the post in Grade I of that service for at least three years.

Section 58 provides for the procedure and power of the Cyber Appellate Tribunal. The Tribunal shall also have the powers of the civil court under the code of Civil Procedure 1908.

Some of the powers specified are in respect of the following matters:

- (a) Summoning and enforcing the attendance of any person and examining him on oath.
 - (b) Requiring production of documents and other electronic records.
 - (c) Receiving evidence of affidavits
 - (d) Reviewing its decisions
 - (e) Issuing commissions for examination of witness etc.
- (c) Most of the attacks on online banking used today are based on deceiving the user to steal login data and valid PINs. Two well known examples for those attacks are phishing and pharming. Cross-site scripting and key logger/Trojan horses can also be used to steal login information.

Phishing is the criminally fraudulent process of attempting to acquire sensitive information such as user names, passwords and credit card details by masquerading as trust worthy entity in an electronic communication.

Pharming is hackers attack aiming to redirect websites traffic to another, bogus website. Pharming can be conducted either by changing the hosts file on a victims computer or by exploitation of a vulnerability in DNS server software.

Under such circumstances, all the customers must be informed about possible traps that they may fall into if they reveal their login and passwords. Continuous update and awareness should be created by the bank about various methods that are followed by

fraudsters. The company should have constant watch and vigil over such happenings and inform the customers immediately. To be more secure:

- (1) The Company should have a policy which states very clearly that no login information will be sought by the bank either in email, or over phone. This should be communicated to all customers.
- (2) There should be more than just two co-ordinates of login and password to make the transaction more secure. It can ask for additional details which are known only to the customer.
- (3) The company should educate the customers about the use of strong passwords and the benefits of changing the passwords.

Question 2

- (a) What is Payroll accounting? Describe in brief the inputs and master file, output and system flow diagram required for it.
- (b) State main objectives of system development tools. Briefly describe the major categories of documentation tools that are used for system development with any one simple illustrative example for each. (10 + 10 = 20 Marks)

Answer

- (a) A payroll system is intended to basically produce pay slips and pay cheques for the employees every month. Preparing a payroll requires collecting employee work hours through their attendance cards, converting hours to gross earnings and computing deductions and net pay. Other activities to be performed as by products of payroll include accumulating summary data for general ledger reports, printing quarterly and year-end reporting statements and making labour distribution job costing or job performance measurements and reporting them. In addition to accounting activities, a payroll system also maintains record of sick leave, earned accruals and usage, and other details of the employees.

Inputs and Master File:

Master file: The payroll computer application uses a combination of current and year-to-date master computer file having records for the current period as well as for yearly reporting. The master file contains permanent as well as current data.

Information such as employee's rate of pay, accumulated earned leave, change in status code etc. are used as inputs to transform gross salary into net pay. The payroll master file may consist of following field:

Personnel Data:

Record code	Employee number	Employee name	Address	Phone number	Sex	Date of birth	Date started employment
-------------	-----------------	---------------	---------	--------------	-----	---------------	-------------------------

Payroll computation Data:

Job number	Department number	Type of cost code	Basic pay	Exempt status (exempt employees do not get extra pay for overtime)	Overtime rate
------------	-------------------	-------------------	-----------	--	---------------

Leave Data:

Earned leave accumulation rate	Sick leave accumulation rate	Accumulated Earned leave	Accumulated Sick leave	Earned leave used in this year	Sick leave used in this year
--------------------------------	------------------------------	--------------------------	------------------------	--------------------------------	------------------------------

Payment data for the payroll:

Current gross pay	Current dearness allowance	Current housing allowance	Special allowance	Current regular hours	Current overtime hours	Current provident fund	Current insurance premium	Current voluntary deductions	Current net pay	YTD gross pay	YTD income tax	YTD provident fund	YTD Insurance Premium	YTD Voluntary deductions	YTD hours
-------------------	----------------------------	---------------------------	-------------------	-----------------------	------------------------	------------------------	---------------------------	------------------------------	-----------------	---------------	----------------	--------------------	-----------------------	--------------------------	-----------

Transaction File:

Employee number	Regular hours	Overtime hours	Earned leave	Sick leave	Special deductions
-----------------	---------------	----------------	--------------	------------	--------------------

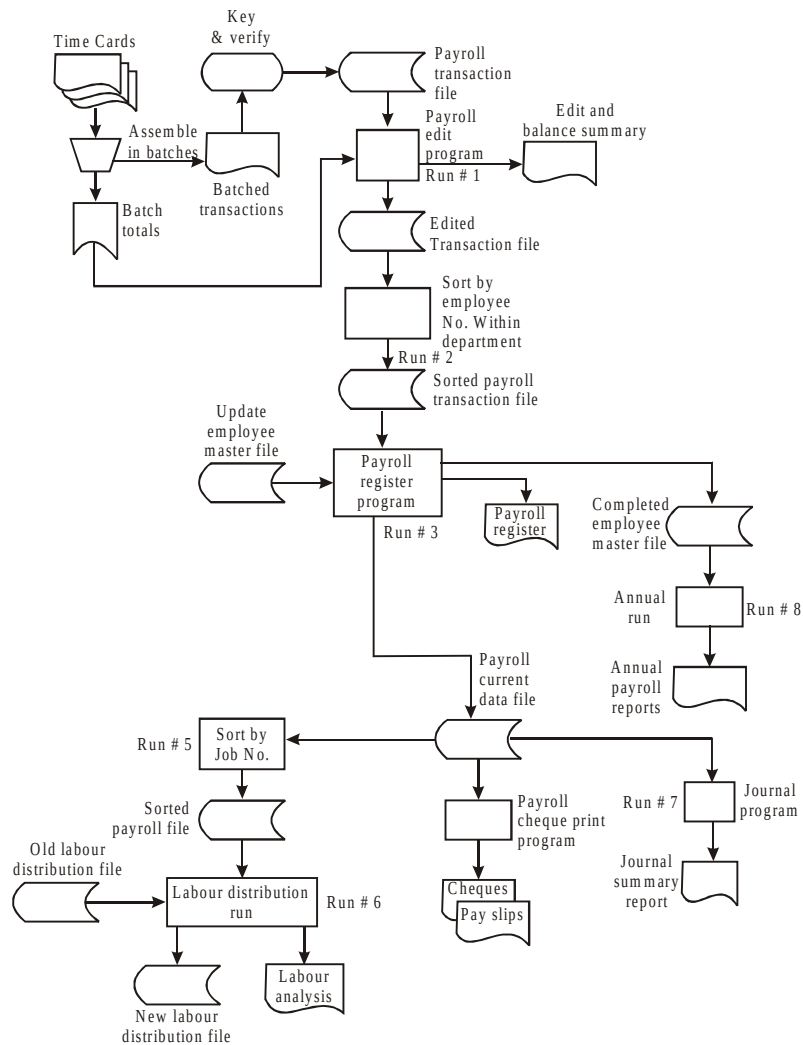
The permanent portion of the master file must be updated before current transactions are entered into the system. The accounting department also obtains data in new employees and recent changes to existing employees for updation of payroll master file. Inputs to the system consist of keyed data for time cards, batch control information and the employee master file updated by the preliminary master file update.

Outputs: The payroll accounting system produces following Outputs:

- Cheques, pay slips of employees
- Labour analysis – Job No. wise and trade wise
- Payroll Budget Report – Amount v/s Description head (i.e. salary, income tax etc.)
- Payroll Journal summary – quarterly, annual basis.

The system flow chart is given below:

System flow diagram



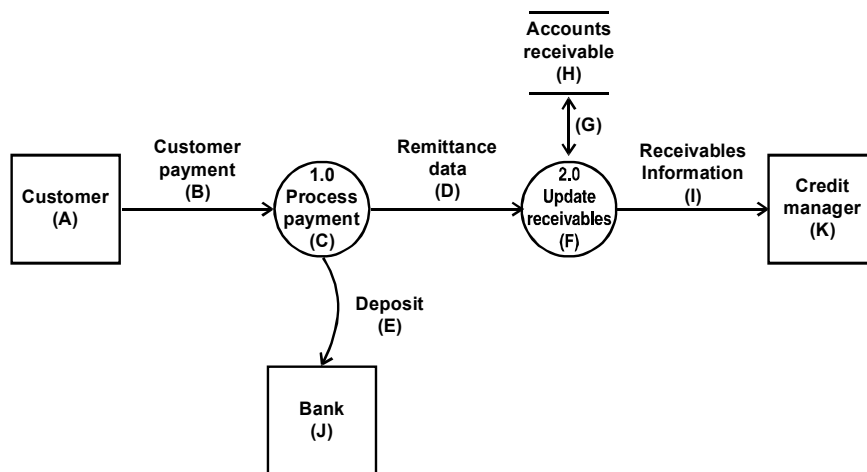
Payroll Accounting

(b) System development tools are used to help end users and systems analysts to improve current information systems and to develop new ones. Their main purposes are

- To conceptualize, clarify, document and communicate the activities and resources involved in the organisation and its information systems.
- To analyze present business operations, management decision making and information processing activities of the organisation.
- To propose and design new or improved information systems to solve business problems or pursue business opportunities that have been identified.

The major tools used for system development can be divided under four categories based on the systems features documentation as discussed below:

1. System Components and Flows: These tools help the system analysts to document the data flow among the major resources and activities of an information system. They show the flow of data as they are processed by the hardware devices and manual activities. A Data Flow Diagram (DFD) uses a few simple symbols to illustrate the flow of data among entities (such as people or organisations etc.), processing activities and data storage elements. A system component matrix provides a matrix framework to document the resources used, the activities performed and the information produced by the information system. A DFD is drawn below:



2. User Interface: A friendly interface between end users and the computer system is a major consideration. Layout forms and screens are used to construct the formats and contents of input/output media and methods. Data flow diagrams analyze the flow of dialogue through an Information system. They document the flows among different display screens generated by alternative end user responses to menus and prompts.

Figure below illustrates a layout screen for the design of a customer order form.

CUSTOMER ORDER FORM				
DATE MM/DD/YY				
ORDER NUMBER	9999			
CUSTOMER NAME	XXXXXXXXXXXXXXXXXXXXXX			
CATALOG NUMBER	AVAILABLE	LOCATION	COST	DELMODE
XXXXXXXXXXXXXX	X	XXXXXXX	999.99	XXXX
XXXXXXXXXXXXXX	X	XXXXXXX	999.99	XXXX

3. Data attributes and relationships: The data resources in information system are defined, catalogued and designed by this category of tools. A data – dictionary catalogs the description of attributes (characteristics) of all data elements and their relationships to each other as well as to external systems. Entity-relationship diagrams are used to document the number and type of relationship among entities in a system. File layout forms document type, size and names of the data elements in a system. Grid charts help in identifying the use of each type of data element in input/output or storage media of a system. An example of a data dictionary is drawn below:

Name of data field	File in which stored	Source document	Size in bytes	Type
Inventory quantity on hand	Inventory master file	Form number ABC 123	4	Numeric

← Data dictionary

4. Detailed system process: These tools are used to help the programmer to develop detailed procedures and processes required in the design of a computer program. Decision trees and decision tables are drawn in a network or tabular form to document the complex conditional logic involved to select from alternatives. Structure charts document the purpose, structure and hierarchical relationships of the modules in a program. A decision table is represented below:

		Granting Credit Facility	R1	R2	R3	
Part 1	C1	Credit limit Okay	Y	N	N	Part 3
	C2	Pay experience Favourable	-	Y	N	
Part 2	A1	Allow Credit Facility	X	X		
	A2	Reject Order			X	Part 4

Question 3

- (a) What is Financial decision making? Which Financial decisions are made with the help of Financial information system?
- (b) Discuss the functions and facilities provided by Treasury Cash Management module of an ERP package.
- (c) Discuss the main provisions provided in Information Technology Act, 2000 to facilitate E-governance. (10 + 5 + 5 = 20 Marks)

Answer

- (a) Financial Decision Making: It deals with procurement of funds and their effective utilization in the business. There are two important aspects of financial decision making – first relates to decisions regarding procurement of funds and second to decisions regarding effective utilization of funds in the business.

Procurement of funds is a complex problem since there are number of sources from where the funds may be raised for long-term such as equity, debentures, bonds etc. or on short-term such as banks, suppliers, credit etc. These sources have different characteristics in terms of risk, control and cost.

Effective utilization of funds implies deployment of funds in several long term and short term assets, properly and profitably. The funds are procured at a certain cost with a certain level of risk. If they are not utilized in a manner as to generate higher income over their cost, they will cause losses to business. Thus, each decision should be properly analysed while investing in fixed assets.

Financial Decisions by Financial Information Systems are as under:

- (i) Estimation of requirements of funds: A careful estimation of funds and the timing or period of their need is to be made. This can be done by forecasting all physical activities of the firm and translating them into monetary units.
- (ii) Capital Structure Decision: Decisions are to be taken to select an optimum mix of different sources of capital structure, and various options available for procuring funds. Ratio between debt and equity, long term and short term funds etc needs to be decided such that the company is able to procure funds at minimum costs.
- (iii) Capital Budgeting Decisions: Funds procured from different sources are required to be invested in different assets. Capital budgeting helps to determine feasibility of investment in long term assets as per financial objectives.
- (iv) Profit Planning: Financial decisions concerning profits and dividends are to be taken such that adequate surpluses exist in future for growth and distribution of dividends.
- (v) Tax Management: Tax planning is aimed at reducing cash outflow by way of taxes so that the same may be effectively utilized for the benefit of business. Tax planning

must make full advantage of exemptions, deductions, concessions, rebates, allowances and other reliefs.

- (vi) Working Capital Management: It deals with investment of long term funds into current assets. Effective financing of current assets can be: achieved for day-to-day running of the organisation by working capital management.
 - (vii) Current Asset Management: Policy decisions are taken regarding various items of current assets. Credit policy determines the amount of sundry debtors at any point of time. Inventory policy is to be determined jointly between finance and production department.
- (b) Treasury Cash Management: Treasury Cash Management component allows the analysis of financial transactions for a given period. It identifies and records future developments for the purpose of financial budgeting.

In Treasury Cash Management, the company's payment transactions are grouped into cash holdings, cash inflows and cash outflows. Cash Management module provides:

- (i) Information on the sources and uses of funds to secure liquidity to meet payment obligations when they become due.
 - (ii) Monitors and controls incoming and outgoing payments flows.
 - (iii) Supplies data required for managing short term market investment and borrowings.
 - (iv) Enables to know current cash position, short term cash management and medium and long term financial budgeting.
 - (v) Enables analysis of liquidity.
 - (vi) Helps in cash management decisions.
 - (vii) In bank accounting, it helps in electronic banking and control functions for managing and monitoring of bank accounts.
 - (viii) The liquidity forecast function integrates anticipated payment flows from financial accounting, purchasing and sales to create liquidity outlook from medium to long term.
 - (ix) Covers foreign currency holdings and foreign currency items.
- (c) E-Governance: Sections 6, 7 and 8 of chapter III are the main sections for provisions related to E-governance provided in IT Act, 2000 to facilitate e-governance.

Section 6 lays down the foundation of electronic Governance. It provides that the filling of any form, application or other documents; creation, retention or preservation of records, issue or grant of any license or permit; receipt or payment in Government offices and its agencies may be done by means of electronic form. The appropriate Government has the power to prescribe the manner and format of the electronic records and the method of payment of fee in that connection.

Section 7 provides that the documents, records or information which has to be retained for any specified period shall be deemed to have been retained if the same is retained in the electronic form under the following conditions:

- (i) The information therein remains accessible so as to be usable subsequently.
- (ii) The electronic record is retained in its original format or in a format which accurately represents the information contained.
- (iii) The details which will facilitate the identification of the origin, destinations, dates and time of despatch or receipt of such electronic record to be dispatched or received.

This section does not apply to any information which is automatically generated solely for the purpose of enabling an electronic record to be dispatched or received. Moreover this section does not apply to any law that expressly provides for the retention of documents, records or information in the form of electronic records.

Section 8 provides for the publication of rules, regulations, order, bye-law and notifications in the official Gazette in an electronic form. It provides that where any law requires the publication of any rule regulation, order, bye law, notification or any other matter in the Official Gazette, both in the printed as well as in the electronic form, the date of publication shall be the date of publication of the Official Gazette which was first published in any form.

Question 4

- (a) Discuss in brief salient features of consideration while selecting a computer system. Also suggest contents in a point scoring table for evaluation of a ready to use software.
- (b) What control techniques can be utilized for increasing security in a client-server model?
- (c) What are the characteristics of good coding scheme for data input?

(10 + 5 + 5 = 20 Marks)

Answer

- (a) The following points may be considered while selecting a computer system:
 - Today all computer systems available in the market have good hardware, competent software and roughly similar facilities. Due to rapid advances in computer technology, more recent computers are better in performance and the lower in cost. Hence as far as possible, the latest possible technology should be acquired in general.
 - Commercial data processing involves mainly reading-in-data, printing data, storing and retrieving information from media. For commercial work computer performance is affected by the speed and capabilities of input/output and storage peripherals in contrast to scientific, engineering and operations problems which require good computational facilities, hence the efficiency of a computer system in handling such

problems will depend on the main storage available. A comparison along these lines may be made.

- The software supplied by the manufacturer may make a significant difference if it contains a package of special applicability to the jobs envisaged. The selection of computer can also be made on software considerations. While all manufacturers supply general software packages for documentation and linear programming etc, a few manufacturers also offer packages specially designed for a particular industry such as Accounting applications in banking and insurance. Obviously, a manufacturer who has a package for users special needs will enjoy a significant advantage.
- Modern computers are marketed as series of compatible, increasingly powerful and interchangeable peripherals. After some period, work expands beyond to fit in the existing computer needing higher capacity machine. Also, in case of breakdown, compatibility allows a wider range of machines to be used as back-up. Thus, the choice of a computer really becomes the choice of the model within the series, based on the long-range plan of expansion. But dependence on vendor/server is preferable to reprogramming which can be prohibitively expensive or time consuming. The selection of the computer configuration and a plan for its gradual expansion, as a properly considered model can save a great deal of money. The computer systems must be forward and backward compatible.
- Outside assistance in computer selection can be had from computer manufacturers, independent consultants specializing in computers, or management consulting firms. The distinction between vendor selection and machine selection is essentially a matter of business judgment. Once, however, the vendor is selected, he can be counted upon to provide useful guidance for machine also.

Point scoring Table for 'Ready to use' software:-

Software Evaluation Criteria	Possible points	Vendor A	Vendor B	Vendor C
Does the software's meet the mandatory specifications?	10	7	9	6
Will program modifications, if any, be minimal to meet company needs?	10	8	9	7
Does the software contain adequate controls?	10	9	9	8
Is the performance (speed, accuracy, reliability etc.) adequate?	10	7	9	6
Are other users satisfied with the software?	8	6	7	5
Is the software user-friendly?	10	7	8	6
Can the software be demonstrated and	9	8	8	7

test-driven?				
Does the software have an adequate warranty?	8	6	7	6
Is the software flexible and easily maintained?	8	5	7	6
Is online inquiry of files and records possible?	10	8	9	7
Will the vendor keep the software up to date?	10	8	8	7
Total	123	94	106	85

It may be noted that the data shown above are indicative only.

(b) Client/Server Security:

Client/server technology utilise distributed techniques, thus there is an increased risk of unauthorised access to data and modification. To increase the security; following techniques can be utilised:

- Disabling the floppy disk drives, ports, and use of Diskless workstations to control unauthorized access and thus securing data and applications.
- Unauthorised users can be prevented from overriding login scripts and access by securing automatic boot or start up batch file.
- Monitoring of the client using detective control technique can help network security and aid later investigations.
- Data encryption techniques can be used to protect data from unauthorized access.
- Authentication systems can be provided for a client so that they can enter into system only by entering login name and password.
- Use of smart cards i.e. intelligent hand held devices and encryption techniques can be used to decipher random codes provided by client-server based operating systems. A smart card displays a temporary password based on an algorithm and must be re-entered by the user during the login session for access onto the client – server system.
- Applications controls may be used and users should be limited to access only those functions in the system those are required to perform their duties.

(c) Codes are used to express data/information to reduce input, control errors and to speed up the entire process. A code is a brief number, title or symbol used instead of lengthy or ambiguous description. With code, fewer details are necessary in computer input but it may result in loss of information.

Some of the desired characteristics of good coding schemes are enumerated below:

- (i) **Individuality:** The code must identify each object in a set uniquely and precisely. Use of same code number for several types of objects in a set causes great confusions. Further, the code should be universally used over the entire organization.
- (ii) **Space:** A code number must be much compact than description.
- (iii) **Convenience:** The formats of code numbers should facilitate their use by people i.e. it should be short, simple and consist of digits and / or upper case alphabets. It is better to avoid the use of special symbols like hyphens, oblique, dot etc.
- (iv) **Expandability:** As far as possible future growth in number of objects in a set should be provided for i.e. longer number of digit/number than necessary at present may be adopted as the code length. Related items must use fundamentally similar numbers.
- (v) **Suggestiveness:** The logic of the coding scheme should be readily understandable. Also the letter or number should be suggestive of the item characteristics. But this should not be carried too far in lengthening the code since it would defeat the purpose of brevity.
- (vi) **Permanence:** Changing circumstances should not invalidate the coding scheme or in other words invalidation in the future should not be considered.

Question 5

- (a) What is Executive Information System (EIS)? How does EIS differ from Traditional Information Systems?
- (b) Define and differentiate between 'Scheduled maintenance' and 'Rescue maintenance' along with their respective benefits.
- (c) XYZ company engaged in manufacturing and installing power plant equipments has installed a new MIS and you have been requested to evaluate its effectiveness. On what parameters would you evaluate the MIS system? (5 + 5 + 10 = 20 Marks)

Answer

- (a) An Executive Information System (EIS) is referred to as an executive support system that is designed to meet the special needs of top-level managers. It is a tool that provides direct on-line access to relevant information in a useful and navigable format, which is timely, accurate and actionable about aspects of a business that are of particular interest to the senior manager.

EIS differs from traditional information systems in the following manner:

- (i) These are specifically tailored to meet executive's information needs and particularly easy to use (typically mouse or touch screen driven). EIS require large amounts of storage capacity and processing power both 'within the system and the network.

- (ii) These have ability to access data about specific issues and problems as well as aggregate reports. Also these provide extensive on-line analysis tools including trend analysis and exception reporting.
 - (iii) EIS present information in summary format, with facility to 'drill down' to other levels of information. They have ability to manipulate data to project 'what if' outcomes and have modeling tools to work with internal and external information.
 - (iv) EIS tend to be externally-focused, strategically-based systems using both internal and external data, whereas other computer systems mainly concentrate on internal control aspects of the organization.
- (b) Most information systems need some modifications after development. This need arises from time to time, due to failures to anticipate all requirements during system design and/or due to changed organisational needs. The changing needs impact most information systems and thus regular systems maintenance involves adding new data elements, modifying reports, adding new reports, changing calculations etc.

Such maintenance can be categorised in the following two ways:

- (1) Scheduled Maintenance is undertaken for tasks which can be anticipated and can be planned for in advance. An information system may remain in an operational and maintenance mode for several years. The system should be evaluated periodically to ensure that it is operating properly and is still workable for the organisation.
 - (2) Rescue maintenance refers to previously undetected malfunctions or such sudden changes that were not anticipated but require immediate solution. A system that is properly developed and tested should have few occasions of rescue maintenance. Rescue maintenance is unplanned and generally puts system stand still.
- (c) Evaluation of MIS:

An effective MIS should be capable of meeting the information requirements of its executives in present and future as well. This capability can be maintained by evaluating the MIS and taking appropriate timely action. The evaluation of MIS should take into account the following points:

- (1) Examining whether enough flexibility exists in the system, to cope with any expected or unexpected information requirement in future.
- (2) Ascertaining the views of users and the designers about the capabilities and deficiencies of the system.
- (3) Guiding the appropriate authority about the steps to be taken to maintain effectiveness of MIS.

The following factors should be considered for designing an effective MIS:

- (1) Management Oriented: The development of Management Information system should start from assessment of management needs and overall business objectives. Such system does not only take care of the information

requirements of the top management but it also caters to the information needs of the middle and operating levels of management.

- (2) **Management Directed:** As MIS is oriented towards the information needs of the management; it is essential that management should direct the development efforts of such systems on an on-going basis. Management should devote sufficient time not only at the stage of conceptualization and designing, but also for the regular reviews of its effectiveness. In short, management should play the key role in setting the system specifications as well as subsequent trade-off occurring in system development.
- (3) **Integrated:** All functional and operational information sub-systems should be integrated into one entity. Such Information system has the potential of generating meaningful and comprehensive information to management.
- (4) **Common Data flows:** For such integrated information system, data is captured only once and as close to its original generating source as possible. This eliminates duplication in data collection, documents and procedures. It also simplifies operations and produces an efficient and effective information system. However, the duplication cannot be avoided to some extent in order to ensure effective information system.
- (5) **Meticulous Planning:** It takes 3 to 5 years, sometimes even longer period, to get the MIS system established firmly in an organization. Therefore, there should be meticulous planning in designing and development of MIS system. It should be designed considering the future objectives and information needs of the organization. The system obsolescence should be avoided before it becomes operational.
- (6) **Sub Systems approach:** Although MIS is considered to be a single entity; it is broken into various sub systems so that it can be implemented one at a time by developing the systems in phases. This ensures meaningful and effective implementation of information systems.
- (7) **Common Database:** The common database holds all functional systems together, consolidates and also integrates data of all functional systems. The access to this database is allowed to the users of sub systems on need-to-know and need-to-do basis. It eliminates duplication in data storage, updating and protection as well as optimizes the cost of data storage and management.
- (8) **Computerized:** MIS can also be established using a manual system, but use of computers increases the effectiveness of the system. In fact, it equips the information system to handle variety of applications by catering quickly to their information requirements.

While designing an MIS, it should also be considered that computerization has following effects on management Information Systems:

- (1) High speed of data processing and retrieval.

- (2) Expanded scope of use of Information system.
- (3) Wide scope analysis.
- (4) Increased complexity of system design and operations.
- (5) Integrated functioning of various information sub-systems.
- (6) Enhanced effectiveness of Information Systems.
- (7) Comprehensive Information.

Question 6

- (a) What is 'Disaster Recovery Plan'? Discuss its various components.
- (b) Persian Paints is a small but highly regarded paint manufacturing company. The company has a network in place linking many of its business operations. Though the firm believes that its security is adequate, the recent addition of a Web site has become an open invitation to hackers. Management requested a risk assessment. The risk assessment identified a number of potential exposures. These exposures, their associated probabilities and average losses are summarized in the following table:

Persian Paints Risk Assessment

Exposure	Probability of Occurrence (%)	Annual Average Loss (Rs.)
1. Virus attack	60	75,000
2. Data Loss	12	70,000
3. Embezzlement	3	30,000
4. User Errors	95	25,000
5. Threats from Hackers	95	90,000
6. Improper use by Employees	5	5,000
7. Power Failure	15	3,00,000

Using the above risk assessment data, calculate the expected annual loss for each exposure. Which control points have the greatest vulnerability and Least vulnerability? Prepare a written report that summarises your findings and recommendations.

(10 + 10 = 20 Marks)

Answer

- (a) 'Disaster Recovery' implies contingency measures that organisation adopt at key computing sites to recover from or to prevent momentary bad events or disasters such as fire, flood, earthquake etc. or a violent takeover, willful or accidental destruction of equipments or other acts of such nature.

Disaster Recovery Plan (DRP): With careful planning, the impact of disaster can be absorbed and the organisation can recover. DRP assures a set time after disaster occurrence to minimise losses to the organisation and restore normalcy.

The general components of the plan would be as follows:

- (1) Emergency Plan: It provides for actions to be taken as soon a disaster occurs which are stated below:
 - It identifies the personnel to be notified immediately i.e. fire service, police, management, insurance company etc.
 - It provides guidelines on guides equipment shutdown, termination of power supply, removal of storage files and removable disks if any.
 - It sets out evacuation procedures like sounding the alarm bell, activating fire extinguishers, evacuation of personnel etc.
 - It provides return procedures as soon the primary facility gets ready for operation such as back up files to be brought from the off-site, deleting data from disk drives at third party's site, relocation of proper versions of backup files etc.
- (2) Recovery Plan: This part of DRP sets steps for restoration of full capabilities. A recovery committee is constituted to set priorities for recovery operations to undertake following:
 - (i) An inventory of the hardware, application systems, system software, documentation etc. must be taken.
 - (ii) Criticality of application systems to the organisation and the importance of loss are evaluated. An indication of the efforts and cost involved in restoring the various application systems is made.
 - (iii) An application system hierarchy is decided to accept a degraded mode of operation.
 - (iv) Selection of a disaster recovery site such as a reciprocal agreement with another organisation having compatible hardware and software could be made, considering system availability and data security. Hiring a service bureau or a fully operational backup site could be other alternatives.
 - (v) A formal backup agreement with another company may be done to cover the periodical exchange of information between two sites regarding changes to hardware/ software, the time and duration of system availability, modalities of testing plan etc.
- (3) Backup Plan: Despite recovery procedures, systems are still vulnerable to disasters. A safeguard could also be destroyed be it hardware or software. Thus stand-by hardware, keeping copies of important programs, data files, operating systems and test programs etc. help get back into operation quickly. These backups

must be kept at separate places which are not susceptible to the same hazard as the originals.

- (4) Test Plan: This plan is required to look after the testing of the Disaster Recovery Plan (DRP) i.e. to identify deficiencies in the emergency, backup or recovery plan. It defines procedures for testing the plan like –

- Paper walk-through: It involves critical personnel in the plan's execution reasoning out what might happen in the event of different disasters.
- Localised Tests: It simulates system crash on different aspects of the plan.
- Full operational test: It is nearer to disaster conditions. Paper walk-through and localised tests should have been conducted before completely shutting down operations to simulate disasters.

- (b) Persian Points Company has recently added a website and this has opened up invitation to hackers and the management is in the process of assessing its risk management. Various risk assessment factors are identified. The annual average losses and the associated problems are provided. We can calculate the expected monetary losses for each of the potential exposures.

	Exposure	Expected Monetary Loss		Rs.
1.	Virus Attack	$0.60 \times 75,000$	=	45,000
2.	Data loss	$0.12 \times 70,000$	=	8,400
3.	Embezzlement	$0.03 \times 30,000$	=	900
4.	User Errors	$0.95 \times 25,000$	=	23,750
5.	Threats from Hackers	$0.95 \times 90,000$	=	85,500
6.	Improper use by Employees	$0.05 \times 5,000$	=	250
7.	Power Failure	$0.15 \times 3,00,000$	=	45,000

Amongst all the expected monetary losses listed in the above table, Item No. 5 results in the highest expected loss. Hence, "threats from hackers" has the highest vulnerability. Item No. 6, "improper use by employees" has the least vulnerability since it results in the least expected loss.

A careful analysis of the last column in the above table would show that the top management should exercise control by having a careful watch on the following factors in the following order of priority as listed below:

- (i) Threats from Hackers (Item 5)
- (ii) Virus Attack (Item 1) and power failure (Item 7).
- (iii) User errors (Item 4)
- (iv) Data Loss (Item 2)

- (v) Embezzlement (Item 3)
- (vi) Improper use by employees (Item 6).

Question 7

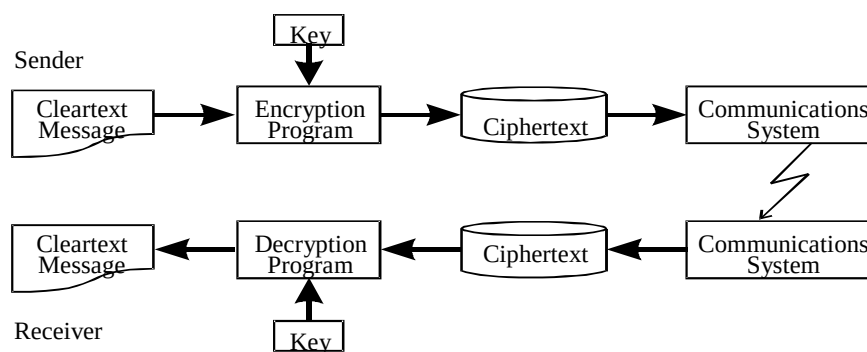
Write short notes on the following:

- (a) Encryption techniques
- (b) Testing work benches
- (c) Audit trail controls in Computer Based Information System (CBIS)
- (d) Expert systems. (4 × 5 = 20 Marks)

Answer

- (a) **Encryption Technique:** It is the conversion of data into secret code for storage in databases and transmission over networks. The sender uses an encryption algorithm to convert the original message called clear text into a coded equivalent called cipher text. At the receiving end, cipher text is decoded back into clear text. The encryption algorithm uses a key, which is a binary number ranging typically from 56 to 128 bits in length. The more bits in the key, the stronger is the encryption method. Two general approaches used are private key and public key encryption.

Private Key Encryption: Data encryption standard (DES) uses a single key known to both the sender and the receiver of the message. To encode a message, the sender provides the encryption algorithm with the key, to produce a cipher text message. The encoded message is transmitted to the receiver, which decodes the message with a decryption program that uses the same key employed by the sender. Figure given below illustrates this technique.



In DES approach, a perpetrator may discover the key and intercept and decipher the message. The more individuals who know the key, the greater is the probability of it falling into wrong hands.

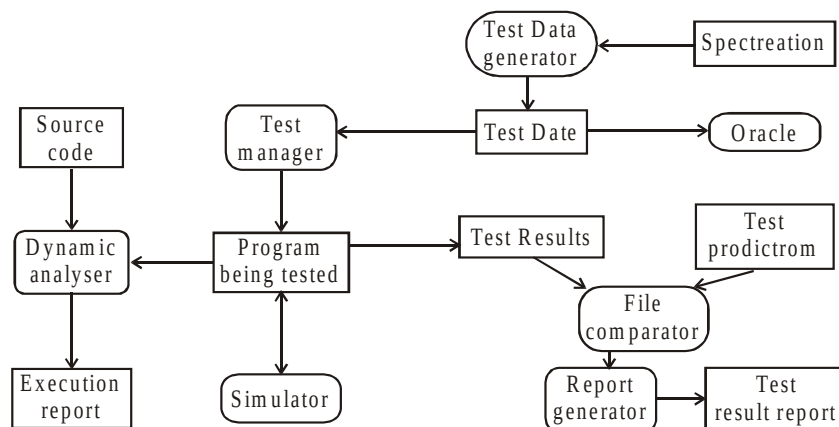
Public Key Encryption: It uses separate keys for encoding messages and for decoding them. Each recipient has a private key that is kept secret and a public key to encrypt the message. The receiver then uses his or her private key to decrypt the message. Users never need to share their private keys to decrypt messages, thus reducing the likelihood that they fall into the hands of a criminal.

- (b) Testing Workbenches: These are open systems which evolve to suit the needs of the system being tested.

The tools which might be included in a testing workbench are:

- (a) Test manager: Manages the running and reporting of program tests. It keeps track of test data, expected results, program facilities tested and so on;
- (b) Test data generator: Generates test data for the program to be tested. This may be accomplished by selecting data from a database or by using patterns to generate random data of the correct form.
- (c) Oracle: Generates predictions of the expected results.
- (d) File compactor: Compares the results of program tests with previous test results and reports differences between them.
- (e) Report generator: Provides report definition and generation facilities for test results.
- (f) Dynamic Analyser: Adds code to a program to count the number of times each statement has been executed.
- (g) Simulators: Different kinds of simulators such as Target simulators, User Interface simulators, I/O simulators are available for simulation.

A typical testing workbench layout is shown in the figure.



- (c) **Audit Trail Controls in CBIS:** Every transaction must be traceable through each stage of processing from its economic source to its presentation in financial statements. In CBIS environment, the audit trail can become fragmented and difficult to follow. The following techniques can be used to preserve audit trails in a CBIS:
 - (a) **Transactions Logs:** Every successful transaction should be recorded on a transaction log, which serves as a journal. Thus the transaction log becomes permanent record of validated transactions etc. those that have changed account balances. Unsuccessful transactions are placed in error file. The consolidation of transaction log and error files accounts for all transactions.
 - (b) **Transaction Listing:** The system should produce a hard-copy transaction listing of all successful transactions which may be reconciled by users.
 - (c) **Log and Listing of Automatic Transactions:** Some transactions are triggered internally by the system. All internally generated transactions must be placed in transaction log to maintain an audit trail. The responsible end user should receive detailed listing.
 - (d) **Unique Transaction Identifiers:** Each transaction processed by the system must be uniquely identified with a transaction number among thousands of records. In real-time systems, each validated transaction is assigned a unique number by the system.
 - (e) **Error Listing:** A listing of all error records should go to the appropriate user to support error correction and resubmission.
- (d) **Expert Systems:** An expert system is software that attempts to reproduce the performance of one or more human experts, and is a traditional application of artificial intelligence.

Expert Systems are designed to replace the need for a human expert. They are particularly important where expertise is scarce and therefore expensive. This is not 'number-crunching' software, but software that expresses knowledge in terms of facts and rules. This knowledge will be in a specific area, and therefore expert systems are not general, as are most decision support systems which can be applied to most scenarios, an expert system for oil drilling is not of much use in solving company taxation problems.

While there may have been a progression from transaction – processing systems, through management information systems, to decision-support and executive information systems, expert systems have arisen largely from academic research into artificial intelligence. The expert system should be able to learn, i.e. change or add new rules. They are developed using very different programming languages such as PROLOG which are referred to as fifth generation languages or expert systems shells which can make the process quicker and easier. It has been suggested that expert systems would be of greater use in the tactical and strategic level. This has been the case in banking, where expert systems scrutinize applications for loans, and lower level staff accepts the system's decision. This has replaced the somewhat subjective decision-making of most senior managers.

The Suggested Answers for Paper 7: - Direct Taxes are based on the provisions applicable for A.Y. 2008-09, which is the assessment year relevant for November, 2008 examination.

PAPER – 7 : DIRECT TAXES

Answer all questions

Question 1

Hyper Ltd., engaged in diversified activities, earned a net profit of Rs.14,25,000 after debit/credit of the following items to its profit and loss account for the year ended on 31.3.2008:

(a) Items debited to Profit and Loss Account	Rs.
Expenses on Industrial Unit exempt under section 10A	2,10,000
Provision for Loss of Subsidiary	70,000
Provision for Sales Tax Demand (paid before due date)	75,000
Provision for Wealth Tax Demand	90,000
Provision for Income Tax Demand	1,05,000
Expenses on purchase/sale of equity shares	15,000
Depreciation	3,60,000
Interest on deposit credited to buyers on 31.3.2008 for advance received from them, on which TDS was deposited on 31.7.2008	90,000
 (b) Items credited to Profit and Loss Account	
Income on Industrial Unit exempt under section 10A	2,70,000
Profit from 100% EOU under section 10B	60,000
Long term capital gain on sale of equity shares on which securities transaction tax was paid	3,60,000
Income from units of UTI	75,000

The company provides the following additional information:

- (i) Depreciation includes Rs.1,50,000 on account of revaluation of fixed assets.
- (ii) Depreciation allowable as per Income-tax Rules is Rs.2,80,000.
- (iii) Brought forward Business Loss/Unabsorbed Depreciation:

F.Y.	Amount as per books		Amount as per Income-tax	
	Loss	Depreciation	Loss	Depreciation
1999-2000	2,50,000	3,00,000	2,00,000	2,50,000

2004-2005	Nil	2,70,000	1,00,000	1,80,000
2005-2006	3,50,000	3,15,000	1,20,000	2,10,000

You are required to:

- compute the total income of the company for the assessment year 2008-09 giving the reasons for treatment of items and
- examine the applicability of section 115JB of the Income-tax Act, and compute book profit and the tax credit to be carried forward. (16 Marks)

Answer

Computation of total income of M/s Hyper Ltd. for the A.Y. 2008-09

Particulars	Rs.	Rs.
Net profit as per Profit & Loss Account		14,25,000
Add: Items disallowed /considered separately		
Expenses on industrial unit exempt under section 10A [expenses in relation to exempt income are not be allowed]	2,10,000	
Provision for loss of subsidiary [since it is not wholly and exclusively for the purpose of business of the assessee]	70,000	
Provision for wealth-tax [disallowed under section 40(a)(ia)]	90,000	
Provision for sales tax [is fully allowable since the sales tax has been paid before the due date]	-	
Provision for income-tax [disallowed under section 40(a)(ii)]	1,05,000	
Expenses on transfer of shares [not deductible from business income. It is to be deducted from gross sale consideration while computing capital gains]	15,000	
Interest on deposit credited to buyers on 31.3.2008, but tax deposited after 2 months i.e. after 31.5.2008 [disallowed under section 40(a)(ia)]	90,000	
Depreciation debited to profit and loss account [only depreciation calculated as per Income-tax Rules is allowable as deduction]	3,60,000	9,40,000
		23,65,000
Less: Items credited but not includible under business income or are exempt under the provisions of the Act		
Income of industrial unit under section 10A, since it is an exempt income	2,70,000	
Profit from 100% EOU under section 10B, being an exempt income	60,000	

Long-term capital gain on sale of equity shares on which securities transaction tax was paid, since it is not a business income.	3,60,000	
Income from UTI, since it is not a business income.	75,000	
		7,65,000
		16,00,000
Less: Depreciation (allowable as per Income-tax rules)		2,80,000
		13,20,000
Less: Set-off of brought forward business loss and unabsorbed depreciation		
Brought forward business loss under section 72	4,20,000	
Brought forward depreciation under section 32	6,40,000	10,60,000
Income from business		2,60,000
Capital Gains		
Long term capital gain on sale of equity shares on which securities transaction tax was paid	3,60,000	
Less: Exempt under section 10(38)	3,60,000	Nil
Income from Other Sources		
Income from units of UTI	75,000	
Less: Exempt under section 10(35)	75,000	Nil
Total Income		2,60,000
Tax payable @ 30%		78,000
Add: Education cess @ 2%	1,560	
Secondary and higher education cess @ 1%	780	2,340
Tax Payable as per the Income-tax Act		80,340

Computation of Book Profit under section 115JB

Particulars	Rs.	Rs.
Net Profit as per Profit & Loss Account		14,25,000
Add: Net Profit to be increased by the following amounts as per Explanation 1 to section 115JB		
Provision for loss of subsidiary	70,000	

Provision for income-tax	1,05,000	
Depreciation	3,60,000	5,35,000
		<u>19,60,000</u>
Less: Net Profit to be reduced by the following amounts as per Explanation 1 to section 115JB		
Depreciation debited to profit and loss account (excluding depreciation on account of revaluation of fixed assets) (i.e. Rs.3,60,000 – Rs.1,50,000)	2,10,000	
Income from UTI [since it is an income exempt under section 10(35)]	75,000	
Brought forward business loss or unabsorbed depreciation as per books of account, whichever is less, taken on cumulative basis	6,00,000	8,85,000
Book Profit		<u>10,75,000</u>
10% of book profit		1,07,500
Add: Education cess @ 2%	2,150	
Secondary and higher education cess @ 1%	1,075	3,225
		<u>1,10,725</u>

In case of a company, it has been provided that where income-tax payable on total income computed as per the provisions of the Act is less than 10% of book profit, the book profit shall be deemed as the total income and the tax payable on such total income shall be 10% thereof plus education cess @2% and secondary and higher education cess @ 1%. Accordingly, in this case, since income-tax payable on total income computed as per the provisions of the Act is less than 10% of book profit, the book profit of Rs.10,75,000 is deemed to be the total income and income-tax is payable @ 10% thereof plus education cess @2% and secondary and higher education cess @ 1%. The tax liability, therefore, works out to be Rs.1,10,725.

Section 115JAA provides that where tax is paid in any assessment year in relation to the deemed income under section 115JB(1), the excess of tax so paid, over and above the tax payable under the other provisions of the Income-tax Act, will be allowed as tax credit in the subsequent years. The tax credit is, therefore, the difference between the tax paid under section 115JB(1) and the tax payable on the total income computed in accordance with the other provisions of the Act. This tax credit is allowed to be carried forward for seven assessment years succeeding the assessment year in which the credit became allowable. Such credit is allowed to be set off against the tax payable on the total income in an assessment year in which the tax is computed in accordance with the provisions of the Act, other than section 115JB, to the extent of excess of such tax payable over the tax payable on book profits in that year.

Particulars	Rs.
Tax on book profit under section 115JB	1,10,725
Less: Tax on total income computed as per the other provisions of the Act	80,340
Tax credit to be carried forward	<u>30,385</u>

Notes:

1. Income from industrial unit under section 10A and profit from 100% E.O.U. under section 10B are exempt from income-tax. However, w.e.f. A.Y.2008-09, MAT is leviable on income eligible for exemption under section 10A and 10B. Hence, such income should not be reduced while computing book profits and consequently, expenses relating to such units should not be added back while computing book profits.
2. Long-term capital gains on sale of equity shares through a recognized stock exchange on which securities transaction tax (STT) is paid is exempt under section 10(38). One of the adjustments to the book profit is that exempt income under section 10, which is credited to profit and loss account, would be deducted in arriving at the book profit. However, w.e.f. A.Y.2007-08, deduction of such long-term capital gains is not allowed for computing book profit. Consequently, expenditure to earn such income should not be added back to arrive at the book profit. Section 10(38) also provides that such long term capital gain of a company shall be taken into account in computing the book profit and income-tax payable under section 115JB.

Question 2

- (a) Ayush, an employee with M/s Isomer Solutions Ltd., provides the following information relating to his income for financial year 2007-08:
- (i) He received salary Rs.25,000 per month including conveyance allowance @ Rs. 2,500 per month for official purposes.
 - (ii) He deposited Rs.2,500 per month in his account under a pension scheme notified by the Central Government.
 - (iii) He paid a sum of Rs.60,000 during the year as interest on loan taken in April, 2006 from bank for higher studies of his daughter.
 - (iv) He paid health insurance premium for himself and for his family members Rs.8,500 in cash and Rs.9,000 by credit card.
 - (v) He invested Rs.40,000 in notified bonds under section 80C issued by NABARD in July, 2007.

- (vi) Equity shares having fair market price of Rs.1,00,000 were allotted to him by the company at a concessional price of Rs. 20,000 on 30.5.2007, which were sold by him for Rs.1,80,000 on 28.2.2008.

Compute the total income of Ayush for assessment year 2008-09 and give reasons for treatment to each of the items. (6 Marks)

- (b) 'X' Ltd., transferred its fertilizer business to a new company 'Y' Ltd., by way of demerger with effect from appointed date of 1.4.2007 after satisfying the conditions of demerger. Further information given:
- WDV of the entire block of plant and machinery held by 'X' Ltd. as on 1.4.2007 is Rs. 100 crores;
 - Out of the above, WDV of block of plant and machinery of fertilizer division is 70 crores;
 - 'X' Ltd. has unabsorbed depreciation of Rs.50 lakhs as at 31.3.2007;

On the above facts:

- You are required to explain the provisions of the income-tax as to the allowability of depreciation, post-merger, in the hands of 'X' Ltd. and 'Y' Ltd. as at 31.3.2008 duly calculating the depreciation. (4 Marks)
- State how the unabsorbed depreciation has to be dealt with for the assessment year 2008-09. (3 Marks)

Answer

- (a) Computation of total income of Mr. Ayush for the Assessment Year 2008-09

Particulars	Rs.	Rs.
Salaries		
Gross salary received	3,00,000	
Less: Conveyance allowance exempt under section 10(14)	<u>30,000</u>	2,70,000
Capital gains		
Sale consideration of equity shares sold on 28.02.2008	1,80,000	
Less: Fair Market Price of shares on 30.5.2007	<u>1,00,000</u>	
Short-term Capital Gains		<u>80,000</u>
Gross Total Income		3,50,000
Less: Deduction under Chapter VIA		
Under section 80C		
For investment in notified bonds issued by NABARD	40,000	

Under section 80CCD

For deposit in pension scheme notified by Central Government
[Rs.30,000 but restricted to 10% of salary i.e. 10% of Rs.2,70,000] 27,000

Under section 80D

For payment of health insurance premium by credit card 9,000

Under section 80E

For payment of interest on loan taken from bank for higher studies of daughter 60,000 1,36,000

Total Income 2,14,000

Notes:

- (i) Conveyance allowance received for official duties is fully exempt under section 10(14).
- (ii) Section 80CCD provides for deduction of employee's and employer's contribution to pension scheme notified by the Central Government. The Finance Act, 2007 has extended this deduction also to individuals employed by any other employer on or after 1.1.2004. However, if the amount contributed exceeds 10% of salary, then the deduction would be restricted to 10% of salary.
- (iii) The deduction under section 80E available to an individual in respect of interest on loan taken for his higher education has now been extended by the Finance Act, 2007, to also include interest on such loan taken for higher education of his relative i.e. his or her spouse and children. Hence, interest on loan taken by Mr. Ayush from bank for the higher studies of his daughter is eligible for deduction under section 80E.
- (iv) The maximum permissible deduction under section 80D in respect of medical insurance premium has been increased from Rs.10,000 to Rs.15,000 by the Finance Act, 2007, and such payment can be made by any mode other than cash. Hence, payment of Rs.8,500 made in cash will not qualify for deduction under section 80D.
- (v) Subscription to notified bonds of NABARD will qualify for deduction under section 80C with effect from A.Y.2008-09.
- (vi) The Finance Act, 2007 has widened the fringe benefit tax net. Fringe benefit tax would be leviable on the employer to the extent of concession given to the employee while allotting any specified security or sweat equity shares. The value of fringe benefits would be the fair market value of the specified security or sweat equity shares on the date on which the option vests with employee as reduced by the amount actually paid by, or recovered from the employee in respect of such security or shares. Consequently, it has been provided that for the purpose of computing capital gains in the hands of the employee at the time of sale of such securities/shares by the employee, the cost of acquisition shall be the fair market

value which has been taken into account for the purpose of computing the value of fringe benefits in the hands of the employer.

- (b) (i) In the case of a demerger, satisfying the conditions as laid down in section 2(19AA), the depreciation claim is governed by the provisions as under:
- (1) As per the Explanation 7A of section 43(1), where in a scheme of demerger, if the demerged company transfers any capital asset to the resulting company, being an Indian company, the actual cost of the capital asset transferred shall be taken to be the same as it would have been if the demerged company had continued to hold the capital asset for the purpose of its own business.
 - (2) The resulting company will be entitled to depreciation on the written down value of the block of assets transferred to it, which will be the written down value of the transferred assets of the demerged company immediately before the demerger [Explanation 2B to section 43(6)].
 - (3) Explanation 2A to section 43(6) provides that the written down value of the block of assets in the hands of the demerged company shall be the written down value of the block of assets of the demerged company for the immediately preceding previous year as reduced by the written down value of the assets transferred to the resulting company pursuant to the demerger.
 - (4) As per the above provisions, the calculation of depreciation on plant and machinery in the hands of 'X' Ltd. and 'Y' Ltd. is as under:

WDV of plant and machinery	'X' Ltd.	'Y' Ltd.
	Amt. in crores	
As at 1 st April, 2007	30.00	70.00
Less: Depreciation @ 15%	4.50	10.50
WDV as at 31 st March, 2008	25.50	59.50

Note – It is presumed that Y Ltd. is an Indian company

- (ii) Set-off of unabsorbed depreciation:
- (i) As per section 72A(4), on demerger, the unabsorbed depreciation directly relatable to the undertakings transferred to the resulting company is allowed to be carried forward and set off in the hands of the resulting company.
 - (ii) Where such unabsorbed depreciation is not directly relatable to the undertaking transferred to the resulting company, it has to be apportioned between the demerged company and the resulting company in the same proportion in which the assets of the undertakings have been retained by the demerged company and transferred to the resulting company.
 - (iii) The demerged company and the resulting company would be allowed to carry forward and set-off their respective portion of unabsorbed depreciation, as calculated above, for an unlimited period as per section 32(2).

Question 3

- (a) Bharat Charitable Trust created on 1.1.2003 applied for registration of trust under section 12A of the Income-tax Act before the Commissioner of Income-tax on 1.7.2007 and requested for condonation of delay.
- (i) Explain with reasons the period for which the trust is eligible to get exemption under section 11 and 12 of the Income-tax Act.
 - (ii) Can the exemption under sections 11 and 12 for assessment year 2008-09 be denied if the trust is holding investments in equity shares of a public sector company since 1.4.2005.
 - (iii) The Trust has also applied for granting exemption under section 80G of the Income-tax Act. But the approval for the same has been rejected by the Commissioner of Income-tax under section 80G(5)(vi) of the Income-tax Act on 30.9.2007. The Trust seeks your advice on whether it can file an appeal against the said rejection before the higher authorities. (6 Marks)
- (b) Xtra Ltd. gives the following information for the year ended 31.3.2008:
- Net Profit as per Profit and Loss Account for the financial year 2006-07 Rs.33,00,000 was included in General Reserve.
 - On 1.8.2007, the company redeemed its redeemable bonus shares for Rs.9,09,000.
 - A shareholder holding 10% equity shares of the company borrowed Rs.3,00,000 from the company @ 18% per annum on 31.8.2008.
 - The company declared dividend of Rs.14,00,000 at its annual general meeting held on 30.9.2007. But the dividend remained unpaid up to 31.3.2008.

Compute the tax liability of the company under section 115-O (tax on distributed profits) for the A.Y. 2008-09.

Also give reasons for treatment of each item.

(4 marks)

Answer

- (a) (i) The Finance Act, 2007 has inserted a new sub-section (2) in section 12A providing that in respect of applications filed on or after 1st June, 2007, the provisions of section 11 and 12 shall apply in relation to the income of the trust from the assessment year relevant to the financial year in which the application is made i.e. the exemption would be available only with effect from the assessment year relevant to the previous year in which the application is filed. It would not be available in respect of any earlier assessment year. Further, the power of the Commissioner to grant registration for past years, by condoning the delay in filing such application, has also been removed.

Hence, Bharat Charitable Trust shall be eligible to get exemption under section 11 and 12 with effect from the financial year 2007-08 only.

- (ii) The exemption under section 11 and 12 for A.Y. 2008-09 cannot be denied to the trust for holding investments in equity shares of a public sector company in accordance with the amendment by the Finance Act, 2007 in section 13(1)(d)(iii) denying exemption to a trust holding any shares in a company, other than, inter alia, shares in a public sector company. Therefore, a trust cannot be denied exemption for holding shares in a public sector company.
 - (iii) Section 253 has been amended by the Finance Act, 2007 to allow an appeal to be filed before the Appellate Tribunal against an order passed by the Commissioner under section 80G(5)(vi) rejecting the application of such trusts for the purpose of recognition under section 80G.
- (b) Computation of tax liability of Xtra Ltd. under section 115-O for the A.Y. 2008-09

Particulars	Rs.
Redemption of Bonus Shares [See Note 1 below]	9,09,000
Dividend declared at AGM [See Note 3 below]	<u>14,00,000</u>
Taxable Dividend	<u>23,09,000</u>
Tax payable on distributed profits under section 115-O [Rs.23,09,000×16.995%] [See Note 4 below]	3,92,415

Notes –

- (1) It is assumed that the bonus shares are in the form of redeemable preference shares, since only then would redemption be possible. If such bonus shares are issued to equity shareholders, it does not amount to distribution of dividend at the time of issue of bonus shares, as there is no release of assets. However, when bonus shares are redeemed, there will be release of assets and in that event it would constitute dividend under section 2(22)(a).
- (2) Borrowing by a shareholder holding 10% equity shares of the company is deemed dividend under section 2(22)(e), taxable in the hands of shareholder during the P.Y.2008-09. Therefore, the company is not liable to pay any tax on it.
- (3) The tax on distributed profits shall be paid within 14 days from the date of declaration or distribution or payment of any dividend, whichever is earliest. Therefore, in this case, the dividend distribution tax is payable within 14 days of the declaration though dividend is not actually paid up to 31.03.2008.
- (4) The Finance Act, 2007 has raised the rate of tax on distributed profits to 15% in respect of any amount declared, distributed or paid by a domestic company by way of dividends [Section 115-O]. The effective rate of tax (including surcharge@10%, education cess@2% and secondary and higher education cess@1%) is 16.995%.

Question 4

Discuss the correctness or otherwise of the following propositions in the context of the Income-tax Act, 1961:

- (a) A fresh claim before the Assessing Officer can be made only by filing a revised return and not otherwise.
- (b) The powers of the Commissioner of Income-tax (Appeals) to enhance the assessment are plenary and quite wide.
- (c) At the time of hearing of rectification application, the Income-tax Appellate Tribunal can re-appreciate the evidence produced during the proceedings of the appeal hearing.
- (d) The High Court cannot interfere with the factual finding recorded by the lower authorities and the tribunal, without any valid reasons. (4 × 4 = 16 Marks)

Answer

- (a) This proposition is correct. A return of income filed within the due date may be revised by filing a revised return under section 139(5) where the assessee finds any omission or wrong statement in the original return subject to satisfying other conditions. There is no provision in the Income-tax Act to make changes or modification in the return of income by filing a letter. In a case where a return of income has been filed within the due date, the only option available to the assessee to make an amendment to such return is by way of filing a revised return under section 139(5). Therefore, a fresh claim can be made before the Assessing Officer only by filing a revised return and not otherwise. The Supreme Court in *Goetze (India) Ltd. vs. CIT* (2006) 284 ITR 323 has held that there was no provision in the Income-tax Act to allow an amendment in the return of income filed except by way of filing a revised return.
- (b) The proposition is correct in law. The Supreme Court has, in *CIT vs. McMillan & Co.* (1958) 33 ITR 182 and *CIT vs. Kanpur Industrial Syndicate* (1964) 53 ITR 225, held that in disposing of an appeal before him, the appellate authority can travel over a whole range of the assessment order. The scope of his powers is co-terminus with that of the Assessing Officer. He can do what the Assessing Officer can do and can also direct him to do what he has failed to do. He can assess income from sources which have been considered by the Assessing Officer but not brought to tax. He can consider every aspect of the assessment order and give appropriate reliefs. The Allahabad High Court has, in *CIT v. Kashi Nath Chandiwalla* (2006) 280 ITR 318, held that the appellate authority is empowered to consider and decide any matter arising out of the proceedings in which the order appealed against was passed notwithstanding the fact that such matter was not raised before him by the assessee. The Commissioner (Appeals) is entitled to direct additions in respect of items of income not considered by the Assessing Officer.

Further, the Apex Court has, in the case of Jute Corporation of India Ltd. vs. CIT (1991) 187 ITR 688, held that the appellate authority is vested with all the plenary powers which the subordinate authority may have in the matter. He also has the jurisdiction to permit the appellant to raise an additional ground, if the ground became available subsequently because of change in law or because of change in circumstances and such ground could not have been raised at the time of filing the return or at the time of making an assessment. He must be satisfied that the ground raised is bona fide and that the same could not have been raised earlier for good reasons.

Thus, the powers of the appellate authority in enhancing the assessment are very wide and plenary.

- (c) The proposition is not correct as per law. This is because section 254(2) specifically empowers the Appellate Tribunal to amend any order passed by it, either suo-moto or on an application made by the assessee or Assessing Officer, with a view to rectifying any mistake apparent from record, at any time within 4 years from the date of the order sought to be amended.

The powers of the tribunal under section 254(2) relating to rectification of its order are very limited. Such powers are confined to rectifying any mistake apparent from the record. The mistake has to be such that for which no elaborate reasons or inquiry is necessary. Accordingly, the re-appreciation of evidence placed before the Tribunal during the course of the appeal hearing is not permitted. It cannot re-adjudicate the issue afresh under the garb of rectification. This issue came up for consideration before the Punjab & Haryana High Court in the case of CIT vs. Vardhman Spinning (1997) 226 ITR 296. The Court observed that the jurisdiction to review or modify orders passed by the authorities under the Act cannot be inferred on the basis of a supposed inherent right.

- (d) The proposition is correct in law. A finding of fact cannot be disturbed by the High Court in exercise of its powers under section 260A. The Income-tax Appellate Tribunal is a fact finding authority and the findings of fact recorded by the Tribunal can be interfered with by the High Court under section 260A only on the ground that the same were without evidence or material, or if the finding is contrary to the evidence, or is perverse or there is no direct nexus between conclusion of fact and the primary fact upon which that conclusion is based.

In CIT vs. P. Mohanakala (2007) 291 ITR 278 and Commissioner of Agricultural income-tax vs. M.N.Moni (2007) 291 ITR 387, the Apex Court observed that the High Court had set aside the factual findings of the lower authorities and the Tribunal without any valid reason. The Apex Court held that the findings of fact could not be interfered with by the High Court without carefully considering the facts on record, the surrounding circumstances and the material evidence. There is no scope for interference with the factual findings, unless the findings are per se without reason or basis, perverse and/or contrary to the material on record.

Question 5

- (a) The Commissioner of Income-tax issued notice to revise the order passed by an Assessing Officer under section 143. During the pendency of proceedings before the Commissioner, on the basis of material gathered during survey under section 133A, the Commissioner of Income-tax issued a second notice, the contents of which were different from the contents of the first notice. State with reasoning whether the action of the Commissioner is justified as to the second notice. (3 Marks)
- (b) State the circumstances where the appellant shall be entitled to produce additional evidence, oral or documentary, before the Commissioner of Income-tax (Appeals) other than the evidence produced during the proceedings before the Assessing Officer. (3 Marks)
- (c) In the context of transfer pricing provisions, read with rules, what are the factors to be considered while selecting the most appropriate method? (6 Marks)

Answer

- (a) The action of the Commissioner in issuing the second notice is not justified. The term "record" has been defined in clause (b) of Explanation to section 263(1). According to this definition "record" shall include and shall be deemed always to have included all records relating to any proceeding under the Act available at the time of examination by the Commissioner. In other words, the information, material, report etc. which were not in existence at the time the assessment was made and came into existence afterwards can be taken into consideration by the Commissioner for the purpose of invoking his jurisdiction under section 263(1). However, at the same time, in view of the express provisions contained in clause (b) of the Explanation to section 263(1), such information, material, report etc. can be relied upon by the Commissioner only if the same forms part of record when the action under section 263 is taken by the Commissioner,
- Issuance of a notice under section 263 succeeds the examination of record by Commissioner. In the present case, the Commissioner initially issued a notice under section 263, after the examination of the record available before him. The subsequent second notice was on the basis of material collected under section 133A, which was totally unrelated and irrelevant to the issues sought to be revised in the first notice. Accordingly, the material on the basis of which the second notice was issued could not be said to be "record" available at the time of examination as emphasised in Explanation (b) to section 263(1).
- (b) As per Rule 46A(1) of the Income-tax Rules 1962, an appellant shall be entitled to produce before the Commissioner (Appeals), evidence, either oral or documentary, other than the evidence produced by him during the course of proceedings before the Assessing Officer, only in the following circumstances -

- (a) where the Assessing Officer has refused to admit evidence which ought to have been admitted; or
 - (b) where the appellant was prevented by sufficient cause from producing the evidence which he was called upon to produce by the Assessing Officer; or
 - (c) where the appellant was prevented by sufficient cause from producing before the Assessing Officer any evidence which is relevant to any ground of appeal; or
 - (d) where the Assessing Officer has made the order appealed against without giving sufficient opportunity to the appellant to adduce evidence relevant to any ground of appeal.
- (c) Rule 10C deals with the determination of the most appropriate method. Under this Rule, the method which is best suited to the facts and circumstances of each particular international transaction, and which provides the most reliable measure of an arm's length price in relation to the international transaction will be considered as the most appropriate method.

For the purpose of selecting the most appropriate method, the following factors should be taken into account -

- (i) the nature and class of the international transaction;
- (ii) the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;
- (iii) the availability, coverage and reliability of data necessary for application of the method;
- (iv) the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;
- (v) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;
- (vi) the nature, extent and reliability of assumptions required to be made in application of a method.

Question 6

- (a) P Ltd. is engaged in manufacture of a product. It paid a lump-sum deposit and obtained 50 mobile phone services so that the employees of the assessee can be contacted immediately. The company paid Rs.45,000 every month towards the service and call charges to the mobile phone franchise. On these facts:
- (i) Whether P Ltd. has to deduct tax at source on the payment?
 - (ii) If so, under which provisions of the Act?

(3 Marks)

- (b) R Ltd. paid Rs.5 lakhs as sales commission to Mr. Francis (non-resident), who acted as its agent for booking orders from various customers who are outside India. The assessee has not deducted tax at source on the commission payment for the year ended 31.3.2008. On these facts:
- (i) Decide whether the commission is chargeable to tax in the hands of Mr. Francis in India.
 - (ii) Decide about the deductibility of the commission payment in the assessment of R Ltd. (4 Marks)

Answer

- (a) In this case, the assessee pays the service and call charges every month to a mobile phone franchise. Explanation 2 to section 9(1)(vii) provides that "fees for technical services" means any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel). Therefore, mere collection of fee by the mobile phone franchise from the customers for use of mobile phone services will not amount to receipt of fees towards technical services. When a subscriber pays money to the mobile phone franchise, it is towards the benefit of availing the services to communicate with others and not for any technical services. The payment made is for the use of airtime. Installation of technical equipment to ensure connectivity to the subscriber cannot make it technical services. Therefore, P Ltd. does not have to deduct tax at source under section 194J on the payments made to the mobile phone franchisee towards the service and call charges. This view was upheld by the Madras High Court in Skycell Communications Ltd. v. Dy. CIT (2001) 251 ITR 53.
- (b) (i) A foreign agent of an Indian exporter operates in his own country and no part of his income arises in India. His commission is usually remitted directly to him and is, therefore, not received by him or on his behalf in India. Such an agent is not liable to income-tax in India on the commission. This has been clarified in Circular No.23, dated 23.7.1969. In view of the specific circular, the commission paid to the non-resident agent of the Indian exporter for services rendered outside India is not chargeable to tax in India for the A.Y. 2008-09.
- (ii) Section 40(a)(i) requires deduction of tax at source in respect of any interest, royalty, fees for technical services or other sum chargeable under this Act, which is payable outside India or in India to a non-resident. However, in this case, the commission payable to the non-resident agent is not chargeable to income-tax in view of the clarification given by Circular No.23 dated 23.7.1969 explained in (i) above. Further, Circular No.786 dated 7.2.2000 clarifies that, in such a case, no tax is required to be deducted at source under section 195. Hence, disallowance under section 40(a)(i) would not be attracted, and the commission payment would be deductible in the assessment of R Ltd.

Question 7

(a) Zeta (India) Ltd., a non-resident company dealing in consumer products and having their employee base in India, has furnished the following information for the year ended on 31.3.2008:

- (i) Expenditure on foreign travelling Rs.1,80,000.
- (ii) Expenditure on display of its products Rs.3,60,000.
- (iii) Expenditure on distribution of free samples Rs.2,40,000.
- (iv) Expenditure on providing transport facility for movement of offshore employees from their residence in home countries (outside India) to place of work (rigs in India) and back Rs.6,30,000.
- (v) The company granted to its 300 employees, options to buy 200 sweat equity shares of the company over a period of two years at Rs.100 per share on 1.6.2007. Out of which 250 employees exercised their option to buy 50% shares by 31.12.2007 and balance 50% shares after 1.6.2008. The Fair Market Price of shares as on 1.6.2007 was Rs.200 per share.

Calculate the fringe benefit tax liability of the company for Assessment Year 2008-09 along with due dates and amount of advance fringe benefit tax payable under section 115WJ of the Income-tax Act. Reasons for treatment of each of the above items should form part of your answer. (8 Marks)

(b) Explain as to what the term 'Advance Ruling' means under the Income-tax Act 1961.

(4 Marks)

(c) State the circumstances under which a certificate can be issued by the Assessing Officer to the Tax Recovery Officer. (4 Marks)

Answer

(a) Computation of fringe benefit tax liability of M/s Zeta (India) Ltd. for the A.Y. 2008-09.

	Amount (Rs.)	% of expenditure to be treated as value of fringe benefit	Value of fringe benefit (Rs.)
(i) Expenditure of foreign traveling	1,80,000	5%	9,000
(ii) Expenditure on display of products	3,60,000	-	-
(iii) Expenditure on distribution of free samples	2,40,000	-	-

(iv) Expenditure on providing transport facility for movement of offshore employees from their residence in home countries (outside India) to place of work (rigs in India) and back	6,30,000	-	-
(v) Sweat equity shares transferred to employees during the year at a concessional price	25,00,000	100%	25,00,000
Total value of fringe benefits			<u>25,09,000</u>
FBT payable @ 30%			7,52,700
Add: Surcharge @ 2.5%			<u>18,818</u>
			7,71,518
Add: Education cess@ 2%		15,430	
Secondary and higher education cess@1%		<u>7,715</u>	<u>23,145</u>
Total FBT payable			<u>7,94,663</u>
Total FBT payable (rounded off)			7,94,660

Advance FBT payable under section 115WJ

Due date of installment	Installments payable	Advance FBT payable	Rs.
On or before 15 th June, 2007	Not less than 15% of such advance tax.	15% of Rs.7,94,660 =	1,19,200
On or before 15 th September, 2007	Not less than 45% of such advance tax, as reduced by the amount, if any, paid in the earlier installment.	45% of Rs.7,94,660 - Rs.1,19,200 = Rs.3,57,600 - Rs.1,19,200 =	2,38,400
On or before 15 th December, 2007	Not less than 75% of such advance tax, as reduced by the amount or amounts, if any, paid in the earlier installment or installments.	75% of Rs.7,94,660 - (Rs.1,19,200+Rs.2,38,400) =Rs.5,96,000 – Rs.3,57,600 =	2,38,400

On or before the 15th March, 2008 The whole amount of such advance tax as reduced by the amount or amounts, if any, paid in the earlier installment or installments. Rs.7,94,660 – (Rs.1,19,200 +Rs.2,38,400+Rs.2,38,400) = Rs.7,94,660 – Rs.5,96,000 = 1,98,660

Notes:

- (i) Expenditure on tour and travel including foreign travel is liable for FBT @ 5% .
- (ii) Expenditure on display of products has been excluded from 'Sales promotion including publicity' by the Finance Act, 2007 and hence, is exempt from FBT from A.Y.2008-09.
- (iii) Expenditure on distribution of free samples has now been excluded from 'Sales promotion including publicity' by the Finance Act, 2007 and hence, such expenditure is exempt from FBT for A.Y. 2008-09.
- (iv) The expenditure incurred by the company on providing free or subsidised transport facility for movement of offshore employees from their residence in home countries (outside India) to their place of work (rigs in India) does not attract FBT. This has been held by the Supreme Court in R & B Falcon (A)(P.) Ltd. v. CIT (2008) 301 ITR 309.
- (v) FBT liability has also been extended to sweat equity shares allotted or transferred, directly or indirectly, by the employer, free of cost or at a concessional rate, to his employees, including former employees, by insertion of a new clause (d) in section 115WB(1) by the Finance Act, 2007. The value of fringe benefit is the fair market value on the date on which the option vests with the employee as reduced by the amount actually paid by, or recovered from, the employee in respect of such shares. Hence, the taxable fringe benefit in respect of options exercised during the financial year 2007-08 is calculated as under:

		Rs.
Fair market value of 100 shares as on 1.6.2007		
i.e. the date of vesting of option	= 250×100×200 =	50,00,000
Less: Amount recovered from employees	= 250×100×100 =	25,00,000
Taxable value of fringe benefit for A.Y. 2008-09		<u>25,00,000</u>

- (b) The term 'advance ruling' has been defined in section 245N(a) to mean :-
 - (a) a determination by the Authority in relation to a transaction which has been undertaken or is proposed to be undertaken by a non-resident applicant; or

- (b) a determination by the Authority in relation to the tax liability of a non-resident arising out of a transaction which has been undertaken or is proposed to be undertaken by a resident applicant with such non-resident,
and such determination shall include the determination of any question of law or of fact specified in the application;
- (c) a determination or decision by the Authority in respect of an issue relating to computation of total income which is pending before any income-tax authority or the Appellate Tribunal and such determination or decision shall include the determination or decision on any question of law or of fact relating to such computation of total income specified in the application.
- (c) The assessee is required to pay the tax due as per the notice of demand issued under section 156 within 30 days of the service of notice. If the amount is not paid within 30 days, then it could be recovered as per the provisions of sections 222 to 227, 229 and 232 of the Income-tax Act. Where the assessee has not paid the tax due within the specified period, the Assessing Officer may issue a certificate to the Tax Recovery Officer for initiating recovery proceedings in the following circumstance –
 - (a) where the assessee has not filed an appeal before Commissioner (Appeals) or Appellate Tribunal; and
 - (b) has also not made any request for extension of time for payment of tax.

As per the provisions of section 222, when an assessee is in default or is deemed to be in default in making a payment of tax, the Tax Recovery Officer may draw up under his signature a statement in the prescribed form specifying the amount of arrears due from the assessee. Such statement is referred to as “certificate”. He shall proceed to recover from such assessee the amount specified in the certificate by one or more of the modes mentioned below, in accordance with the rules laid down in the Second Schedule -

- (a) attachment and sale of the assessee's movable property;
- (b) attachment and sale of the assessee's immovable property;
- (c) arrest of the assessee and his detention in person;
- (d) appointing a receiver for the management of assessee's movable and immovable properties.

The Tax Recovery Officer may have recourse to any of the above measures notwithstanding that proceedings for recovery of the arrears by any other mode have already been taken.

Question 8

- (a) Matisha Constructions Ltd. furnishes the following particulars of its wealth for the valuation date as on 31.3.2008:

	Rs.in lacs
(i) Land in urban area (held as stock in trade since 1996).	81
(ii) Motor cars (including one imported car, worth Rs.18 lacs used for hiring)	38
(iii) 250 acres agricultural land acquired at Greater Noida Township on 27.8.2007 for construction of residential flats/commercial complex. However, Greater Noida Authority has reserved 25 acres land as green belt.	250
(iv) Residential flats of 1500 sq feet each provided to 3 employees (salary of one employee exceeded Rs.5 lacs per annum)	36
(v) Farm house of 5 acre at a remote village	9
(vi) Cash in hand as per cash book	3

Liabilities:

(i) Loan for purchase of land at Urban area	30
(ii) Loan for purchase of land at Greater Noida	120
(iii) Wealth-tax liability for Assessment year 2007-08	12
(iv) Loan for construction of residential flats	9

Compute the net wealth of the company for assessment year 2008-09. (8 Marks)

- (b) Mr. X, a member of co-operative housing society, was allotted a plot as per the bylaws of the society. He constructed a house on plot and substituted the name of his wife in the records of the society in his place. The society executed the registered sale deed in respect of said plot in favour of his wife. The Assessing Officer included the value of the said property in the hands of Mr. X. Examine the validity of the action of the Assessing Officer. (2 Marks)

Answer

- (a) Computation of Net Wealth of M/s Matisha Constructions Ltd. for A.Y. 2008-09

Particulars	Rs. in lacs
Assets [as per the definition of assets under section 2(ea)]	
(i) Land in urban area (held as stock in trade since 1996) – taxable since it is held as stock-in-trade for more than 10 years	81
(ii) Motor cars (excluding imported car not being an asset since it is used for hiring) [38 lac – 18 lac]	20

(iii)	Agricultural land acquired for construction of residential and commercial complex (is a stock-in-trade in the hands of a construction company – hence, not an asset)	Nil
(iv)	(a) Residential flats provided to 2 employees drawing salary less than Rs.5 lacs per annum – not an asset	Nil
	(b) Residential flat provided to one employee drawing salary exceeding Rs.5 lacs per annum is an asset $[36 \times 1/3]$	12
(v)	Farm house at a remote village is not an asset (assuming that it is not situated within 25 km from the local limits of any municipality)	Nil
(vi)	Cash in hand as per cash book is not an asset since it represents cash recorded in the books	Nil
		113

Less: Liabilities

(i)	Loan for purchase of land in urban area – deductible, since it is incurred in relation to land in urban area, which is an asset chargeable to wealth-tax.	30
(ii)	Loan for purchase of agricultural land - not deductible, since land is not an asset	Nil
(iii)	Wealth Tax liability for Assessment year 2007-08 – wealth tax liability is not deductible	Nil
(iv)	Loan for construction of residential flats - the portion relating to taxable asset (1/3) is deductible i.e. $\frac{1}{3} \times 9$ lacs	
		3
		33
Net Wealth		80

- (b) The Allahabad High Court has, in the case of Ram Saran Das Tandon v. CWT (2007) 292 ITR 546, held that when the assessee has ceased to be a member of the society, he could not be treated as the owner of the house property. Therefore, the value of the property is not assessable in his hands.

In this case, assuming that Mr.X has received adequate consideration from his wife Mrs.X for the transfer, the action of the Assessing Officer in including the value of said property in the hands of Mr. X is not valid.

The suggested answers for Indirect Taxes (Paper 8) are based on the provisions as amended by the Finance Act, 2007 and Notifications/Circulars issued up to 30.04.2008 which are relevant for November 2008 examinations.

PAPER – 8 : INDIRECT TAXES

Answer to question nos. 1, 6 and 9 are compulsory. In addition thereto, answer any two questions from Part “A” and one question from Part “B”.

PART – A

Question 1

- (a) Briefly explain the following with reference to the provisions of the Central Excise Act, 1944:

(i) Curing

(ii) Broker or Commission agent.

(2 × 2 = 4 Marks)

- (b) SC Ltd. is a manufacturer of caustic soda, cement etc. It uses LSHS (Low Sulphur Heavy Stock) as fuel for generating electricity which in turn is captively consumed for the manufacture of final products. It has claimed CENVAT credit on LSHS on the reasoning that this is used ‘in relation to manufacture of final products’ and hence it is an input.

However, the department did not allow the credit as LSHS had been used to generate electricity, which is not excisable and hence LSHS could not be considered as input used as fuel. State with reasons whether the action taken by the department is covered by the CENVAT Credit Rules, 2004. You may take help of the decided case law(s), if any.

(4 Marks)

- (c) Explain the term ‘normal transaction value’ under the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000. How is the term used for valuation of excisable goods?

(4 Marks)

- (d) A particular product of a manufacturer was exempt from duty. Subsequently, central excise duty was imposed on it. The manufacturer assessee continued to sell the product without any change in selling price. Later, he realised that he had paid higher quantum of duty. He filed a refund claim stating that there was no change in the price before and after imposition of duty and hence, the burden of duty has not been passed on to the buyer. Will his stand for refund claim be acceptable ? Discuss briefly.

(4 Marks)

- (e) State in brief the penal provisions under the Central Excise Act, 1944 and rules made thereunder if a manufacturer of excisable goods does not apply for registration. (4 Marks)

Answer

- (a) (i) As per section 2(c) of the Central Excise Act, 1944, ‘curing’ includes wilting, drying, fermenting and any process for rendering an unmanufactured product fit for marketing or manufacture.

- (ii) As per section 2(aaa) of the Central Excise Act, 1944, broker or commission agent means a person who in the ordinary course of business makes contracts for the sale or purchase of excisable goods for others.

- (b) In the present case, LSHS (low sulphur heavy stock) is used as fuel for generation of 'electricity', which in turn is used in relation to manufacture of final products.

As per rule 2(k)(i) of the CENVAT Credit Rules, 2004, goods used for generation of electricity used in or in relation to manufacture of final products or for any other purpose, within the factory of production, are inputs.

Thus, SC Ltd. can claim CENVAT credit on LSHS and hence, the action taken by the department is not covered by the CENVAT Credit Rules, 2004. The Apex Court in the case of CCE v. Solaris Chemtech Ltd. (2007) 214 ELT 481 (SC) has also confirmed that LSHS and furnace oil used for generation of electricity used for manufacture of final products are inputs eligible for CENVAT credit.

- (c) As per rule 2(b) of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000, 'normal transaction value' means the transaction value at which the greatest aggregate quantity of goods are sold.

The term is used for valuation in case of depot transfer under rule 7, sale to related person under rule 9 and valuation in case of job-work under rule 10A of the said rules.

In case of depot transfer under rule 7, the value of the excisable goods is the normal transaction value of such goods sold from such depot at or about the same time and, where such goods are not sold at or about the same time, at the time nearest to the time of removal of goods under assessment.

In case of sale to related person under rule 9, the value of the excisable goods is the normal transaction value at which these are sold by the related person at the time of removal, to buyers (not being related person); or where such goods are not sold to such buyers, to buyers (being related person), who sells such goods in retail.

Under rule 10A(ii), where the goods are not sold by the principal manufacturer at the time of removal of goods from the factory of the job-worker, but are transferred to some other place, the value of the excisable goods shall be the normal transaction value of such goods sold from such other place at or about the same time and, where such goods are not sold at or about the same time, at the time nearest to the time of removal of said goods from the factory of job-worker.

- (d) In CCE v. Allied Photographics 2004 166 ELT 3(SC), it has been held that even if there is no change in price before and after assessment (i.e. before and after imposition of duty), it does not lead to the inevitable conclusion that incidence of duty has not been passed on to the buyer as such uniformity may be due to various factors. Thus, even if the price remains the same before and after imposition of duty, the assessee has to establish that he has not passed on the burden of duty to the buyer.

Thus, the refund claim of the manufacturer will not be acceptable.

- (e) As per section 9(1)(a) of the Central Excise Act, 1944, any person who contravenes the provisions of rules regarding registration of a unit (required under section 6 of the Act), shall be punishable with imprisonment upto seven years and fine (without limit) if the duty leviable on the excisable goods exceeds Rs.1,00,000. The imprisonment should be minimum for six months unless there are special and adequate reasons for granting lesser punishment. However, if the duty leviable on goods is less than Rs.1,00,000, imprisonment upto three years or fine or both can be imposed.

Under rule 25 of the Central Excise Rules, 2002, where any manufacturer or producer engages in manufacture, production or storage of any excisable goods without having applied for registration, all such goods shall be liable to confiscation. Moreover, such manufacturer/producer shall also be liable to a penalty not exceeding the duty on such excisable goods or Rs.2,000, whichever is greater.

Question 2

- (a) P Ltd. manufactures two products namely 'A' and 'B'. 'A' is a specified product under section 4A of the Central Excise Act, 1944. The sale prices of products 'A' and 'B' are Rs.50 per unit and Rs.30 per unit respectively. The sale prices of both the products include 14% basic excise duty plus 2% education cess and 1% secondary and higher education cess. Central sales tax @ 3% is also included in both the selling prices.

1,00,000 units each of the two products were removed from the factory for sale. Calculate the total excise duty liability of P Ltd. on both the products assuming that 40% abatement is permissible under section 4A on product 'A'. (5 Marks)

- (b) What is the 'relevant date' for claiming refund under section 11B of the Central Excise Act, 1944? (4 Marks)
- (c) What are the documents required to be submitted for filing claim of rebate by an exporter? (4 Marks)
- (d) K Ltd. is a manufacturer of glass fibre reinforced plastics, which are used for roofing sheets and partition. It is manufactured by impregnating plastics with glass to give stiffness and increased insulated capacity. Mention the relevant rule of "General Interpretative Rules", which is applicable here for the classification of the product. (2 Marks)

Answer

- (a) Computation of duty liability in case of product 'A'

	Rs.
Retail sale price (Rs.50 x 1,00,000)	50,00,000
Less: 40% abatement	<u>20,00,000</u>
Assessable value under section 4A	<u>30,00,000</u>
Excise duty + cess @ 14.42% on Rs.30,00,000	<u>4,32,600</u>

Note : Sale price of product 'A' is taken as its retail sale price as it includes central sales tax, excise duty and cesses.

Computation of duty liability in case of product 'B'

	Rs.
Sale price (Rs.30 x 1,00,000)	30,00,000
Less : Central sales tax (Rs.30,00,000 x 3/103)	<u>87,379</u>
Price inclusive of excise duty & cess	<u>29,12,621</u>
Excise duty payable (Rs.29,12,621 x 14.42)/114.42	<u>3,67,069</u>

- (b) The relevant dates for claiming refund under section 11B of the Central Excise Act, 1944 in different circumstances are given in the following table:

Particulars	Relevant date
(i) In case of exports	
(a) by sea or air	Date of departure of the ship or aircraft
(b) by land	Date on which the goods pass the frontier
(c) by post	Date of despatch of goods by post office
(ii) In case of goods returned to factory for being remade, refined etc.	Date of entry into factory
(iii) In case of goods to which banderols are required to be affixed if removed for home consumption but not so required when exported outside India, if returned to a factory after having been removed from such factory for export out of India	Date of entry into the factory
(iv) In case of reduction of duty in case of compounded levy scheme	Date of reduction
(v) In case of a person, other than the manufacturer	Date of purchase of the goods by such person
(vi) In case of provisional assessment	Date of adjustment of duty after final assessment
(vii) In case of a refund arising as a consequence of judgment, decree, order or direction of Appellate Authority, Tribunal, any court	Date of such judgment, decree, order or direction

(viii) In case of goods exempt from payment of duty vide a special order issued under section 5A(2)	Date of issue of such order
(ix) In any other case	Date of payment of duty

Note: Any four cases of relevant dates can be given in the answer.

- (c) An exporter has to submit the following documents for filing claim of rebate:
- (i) a request on the letterhead of the exporter containing claim of rebate, A.R.E. 1 numbers and dates, corresponding invoice numbers and dates, amount of rebate on each A.R.E. 1 and its calculations
 - (ii) original copy of the A.R.E. 1
 - (iii) invoice issued under rule 11
 - (iv) self attested copy of shipping bill
 - (v) self attested copy of bill of lading
 - (vi) disclaimer certificate (in case where claimant is other than exporter)
- (d) In this case, rule 3(b) of the General Interpretative Rules will apply as the product is a 'composite item'. Rule 3(b) provides that mixtures, composite goods consisting of different materials or made up of different components, and goods put up in sets for retail sale should be classified on the basis of material or component which gives the product its essential character.

Therefore, since plastic is the more essential item in the product, applying the test of essentiality, the product will be classified under plastic items under the appropriate heading of the tariff. Same view was expressed in the case of *Kemrock Industries and Exports Ltd. v. CCE (2007) 210 ELT 497 (SC)*

Question 3

- (a) Briefly explain the provisions of sub rule (5B) of rule 3 of the CENVAT Credit Rules, 2004 regarding the value of input or capital goods, on which CENVAT credit has been taken, is written off fully, before being put to use. (4 Marks)
- (b) Discuss briefly the provisions of rule 4(4) of the Central Excise Rules, 2002 regarding storage of non-duty paid goods outside the factory. (4 Marks)
- (c) Mention any four important types of bonds with their purpose for use under the central excise laws. (4 Marks)
- (d) Write a note on publication of information in respect of certain person in certain cases under the Central Excise Act, 1944. (3 Marks)

Answer

- (a) Sub-rule (5B) of rule 3 of the CENVAT Credit Rules, 2004 provides that if the value of any,

- (i) input, or
- (ii) capital goods before being put to use,

on which CENVAT credit has been taken is written off fully or where any provision to write off fully has been made in the books of account, then the manufacturer shall pay an amount equivalent to the CENVAT credit taken in respect of the said input or capital goods. However, if the said input or capital goods is subsequently used in the manufacture of final products, the manufacturer shall be entitled to take the credit of the amount equivalent to the CENVAT credit paid earlier subject to the other provisions of these rules.

- (b) As per rule 4(4) of the Central Excise Rules, 2002, the storage of non-duty paid goods outside the factory can be permitted by the Commissioner of Central Excise subject to such safeguards as he may specify. Such storage outside the factory premises is permissible in exceptional circumstances having regard to the nature of the goods and shortage of storage space in the factory.
- (c) Bond is a collateral security and its purpose is to secure compliance with the rules and procedures laid down under the excise law. The types and purpose of the bonds are given below.

Type of bond	Purpose
B -1 Surety/Security	Export of goods without payment of duty (Rule 19)
B - 2 Surety/Security	Provisional Assessment
B - 3	Despatch of excisable goods removed for rewarehousing and export therefrom without payment of duty
B - 11	Provisional release of seized goods
B – 17 Surety/Security	Composite bond of 100% EOUs/EPZ for assessment, export, accounting and disposal of excisable goods obtained free of duty

Note: Any four types of bonds can be given in the answer.

- (d) Section 37E of the Central Excise Act, 1944 provides that the Central Government may publish the name and other particulars of any person relating to any proceeding under the central excise law, in such manner as it thinks fit, if in its opinion it is in public interest to do so. However, the publication in relation to any penalty can be made only after the time for presenting an appeal to the Commissioner (Appeals) or the Appellate Tribunal expires without an appeal being presented or the appeal, if presented, gets disposed of.

In case of a firm, company or other association of persons, the name (s) of partners of the firm, directors, managing agents, secretaries and treasurers or managers of the company, or the members of the association may also be published if circumstances justify such publication.

Question 4

- (a) State the matters, which can be referred for advance ruling under section 23C of the Central Excise Act, 1944. (5 Marks)
- (b) Which goods, bearing the brand name or trade name of others, are eligible for exemption available to small-scale units? (5 Marks)
- (c) A manufacturer purchased certain inputs from Z. The assessable value was Rs.20,000 and the central excise duty was calculated at Rs.3,296 making the total amount of invoice at Rs.23,296. However, the buyer manufacturer paid only Rs.20,800 to Z in full settlement of this bill. How much CENVAT credit can be availed by the manufacturer and why? (3 Marks)
- (d) A merchant manufacturer gets the goods manufactured according to his design and specifications from a job worker. Who will be called as manufacturer under the central excise law? (2 Marks)

Answer

- (a) The following matters can be referred for advance ruling under section 23C of the Central Excise Act, 1944:
 - (i) classifications of any goods under the Central Excise Tariff Act, 1985;
 - (ii) applicability of a notification issued under section 5A(1) having a bearing on the rate of duty;
 - (iii) principles to be adopted for the purposes of determination of value of goods under the provisions of the Central Excise Act, 1944;
 - (iv) notifications issued, in respect of duties of excise under the Central Excise Act, 1944, the Central Excise Tariff Act, 1985 and any duty chargeable under any other law for the time being in force in the same manner as duty of excise leviable under the Central Excise Act, 1944;
 - (v) admissibility of credit of excise duty paid or deemed to have been paid on the goods used in or in relation to the manufacture of the excisable goods;
 - (vi) determination of the liability to pay excise duty on any goods under the Central Excise Act, 1944.

Note: Any five matters can be given in the answer.

- (b) As per Notification No. 8/2003 dated 01.03.2003 as amended, the small scale exemption is available in respect of the goods bearing the brand name or trade name of others in the following instances:

- (a) where the goods, being in the nature of components or parts of any machinery or equipment or appliances, are cleared for use as original equipment in the manufacture of the said machinery or equipment or appliances by following the procedure laid down in the Central Excise (Removal of Goods at Concessional Rate of Duty for Manufacture of Excisable Goods) Rules, 2001;
 - (b) where the goods bear a brand name or trade name of -
 - (i) the Khadi and Village Industries Commission; or
 - (ii) a State Khadi and Village Industry Board; or
 - (iii) the National Small Industries Corporation; or
 - (iv) a State Small Industries Development Corporation; or
 - (v) a State Small Industries Corporation;
 - (c) where the goods are manufactured in a factory located in a rural area;
 - (d) where the goods are account books, registers writing pads and file folders falling under Heading 4820 or 4821 of the First Schedule.
- (c) As per rule 3(1) of the CENVAT Credit Rules, 2004, a manufacturer of final products is allowed to take credit of excise duty paid on any input or capital goods received in the factory of manufacture of final product. Thus, in case of inputs or capital goods the eligibility of availing CENVAT credit does not depend upon making the payment for such inputs or capital goods to the supplier.

Therefore, the manufacturer can avail full CENVAT credit of Rs.3296, provided Z does not claim the refund of the excess excise duty paid by him.

- (d) Excise duty liability arises when goods are manufactured. Thus, only if the goods are manufactured during job work, excise duty liability will arise. It will be immaterial as to who has supplied the raw material. However, if an item is only repaired or the process undertaken by the job worker does not amount to manufacture, there will not be any duty liability.

Thus, in the given case the job-worker will be the manufacturer as he is the one who manufactures the goods as per the design and specifications of the merchant manufacturer.

Question 5

- (a) Discuss whether remission of duty will be granted under the Central Excise Rules, 2002, in the following cases:
 - (i) Loss of molasses due to auto combustion in sugar factory.
 - (ii) Normal evaporation, storage and handling losses of petroleum products.
 - (iii) There was natural calamity in the factory, but the department was not intimated in time. (2 × 3 = 6 Marks)
- (b) What do you mean by scrutiny of assessment in view of the self- assessment procedure under central excise? (3 Marks)

- (c) SP Ltd. purchased capital goods worth Rs.11,44,200, inclusive of excise duty @ 14.42%, on 1.4.2007. CENVAT credit attributable on such capital goods was duly accounted for. You are required to compute the amount of CENVAT credit to be reversed, if the capital goods were removed, after being used, on 2.11.2008. (3 Marks)
- (d) State the obligation of a small-scale unit to file declaration under the following circumstances:

Year	Turnover (Rs. in lakhs)
2006-07	45
2007-08	80
2008-09	100

(3 Marks)

Answer

- (a) (i) Yes. Loss of molasses due to auto combustion in sugar factory is an unavoidable accident and hence, remission is admissible [Shankar Sugar Mills v. CCE 1994 (71) ELT 753 (Tri.)].
- (ii) Yes. Remission can be granted in case of normal evaporation, storage and handling losses of petroleum products.
- (iii) Yes. Remission cannot be denied simply because there was delay in giving intimation to the Department. If there is a natural calamity in the factory, procedural lapse cannot come in the way of benefit [Bengal Chem. & Pharmaceuticals Ltd. v. CCE 2003 (158) ELT 327].
- (b) In view of the self-assessment procedure wherein the assessee himself assesses the duty liability, the Departmental officers have been entrusted with the responsibility of scrutinizing the assessment for verification of its correctness.

For this purpose, the proper officer may on the basis of information contained in the return filed by the assessee and after such further enquiry as he may consider necessary, scrutinize the correctness of the duty assessed by the assessee on the goods removed, in the manner to be prescribed by the Board [Rule 12(3)]. Sub-rule 4 of rule 12 casts a responsibility on every assessee to make available to the proper officer all the documents and records for verification as and when required by such officer.

- (c) As per the second proviso to rule 3(5) of the CENVAT Credit Rules, 2004, where any capital goods, on which CENVAT credit has been taken, are removed after being used, the manufacturer shall pay an amount equal to the CENVAT credit taken on the said capital goods reduced by 2.5% for each quarter of a year or part thereof from the date of taking the CENVAT credit.

No. of quarters or part thereof expired from 1.4.2007 to 2.11.2008 = 7 quarters
 Amount of CENVAT credit taken = $(11,44,200 \times 14.42)/114.42$ = Rs.1,44,200

Amount of CENVAT credit to be reserved = Rs.1,44,200 – (17.5% of Rs.1,44,200)
= Rs.1,18,965

- (d) SSI units whose turnover is more than prescribed limit (called specified limit) have to file a declaration in a prescribed form. The specified limit is defined as Rs.60 lakh below the exemption limit. The exemption limit was Rs.100 lakh in 2006-07. However, from 01.04.2007 it was raised to Rs.150 lakh. Thus, the specified limit for the year 2006-07 is Rs.40 lakh and from 2007-08 onwards it has been increased to Rs.90 lakh.

Therefore, the unit was required to file the declaration in the year 2006-07, as the turnover was Rs.45 lakh (more than Rs.40 lakh). However, such declaration has to be filed only once in the lifetime of the assessee and not every year. Therefore, the unit is not required to file the declaration again in the year 2008-09 when its turnover is anticipated to cross the limit of Rs.90 lakh.

PART – B

Question 6

- (a) Explain briefly, with reference to the provisions of the Customs Act, 1962, the following:
- (i) Bill of export
 - (ii) Import report (2 × 2 = 4 Marks)
- (b) Answer the following with reference to the provisions of section 14 of the Customs Act, 1962 and the rules made thereunder:
- (i) What shall be the value, if there is a price rise between the date of contract and the date of actual importation?
 - (ii) Whether the payment for post-importation process is includible in the value if the same is related to imported goods and is a condition of the sale of the imported goods?
 - (iii) Bill of entry was filed on 27.10.2008. Will you apply the exchange rate notified by the Central Board of Excise and Customs on 25.9.2008 or notified on 25.10.2008? (2 × 3 = 6 Marks)
- (c) BL Ltd. imported Super Kerosene Oil (SKO) and stored it in a warehouse. An ex-bond bill of entry for home consumption was filed and duty was paid as per rate prevalent on the date of presentation of such bill of entry; and the order for clearance for home consumption was passed. On account of highly combustible nature of SKO, the importer made an application to permit the storage of such kerosene oil in the same warehouse until actual clearance for sale/use. The application was allowed. When the goods were actually removed from the warehouse, the rate of duty got increased. The department demanded the differential duty. The company challenged the demand. Whether it will succeed? Discuss briefly taking support of decided case law(s), if any. (5 Marks)

- (d) What are the conditions required to be fulfilled by the importer to make the imported goods eligible for preferential rate of duty prescribed by the Central Government by notification under section 25 of the Customs Act, 1962? (5 Marks)

Answer

- (a) (i) As per section 2(5) of the Customs Act, 1962, bill of export means a bill of export referred to in section 50. Section 50 inter alia provides that the exporter of any goods shall make entry thereof by presenting to the proper officer in the case of goods to be exported by land, a bill of export in the prescribed form.
- (ii) As per section 2(24) of the Customs Act, 1962, import report means the report required to be delivered under section 30. Section 30 inter alia provides that the person-in-charge of a vehicle carrying imported goods or any other person as may be notified by the Central Government shall, in the case of a vehicle, deliver to the proper officer an import report within twelve hours after its arrival in the customs station, in the prescribed form.
- (b) (i) As per the amended section 14(1) of the Customs Act, 1962, the value of imported or export goods shall be their transaction value. The old concept of deemed value has been dispensed with. Accordingly, the value of the goods shall be the price of contract (i.e., the transaction value), even if there is price rise subsequently.
- (ii) On account of insertion of explanation to rule 10(1) of the Customs Valuation (Determination of Value of Imported Goods) Rules, 2007, the payment for post-importation process is includible in the value of the imported goods if the same is related to such imported goods and is a condition of the sale thereof.
- (iii) The third proviso to section 14(1) of the Customs Act, 1962 inter alia provides that for imported goods, value under section 14(1) shall be calculated with reference to the rate of exchange as in force on the date on which a bill of entry is presented under section 46. The rate of exchange applicable for a month is generally notified by the Board in the preceding month. Hence, the rate notified on 25.09.08 will apply for the bill of entry filed on 27.10.2008.
- However, it may be noted that the rate of exchange is not notified during the preceding month as a rule as the power to determine the rate of exchange given to the Board vide clause (a) of the explanation to section 14 of the Customs Act, 1962 is open ended.
- (c) Yes, the company will succeed. The facts of the given situation are similar to the case of CCUs vs. Biecco Lawrie Ltd. 2008 (223) ELT 3 (SC) wherein the Supreme Court has held that where duty on the warehoused goods is paid and out of charge order for home consumption is made by the proper officer in compliance of the provisions of section 68, the goods removed in smaller lots have to be treated as cleared for home consumption and importer would not be required to pay anything more.

Further, section 49 of the Customs Act, 1962 inter alia also provides that imported goods entered for home consumption if stored in a public warehouse, or in a private warehouse

on the application of the importer that the same cannot be cleared within a reasonable time shall not be deemed to be warehoused goods for the purposes of this Act, and accordingly the provisions of Chapter IX shall not apply to such goods.

- (d) The Government may by notification under section 25 of the Customs Act, 1962 prescribe preferential rate of duty in respect of imports from certain preferential areas. The importer will have to fulfill the following conditions to make the imported goods eligible for preferential rate of duty:
- (i) At the time of importation, he should make a specific claim for the preferential rate.
 - (ii) He should also claim that the goods are produced or manufactured in such preferential area.
 - (iii) The area should be notified under section 4(3) of the Customs Tariff Act, 1975 to be a preferential area.
 - (iv) The origin of the goods shall be determined in accordance with the rules made under section 4(2) of the Customs Tariff Act, 1975.

Question 7

- (a) Briefly explain the law relating to private warehouses. What are the guidelines for storage of sensitive goods in such warehouses? (6 Marks)
- (b) Who has the powers to -
- (i) appoint inland container depots;
 - (ii) appoint land customs stations;
 - (iii) specify limits of customs area; and
 - (iv) appoint public warehouse at places notified under the Customs Act, 1962?
- (1 × 4 = 4 Marks)
- (c) Explain the provisions of section 146 of the Customs Act, 1962 regarding licensing of customs house agents. (5 Marks)

Answer

- (a) According to section 58 of the Customs Act, 1962, at any warehousing station, the Assistant/Deputy Commissioner may licence private warehouses where dutiable goods or any other imported goods may be deposited. However, where public warehouses are available, private warehouses are not permitted.

The Assistant Commissioner may cancel the licence by giving one month notice in writing to the licensee or if the licensee has contravened any provisions of the Customs Act, 1962 or any of the conditions of the licence. However, the cancellation of the licence in the latter case can be done only by giving the licensee a reasonable opportunity of being heard.

In case of sensitive items, the following guidelines are to be observed:

- (i) Applicants should produce a Solvency Certificate from a Scheduled Bank of repute for a value not less than Rs.50 lakhs;
- (ii) Such warehouses should not be located in residential areas;
- (iii) The premises should be secure, possess fire-fighting provisions and be easily accessible to the customs officers;
- (iv) Goods deposited should be fully insured for a value at least equal to the customs duty;
- (v) The proprietor/partner/director must not be involved in any customs or excise offence;
- (vi) A cash deposit/ bank guarantee equal to 25% of the duty liability (effective duty foregone) will be taken for each consignment.

Note: Any three guidelines can be given in the answer.

- (b) (i) Section 7 of the Customs Act, 1962 empowers the Central Board of Excise and Customs to appoint inland container depots.
- (ii) Section 7 of the Customs Act, 1962 empowers the Central Board of Excise and Customs to appoint land customs stations.
- (iii) Section 8 of the Customs Act, 1962 empowers the Commissioner of Customs to specify limits of customs area.
- (iv) Section 57 of the Customs Act, 1962 empowers the Assistant/Deputy Commissioner of Customs to appoint public warehouse at places notified under the Customs Act, 1962.
- (c) Section 146 of the Customs Act, 1962 stipulates that no person shall carry on the business as an agent relating to the entry or departure of a conveyance or the import or export of goods at any customs station unless such person holds a licence granted in this behalf in accordance with the regulations.

The Board may make regulations for the purpose of carrying out the provisions of this section and, in particular, such regulation may provide for:

- (i) the authority by which a licence may be granted under the section and the period of validity of any such licence;
- (ii) the form of the licence and the fees payable therefor;
- (iii) the qualifications of persons who may apply for a licence and the qualifications of persons to be employed by a licensee to assist him in his work as an agent;
- (iv) the restrictions and conditions subject to which licence may be granted;
- (v) the circumstances in which a licence may be suspended or revoked;
- (vi) the appeals, if any, against an order of suspension or revocation of a licence, and the period within which such appeals shall be filed.

Question 8

- (a) Explain the obligation cast on person-in-charge on arrival of vessels or aircrafts in India under section 29 of the Customs Act, 1962. (5 Marks)
- (b) Explain the term 'joint venture in India' under the explanation to section 28E(c) of the Customs Act, 1962 for the purpose of advance ruling. (5 Marks)
- (c) A show cause notice demanding customs duty was issued in case of clearances made by a 100% Export Oriented Undertaking (EOU) to Domestic Tariff Area (DTA). Is the show-cause notice defective in law? (3 Marks)
- (d) What do you mean by assessment of goods under the Customs Act, 1962? (2 Marks)

Answer

- (a) Section 29(1) of the Customs Act, 1962 provides that the person-in-charge of a vessel or an aircraft entering India from any place outside India shall not cause or permit the vessel or aircraft to call or land:

- (i) for the first time after arrival in India; or
- (ii) at any time while it is carrying passengers or cargo brought in that vessel or aircraft at any place other than a customs port or a custom airport, as the case may be.

Sub-section (2) of section 29 provides that the above provisions are not applicable in relation to any vessel or aircraft, which is compelled by accident, stress of weather or other unavoidable cause to call or land at a place other than a customs port or customs airport. However, in such a case the person-in-charge of such vessel or aircraft has the following obligations cast on him:

- (i) He shall have to report the arrival of the vessel/landing of the aircraft to the nearest customs officer or the officer-in-charge of a police station and shall produce the log book belonging to the vessel or the aircraft if demanded.
 - (ii) He shall not without the consent of any such officer permit any goods carried in the vessel or the aircraft to be unloaded from, or any of the crew or passengers to depart from the vicinity of, the vessel or the aircraft. However, passengers and crew can be allowed to depart from the vicinity of, or the goods can be removed from, the vessel/aircraft if the same is necessary for reason of health, safety or preservation of life or property.
 - (iii) He shall comply with any directions given by any such officer with respect to any such goods.
- (b) As per section 28E (c) of the Customs Act, 1962 which defines an applicant eligible for advance ruling, a joint venture in India is an eligible applicant. The concept of joint venture in India has been explained in a new explanation inserted in the definition of the applicant.

The explanation clarifies that joint venture in India means a contractual arrangement whereby two or more person undertake an economic activity which is subject to joint

control and one or more of the partners or participants or equity holders is a non resident having substantial interest in such arrangement.

- (c) Yes, the show cause notice issued is defective in law as in respect of clearances made by a 100% export oriented undertaking (EOU) to domestic tariff area, the duty to be paid by the 100% EOU is the duty of excise and not customs duty. Therefore, show cause notice using the word 'customs duty' instead of 'central excise duty' is not maintainable. Similar view was expressed in the case of CCE v. Suresh Synthetics (2007) 216 ELT 662 (SC).
- (d) The provisions regarding assessment of goods are contained in section 17 of the Customs Act. After the bill of entry is filed, it is assessed by the appraisers of the customs department. There are two systems of assessment:
 - (i) First appraisalment system or first check procedure: In this type of assessment, goods are examined first and then assessed [Section 17(2)].
 - (ii) Second system of assessment or second check procedure: In this type of assessment, goods are assessed first and then examined [Section 17(4)].

PART – C

Question 9

- (a) Explain in brief the manner of determination of value as per rule 3 of the Service Tax (Determination of Value) Rules, 2006. (4 Marks)
- (b) What action can be taken by the department in case of misuse of service tax credit? (3 Marks)
- (c) The value of service provided by a consulting engineer is Rs.10,00,000. He has paid Rs.50,000 as cess under section 3 of the Research and Development Cess Act, 1986. What is the amount of service tax payable by him? (3 Marks)
- (d) Whether a manufacturer of excisable goods, who has paid service tax on freight, can himself take credit of service tax paid, if such transportation service is in relation to the manufacture and clearance of his final products? (3 Marks)
- (e) The goods manufactured by a company got destroyed by fire. The payment of duty was ordered to be remitted. Is the company required to reverse the CENVAT credit taken on input services used in manufacture of such destroyed goods? (2 Marks)

Answer

- (a) As per rule 3 of the Service Tax (Determination of Value) Rules, 2006, the value of taxable service, the consideration for which is not wholly or partly consisting of money, shall be determined by the service provider in the manner described below. However, the same is subject to the provisions of section 67.
 - (i) The value of such taxable service shall be equivalent to the gross amount charged by the service provider to provide similar service to any other person in the ordinary course of trade. The gross amount charged is the sole consideration.

- (ii) Where the value cannot be determined in accordance with above clause, the service provider shall determine the equivalent money value of such consideration. However, such value shall in no case be less than the cost of provision of such taxable service.
- (b) The following actions can be taken by the Department in case of misuse of service tax credit:
 - (i) Penalty extending upto Rs.2,000 can be levied if a person has taken CENVAT credit in respect of input service wrongly [Rule 15(3) of the CENVAT Credit Rules, 2004];
 - (ii) Penalty prescribed under section 78 of the Finance Act, 1994 shall also be levied on the output service provider if the CENVAT credit in respect of input services has been taken or utilized wrongly by reason of fraud, collusion etc. with an intent to evade payment of service tax [Rule 15(4) of the CENVAT Credit Rules, 2004];
 - (iii) The special audit, in cases where credit of duty availed or utilized is not within the normal limits etc., prescribed under section 14AA of the Central Excise Act, 1944 can be ordered in case of misuse of service tax credit.
- (c) Notification No. 18/2002 dated 16.12.2002 provides exemption to the taxable services provided by a consulting engineer to a client on transfer of technology from so much of the service tax leviable thereon as is equivalent to the amount of cess paid on the said transfer of technology under the provisions of section 3 of the Research and Development Cess Act, 1986.

Thus, service tax payable will be computed in the following manner:

Value of taxable services	= Rs.10,00,000
Service tax @ 12.36%	= Rs.1,23,600
Less : Cess paid	= <u>Rs.50,000</u>
Net service tax payable	= <u>Rs. 73,600</u>

- (d) Credit of service tax paid on freight is eligible in case of the manufacturer who pays service tax for inward transportation and satisfies the definition of input service. For outward freight, credit is admissible upto the place of removal.
- (e) As per rule 3(5C) of the CENVAT Credit Rules, 2004, where on any goods manufactured by an assessee, the payment of duty is ordered to be remitted, the credit taken on inputs used in the manufacture of said goods shall be reversed. Thus, there is no requirement for the reversal of CENVAT credit taken on input services used in the manufacture of such goods.